ORRSTOWN FINANCIAL SERVICES INC
Form 10-K
March 15, 2019
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-K

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2018

Commission file number: 001-34292

ORRSTOWN FINANCIAL SERVICES, INC.
(Exact Name of Registrant as Specified in its Charter)

Pennsylvania (State or Other Jurisdiction of Incorporation or Organization)	**23-2530374** (I.R.S. Employer Identification No.)
77 East King Street, P. O. Box 250, Shippensburg, Pennsylvania (Address of Principal Executive Offices)	**17257** (Zip Code)

Registrant’s Telephone Number, Including Area Code: (717) 532-6114
Securities registered pursuant to Section 12(b) of the Act:

Title of Each Class	Name of Each Exchange on Which Registered
Common Stock, No Par Value	**The NASDAQ Capital**

Market

Securities registered pursuant to Section 12(g) of the Act: None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes ¨ No x
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 ¨ No x
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 period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No ¨
Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit such files). Yes x No ¨
Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§229.405 of this chapter) 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. x
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 "accelerated filer," "large accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer	¨	Accelerated filer	x
Non-accelerated filer	¨ (Do not check if a smaller reporting company)	Smaller reporting company	x
		Emerging growth company	¨

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act. ¨

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act.). Yes ¨ No x
The aggregate market value of the voting stock held by non-affiliates computed by reference to the price at which the common stock was last sold as of the last business day of the Registrant's most recently completed second fiscal quarter, was approximately $207.4 million. For purposes of this calculation, the term "affiliate" refers to all directors and executive officers of the registrant, and all persons beneficially owning more than 5% of the registrant's common stock.
Number of shares outstanding of the Registrant's common stock as of February 28, 2019: 9,481,969.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Proxy Statement for the 2019 Annual Meeting of Shareholders are incorporated by reference in Part III of this Form 10-K.

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Glossary of Defined Terms

The following terms may be used throughout this Report, including the consolidated financial statements and related notes.

Term	Definition
ALL	Allowance for loan losses
AFS	Available for sale
AOCI	Accumulated other comprehensive income (loss)
ASC	Accounting Standards Codification
ASU	Accounting Standards Update
Bank	Orrstown Bank, the commercial banking subsidiary of Orrstown Financial Services, Inc.
BHC Act	Bank Holding Company Act of 1965
CDI	Core deposit intangible
CET1	Common Equity Tier 1
CMO	Collateralized mortgage obligation
Company	Orrstown Financial Services, Inc. and subsidiaries (interchangeable with "Orrstown" below)
CFPB	Consumer Financial Protection Bureau
CRA	Community Reinvestment Act
Dodd-Frank Act	Dodd-Frank Wall Street Reform and Consumer Protection Act
EPS	Earnings per common share
ERM	Enterprise risk management
Exchange Act	Securities Exchange Act of 1934, as amended
FASB	Financial Accounting Standards Board
FDIA	Federal Deposit Insurance Act
FDIC	Federal Deposit Insurance Corporation
FHC	Financial holding company
FHLB	Federal Home Loan Bank
FRB	Board of Governors of the Federal Reserve System
GAAP	Accounting principles generally accepted in the United States of America

GLB Act	Gramm-Leach-Bliley Act
GSE	United States government-sponsored enterprise
Hamilton	Hamilton Bancorp, Inc., and its wholly-owned banking subsidiary, Hamilton Bank
IRC	Internal Revenue Code of 1986, as amended
LHFS	Loans held for sale
MBS	Mortgage-backed securities
Mercersburg	Mercersburg Financial Corporation and its wholly-owned banking subsidiary, First Community Bank of Mercersburg (acquired October 1, 2018)
MPF Program	Mortgage Partnership Finance Program
MSR	Mortgage servicing right
NIM	Net interest margin
OCI	Other comprehensive income (loss)
OFA	Orrstown Financial Advisors, a division of the Bank that provides investment and brokerage services
OREO	Other real estate owned (foreclosed real estate)
Orrstown	Orrstown Financial Services, Inc. and subsidiaries
OTTI	Other-than-temporary impairment
Parent Company	Orrstown Financial Services, Inc., the parent company of Orrstown Bank and Wheatland Advisors, Inc.
2011 Plan	2011 Orrstown Financial Services, Inc. Stock Incentive Plan
PCI loans	Purchased credit impaired loans
Repurchase Agreements	Securities sold under agreements to repurchase
SEC	Securities and Exchange Commission
Securities Act	Securities Act of 1933, as amended
TDR	Troubled debt restructuring
U.S.	United States of America
Wheatland	Wheatland Advisors, Inc., the Registered Investment Advisor subsidiary of Orrstown Financial Services, Inc.

Unless the context otherwise requires, the terms “Orrstown,” “we,” “us,” “our,” and “Company” refer to Orrstown Financial Services, Inc. and its subsidiaries.

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PART I

Forward-Looking Statements:

Certain statements appearing herein which are not historical in nature are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. In addition, we may make other written and oral communications, from time to time, that contain such statements. Such forward-looking statements refer to a future period or periods, reflecting our current beliefs as to likely future developments, and use words like “may,” “will,” “expect,” “estimate,” “anticipate” or similar terms. Forward-looking statements are statements that include projections, predictions, expectations, or beliefs about events or results or otherwise are not statements of historical facts, including, but not limited to, statements related to new business development, new loan opportunities, growth in the balance sheet and fee based revenue lines of business, merger and acquisition activity, reducing risk assets, and mitigating losses in the future. Actual results and trends could differ materially from those set forth in such statements and there can be no assurances that we will achieve the desired level of new business development and new loans, growth in the balance sheet and fee based revenue lines of business, successful merger and acquisition activity, continue to reduce risk assets or mitigate losses in the future. Factors that could cause actual results to differ from those expressed or implied by the forward-looking statements include, but are not limited to, the following: ineffectiveness of the Company’s business strategy due to changes in current or future market conditions; the effects of competition, including industry consolidation and development of competing financial products and services; the integration of the Company's strategic acquisitions; the inability to fully achieve expected savings, efficiencies or synergies from mergers and acquisitions, or taking longer than estimated for such savings, efficiencies and synergies to be realized; changes in laws and regulations; interest rate movements; changes in credit quality; inability to raise capital, if necessary, under favorable conditions; volatilities in the securities markets; deteriorating economic conditions; expenses associated with pending litigation and legal proceedings; and other risks and uncertainties.

This Annual Report on Form 10-K includes forward-looking statements. With respect to all such forward-looking statements, you should review our Risk Factors discussion in Item 1A, our Critical Accounting Policies and Cautionary Statement About Forward-Looking Statements sections included in Item 7, and Note 21, Contingencies, in the Notes To Consolidated Financial Statements included in Item 8 of this Annual Report on Form 10-K. We encourage readers of this report to understand forward-looking statements to be strategic objectives rather than absolute targets of future performance. Forward-looking statements speak only as of the date they are made. We do not intend to update publicly any forward-looking statements to reflect circumstances or events that occur after the date the forward-looking statements are made.

ITEM 1 – BUSINESS

Orrstown Financial Services, Inc., a Pennsylvania corporation, is the holding company for its wholly-owned subsidiaries Orrstown Bank and Wheatland Advisors, Inc. The Company’s principal executive offices are located at 77 East King Street, Shippensburg, Pennsylvania, 17257, with additional executive and administrative offices at 4750 Lindle Road, Harrisburg, Pennsylvania, 17111. The Parent Company was organized on November 17, 1987, for the purpose of acquiring the Bank and such other banks and bank-related activities as are permitted by law and desirable. The Company provides banking and bank-related services through branches located in south central Pennsylvania, principally in Berks, Cumberland, Dauphin, Franklin, Lancaster, Perry and York Counties and in Washington County, Maryland. Wheatland was acquired in December 2016 and provides services as a registered investment advisor through its office in Lancaster County, Pennsylvania.

The Company files periodic reports with the SEC in the form of quarterly reports on Form 10-Q, annual reports on Form 10-K, annual proxy statements and current reports on Form 8-K for any significant events that may arise during the year. Copies of these reports, and any amendments to such reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended (the “Exchange Act”), may be obtained free of charge through the SEC’s Internet site at www.sec.gov or by accessing the Company’s website at www.orrstown.com as soon as reasonably practicable after such reports are electronically filed with, or furnished to, the SEC. Information on our website shall not be considered a part of this Annual Report on Form 10-K.

Recent Merger and Acquisition Activity

On October 1, 2018, the Company expanded its presence in Franklin County, Pennsylvania, with the completion of its acquisition of Mercersburg Financial Corporation and the merger of its banking subsidiary, First Community Bank of Mercersburg, with and into Orrstown Bank.

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On October 23, 2018, the Company announced it had entered into an agreement and plan of merger with Hamilton Bancorp, Inc., the holding company for Hamilton Bank, based in Towson, Maryland. The merger is expected to close in the second quarter of 2019, subject to receipt of regulatory approvals, the approval of Hamilton's shareholders, and the satisfaction of other customary closing conditions. If completed, the Hamilton acquisition will expand the Company's presence into the greater Baltimore, Maryland, market.

Business

The Bank was originally organized in 1919 as a state-chartered bank. On March 8, 1988, in a bank holding company reorganization transaction, the Parent Company acquired 100% ownership of the Bank.

The Parent Company's primary activity consists of owning and supervising its subsidiaries, the Bank and Wheatland. Day-to-day management is conducted by its officers, who are also Bank officers. The Parent Company has historically derived most of its income through dividends from the Bank. At December 31, 2018, the Company had total assets of $1,934,388,000, total deposits of $1,558,756,000 and total shareholders' equity of $173,433,000.

The Parent Company has no employees. Its 10 officers are employees of the Bank. On December 31, 2018, the Bank and Wheatland combined had 367 full-time and 19 part-time employees.

The Bank is engaged in the commercial banking and trust business as authorized by the Pennsylvania Banking Code of 1965. This involves accepting demand, time and savings deposits, and granting loans. The Bank holds commercial, residential, consumer and agribusiness loans primarily in its market areas of Cumberland, Dauphin, Franklin, Lancaster, Perry and York Counties in Pennsylvania; Washington County, Maryland; and in contiguous counties. The concentrations of credit by type of loan are included in Note 4, Loans and Allowance for Loan Losses, to the Consolidated Financial Statements under Part II, Item 8, "Financial Statements and Supplementary Data." The Bank maintains a diversified loan portfolio and evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Bank upon the extension of credit, is based on management's credit evaluation of the customer pursuant to collateral standards established in the Bank's credit policies and procedures.

Wheatland supplements the Bank's trust and wealth management group and is anticipated to provide opportunities for future growth in these areas.

Lending

All secured loans are supported with appraisals or evaluations of collateral. Business equipment and machinery, inventories, accounts receivable, and farm equipment are considered appropriate security, provided borrowers meet acceptable standards for liquidity and marketability. Loans secured by real estate generally do not exceed 90% of the appraised value of the property. Loan to collateral values are monitored as part of the loan review process, and appraisals are updated as deemed appropriate under the circumstances.

Commercial Lending

A majority of the Company's loan assets are loans for business purposes. Approximately 62% of the loan portfolio is comprised of commercial loans. The Bank makes commercial real estate, equipment, working capital and other commercial purpose loans as required by the broad range of borrowers across the Bank's various markets.

The Bank's credit policy dictates the underwriting requirements for the various types of loans the Bank would extend to borrowers. The policy covers such requirements as debt coverage ratios, advance rates against different forms of collateral, loan-to-value ratios and maximum term.

Consumer Lending

The Bank provides home equity loans, home equity lines of credit and other consumer loans primarily through its branch network and customer call center. A large majority of the consumer loans are secured by either a first or second lien position on the borrower's primary residential real estate. The Bank requires a loan-to-value ratio of no greater than 90% of the value of the real estate being taken as collateral. We also, at times, purchase consumer loans to help diversify credit risk in our loan portfolio.

Residential Lending

The Bank provides residential mortgages throughout its various markets through a network of mortgage loan officers. A majority of the residential mortgages originated are sold to secondary market investors, primarily Wells Fargo, Fannie Mae and

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the FHLB of Pittsburgh. All mortgages, regardless of being sold or held in the Bank's portfolio, are generally underwritten to secondary market industry standards for prime mortgages. The Bank generally requires a loan-to-value ratio of no greater than 80% of the value of the real estate being taken as collateral, without the borrower obtaining private mortgage insurance.

Loan Review

The Bank has a loan review policy and program which is designed to identify and monitor risk in the lending function. The ERM Committee, comprised of executive officers and loan department personnel, is charged with the oversight of overall credit quality and risk exposure of the Bank's loan portfolio. This includes the monitoring of the lending activities of all Bank personnel with respect to underwriting and processing new loans and the timely follow-up and corrective action for loans showing signs of deterioration in quality. The loan review program provides the Bank with an independent review of the Bank's commercial loan portfolio on an ongoing basis. Generally, consumer and residential mortgage loans are included in Pass categories unless a specific action, such as extended delinquencies, bankruptcy, repossession, or death of the borrower occurs, which heightens awareness as to a possible credit event. Internal loan reviews are completed annually on all commercial relationships with a committed loan balance in excess of $500,000, which includes confirmation of risk rating by an independent credit officer. In addition, all relationships greater than $250,000 rated Substandard, Doubtful or Loss are reviewed quarterly and corresponding risk ratings are reaffirmed by the Bank's Problem Loan Committee, with subsequent reporting to the ERM Committee.

The Bank outsources its independent loan review to a third-party provider, which monitors and evaluates loan customers on a quarterly basis utilizing risk-rating criteria established in the credit policy in order to identify deteriorating trends and detect conditions which might indicate potential problem loans. The results of the third-party loan review are reported quarterly to the ERM Committee for approval. The loan ratings provide the basis for evaluating the adequacy of the ALL.

Investment Services

Through its trust department, the Bank renders services as trustee, executor, administrator, guardian, managing agent, custodian, investment advisor, and other fiduciary activities authorized by law under the trade name "Orrstown Financial Advisors." OFA offers retail brokerage services through a third-party broker/dealer arrangement with Cetera Advisor Networks LLC. Wheatland also offers investment advisor services as a registered investment advisor. At December 31, 2018, assets under management by OFA and Wheatland totaled $1,330,595,000.

Regulation and Supervision

The Parent Company is a bank holding company registered with the FRB and has elected status as a financial holding company. As a registered bank holding company and FHC, the Company is subject to regulation under the Bank Holding Company Act of 1956 and to inspection, examination, and supervision by the FRB.

The Bank is a Pennsylvania-chartered commercial bank and a member of the FRB. The operations of the Bank are subject to federal and state statutes applicable to banks chartered under Pennsylvania law, to FRB member banks and to banks whose deposits are insured by the FDIC. The Bank's operations are also subject to regulations of the Pennsylvania Department of Banking and Securities, the FRB and the FDIC.

Wheatland is subject to periodic examination by the SEC.

Several of the more significant regulatory provisions applicable to bank holding companies and banks to which the Company and the Bank are subject are discussed below, along with certain regulatory matters concerning the Company and the Bank. To the extent that the following information describes statutory or regulatory provisions, such information is qualified in its entirety by reference to the particular statutes or regulations. Any change in applicable law or regulation may have a material effect on the business and prospects of the Company and the Bank.

Financial and Bank Holding Company Activities

As an FHC, we are permitted to engage, directly or through subsidiaries, in a wide variety of activities that are financial in nature or are incidental or complementary to a financial activity, in addition to all of the activities otherwise allowed to us.

As an FHC, the Company is generally subject to the same regulation as other bank holding companies, including the reporting, examination, supervision and consolidated capital requirements of the FRB. To preserve our FHC status, we must remain well-capitalized and well-managed and ensure that the Bank remains well-capitalized and well-managed for regulatory purposes and earns “satisfactory” or better ratings on its periodic Community Reinvestment Act examinations. An FHC ceasing to meet these standards is subject to a variety of restrictions, depending on the circumstances.

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If the Parent Company or the Bank are either not well-capitalized or not well-managed, the Parent Company or the Bank must promptly notify the FRB. Until compliance is restored, the FRB has broad discretion to impose appropriate limitations on an FHC's activities. If compliance is not restored within 180 days, the FRB may ultimately require the FHC to divest its depository institutions or in the alternative, to discontinue or divest any activities that are permitted only to non-FHC bank holding companies.

If the FRB determines that an FHC or its subsidiaries do not satisfy the CRA requirements, the potential restrictions are different. In that case, until all the subsidiary institutions are restored to at least "satisfactory" CRA rating status, the FHC may not engage, directly or through a subsidiary, in any of the additional activities permissible under the BHC Act nor make additional acquisitions of companies engaged in the additional activities. However, completed acquisitions and additional activities and affiliations previously begun are left undisturbed, as the BHC Act does not require divestiture for this type of situation.

Federal Financial Regulatory Reform

The Dodd-Frank Wall Street Reform and Consumer Protection Act, enacted in 2010, substantially increased regulatory oversight and enforcement and imposed additional costs and risks on the operations of financial holding companies and banks.

The Dodd-Frank Act materially changed the regulation of financial institutions and the financial services industry and created a framework for regulatory reform. The Dodd-Frank Act and the regulations thereunder, some of which are still being drafted and implemented, include provisions affecting large and small financial institutions alike, including several provisions that affect the regulation of community banks and bank holding companies.

