FRANKLIN FINANCIAL SERVICES CORP /PA/
Form 10-K
March 13, 2009

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
Form 10-K

þ	**ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
	For the fiscal year ended December 31, 2008
o	**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
	For the transition period from to

Commission file number 0-12126

FRANKLIN FINANCIAL SERVICES CORPORATION
(Exact name of registrant as specified in its charter)

PENNSYLVANIA	**25-1440803**
(State or other jurisdiction of incorporation or organization)	*(I.R.S. Employer Identification No.)*
20 South Main Street, Chambersburg, PA	**17201-0819**
(Address of principal executive offices)	*(Zip Code)*

(717) 264-6116
(Registrant s telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act

NONE

Securities registered pursuant to Section 12(g) of the Act:

Common Stock, par value $1.00 per share
(Title of Class)

Indicate by check mark if the Registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes o No þ

Indicate by check mark if the Registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes o No þ

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter periods that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes þ No o

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of Registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. þ

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer o	Accelerated filer þ	Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company o

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Act) Yes o No þ

The aggregate market value of the 3,570,401 shares of the Registrant s common stock held by nonaffiliates of the Registrant as of June 30, 2008 based on the price of such shares was $82,119,223.

There were 3,821,898 outstanding shares of the Registrant s common stock as of February 28, 2009.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the definitive annual proxy statement to be filed, pursuant to Reg. 14A within 120 days after December 31, 2008, are incorporated into Part III.

FRANKLIN FINANCIAL SERVICES CORPORATION

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Part I

Item 1. *Business*

General

Franklin Financial Services Corporation (the Corporation) was organized as a Pennsylvania business corporation on June 1, 1983 and is a registered bank holding company under the Bank Holding Company Act of 1956, as amended (the BHCA). On January 16, 1984, pursuant to a plan of reorganization approved by the shareholders of Farmers and Merchants Trust Company of Chambersburg (F&M Trust or the Bank) and the appropriate regulatory agencies, the Corporation acquired all the shares of F&M Trust and issued its own shares to former F&M Trust shareholders on a share-for-share basis.

The Corporation s common stock is not actively traded in the over-the-counter market. The Corporation s stock is listed under the symbol FRAF on the OTC Electronic Bulletin Board, an automated quotation service. The Corporation s Internet address is www.franklinfin.com. Electronic copies of the Corporation s 2008 Annual Report on Form 10-K are available free of charge by visiting the Investor Information section of www.franklinfin.com. Electronic copies of quarterly reports on Form 10-Q and current reports on Form 8-K are also available at this Internet address. These reports are posted as soon as reasonably practicable after they are electronically filed with the Securities and Exchange Commission (SEC).

The Corporation conducts substantially all of its business through its direct banking subsidiary, F&M Trust (the Bank), which is wholly owned. Other direct subsidiaries of the Corporation include Franklin Financial Properties Corp. and Franklin Future Fund Inc. F&M Trust, established in 1906, is a full-service, Pennsylvania-chartered commercial bank and trust company, which is not a member of the Federal Reserve System. F&M Trust operates twenty-five community banking offices in Franklin, Cumberland, Fulton and Huntingdon Counties, Pennsylvania, and engages in general commercial, retail banking and trust services normally associated with community banks and its deposits are insured (up to applicable limits) by the Federal Deposit Insurance Corporation (the FDIC). F&M Trust offers a wide variety of banking services to businesses, individuals, and governmental entities. These services include, but are not necessarily limited to, accepting and maintaining checking, savings, and time deposit accounts, providing investment and trust services, making loans and providing safe deposit facilities. Franklin Financial Properties Corp. is a qualified real estate subsidiary established to hold real estate assets used by F&M Trust in its banking operations. Franklin Future Fund Inc. is a non-bank investment company that makes venture capital investments within the Corporation s primary market area.

The Corporation s banking subsidiary is not dependent upon a single customer or a few customers for a material part of its business. Thus, the loss of any customer or identifiable group of customers would not materially affect the business of the Corporation or the Bank in an adverse manner. Also, none of the Corporation s business is seasonal. The Bank s lending activities consist primarily of commercial real estate, construction and land development, agricultural, commercial and industrial loans, installment and revolving loans to consumers and residential mortgage loans. Secured and unsecured commercial and industrial loans, including accounts receivable and inventory financing, and commercial equipment financing, are made to small and medium-sized businesses, individuals, governmental entities, and non-profit organizations. F&M Trust also participates in Pennsylvania Higher Education Assistance Act student loan programs, Pennsylvania Housing Finance Agency programs and is a Small Business Administration approved lender.

Installment loans involve both direct loans to consumers and the purchase of consumer obligations from dealers who have sold or financed the purchase of automobiles to their customers. The Bank s mortgage loans include long-term loans to individuals and to businesses secured by mortgages on the borrower s real property. Construction loans are made to finance the purchase of land and the construction of residential and commercial buildings thereon, and are secured by mortgages on real estate. In certain situations, the Bank acquires properties through foreclosure on delinquent mortgage loans. The Bank holds these properties until such time as they are sold.

F&M Trust s Investment and Trust Services Department offers all of the personal and corporate trust services normally associated with trust departments of area banks including: estate planning and administration, corporate and personal trust fund management, pension, profit sharing and other employee benefit funds management, and

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custodial services. F&M Trust s Personal Investment Center sells mutual funds, annuities and selected insurance products.

Acquisition

On November 29, 2008, Franklin Financial Services Corporation completed its acquisition of Community Financial, Inc. (Community). Community is the holding company of Community Trust Company, a Pennsylvania trust company headquartered in Camp Hill, Pennsylvania. In connection with the Community merger, Community Trust Company merged with and into Farmers and Merchants Trust Company. The acquisition increased the Bank s trust assets under managements by approximately $62 million. The acquisition provided the Bank quick entry into an attractive market for asset management services and presents the opportunity for the expansion of retail and commercial banking services via an established office.

Competition

The Corporation and its banking subsidiary operate in a competitive environment that has intensified in the past few years as it has been compelled to share its market with institutions that are not subject to the regulatory restrictions on domestic banks and bank holding companies. Profit margins in the traditional banking business of lending and gathering deposits have declined as deregulation has allowed nonbanking institutions to offer alternative services to many of F&M Trust s customers.

The principal market of F&M Trust is in south central Pennsylvania, primarily the counties of Franklin, Cumberland, Fulton and Huntingdon. The majority of the Bank s loan and deposit customers are in Franklin County. There are many commercial bank competitors in this region, in addition to credit unions, savings and loan associations, mortgage banks, brokerage firms and other competitors. The Bank utilizes various strategies including customer service and convenience as part of a relationship management culture, a wide variety of products and services, and the pricing of loans and deposits to compete. F&M Trust is the largest financial institution headquartered in Franklin County and had total assets of approximately $902.5 million on December 31, 2008.

Staff

As of December 31, 2008, the Corporation and its banking subsidiary had 261 full-time equivalent employees. The officers of the Corporation are employees of the bank. Most employees participate in pension, incentive compensation plans, and employee stock purchase plans and are provided with group life and health insurance. Management considers employee relations to be excellent.

Supervision and Regulation

Various requirements and restrictions under the laws of the United States and under Pennsylvania law affect the Corporation and its subsidiaries.

General

The Corporation is registered as a bank holding company and is subject to supervision and regulation by the Board of Governors of the Federal Reserve System under the Bank Holding Act of 1956, as amended. The Corporation has also made an effective election to be treated as a financial holding company. Financial holding companies are bank holding companies that meet certain minimum capital and other standards and are therefore entitled to engage in financially related activities on an expedited basis; see further discussion below. As a financial holding company, the Corporation s activities and those of its bank subsidiary are limited to the business of banking and activities closely

related or incidental to banking. Bank holding companies are required to file periodic reports with and are subject to examination by the Federal Reserve Board. The Federal Reserve Board has issued regulations under the Bank Holding Company Act that require a bank holding company to serve as a source of financial and managerial strength to its subsidiary banks. As a result, the Federal Reserve Board, pursuant to such regulations, may require the Corporation to stand ready to use its resources to provide adequate capital funds to its bank subsidiary during periods of financial stress or adversity.

The Bank Holding Company Act prohibits the Corporation from acquiring direct or indirect control of more than 5% of the outstanding shares of any class of voting stock, or substantially all of the assets of any bank, or from merging or consolidating with another bank holding company, without prior approval of the Federal Reserve Board. Additionally, the Bank Holding Company Act prohibits the Corporation from engaging in or from acquiring ownership or control of more than 5% of the outstanding shares of any class of voting stock of any company engaged in a non-banking business, unless such business is determined by the Federal Reserve Board to be so closely related to banking as to be a proper incident thereto. Federal law and Pennsylvania law also require persons or entities desiring to acquire certain levels of share ownership (generally, 10% or more, or 5% or more for another bank holding company) of the Corporation to first obtain prior approval from the Federal Reserve and the Pennsylvania Department of Banking.

As a Pennsylvania bank holding company for purposes of the Pennsylvania Banking Code, the Corporation is also subject to regulation and examination by the Pennsylvania Department of Banking.

