

FRANKLIN FINANCIAL SERVICES CORP /PA/

Form 10-K

March 12, 2018

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, 2017

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

For the transition period from _____ to _____

Commission file number 0-12126

FRANKLIN FINANCIAL SERVICES CORPORATION

(Exact name of registrant as specified in its charter)

PENNSYLVANIA

(State or other jurisdiction of incorporation or organization)

25-1440803

(I.R.S. Employer Identification No.)

20 South Main Street, Chambersburg, PA

(Address of principal executive offices)

17201-0819

(Zip Code)

(717) 264-6116

(Registrant's telephone number, including area code)

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

NONE

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

Common Stock, par value \$1.00 per share

(Title of class)

Indicate by check mark if the Registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes No

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

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted 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 and post such files). Yes No

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

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

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company
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

The aggregate market value of the 4,050,683 shares of the Registrant's common stock held by nonaffiliates of the Registrant as of June 30, 2017 based on the price of such shares was \$129,621,856.

There were 4,364,433 outstanding shares of the Registrant's common stock as of February 28, 2018.

DOCUMENTS INCORPORATED BY REFERENCE

Article I. Portions of the definitive annual proxy statement to be filed, pursuant to Reg. 14A within 120 days after December 31, 2017, are incorporated into Part III.

FRANKLIN FINANCIAL SERVICES CORPORATION

FORM 10-K

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Part I

Item 1. Business

General

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

The Corporation’s common stock is thinly traded in the over-the-counter market. The Corporation’s stock is listed under the symbol “FRAF” (www.otcmarkets.com/stock/FRAF/quote) on the OTCQX Market Tier of the OTC Markets. The Corporation’s internet address is www.franklinfin.com. Electronic copies of the Corporation’s 2017 Annual Report on Form 10-K are available free of charge by visiting the “Investor Information” section of www.franklinfin.com. Electronic copies of quarterly reports on Form 10-Q and current reports on Form 8-K are also available at this internet address. These reports are posted as soon as reasonably practicable after they are electronically filed with the Securities and Exchange Commission (SEC).

The Corporation conducts substantially all of its business through its direct banking subsidiary, F&M Trust, which is wholly owned. F&M Trust, established in 1906, is a full-service, Pennsylvania-chartered commercial bank and trust company, which is not a member of the Federal Reserve System. F&M Trust operates twenty-two community banking offices in Franklin, Cumberland, Fulton and Huntingdon Counties, Pennsylvania. The Bank engages in general commercial, retail banking and trust services normally associated with community banks and its deposits are insured (up to applicable limits) by the Federal Deposit Insurance Corporation (the “FDIC”). F&M Trust offers a wide variety of banking services to businesses, individuals, and governmental entities. These services include, but are not necessarily limited to, accepting and maintaining checking, savings, and time deposit accounts, providing investment and trust services, making loans and providing safe deposit facilities. Franklin Future Fund Inc., a direct subsidiary of the Corporation, is a non-bank investment company that makes venture capital investments, limited to 5% or less of the outstanding shares of any class of voting securities of any company, within the Corporation’s primary market area. Franklin Financial Properties Corp. is a “qualified real estate subsidiary,” a wholly owned subsidiary of F&M Trust, and was established to hold real estate assets used by F&M Trust in its banking operations.

F&M Trust is not dependent upon a single customer or a few customers for a material part of its business. Thus, the loss of any customer or identifiable group of customers would not materially affect the business of the Corporation or the Bank in an adverse manner. Also, none of the Bank’s business is seasonal. The Bank’s lending activities consist primarily of commercial real estate, construction and land development, agricultural, commercial and industrial loans,

installment and revolving loans to consumers and residential mortgage loans. Secured and unsecured commercial and industrial loans, including accounts receivable and inventory financing, and commercial equipment financing, are made to small and medium-sized businesses, individuals, governmental entities, and non-profit organizations.

The Bank classifies loans in this report by the type of collateral, primarily residential or commercial and agricultural real estate. Loans secured by residential real estate loans may be further broken down into consumer or commercial purposes. Consumer purpose residential real estate loans represent traditional residential mortgages and home equity products. Both of these products are underwritten in generally the same manner; however, home equity products may present greater risk since many of these loans are secured by a second lien position where the Bank may or may not hold the first lien position. Commercial purpose residential real estate loans represent loans made to businesses, but are secured by residential real estate. These loans are underwritten as commercial loans and the repayment ability may be dependent on the business operation, despite the residential collateral. In addition to the real estate collateral, it is possible that personal guarantees or UCC filings on business assets provide additional security. In certain situations, the Bank acquires properties through foreclosure on delinquent loans. The Bank initially records these properties at the estimated fair value less cost to sell with subsequent adjustments to fair value recorded as needed.