The Dodd-Frank Act, among other things, imposed new capital requirements on bank holding companies; changed the base for FDIC insurance assessments to a bank's average consolidated total assets minus average tangible equity, rather than upon its deposit base; permanently raised the current standard deposit insurance limit to $250,000; and expanded the FDIC's authority to raise insurance premiums. The legislation also called for the FDIC to raise its ratio of reserves to deposits from 1.15% to 1.35% for deposit insurance purposes by September 30, 2020 and to "offset the effect" of increased assessments on insured depository institutions with assets of less than $10 billion.

The Dodd-Frank Act also included provisions that affect corporate governance and executive compensation at all publicly-traded companies and allows financial institutions to pay interest on business checking accounts. The legislation also restricts proprietary trading by banking organizations, places restrictions on the owning or sponsoring of hedge and private equity funds, and regulates the derivatives activities of banks and their affiliates. The Dodd-Frank Act established the Financial Stability Oversight Council to identify threats to the financial stability of the U.S., promote market discipline, and respond to emerging threats to the stability of the U.S. financial system.

The Dodd-Frank Act also established the Consumer Financial Protection Bureau as an independent entity funded by the FRB. The CFPB has broad rulemaking, supervisory and enforcement authority over consumer financial products and services, including deposit products, residential mortgages, home-equity loans and credit cards. The CFPB's rules contain provisions on mortgage-related matters such as steering incentives, and determinations as to a borrower's ability to repay, loan servicing, and prepayment penalties. The CFPB has primary examination and enforcement authority over banks with over $10 billion in assets as to consumer financial products.

One of the announced goals of the CFPB is to bring greater consumer protection to the mortgage servicing market. The CFPB has defined a "qualified mortgage" for purposes of the Dodd-Frank Act, and set standards for mortgage lenders to determine whether a consumer has the ability to repay the mortgage. It has also issued regulations affording safe harbor legal protections for lenders making qualified loans that are not "higher priced." The CFPB's regulations contain new mortgage servicing rules applicable to the Bank, which took effect in 2014. Changes affect notices to be given to consumers as to delinquency, foreclosure alternatives, modification applications, interest rate adjustments and options for avoiding "force-placed" insurance. Servicers are prohibited from processing foreclosures when a loan modification is pending, and must wait until a loan is more than 120 days delinquent before initiating a foreclosure action.

The servicer must provide direct and ongoing access to its personnel, and provide prompt review of any loss mitigation application. Servicers must maintain accurate and accessible mortgage records for the life of a loan and until one year after the loan is paid off or transferred.

The Bank presently services 5,000 or fewer mortgage loans which it owns or originated, so it is considered a "Small Servicer" and is exempt from certain parts of the mortgage servicing rules. The mortgage servicing requirements applicable to the Bank's servicing operations under the new mortgage servicing rules are: adjustable rate mortgage interest rate adjustment notices; prompt payment crediting and payoff statements; limits on force-placed insurance; responses to written information requests and complaints of errors; and loss mitigation with regard to the first notice or filing for a foreclosure and no foreclosure proceedings if a borrower is performing pursuant to the terms of a loss mitigation agreement.

Federal Deposit Insurance

The Bank's deposits are insured to applicable limits by the FDIC. The maximum deposit insurance amount is $250,000 under the Dodd-Frank Act.

The FDIC is required by the Dodd-Frank Act to return its insurance reserve ratio to 1.35% no later than September 30, 2020. When the fund reached 1.15%, banks larger than $10 billion in assets were required to assume the burden of bringing the fund to 1.35%. In 2016, the fund reached the 1.15% ratio and smaller banks' assessments decreased. In September 2018, the fund reached 1.36%, exceeding the statutorily required minimum reserve ratio of 1.35%. FDIC regulations provide for two changes to deposit insurance assessments upon reaching the minimum: (1) surcharges on insured large banks will cease; and (2) small banks will receive assessment credits for the portion of their assessments that contributed to the growth in the reserve ratio from between 1.15 percent and 1.35 percent, to be applied when the reserve ratio is at or above 1.38%. At December 31, 2018, the reserve ratio did not exceed 1.38 percent.

As required by the Dodd-Frank Act, the FDIC changed its calculation of FDIC insurance premiums. Institutions are now assigned a base rate using their examination ratings, which is then adjusted based on their leverage ratio, net income before taxes to total assets ratio, nonperforming loans and leases to gross assets ratio, other real estate owned to gross assets ratio, loan mix index, and one-year asset growth rate. The result is then further adjusted to reflect its level of unsecured debt issued, the level of unsecured depository institution debt it owns, and the level of brokered deposits (excluding reciprocal deposits) it has issued above regulatory minimums.

If the FDIC is appointed conservator or receiver of a bank upon the bank's insolvency or the occurrence of other events, the FDIC may sell some, part or all of a bank's assets and liabilities to another bank or repudiate or disaffirm most types of contracts to which the bank was a party if the FDIC believes such contracts are burdensome. In resolving the estate of a failed bank, the FDIC as receiver will first satisfy its own administrative expenses, and the claims of holders of U.S. deposit liabilities also have priority over those of other general unsecured creditors.

Liability for Banking Subsidiaries

Under the Dodd-Frank Act and applicable FRB policy, a bank holding company is expected to act as a source of financial and managerial strength to each of its subsidiary banks and to commit resources to their support. This support may be required at times when the bank holding company may not have the resources to provide it. Similarly, under the cross-guarantee provisions of the Federal Deposit Insurance Act (the "FDIA"), the FDIC can hold any FDIC-insured depository institution liable for any loss suffered or anticipated by the FDIC in connection with the "default" of a commonly controlled FDIC-insured depository institution; or any assistance provided by the FDIC to a commonly controlled FDIC-insured depository institution "in danger of default."

Pennsylvania Banking Law

The Pennsylvania Banking Code ("Banking Code") contains detailed provisions governing the organization, location of offices, rights and responsibilities of directors, officers, and employees, as well as corporate powers, savings and investment operations and other aspects of the Bank and its affairs. The Banking Code delegates extensive rule-making power and administrative discretion to the PDB so that the supervision and regulation of state chartered banks may be flexible and readily responsive to changes in economic conditions and in savings and lending practices. The FDIA, however, prohibits state chartered banks from making new investments, loans, or becoming involved in activities as principal and equity investments which are not permitted for national banks unless the FDIC determines the activity or investment does not pose a significant risk of loss to the Deposit Insurance Fund; and the bank meets all applicable capital requirements. Accordingly, the additional operating authority provided to the Bank by the Banking Code is significantly restricted by the FDIA.

Dividend Restrictions

The Parent Company's funding for cash distributions to its shareholders is derived from a variety of sources, including cash and temporary investments. One of the principal sources of those funds has historically been dividends received from the Bank. Various federal and state laws limit the amount of dividends the Bank can pay to the Parent Company without regulatory approval. In addition, federal bank regulatory agencies have authority to prohibit the Bank from engaging in an unsafe or unsound practice in conducting its business. The payment of dividends, depending upon the financial condition of the bank in question, could be deemed to constitute an unsafe or unsound practice. The ability of the Bank to pay dividends in the future may be influenced by bank regulatory policies and capital guidelines.

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Regulatory Capital Requirements

Compliance by the Company and the Bank with respect to capital requirements is incorporated by reference from Note 15, Shareholders' Equity and Regulatory Capital, to the Consolidated Financial Statements under Part II, Item 8, "Financial Statements and Supplementary Data," and from the Capital Adequacy and Regulatory Matters section of Item 7, “Management’s Discussion and Analysis of Consolidated Financial Condition and Results of Operations.”

Basel III Capital Rules

The Company and the Bank are subject to the Basel III Capital Rules, which prescribe a standardized approach for risk weightings that expanded the risk-weighting categories to a larger and more risk-sensitive number of categories than previously used, depending on the nature of the assets. These categories generally range from 0%, for U.S. government and agency securities, to 600%, for certain equity exposures, and result in higher risk weights for a variety of asset categories.

The Basel III Capital Rules incorporate a capital measure called Common Equity Tier 1 and a related regulatory capital ratio of CET1 to risk-weighted assets and a “capital conservation buffer,” designed to absorb losses during periods of economic stress. Institutions with a ratio of CET1 to risk-weighted assets above the minimum but below the capital conservation buffer are subject to constraints on dividends, equity repurchases and discretionary bonuses to executive officers based on the amount of the shortfall. The capital standards were fully phased-in and fully implemented on January 1, 2019. Those applicable to the Parent Company and the Bank include an additional capital conservation buffer of 2.5% of CET1, effectively resulting in minimum ratios inclusive of the capital conservation buffer of (i) CET1 to risk-weighted assets of at least 7%, (ii) Tier 1 capital to risk-weighted assets of at least 8.5%, and (iii) Total capital to risk-weighted assets of at least 10.5%.

The Basel III Capital Rules provide for a number of deductions from and adjustments to CET1. These include, for example, the requirement that mortgage servicing rights, deferred tax assets arising from temporary differences that could not be realized from net operating loss carrybacks and significant investments in unconsolidated financial entities be deducted from CET1 to the extent that any one such category exceeds 10% of CET1 or all such categories, in the aggregate, exceed 15% of CET1. Under a one-time permanent election made by the Company and the Bank, the effects of certain accumulated other comprehensive income items are not excluded from regulatory capital, including unrealized gains or losses on certain securities available for sale. Implementation of the deductions and other adjustments to CET1 were phased in and fully implemented beginning January 1, 2018.

Other Federal Laws and Regulations

The Company’s operations are subject to additional federal laws and regulations applicable to financial institutions, including, without limitation:

•Privacy provisions of the Gramm-Leach-Bliley Act and related regulations, which require us to maintain privacy policies intended to safeguard customer financial information, to disclose the policies to our customers and to allow customers to “opt out” of having their financial service providers disclose their confidential financial information to non-affiliated third parties, subject to certain exceptions;

•Right to Financial Privacy Act, which imposes a duty to maintain confidentiality of consumer financial records and prescribes procedures for complying with administrative subpoenas of financial records;

•Consumer protection rules for the sale of insurance products by depository institutions, adopted pursuant to the requirements of the GLB Act; and

•the USA PATRIOT Act, which requires financial institutions to take certain actions to help prevent, detect and prosecute international money laundering and the financing of terrorism.

Future Legislation and Regulation

Changes in federal laws and regulations, as well as laws and regulations in states where the Parent Company and the Bank do business, can affect the operating environment of the Company and the Bank in substantial ways. We cannot predict whether those changes in laws and regulations will occur, and, if they occur, the ultimate effect they would have upon the financial condition or results of operations of the Company.

NASDAQ Capital Market

The Company’s common stock is listed on The NASDAQ Capital Market under the trading symbol “ORRF” and is subject to NASDAQ’s rules for listed companies.

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Competition

The Bank's principal market area consists of Berks County, Cumberland County, Dauphin County, Franklin County, Lancaster County, Perry County, and York County, Pennsylvania, and Washington County, Maryland. The Bank serves a substantial number of depositors in this market area and contiguous counties, with the greatest concentration in Chambersburg, Shippensburg, and Carlisle, Pennsylvania and the surrounding areas.

We are subject to robust competition in our market areas. Like other depository institutions, we compete with less heavily regulated entities such as credit unions, brokerage firms, money market funds, consumer finance and credit card companies, and with other commercial banks, many of which are larger than the Bank. The principal methods of competing effectively in the financial services industry include improving customer service through the quality and range of services provided, improving efficiencies and pricing services competitively. The Bank is competitive with the financial institutions in its service areas with respect to interest rates paid on time and savings deposits, service charges on deposit accounts and interest rates charged on loans.

We continue to implement strategic initiatives focused on expanding our core businesses and to explore, on an ongoing basis, acquisition, divestiture, and joint venture opportunities to the extent permitted by our regulators. We analyze each of our products and businesses in the context of shareholder return, customer demands, competitive advantages, industry dynamics, and growth potential. We believe our market area will support growth in assets and deposits in the future, which we expect to contribute to our ability to maintain or grow profitability.

ITEM 1A – RISK FACTORS

An investment in our common stock is subject to risks inherent in our business. The material risks and uncertainties that management believes affect us are described below. Before making an investment decision, you should carefully consider the risks and uncertainties described below together with all of the other information included or incorporated by reference in this report. The risks and uncertainties described below are not the only ones facing us. Additional risks and uncertainties that management is not aware of or focused on or that management currently deems immaterial may also impair our business operations. This report is qualified in its entirety by these risk factors.

If any of the following risks actually occur, our business, financial condition and results of operations could be materially and adversely affected. If this were to happen, the market price of our common stock could decline significantly, and you could lose all or part of your investment.

Risks Related to Credit

If our allowance for loan losses is not sufficient to cover actual losses, our earnings would decrease.

There is no precise method of predicting loan losses. The required level of reserves, and the related provision for loan losses, can fluctuate from year to year, based on charge-offs and/or recoveries, loan volume, credit administration practices, and local and national economic conditions, among other factors. The ALL, which is a reserve established through a provision for loan losses charged to expense, represents management's best estimate of probable incurred losses within the existing portfolio of loans. The level of the allowance reflects management's evaluation of, among other factors, the status of specific impaired loans, trends in historical loss experience, delinquency, credit concentrations and economic conditions within our market area. The determination of the appropriate level of the ALL inherently involves a high degree of subjectivity and judgment and requires us to make significant estimates of current credit risks and future trends, all of which may undergo material changes. Changes in economic conditions affecting borrowers, new information regarding existing loans, identification of additional problem loans and other factors, both within and outside of our control, may require us to increase our ALL.

In addition, bank regulatory agencies periodically review our ALL and may require us to increase the provision for loan losses or to recognize further loan charge-offs, based on judgments that differ from those of management. If loan charge-offs in future periods exceed the ALL, there would be a need to record additional provisions to increase our ALL. Furthermore, growth in the loan portfolio would generally lead to an increase in the provision for loan losses. Generally, increases in our ALL will result in a decrease in net income and stockholders' equity, and may have a material adverse effect on the financial condition of the Company, results of operations and cash flows.

The deterioration of one or more of our significant lending relationships could result in a significant increase in the nonperforming loans and the provisions for loan losses, which would negatively impact our results of operations.

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Commercial real estate lending may expose us to a greater risk of loss and impact our earnings and profitability.

Our business strategy includes making loans secured by commercial real estate. These types of loans generally have higher risk-adjusted returns and shorter maturities than other loans. Loans secured by commercial real estate properties are generally for larger amounts and may involve a greater degree of risk than other loans. Payments on loans secured by these properties are often dependent on the income produced by the underlying properties which, in turn, depends on the successful operation and management of the properties. Accordingly, repayment of these loans is subject to conditions in the real estate market or the local economy. In challenging economic conditions, these loans represent higher risk and could result in an increase in our total net charge-offs, requiring us to increase our ALL, which could have a material adverse effect on our financial condition or results of operations. While we seek to minimize these risks in a variety of ways, there can be no assurance that these measures will protect against credit-related losses.

The credit risk related to commercial and industrial loans is greater than the risk related to residential loans.

Commercial and industrial loans generally carry larger loan balances and involve a greater degree of risk of nonpayment or late payment than home equity loans or residential mortgage loans.

Commercial and industrial loans include advances to local and regional businesses for general commercial purposes and include permanent and short-term working capital, machinery and equipment financing, and may be either in the form of lines of credit or term loans. Although commercial and industrial loans may be unsecured to our highest rated borrowers, the majority of these loans are secured by the borrower's accounts receivable, inventory and machinery and equipment. In a significant number of these loans, the collateral also includes the business real estate or the business owner's personal real estate or assets. Commercial and industrial loans are more susceptible to risk of loss during a downturn in the economy, as borrowers may have greater difficulty in meeting their debt service requirements and the value of the collateral may decline. We attempt to mitigate this risk through our underwriting standards, including evaluating the creditworthiness of the borrower and, to the extent available, credit ratings on the business. Additionally, monitoring of the loans through annual renewals and meetings with the borrowers are typical. However, these procedures cannot eliminate the risk of loss associated with commercial and industrial lending.

Our commercial and industrial lending operations are located primarily in south central Pennsylvania and in Washington County, Maryland. Our borrowers' ability to repay these loans depends largely on economic conditions in these and surrounding areas. A deterioration in the economic conditions in these market areas could materially adversely affect our operations and increase loan delinquencies, increase problem assets and foreclosures, increase claims and lawsuits, decrease the demand for our products and services and decrease the value of collateral securing loans.

Risks Related to Interest Rates and Investments

Changes in interest rates could adversely impact the Company's financial condition and results of operations.

Our operations are subject to risks and uncertainties surrounding our exposure to changes in the interest rate environment. Operating income, net income and liquidity depend to a great extent on our net interest margin, i.e., the difference between the interest yields we receive on interest-earning assets, such as loans and securities, and the interest rates we pay on interest-bearing liabilities, such as deposits and borrowings. These rates are highly sensitive to many factors beyond our control, including competition; general economic conditions; and monetary and fiscal policies of various governmental and regulatory authorities, including the FRB. If the rate of interest we pay on our interest-bearing liabilities increases more than the rate of interest we receive on our interest-earning assets, our net interest income, and therefore our earnings, and liquidity could be materially adversely affected. Our earnings and liquidity could also be materially adversely affected if the rates on interest-earning assets fall more quickly than those on our interest-bearing liabilities.