The Bank is a state chartered bank that is not a member of the Federal Reserve System, and its deposits are insured (up to applicable limits) by the Federal Deposit Insurance Corporation (the FDIC). Accordingly, the Bank s primary federal regulator is the FDIC, and the Bank is subject to extensive regulation and examination by the FDIC and the Pennsylvania Department of Banking. The Bank is also subject to requirements and restrictions under federal and state law, including requirements to maintain reserves against deposits, restrictions on the types and amounts of loans that may be granted and the interest that may be charged thereon, and limitations on the types of investments that may be made and the types of services that may be offered. The Bank is subject to extensive regulation and reporting requirements in a variety of areas, including to help prevent money laundering, to preserve financial privacy, and to properly report late payments, defaults, and denials of loan applications. The Community Reinvestment Act requires the Bank to help meet the credit needs of the entire community where the Bank operates, including low and moderate income neighborhoods. The Bank s rating under the Community Reinvestment Act, assigned by the FDIC pursuant to an examination of the Bank, is important in determining whether the bank may receive approval for, or utilize certain streamlined procedures in, applications to engage in new activities. The Bank s present CRA rating is satisfactory. Various consumer laws and regulations also affect the operations of the Bank. In addition to the impact of regulation, commercial banks are affected significantly by the actions of the Federal Reserve Board as it attempts to control the money supply and credit availability in order to influence the economy.

Capital Adequacy Guidelines

Bank holding companies are required to comply with the Federal Reserve Board s risk-based capital guidelines. The required minimum ratio of total capital to risk-weighted assets (including certain off-balance sheet activities, such as standby letters of credit) is 8%. At least half of the total capital is required to be Tier 1 capital, consisting principally of common shareholders equity less certain intangible assets. The remainder (Tier 2 capital) may consist of certain preferred stock, a limited amount of subordinated debt, certain hybrid capital instruments and other debt securities, and a limited amount of the general loan loss allowance. The risk-based capital guidelines are required to take adequate account of interest rate risk, concentration of credit risk, and risks of nontraditional activities.

In addition to the risk-based capital guidelines, the Federal Reserve Board requires a bank holding company to maintain a leverage ratio of a minimum level of Tier 1 capital (as determined under the risk-based capital guidelines) equal to 3% of average total consolidated assets for those bank holding companies which have the highest regulatory examination ratings and are not contemplating or experiencing significant growth or expansion. All other bank holding companies are required to maintain a ratio of at least 1% to 2% above the stated minimum. The Bank is subject to almost identical capital requirements adopted by the FDIC. In addition to FDIC capital requirements, the Pennsylvania Department of Banking also requires state chartered banks to maintain a 6% leverage capital level and 10% risk based capital, defined substantially the same as the federal regulations.

Prompt Corrective Action Rules

The federal banking agencies have regulations defining the levels at which an insured institution would be considered well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized and critically undercapitalized. The applicable federal bank regulator for a depository institution could, under certain circumstances, reclassify a well-capitalized institution as adequately capitalized or require an adequately capitalized or undercapitalized institution to comply with supervisory actions as if it were in the next lower category. Such a reclassification could be made if the regulatory agency determines that the institution is in an unsafe or unsound condition (which could include unsatisfactory examination ratings). At December 31, 2008, the Corporation and the Bank each satisfied the criteria to be classified as well capitalized within the meaning of applicable regulations.

Regulatory Restrictions on Dividends

Dividend payments by the Bank to the Corporation are subject to the Pennsylvania Banking Code, the Federal Deposit Insurance Act, and the regulations of the FDIC. Under the Banking Code, no dividends may be paid except from accumulated net earnings (generally, retained earnings). The Federal Reserve Board and the FDIC have formal and informal policies which provide that insured banks and bank holding companies should generally pay dividends only out of current operating earnings, with some exceptions. The Prompt Corrective Action Rules, described above, further limit the ability of banks to pay dividends, because banks which are not classified as well capitalized or adequately capitalized may not pay dividends.

FDIC Insurance Assessments

The Bank is a member of the Deposit Insurance Fund (the DIF), which is administered by the FDIC. Deposit accounts at the Bank are insured by the FDIC, generally up to a maximum of $100,000 for each separately insured depositor and up to a maximum of $250,000 for self-directed retirement accounts. However, the FDIC increased the deposit insurance available on all deposit accounts to $250,000, effective until December 31, 2009. In addition, certain noninterest-bearing transaction accounts maintained with financial institutions participating in the FDIC s Transaction Account Guarantee Program are fully insured regardless of the dollar amount until December 31, 2009. The Bank has opted to participate in the FDIC s Transaction Account Guarantee Program. See Temporary Liquidity Guarantee Program below.

The FDIC imposes an assessment against all depository institutions for deposit insurance. This assessment is based on the risk category of the institution and, prior to 2009, ranged from 5 to 43 basis points of the institution s deposits. On October 7, 2008, as a result of decreases in the reserve ratio of the DIF, the FDIC issued a proposed rule establishing a Restoration Plan for the DIF. The rulemaking proposed that, effective January 1, 2009, assessment rates would increase uniformly by 7 basis points for the first quarter 2009 assessment period. The rulemaking proposed to alter the way in which the FDIC s risk-based assessment system differentiates for risk and set new deposit insurance assessment rates, effective April 1, 2009. Under the proposed rule, the FDIC would first establish an institution s initial base assessment rate. This initial base assessment rate would range, depending on the risk category of the institution, from 10 to 45 basis points. The FDIC would then adjust the initial base assessment (higher or lower) to obtain the total base assessment rate. The adjustment to the initial base assessment rate would be based upon an institution s levels of unsecured debt, secured liabilities, and brokered deposits. The total base assessment rate would range from 7 to 77.5 basis points of the institution s deposits. On February 27, 2009, the FDIC published a final rule raising the current deposit insurance assessment rates uniformly for all institutions by seven basis points (to a range from 12 to 45 basis points) for the second quarter of 2009. This action also changed the way that the FDIC s assessment system differentiates for risk and extended the time frame to restore the DIF from 5 years to 7 years and imposes a special assessment on insured institutions of 20 basis points, payable September 30, 2009. The ruling also allows the FDIC to impose an emergency assessment of 10 basis points after June 30, 2009 if necessary to maintain public confidence in

federal deposit insurance.

Insurance of deposits may be terminated by the FDIC upon a finding that an institution has engaged in unsafe or unsound practices, is in an unsafe or unsound condition to continue operations or has violated any applicable law,

regulation, rule, order or condition imposed by the FDIC. We do not currently know of any practice, condition or violation that might lead to termination of our deposit insurance.

In addition to the FDIC assessments, the Financing Corporation (FICO) is authorized to impose and collect, with the approval of the Federal Deposit Insurance Corporation, assessments for anticipated payments, issuance costs and custodial fees on bonds issued by the FICO in the 1980s to recapitalize the former Federal Savings and Loan Insurance Corporation. The bonds issued by the FICO are due to mature in 2017 through 2019. For the quarter ended December 31, 2008, the annualized FICO assessment was equal to 1.10 basis points for each $100 in domestic deposits maintained at an institution.

Temporary Liquidity Guarantee Program.

On October 14, 2008, the FDIC announced a new program the Temporary Liquidity Guarantee Program. This program has two components The Debt Guarantee Program and the Transaction Account Guarantee Program. The Debt Guarantee Program guarantees newly issued senior unsecured debt of a participating organization, up to certain limits established for each institution, issued between October 14, 2008 and June 30, 2009. The FDIC will pay the unpaid principal and interest on an FDIC-guaranteed debt instrument upon the uncured failure of the participating entity to make a timely payment of principal or interest in accordance with the terms of the instrument. The guarantee will remain in effect until June 30, 2012. In return for the FDIC s guarantee, participating institutions will pay the FDIC a fee based on the amount and maturity of the debt. The Bank and the Corporation have opted not to participate in the Debt Guarantee Program.

The Transaction Account Guarantee Program provides full federal deposit insurance coverage for non-interest bearing transaction deposit accounts, regardless of dollar amount, until December 31, 2009. An annualized 10 basis point assessment on balances in noninterest-bearing transaction accounts that exceed the existing deposit insurance limit of $250,000 will be assessed on a quarterly basis to insured depository institutions that have not opted out of this component of the Temporary Liquidity Guarantee Program. The Bank has opted to participate in the Transaction Account Guarantee Program.

U.S. Treasury s Troubled Asset Relief Program Capital Purchase Program.

On October 3, 2008, the Emergency Economic Stabilization Act of 2008 (EESA) was enacted that provides the U.S. Secretary of the Treasury with broad authority to implement certain actions to help restore stability and liquidity to U.S. markets. One of the provisions resulting from the legislation is the Troubled Asset Relief Program Capital Purchase Program (CPP), which provides direct equity investment in perpetual preferred stock by the U.S. Treasury Department in qualified financial institutions. The program is voluntary and requires an institution to comply with a number of restrictions and provisions, including limits on executive compensation, stock redemptions and declaration of dividends. The CPP provides for a minimum investment of one percent of total risk-weighted assets and a maximum investment equal to the lesser of three percent of total risk-weighted assets or $25 billion. Participation in the program is not automatic and is subject to approval by the U.S. Treasury Department. The Corporation opted not to participate in the CPP because it believes its strong capital position, asset quality and earnings allow us to effectively execute on our strategic objectives, and continue to originate and invest in loans to creditworthy borrowers in our marketplace. Our management team concluded that CPP participation would not be beneficial to our customers, shareholders or communities as it would restrict dividend increases and share repurchases as well as dilute ownership, earnings per share, and return on equity.