Commercial and agricultural real estate loans are secured by properties such as hotels, office buildings, apartment buildings, retail sites, and farmland or agricultural related properties. These loans are highly dependent on the business operations for repayment. Compared to residential real estate, this collateral may be more difficult to sell in the event of a delinquency.

Construction loans are made to finance the purchase of land and the construction of residential and commercial buildings, and are secured by mortgages on real estate. These loans are primarily comprised of loans to consumers to build a home, and loans to contractors and developers to construct residential properties for resale or rental. Construction loans present various risks that include, but are not limited to: schedule delays, cost overruns, changes in economic conditions during the construction period, and the inability to sell or rent the property upon completion.

Commercial loans are made to businesses and government municipalities of various sizes for a variety of purposes including operations, property, plant and equipment, and working capital. These loans are highly dependent on the business operations for

repayment and are generally secured by business assets and personal guarantees. As such, this collateral may be more difficult to sell in the event of a delinquency. Commercial lending, including commercial real estate, is concentrated in the Bank's primary market, but also includes purchased loan participations originated primarily in south-central Pennsylvania.

Consumer loans are comprised of unsecured personal lines of credit and installment loans. While some of these loans are secured, the collateral behind the loans is often comprised of assets that lose value quickly (e.g. automobiles) and if repossessed, may not fully satisfy the loan in the event of default. Repayment of these loans is highly dependent on the borrowers' financial condition that can be affected by economic factors beyond their control and personal circumstances.

F&M Trust's Investment and Trust Services Department offers all of the personal and corporate trust services normally associated with community bank trust departments including: estate planning and administration, corporate and personal trust fund management, pension, profit sharing and other employee benefit funds management, and custodial services. F&M Trust through licensed members of its Investment and Trust Services Department sells mutual funds, annuities and selected insurance products.

Competition

The Corporation and its banking subsidiary operate in a highly competitive environment. The principal market of F&M Trust is in south central Pennsylvania, primarily the counties of Franklin, Cumberland, Fulton and Huntingdon. There are 24 competing commercial banks that have offices within the Corporation's primary market area. These banks range from large regional banks to independent community banks. In addition, credit unions, savings and loan associations, mortgage banks, brokerage firms and other on-line competitors compete within the market.

The following table shows the Bank's market share in its primary market as reported on the June 30, 2017 FDIC Summary of Deposits Report:

(Dollars in thousands)

County	F&M Trust # of Locations	F&M Trust Deposits	Market	
			Deposits	Market Share
Franklin	12	\$ 687,688	\$ 2,140,858	32%
Cumberland	7	230,960	6,775,750	3%

Fulton	2	73,119	209,071	35%
Huntingdon	1	15,906	605,093	3%
	22	\$ 1,007,673	\$ 9,730,772	10%

Because of increasing competition, profit margins in the traditional banking business of lending and gathering deposits have been flat and many nonbanking institutions offer services similar to those offered by the Bank. Some competitors may have access to resources (e.g., financial and technological) sooner than they are available to the Bank, or that may be unavailable to the Bank, thereby creating a competitive disadvantage for the Bank in terms of product, service pricing and delivery. The Bank utilizes various strategies including its long history of local customer service and convenience as part of a relationship management culture, a wide variety of products and services and, to a lesser extent, the pricing of loans and deposits, to compete. F&M Trust is the largest financial institution headquartered in Franklin County and had total assets of approximately \$1.2 billion on December 31, 2017.

Staff

As of December 31, 2017, the Corporation and its banking subsidiary had 255 full-time equivalent employees. The officers of the Corporation are employees of the Bank. The Bank offers a 401(k) plan, employee stock purchase plan and incentive compensation plans and employees are also provided with group life and health insurance. Management considers employee relations to be excellent.

Supervision and Regulation

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

General

The Corporation is registered as a bank holding company and is subject to supervision and regulation by the Board of Governors of the Federal Reserve System under the Bank Holding Act of 1956, as amended. The Corporation has also made an effective election to be treated as a "financial holding company." Financial holding companies are bank holding companies that meet certain minimum

capital and other standards and are therefore entitled to engage in financially related activities on an expedited basis as further discussed below. Bank holding companies are required to file periodic reports with and are subject to examination by the Federal Reserve. The Federal Reserve has issued regulations under the Bank Holding Company Act that require a bank holding company to serve as a source of financial and managerial strength to its subsidiary banks. As a result, the Federal Reserve, pursuant to such regulations, may require the Corporation to stand ready to use its resources to provide adequate capital funds to its Bank subsidiary during periods of financial stress or adversity. In addition to the impact of regulation, commercial banks are affected significantly by the actions of the Federal Reserve Board as it attempts to control the money supply and credit availability in order to influence the economy.