Changes in interest rates also can affect our ability to originate loans; the ability of borrowers to repay adjustable or variable rate loans; our ability to obtain and retain deposits in competition with other available investment alternatives; and the value of interest-earning assets, which would negatively impact stockholders' equity, and the ability to realize gains from the sale of such assets. Based on our interest rate sensitivity analyses, an increase in the general level of interest rates will negatively affect the market value of the investment portfolio because of the relatively higher duration of certain securities included in the investment portfolio.

Our subordinated notes, issued in December 2018, have a 6.0% fixed interest rate through December 2023, after which the interest rate will convert to a variable rate of the London Interbank Offered Rate (“LIBOR”) for the applicable interest period plus 3.16% through maturity in December 2028. Depending on our financial condition at the time of the rate changing from fixed to variable, an increase in the interest rate on our subordinated debt could have a material adverse effect on our liquidity and results of operations.

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The expected discontinuance of LIBOR presents risks to the financial instruments originated, issued or held by us that use LIBOR as a reference rate.

LIBOR is used as a reference rate for many of our transactions, which means it is the base on which relevant interest rates are determined. Transactions include those in which we lend and borrow money and issue, purchase and sell securities. LIBOR is the subject of recent national and international regulatory guidance and proposals for reform. The United Kingdom Financial Conduct Authority, which regulates the process for setting LIBOR, announced in July 2017 that it intends to stop persuading or compelling banks to submit rates for the calculation of LIBOR to the administrator of LIBOR after 2021.

While there are ongoing efforts to establish an alternative reference rate to LIBOR, as of the date of this report, no such rate has been accepted or is considered ready to be implemented.

If another rate does not achieve wide acceptance as the alternative to LIBOR, there likely will be disruption to all of the markets relying on the availability of a broadly accepted reference rate. Even if another reference rate ultimately replaces LIBOR, risks will remain for us with respect to outstanding loans, or other instruments using LIBOR. Those risks arise in connection with transitioning those instruments to a new reference rate and the corresponding value transfer that may occur in connection with that transition. Risks related to transitioning instruments to a new reference rate or to how LIBOR is calculated and its availability include impacts on the yield on loans or securities held by us and amounts paid on securities we have issued. The value of loans, securities, or borrowings tied to LIBOR and the trading market for LIBOR-based securities could also be impacted upon its discontinuance or if it is limited.

Further, it is possible that LIBOR quotes will become unavailable prior to 2021 if sufficient banks decline to make submissions to the LIBOR administrator. In that case, the risks associated with the transition to an alternative reference rate will be accelerated and magnified. These risks may also be increased due to the shorter time frame for preparing for the transition.

Risks Related to Competition and to Our Business Strategy

Difficult economic and market conditions can adversely affect the financial services industry and may materially and adversely affect the Company.

Our operations are sensitive to general business and economic conditions in the U.S. If the growth of the U.S. economy slows, or if the economy worsens or enters into a recession, our growth and profitability could be constrained. In addition, economic conditions in foreign countries can affect the stability of global financial markets, which could impact the U.S. economy and financial markets. Weak economic conditions are characterized by deflation, fluctuations in debt and equity capital markets, including a lack of liquidity and/or depressed prices in the secondary market for mortgage loans, increased delinquencies on mortgage, consumer and commercial loans, residential and commercial real estate price declines and lower home sales and commercial activity. All of these factors are detrimental to our business. Our business is significantly affected by monetary and related policies of the U.S. federal government, its agencies and government-sponsored entities. Changes in any of these policies could have a material adverse effect on our business, financial position, results of operations and cash flows.

In particular, we may face the following risks in connection with volatility in the economic environment:

- Loan delinquencies could increase;
- Problem assets and foreclosures could increase;
- Demand for our products and services could decline; and
- Collateral for loans made by us, especially real estate, could decline in value, reducing customers' borrowing power, and reducing the value of assets and collateral associated with our loans.

Because our business is concentrated in south central Pennsylvania and Washington County, Maryland, our financial performance could be materially adversely affected by economic conditions and real estate values in these market areas.

Our operations and the properties securing our loans are primarily located in south central Pennsylvania and in Washington County, Maryland. Our operating results depend largely on economic conditions and real estate valuations in these and surrounding areas. A deterioration in the economic conditions in these market areas could materially adversely affect our operations and increase loan delinquencies, increase problem assets and foreclosures, increase claims and lawsuits, decrease the demand for our products and services and decrease the value of collateral securing loans, especially real estate, in turn reducing customers' borrowing power, the value of assets associated with nonperforming loans and collateral coverage.

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Competition from other banks and financial institutions in originating loans, attracting deposits and providing other financial services may adversely affect our profitability and liquidity.

We experience substantial competition in originating loans, both commercial and consumer loans, in our market area. This competition comes principally from other banks, savings institutions, credit unions, mortgage banking companies and other lenders. Some of our competitors enjoy advantages, including greater financial resources, and higher lending limits, a wider geographic presence, more accessible branch office locations, the ability to offer a wider array of services or more favorable pricing alternatives, as well as lower origination and operating costs. This competition could reduce our net income and liquidity by decreasing the number and size of loans that we originate and the interest rates we are able to charge on these loans.

As we expand our on-line lending capabilities, we will face competition, particularly in residential mortgage lending, from non-bank lenders (financial institutions that only make loans and do not offer deposit accounts such as a savings account or checking account) and financial technology companies (that use new technology and innovation with available resources in order to compete in the marketplace of traditional financial institutions and intermediaries in the delivery of financial services). This competition could similarly reduce our net income and liquidity.

In attracting business and consumer deposits, we face substantial competition from other insured depository institutions such as banks, savings institutions and credit unions, as well as institutions offering uninsured investment alternatives, including money market funds. Some of our competitors enjoy advantages, including more expansive marketing campaigns, better brand recognition and more branch locations. These competitors may offer higher interest rates than we do, which could decrease the deposits that we attract or require us to increase our rates to retain existing deposits or attract new deposits. Increased deposit competition could materially adversely affect our ability to generate the funds necessary for lending operations. As a result, we may need to seek other sources of funds that may be more expensive to obtain and could increase our cost of funds.

The Company's business strategy includes the continuation of moderate growth plans, and our financial condition and results of operations could be negatively affected if we fail to grow or fail to manage our growth effectively.

Over the long term, we expect to continue to experience organic growth in loans and total assets, the level of our deposits and the scale of our operations. Achieving our growth targets requires us to successfully execute our business strategies, which includes continuing to grow our loan portfolio. Our ability to successfully grow will also depend on the continued availability of loan opportunities that meet underwriting standards. In addition, we may consider the acquisition of other financial institutions and branches within or outside of our market area to the extent permitted by our regulators. The success of any such acquisition will depend on a number of factors, including our ability to integrate the acquired institutions or branches into the current operations of the Company; our ability to limit the outflow of deposits held by customers of the acquired institution or branch locations; our ability to control the incremental increase in noninterest expense arising from any acquisition; and our ability to retain and integrate the appropriate personnel of the acquired institution or branches. We believe we have the resources and internal systems in place to successfully achieve and manage our future growth. If we do not manage our growth effectively, we may not be able to achieve our business plan goals and our business and prospects could be harmed.

The Company may be adversely affected by technological advances.

Technological advances impact our business. The banking industry undergoes technological change with frequent introductions of new technology-driven products and services. In addition to improving customer services, the effective use of technology increases efficiency and enables financial institutions to reduce costs. Our future success may depend, in part, on our ability to address the needs of our current and prospective customers by using technology to provide products and services that will satisfy demands for convenience, as well as to create additional efficiencies in operations.

The Company may not be able to attract and retain skilled people.

The Company's success depends, in large part, on our ability to attract and retain skilled people. We have, at times, experienced turnover among our senior officers. Competition for the best people in most activities engaged in by us can be intense, and we may not be able to attract and hire sufficiently skilled people to fill open and newly created positions or to retain current or future employees. An inability to attract and retain individuals with the necessary skills to fill open positions, or the unexpected loss of services of one or more of our key personnel, could have a material adverse impact on our business due to the loss of their skills, knowledge of our markets, years of industry experience or the difficulty of promptly finding qualified replacement personnel.

An interruption or breach in security with respect to our information systems, or our outsourced service providers, could adversely impact the Company's reputation and have an adverse impact on our financial condition or results of operations.

Information systems are critical to our business as our business operations and interaction with customers are increasingly supported by electronic means. We use various technological systems to manage our customer relationships, general ledger, securities investments, deposits and loans. We rely on software, communication, and information exchange on a variety of

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computing platforms and networks and over the internet, and we rely on the services of a variety of vendors to meet our data processing and communication needs. If these third-party providers encounter difficulties, or if we have difficulty communicating with them, our ability to adequately process and account for transactions could be affected, and our business operations could be adversely affected. Threats to information security also exist in the processing of customer information through various other third-party vendors and their personnel.

Security breaches of our systems or the systems of third-parties on which we rely could expose us to litigation, remediation costs, increased costs for security measures, loss of revenue, damage to our reputation and potential liability. Our corporate systems, third-party systems and security measures may be breached due to the actions of outside parties, employee error, malfeasance, a combination of these, or otherwise, and, as a result, an unauthorized party may obtain access to our information, our employees' information or our customers' information. In addition, outside parties may attempt to fraudulently induce employees to disclose information in order to gain access to such confidential information. In July 2018, we fell victim to a phishing attack, which led to an unauthorized third-party gaining access to two employee email accounts. Although this incident did not result in a material loss of revenue, any future incidents, particularly of larger scope or longer duration, could damage our brand and reputation and result in a material loss of revenue. If an actual or perceived security breach occurs, the market perception of the effectiveness of our security measures could be harmed, we could lose customers, and we could suffer significant legal and financial harm due to such events or in connection with remediation efforts and costs, investigation costs or penalties, litigation, regulatory and enforcement actions, changed security and system protection measures. Any of these actions could have a material and adverse effect on our business, reputation and operating results. In addition, the cost and operational consequences of investigating, remediating, eliminating and putting in place additional information technology tools and devices designed to prevent actual or perceived security breaches, as well as the costs to comply with any notification obligations resulting from such a breach, could have a significant impact on our financial and operating results.

We could be adversely affected by a failure in our internal controls.

A failure in our internal controls could have a significant negative impact not only on our earnings, but also on the perception that customers, regulators and investors may have of us. We continue to devote a significant amount of effort and resources to constantly strengthening our controls and ensuring compliance with complex accounting standards and banking regulations. However, these efforts may not be effective in preventing a breach in or failure of our controls.

Negative public opinion could damage our reputation and adversely affect our earnings.

Reputational risk, or the risk to the Company's earnings and capital from negative public opinion, is inherent in our business. Negative public opinion can result from the actual or perceived manner in which we conduct our business activities, including banking operations and trust and investment operations, our management of actual or potential conflicts of interest and ethical issues, and our protection of confidential client information. Negative public opinion can adversely affect the Company's ability to keep and attract customers and can expose the Company to litigation and regulatory action. Although we take steps to minimize reputation risk in the way we conduct our business activities and deal with our customers, communities and vendors, these steps may not be effective.

We may become subject to claims and litigation pertaining to fiduciary responsibility.

We provide fiduciary services through OFA and Wheatland. From time to time, customers may make claims and take legal action with regard to the performance of our fiduciary responsibilities. Whether such claims and legal actions are founded or unfounded, if such claims or legal actions are not resolved in a manner favorable to us, the claims or related actions may result in significant financial expense and liability to us and/or adversely affect our reputation in the marketplace, as well as adversely impact customer demand for our products and services. Any financial liability or reputation damage could have a material adverse effect on our business, which, in turn, could have a material adverse effect on our financial condition and results of operations.

Risks Related to Mergers and Acquisitions

On October 1, 2018, we completed the acquisition of Mercersburg. On October 23, 2018, we announced the signing of a definitive agreement to acquire Hamilton Bancorp, Inc.

Growing by acquisition involves risks.

We intend to pursue a growth plan consistent with our business strategy, including growth by acquisition, as well as leveraging our existing branch network and adding new branch locations in current and future markets we choose to serve.

Our ability to manage growth successfully will depend on our ability to attract qualified personnel and maintain cost controls and asset quality while attracting additional loans and deposits on favorable terms, as well as on factors beyond our

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control, such as economic conditions and competition. If we grow too quickly and are not able to attract qualified personnel, control costs and maintain asset quality, this continued rapid growth could materially adversely affect our financial performance.

There is no assurance when, or even if, our acquisition of Hamilton will be completed.
The merger agreement between the Company and Hamilton is subject to a number of conditions which must be fulfilled in order to complete the merger. Those conditions include:
•approval of the merger agreement and the merger by Hamilton shareholders;
•the receipt of required regulatory approvals;
•absence of orders prohibiting the completion of the merger;
•effectiveness of the registration statement filed by the Company to register the shares of our common stock to be issued to Hamilton shareholders in the merger;
•the continued accuracy of the representations and warranties by both parties and the performance by both parties of their covenants and agreements; and
•the receipt by both parties of legal opinions from their respective tax counsels.
There can be no assurance that the parties will be able to satisfy the closing conditions or that closing conditions beyond their control will be satisfied or waived.
The Hamilton merger agreement may be terminated in accordance with its terms and the merger may not be completed.
The parties can agree at any time to terminate the merger agreement under specified circumstances. In addition, Hamilton may choose to terminate the merger agreement if the volume weighted average stock price of our common stock as reported on NASDAQ during the 15 trading day period immediately preceding the determination date (as defined in the merger agreement) is less than $20.1535 per share and our common stock underperforms the NASDAQ Bank Index by more than 15% between October 23, 2018 and the determination date. Any such termination would be subject to the right of the Company to increase the amount of our common stock or cash consideration to be provided to Hamilton shareholders pursuant to the formulas prescribed in the merger agreement.
Regulatory approvals may not be received or may take longer than expected in order to be obtained for the Hamilton merger.
We are required to obtain the approvals of the Board of Governors of the Federal Reserve System, the Pennsylvania Department of Banking and Securities, and the Maryland Office of the Commissioner of Financial Regulation prior to completing the merger. Obtaining the approval of these regulatory agencies may delay the date of completion of the merger. In addition, you should be aware that, as in any transaction, it is possible that, among other things, restrictions on the combined operations of the two companies may be sought by governmental agencies as a condition to obtaining the required regulatory approvals. This may diminish the benefits of the merger to us or have an adverse effect on us following the merger and prevent us from achieving the expected benefits of the merger. We have the right to terminate the merger agreement if the approval of any governmental authority required for consummation of the merger and the other transactions provided for in the merger agreement, imposes any term, condition or restriction upon us or any of our subsidiaries that we reasonably determine would (a) prohibit or materially limit the ownership or operation by us of any material portion of Hamilton's business or assets, (b) compel us to dispose or hold separate any material portion of Hamilton's assets or (c) compel us to take any action, or commit to take any action, or agree to any condition or request, if the prohibition, limitation, condition or other requirement described in clauses (a)-(c) of this sentence would have a material adverse effect on the future operation by us of our business, taken as a whole.
If the Hamilton merger is not completed, we will have incurred substantial expenses without realizing the expected benefits.
We will incur substantial expenses in connection with the pending acquisition of Hamilton. If the merger is not completed, these expenses may have a material adverse impact on our operating results.
Goodwill incurred in the Mercersburg and Hamilton mergers may negatively affect our financial condition.
To the extent that the merger consideration, consisting of the cash and the number of shares of our common stock issued in the Mercersburg merger or to be issued in the Hamilton merger, exceeds the fair value of the net assets acquired, including identifiable intangibles, that amount will be reported as goodwill by us. In accordance with current

accounting guidance, goodwill will not be amortized but will be evaluated for impairment annually or more frequently if events or circumstances warrant. A failure to realize expected benefits of the merger could adversely impact the carrying value of the goodwill recognized in the merger and, in turn, negatively affect our financial results.

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We may be unable to successfully integrate Mercersburg’s and Hamilton's operations.
The mergers involve the integration of companies that previously operated independently with Orrstown. The difficulties of combining the companies’ operations include:
•integrating personnel with diverse business backgrounds;
•integrating departments, systems, operating procedures and information technologies;
•combining different corporate cultures;
•retaining existing customers and attracting new customers; and
•retaining key employees.
The process of integrating operations could cause an interruption of, or loss of momentum in, the activities of one or more of the combined company’s businesses and the loss of key personnel. The diversion of management’s attention and any delays or difficulties encountered in connection with the merger and the integration of the two companies’ operations could have a material adverse effect on the business and results of operations of the combined company.
The success of the mergers will depend, in part, on our ability to realize the anticipated benefits and cost savings from combining the business of the Company with Mercersburg and Hamilton. If we are unable to successfully integrate Mercersburg or Hamilton, the anticipated benefits and cost savings of the mergers may not be realized fully or may take longer to realize than expected. For example, we may fail to realize the anticipated increase in earnings and cost savings anticipated to be derived from the acquisitions. In addition, as with regard to any merger, a significant change in interest rates or economic conditions or decline in asset valuations may also cause us not to realize expected benefits and result in the mergers not being as accretive as expected.
Unanticipated costs relating to the mergers could reduce our future earnings per share.
We believe that we have reasonably estimated the likely costs of integrating the operations of the Company and Mercersburg and Hamilton, and the incremental costs of operating as a combined company. However, it is possible that we could incur unexpected transaction costs such as taxes, fees or professional expenses or unexpected future operating expenses such as increased personnel costs or increased taxes, which could result in the mergers not being as accretive as expected or having a dilutive effect on the combined company’s earnings per share.
The market price of our common stock after the mergers may be affected by factors different from those affecting our shares currently.
The businesses of the Company and Mercersburg and Hamilton differ and, accordingly, the results of operations of the combined company and the market price of the combined company’s shares of common stock may be affected by factors different from those currently affecting the independent results of operations and market prices of common stock of each of us, Mercersburg and Hamilton. The market value of our common stock fluctuates based upon various factors, including changes in our business, operations or prospects, market assessments of the merger, regulatory considerations, market and economic considerations, and other factors. Further, the market price of our common stock after the merger may be affected by factors different from those currently affecting our common stock.