New Legislation

Congress is often considering new financial industry legislation, and the federal banking agencies routinely propose new regulations. The Corporation cannot predict how any new legislation, or new rules adopted by the federal banking agencies, may affect its business in the future.

Selected Statistical Information

Certain statistical information is included in this report as part of Management s Discussion and Analysis of Financial Condition and Results of Operations.

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Item 1A. *Risk Factors*

The following is a summary of the primary risks associated with the Corporation s business, financial condition and results of operations, and common stock. The list of risks identified below is not intended to be exhaustive and does not include risks that are faced by businesses generally. In addition to the risks identified below, there may be other risks and uncertainties, including those not presently known to us or those we currently consider immaterial that could adversely affect the Corporation and its business.

Risk Factors Relating to the Corporation

A focus on commercial loans may increase the risk of substantial credit losses.

The Bank offers a variety of loan products, including residential mortgage, consumer, construction and commercial loans. At December 31, 2008, approximately 69% of its loans were commercial loans, including those secured by commercial real estate. As the Bank grows, it is expected that this percentage will grow as the Bank continues to focus its efforts on commercial lending. Commercial lending is more risky than residential mortgage and consumer lending because loan balances are greater and the borrower s ability to repay is contingent on the successful operation of a business. Risk of loan defaults is unavoidable in the banking industry, and Management tries to limit exposure to this risk by carefully monitoring the amount of loans in specific industries and by exercising prudent lending practices. However, this risk cannot be eliminated and substantial credit losses could result in reduced earnings or losses.

The allowance for loan losses may prove to be insufficient to absorb potential losses in our loan portfolio.

The Bank maintains an allowance for loan losses that Management believes is appropriate to provide for any potential losses in the loan portfolio. The amount of the allowance is determined through a periodic review and consideration of several factors, including an ongoing review of the quality, size and diversity of our loan portfolio; evaluation of nonperforming loans; historical loan loss experience; and the amount and quality of collateral, including guarantees, securing the loan. Although Management believes the loan loss allowance is adequate to absorb probable losses in the loan portfolio, such losses cannot be predicted and the allowance may not be adequate. Excess loan losses could have a material adverse effect on the Bank s financial condition and results of operations.

The Bank s lending limit is smaller than many of our competitors, which affects the size of the loans it can offer customers.

The Bank s lending limit is approximately $10.4 million. Accordingly, the size of the loans that can be offered to potential customers is less than the size of loans that many of our competitors with larger lending limits can offer. This limit affects the Bank s ability to seek relationships with larger businesses in its market area. Loan amounts in excess of the lending limits can be accommodated through the sale of participations in such loans to other banks. However, there can be no assurance that the Bank will be successful in attracting or maintaining customers seeking larger loans or that it will be able to engage in participation of such loans or on terms favorable to the Bank.

The Corporation depends on the services of its Management team and the unexpected loss of any member of the Management team could disrupt and adversely affect its operations.

Banking is a relationship-driven organization. The Bank s growth and development to date have depended in large part on the efforts of its senior officers, who have primary contact with its customers. These senior officers are extremely important in maintaining personalized relationships with the Bank s customer base and increasing its market presence. The unexpected loss of services of one or more of these key employees could have a material adverse effect on the Bank s operations and possibly result in reduced revenues. The Management team has considerable experience in the

banking industry and is extremely valuable to the Bank and would be difficult to replace. The loss of the services of these officers could have a material adverse effect upon the Bank s future prospects.

There is strong competition in the Bank s primary market areas.

The Bank encounters strong competition from other financial institutions in its primary market area, which consists of Franklin, Cumberland, Fulton and Huntingdon County, Pennsylvania. In addition, established financial institutions not already operating in the Bank s primary market area may open branches there at future dates or can compete in the market via the internet. In the conduct of certain aspects of banking business, the Bank also competes with savings institutions, credit unions, mortgage banking companies, consumer finance companies, insurance companies and other institutions, some of which are not subject to the same degree of regulation or restrictions as are imposed upon the Bank. Many of these competitors have substantially greater resources and lending limits and can offer services that the Bank does not provide. In addition, many of these competitors have numerous branch offices located throughout their extended market areas that provide them with a competitive advantage. No assurance can be given that such competition will not have an adverse effect on the Bank s financial condition and results of operations.

The Corporation may be affected by local, regional and national economic conditions over which it has no control.

The results of operations for financial institutions, including the Corporation, may be materially and adversely affected by changes in prevailing economic conditions, including declines in real estate markets, unemployment, recession, international developments, rapid changes in interest rates and the monetary and fiscal policies of the federal government. Substantially all of the Bank s loans are to businesses and individuals in its primary market area and any decline in the economy of this area could have an adverse impact on the Bank. Accordingly, the Bank could be more vulnerable to economic downturns in our market area than its larger competitors, who are more geographically diverse. Changes in governmental economic and monetary policies, the Internal Revenue Code and banking and credit regulations may affect the demand for loans and the Bank s ability to attract deposits. The interest rate payable on deposits and chargeable on loans is further subject to governmental regulations and fiscal policy, as well as national, state and local economic growth, employment rates and population trends.

Changes in interest rates could have an adverse impact upon our results of operations.

The Bank s profitability is in part a function of the spread between interest rates earned on investments, loans and other interest-earning assets and the interest rates paid on deposits and other interest-bearing liabilities. Recently, interest rate spreads have generally narrowed due to changing market conditions and competitive pricing pressure. Interest rates are highly sensitive to many factors that are beyond the Bank s control, including general economic conditions and policies of various governmental and regulatory agencies and, in particular, the Board of Governors of the Federal Reserve System. Changes in monetary policy, including changes in interest rates, will influence not only the interest received on loans and investment securities and the amount of interest we pay on deposits and borrowings, but will also affect the Bank s ability to originate loans and obtain deposits and the value of our investment portfolio. If the rate of interest paid on deposits and other borrowings increases more than the rate of interest earned on loans and other investments, the Bank s net interest income, and therefore earnings, could be adversely affected. Earnings could also be adversely affected if the rates on loans and other investments fall more quickly than those on deposits and other borrowings. While Management takes measures to guard against interest rate risk, there can be no assurance that such measures will be effective in minimizing the exposure to interest rate risk.

The Corporation may be affected by events that have an adverse impact on its liquidity.

The Corporation must maintain sufficient liquidity in order to respond quickly to the changing level of funds required for loan and deposit activity, operational costs and other corporate purposes. The Bank obtains funding through deposits, short-term borrowings from corporate customers, brokered certificates of deposits, and borrowings from the Federal Home Loan Bank of Pittsburgh. If the Corporation experienced a significant deterioration in its financial performance or if other external economic events occur beyond the control of the Corporation, its access to funding

from any or all of its sources could be disrupted. The Bank maintains secured borrowing facilities at both the Pittsburgh FHLB and the Federal Reserve Discount Window that it believes are sufficient to meet all of its liquidity demands.

Our controls and procedures may fail or could be circumvented.

Management has implemented a series of internal controls, disclosure controls and procedures, and corporate governance policies and procedures in order to ensure accurate financial control and reporting. However, any system of controls, no matter how well designed and operated, can only provide reasonable, not absolute assurance that the objectives of the system are met. Any failure or circumvention of our controls and/or procedures could have a material adverse effect on our business and results of operation and financial condition.

The Corporation is subject to extensive governmental regulation.

The Corporation is subject to intensive regulation by federal and state bank regulatory agencies. There can be no assurance that this supervision and regulation will not have a material adverse effect on the Corporation s results of operations. The primary purpose of this regulation is the protection of the federal deposit insurance funds administered by the FDIC, as well as the Bank s depositors, as opposed to the Corporation s shareholders. Further, the financial services industry has received significant legislative attention in recent years, resulting in increased regulation in certain areas and deregulation in other areas. As a result, banks now face strong competition from other financial service providers in areas that were previously, almost the exclusive domain of banks.

In order to remain competitive, the Bank may be required to spend a significant amount of money on technology.

The banking industry continues to undergo rapid technological changes with frequent introduction of new technology-driven products and services. In addition to providing better services to customers, the effective use of technology increases efficiency and reduces costs. The Bank s future success depends in part upon its ability to address the needs of its customers by using technology to provide products and services that will satisfy customer demands for convenience, as well as to create additional operating efficiencies. Many of our competitors have substantially greater resources to invest in technological improvements. Such technology may permit competitors to perform certain functions at a lower cost than the Bank. The Bank may not be able to effectively implement new technology-driven products and services or be successful in marketing these to our customers.

Risk Factors Relating to the Common Stock

The FDIC does not insure investments in the Corporation s common stock.

Investments in the Corporation s common stock are not deposit accounts and are not insured by the FDIC or any other governmental agency. Investments in the Corporation s common stock are not guaranteed, may lose value, and are subject to a variety of investment risks, including loss of principal.