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

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

The Bank is a state chartered bank that is not a member of the Federal Reserve System, and its deposits are insured (up to applicable limits) by the Federal Deposit Insurance Corporation (FDIC). Accordingly, the Bank's primary federal regulator is the FDIC, and the Bank is subject to extensive regulation and examination by the FDIC and the Pennsylvania Department of Banking and Securities. The Bank is also subject to requirements and restrictions under federal and state law, including requirements to maintain reserves against deposits, restrictions on the types and amounts of loans that may be granted and the interest that may be charged thereon, and limitations on the types of investments that may be made and the types of services that may be offered. The Bank is subject to extensive regulation and reporting requirements in a variety of areas, including helping to prevent money laundering, to preserve financial privacy, and to properly report late payments, defaults, and denials of loan applications.

Community Reinvestment Act

The Community Reinvestment Act (CRA) requires the Bank to help meet the credit needs of the entire community where the Bank operates, including low and moderate-income neighborhoods. The Bank's rating under the Community Reinvestment Act, assigned by the FDIC pursuant to an examination of the Bank, is important in

determining whether the bank may receive approval for, or utilize certain streamlined procedures in applications to engage in new activities. The Bank's present CRA rating is "satisfactory." Various consumer laws and regulations also affect the operations of the Bank.

Capital Adequacy Guidelines

The Corporation, as a bank holding company, is required to comply with the capital adequacy standards established by Federal Reserve Board. The Bank is required to comply with capital adequacy standards established by the FDIC. In addition, the Pennsylvania Department of Banking and Securities also requires state chartered banks to maintain minimum capital ratios, defined substantially the same as the federal regulations.

In July 2013, Federal banking regulators approved the final rules from the Basel Committee on Banking Supervision for the regulation of capital requirements for bank holding companies and U.S banks, generally referred to as "Basel III." The Basel III standards were effective for the Corporation and the Bank, effective January 1, 2015 (subject to a phase-in period for certain provisions). Basel III imposes significantly higher capital requirements and more restrictive leverage and liquidity ratios than those previously in place. The capital ratios to be considered "well capitalized" under Basel III are: (1) Common Equity Tier 1(CET1) of 6.5%, (2) Tier 1 Leverage of 5%, (3) Tier 1 Risk-Based Capital of 8%, and (4) Total Risk-Based Capital of 10%. The rules also include changes in the risk weights of certain assets to better reflect credit and other risk exposures. In addition, a capital conservation buffer is phased-in beginning at 0.625% for 2016, 1.25% for 2017, 1.875% for 2018 and 2.50% for 2019 and thereafter. The capital conservation buffer is applicable to all of the capital ratios except for the Tier1 Leverage ratio. The capital conservation buffer is equal to the lowest value of the three applicable capital ratios less the regulatory minimum for each respective capital measurement. The Bank's capital conservation buffer at December 31, 2017 was 7.19% (total risk-based capital 15.19% less 8.00%) compared to the 2017 regulatory buffer of 1.25%. Compliance with the capital conservation buffer is required in order to avoid limitations on certain capital distributions, especially dividends. As of December 31, 2017, the Bank was "well capitalized" under the Basel III requirements and believes it would be "well capitalized" on a fully-phased in basis had such requirements been in effect. The minimum capital ratios (shown as "adequately capitalized") and the "well capitalized" capital ratios are reported in Note 2 of the accompanying financial statements.

Prompt Corrective Action Rules

The federal banking agencies have regulations defining the levels at which an insured institution would be considered "well capitalized," "adequately capitalized," "undercapitalized," "significantly undercapitalized" and "critically undercapitalized." The applicable federal bank regulator for a depository institution could, under certain circumstances, reclassify a "well capitalized" institution as "adequately capitalized" or require an "adequately capitalized" or "undercapitalized" institution to comply with supervisory actions as if it were in the next lower category. Such a reclassification could be made if the regulatory agency determines that the institution is in an unsafe or unsound condition (which could include unsatisfactory examination ratings). At December 31, 2017, the Bank satisfied the criteria to be classified as "well capitalized" within the meaning of applicable regulations.

Regulatory Restrictions on Dividends

Dividend payments by the Bank to the Corporation are subject to the Pennsylvania Banking Code, the Federal Deposit Insurance Act, and the regulations of the FDIC. Under the Banking Code, no dividends may be paid except from "accumulated net earnings" (generally, retained earnings). The Federal Reserve and the FDIC have formal and informal policies which provide that insured banks and bank holding companies should generally pay dividends only out of current operating earnings, with some exceptions. The Prompt Corrective Action Rules and the Basel III rules, described above, may further limit the ability of banks to pay dividends or make capital distributions if regulatory capital requirements are not met. There are currently no restrictions on the payments of dividends by either the Bank or the Corporation.