Risks Related to Regulatory Compliance and Legal Matters
Governmental regulation and regulatory actions against us may impair our operations or restrict our growth.
The Company is subject to regulation and supervision under federal and state laws and regulations. The requirements and limitations imposed by such laws and regulations limit the manner in which we conduct our business, undertake new investments and activities and obtain financing. These regulations are designed primarily for the protection of the deposit insurance funds and consumers and not to benefit our shareholders. Financial institution regulation has been the subject of significant legislation in recent years and may be the subject of further significant legislation in the future, none of which is within our control. Federal and state regulatory agencies also frequently adopt changes to their regulations or change the manner in which existing regulations are applied or enforced. The Company cannot predict the substance or impact of pending or future legislation, regulation or the application thereof. Compliance with such current and potential regulation and scrutiny may significantly increase our costs, impede the efficiency of our internal business processes, require us to increase our regulatory capital and limit our ability to pursue business opportunities in an efficient manner. Bank regulations can hinder our ability to compete with financial services companies that are not regulated in the same manner or are subject to less regulation.

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The Dodd-Frank Act may affect the Company's financial condition, results of operations, liquidity and stock price.

The Dodd-Frank Act includes provisions affecting large and small financial institutions, including several provisions that affect how community banks and bank holding companies will be regulated in the future. Among other things, these provisions relax rules regarding interstate branching; allow financial institutions to pay interest on business checking accounts; change the scope of federal deposit insurance coverage; and impose new capital requirements on bank holding companies. Many of the requirements called for in the Dodd-Frank Act will be implemented over time and will be subject to implementation regulations developed over the course of several years. Given the uncertainty associated with the manner in which the provisions of the Dodd-Frank Act will be implemented by the various regulatory agencies and through regulations, the full extent of the impact such requirements will have on our operations is not certain.

The Dodd-Frank Act created the CFPB which has broad rule-making authority for a wide range of consumer protection laws that apply to all banks and savings institutions including the authority to prohibit "unfair, deceptive or abusive" acts and practices. The CFPB has examination and enforcement authority over all banks and savings institutions with more than $10 billion in assets. Banks and savings institutions with $10 billion or less in assets are examined by their applicable bank regulators.

The Company may be required to invest significant management attention and resources to evaluate and make any changes necessary to comply with new statutory and regulatory requirements under the Dodd-Frank Act. Failure to comply with requirements may negatively impact our results of operations and financial condition. While the Company cannot predict what effect any presently contemplated or future changes in the laws or regulations or their interpretations would have on us, these changes could be materially adverse to our investors.

Increases in FDIC insurance premiums may have a material adverse effect on our results of operations.

We are generally unable to control the amount of premiums that are required to be paid for FDIC insurance. If there are bank or financial institution failures, the Company may be required to pay significantly higher premiums than the levels currently imposed or additional special assessments or taxes that could adversely affect earnings. Any future increases or required prepayments in FDIC insurance premiums may materially adversely affect the results of operations.

Legislative, regulatory and legal developments involving income and other taxes could materially adversely affect the Company's results of operations and cash flows.

The Company is subject to U.S. federal and U.S. state income, payroll, property, sales and use, and other types of taxes including the Pennsylvania Bank Shares Tax. Significant judgment is required in determining the Company's provisions for income taxes. Changes in tax rates, enactments of new tax laws, revisions of tax regulations, and claims or litigation with taxing authorities could result in substantially higher taxes, and therefore, could have a significant adverse effect on the Company's results of operations, financial condition and liquidity. Increases in the assessment rate for the Pennsylvania Bank Shares Tax, which is calculated on the outstanding equity of the Bank, may also materially adversely affect results of operations.

The Company is required to use judgment in applying accounting policies and different estimates and assumptions in the application of these policies could result in a decrease in capital and/or other material changes to the reports of financial condition and results of operations.

Material estimates that are particularly susceptible to significant change relate to the determination of the ALL, the fair value of certain financial instruments, particularly securities, and goodwill and purchase accounting associated with acquisitions. While we have identified those accounting policies that we consider critical and have procedures in place to facilitate the associated judgments, different assumptions in the application of these policies could have a material adverse effect on our financial condition and results of operations.

Changes in our accounting policies or in accounting standards could materially affect how we report our financial results and condition.

From time to time, the FASB and SEC and other regulatory bodies change the financial accounting and reporting standards that govern the preparation of our consolidated financial statements. These changes can be operationally complex to implement and can materially impact how we record and report our financial condition and results of operations. For example, in June 2016, the FASB issued Accounting Standards Update 2016-13, Measurement of Credit Losses on Financial Instruments, that will, effective on January 1, 2020, substantially change the accounting for credit losses on loans and other financial assets held by banks, financial institutions and other organizations. The update replaces existing incurred loss impairment guidance and establishes a single allowance framework for financial assets carried at amortized cost. Upon adoption of ASU 2016-13, companies must recognize credit losses on these assets equal to management's estimate of credit losses over the full remaining expected life. Companies must consider all relevant information when estimating expected credit losses, including details about

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past events, current conditions, and reasonable and supportable forecasts. In December 2018, the Federal Reserve, OCC and FDIC released a final rule to revise their regulatory capital rules to address this upcoming change to the treatment of credit expense and allowances. The final rule provides an optional three-year phase-in period for the day-one adverse regulatory capital effects upon adopting the standard. The impact of this final rule on the Company will depend on whether we elect to phase in the impact of the standard over a three-year period. The standard is likely to have a negative impact, potentially materially, to the allowance and capital at adoption in 2020; however, we are still evaluating the impact. It is also possible that our ongoing reported earnings and lending activity will be negatively impacted in periods following adoption.

The short-term and long-term impact of changing regulatory capital requirements and new capital rules is uncertain.

The Basel III Capital Rules have targeted higher levels of base capital, certain capital buffers, and a migration toward common equity as the key source of regulatory capital, as domestic and international bank regulatory agencies have sought to require financial institutions, including depository institutions, to maintain generally higher levels of capital. The application of more stringent capital requirements to the Company and the Bank could, among other things, result in lower returns on invested capital, result in the need for additional capital, and result in regulatory actions if we were to be unable to comply with such requirements, including limitations on our ability to make distributions, including paying out dividends or buying back shares. Furthermore, the imposition of liquidity requirements in connection with the implementation of Basel III could result in our having to lengthen the term of our funding, restructure our business models, and/or increase our holdings of liquid assets.

Pending litigation and legal proceedings and the impact of any finding of liability or damages could adversely impact the Company and its financial condition and results of operations.

As more fully described in Note 21, Contingencies, to the Consolidated Financial Statements under Part II, Item 8, "Financial Statement and Supplementary Data," of this Annual Report on Form 10-K, the allegations of Southeastern Pennsylvania Transportation Authority's ("SEPTA") second amended complaint disclosed the existence of a confidential, non-public, fact-finding inquiry regarding the Company being conducted by the SEC. On September 27, 2016, the Company entered into a settlement agreement with the SEC resolving the investigation of accounting and related matters at the Company for the periods ended June 30, 2010 to December 31, 2011. As part of the settlement agreement, the Company agreed to pay a civil money penalty of $1 million. In February 2018, the Court issued an order continuing all case management deadlines for the completion of discovery, the filing of motions and various pre-trial conferences, until further order of the Court. Discovery in the case is ongoing.

The Company believes that the allegations of SEPTA's second amended complaint are without merit and intends to vigorously defend itself against those claims. It is not possible at this time to estimate reasonably possible losses, or even a range of reasonably possible losses, in connection with the litigation. However, there can be no assurances that the Company will not incur any losses associated with this litigation or that any losses that are incurred will not be material.

Indemnification costs associated with litigation and legal proceedings could adversely impact the Company and its financial condition and results of operations.

We are generally required, to the extent permitted by Pennsylvania law, to indemnify our current and former directors and officers who are named as defendants in lawsuits. We also have certain contractual indemnification obligations to third parties regarding litigation. Generally, insurance coverage is not available for such indemnification costs we could incur to third parties. Current or future litigation could result in indemnification expenses that could have a materially adverse impact on our financial condition and results of operations.

Risks Related to Liquidity

The Parent Company is a holding company dependent for liquidity on payments from its bank subsidiary, which is subject to restrictions.

The Parent Company is a holding company and depends on dividends, distributions and other payments from the Bank to fund dividend payments and stock repurchases, if permitted, and to fund all payments on obligations. The Bank is subject to laws that restrict dividend payments or authorize regulatory bodies to prohibit or reduce the flow of funds from it to us. In addition, our right to participate in a distribution of assets upon the Bank's liquidation or reorganization is subject to the prior claims of the Bank's creditors, including its depositors.

The soundness of other financial institutions could adversely affect the Company.

Our ability to engage in routine funding and other transactions could be adversely affected by the actions and commercial soundness of other financial institutions. Financial services institutions are interrelated as a result of trading, clearing, counterparty or other relationships. As a result, defaults by, or even rumors or questions about, one or more financial services institutions, or the financial services industry generally, have historically led to market-wide liquidity problems, losses of

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depositor, creditor and counterparty confidence and could lead to losses or defaults by us or by other institutions. We could experience increases in deposits and assets as a result of other banks' difficulties or failure, which would increase the capital we are required to maintain to support such growth.

Risks Related to Owning our Stock

If the Company wants, or is compelled, to raise additional capital in the future, that capital may not be available when it is needed or on terms favorable to current shareholders.

Federal banking regulators require us and our banking subsidiary to maintain adequate levels of capital to support our operations. These capital levels are determined and dictated by law, regulation and banking regulatory agencies. In addition, capital levels are also determined by our management and board of directors based on capital levels that, they believe, are necessary to support our business operations. At December 31, 2018, all four capital ratios for us and our banking subsidiary were above regulatory minimum levels to be deemed "well capitalized" under current bank regulatory guidelines. To be "well capitalized," banks generally must maintain a tier 1 leverage ratio of at least 5.0%, CET1 capital ratio of 6.5%, Tier 1 risk-based capital ratio of at least 8.0%, and a total risk-based capital ratio of at least 10.0%. The phase-in implementation of the capital conservation buffer was completed on January 1, 2019, which essentially increased the aforementioned capital ratios by 2.5% .

The Company's ability to raise additional capital will depend on conditions in the capital markets at that time, which are outside of our control, and on our financial performance. Accordingly, we cannot provide assurance of our ability to raise additional capital on terms and time frames acceptable to us or to raise additional capital at all. Additionally, the inability to raise capital in sufficient amounts may adversely affect our operations, financial condition and results of operations. Our ability to borrow could also be impaired by factors that are nonspecific to us, such as severe disruption of the financial markets or negative news and expectations about the prospects for the financial services industry as a whole. If we raise capital through the issuance of additional shares of our common stock or other securities, we would likely dilute the ownership interests of current investors and the price at which we issue additional shares of stock could be less than the current market price of our common stock and, thus, could dilute the per share book value and earnings per share of our common stock. Furthermore, a capital raise through the issuance of additional shares may have an adverse impact on our stock price.

The market price of our common stock is subject to volatility.

The market price of the Company's common stock has been subject to fluctuations in response to numerous factors, many of which are beyond our control. These factors include actual or anticipated variations in our operational results and cash flows, changes in financial estimates by securities analysts, trading volume, large purchases or sales of our common stock, market conditions within the banking industry, the general state of the securities markets and the market for stocks of financial institutions, as well as general economic conditions.

The Parent Company's primary source of income is dividends received from its bank subsidiary.

The Parent Company is a separate legal entity from the Bank and must provide for its own liquidity. In addition to its operating expenses, the Company is responsible for paying any dividends declared to its shareholders. The Company also has repurchased shares of its common stock. The Company's primary source of income is dividends received from the Bank. Banking regulations limit the amount of dividends that may be paid from the Bank to the Company without prior approval of regulatory agencies. Restrictions on the Bank's ability to dividend funds to the Company are included in Note 14, Restrictions on Dividends, Loans and Advances, to the Consolidated Financial Statements under Part II, Item 8, "Financial Statements and Supplementary Data."

ITEM 1B – UNRESOLVED STAFF COMMENTS

None.

ITEM 2 – PROPERTIES

Our principal executive offices are located at 77 East King Street, Shippensburg, Pennsylvania, with additional executive and administrative offices at 4750 Lindle Road, Harrisburg, Pennsylvania. These facilities are owned by the Bank, which also maintains its principal and additional executive and administrative offices at those locations.

We own or lease other premises for use in conducting our business activities, including bank branches, an operations center, and offices in Berks, Cumberland, Dauphin, Franklin, Lancaster, Perry and York Counties, Pennsylvania and

Washington County, Maryland. We believe that the properties currently owned and leased are adequate for present levels of operation. We are constantly evaluating the best and most efficient mix of branch locations to service our customers due to evolving trends in our industry and increased engagement through digital channels.

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ITEM 3 – LEGAL PROCEEDINGS

Information regarding legal proceedings is included in Note 21, Contingencies, to the Consolidated Financial Statements under Part II, Item 8, "Financial Statement and Supplementary Data."

In connection with the pending merger acquisition of Hamilton, on February 15, 2019, Orrstown filed with the SEC a proxy statement/prospectus dated February 8, 2019 (the “Proxy Statement/Prospectus”). The Proxy Statement/Prospectus is the proxy statement for Hamilton’s special meeting of stockholders (the “Special Meeting”) to be held on March 20, 2019 to vote on the approval of the merger, and is also Orrstown’s prospectus with respect to the shares of Orrstown’s common stock to be issued to Hamilton stockholders in the merger.

On March 5, 2019, Paul Parshall, a purported individual stockholder of Hamilton, filed, on behalf of himself and all of Hamilton’s stockholders other than the named defendants and their affiliates (the “Purported Class”), a derivative and putative class action complaint in the Circuit Court for Baltimore City, Maryland, captioned Paul Parshall v. Carol Coughlin et. al., naming each Hamilton director, Orrstown and Hamilton as defendants (the “Action”). The Action alleges, among other things, that Hamilton’s directors breached their fiduciary duties to the Purported Class in connection with the merger, and that the Proxy Statement/Prospectus omitted certain material information regarding the merger. Orrstown is alleged to have aided and abetted the Hamilton directors’ alleged breaches of their fiduciary duties. The Action seeks, among other remedies, to enjoin the merger or, in the event the merger is completed, rescission of the merger or rescissory damages; unspecified damages; and costs of the lawsuit, including attorneys’ and experts’ fees. Orrstown believes that the lawsuit is without merit as there are substantial legal and factual defenses to the claims asserted and intends to vigorously defend the lawsuit. It is not possible at this time to estimate reasonably possible losses, or even a range of reasonably possible losses, in connection with the litigation.

ITEM 4 – MINE SAFETY DISCLOSURES

Not applicable.

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PART II

ITEM 5 – MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

Market Information

Our common stock is traded on the NASDAQ Capital Market under the symbol "ORRF." At the close of business on February 28, 2019, there were approximately 3,000 shareholders of record.

The Board declared cash dividends of $0.51 and $0.42 per common shares in 2018 and 2017, respectively. Our management is currently committed to continuing to pay regular cash dividends; however, there can be no assurance as to future dividends because they are dependent on our future earnings, capital requirements and financial condition. Restrictions on the payment of dividends are discussed in Note 15, Shareholders' Equity and Regulatory Capital, to the Consolidated Financial Statements under Part II, Item 8, "Financial Statements and Supplementary Data." On January 23, 2019, the Board declared a cash dividend of $0.15 per common share, which was paid on February 11, 2019.

Securities Authorized for Issuance under Equity Compensation Plans

Information regarding the Company's equity compensation plans is included in Part III, Item 12, Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters.

Issuer Purchases of Equity Securities

In September 2015, the Board of Directors of the Company authorized a share repurchase program under which the Company may repurchase up to 5% of the Company's outstanding shares of common stock, or approximately 416,000 shares, in accordance with all applicable securities laws and regulations, including Rule 10b-18 of the Securities Exchange Act of 1934, as amended. When and if appropriate, repurchases may be made in open market or privately negotiated transactions, depending on market conditions, regulatory requirements and other corporate considerations, as determined by management. Share repurchases may not occur and may be discontinued at any time.

No shares were repurchased from October 1, 2018 to December 31, 2018. At December 31, 2018, 82,725 shares had been repurchased under the program at a total cost of $1,438,000, or $17.38 per share and the maximum number of shares that may yet be purchased under the plan is 333,275 shares.

