



SMALL BANK

Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

PUBLIC DISCLOSURE

February 3, 2009

COMMUNITY REINVESTMENT ACT PERFORMANCE EVALUATION

The First National Bank of Mercersburg
Charter Number 9330

12 South Main Street
Mercersburg, PA 17236

Office of the Comptroller of the Currency

WESTERN PENNSYLVANIA FIELD OFFICE
4075 Monroeville Boulevard Building 2, Suite 300
Monroeville, PA 15146-2529

NOTE: This document is an evaluation of this institution's record of meeting the credit needs of its entire community, including low- and moderate-income neighborhoods consistent with safe and sound operation of the institution. This evaluation is not, nor should it be construed as, an assessment of the financial condition of this institution. The rating assigned to this institution does not represent an analysis, conclusion, or opinion of the federal financial supervisory agency concerning the safety and soundness of this financial institution.

INSTITUTION'S CRA RATING: This institution is rated Satisfactory.

The major factors supporting the institution's rating include:

- The loan-to-deposit ratio is more than reasonable given the bank's size, financial condition, and assessment area (AA) credit needs;
- A substantial majority of loans were originated in the bank's AA;
- The distribution of loans reflects reasonable penetration among borrowers of different incomes when considering the bank's performance context; and
- The geographic distribution of loans reflects reasonable dispersion throughout census tracts of different income levels.

SCOPE OF EXAMINATION

The First National Bank of Mercersburg (FNB) was evaluated under the Small Bank Community Reinvestment Act (CRA) examination procedures. Our review covered the bank's performance from January 1, 2006 through September 30, 2008, as this is representative of its lending strategy since the last CRA examination. Residential mortgage loans were determined to be the bank's primary loan product and were reviewed as part of this examination. In order to assess the bank's lending activity, we sampled 46 home mortgage loans from January 1, 2006 through September 30, 2008.

DESCRIPTION OF INSTITUTION

FNB is a \$158 million intrastate community bank. It is wholly owned by Mercersburg Financial Corporation, a single-bank holding company. This holding company has no other operating subsidiaries. The bank's main office is located in Mercersburg, Pennsylvania, within Franklin County. FNB operates six full-service branch offices in addition to its main office location. These branches are located in Mercersburg, Fort Loudon, Greencastle, Waynesboro, and two in Chambersburg, Pennsylvania, all in Franklin County.

FNB is a full-service bank offering retail and commercial banking services as well as internet and telephone banking. FNB offers normal business hours during the week at all of its branches and offers Saturday lobby hours at six branches, not including the main office. All seven branch offices have drive-up capabilities that offer Saturday hours. Six of the branch locations also provide customers with access to deposits through Automated Teller Machines (ATMs). The bank has opened two of its branches during the evaluation period. The Waynesboro branch was opened in July 2007 and the Chambersburg branch was opened in April 2008. The bank has not closed any branches during the evaluation period.

As of September 30, 2008, FNB had net loans of \$131 million, 83% of total assets, and tier-one capital of \$14 million. The loan portfolio consists of 47% one to four family residential real estate loans, 30% commercial real-estate loans, 16% agriculture and farmland, and 7% consumer loans.

There are no legal or financial factors impeding the bank's ability to help meet the credit needs in its AA. At the prior CRA examination, dated June 2, 2003, FNB was rated as "Satisfactory".

DESCRIPTION OF ASSESSMENT AREA(S)

FNB has two assessment areas, which are described below.

Franklin and Fulton County non-MSA

The Franklin and Fulton County non-MSA is the bank's primary assessment area. This AA is comprised of two complete counties, Franklin County and Fulton County, in Pennsylvania. FNB integrated Fulton County into their AA in December 2005. While there are no branches in Fulton County, FNB has branches in Franklin County that can reasonably service Fulton County. This AA is primarily a rural area located in south central Pennsylvania within the Cumberland Valley, and it is located just over the Mason-Dixon Line. Franklin County covers 773 square miles, and the county seat is Chambersburg. Fulton County covers 438 square miles, and the county seat is McConnellsburg.