Volker Rule

In December 2013, Federal banking regulators issued rules for complying with the Volker Rule provision of the Dodd-Frank Act. The Bank does not engage in, or expect to engage in, any transactions that are considered "covered activities" as defined by the Volker Rule. Therefore, the Bank does not have any compliance obligations under the Volker Rule.

Consumer Laws and Regulations

The Consumer Financial Protection Bureau ("CFPB") was created under the Dodd-Frank Act to centralize responsibility for consumer financial protection with broad rulemaking, supervision, and enforcement authority for a wide range of

consumer protection laws that would apply to all banks and thrifts, including the Equal Credit Opportunity Act, Truth in Lending Act (“TILA”), Real Estate Settlement Procedures Act (“RESPA”), Fair Credit Reporting Act, Fair Debt Collection Act, the Consumer Financial Privacy provisions of the Gramm-Leach-Bliley Act, and certain other statutes. Violations of consumer protection laws may result in litigation and liability from consumers and regulators. It is likely that future CFPB rulemaking action will affect the Bank. Banks with total assets less than \$10 billion are not subject to examination by the CFPB. However, the CFPB can require any bank to submit reports it deems necessary to fulfill its mission and it can request to be part of any bank examination.

Ability to Repay / Qualified Mortgages

In July 2013, the Consumer Finance Protection Bureau adopted the final rules that implement the Ability to Repay (ATR) / Qualified Mortgages (QM) provisions of the Dodd-Frank Act. Regulators believe that the ATR/QM rules will prevent many of the loose underwriting practices that contributed to the mortgage crisis in 2008. The ATR/QM rule applies to almost all closed-end consumer credit transactions secured by a dwelling. The ATR rule provides eight specific factors that must be considered during the underwriting process. QMs generally have three types of requirements: restrictions on loan features, points and fees, and underwriting criteria. A QM is presumed to comply with the ATR requirements. The ATR/QM rule was effective January 10, 2014.

Commercial Real Estate Guidance

In December 2015, the federal banking agencies released a “Statement on Prudent Risk Management for Commercial Real Estate Lending” (the “CRE Statement”). The agencies stated that financial institutions should review their policies and practices related to CRE lending and should maintain risk management practices and capital levels commensurate with the level and nature of their CRE concentration risk, including maintaining underwriting discipline and exercising prudent risk management practices that identify, measure, monitor and manage the risks arising from their CRE lending activity. Financial institutions were directed to review the interagency guidance on “Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices” issued in 2006 providing that a financial institution is potentially exposed to significant CRE concentration risk, and should employ enhanced risk management practices where (1) total CRE loans represent 300% or more of total capital, and (2) the outstanding balance the CRE loan portfolio has increased by 50% or more during the prior 36 months. The agencies state in the CRE statement that they will focus on those financial institutions that have recently experienced, or whose lending strategy plans for, substantial growth in CRE lending activity, or that operate in markets or loan segments with increasing growth or risk fundamentals.

Pennsylvania Regulation and Supervision

In December 2012, the “Banking Law Modernization Package” became effective. The law permits banks to disclose formal enforcement actions initiated by the Pennsylvania Department of Banking and Securities, clarifies that the Department has examination and enforcement authority over subsidiaries as well as affiliates of regulated banks, and bolsters the Department’s enforcement authority over its regulated institutions by clarifying its ability to remove directors, officers and employees from institutions for violations of laws or orders or for any unsafe or unsound practice or breach of fiduciary duty. The Department also may assess civil money penalties of up to \$25,000 per violation.

FDIC Insurance

The Bank is a member of the Deposit Insurance Fund (DIF), which is administered by the FDIC. The FDIC insures deposit accounts at the Bank, generally up to a maximum of \$250,000 for each separately insured depositor. The FDIC charges a premium to depository institutions for deposit insurance. This rate is based on the risk category of the institution and the total premium is based on average total assets less average tangible equity. As of December 31, 2017, the Bank was considered well capitalized and its assessment rate was approximately 3 basis points of the assessment base.

Insurance of deposits may be terminated by the FDIC upon a finding that an institution has engaged in unsafe or unsound practices, is in an unsafe or unsound condition to continue operations or has violated any applicable law, regulation, rule, order or condition imposed by the FDIC. We do not currently know of any practice, condition or violation that might lead to termination of our deposit insurance.

In addition to the FDIC assessments, the Financing Corporation (“FICO”) is authorized to impose and collect, with the approval of the Federal Deposit Insurance Corporation, assessments for anticipated payments, issuance costs and custodial fees on bonds issued by the FICO in the 1980s to recapitalize the former Federal Savings and Loan Insurance Corporation. The bonds issued by the FICO are due to mature in 2019. The Bank’s FICO assessment was approximately \$52 thousand in 2017 and was included in FDIC insurance expense.