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PERFORMANCE GRAPH

The performance graph below compares the cumulative total shareholder return on our common stock with other indexes: the SNL index of banks with assets between $1 billion and $5 billion, the S&P 500 Index, and the NASDAQ Composite index. The graph assumes an investment of $100 on December 31, 2013 and reinvestment of dividends on the date of payment without commissions. Shareholder returns on our common stock are based upon trades on the NASDAQ Stock Market. The performance graph represents past performance and should not be considered to be an indication of future performance.

	Period Ending					
Index	**12/31/13**	**12/31/14**	**12/31/15**	**12/31/16**	**12/31/17**	**12/31/18**
Orrstown Financial Services, Inc.	100.00	103.98	110.50	141.39	162.23	119.46
SNL Bank $1B-$5B Index	100.00	104.56	117.04	168.38	179.51	157.27
S&P 500 Index	100.00	113.69	115.26	129.05	157.22	150.33
NASDAQ Composite Index	100.00	114.75	122.74	133.62	173.22	168.30

Source : S&P Global Market Intelligence © 2019

In accordance with the rules of the SEC, this section captioned "Performance Graph" shall not be incorporated by reference into any of our future filings made under the Exchange Act or the Securities Act. The Performance Graph and its accompanying table are not deemed to be soliciting material or to be filed under the Exchange Act or the Securities Act.

Recent Sales of Unregistered Securities

The Company has not sold any equity securities within the past three years which were not registered under the Securities Act.

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ITEM 6 – SELECTED FINANCIAL DATA

	At or For The Year Ended December 31,				
(Dollars in thousands except per share information)	**2018**	**2017**	**2016**	**2015**	**2014**
Summary of Operations					
Interest income	**$ 64,837**	$ 51,015	$ 41,962	$ 38,635	$ 38,183
Interest expense	**13,467**	7,644	5,417	4,301	4,159
Net interest income	**51,370**	43,371	36,545	34,334	34,024
Provision for loan losses	**800**	1,000	250	(603)	(3,900)
Net interest income after provision for loan losses	**50,570**	42,371	36,295	34,937	37,924
Investment securities gains	**1,006**	1,190	1,420	1,924	1,935
Noninterest income	**20,848**	19,197	18,319	17,254	16,919
Noninterest expenses	**57,979**	50,330	48,140	44,607	43,768
Income before income tax expense (benefit)	**14,445**	12,428	7,894	9,508	13,010
Income tax expense (benefit)	**1,640**	4,338	1,266	1,634	(16,132)
Net income	**$ 12,805**	$ 8,090	$ 6,628	$ 7,874	$ 29,142
Per Share Information					
Basic earning per share	**$ 1.53**	$ 1.00	$ 0.82	$ 0.97	$ 3.59
Diluted earnings per share	**1.50**	0.98	0.81	0.97	3.59
Dividends paid per share	**0.51**	0.42	0.35	0.22	0.00
Book value at December 31	**18.39**	17.34	16.28	16.08	15.40
Weighted average shares outstanding – basic	**8,359,703**	8,070,472	8,059,412	8,106,438	8,110,344
Weighted average shares outstanding – diluted	**8,536,697**	8,226,261	8,145,456	8,141,600	8,116,054
Stock Price Statistics					
Close	**$ 18.21**	$ 25.25	$ 22.40	$ 17.84	$ 17.00
High	**27.05**	26.95	23.75	18.45	17.50
Low	**18.10**	19.05	16.60	15.10	15.33
Price earnings ratio at close	**11.9**	25.3	27.3	18.4	4.7
Diluted price earnings ratio at close	**12.1**	25.8	27.7	18.4	4.7
Price to book at close	**1.0**	1.5	1.4	1.1	1.1
Year-End Information					
Total assets	**$ 1,934,388**	$ 1,558,849	$ 1,414,504	$ 1,292,816	$ 1,190,443
Loans	**1,247,657**	1,010,012	883,391	781,713	704,946
	476,686	425,305	408,124	402,844	384,549

Total investment securities					
Deposits – noninterest-bearing	**204,843**	162,343	150,747	131,390	116,302
Deposits – interest-bearing	**1,353,913**	1,057,172	1,001,705	900,777	833,402
Total deposits	**1,558,756**	1,219,515	1,152,452	1,032,167	949,704
Repurchase agreements	**9,069**	43,576	35,864	29,156	21,742
Borrowed money	**170,309**	133,815	76,163	84,495	79,812
Total shareholders' equity	**173,433**	144,765	134,859	133,061	127,265
Assets under management – market value	**1,330,595**	1,370,950	1,174,143	966,362	1,017,013
Financial Ratios					
Average equity / average assets	**8.75%**	9.49 %	10.41 %	10.66 %	8.63 %
Return on average equity	**8.56%**	5.73 %	4.80 %	5.99 %	28.78 %
Return on average assets	**0.75%**	0.54 %	0.50 %	0.64 %	2.48 %

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ITEM 7 – MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion and analysis is intended to assist readers in understanding the consolidated financial condition and results of operations of Orrstown and should be read in conjunction with our Consolidated Financial Statements and notes thereto included in this Annual Report on Form 10-K. Certain prior period amounts presented in this discussion and analysis have been reclassified to conform to current period classifications.

Overview

The results of our operations are highly dependent on economic conditions and market interest rates. The Company's profitability for the years ended December 31, 2018, 2017 and 2016 was influenced by its continued organic growth and ongoing expansion into targeted markets, the acquisition of Mercersburg, and a continued focus on maintaining strong asset quality. These and other matters are discussed more fully below.

Critical Accounting Estimates

The Company's consolidated financial statements are prepared in accordance with GAAP, and follow general practices within the financial services industry. The most significant accounting policies followed by the Company are presented in Note 1, Summary of Significant Accounting Policies, to the Consolidated Financial Statements under Part II, Item 8, "Financial Statements and Supplementary Data." In applying those accounting policies, management of the Company is required to exercise judgment in determining many of the methodologies, assumptions and estimates to be utilized. Certain of the critical accounting estimates are more dependent on such judgment and in some cases may contribute to volatility in the Company's reported financial performance should the assumptions and estimates used change over time due to changes in circumstances. Some of the more significant areas in which management of the Company applies critical assumptions and estimates include the following.

Accounting for credit losses — The loan portfolio is the largest asset on the consolidated balance sheets. The allowance for loan loss represents the amount that in management's judgment appropriately reflects credit losses inherent in the loan portfolio at the balance sheet date. A provision for credit losses is recorded to adjust the level of the allowance as deemed necessary by management. In estimating losses inherent in the loan portfolio, assumptions and judgment are applied to measure amounts and timing of expected future cash flows, collateral values and other factors used to determine the borrowers' abilities to repay obligations. Historical loss trends are also considered, as are economic conditions, industry trends, portfolio trends and borrower-specific financial data. In accounting for loans acquired at a discount that is, in part, attributable to credit quality which are initially recorded at fair value with no carry-over of an acquired entity's previously established allowance for credit losses, the cash flows expected at acquisition in excess of estimated fair value are recognized as interest income over the remaining lives of the loans. Subsequent decreases in the expected principal cash flows require the Company to evaluate the need for additions to the Company's allowance for credit losses. Subsequent improvements in expected cash flows result first in the recovery of any applicable allowance for credit losses and then in the recognition of additional interest income over the remaining lives of the loans. Changes in the circumstances considered when determining management's estimates and assumptions could result in changes in those estimates and assumptions, which may result in adjustment of the allowance or, in the case of loans acquired at a discount, increases in interest income in future periods.

Valuation methodologies — Management applies various valuation methodologies to assets and liabilities which often involve a significant degree of judgment, particularly when liquid markets do not exist for the particular items being valued. Quoted market prices are referred to when estimating fair values for certain assets, such as; most investment securities. However, for those items for which an observable liquid market does not exist, management utilizes significant estimates and assumptions to value such items. Examples of these items include loans, deposits, borrowings, goodwill, core deposit and other intangible assets, other assets and liabilities obtained or assumed in business combinations, and capitalized servicing assets. These valuations require the use of various assumptions, including, among others, discount rates, rates of return on assets, repayment rates, cash flows, default rates, costs of servicing and liquidation values. The use of different assumptions could produce significantly different results, which could have material positive or negative effects on our results of operations, financial condition or disclosures of fair value information. In addition to valuation, the Company must assess whether there are any declines in value below the carrying value of assets that should be considered other than temporary or otherwise require an adjustment in carrying value and recognition of a loss in the consolidated statement of income. Examples include investment securities, loan servicing rights, goodwill and core deposit and other intangible assets, among others.

Readers of the consolidated financial statements should be aware that the estimates and assumptions used in the Company's current financial statements may need to be updated in future financial presentations for changes in circumstances, business or economic conditions in order to fairly represent the condition of the Company at that time.

Economic Climate, Inflation and Interest Rates

Preliminary annual real GDP growth for 2018 was 2.9%. This robust pace tied with 2015 for the strongest in over a decade. While the pace of U.S. economic growth was strong in 2018, growth peaked in the second quarter and has declined each quarter since. The positive impact of tax cuts and a significant increase in government spending appears to be fading. The Federal Reserve raised the Fed Funds rate four times in 2018 to the rate of 2.50% and has since announced that future interest rate increases are on hold. It remains to be seen if growth will return to the one to two percent range that persisted before the tax cuts and expansion of the federal deficit or if the economy will tip into recession. Credit spreads have recovered some of the widening they experienced late last year when the stock market entered correction territory. The unemployment rate recently increased as more of the population joined the work force, while inflation fell back from the Federal Reserve's two percent target. The U.S. Treasury yield curve has inverted with two-year rates above five-year rates, as some market participants take out recession insurance.

The majority of the assets and liabilities of a financial institution are monetary in nature, and therefore, differ greatly from most commercial and industrial companies that have significant investments in fixed assets or inventories. However, inflation does have an impact on the growth of total assets and on noninterest expenses, which tend to rise during periods of general inflation. Inflationary pressures remain modest and there is great uncertainty about when or if inflation will increase and pressure interest rates to move higher.

As the Company's balance sheet consists primarily of financial instruments, interest income and interest expense are greatly influenced by the level of interest rates and the slope of the yield curve. During 2016, interest rates were near all-time lows. The FRB raised the Fed Funds rate 25 basis points eight times between December of 2016 and December of 2018. The yield curve is currently flat with the ten-year U.S. Treasury yield less than 25 basis points above the Fed Funds rate. The Company has been able to grow its net interest income by $14,825,000 from 2016 to 2018, through the growth of loans and higher yielding securities in combination with slower increases in its funding costs. Competition for quality lending opportunities remains intense, which, together with a flattening yield curve, will continue to challenge our ability to grow our net interest margin and to leverage our overhead expenses.

Results of Operations

Summary

Earnings in 2018 reflected continuing increased interest income from expanding loan and investment portfolios in a rising rate environment, partially offset by increases in interest expense. In addition, the comparability of operating results for 2018 with 2017 have been impacted by the Mercersburg acquisition, which was completed on October 1, 2018 and added securities, loans and deposits totaling $7,352,000, $141,103,000 and $160,433,000, respectively.

The Company recorded net income of $12,805,000, $8,090,000 and $6,628,000 for 2018, 2017 and 2016. Diluted earnings per share totaled $1.50, $0.98 and $0.81 for 2018, 2017 and 2016.

Net interest income totaled $51,370,000, $43,371,000 and $36,545,000 for 2018, 2017 and 2016, principally reflecting our organic growth in loans from an expanded sales force and efforts to expand our geographic footprint while taking advantage of market opportunities. A higher interest rate environment each year contributed to increased yields on loans and investments, and, to a lesser extent, costs of interest-bearing liabilities.

Favorable historical charge-off data and management's emphasis on loan quality have positively impacted our results, as the allowance for loan losses increased moderately as loans have increased. The provision for loan losses totaled $800,000, $1,000,000 and $250,000 in 2018, 2017 and 2016.

Noninterest expenses totaled $57,979,000, $50,330,000 and $48,140,000 for 2018, 2017 and 2016. The changes in certain components of noninterest expenses between the years are reflective of the Company's focus on investing in additional talent and locations to better serve the needs of our customers and continuing efforts to develop new relationships by taking advantage of market opportunities created by consolidation of other banks. Salaries and employee benefits expense increased $3,775,000 from 2016 to 2017 and $2,379,000 from 2017 to 2018. Occupancy and furniture and fixture costs increased $414,000 from 2016 to 2017 and $923,000 from 2017 to 2018 as new branch locations were opened. In 2018, the Company incurred $3,197,000 in pretax expense for merger related activity.

Income tax expense totaled $1,640,000, $4,338,000 and $1,266,000 for 2018, 2017 and 2016, or an effective tax rate of 11.4%, 34.9% and 16.0% respectively. In 2017, we remeasured our net deferred tax asset due to the enactment of the Tax Act in December 2017. The Tax Act lowered our statutory tax rate from 34% to 21% effective January 1, 2018. Remeasurement of our net deferred tax asset at the lower rate resulted in an expense of $2,635,000, which is included in total tax expense for 2017.

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Net Interest Income

Net interest income is the primary component of the Company's revenue. Interest-earning assets include loans, securities and federal funds sold. Interest-bearing liabilities include deposits and borrowed funds.

Net interest income is affected by changes in interest rates, volumes of interest-earning assets and interest-bearing liabilities, and the composition of those assets and liabilities. “Net interest spread” and “net interest margin” are two common statistics related to changes in net interest income. The net interest spread represents the difference between the yields earned on interest-earning assets and the rates paid for interest-bearing liabilities. The net interest margin is defined as the ratio of net interest income to average earning asset balances. Through the use of noninterest-bearing demand deposits and shareholders' equity, the net interest margin exceeds the net interest spread, as these funding sources are noninterest-bearing.

The Federal Reserve influences the general market rates of interest, including the deposit and loan rates offered by many financial institutions. Our loan portfolio is affected by changes in the prime interest rate. In 2016, the prime rate was at 3.50% until it increased 25 basis points in December to end the year at 3.75%. During 2017, the prime rate increased 25 basis points in each of March, June and December to end the year at 4.50%. And in 2018, the prime rate continued to rise with 25 point increases in each of March, June, September and December, ending the year at 5.50%.

Core deposits are deposits that are stable, lower cost and generally reprice more slowly than other deposits when interest rates change. Core deposits are typically funds of local customers who also have a borrowing or other relationship with the Bank. We are primarily funded by core deposits, with noninterest-bearing demand deposits historically being a significant source of funds. This lower-cost funding base is expected to have a positive impact on our net interest income and net interest margin in a rising interest rate environment.

Net interest income totaled $51,370,000, $43,371,000 and $36,545,000 in 2018, 2017 and 2016. The following table presents net interest income, net interest spread and net interest margin on a taxable-equivalent basis for 2018, 2017 and 2016. Taxable-equivalent adjustments are the result of increasing income from tax-free loans and investments by an amount equal to the taxes that would be paid if the income were fully taxable based on a 21% federal corporate tax rate for 2018 and 34% for 2017 and 2016, reflecting our statutory tax rates for those years. The lower rate in 2018 reflects tax law changes to our statutory tax rate effective January 1, 2018.

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	2018			2017			2016		
(Dollars in thousands)	**Average Balance**	**Taxable-Equivalent Interest**	**Taxable-Equivalent Rate**	**Average Balance**	**Taxable-Equivalent Interest**	**Taxable-Equivalent Rate**	**Average Balance**	**Taxable-Equivalent Interest**	**Taxable-Equivalent Rate**
Assets									
Federal funds sold and interest-bearing bank balances	**$ 16,442**	**$ 327**	**1.99%**	$ 15,487	$ 218	1.41%	$ 31,452	$ 208	0.66%
Taxable securities	**359,852**	**10,858**	**3.02**	326,900	7,478	2.29	303,124	6,012	1.98
Tax-exempt securities	**119,665**	**4,873**	**4.07**	93,683	4,748	5.07	57,231	2,767	4.83
Total securities	**479,517**	**15,731**	**3.28**	420,583	12,226	2.91	360,355	8,779	2.44
Taxable loans	**1,053,308**	**48,321**	**4.59**	893,555	38,568	4.32	774,984	32,036	4.13
Tax-exempt loans	**47,318**	**1,875**	**3.96**	50,797	2,450	4.82	58,281	2,848	4.89
Total loans	**1,100,626**	**50,196**	**4.56**	944,352	41,018	4.34	833,265	34,884	4.19
Total interest-earning assets	**1,596,585**	**66,254**	**4.15**	1,380,422	53,462	3.87	1,225,072	43,871	3.58
Cash and due from banks	**18,951**			20,391			20,803		
Bank premises and equipment	**35,399**			35,055			31,413		
Other assets	**72,960**			65,293			61,391		
Allowance for loan losses	**(13,298)**			(12,738)			(13,529)		
Total	**$ 1,710,597**			$ 1,488,423			$ 1,325,150		
Liabilities and Shareholders' Equity									
Interest-bearing demand deposits	**$ 767,863**	**4,924**	**0.64**	$ 648,174	2,148	0.33	$ 565,524	1,195	0.21
Savings deposits	**102,189**	**159**	**0.16**	94,815	150	0.16	90,272	144	0.16
Time deposits	**324,118**	**5,102**	**1.57**	292,616	3,836	1.31	289,574	3,472	1.20
Short-term borrowings	**81,172**	**1,577**	**1.94**	97,814	784	0.80	56,387	187	0.33
Long-term debt	**83,640**	**1,632**	**1.95**	36,336	726	2.00	24,335	419	1.72
Subordinated notes	**1,139**	**73**	**6.41**	0	0	0.00	0	0	0.00
Total interest-bearing liabilities	**1,360,121**	**13,467**	**0.99**	1,169,755	7,644	0.65	1,026,092	5,417	0.53
	183,387			161,917			147,473		

Noninterest-bearing demand deposits								
Other	**17,427**			15,450			13,612	
Total Liabilities	**1,560,935**			1,347,122			1,187,177	
Shareholders' Equity	**149,662**			141,301			137,973	
Total	**$ 1,710,597**			$ 1,488,423			$ 1,325,150	
Taxable-equivalent net interest income / net interest spread		**52,787**	**3.16 %**		45,818	3.22 %		38,454	3.05 %
Taxable-equivalent net interest margin			**3.31 %**			3.32 %			3.14 %
Taxable-equivalent adjustment		**(1,417)**			(2,447)			(1,909)	
Net interest income		**$ 51,370**			$ 43,371			$ 36,545	

Note: Yields and interest income on tax-exempt assets have been computed on a taxable-equivalent basis assuming a 21% tax rate in 2018 and 34% in 2017 and 2016. For yield calculation purposes, nonaccruing loans are included in the average loan balance.