The Franklin and Fulton County non-MSA AA contains a total of twenty-nine census tracts. There are twenty-six census tracts in Franklin County. Two are moderate-income geographies (8%), seventeen are middle-income geographies (65%), and seven are upper-income geographies (27%). There are no low-income census tracts in the non-MSA AA. There are three census tracts in Fulton County, all of which are middle-income geographies (100%). Fulton County has been classified as an underserved area. The AA meets the requirements of the regulation and does not arbitrarily exclude any low- or moderate-income areas.

The following chart describes the AA:

Demographic Information for Full Scope Area: Franklin and Fulton County NonMSA						
Demographic Characteristics	#	Low % of #	Moderate % of #	Middle % of #	Upper % of #	NA* % of #
Geographies (Census Tracts/BNAs)	29	0.00	6.90	68.97	24.14	0.00
Population by Geography	143,574	0.00	5.20	67.00	27.80	0.00
Owner-Occupied Housing by Geography	41,942	0.00	3.08	67.68	29.24	0.00
Business by Geography	9,043	0.00	8.00	65.72	26.29	0.00
Farms by Geography	790	0.00	0.89	70.13	28.99	0.00
Family Distribution by Income Level	40,609	12.97	17.79	24.54	44.70	0.00
Distribution of Low and Moderate Income Families throughout AA Geographies	12,491	0.00	7.89	70.77	21.34	0.00
Median Family Income		41,475	Median Housing Value		93,403	
HUD Adjusted Median Family Income for 2008		49,800	Unemployment Rate (2000 US Census)		1.85%	
Households Below Poverty Level		8%				

(*) The NA category consists of geographies that have not been assigned an income classification.

Source: 2000 US Census and 2008 HUD updated MFI

The 2000 U.S. Census reported the total population of the AA at 143,574. The median cost of housing in the non-MSA AA is \$93,403. The 2008 HUD updated median family income is \$49,800. The percentage of households below the poverty level is 8%. The AA population is comprised of 40,609 families with the following family income distribution: 12.97% are low-income, 17.79% are moderate-income, 24.54% are middle-income, and 44.70% are upper-income.

The current economy in Franklin County is characterized as good. Franklin County has benefited from its proximity to Interstates 81, 70, and the Pennsylvania Turnpike, drawing a workforce from Pennsylvania, Maryland, West Virginia, and Virginia. Employment continues to increase in Franklin County despite the national economic decline. According to the Bureau of Labor Statistics, the November 2008 unemployment rate for Franklin County was 5.1%. This rate is lower than the state unemployment rate of 5.9%. As of March 30, 2008, the top five employers in the county were: Grove U.S. LLC, the U.S. Navy, Chambersburg Hospital, Franklin County government, and Whitetail Resort. By industry type and number of employees, the largest sectors of employment in the county are manufacturing, health care and social assistance, retail trade, local government, and transportation and warehousing.

Fulton County is experiencing more difficult economic times than Franklin County. According to the Bureau of Labor Statistics, the November 2008 unemployment rate for Fulton County was 9.5%. This rate is much higher than the state unemployment rate of 5.9%. As of March 30, 2008, the top five employers in the county were: JLG Industries, Inc., Fulton County Medical Center, HB Mellott Estate, Inc., Giant Food

Stores, LLC, and Pennsylvania Department of Transportation. By industry type and number of employees, the largest sectors of employment in the county are local government, health care and social assistance, retail trade, and construction.

Competition for deposits in the AA is strong. According to the June 30, 2008 FDIC Summary of Deposit Market Share Report, FNB was ranked sixth out of eight institutions in Franklin County, Pennsylvania with 6.92% of deposits. Competitors in this market include Farmers & Merchants Trust of Chambersburg, ranked first with 24.04% of deposits, and Manufacturers and Traders Trust Company, ranked second with 21.10% of deposits. FNB does not have a branch in Fulton County.