New Legislation

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

Tax Reform

On December 22, 2017 the Tax Cuts and Jobs Act (the Act) was signed into law. This comprehensive tax legislation provides for significant changes to the U.S. Internal Revenue Code of 1986, as amended, that impact corporate taxation such as the reduction in the federal corporate income tax rate from 35% to 21% effective January 1, 2018. The Act repeals the corporate alternative minimum tax, provides for earlier recognition of certain revenue, accelerates expensing of investments in tangible property and limits several deductions such as FDIC premiums, certain executive compensation and meals and entertainment expenses. We are currently assessing the overall impact of the Act on the future expected federal income tax obligations of the Corporation and our customers. While we expect that our future federal income tax liabilities will benefit overall from the provisions in the Act, we also expect that certain aspects of our business may change over time as to the investments we may make, how the Act may affect our customers, and how, in response, we may offer and deliver our products and services.

Selected Statistical Information

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

Item 1A. Risk Factors

The following is a summary of the primary risks associated with the Corporation's business, financial condition and results of operations, and common stock.

Risk Factors Relating to the Corporation

Real estate related loans are a significant portion of our loan portfolio.

The Bank offers a variety of loan products, including residential mortgage, consumer, construction and commercial loans. The Bank requires real estate as collateral for many of its loans. At December 31, 2017, approximately 68% (\$647.1 million) of its loans

were secured by real estate. Loans secured by real estate and the percent of the loan portfolio are reported in Table 16. These real estate loans are located primarily in the Bank's market area of south central Pennsylvania. Real estate values tend to follow changes in general economic cycles. If a loan becomes delinquent as the result of an economic downturn and the Bank becomes dependent on the real estate collateral as a source of repayment, it is likely that the value of the real estate collateral has also declined. A decline in real estate values means it is possible that the real estate collateral may be insufficient to cover the outstanding balance of a delinquent or foreclosed loan, resulting in a loss to the Bank. In addition, the real estate collateral is concentrated in a small market area of south central Pennsylvania. Localized events such as plant closures or layoffs may affect real estate prices and collateral values and could have a more negative affect on the Bank as compared to other competitors with a more geographically diverse portfolio. As the Bank grows, it is expected that real estate secured loans will continue to comprise a significant part of its balance sheet. Risk of loan default is unavoidable in the banking industry, and Management tries to limit exposure to this risk by carefully monitoring the amount of loans in specific industries and by exercising prudent lending practices and securing appropriate collateral. However, this risk cannot be eliminated and substantial credit losses could result in reduced earnings or losses.

Commercial loans are a significant portion of our loan portfolio.

The Bank continues to grow its commercial loan portfolio. Commercial purpose loans account for 84% (\$795 million) of the total loan portfolio. These loans are made to businesses for a variety of commercial purposes and may include fixed and variable rate loans, term loans, and lines of credit. Commercial purpose loans may be secured by real estate, business assets and equipment, personal guarantees, or non-real estate collateral. Commercial purpose loans secured by real estate were \$469.1 million at December 31, 2017 and account for 63% of the total commercial loan portfolio. These loans contain all the risks associated with real estate lending as discussed above. In addition, commercial real estate collateral may be more difficult to liquidate for repayment purposes than residential real estate. The repayment of commercial loans is highly dependent upon the success of the business activity and as such maybe more susceptible to risk of loss during a downturn in the economy. Because the Bank's commercial loan portfolio is concentrated in south-central Pennsylvania, the ability to repay these loans could be affected by deterioration of the economy in this region. As commercial lending continues to be the primary drive of loan growth, these new loans may present additional risk due to a lack of repayment history with the Bank. The Bank attempts to mitigate these risks through its underwriting and loan review process; however, this risk cannot be eliminated and substantial credit losses could result in reduced earnings or losses.

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

The Bank maintains an allowance for loan losses that Management believes is appropriate to provide for any inherent losses in the loan portfolio. The amount of the allowance is determined through a periodic review and consideration of several factors, including an ongoing review of the quality, size and diversity of our loan portfolio; evaluation of nonperforming loans; historical loan loss experience; and the amount and quality of collateral, including guarantees, securing the loan.

Although Management believes the loan loss allowance is adequate to absorb inherent losses in the loan portfolio, such losses cannot be predicted and the allowance may not be adequate. Excessive loan losses could have a material adverse effect on the Bank's financial condition and results of operations.

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

The Bank's lending limit is approximately \$18.5 million. Accordingly, the size of the loans that can be offered to customers is less than the size of loans that many of our competitors, with larger lending limits, can offer. This limit affects the Bank's ability to seek relationships with larger businesses in its market area. Loan amounts in excess of the lending limits can be accommodated through the sale of participations in such loans to other banks. However, there can be no assurance that the Bank will be successful in attracting or maintaining customers seeking larger loans or that it will be able to engage in participation of such loans or on terms favorable to the Bank.