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The following table presents changes in net interest income on a taxable-equivalent basis for 2018, 2017 and 2016 by rate and volume components.

	2018 Versus 2017 Increase (Decrease) Due to Change in			**2017 Versus 2016 Increase (Decrease) Due to Change in**		
(Dollars in thousands)	**Average Volume**	**Average Rate**	**Total**	**Average Volume**	**Average Rate**	**Total**
Interest Income						
Federal funds sold and interest-bearing bank balances	**$ 13**	**$ 96**	**$ 109**	$ (106)	$ 116	$ 10
Taxable securities	**754**	**2,626**	**3,380**	472	994	1,466
Tax-exempt securities	**1,317**	**(1,192)**	**125**	1,762	219	1,981
Taxable loans	**6,895**	**2,858**	**9,753**	4,901	1,631	6,532
Tax-exempt loans	**(168)**	**(407)**	**(575)**	(366)	(32)	(398)
Total interest income	**8,811**	**3,981**	**12,792**	6,663	2,928	9,591
Interest Expense						
Interest-bearing demand deposits	**397**	**2,379**	**2,776**	175	778	953
Savings deposits	**12**	**(3)**	**9**	7	(1)	6
Time deposits	**413**	**853**	**1,266**	36	328	364
Short-term borrowings	**(133)**	**926**	**793**	137	460	597
Long-term debt	**945**	**(39)**	**906**	207	100	307
Subordinated notes	**73**	**0**	**73**	0	0	0
Total interest expense	**1,707**	**4,116**	**5,823**	562	1,665	2,227
Net Interest	**$ 7,104**	**$ (135)**	**$ 6,969**	$ 6,101	$ 1,263	$ 7,364

Income

Note: The change attributed to volume is calculated by taking the average change in average balance times the prior year's average rate and the remainder is attributable to rate.

2018 versus 2017

In 2018, net interest income increased $7,999,000, or 18.4%, compared with 2017. Net interest income for 2018 on a taxable-equivalent basis increased $6,969,000, or 15.2%, compared with 2017. The Company’s net interest spread decreased 6 basis point to 3.16% for 2018 compared with 2017. Taxable-equivalent yields on interest-earning assets and costs of interest-bearing liabilities both increased from 2017 to 2018, reflecting the increased interest rate environment between years. Other factors impacting the comparison of taxable-equivalent yields between 2017 and 2018 included the effect of purchase accounting related to the Mercersburg acquisition; the Company's gradual increase in rates paid on interest-bearing deposits in response to market demand; and the change in our statutory tax rate.

Interest income on a taxable-equivalent basis on loans increased $9,178,000, or 22.4%, from 2017 to 2018. The increase resulted from an increase in both average loan volume and yield, with average loans increasing $156,274,000, or 16.5%, and yield increasing 22 basis points from 4.34% in 2017 to 4.56% in 2018. The Company's geographic expansion and sales efforts with additional loan officers continued to drive loan growth in 2018 across most loan classes. Increases in prime lending rates during the year contributed to the increased yield, but a flattened yield curve partially offset the benefit of the rate increases. Accretion of purchase accounting adjustments in connection with the Mercersburg acquisition increased 2018 interest income by $335,000.

Interest income earned on a taxable-equivalent basis on securities increased $3,505,000, or 28.7%, from 2017 to 2018, with both average volume and yield increasing. Average securities increased $58,934,000, or 14.0%, and yield increased from 2.91% in 2017 to 3.28% in 2018. Contributing to the increase in interest income on securities was the higher rate environment in 2018 and strategic moves within the portfolio as the interest rate environment changed.

Interest expense on deposits and borrowings increased $5,823,000 from 2017 to 2018, as the average balance of interest-bearing liabilities increased $190,366,000, or 16.3%.

Our ability to attract new deposits in all categories, but in particular interest-bearing demand deposits, resulted in an increase in average interest-bearing deposits totaling $119,689,000, or 18.5%, in 2018. Interest expense for these deposits increased $2,776,000, with the cost of funds increasing from 0.33% in 2017 to 0.64% in 2018. Generally, the Company

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increased rates paid on interest-bearing deposits in 2018 in response to market conditions, but at a slower pace than yields earned on interest-earning assets.

We also increased our short-term and long-term borrowings in 2018 to partially fund loan and investment portfolio growth. In late 2018, we issued $32,500,000 in aggregate principal amount of subordinated notes, the proceeds of which were designated for the cash portion of merger and acquisition activity and for general corporate purposes. Borrowings generally have higher interest rates associated with them than interest-bearing deposits. Interest expense on all borrowings increased $1,772,000 in 2018, with average balances decreasing $16,642,000 for short-term borrowings while long-term borrowings increased $47,304,000 as the Company responded to the changing interest rate environment. The average rate paid on short-term borrowings increased from 0.80% in 2017 to 1.94% in 2018 and the average rate paid on long-term borrowings decreased from 2.00% in 2017 to 1.95% in 2018.

<u>2017 versus 2016</u>

In 2017, net interest income increased $6,826,000, or 18.6%, compared with 2016. Net interest income for 2017 on a taxable-equivalent basis increased $7,364,000, or 19.2%, compared with 2016.

Interest income on a taxable-equivalent basis on loans increased $6,134,000, or 17.6%, from 2016 to 2017. The increase resulted from an increase in both average loan volume and yield, with average loans increasing $111,087,000, or 13.3%, and yield increasing 15 basis points from 4.19% in 2016 to 4.34% in 2017. The Company's geographic expansion and sales efforts with additional loan officers continued to drive loan growth in 2017 across most loan classes. Increases in prime lending rates during the year contributed to the increased yield, but a flattening yield curve partially offset the benefit of the rate increases.

Interest income earned on a taxable-equivalent basis on securities increased $3,447,000, or 39.3%, from 2016 to 2017, with both average volume and yield increasing. Average securities increased $60,228,000, or 16.7%, and yield increased from 2.44% in 2016 to 2.91% in 2017. Contributing to the increase in interest income on securities was the higher rate environment in 2017, a higher composition of tax free securities with accompanying higher taxable-equivalent yields and strategic moves within the portfolio as the interest rate environment changed.

Interest expense on deposits and borrowings increased $2,227,000 from 2016 to 2017, as the average balance of interest-bearing liabilities increased $143,663,000, or 14.00%. Generally, the cost of interest-bearing liabilities increased at a slower pace than yields earned on interest-earning assets in 2017, as the market for interest-bearing liabilities was initially slower to respond to interest rate changes.

Our ability to attract new deposits in all categories, but in particular interest-bearing demand deposits, resulted in an increase in average interest-bearing deposits totaling $82,650,000, or 14.6%, in 2017. Interest expense for these deposits increased $953,000, with the cost of funds increasing from 0.21% in 2016 to 0.33% in 2017.

We also increased our short-term and long-term borrowings in 2017 to partially fund loan and investment portfolio growth. Interest expense on borrowings increased $904,000 in 2017, with average balances increasing $41,427,000 for short-term borrowings and $12,001,000 for long-term borrowings. The average rate paid on short-term borrowings increased from 0.33% in 2016 to 0.80% in 2017 and the average rate paid on long-term borrowings increased from 1.72% in 2016 to 2.00% in 2017.

Provision for Loan Losses

The Company recorded a provision for loan losses of $800,000, $1,000,000 and $250,000 in 2018, 2017, and 2016. In calculating the provision for loan losses, both quantitative and qualitative factors, including the Company's favorable historical charge-off data and stable economic and market conditions, were considered in the determination of the adequacy of the ALL. Net charge-offs and loan growth resulted in the determination that a provision expense was required in 2018, 2017 and 2016. The provision expense in 2017 principally reflected a charge-off on one commercial loan that was downgraded to nonaccrual status in the fourth quarter.

See further discussion in the “Asset Quality” and “Credit Risk Management” sections of this Management’s Discussion and Analysis of Financial Condition and Results of Operations.

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Noninterest Income

The following table compares noninterest income for 2018, 2017 and 2016.

(Dollars in thousands)	2018	2017	2016	$ Change 2018-2017	$ Change 2017-2016	% Change 2018-2017	% Change 2017-2016
Service charges on deposit accounts	$ 6,054	$ 5,675	$ 5,445	$ 379	$ 230	6.7%	4.2%
Other service charges, commissions and fees	1,737	1,008	994	729	14	72.3%	1.4%
Trust and investment management income	6,576	6,400	5,091	176	1,309	2.8%	25.7%
Brokerage income	2,035	1,896	1,933	139	(37)	7.3%	(1.9)%
Mortgage banking activities	2,663	2,919	3,412	(256)	(493)	(8.8)%	(14.4)%
Income from life insurance	1,463	1,109	1,099	354	10	31.9%	0.9%
Other income	320	190	345	130	(155)	68.4%	(44.9)%
Subtotal before securities gains	20,848	19,197	18,319	1,651	878	8.6%	4.8%
Investment securities gains	1,006	1,190	1,420	(184)	(230)	(15.5)%	(16.2)%
Total noninterest income	$ 21,854	$ 20,387	$ 19,739	$ 1,467	$ 648	7.2%	3.3%

2018 versus 2017

Noninterest income increased $1,467,000 from 2017 to 2018. In addition to the impact of the Mercersburg acquisition, the following were significant factors to that net increase.

- Service charges on deposit accounts continued to increase in 2018 as a result of new product offerings and increased activity associated with deposit growth.
- Other service charges, commissions and fees in 2018 included additional gains on SBA loan sales and an increase in loan transaction fees.
- Trust department income increased more modestly in 2018 than in 2017, reflecting a reduction in fee income in the latter part of 2018 as financial markets declined.
- The decrease in mortgage banking activities reflects a combination of overall decreased refinance activity as interest rates increased and a shortage of available housing inventory during the year.
- Income from life insurance increased principally due to death benefit proceeds.
- In both 2018 and 2017, asset/liability management strategies resulted in net gains on sales of securities, as market conditions presented opportunities to improve responsiveness of the portfolio to interest rate conditions, while also considering funding requirements of anticipated lending activity.

2017 versus 2016

Noninterest income increased $648,000 from 2016 to 2017. The following factors contributed to that net increase.

•Service charges on deposit accounts continued to increase in 2017 as a result of new product offerings and increased activity associated with deposit growth.
•Increased trust department income was realized throughout 2017 from favorable market conditions and the addition of an office in Berks County, Pennsylvania. Wheatland, which was acquired in December 2016, contributed approximately 39% of this increased revenue category in 2017.
•The decrease in mortgage banking activities reflects a combination of overall decreased refinance activity as interest rates have increased, some slight compression in sales profit margins that the Company has experienced and the portion of mortgage production retained for the Company's loan portfolio.
•Other income decreased in 2017 principally due to lower gains on sales of other real estate owned.
•In both 2017 and 2016, asset/liability management strategies resulted in net gains on sales of securities, as market and interest rate conditions presented opportunities to accelerate earnings on securities, while meeting funding requirements of the Company. In 2017, the Company repositioned a part of its investment portfolio at a gain to improve responsiveness of the portfolio to increases in short-term interest rates.

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Noninterest Expenses

The following table compares noninterest expenses for 2018, 2017 and 2016.

				$ Change		% Change	
(Dollars in thousands)	**2018**	**2017**	**2016**	**2018-2017**	**2017-2016**	**2018-2017**	**2017-2016**
Salaries and employee benefits	**$ 32,524**	$ 30,145	$ 26,370	**$ 2,379**	$ 3,775	**7.9%**	14.3%
Occupancy	**3,084**	2,806	2,491	**278**	315	**9.9%**	12.6%
Furniture and equipment	**4,079**	3,434	3,335	**645**	99	**18.8%**	3.0%
Data processing	**2,674**	2,271	2,378	**403**	(107)	**17.7%**	(4.5)%
Telephone and communication	**753**	647	740	**106**	(93)	**16.4%**	(12.6)%
Automated teller machine and interchange fees	**806**	767	748	**39**	19	**5.1%**	2.5%
Advertising and bank promotions	**1,592**	1,600	1,717	**(8)**	(117)	**(0.5)%**	(6.8)%
FDIC insurance	**681**	606	775	**75**	(169)	**12.4%**	(21.8)%
Legal	**413**	802	850	**(389)**	(48)	**(48.5)%**	(5.6)%
Other professional services	**1,434**	1,571	1,332	**(137)**	239	**(8.7)%**	17.9%
Directors' compensation	**984**	996	969	**(12)**	27	**(1.2)%**	2.8%
Real estate owned	**97**	69	239	**28**	(170)	**40.6%**	(71.1)%
Taxes other than income	**1,012**	866	767	**146**	99	**16.9%**	12.9%
Intangible asset amortization	**286**	102	99	**184**	3	**180.4%**	3.0%
Regulatory settlement	**0**	0	1,000	**0**	(1,000)	**0.0%**	(100.0)%
Merger related	**3,197**	0	0	**3,197**	0	**0.0%**	0.0%
Other operating expenses	**4,363**	3,648	4,330	**715**	(682)	**19.6%**	(15.8)%
Total noninterest expenses	**$ 57,979**	$ 50,330	$ 48,140	**$ 7,649**	$ 2,190	**15.2%**	4.5%

<u>2018 versus 2017</u>

Noninterest expenses increased $7,649,000 from 2017 to 2018. In addition to the impact of the Mercersburg acquisition, the following were significant factors to that net increase.

•The salaries and employee benefits increase includes the impact in 2018 of additional employees, including new customer-facing employees in new branches in targeted expansion markets and others that were hired throughout 2017 and 2018. Higher costs in 2018 also include annual merit increases awarded in 2018 and incentive compensation increases, additional share-based awards granted in 2017, net of the benefit of forfeitures, and increased medical costs for the expanded workforce. Medical costs in 2018 benefited from reduced claim activity from that experienced in 2017.

•Occupancy and furniture and equipment expenses reflect a full period of expense for new facilities opened in 2017 and 2018, principally in Lancaster County, Pennsylvania.

•The Company incurred certain indemnification costs, totaling $645,000, which is included in legal fees, with several professional service providers in 2017 in connection with previously disclosed outstanding litigation. Indemnification costs incurred in 2018 were not material. Additional costs may be incurred as the litigation progresses.

•Intangible asset amortization increased due to the core deposit intangible recorded in the Mercersburg acquisition.
•Merger related costs were principally for investment banking and legal and consulting fees for the Mercersburg acquisition.
•Other line items within noninterest expenses are generally attributable to normal fluctuations in the conduct of business.

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2017 versus 2016

Noninterest expenses increased $2,190,000 from 2016 to 2017. The following factors contributed to that net increase.

•The salaries and employee benefits increase includes the impact in 2017 of additional employees, including new customer-facing employees in targeted expansion markets, throughout 2016 and 2017. Higher costs in 2017 also include annual merit increases awarded in 2017, increased medical benefit costs for the expanded workforce and increased claim activity, incentive compensation increases and additional share-based awards granted in 2017.

•Occupancy and furniture and equipment expenses reflect a full period of expense for new facilities acquired in 2016 in Berks, Cumberland, Dauphin and Lancaster Counties, Pennsylvania, as well as increases attributable to new facilities acquired in 2017 in Lancaster County, Pennsylvania.

•Advertising and bank promotion expense in 2016 included higher expenses related to expansion activities.

•The FDIC reached its 1.15% of insured funds target in June 2016, resulting in lower assessments. FDIC insurance expense in 2017 benefited from that lower assessment applied to our increased deposit base.

•Resolution of the SEC administrative proceedings in 2016 generally resulted in lower legal fees incurred in 2017. However, the Company incurred certain indemnification costs totaling $645,000, which is included in legal fees, with several professional service providers in 2017 in connection with previously disclosed outstanding litigation. Additional costs may be incurred as the litigation progresses.

•In 2016, the Company agreed to pay a $1,000,000 civil money penalty to the SEC to settle administrative proceedings.

•Principal contributors to lower other operating expenses in 2017 were decreases in provision expense for off-balance sheet reserves on loans that have been committed to borrowers, but not funded, resulting from changes in qualitative factors similar to those used in the determination of the provision for loan losses, and reduced consumer fraud expenses.

•Other line items within noninterest expenses are generally attributable to normal fluctuations in the conduct of business.