There is a limited trading market for the Corporation s common stock.

There is currently only a limited public market for the Corporation s common stock. It is listed on the Over the Counter Bulletin Board (OTC-BB) under the symbol FRAF. Because it is thinly traded, you may not be able to resell your shares of common stock for a price that is equal to the price that you paid for your shares. The Corporation has no plans to apply to have its common stock listed for trading on any stock exchange or the NASDAQ market.

The Bank s ability to pay dividends to the Corporation is subject to regulatory limitations that may affect the Corporation s ability to pay dividends to its shareholders.

As a holding company, the Corporation is a separate legal entity from the Bank and does not have significant operations of its own. It currently depends upon the Bank s cash and liquidity to pay dividends to its shareholders. The

Corporation cannot assure you that in the future the Bank will have the capacity to pay dividends to the Corporation. Various statutes and regulations limit the availability of dividends from the Bank. It is possible; depending upon the Bank s financial condition and other factors, that the Bank s regulators could assert that payment of dividends by the Bank to the Corporation is an unsafe or unsound practice. In the event that the Bank is unable to pay dividends to the Corporation, the Corporation may not be able to pay dividends to its shareholders.

Item 1B. ***Unresolved Staff Comments***

None

Item 2. ***Properties***

The Corporation s headquarters is located in the main office of F&M Trust at 20 South Main Street, Chambersburg, Pennsylvania. This location also houses a community banking office as well as operational support services for the Bank. The Corporation owns or leases thirty-five properties in Franklin, Cumberland, Fulton and Huntingdon Counties, Pennsylvania as described below:

Property	Owned	Leased
Community Banking Offices	18	7
Remote ATM Sites		6
Other Properties	4	

Item 3. ***Legal Proceedings***

The nature of our business generates a certain amount of litigation involving matters arising in the ordinary course of business. However, in management s opinion, there are no proceedings pending to which the Corporation is a party or to which our property is subject, which, if determined adversely to the Corporation, would be material in relation to our shareholders equity or financial condition. In addition, no material proceedings are pending nor are known to be threatened or contemplated against us by governmental authorities or other parties.

Item 4. ***Submission of Matters to a Vote of Security Holders***

None

Part II

Item 5. ***Market for Registrant s Common Equity, Related Shareholder Matters and Issuer Purchases of Equity Securities***

Market and Dividend Information

The Corporation s common stock is not actively traded in the over-the-counter market. The Corporation s stock is listed under the symbol FRAF on the OTC Electronic Bulletin Board, an automated quotation service. Current price information is available from account executives at most brokerage firms as well as the registered market makers of Franklin Financial Services Corporation common stock as listed below under Shareholders Information.

The range of high and low bid prices is shown in the following table for the years 2008 and 2007, as well as cash dividends declared for those periods. The bid quotations reflect interdealer quotations, do not include retail mark-ups, markdowns or commissions, and may not necessarily represent actual transactions. The closing price of

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Franklin Financial Services Corporation common stock recorded from an actual transaction on December 31, 2008 was $18.25. The Corporation had 2,123 shareholders of record as of December 31, 2008.

Market and Dividend Information
Bid Price Range Per Share

	2008			2007		
	High	Low	Dividends Declared	High	Low	Dividends Declared
			(Dollars per share)			
First quarter	**$ 24.80**	**$ 23.10**	**$ 0.26**	$ 27.23	$ 26.93	$ 0.25
Second quarter	**24.15**	**23.00**	**0.27**	27.23	26.74	0.26
Third quarter	**23.00**	**20.30**	**0.27**	27.08	24.60	0.26
Fourth quarter	**21.51**	**16.50**	**0.27**	25.80	24.25	0.26
			$ 1.07			$ 1.03

For limitations on the Corporation s ability to pay dividends, see Supervision and Regulation Regulatory Restrictions on Dividends in Item 1 above.

The information related to equity compensation plans is incorporated by reference to the materials set forth under the heading Executive Compensation Compensation Tables in the Corporation s Proxy Statement for the 2009 Annual Meeting of Shareholders.

Common Stock Repurchases:

The following table represents the repurchase of issuer equity securities during the fourth quarter of 2008:

Period	Number of Shares Purchased	Weighted Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Program	Number of Shares that May yet Be Purchased Under Program
October 2008	10,700	$ 19.67	10,700	83,668
November 2008				83,668
December 2008				83,668
Total	10,700	$ 19.67	10,700	

On July 10, 2008, the Board of Directors authorized the repurchase of up to 100,000 shares of the Corporation s $1.00 par value common stock over a twelve-month period ending on July 10, 2009. The common shares of the Corporation will be purchased in the open market or in privately negotiated transactions. The Corporation uses the repurchased common stock (Treasury stock) for general corporate purposes including stock dividends and splits, employee benefit and executive compensation plans, and the dividend reinvestment plan. A plan approved July 12, 2007 that authorized the repurchase of up 100,000 shares expired in 2008 with 56,309 shares repurchased during the plan year.

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The following graph compares the cumulative total return to shareholders of Franklin Financial with the NASDAQ Total U.S. Index (a broad market index prepared by the Center for Research in Security Prices at the University of Chicago Graduate School of Business) and with the Northeast OTC-BB and Pink Banks Index (an industry-specific index prepared by SNL Financial LC) for the five year period ended December 31, 2008, in each case assuming an initial investment of $100 on December 31, 2003 and the reinvestment of all dividends.

Franklin Financial Services Corporation

Total Return Performance

	Period Ending					
Index	**12/31/03**	**12/31/04**	**12/31/05**	**12/31/06**	**12/31/07**	**12/31/08**
Franklin Financial Services Corporation	100.00	101.98	98.04	110.12	104.66	80.23
NASDAQ Composite	100.00	108.59	110.08	120.56	132.39	78.72
SNL Northeast OTC-BB & Pink Banks	100.00	116.50	116.15	120.03	116.89	95.21

Source : SNL Financial LC, Charlottesville, VA (434) 977-1600
©2009 www.snl.com

Shareholders Information

Dividend Reinvestment Plan:

Franklin Financial Services Corporation offers a dividend reinvestment program whereby shareholders with stock registered in their own names may reinvest their dividends in additional shares of the Corporation. Information concerning this optional program is available by contacting the Corporate Secretary at 20 South Main Street, P.O. Box 6010, Chambersburg, PA 17201-6010, telephone 717-264-6116.

Dividend Direct Deposit Program:

Franklin Financial Services Corporation offers a dividend direct deposit program whereby shareholders with registered stock in their own names may choose to have their dividends deposited directly into the bank account of their choice on the dividend payment date. Information concerning this optional program is available by contacting the Corporate Secretary at 20 South Main Street, P.O. Box 6010, Chambersburg, PA 17201-6010, telephone 717-264-6116.

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Annual Meeting:

The Annual Shareholders Meeting will be held on Tuesday, April 28, 2009, at the Orchard Restaurant & Banquet Facility, 1580 Orchard Drive, Chambersburg, Pennsylvania. The Business Meeting will begin at 10:30 a.m. followed by a luncheon.

Website:

www.franklinfin.com

Stock Information:

The following brokers are registered as market makers of Franklin Financial Services Corporation s common stock:

RBC Wealth Management	2101 Oregon Pike, Lancaster, PA 17601	800/646-8647
Boenning & Scattergood, Inc.	1700 Market Street, Suite 1420, Philadelphia, PA 19103-3913	800/883-1212
Ryan, Beck & Co.	3 Parkway, Philadelphia, PA 19102	800/223-8969
Morgan Keegan	Two Buckhead Plaza, 3050 Peachtree Road, NW, Suite 704 Atlanta, GA 30305	866/353-7522

Registrar and Transfer Agent:

The registrar and transfer agent for Franklin Financial Services Corporation is Fulton Financial Advisors, N.A., P.O. Box 4887, Lancaster, PA 17604.