There is strong competition in the Bank's primary market areas and its geographic diversification is limited.

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

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

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

Our operational or security systems may experience interruption or breach in security, including cyber-attacks.

We rely heavily on communications and information systems to conduct our business. These systems include both our internal network and data systems, as well as those of third party vendors. Any failure, interruption or breach in security or these systems, including a cyber-attack, could result in the disclosure or misuse of confidential or proprietary information. Cyber security risks for financial institutions have significantly increased in recent years in part because of the proliferation of new technologies, the use of the Internet and telecommunications technologies to conduct financial transactions, and the increased sophistication and activities of organized crime, hackers, terrorists and other external parties, including foreign state actors. Financial services institutions have been subject to, and are likely to continue to be the target of, cyber-attacks, including computer viruses, malicious or destructive code, phishing attacks, denial of service or information or other security breaches that could result in the unauthorized release, gathering, monitoring, misuse, loss or destruction of confidential, proprietary and other information of the institution, its employees or customers or of third parties, or otherwise materially disrupt network access or business operations. Cyber threats could result in unauthorized access, loss or destruction of customer data, unavailability, degradation or denial of service, introduction of computer viruses and other adverse events, causing the Corporation to incur additional costs (such as repairing systems or adding new personnel or protection technologies). Cyber threats may also subject the Corporation to regulatory investigations, litigation or enforcement, require the payment of regulatory fines or penalties or undertaking costly remediation efforts. While we have systems, policies and procedures designed to prevent or limit the effect of the failure, interruption or security breach of our information systems, there can be no assurance that any such failures, interruptions or security breaches will not occur or, if they do occur, that they will be adequately addressed. The occurrence of any failures, interruptions or security breaches of our information systems could damage our reputation, result in a loss of client business, or expose us to civil litigation and possible financial liability, any of which could have a material adverse effect on our business, financial condition and results of operations.

A large component of fee income is dependent on stock market values.

Fee income from the Bank's Investment and Trust Services Department comprises a large percentage of total noninterest income. Fee income from Investment and Trust Services is comprised primarily of asset management fees as measured by the market value of assets under management. As such, the market values are directly related to stock market values. Therefore, any significant change in the value of assets under management due to stock market fluctuations could greatly affect fee income.

A large component of fee income is dependent on two deposit services.

Fee income from the Bank's debit card is a significant contributor of fee income. As technology changes and consumer payment preferences change it is possible that debit card income does not continue to grow or may decline. The Bank's overdraft protection program has also been a significant contributor of fee income. It is possible that the usage of this product slows or that regulatory changes effect the fees that can be charged for such services.

A large percentage of certificates of deposit have short-term maturities.

Sixty-five percent (\$49.3 million) of the Bank's certificates of deposit are scheduled to mature within one year. If the Bank is unable to retain these deposits, it may require the Bank to access other sources of liquidity that may carry a higher cost.

Liquidity contingency funding is highly concentrated.

The Bank is a member of the Federal Home Loan Bank of Pittsburgh (FHLB). Access to funding through the FHLB is the largest component of the Bank's liquidity stress testing and contingency funding plans. The ability to access funding from FHLB may be critical if a funding need arises. However, there can be no assurance that the FHLB will be able to provide funding when needed, nor can there be assurance that the FHLB will provide funds to the Bank if its financial condition deteriorates. The inability to access

FHLB funding, through a restriction on credit or the failure of the FHLB, could have a materially adverse effect on the Bank's liquidity management.

Our business and financial results could be impacted materially by adverse results in legal proceedings.

The nature of the Corporation's business generates a certain amount of litigation involving matters arising in the ordinary course of business (and, in some cases, from the activities of companies we have acquired). These legal proceedings, whether founded or unfounded, could result in reputation damage and have an adverse effect on our financial condition and results of operation if they are not resolved in a manner favorable to the Corporation. Although we establish legal accruals for legal proceedings when information related to the loss contingencies represented by these matters indicates that both a loss is probable and that the amount of the loss can be reasonably estimated, we do not have accruals for all legal proceedings where we face a risk of loss. In addition, due to the inherent subjectivity of the assessments and unpredictability of outcomes of legal proceedings, any amounts that may be accrued or included in estimates of possible losses or ranges of possible losses may not represent the actual loss to the Corporation. We discuss these matters further in Part I Item 3 Legal Proceedings and in Note 18 Commitments and Contingencies in the Notes to Consolidated Financial Statements in Part II Item 8 of this Report.

Risk Factors Relating to the Common Stock

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

There is currently only a limited public market for the Corporation's common stock. It is quoted on the OTCQX Market Tier of the OTC Markets under the symbol "FRAF" (www.otcmarkets.com/stock/FRAF/quote). Because it is thinly traded, you may not be able to resell your shares of common stock for a price that is equal to the price that you paid for your shares.