We reviewed a recent community contact performed in Franklin County. The contact was a county area development corporation that implements and promotes a comprehensive countywide economic development strategy and strives to create an atmosphere of planned growth and family sustainable employment opportunities. The contact identified affordable housing as a need in the community. The contact stated that local banks have a strong degree of involvement in the community.

Washington County MSA

The bank's second AA is a portion of the Hagerstown-Martinsburg MD-WV MSA 25180. The Hagerstown-Martinsburg, MD-WV MSA 25180 is comprised of Washington County, which located in Maryland and Berkeley County and Morgan County, which are located in West Virginia. FNB identified Washington County, Maryland as an AA in December 2007. While there are no branches in Washington County, FNB has branches in Franklin County that can reasonably service this county. The Washington County MSA AA is located in western Maryland and borders Pennsylvania, Virginia, and West Virginia. It covers 468 square miles, and the county seat is Hagerstown.

The Washington County MSA AA consists of thirty-two census tracts. One is a low-income geography (3%), six are moderate-income geographies (19%), sixteen are middle-income geographies (50%), eight are upper-income geographies (25%), and one is in a geography where an income classification has not been assigned (3%). The AA meets the requirements of the regulation and does not arbitrarily exclude any low- or moderate-income areas.

The following information describes the AA:

Demographic Information for Full Scope Area: Washington County MSA						
Demographic Characteristics	#	Low % of #	Moderate % of #	Middle % of #	Upper % of #	NA* % of #
Geographies (Census Tracts/BNAs)	32	3.13	18.75	50.00	25.00	3.13
Population by Geography	131,923	1.75	13.92	51.67	27.40	5.26
Owner-Occupied Housing by Geography	32,630	0.52	8.65	57.98	32.84	0.00
Business by Geography	9,106	7.02	17.64	47.49	27.69	0.18
Farms by Geography	381	1.31	4.20	65.88	28.61	0.00
Family Distribution by Income Level	34,235	16.80	17.74	23.90	41.56	0.00
Distribution of Low and Moderate Income Families throughout AA Geographies	11,825	2.52	22.22	55.21	20.05	0.00
Median Family Income		46,565	Median Housing Value		109,631	
HUD Adjusted Median Family Income for 2008		57,900	Unemployment Rate (2000 US Census)		1.59%	
Households Below Poverty Level		10%				

(*) The NA category consists of geographies that have not been assigned an income classification.

Source: 2000 US Census and 2008 HUD updated MFI

The 2000 U.S. Census reported the total population of the AA at 131,923. The median cost of housing in the MSA AA is \$109,631. The 2008 HUD updated median family income is \$57,900. The percentage of households below the poverty level is 10%. The AA population is comprised of 34,235 families with the following family income distribution: 16.80% are low-income, 17.74% are moderate-income, 23.90% are middle-income, and 41.56% are upper-income.

The current local economy has fallen into recession. However, when compared to the national economy, the area's recession should be relatively mild. The recession was spurred by the global downturn, which caused industrial production to plummet and layoffs in manufacturing to increase. Manufacturing has fallen steadily over the years and the limited credit availability and the slumping global economy are burdening local manufacturers. The consumer-driven industries are also suffering as consumers began to rein in spending in response to declining house prices. The area has benefited from being a bedroom community to Bethesda and Washington DC. Strong government spending should support local industries such as financial services and leisure/hospitality. According to the Bureau of Labor Statistics, the November 2008 unemployment rate for Washington County was 6.7%. This rate is higher than the state unemployment rate of 5.6%. According to 2007-2008 data, major employers in the county (excluding post offices and local and state government) were: Washington County Health System, Citi, First Data Merchant Services, Volvo Powertrain North America, and Staples.

We reviewed a community contact with the local economic development commission.