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Item 6. ***Selected Financial Data***

Summary of Selected Financial Data

	2008	2007	2006	2005	2004
	(Dollars in thousands, except per share)				
Summary of operations					
Interest income	**$ 46,156**	$ 49,487	$ 40,902	$ 29,711	$ 24,809
Interest expense	**16,037**	23,796	19,956	12,173	8,819
Net interest income	**30,119**	25,691	20,946	17,538	15,990
Provision for loan losses	**1,193**	990	240	426	880
Net interest income after provision for loan losses	**28,926**	24,701	20,706	17,112	15,110
Noninterest income	**6,538**	10,107	8,257	6,995	7,093
Noninterest expense	**23,189**	22,793	19,296	17,058	15,996
Income before income taxes	**12,275**	12,015	9,667	7,049	6,207
Income tax	**3,680**	2,759	2,097	937	1,015
Net income	**$ 8,595**	$ 9,256	$ 7,570	$ 6,112	$ 5,192
Per common share					
Basic earnings per share	**$ 2.24**	$ 2.41	$ 2.11	$ 1.82	$ 1.54
Diluted earnings per share	**2.24**	2.40	2.10	1.81	1.54
Cash dividends paid	**1.07**	1.03	0.99	0.95	0.88
Market value	**18.25**	24.95	27.30	25.25	27.25
Balance sheet data (end of year)					
Total assets	**$ 902,460**	$ 820,371	$ 799,333	$ 621,357	$ 563,268
Loans, net	**668,860**	564,256	521,684	391,788	343,130
Deposits	**627,341**	606,277	595,295	456,799	399,896
Long-term debt	**106,141**	59,714	38,449	48,546	52,359
Shareholders equity	**73,059**	77,642	71,614	55,670	54,643
Performance measurements					
Return on average assets	**1.01%**	1.14%	1.07%	1.03%	0.93%
Return on average equity	**10.99%**	12.62%	11.92%	11.13%	9.77%
Return on average tangible assets(1)	**1.05%**	1.18%	1.09%	1.03%	0.93%
Return on average tangible equity(1)	**13.19%**	15.41%	13.42%	11.13%	9.77%
Dividend payout ratio	**47.66%**	42.77%	47.03%	52.31%	56.82%
Average equity to average asset ratio	**9.18%**	8.98%	8.96%	9.28%	9.47%
Efficiency ratio(2)	**61.25%**	61.35%	63.06%	66.39%	66.24%
Net interest margin	**4.03%**	3.67%	3.45%	3.45%	3.34%
Trust assets under management (market value)	**$ 497,215**	$ 507,920	$ 538,152	$ 411,165	$ 410,491

(1) See Item 7 for definition of non-GAAP measurements.

(2) Efficiency ratio: Noninterest expense / (Tax equivalent net interest income plus noninterest income less security gains)

Item 7. ***Management s Discussion and Analysis of Financial Condition and Results of Operations***

Application of Critical Accounting Policies:

Disclosure of the Corporation s significant accounting policies is included in Note 1 to the consolidated financial statements. These policies are particularly sensitive requiring significant judgments, estimates and assumptions to be made by Management. Senior management has discussed the development of such estimates, and related Management Discussion and Analysis disclosure, with the Audit Committee of the Board of Directors. The following accounting policies are the ones identified by management to be critical to the results of operations:

Allowance for Loan Losses The allowance for loan losses is the estimated amount considered adequate to cover credit losses inherent in the outstanding loan portfolio at the balance sheet date. The allowance is established through the provision for loan losses, charged against income. In determining the allowance for loan losses, Management makes significant estimates and, accordingly, has identified this policy as probably the most critical for the Corporation.

Management performs a monthly evaluation of the adequacy of the allowance for loan losses. Consideration is given to a variety of factors in establishing this estimate including, but not limited to, current economic conditions, diversification of the loan portfolio, delinquency statistics, results of internal loan reviews, borrowers actual or perceived financial and managerial strengths, the adequacy of the underlying collateral (if collateral dependent) and other relevant factors. This evaluation is inherently subjective, as it requires material estimates that may be susceptible to significant change, including the amounts and timing of future cash flows expected to be received on impaired loans.

The analysis has two components, specific and general allocations. Collateral values discounted for market conditions and selling costs are used to establish specific allocations. The Bank s historical loan loss experience and loan administration factors are used to establish general allocations for the remainder of the portfolio. The allowance for loan losses was $7.4 million at December 31, 2008.

Management monitors the adequacy of the allowance for loan losses on an ongoing basis and reports its adequacy assessment monthly to the Board of Directors, and quarterly to the Audit Committee.

Mortgage Servicing Rights Fixed rate mortgages originated by the Bank were sold primarily to Federal National Mortgage Association (FNMA). Although the Bank has chosen to sell these loans, its practice is to retain the servicing of these loans. This means that the customers whose loans have been sold to the secondary market make their monthly payments to the Bank.

As required by Statement of Financial Accounting Standard No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities , upon the sale of mortgage loans, the Bank capitalizes the value allocated to the servicing rights in other assets and makes a corresponding entry to other income from mortgage banking activities. The capitalized servicing rights are amortized against noninterest income in proportion to, and over the periods of, the estimated net servicing income of the underlying financial assets.

Capitalized servicing rights are carried at the lower of cost or market and are evaluated for impairment based upon the fair value of the rights as compared to amortized cost. The rights are deemed to be impaired when the fair value of the rights is less than the amortized cost. If impaired, the Bank records a charge against noninterest income from mortgage banking activities through a mortgage servicing rights valuation allowance. The amount charged to the valuation allowance can be reversed in future periods if the rights are determined to no longer be impaired. However, the amount of impairment reversed may not exceed the balance of the valuation allowance.

The fair value of the servicing rights is determined through a discounted cash flow analysis and calculated using a computer-pricing model. The pricing model is based on the objective characteristics of the mortgage servicing portfolio (e.g, loan balance and interest rate) and commonly used industry assumptions (e.g., prepayment speeds, discount rates). The assumptions take into account those that many active purchasers of servicing rights employ in their evaluations of portfolios for sale in the secondary market. The unique characteristics of the secondary servicing market often dictate adjustments to the assumptions over short periods of time. Subjective factors are also considered in the derivation of market values, including levels of supply and demand for servicing, interest rate trends, and perception of risk not incorporated into prepayment assumptions.

Financial Derivatives As part of its interest rate risk management strategy, the Bank has entered into interest rate swap agreements. A swap agreement is a contract between two parties to exchange cash flows based upon an underlying notional amount. Under the swap agreements, the Bank pays a fixed rate and receives a variable rate from an unrelated financial institution serving as counter-party to the agreements. The swaps are designated as cash flow hedges and are designed to minimize the variability in cash flows of the Bank s variable rate liabilities attributable to changes in interest rates. The swaps in effect convert a portion of a variable rate liability to a fixed rate liability.

The interest rate swaps are recorded on the balance sheet at fair value as an asset or liability. To the extent the swaps are effective in accomplishing their objectives, changes in the fair value are recorded in other comprehensive income. To the extent the swaps are not effective, changes in fair value are recorded in interest expense. Cash flow hedges are determined to be highly effective when the Bank achieves offsetting changes in the cash flows of the risk being hedged. The Bank measures the effectiveness of the hedges on a quarterly basis and it has determined the hedges are highly effective. Fair value is heavily dependent upon the market s expectations for interest rates over the remaining term of the swaps.

Temporary Investment Impairment Investment securities are written down to their net realizable value when there is impairment in value that is considered to be other-than-temporary. The determination of whether or not other-than-temporary impairment exists is a matter of judgment. Management reviews investment securities regularly for possible impairment that is other-than-temporary by analyzing the facts and circumstances of each investment and the expectations for that investment s performance. Other-than-temporary impairment in the value of an investment may be indicated by the length of time and the extent to which market value has been less than cost; the financial condition and near term prospects of the issuer; or the intent and ability to retain the investment for a period of time sufficient to allow for any anticipated recovery in market value.

Stock-based Compensation The Corporation has two stock compensation plans in place consisting of an Employee Stock Purchase Plan (ESPP) and an Incentive Stock Option Plan (ISOP).

The Corporation accounts for stock compensation plans in accordance with Financial Accounting Standards Board Statement No. 123(R), Share-Based Payment. Statement No. 123(R) requires compensation costs related to share-based payment transactions to be recognized in the financial statements (with limited exceptions). The amount of compensation cost is measured on the grant-date fair value of the equity or liability instruments issued. Compensation cost is recognized over the period that an employee provides services in exchange for the award.

The Corporation calculates the compensation cost of the options by using the Black-Scholes method to determine the fair value of the options granted. In calculating the fair value of the options, the Corporation makes assumptions regarding the risk-free rate of return, the expected volatility of the Corporation s common stock, dividend yield and the expected life of the option. These assumptions are made independently for the ESPP and the ISOP and if changed, would change the compensation cost of the options and net income.

Note 1 of the accompanying financial statements provides additional information about stock option expense.

GAAP versus Non-GAAP Presentations The Corporation supplements its traditional GAAP measurements with Non-GAAP measurements. The Non-GAAP measurements include Return on Average Tangible Assets and Return on Average Tangible Equity. As a result, intangible assets (primarily goodwill, core deposit intangibles and customer list) were created. The Non-GAAP disclosures are intended to eliminate the effects of the intangible assets and allow for better comparisons to periods when such assets did not exist. The following table shows the adjustments made between the GAAP and NON-GAAP measurements:

GAAP Measurement	**Calculation**
Return on Average Assets	Net Income/Average Assets
Return on Average Equity	Net Income/Average Equity

Non- GAAP Measurement	Calculation
Return on Average Tangible Assets	Net Income plus Intangible Amortization/Average Assets less Average Intangible Assets
Return on Average Tangible Equity	Net Income plus Intangible Amortization/Average Equity less Average Intangible Assets

Results of Operations:

Management s Overview

The following discussion and analysis is intended to assist the reader in reviewing the financial information presented and should be read in conjunction with the consolidated financial statements and other financial data presented elsewhere herein.

In our 2007 report, we commented that 2007 ended with the financial markets in turmoil. A credit crisis resulting from sub-prime mortgages problems was surfacing, banks were facing liquidity problems, bank stock values plummeted and the possibility of a recession loomed. As we close 2008, many aspects of the financial markets have collapsed.