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

As a holding company, the Corporation is a separate legal entity from the Bank and does not have significant operations of its own. It currently depends upon the Bank's cash and liquidity to pay dividends to its shareholders. The Corporation cannot assure you that in the future the Bank will have the capacity to pay dividends to the Corporation. Various statutes and regulations limit the availability of dividends from the Bank. It is possible;

depending upon the Bank's financial condition and other factors, that the Bank's regulators could assert that payment of dividends by the Bank to the Corporation would constitute an unsafe or unsound practice. In the event that the Bank is unable to pay dividends to the Corporation, the Corporation may not be able to pay dividends to its shareholders.

Item 1B. Unresolved Staff Comments

None

Item 2. Properties

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

Property	Owned	Leased
Community Banking Facilities	16	6
Remote ATM Sites	3	7
Other Properties	3	2

Included in Other Properties are two properties used for operational support services for the Bank, a drive-up location, one office that was closed as part of a branch consolidation in January 2015 and one other property leased for future use. The office closed in 2015 and was sold on February 28, 2018.

Item 3. Legal Proceedings

The nature of the Corporation's business generates a certain amount of litigation involving matters arising in the ordinary course of business including, without limitation, the Kalan et al. v. Farmers and Merchants Trust Company of Chambersburg, et al. (Case No. 2:15-CV-01435-WB) case filed in the United States District Court for the Eastern District of Pennsylvania and described in our current reports on Form 8-K filed July 29, 2016, July 28, 2017, November 3, 2017 and January 2, 2018.

The Kalan case was brought by the named plaintiffs as a putative class action on behalf of certain employee health and welfare benefit plans whose assets are held by trusts known as the Regional Employers Assurance League Voluntary Employee's Beneficiary Association and the Single Employer Welfare Benefit Plan, and the participants and beneficiaries of those plans. The plaintiffs allege that F&M Trust, as successor by merger to Community Trust Company, which F&M Trust acquired in 2008, and in its own capacity, served as trustee of the trusts and failed to perform its fiduciary duties in accordance with the prudent man standard of care, knowingly participated in and facilitated misconduct by its co-fiduciaries, and failed to take reasonable steps to prevent or remedy any fiduciary breaches of its co-fiduciaries. The plaintiffs purport to state claims against F&M Trust under the Employee Retirement Income Security Act (ERISA), the Racketeer Influenced and Corrupt Organizations Act (RICO), common law breach of fiduciary duties, and equitable restitution and disgorgement, and seek recovery of damages allegedly totaling at least \$40 million, along with reasonable attorney's fees and other relief. F&M Trust denies any and all wrongdoing and liability and has vigorously defended against the plaintiffs' claims.

As described in our current report on Form 8-K filed January 2, 2018, F&M Trust entered into a Class Action Settlement Term Sheet on December 29, 2017 with the named plaintiffs and certain of the other remaining defendants in the Kalan case following a mediation of the case held pursuant to a stipulation for selection of a Mediator submitted jointly by the parties and approved by the Court. The Term Sheet provides for F&M Trust to make a settlement payment of \$10 million in full and final settlement of all claims that the named plaintiffs and members of the Settlement Class (as defined by the Term Sheet) have brought or could have brought against F&M Trust. The Term Sheet further provides that the parties will enter into a definitive settlement agreement that is to provide for a general release of all claims by all parties to the case. The terms of the settlement will be subject to preliminary and final approval by the court.

The Corporation has accrued the \$10 million settlement payment as an expense for the year ended December 31, 2017.

In management's opinion, there are no other proceedings pending to which the Corporation is a party or to which its property is subject which, if determined adversely to the Corporation, would be material. No material proceedings are pending or are known to be threatened or contemplated against us by any governmental authorities.

Item 4. Mine Safety Disclosures

Not Applicable

Part II

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

Market and Dividend Information

The Corporation’s common stock is traded in the over-the-counter market. It is quoted on the OTCQX Market Tier of the OTC Markets under the symbol “FRAF” (www.otcm Markets.com/stock/FRAF/quote). The range of high and low prices is shown in the following table for the years 2017 and 2016, as well as cash dividends declared for those periods. The closing price of Franklin Financial Services Corporation common stock recorded from an actual transaction on December 31, 2017 was \$37.36. The Corporation had 1,756 shareholders of record as of December 31, 2017.