The organization's purpose is to attract and retain commercial and industrial businesses. The contact's perception of financial institutions was positive. The contact explained that there is a continued need for affordable housing and small businesses within the community. According to this contact, financial institutions have been helpful in meeting the needs of the community, and the contact could not identify unmet credit needs in the community.

CONCLUSIONS WITH RESPECT TO PERFORMANCE CRITERIA

FNB's performance under the lending test is satisfactory. FNB's loan-to-deposit ratio is more than reasonable given the bank's size, financial condition, and AA credit needs. A substantial majority of FNB's primary loan product was originated within the bank's AAs. When considering the bank's overall performance context, FNB's record of lending to borrowers of different income is reasonable and meets the standard for satisfactory performance. Furthermore, FNB's record of lending to borrowers in different geographies meets the standards for satisfactory performance.

Loan-to-Deposit Ratio

FNB's loan-to-deposit ratio is more than reasonable given the bank's size, financial condition, and AA credit needs, and it exceeds the standard for satisfactory performance. We reviewed the quarterly average net loan-to-deposit ratios for the twenty-two quarters since the last CRA examination, which was from June 30, 2003 through September 30, 2008, inclusive. During this period, FNB's quarterly average net loan-to-deposit ratio was 91%. The bank's quarterly average net loan-to-deposit ratio is well above similarly sized banks in the state of Pennsylvania. The quarterly average net loan-to-deposit ratio for similarly sized banks in the state of Pennsylvania was 78% over the same twenty-two quarters.

Lending in Assessment Area

A substantial majority of FNB's home mortgage loans were originated within the bank's AAs, and FNB exceeds the standard for satisfactory performance for lending in the AA. Based the loan sample, 90% of the loans were made within the bank's AAs.

Lending to Borrowers of Different Incomes

The distribution of loans reflects reasonable penetration among individuals of different income levels, meeting the standard for satisfactory performance.

Franklin and Fulton County non-MSA AA

FNB's distribution of loans reflects reasonable penetration among individuals of different income levels, and FNB's record of lending to borrowers of different incomes meets the standards for satisfactory performance.

In our analysis, we took into consideration how affordable it was for low-income families

to purchase a home. The average median housing value was \$93,403. The 2008 HUD updated median family income for the AA was \$49,800, resulting in an income of less than \$24,900 for a family classified as low-income. Based on these statistics, it would be difficult for low-income families to purchase housing in the AA. Therefore, we placed more emphasis on FNB's lending to moderate-income borrowers.

Based on our loan sample, there were no loans to low-income families. The percentage of home mortgage loans made to moderate-income borrowers exceeds the percentage of moderate-income families in the AA.

The following, Table 1, shows the distribution of home loan products among borrowers of different income levels as compared to the percent of families in each income category:

Borrower Income Level	Low		Moderate		Middle		Upper	
	% of AA Families	% of Number of Loans	% of AA Families	% of Number of Loans	% of AA Families	% of Number of Loans	% of AA Families	% of Number of Loans
Mortgage Loans	12.97	0.00	17.79	20.00	24.54	32.00	44.70	48.00

Source: Loan Sample; 2000 US Census

Washington County MSA

FNB's distribution of loans reflects reasonable penetration among individuals of different income levels, and FNB's record of lending to borrowers of different incomes meets the standards for satisfactory performance.

The percentage of home mortgage loans made to low-income borrowers in the AA is significantly lower than the percentage of low-income families in the AA. However, when considering the affordability of housing in this AA, this performance is reasonable. The average median housing value in 2008 was \$109,631. The 2008 HUD updated median family income for the MSA was \$57,900, resulting in an income of less than \$28,950 for a family classified as low-income. Based on these statistics, it would be difficult for low-income families to purchase housing in the AA. Therefore, we placed more emphasis on FNB's lending to moderate-income borrowers. The percentage of home mortgage loans made to moderate-income borrowers exceeds the percentage of moderate-income families in the AA.