During 2008, the sub-prime mortgage problems and liquidity crunch continued to worsen. These factors contributed to an economic collapse during the year that saw failure of Bear Stearns, Lehman Brothers and Washington Mutual. Likewise Fannie Mae and Freddie Mac were placed in conservatorship. As these events unfolded, the bond market witnessed a flight to quality as demand for U.S. Treasury obligations skyrocketed and yields plummeted to historic lows. Short-term Treasury yields fell by more than 300 basis points during the year, with the shortest term rates actually hitting a 0% yield for a brief period. As stress on the financial markets continued to increase, the Federal Reserve continued to cut the Fed Funds rate, doing so 7 times during the year. The Fed Funds rate ended 2008 4% below where it began the year. At year-end, it was clear that the economy was in a recession and 2009 began with the passage of the largest ever government spending and economic stimulus plan in an effort to jump start the economy.

For Franklin Financial Services Corporation, 2008 produced earnings of $8.6 million, a decrease of 7.1% from the record earnings reported in 2007. Likewise, diluted earnings per share dropped to $2.24 from $2.40 in 2007. Despite strong growth in its core banking business and a 15% increase in tax equivalent net interest income, the Corporation incurred losses from declining assets values and these losses were the primary contributor to the earnings decrease during the year. Other key measurements are presented above in Item 6, Selected Financial Data.

Tax equivalent net interest income improved by 15% during 2008, driven both by an increase in earning assets and the Bank s ability to lower its interest expense. For 2008, the Bank s net interest margin increased to 4.03% from 3.67% in 2007. This is the second consecutive year that the margin improved. The Bank increased its provision for loan loss in 2008 due to loan growth and higher charge-offs. Noninterest income decreased during 2008 due to market conditions that effected asset values and subsequently resulted in impairment charges on bank investments. Noninterest expense was controlled in 2008 and reported only a slight increase over the prior year.

Total assets of the Corporation grew to $902.5 million at December 31, 2008 compared to $820.4 million at December 31, 2007. Total loans grew by approximately $105 million and deposits grew by approximately $21 million over the prior year-end.

A more detailed discussion of the areas that had the greatest affect on reported results follows.

Net Interest Income

The most important source of the Corporation s earnings is net interest income, which is defined as the difference between income on interest-earning assets and the expense of interest-bearing liabilities supporting those assets. Principal categories of interest-earning assets are loans and securities, while deposits, securities sold under agreements to repurchase (Repos), short-term borrowings and long-term debt are the principal categories of interest-bearing liabilities. For the purpose of this discussion, net interest income is adjusted to a fully taxable-equivalent basis (refer to Table 1). This adjustment facilitates performance comparisons between taxable and tax-

free assets by increasing the tax-free income by an amount equivalent to the Federal income taxes that would have been paid if this income were taxable at the Corporation s 34% Federal statutory rate. The components of net interest income are detailed in Tables 1, 2 and 3.

2008 versus 2007

In 2008, the Corporation s tax equivalent net interest income increased by approximately 15%, growing from $27.4 million in 2007 to $31.5 million in 2008. Interest rates dropped dramatically during the year as the liquidity and credit problems in the financial markets grew worse. Rates moved down throughout the year with the Federal Reserve cutting the Fed funds rate 7 times. These actions drove the Fed funds rate from 4.25% at year-end 2007 to .25% at year-end 2008. Likewise, the Prime rate fell 4% during the year to 3.25% at the end of 2008. Treasury yields experienced extreme volatility during the year and short-term yields actually hit 0% for a short time. These market conditions are just two years removed from 2006 when the Fed ended a twenty-four month period of rate increases.

Tax-equivalent interest income on earning assets was $47.5 million, a decrease of $3.6 million or approximately 7% from 2007. The previously mentioned market rate decreases during the year had the effect of reducing the interest rates of new and re-pricing assets. As a result, $6.7 million of the reduction in interest income was a result of rate changes. However, an increase in average earning assets of $36.2 million produced an increase in interest income of $3.1 million that partially offset the effects of lower pricing. The Bank s investment portfolio decreased by approximately $22 million on average as maturities and pay-downs were not reinvested. The lower balance, coupled with a yield reduction of approximately .25% produced lower interest income in the portfolio compared to the previous year. Tax-equivalent interest income generated by the loan portfolio totaled $39 million in 2008, down from $40.6 million in 2007. Total average loans during the year were $620.4 million, an increase of approximately $64 million from the prior year average and produced an increase of $4.4 million in interest income. However, this increase was completely offset by falling rates with the yield on the loan portfolio falling more than 1% and in total, interest income decreased by $1.7 million year over year.

The commercial loan portfolio continued to grow during 2008 and the average balance of the portfolio increased by more than $70 million during the year. The commercial loan portfolio is comprised of approximately 50% fixed rate and 50% variable rate loans. As market rates fell during the year, new loans were booked at lower rates and existing loans repriced downward. The yield on the commercial loan portfolio fell by 1.45% during the year and the decrease in interest income produced by falling rates more than offset the increase produced by the higher volume.

Interest income on consumer loans increased slightly during the year despite a declining yield. Interest income from growth in the consumer loan portfolio, primarily home equity loans, more than offset the effect of a lower yield. The yield on consumer loans was 6.69% in 2008, down from 7.08% during the prior year. Mortgage interest income and balances continue to decline as the Bank sells nearly all of its new mortgage production and its existing portfolio of mortgages continues to pay down. Mortgage yields were also lower in 2008, 6.43%, compared to 6.68% in 2007.

The total effect of rate changes on earning assets was a drop in interest income of $6.7 million in 2008 while volume growth increased interest income by $3.1 million. The yield on earning assets for 2008 dropped to 6.08% from 6.86% in 2007.

For 2008, total interest expense was $16.0 million. This represents a decrease in interest expense of $7.8 million (32.6%) from 2007 interest expense of $23.8 million. Interest expense on deposits decreased $6.9 million when compared to the prior year. Ninety-two percent of the reduction in deposit interest expense is attributable to lower interest rates in 2008. Within the deposit category, the largest drop in interest expense was a $5.3 million reduction of interest expense on the Bank s Money Management product. This product is tied to short-term market interest rates and as these rates fell during 2008, the interest expense on this product fell. In fact, the rate decrease accounted for

$4.3 million of the total decrease in Money Management interest expense. After realizing an increase of 39% on average balances from 2006 to 2007, the Money Management product average balance fell by approximately 12% from 2007 to 2008 and this balance change accounted for the remaining drop in interest expense on this product. The decline in the average balance was in part caused by run-off due to low rates in 2008. All other deposit categories also reported a decline in interest expense that was primarily caused by lower interest rates.

Interest expense on time deposits dropped $1.1 million from 2007 to 2008 despite recording an increase in the average balance of $10.8 million year over year. In total, average interest bearing deposits decreased $13.7 million compared to the previous year and the average rate paid fell from 3.39% to 2.14%.

Interest expense on Securities sold under agreement to repurchase (Repos) was $1.4 million in 2008, $2.5 million less than in 2007. While the average balance decreased $5.8 million during the year, declining rates accounted for 89% of the reduction in interest expense as compared to 2007. The average rate paid on Repos was 1.88% in 2008 compared to 4.83% in 2007. The average balance of long-term debt (FHLB advances) increased $42.7 million during the year as the Bank took new advances to fund asset growth that outpaced deposit growth. While the average balance of long-term debt increased approximately 120% during 2008, the average rate paid dropped from 5.16% in 2007 to 4.34% in 2008 because of the low rates on new advances. As a result of these changes, interest expense on long-term debt increased $1.6 million during 2008.

The total cost of interest bearing liabilities was 2.36% for 2008, compared to 3.67% in 2007. See Table 2 for more detail on the change in net interest income that is attributable to changes in balance sheet size or changes in interest rates as compared to the prior year.

2007 versus 2006:

The Corporation recorded tax equivalent net interest income of $27.4 million in 2007, an increase of $4.9 million (22%) over 2006. For much of 2007, interest rates remained fairly stable. However, when the sub-prime mortgage problems were recognized in the second half of the year, market interest rates began to change frequently. The Federal Reserve Open Market Committee reduced the fed funds target rate by 1% within a 90-day period and the fed funds rate and the prime rate both ended 2007 lower than where they began the year. The Treasury yield curve experienced a large decline during the year as investors moved to quality investments. Despite falling market rates, the Corporation actually increased its net interest margin to 3.67% in 2007. The Corporation was liability sensitive and benefited from falling market rates, especially in the 4th quarter of 2007.

Tax-equivalent interest on earning assets improved $8.7 million over 2006. Interest income on all categories of interest earning assets increased from the prior year except on interest-bearing deposits and fed funds sold. The average balance of these accounts was lower in 2007 than 2006 and this fact accounted for the reduction in interest income. The majority of the increase in interest income ($7.7 million) came from the loan portfolio. Approximately 88% of the increase in loan interest is attributable to an increase in the average balance of the loan portfolio. Average commercial loan balances increased during the year and were the primary factor in the increase in commercial loan interest income in 2007. Commercial loan interest also benefited from two nonrecurring prepayment fees totaling $130 thousand that were recorded as interest income. The average yield on commercial loans increased slightly from the prior year. The commercial loan portfolio at year-end was comprised of approximately 55% fixed rate loans and 45% variable rate loans. Average consumer loans outstanding and the yield on these loans both increased year over year and boosted interest income. Average mortgage loans outstanding were down slightly from the 2006 average balance. Interest income from the investment portfolio increased approximately $1.2 million from 2006 and was primarily the result of higher yields in the portfolio. Overall, 80% of the increase in tax equivalent interest income was due to average balance sheet growth and the remainder was the result of changes in interest rates. The yield on earning assets was 6.86% in 2007, up from 6.51% in 2006.