Income Taxes

Income tax expense totaled $1,640,000, $4,338,000 and $1,266,000 for 2018, 2017 and 2016. As described more fully in Note 7, Income Taxes, to the Consolidated Financial Statements under Part II, Item 8, "Financial Statements and Supplementary Data," due to tax reform enacted in 2017, the Company was required to remeasure its net deferred tax asset and incurred a tax expense of $2,635,000, which is included in total tax expense for 2017.

Note 7 also includes a reconciliation of our federal statutory tax rate to our effective tax rate, which is a meaningful comparison between years and measures income tax expense as a percentage of pretax income. The effective tax rate for 2018 was 11.4% compared with 34.9% for 2017 and 16.0% for 2016. Generally, our effective tax rate is lower than the federal statutory tax rate principally due to nontaxable interest income earned on tax-free loans and securities and income from life insurance policies, offset partially by nondeductible expenses. In 2017, our higher effective tax rate was principally impacted by the tax expense incurred due to enacted tax reform. Our statutory federal tax rate was 21% in 2018 and 34% in 2017 and 2016. In 2016, the Company changed its statutory federal tax rate from 35% to 34% to reflect its assessment that it would not be in the higher tax bracket and recognized increased tax expense totaling $185,000 related to the application of the new rate to existing deferred balances.

Financial Condition

Management devotes substantial time to overseeing the investment of funds in loans and securities and the formulation of policies directed toward the profitability and management of the risks associated with these investments.

Securities Available for Sale

The Company utilizes securities available for sale to manage interest rate risk, to enhance income through interest and dividend income, to provide liquidity and to provide collateral for certain deposits and borrowings.

The Company has established investment policies and an asset management policy to assist in administering its investment portfolio. Decisions to purchase or sell these securities are based on economic conditions and management's

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strategy to respond to changes in interest rates, liquidity, pledges to secure deposits and repurchase agreements and other factors while trying to maximize return on the investments. The Company may segregate its investment portfolio into three categories: “securities held to maturity,” “trading securities” and “securities available for sale.” Management has classified the entire securities portfolio as available for sale, which are accounted for at current market value with unrealized gains and losses excluded from earnings and reported in other comprehensive income, net of income taxes.
The Company’s securities available for sale portfolio includes debt investments that are subject to varying degrees of credit and market risks, which arise from general market conditions, and factors impacting specific industries, as well as news that may impact specific issues. Management monitors its debt securities, using various indicators in determining whether a debt security is other-than-temporarily impaired, including the extent of time the security has been in an unrealized loss position, and the extent of the unrealized loss. In addition, management assesses whether it is likely the Company will have to sell the security prior to recovery, or if it is able to hold the security until the price recovers. For those debt securities in which management concludes the security is other-than-temporarily impaired, it recognizes the credit component of an other-than-temporary impairment in earnings and the remaining portion in other comprehensive income. Given the strong asset quality of the debt security portfolio, the Company did not record any other-than-temporary impairment expense in 2018, 2017 or 2016.
The following table summarizes fair value of securities available for sale at December 31.

(Dollars in thousands)	**2018**		2017		2016	
U.S. Government Agencies	**$**	**0**	$	0	$	39,592
States and political subdivisions	**145,004**		159,458		164,282	
GSE residential mortgage-backed securities	**0**		49,530		116,944	
GSE residential CMOs	**108,064**		111,119		69,383	
GSE commercial CMOs	**0**		0		4,856	
Private label residential CMOs	**143**		1,003		5,006	
Private label commercial CMOs	**75,045**		7,653		0	
Asset-backed and other	**137,588**		86,545		91	
Total debt securities	**$**	**465,844**	$	415,308	$	400,154

The Company increased its investment portfolio in 2018, with the average balance of securities increasing from $420,583,000 for the year ended December 31, 2017 to $479,517,000 for the year ended December 31, 2018.
In early 2017, the Company liquidated its U.S. Government Agencies investments in anticipation of a flattening yield curve, with funds reinvested in fixed rate CMOs. The Company also took advantage of historically wide spreads and higher interest rates to add modestly to its holdings of longer-term fixed rate securities issued by states and political subdivisions. In the second half of 2017, the Company reduced its holdings of seasoned GSE residential mortgage-backed securities and intermediate maturity taxable securities issued by states and political subdivisions and reinvested the proceeds in floating rate asset-backed securities in anticipation of further increases in short-term interest rates. Investment in asset-backed securities continued in 2018.

Asset-backed securities and CMOs provide monthly cash flows that may be used, in part, to meet anticipated loan demand in 2019, as management anticipates the loan portfolio will continue to grow.

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The following table shows the maturities of investment securities at book value at December 31, 2018, and weighted average yields of such securities. Yields are shown on a tax equivalent basis, assuming a 21% federal income tax rate.

(Dollars in thousands)	Within 1 year	After 1 year but within 5 years	After 5 years but within 10 years	After 10 years	Total
States and political subdivisions					
Book value	$ 799	$ 2,531	$ 37,168	$ 104,098	$ 144,596
Yield	1.79%	2.49 %	3.42 %	4.09%	3.88%
Average maturity (years)	0.4	2.6	8.7	17.0	14.5
GSE residential CMOs					
Book value	$ 0	$ 0	$ 0	$ 110,421	$ 110,421
Yield	0.00%	0.00 %	0.00 %	2.54%	2.54%
Average maturity (years)	0.0	0.0	0.0	27.6	27.6
Private label residential CMOs					
Book value	$ 0	$ 0	$ 0	$ 144	$ 144
Yield	0.00%	0.00 %	0.00 %	2.30%	2.30%
Average maturity (years)	0.0	0.0	0.0	17.1	17.1
Private label commercial CMOs					
Book value	$ 0	$ 0	$ 4,013	$ 71,898	$ 75,911
Yield	0.00%	0.00 %	3.19 %	3.10%	3.10%
Average maturity (years)	0.0	0.0	6.5	18.8	18.1
Asset-backed and other					
Book value	$ 0	$ 0	$ 12,341	$ 126,194	$ 138,535

Yield	**0.00%**	**0.00 %**	**4.03 %**	**3.22%**	**3.29%**
Average maturity (years)	**0.0**	**0.0**	**6.8**	**22.7**	**21.3**
Total					
Book value	**$ 799**	**$ 2,531**	**$ 53,522**	**$ 412,755**	**$ 469,607**
Yield	**1.79%**	**2.49 %**	**3.54 %**	**3.24%**	**3.26%**
Average maturity (years)	**0.4**	**2.9**	**8.1**	**21.9**	**20.2**

The average maturity is based on the contractual terms of the debt or mortgage-backed securities, and does not factor in required repayments or anticipated prepayments. At December 31, 2018, the weighted average estimated life is 7.9 years for mortgage-backed and CMO securities, and 4.4 years for asset-backed securities, based on current interest rates and anticipated prepayment speeds.

Loan Portfolio

The Company offers a variety of products to meet the credit needs of its borrowers, principally commercial real estate loans, commercial and industrial loans, and retail loans consisting of loans secured by residential properties, and to a lesser extent, installment loans. No loans are extended to non-domestic borrowers or governments.

Generally, we are permitted under applicable law to make loans to single borrowers (including certain related persons and entities) in aggregate amounts of up to 15% of the sum of total capital and the ALL. The Company’s legal lending limit to one borrower was $26,000,000 at December 31, 2018. No borrower had an outstanding exposure exceeding the limit at year-end.

The risks associated with lending activities differ among loan classes and are subject to the impact of changes in interest rates, market conditions of collateral securing the loans and general economic conditions. Any of these factors may adversely impact a borrower’s ability to repay loans, and also impact the associated collateral. A further discussion on the classes of loans the Company makes and related risks is included in Note 1, Summary of Significant Accounting Policies, and Note 4, Loans and Allowance for Loan Losses, to the Consolidated Financial Statements under Part II, Item 8, "Financial Statements and Supplementary Data."

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The following table presents the loan portfolio, excluding residential LHFS, by segments and classes at December 31.

(Dollars in thousands)	2018	2017	2016	2015	2014
Commercial real estate:					
Owner-occupied	**$ 129,650**	$ 116,811	$ 112,295	$ 103,578	$ 100,859
Non-owner occupied	**252,794**	244,491	206,358	145,401	144,301
Multi-family	**78,933**	53,634	47,681	35,109	27,531
Non-owner occupied residential	**100,367**	77,980	62,533	54,175	49,315
Acquisition and development:					
1-4 family residential construction	**7,385**	11,730	4,663	9,364	5,924
Commercial and land development	**42,051**	19,251	26,085	41,339	24,237
Commercial and industrial	**160,964**	115,663	88,465	73,625	48,995
Municipal	**50,982**	42,065	53,741	57,511	61,191
Residential mortgage:					
First lien	**235,296**	162,509	139,851	126,022	126,491
Home equity – term	**12,208**	11,784	14,248	17,337	20,845
Home equity – lines of credit	**143,616**	132,192	120,353	110,731	89,366
Installment and other loans	**33,411**	21,902	7,118	7,521	5,891
Total loans (1)	**$ 1,247,657**	$ 1,010,012	$ 883,391	$ 781,713	$ 704,946

(1) Includes $135,009,000 of acquired loans as of December 31, 2018.

The loan portfolio at December 31, 2018 increased $237,645,000, or 23.5%, from December 31, 2017, with approximately 55% of the increase attributable to acquired loans. The Mercersburg acquisition increased the loan portfolio, principally in the residential mortgage - first lien, commercial and industrial, and commercial real estate - owner occupied classes. The Company's organic growth occurred in both core and newer markets, such as Lancaster County, Pennsylvania, principally in commercial real estate; acquisition and development loans as the need for new construction financing has increased in the market; and in commercial and industrial loans and installment and other loans as we focused on increasing diversification in the portfolio. The growth in installment and other loans in 2017 and 2018 was principally attributable to purchased automobile financing loans at higher returns than comparable cash flows in the investment portfolio.

Competition for new business opportunities remains strong, which may temper loan growth in future quarters.

In addition to monitoring our loan portfolio by loan class as noted above, we also monitor concentrations by industry. The Bank's lending policy defines an industry concentration as one that exceeds 25% of the Bank's total risk-based capital ("RBC"). One industry met this criteria at December 31, 2018.

(Dollars in thousands)	**Balance**	**% of Total Loans**	**% of Total RBC**
Office space	**$81,325**	**6.5%**	**45.7%**

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The following table presents expected maturities of certain loan classes by fixed rate or adjustable rate categories at December 31, 2018.

(Dollars in thousands)	Due In One Year or Less	One Year Through Five Years	After Five Years	Total
Acquisition and development:				
1-4 family residential construction				
Fixed rate	$ 1,551	$ 0	$ 1,625	$ 3,176
Adjustable and floating rate	3,479	0	730	4,209
	5,030	0	2,355	7,385
Commercial and land development				
Fixed rate	1,819	485	22,315	24,619
Adjustable and floating rate	3,771	1,295	12,366	17,432
	5,590	1,780	34,681	42,051
Commercial and industrial				
Fixed rate	2,075	43,823	14,744	60,642
Adjustable and floating rate	71,325	14,217	14,780	100,322
	73,400	58,040	29,524	160,964
	$ 84,020	$ 59,820	$ 66,560	$ 210,400

The final maturity is used in the determination of maturity of acquisition and development loans that convert from construction to permanent status. Variable rate loans shown above include semi-fixed loans that contractually will adjust with prime or LIBOR after the interest lock period, which may be up to 10 years. At December 31, 2018, these semi-fixed loans totaled $23,626,000.

Asset Quality

Risk Elements

The Company’s loan portfolio is subject to varying degrees of credit risk. Credit risk is managed through our underwriting standards, on-going credit reviews, and monitoring of asset quality measures. Additionally, loan portfolio diversification, which limits exposure to a single industry or borrower, and collateral requirements also mitigate our risk of credit loss.

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The following table presents the Company’s risk elements and relevant asset quality ratios at December 31.

(Dollars in thousands)	**2018**	**2017**	**2016**	**2015**	**2014**
Nonaccrual loans (cash basis)	**$ 5,165**	$ 9,843	$ 7,043	$ 16,557	$ 14,432
OREO	**130**	961	346	710	932
Total nonperforming assets	**5,295**	10,804	7,389	17,267	15,364
Restructured loans still accruing	**1,132**	1,183	930	793	1,100
Loans past due 90 days or more and still accruing	**57**	0	0	24	0
Total nonperforming and other risk assets	**$ 6,484**	$ 11,987	$ 8,319	$ 18,084	$ 16,464
Loans 30-89 days past due	**$ 5,186**	$ 5,277	$ 1,218	$ 2,532	$ 1,612
Asset quality ratios:					
Total nonperforming loans to total loans	**0.41%**	0.97%	0.80%	2.12%	2.05%
Total nonperforming assets to total assets	**0.27%**	0.69%	0.52%	1.34%	1.29%
Total nonperforming assets to total loans and OREO	**0.42%**	1.07%	0.84%	2.21%	2.18%
Total risk assets to total loans and OREO	**0.52%**	1.19%	0.94%	2.31%	2.33%
Total risk assets to total assets	**0.34%**	0.77%	0.59%	1.40%	1.38%
Allowance for loan losses to total loans	**1.12%**	1.27%	1.45%	1.74%	2.09%
	271.93%	130.00%	181.39%	81.95%	102.18%

Allowance for loan losses to nonperforming loans					
Allowance for loan losses to nonperforming loans and restructured loans still accruing	**222.55%**	116.05%	160.23%	78.20%	94.95%

The following table provides detail of impaired loans at December 31, 2018 and 2017.

	2018			**2017**		
(Dollars in thousands)	**Nonaccrual Loans**	**Restructured Loans Still Accruing**	**Total**	**Nonaccrual Loans**	**Restructured Loans Still Accruing**	**Total**
Commercial real estate:						
Owner occupied	**$ 1,841**	**$ 39**	**$ 1,880**	$ 1,185	$ 52	$ 1,237
Non-owner occupied	**0**	**0**	**0**	4,065	0	4,065
Multi-family	**131**	**0**	**131**	165	0	165
Non-owner occupied residential	**309**	**0**	**309**	381	0	381
Acquisition and development						
1-4 family residential construction	**0**	**0**	**0**	492	0	492
Commercial and industrial	**286**	**0**	**286**	350	0	350
Residential mortgage:						
First lien	**1,808**	**1,069**	**2,877**	2,734	1,102	3,836
Home equity – term	**16**	**0**	**16**	22	0	22
Home equity – lines of credit	**774**	**24**	**798**	438	29	467
	0	**0**	**0**	11	0	11

Installment and other loans						
	$ 5,165	**$ 1,132**	**$ 6,297**	$ 9,843	$ 1,183	$ 11,026

Nonperforming assets include nonaccrual loans and foreclosed real estate. Risk assets, which incorporate nonperforming assets and restructured and loans past due 90 days or more and still accruing, totaled $6,484,000 at December 31, 2018, a decrease of $5,503,000 or 45.9%, from $11,987,000 at December 31, 2017. Nonaccrual loans totaled $5,165,000 at December 31, 2018, a decrease of $4,678,000 from December 31, 2017. One commercial loan, downgraded to nonaccrual status in the fourth quarter of 2017 and paid off in the second quarter of 2018, was the principal driver of the change. The change in nonaccrual loan amounts also impacted other asset quality ratios detailed above. The overall reduction of risk assets and nonaccrual loans from December 31, 2015 to December 31, 2016 was due principally to the sale of a loan with a carrying balance of $5,946,000 to a third party. Cash proceeds totaled $5,100,000 with the $846,000 difference recorded as a charge-off to the ALL in 2016.

The ALL totaled $14,014,000 at December 31, 2018, a $1,218,000 increase from $12,796,000 at December 31, 2017, resulting from net recoveries of $418,000 and a provision for loan losses of $800,000 for 2018. The ALL is lower as a percentage of the total loan portfolio at December 31, 2018 than in prior years, reflecting in part purchase accounting adjustments for impaired loans acquired from Mercersburg. Management believes its coverage ratios are adequate for the risk profile of the loan portfolio given ongoing monitoring of the portfolio and its quantitative and qualitative analysis performed at December 31, 2018. As new information is learned about borrowers or updated appraisals on real estate with lower fair values are obtained, the Company may continue to experience additional impaired loans.

For the years ended December 31, 2018, 2017, and 2016 recoveries of $882,000, $287,000 and $679,000 were credited to the ALL. These recoveries on previously charged-off relationships are the result of successful loan monitoring and workout solutions. Recoveries are difficult to predict, and any additional recoveries that the Company receives will be used to replenish the ALL. Recoveries favorably impact historical charge-off factors, and contribute to changes in the quantitative as well as qualitative factors used in our allowance adequacy analysis. However, as the loan portfolio continues to grow, future provisions for loan losses may result.

The Company takes partial charge-offs on collateral-dependent loans when carrying value exceeds estimated fair value, as determined by the most recent appraisal adjusted for current (within the quarter) conditions, less costs to dispose. Impairment reserves remain in place if updated appraisals are pending, and represent management's estimate of potential loss.

The following table presents exposure to relationships with an impaired loan balance, partial charge-offs taken to date and specific reserves established on the relationships at December 31, 2018 and 2017. Of the relationships deemed to be impaired at December 31, 2018, none had a recorded balance in excess of $1,000,000 and 64 relationships, comprising 76.4% of the total impaired balances, had recorded balances of less than $250,000.