	Market and Dividend Information 2017			2016		
	High	Low	Dividends Declared	High	Low	Dividends Declared
(Dollars per share)						
First quarter	\$ 31.00	\$ 28.60	\$ 0.21	\$ 23.50	\$ 20.11	\$ 0.19
Second quarter	33.00	30.10	0.24	24.00	21.62	0.21
Third quarter	35.25	31.25	0.24	24.60	23.35	0.21
Fourth quarter	38.50	34.95	0.24	29.00	24.35	0.21
			\$ 0.93			\$ 0.82

Restrictions on the Payment of Dividends

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

Securities Authorized for Issuance under Equity Compensation Plans

The information related to equity compensation plans is incorporated by reference to the materials set forth under the heading “Executive Compensation – Compensation Tables” in the Corporation’s Proxy Statement for the 2018 Annual Meeting of Shareholders.

Common Stock Repurchases

The Board of Directors, from time to time, authorizes the repurchase of the Corporation’s \$1.00 par value common stock. The repurchased shares will be held as Treasury shares available for issuance in connection with future stock dividends and stock splits, employee benefit plans, executive compensation plans, the Dividend Reinvestment Plan and other appropriate corporate purposes.

The following table shows stock repurchase activity under approved plans:

Plan Date	Authorized	Expiration	Shares Repurchased	
			2017	2016
4/18/2016	\$350,000 in shares per calendar quarter	3/31/2017	-	34,048
10/12/2017	100,000 shares	9/30/2018	-	N/A

Performance Graph

The following graph compares the cumulative total return to shareholders of Franklin Financial with selected market indices and a bank peer group, consisting of Mid-Atlantic Banks with assets between \$1 billion - \$2 billion as of September 30, 2017; for the five year period ended December 31, 2017, in each case assuming an initial investment of \$100 on December 31, 2012 and the reinvestment of all dividends. Information is provided by S&P Global Market Intelligence.

Index	Period Ending					
	12/31/12	12/31/13	12/31/14	12/31/15	12/31/16	12/31/17
Franklin Financial Services Corporation	\$ 100.00	\$ 127.44	\$ 169.89	\$ 187.25	\$ 235.97	\$ 317.11
NASDAQ Composite	\$ 100.00	\$ 140.12	\$ 160.78	\$ 171.97	\$ 187.22	\$ 242.71
SNL Mid-Atlantic Bank Index	\$ 100.00	\$ 134.79	\$ 146.85	\$ 152.36	\$ 193.66	\$ 237.34
Peer Group	\$ 100.00	\$ 130.44	\$ 136.13	\$ 143.28	\$ 184.81	\$ 214.62

Shareholders' Information

Dividend Reinvestment Plan:

Franklin Financial Services Corporation offers a dividend reinvestment program whereby shareholders of the Corporation's common stock may reinvest their dividend, or make optional cash payment, to purchase additional shares of the Corporation. Beneficial owners of shares of the Corporation's common stock may participate in the program by making appropriate arrangements through their bank, broker or other nominee. Information concerning this optional program is available by contacting the Corporate Secretary at 20 South Main Street, P.O. Box 6010, Chambersburg, PA 17201-6010, telephone 717-264-6116.

Dividend Direct Deposit Program:

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

Annual Meeting:

The Annual Shareholders' Meeting will be held on Tuesday, April 24, 2018, at the Orchard Restaurant & Banquet Facility, 1580 Orchard Drive, Chambersburg, PA. The Business Meeting will begin at 9:00 a.m. with breakfast provided prior to the meeting.

Websites:

Franklin Financial Services Corporation: www.franklinfin.com

Farmers & Merchants Trust Company: www.fmtrustonline.com

Stock Information:

The Corporation's common stock is traded in the over-the-counter market. It is quoted on the OTCQX Market Tier of the OTC Markets under the symbol "FRAF" (www.otcm Markets.com/stock/FRAF/quote).

Registrar and Transfer Agent:

The registrar and transfer agent for Franklin Financial Services Corporation is: Computershare
P.O. Box 30170
College Station, TX 77842-3170
1-800-368-5948

Item 6. Selected Financial Data

	Summary of Selected Financial Data as of and for the Year Ended				
	December 31				
	2017	2016	2015	2014	2013
(Dollars in thousands, except per share)					
Balance Sheet Highlights					
Total assets	\$ 1,179,813	\$ 1,127,443	\$ 1,035,295	\$ 1,001,448	\$ 984,587
Investment securities	127,336	143,875	159,473	171,751	159,674
Loans, net	931,908	882,798	771,930	717,420	713,711
Deposits	1,047,181	982,120	918,512	881,181	845,724
Shareholders' equity	115,144	116,493	111,376	103,521	95,388
Summary of Operations					
Interest income	\$ 39,885	\$ 36,979	\$ 34,615	\$ 34,794	\$ 36,042
Interest expense	2,491	2,245	2,371	3,180	4,378
Net interest income	37,394	34,734	32,244	31,614	31,664
Provision for loan losses	670	3,775	1,285		