Interest expense totaled $23.8 million in 2007, an increase of approximately 19% over the 2006 total of $20.0 million. Most of this increase came from the Bank s Money Management product that saw an increase in the average balance for 2007 of approximately 39% over the 2006 average balance. This product is indexed to a short-term market rate; therefore, the average cost of these deposits decreased year over year. The benefit gained from lower rates was more than offset by higher balances and resulted in a net increase to interest expense. Interest expense on certificates of

deposit (CD) increased year over year with the increase being almost evenly split between volume and rate factors. In the second half of 2007, the Bank began to see CD promotional rates from competitors that did not fit with the Bank s pricing practices. Therefore, the Bank maintained a disciplined approach to CD pricing and avoided the high rate specials. In part, this contributed to only a modest increase in the cost of CDs year over year. The average cost of interest bearing deposits increased from 3.22% in 2006 to 3.39%. The average balance on Repos increased approximately 17% over 2006 and was the primary driver of a $616 thousand increase

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in interest expense on this product. The total cost of interest bearing liabilities was 3.67% in 2007 compared to 3.56% in 2006. See Table 2 for more detail on the change in net interest income that is attributable to changes in balance sheet size or changes in interest rates as compared to the prior year.

Table 1. Net Interest Income

Net interest income, defined as interest income less interest expense, and the percentage change from the prior year is shown in the following table:

	2008	% Change	2007	% Change	2006	% Change
			(Dollars in thousands)			
Interest income	**$ 46,156**	**(6.73)%**	$ 49,487	20.99%	$ 40,902	37.67%
Interest expense	**16,037**	**(32.61)%**	23,796	19.24%	19,956	63.94%
Net interest income	**30,119**	**17.24%**	25,691	22.65%	20,946	19.43%
Tax equivalent adjustment	**1,369**		1,683		1,563	
Tax equivalent net interest income	**$ 31,488**	**15.03%**	$ 27,374	21.61%	$ 22,509	18.96%

Table 2 identifies increases and decreases in tax equivalent net interest income to either changes in average volume or to changes in average rates for interest-earning assets and interest-bearing liabilities. Numerous and simultaneous balance and rate changes occur during the year. The amount of change that is not due solely to volume or rate is allocated proportionally to both.

Table 2. Rate-Volume Analysis of Net Interest Income

	2008 Compared to 2007 Increase (Decrease) due to:			2007 Compared to 2006 Increase (Decrease) due to:		
	Volume	Rate	Net	Volume	Rate	Net
			(Dollars in thousands)			
Interest earned on:						
Interest-bearing obligations in other banks and Federal funds sold	**$ (231)**	**$ (107)**	**$ (338)**	$ (212)	$ 6	$ (206)
Investment securities						
Taxable	**(968)**	**(484)**	**(1,452)**	108	858	966
Nontaxable	**(145)**	**(60)**	**(205)**	317	(75)	242
Loans:						
Commercial	**4,806**	**(5,341)**	**(535)**	5,164	149	5,313
Mortgage	**(1,144)**	**(249)**	**(1,393)**	(219)	450	231
Consumer	**766**	**(488)**	**278**	1,841	318	2,159
Loans	**4,428**	**(6,078)**	**(1,650)**	6,786	917	7,703

Total net change in interest income	**3,084**	**(6,729)**	**(3,645)**	6,999	1,706	8,705
Interest expense on:						
Interest-bearing checking	**30**	**(187)**	**(157)**	4	8	12
Money market deposit accounts	**(996)**	**(4,268)**	**(5,264)**	2,716	(613)	2,103
Savings accounts	**(39)**	**(334)**	**(373)**	(8)	139	131
Time deposits	**465**	**(1,560)**	**(1,095)**	592	659	1,251
Securities sold under agreements to repurchase	**(264)**	**(2,243)**	**(2,507)**	572	44	616
Short-term borrowings	**204**	**(125)**	**79**	66	6	72
Long-term debt	**1,895**	**(337)**	**1,558**	(308)	(37)	(345)
Total net change in interest expense	**1,295**	**(9,054)**	**(7,759)**	3,634	206	3,840
Increase in net interest income	**$ 1,789**	**$ 2,325**	**$ 4,114**	$ 3,365	$ 1,500	$ 4,865

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No accruing loans are included in the loan balances. All nontaxable interest income has been adjusted to a tax-equivalent basis, using a tax rate of 34%.

Table 3. Analysis of Net Interest Income

	2008			2007			2006		
	Average Balance	Income or Expense	Average Yield/rate	Average Balance	Income or Expense	Average Yield/rate	Average Balance	Income or Expense	Avera Yield/r
				(Dollars in thousands)					
est-earning assets:									
est-bearing obligations her banks and federal s sold	**$ 1,316**	**$ 43**	**3.27%**	$ 7,266	$ 381	5.24%	$ 11,302	$ 587	5.1
stment securities									
ble	**114,290**	**5,448**	**4.77%**	134,079	6,900	5.15%	131,726	5,934	4.5
taxable	**46,193**	**3,061**	**6.63%**	48,362	3,266	6.75%	43,688	3,024	6.9
ns:									
mercial	**404,076**	**24,724**	**6.12%**	333,514	25,259	7.57%	265,321	19,946	7.5
tgage	**83,708**	**5,381**	**6.43%**	101,375	6,774	6.68%	104,813	6,543	6.2
sumer	**132,571**	**8,868**	**6.69%**	121,361	8,590	7.08%	95,180	6,431	6.7
ns	**620,355**	**38,973**	**6.28%**	556,250	40,623	7.30%	465,314	32,920	7.0
l interest-earning assets	**782,154**	**47,525**	**6.08%**	745,957	51,170	6.86%	652,030	42,465	6.5
r assets	**69,242**			68,665			57,777		
l assets	**$ 851,396**			$ 814,622			$ 709,807		
est-bearing liabilities:									
osits:									
est-bearing checking	**$ 83,128**	**245**	**0.29%**	$ 76,923	402	0.52%	$ 76,230	390	0.5
ey Market deposit unts	**209,028**	**4,195**	**2.01%**	236,533	9,459	4.00%	169,560	7,356	4.3
ngs	**48,860**	**290**	**0.59%**	52,091	663	1.27%	52,881	532	1.0
e	**174,191**	**6,296**	**3.61%**	163,364	7,391	4.52%	149,618	6,140	4.1
l interest-bearing sits	**515,207**	**11,026**	**2.14%**	528,911	17,915	3.39%	448,289	14,418	3.2
rities sold under ements to repurchase	**75,238**	**1,412**	**1.88%**	81,077	3,919	4.83%	69,231	3,303	4.7
t- term borrowings	**11,628**	**200**	**1.72%**	2,386	121	5.08%	1,075	49	4.6
g- term debt	**78,381**	**3,399**	**4.34%**	35,654	1,841	5.16%	41,601	2,186	5.2
	680,454	**16,037**	**2.36%**	648,028	23,796	3.67%	560,196	19,956	3.5

l interest-bearing lities									
nterest-bearing deposits	**84,189**			84,029			79,154		
r liabilities	**8,553**			9,385			6,918		
eholders equity	**78,200**			73,180			63,539		
l liabilities and eholders equity	**$ 851,396**			$ 814,622			$ 709,807		
equivalent net interest me/Net interest margin		**31,488**	**4.03%**		27,374	3.67%		22,509	3.4
equivalent adjustment		**(1,369)**			(1,683)			(1,563)	
nterest income		**$ 30,119**			$ 25,691			$ 20,946	

All amounts have been adjusted to a tax-equivalent basis using a tax rate of 34%. Investments include the average unrealized gains or losses. Dividend income is reported as taxable income, but is adjusted for the dividend

received deduction. Loan balances include nonaccruing loans, loans held for sale, and are gross of the allowance for loan losses.

Provision for Loan Losses

For the second consecutive year, the Corporation determined that is was necessary to increase its provision for loan loss expense. The provision expense in 2008 was $1.2 million compared to $990 thousand in 2007. The increase was recorded as a result of Management s analysis of the adequacy of the allowance for loan losses in light of continued loan growth, increased charge-offs and the increasing credit and liquidity stress on the economy. The Bank had $1.2 million of net loan charge-offs in 2008 compared to net charge-offs of $479 thousand in 2007. Management performs a monthly analysis of the loan portfolio considering current economic conditions and other relevant factors to determine the adequacy of the allowance for loan losses and the provision for loan losses. For more information, refer to the Asset Quality discussion and Tables 11, 12 and 13.