(Dollars in thousands)	**# of Relationships**	**Recorded Investment**		**Partial Charge-offs to Date**		**Specific Reserves**	
December 31, 2018							
Relationships greater than $500,000 but less than $1,000,000	**1**	**$**	**810**	**$**	**17**	**$**	**0**
Relationships greater than $250,000 but less than $500,000	**2**	**673**		**0**		**0**	
Relationships less than $250,000	**64**	**4,814**		**873**		**38**	
	67	**$**	**6,297**	**$**	**890**	**$**	**38**
December 31, 2017							
Relationships greater than $1,000,000	1	$	4,065	$	791	$	0
Relationships greater than	1	518		145		0	

$500,000 but less than $1,000,000							
Relationships greater than $250,000 but less than $500,000	4	1,501		120		0	
Relationships less than $250,000	62	4,942		1,160		51	
	68	$	11,026	$	2,216	$	51

Internal loan reviews are completed annually on all commercial relationships with a committed loan balance in excess of $500,000, which includes confirmation of risk rating by an independent credit officer. Credit Administration also reviews loans in excess of $1,000,000. In addition, all relationships greater than $250,000 rated Substandard, Doubtful or Loss are reviewed and corresponding risk ratings are reaffirmed by the Bank's Problem Loan Committee, with subsequent reporting to the ERM Committee.

In its individual loan impairment analysis, the Company determines the extent of any full or partial charge-offs that may be required, or any reserves that may be needed. The determination of the Company’s charge-offs or impairment reserve include an evaluation of the outstanding loan balance and the related collateral securing the credit. Through a combination of collateral securing the loans and partial charge-offs taken to date, the Company believes that it has adequately provided for the potential losses that it may incur on these relationships at December 31, 2018. However, over time, additional information may result in increased reserve allocations or, alternatively, it may be deemed that the reserve allocations exceed those that are needed.

The Company’s foreclosed real estate balance consisted of one commercial property totaling $130,000 at December 31, 2018. The Company believes the value of foreclosed real estate represents its fair value, but if the real estate values decline, additional charges may be needed. During 2018, no expense was recorded for writedown of other real estate owned properties.

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Credit Risk Management

Allowance for Loan Losses

The Company maintains the ALL at a level deemed adequate by management for probable incurred credit losses. The ALL is established and maintained through a provision for loan losses charged to earnings. Quarterly, management assesses the adequacy of the ALL utilizing a defined methodology which considers specific credit evaluation of impaired loans, past loan loss historical experience and qualitative factors. Management addresses the requirements for loans individually identified as impaired, loans collectively evaluated for impairment, and other bank regulatory guidance in its assessment.

The ALL is evaluated based on review of the collectability of loans in light of historical experience; the nature and volume of the loan portfolio; adverse situations that may affect a borrower's ability to repay; estimated value of any underlying collateral; and prevailing economic conditions. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available. A description of the methodology for establishing the allowance and provision for loan losses and related procedures in establishing the appropriate level of reserve is included in Note 4, Loans and Allowance for Loan Losses, to the Consolidated Financial Statements under Part II, Item 8, "Financial Statements and Supplementary Data."

The following table summarizes the Company's internal risk ratings at December 31.

(Dollars in thousands)	Pass	Special Mention	Non-Impaired Substandard	Impaired - Substandard	Doubtful	PCI Loans	Total
December 31, 2018							
Commercial real estate:							
Owner-occupied	**$ 121,903**	**$ 3,024**	**$ 987**	**$ 1,880**	**$ 0**	**$ 1,856**	**$ 129,650**
Non-owner occupied	**242,136**	**10,008**	**0**	**0**	**0**	**650**	**252,794**
Multi-family	**71,482**	**5,886**	**717**	**131**	**0**	**717**	**78,933**
Non-owner occupied residential	**98,125**	**736**	**1,197**	**309**	**0**	**0**	**100,367**
Acquisition and development:							
1-4 family residential construction	**7,385**	**0**	**0**	**0**	**0**	**0**	**7,385**
Commercial and land development	**41,251**	**25**	**583**	**0**	**0**	**192**	**42,051**
Commercial and industrial	**150,286**	**2,278**	**2,940**	**286**	**0**	**5,174**	**160,964**
Municipal	**50,982**	**0**	**0**	**0**	**0**	**0**	**50,982**
Residential mortgage:							
First lien	**229,436**	**0**	**0**	**2,877**	**0**	**2,983**	**235,296**

Home equity – term	**12,170**	**0**	**0**	**16**	**0**	**22**	**12,208**
Home equity – lines of credit	**142,638**	**165**	**15**	**798**	**0**	**0**	**143,616**
Installment and other loans	**33,229**	**15**	**1**	**0**	**0**	**166**	**33,411**
	$ 1,201,023	**$ 22,137**	**$ 6,440**	**$ 6,297**	**$ 0**	**$ 11,760**	**$ 1,247,657**

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December 31, 2017							
Commercial real estate:							
Owner-occupied	$ 113,240	$ 413	$ 1,921	$ 1,237	$ 0	$ 0	$ 116,811
Non-owner occupied	235,919	0	4,507	4,065	0	0	244,491
Multi-family	48,603	4,113	753	165	0	0	53,634
Non-owner occupied residential	76,373	142	1,084	381	0	0	77,980
Acquisition and development:							
1-4 family residential construction	11,238	0	0	492	0	0	11,730
Commercial and land development	18,635	5	611	0	0	0	19,251
Commercial and industrial	113,162	2,151	0	350	0	0	115,663
Municipal	42,065	0	0	0	0	0	42,065
Residential mortgage:							
First lien	158,673	0	0	3,836	0	0	162,509
Home equity – term	11,762	0	0	22	0	0	11,784
Home equity – lines of credit	131,585	80	60	467	0	0	132,192
Installment and other loans	21,891	0	0	11	0	0	21,902
	$ 983,146	$ 6,904	$ 8,936	$ 11,026	$ 0	$ 0	$ 1,010,012

Potential problem loans are defined as performing loans which have characteristics that cause management concern over the ability of the borrower to perform under present loan repayment terms and which may result in the reporting of these loans as nonperforming loans in the future. Generally, management feels that Substandard loans that are currently performing and not considered impaired result in some doubt as to the borrower's ability to continue to perform under the terms of the loan, and represent potential problem loans. Additionally, the Special Mention classification is intended to be a temporary classification reflective of loans that have potential weaknesses that may, if not monitored or corrected, weaken the asset or inadequately protect the Company's position at some future date. Special Mention loans represent an elevated risk, but their weakness does not yet justify a more severe, or classified, rating. These loans require inquiry by lenders on the cause of the potential weakness and, once analyzed, the loan classification may be downgraded to Substandard or, alternatively, could be upgraded to Pass.

The following tables summarize the average recorded investment in impaired loans and interest income recognized, on a cash basis, and interest income earned but not recognized for years ended December 31.

(Dollars in thousands)	Average Impaired Balance	Interest Income Recognized	Interest Earned But Not Recognized
December 31, 2018			
Commercial real estate:			
Owner-occupied	**$ 1,495**	**$ 2**	**$ 156**
Non-owner occupied	**1,842**	**0**	**236**
Multi-family	**148**	**0**	**20**
Non-owner occupied residential	**346**	**0**	**36**
Acquisition and development:			
1-4 family residential construction	**181**	**0**	**0**
Commercial and land development	**1**	**0**	**1**
Commercial and industrial	**322**	**0**	**29**
Residential mortgage:			
First lien	**3,234**	**59**	**130**
Home equity – term	**19**	**0**	**2**
Home equity – lines of credit	**657**	**2**	**52**
Installment and other loans	**4**	**0**	**5**
	$ 8,249	**$ 63**	**$ 667**
December 31, 2017			
Commercial real estate:			
Owner-occupied	$ 1,000	$ 6	$ 114
Non-owner occupied	392	0	10
Multi-family	182	0	19
	418	0	35

Non-owner occupied residential			
Acquisition and development:			
1-4 family residential construction	154	0	7
Commercial and industrial	413	0	25
Residential mortgage:			
First lien	4,012	58	136
Home equity – term	61	0	1
Home equity – lines of credit	488	2	26
Installment and other loans	10	0	3
	$ 7,130	$ 66	$ 376

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(Dollars in thousands)	Average Impaired Balance		Interest Income Recognized		Interest Earned But Not Recognized	
December 31, 2016						
Commercial real estate:						
Owner-occupied	$	1,758	$	0	$	124
Non-owner occupied	6,831		0		326	
Multi-family	216		0		17	
Non-owner occupied residential	645		0		35	
Acquisition and development:						
Commercial and land development	3		0		1	
Commercial and industrial	575		0		25	
Residential mortgage:						
First lien	4,525		33		175	
Home equity – term	98		0		6	
Home equity – lines of credit	455		0		19	
Installment and other loans	12		0		3	
	$	15,118	$	33	$	731
December 31, 2015						
Commercial real estate:						
Owner-occupied	$	2,613	$	0	$	177
Non-owner occupied	3,470		0		256	
Multi-family	402		0		15	
Non-owner occupied residential	1,020		0		56	
Acquisition and development:						
	266		137		2	

Commercial and land development						
Commercial and industrial	1,208		0		28	
Residential mortgage:						
First lien	4,644		37		167	
Home equity – term	130		0		3	
Home equity – lines of credit	571		0		29	
Installment and other loans	22		0		3	
	$	14,346	$	174	$	736
December 31, 2014						
Commercial real estate:						
Owner-occupied	$	3,740	$	20	$	179
Non-owner occupied	6,711		143		156	
Multi-family	274		2		6	
Non-owner occupied residential	2,095		13		62	
Acquisition and development:						
Commercial and land development	1,250		34		59	
Commercial and industrial	1,700		5		19	
Residential mortgage:						
First lien	4,226		53		196	
Home equity – term	85		0		5	
Home equity – lines of credit	111		3		25	
Installment and other loans	9		1		1	
	$	20,201	$	274	$	708

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The following table summarizes activity in the ALL for years ended December 31.

	Commercial					Consumer				
(Dollars in thousands)	**Commercial Real Estate**	**Acquisition and Development**	**Commercial and Industrial**	**Municipal**	**Total**	**Residential Mortgage**	**Installment and Other**	**Total**	**Unallocated**	**Total**
December 31, 2018										
Balance, beginning of year	**$ 6,763**	**$ 417**	**$ 1,446**	**$ 84**	**$ 8,710**	**$ 3,400**	**$ 211**	**$ 3,611**	**$ 475**	**$ 12,796**
Provision for loan losses	**(442)**	**396**	**209**	**14**	**177**	**363**	**165**	**528**	**95**	**800**
Charge-offs	**(17)**	**(7)**	**0**	**0**	**(24)**	**(148)**	**(292)**	**(440)**	**0**	**(464)**
Recoveries	**572**	**11**	**1**	**0**	**584**	**138**	**160**	**298**	**0**	**882**
Balance, end of year	**$ 6,876**	**$ 817**	**$ 1,656**	**$ 98**	**$ 9,447**	**$ 3,753**	**$ 244**	**$ 3,997**	**$ 570**	**$ 14,014**
December 31, 2017										
Balance, beginning of year	$ 7,530	$ 580	$ 1,074	$ 54	$ 9,238	$ 2,979	$ 144	$ 3,123	$ 414	$ 12,775
Provision for loan losses	38	(167)	333	30	234	531	174	705	61	1,000
Charge-offs	(835)	0	(85)	0	(920)	(180)	(166)	(346)	0	(1,266)
Recoveries	30	4	124	0	158	70	59	129	0	287
Balance, end of year	$ 6,763	$ 417	$ 1,446	$ 84	$ 8,710	$ 3,400	$ 211	$ 3,611	$ 475	$ 12,796
December 31, 2016										
Balance, beginning of year	$ 7,883	$ 850	$ 1,012	$ 58	$ 9,803	$ 2,870	$ 121	$ 2,991	$ 774	$ 13,568
Provision for loan losses	107	(270)	129	(4)	(38)	532	116	648	(360)	250
Charge-offs	(872)	0	(79)	0	(951)	(577)	(194)	(771)	0	(1,722)
Recoveries	412	0	12	0	424	154	101	255	0	679
Balance, end of year	$ 7,530	$ 580	$ 1,074	$ 54	$ 9,238	$ 2,979	$ 144	$ 3,123	$ 414	$ 12,775
December 31, 2015										
Balance, beginning	$ 9,462	$ 697	$ 806	$ 183	$ 11,148	$ 2,262	$ 119	$ 2,381	$ 1,218	$ 14,747

of year										
Provision for loan losses	(1,020)	(440)	249	(125)	(1,336)	1,122	55	1,177	(444)	(603)
Charge-offs	(711)	(22)	(115)	0	(848)	(592)	(62)	(654)	0	(1,502)
Recoveries	152	615	72	0	839	78	9	87	0	926
Balance, end of year	$ 7,883	$ 850	$ 1,012	$ 58	$ 9,803	$ 2,870	$ 121	$ 2,991	$ 774	$ 13,568
December 31, 2014										
Balance, beginning of year	$ 13,215	$ 670	$ 864	$ 244	$ 14,993	$ 3,780	$ 124	$ 3,904	$ 2,068	$ 20,965
Provision for loan losses	(1,674)	92	(554)	(61)	(2,197)	(960)	107	(853)	(850)	(3,900)
Charge-offs	(2,637)	(70)	(270)	0	(2,977)	(587)	(177)	(764)	0	(3,741)
Recoveries	558	5	766	0	1,329	29	65	94	0	1,423
Balance, end of year	$ 9,462	$ 697	$ 806	$ 183	$ 11,148	$ 2,262	$ 119	$ 2,381	$ 1,218	$ 14,747

The following table summarizes asset quality ratios for years ended December 31.

	2018	**2017**	**2016**	**2015**	**2014**
Ratio of net charge-offs (recoveries) to average loans outstanding	**(0.04)%**	0.10%	0.13%	0.08%	0.34%
Provision for loan losses to net charge-offs (recoveries)	**(191.39)%**	102.15%	23.97%	(104.69)%	(168.25)%
Ratio of ALL to total loans outstanding at December 31	**1.12%**	1.27%	1.45%	1.74%	2.09%

The Company recorded a provision for loan losses expense of $800,000, $1,000,000, and $250,000, for 2018, 2017 and 2016, and negative provisions, or reversals of amounts previously provided, of $603,000 and $3,900,000 for 2015 and 2014. The negative provision in 2015 and 2014 was due to recovery of loans with prior charge-offs, allowing for the recovery. In addition, in certain cases loans were successfully worked out with smaller charge-offs than the reserve established on them. The Company has benefited from organic loan portfolio growth and favorable historical charge-off data combined with relatively stable economic conditions over the periods presented above. This was a principal factor in management's determination that a

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negative or modest provision could be recorded despite net charge-offs recorded in 2014 through 2016. In 2017, management determined that a provision expense that offset net charge-offs for the year would maintain an adequate ALL, principally due to a charge-off in connection with one commercial credit downgraded to nonaccrual status during the year. In 2018, our continued organic loan portfolio growth was a key factor in the quantitative and qualitative considerations used by management in the determination of the provision expense required to maintain an adequate allowance for loan losses. These significant variations in net charge-offs (recoveries) and provision expense (recovery) resulted in the fluctuations in the ratios as presented in the tables above.

See further discussion in the "Provision for Loan Losses" section of this Management's Discussion and Analysis of Financial Condition and Results of Operations.

The following table shows the allocation of the ALL by loan class, as well as the percent of each loan class in relation to the total loan balance at December 31.

	2018		2017		2016		2015		2014	
	Amount	% of Loan Type to Total Loans	Amount	% of Loan Type to Total Loans	Amount	% of Loan Type to Total Loans	Amount	% of Loan Type to Total Loans	Amount	% of Loan Type to Total Loans
Commercial real estate:										
Owner-occupied	**$ 1,491**	**10 %**	$ 1,488	12 %	$ 1,591	13 %	$ 1,998	13 %	$ 2,059	14 %
Non-owner occupied	**3,683**	**20 %**	4,059	24 %	4,380	23 %	4,033	19 %	4,887	20 %
Multi-family	**792**	**6 %**	444	5 %	604	5 %	709	5 %	1,231	4 %
Non-owner occupied residential	**910**	**8 %**	772	8 %	955	7 %	1,143	7 %	1,285	7 %
Acquisition and development:										
1-4 family residential construction	**104**	**1 %**	169	1 %	102	1 %	236	1 %	222	1 %
Commercial and land development	**713**	**3 %**	248	2 %	478	3 %	614	5 %	475	3 %
Commercial and industrial	**1,656**	**13 %**	1,446	12 %	1,074	10 %	1,012	10 %	806	7 %
Municipal	**98**	**4 %**	84	4 %	54	6 %	58	7 %	183	9 %
Residential mortgage:										
First lien	**2,002**	**19 %**	1,855	16 %	1,624	16 %	1,667	16 %	1,295	18 %
Home equity - term	**109**	**1 %**	119	1 %	151	1 %	184	2 %	206	3 %
Home equity - lines of credit	**1,642**	**12 %**	1,426	13 %	1,204	14 %	1,019	14 %	761	13 %
Installment and other loans	**244**	**3 %**	211	2 %	144	1 %	121	1 %	119	1 %