The following, Table 2, shows the distribution of home loan products among borrowers of different income levels as compared to the percent of families in each income category:

Table 2 - Borrower Distribution of Residential Real Estate Loans in MSA								
Borrower Income Level	Low		Moderate		Middle		Upper	
Loan Type	% of AA Families	% of Number of Loans	% of AA Families	% of Number of Loans	% of AA Families	% of Number of Loans	% of AA Families	% of Number of Loans
Mortgage Loans	16.80	4.76	17.74	28.57	23.90	23.81	41.56	42.86

Source: Loan Sample; 2000 US Census

Geographic Distribution of Loans

The geographic distribution of loans reflects reasonable dispersion throughout census tracts of different income levels, and FNB’s performance meets the standard for satisfactory performance. We did not identify any unexplained conspicuous gaps.

Franklin and Fulton County non-MSA AA

The geographic distribution of loans reflects reasonable dispersion throughout census tracts of different income levels, and FNB’s record of lending to borrowers in different geographies meets the standards for satisfactory performance. There are no low-income CTs, and there are only two moderate-income CTs. Within the two moderate-income CTs, there are only 1,292 owner-occupied housing units. Based on our loan sample, no loans were made in moderate-income geographies. Given the limited opportunities to lend in moderate-income geographies coupled with the competition from larger regional banks in the AA, it would be difficult for FNB to originate loans in the moderate-income CTs. Additionally, Fulton County was designated as an underserved area; therefore, we took into consideration the bank’s lending in the three middle-income geographies in Fulton County.

The following, Table 3, details the bank’s performance as compared to the percentage of owner-occupied housing units in each census tract income level:

Table 3 - Geographic Distribution of Residential Real Estate Loans in non-MSA AA								
Census Tract Income Level	Low		Moderate		Middle		Upper	
Loan type	% of AA Owner Occupied Housing	% of Number of Loans	% of AA Owner Occupied Housing	% of Number of Loans	% of AA Owner Occupied Housing	% of Number of Loans	% of AA Owner Occupied Housing	% of Number of Loans

Mortgage Loans	0.00	0.00	3.08	0.00	67.68	68.00	29.24	32.00
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Source: Loan Sample; 2000 US Census

Washington County MSA

The geographic distribution of loans reflects reasonable dispersion throughout census tracts of different income levels, and FNB's record of lending to borrowers in different geographies meets the standards for satisfactory performance.

The percentage of home mortgage loans originated in the one low-income geography exceeds the percentage of owner-occupied housing in the one low-income geography. When taking into consideration there are only 170 owner-occupied housing units this one low-income geography, FNB's performance is outstanding.

Based on our loan sample, no loans were made in moderate-income geographies. However, we took into consideration the demographics of the AA and the location of the bank's branches. There are only 2,822 owner-occupied housing units located in the six moderate-income geographies. Furthermore, FNB does not have a branch in this AA. Therefore, the bank is competing with local financial institutions for the limited lending opportunities in the moderate-income geographies.

The following, Table 4, details the bank's performance as compared to the percentage of owner-occupied housing units in each census tract income level:

Table 4 - Geographic Distribution of Residential Real Estate Loans in MSA								
Census Tract Income Level	Low		Moderate		Middle		Upper	
Loan type	% of AA Owner Occupied Housing	% of Number of Loans	% of AA Owner Occupied Housing	% of Number of Loans	% of AA Owner Occupied Housing	% of Number of Loans	% of AA Owner Occupied Housing	% of Number of Loans
Mortgage Loans	0.52	14.29	8.65	0.00	57.98	61.90	32.84	23.81

Source: Loan Sample; 2000 US Census

Responses to Complaints

FNB did not receive any complaints about its performance in helping to meet credit needs in the assessment area during this evaluation period.

Fair Lending or Other Illegal Credit Practices Review

We found no evidence of discriminatory or other illegal credit practices inconsistent with helping to meet community credit needs.