Noninterest Income

2008 versus 2007

The Corporation s total noninterest income fell during 2008, primarily the result of falling asset valuations that resulted in write-downs on mortgage servicing rights, other than temporary impairment on investment securities and its investment in American Home Bank, N.A. Fee income from the Bank s Investment and Trust Services department fell by $629 thousand to $3.5 million in 2008 compared to $4.1 million in 2007. This decrease was due primarily to two estate settlements that occurred in 2007 that produced $617 thousand of nonrecurring fee income that year. These estates represented the largest settlements ever handled by the department and contributed to the year over year decrease in fee income. After accounting for these settlements, fee income from Investment and Trust Services was virtually flat year over year despite continued growth in accounts. As the value of assets under management fell during the year due to market conditions, fee revenue fell as well. Low asset values will continue to constrain fee income growth; however, the addition of approximately $62 million of new assets under management from the acquisition of Community near the end of 2008 should serve to provide additional fee income in the future.

Loan service charges increased by approximately 9% from $822 thousand in 2007 to $897 thousand in 2008. A nonrecurring commercial loan prepayment fee of $170 thousand was recorded in 2007. This is an unusually large fee and has somewhat tempered the true growth in 2008 commercial fees and service charges. Mortgage fees and service charges increased $61 thousand in 2008 as a result of a new mortgage program that began in the 4th quarter of 2007. As part of this program, the Bank serves as a third party originator of mortgage loans and can provide a wider range of mortgage products. In return, the Bank collects a fee for this service and is not responsible for funding or servicing the loans. The Bank expects to place most of its mortgage origination business through this program and 2009 is off to a strong start as mortgage rates have dropped significantly and refinance activity has been strong. Consumer loan fees and service charges increased approximately 13% during 2008 fueled primarily by an increase in the Bank s consumer debt protection product that provides debt protection in the event of death, disability or involuntary unemployment.

Mortgage banking activities produced a loss of $335 thousand in 2008 compared to income of $422 thousand in 2007, a negative swing of $758 thousand. Two factors contributed to this large swing. First, gains recognized on the sale of mortgage loans decreased by $159 thousand in 2008 as the Bank originated fewer loans for sale in the secondary market. Fewer loans were originated for sale due to a slow down in purchase and refinance activity and the implementation of the Bank s new mortgage origination program that eliminates its sales activities. Secondly, the Bank s mortgage servicing rights portfolio recorded net impairment charges (i.e., expense) of $500 thousand in 2008, while impairment charges of $98 thousand were reversed (i.e., income) in 2007. Mortgage servicing rights (MSR) represent the Bank s rights to receive future fee income from servicing mortgages that it originated and sold in the

secondary market. MSR are measured and carried at the lower of cost or market value and the value fell in 2008 as rates fell and prepayment assumptions were accelerated. While the Bank does not expect to originate and sell mortgages with servicing retained in the future, it will retain the existing servicing portfolio until those loans are paid-off. See Note 9 of the accompanying consolidated financial statements for additional information on mortgage servicing rights.

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Deposit fees were $2.6 million in 2008 compared to $2.4 million in 2007. Account analysis fees increased $129 thousand year over year as lower market interest rates produced lower earnings credits for commercial account analysis customers and therefore, higher account charges. Retail overdraft fees also increased by $64 thousand (12%) in 2008. Income from the Bank s retail and commercial overdraft protection programs remained unchanged at $1.1 million, year over year.

Other service charges and fees decreased slightly to $1.2 million in 2008 from $1.3 million in 2007. Debit card fees increased by approximately 9% ($59 thousand) during the year, but this increase was more than offset by a nonrecurring fee of $86 thousand in 2007 that was not recorded in 2008. The Bank also recorded a decrease in fee income it earns from a third party provider of check services as the vendor reduced its payment schedule in 2008.

The Bank previously had an investment in American Home Bank, N.A. (AHB) common stock that represented an ownership of approximately 21% of the voting stock of AHB. This investment was accounted for utilizing the equity method of accounting. Under the equity method of accounting, the Corporation recorded a loss of $143 thousand in 2008 and income of $49 thousand in 2007. On December 31, 2008 First Chester County Corporation (FCEC) acquired the common stock of AHB. The acquisition was structured so that shareholders of AHB would receive a combination of cash ($11 per share) and FCEC common stock (0.7 shares of FCEC for each share of AHB) subject to allocation provisions defined in the merger agreement. At the time of the merger announcement, FCEC common stock price was $15.25 per share. After the merger, the Corporation s ownership of FCEC was less than 5% and it would no longer account for this investment using the equity method. On the merger date, the Corporation discontinued the equity method of accounting on the AHB investment and recorded the FCEC transaction with 58,000 shares exchanged at $11.00 per share cash ($638 thousand) and the remaining AHB shares (299,000) exchanged for 209,000 FCEC common shares at the December 31, 2008 fair value of $10.00 per common share. As a result of this transaction, the Corporation recorded a loss of $1.2 million. For 2008, the Corporation recorded a total loss of $1.3 million from its investment in AHB, comprised of $1.2 million loss from the asset exchange and a $143 thousand loss recognized by the equity method of accounting. At December 31, 2008, the Corporation recorded its investment in FCEC common stock on the balance sheet as Investment securities available for sale.

The Corporation also recorded write-downs of $888 thousand on eleven equity securities that it considered to be other than temporarily impaired. All of the equity securities were national or regional bank stocks. In 2007, impairment charges totaled $104 thousand. Net securities gains were $164 thousand in 2008 compared to $284 thousand in 2007. The net gains in 2008 were comprised of a combination of gains and losses on both debt and equity securities.

2007 versus 2006:

Excluding securities gains, the Corporation recorded $9.9 million of noninterest income in 2007, a 22.3% increase over 2006. This increase follows an increase in noninterest income of 19.5% in 2006. Every category of noninterest income increased over 2006 except for one that decreased due to impairment write-downs on equity securities in 2007 and a nonrecurring event in 2006. The Bank s Investment and Trust Services Department takes a comprehensive approach to meeting the financial needs of its customers by offering everything from estate planning to personal investment planning and insurance. These services helped the Investment and Trust Services Department record $4.1 million in fee income in 2007 an increase of $816 thousand year over year. Contributing to the large increase was $617 thousand of fee income from the settlement of two estates. The two estates were related and represented the largest settlement ever handled by the department. The estates required several years of work to settle, including the liquidation of unique assets with limited marketability. Trust assets under management at December 31, 2007 declined 5.6% from the prior year-end. This decline was largely attributable to a short-term deposit into a custody account near year-end 2006 that was subsequently withdrawn and the distribution of the above referenced estates.

Loan service charges increased approximately 31% over the prior year, despite the fact that most recurring loan fees remained flat year over year. However, the consumer debt protection product that provides debt protection in the event of death, disability or involuntary unemployment continued to be popular and fee income from this product was $17 thousand higher in 2007 than in 2006. A nonrecurring loan fee of $170 thousand was recorded from a commercial loan payoff. This fee offset a prepayment fee paid to the Federal Home Loan Bank of Pittsburgh

(FHLB) to payoff an FHLB advance that funded the commercial loan. The FHLB fee is included in noninterest expense.

The Bank is active in residential mortgage banking activities, primarily the sale of originated mortgage loans and the servicing of these mortgage loans. In 2007, mortgage-banking fees increased $143 thousand to $422 thousand. Fee income from servicing loans increased $28 thousand, but was partially offset by a decrease of $26 thousand from gains on mortgage loan sales. Impairment charges on the Bank s mortgage servicing rights (MSR) decreased $187 thousand in 2007. This line item moved from an impairment charge (i.e., expense) of $89 thousand in 2006 to an impairment recovery (i.e., income) of $98 thousand in 2007. The Bank values its MSR portfolio quarterly and its value usually changes in the opposite direction of mortgage interest rates. For the first two quarters of 2007, the Bank reversed previously recorded impairment charges, but in the last two quarters, the Bank recorded impairment charges as rates fell. In 2008, the Bank will begin a new mortgage program that will expand its offering of mortgage products. The Bank expects a significant percent of its 2008 mortgage production to be originated from this program. This will result in a decrease in fees from mortgage sales but an increase in fee income from originations. The Bank also expects to originate and release these loans without retaining the servicing rights and therefore, the Bank s MSRs should decrease over time as no new servicing rights are expected to be booked. See Note 9 of the accompanying financial statements for additional information on mortgage servicing rights.

Deposit service charges and fees increased year over year, led by a $296 thousand increase in the Bank s Courtesy Coverage product, a retail overdraft protection product. The Bank continued to expand this product to the small business market and as a result, saw an increase of approximately 123% in fees from the business Courtesy Coverage product. Commercial account analysis fees also increased $32 thousand in 2007 as part of the Bank s commercial cash management product that continues to attract new accounts.

Other fees and service charges totaled $1.3 million in 2007, up from $1.0 million in 2006. Debit cards continue to be a popular method of electronic payment and as a result, fee income from this product increased $126 thousand. The Bank also recorded $86 thousand from past due fees owed to the Bank by a vendor.

The Corporation has an investment in American Home Bank, N.A, (AHB). The Corporation owns approximately 21% of the voting stock of this bank and accounts for this investment utilizing the equity method of accounting. In 2007, the Corporation recorded income of $49 thousand compared to a loss of $21 thousand in 2006.