PEOPLES FINANCIAL SERVICES CORP.
Form 10-Q
August 07, 2015
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

Form 10-Q

x **Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the quarterly period ended June 30, 2015**

or

¨ **Transition report pursuant to Section 13 or 15 (d) of the Securities Exchange Act of 1934 for the transition period from**

001-36388

(Commission File Number)

PEOPLES FINANCIAL SERVICES CORP.

(Exact name of registrant as specified in its charter)

Pennsylvania	**23-2391852**
(State of	**(IRS Employer**
incorporation)	**ID Number)**
150 North Washington Avenue, Scranton, PA	**18503**
(Address of principal executive offices)	**(Zip code)**

(570) 346-7741

(Registrant s telephone number, including area code)

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 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 during the preceding 12 months or for such shorter period that the registrant was required to submit and post such files. Yes x No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company as defined in Rule 12b-2 of the Exchange Act.

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

Indicate by check mark whether the registrant is a shell company as defined in Rule 12b-2 of the Exchange Act. Yes ¨ No x

APPLICABLE ONLY TO CORPORATE ISSUERS:

Indicate the number of shares outstanding of the registrant s common stock, as of the latest practicable date: 7,542,725 at July 31, 2015.

Exhibit index on page 49

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PEOPLES FINANCIAL SERVICES CORP.

FORM 10-Q

For the Quarter Ended June 30, 2015

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Peoples Financial Services Corp.

CONSOLIDATED BALANCE SHEETS (UNAUDITED)

(Dollars in thousands, except share data)

	June 30, 2015	December 31, 2014
Assets:		
Cash and due from banks	$ 28,847	$ 24,656
Interest-bearing deposits in other banks	6,710	6,770
Federal funds sold		
Investment securities:		
Available-for-sale	318,790	339,586
Held-to-maturity: Fair value June 30, 2015, $14,104; December 31, 2014, $15,215	13,626	14,665
Total investment securities	332,416	354,251
Loans held for sale	2,879	3,486
Loans, net	1,231,541	1,209,894
Less: allowance for loan losses	11,428	10,338
Net loans	1,220,113	1,199,556
Premises and equipment, net	26,552	25,433
Accrued interest receivable	5,507	5,580
Goodwill	63,370	63,370
Intangible assets	4,901	5,501
Other assets	56,460	53,066
Total assets	$ 1,747,755	$ 1,741,669
Liabilities:		
Deposits:		
Noninterest-bearing	$ 296,823	$ 313,498
Interest-bearing	1,127,944	1,112,060
Total deposits	1,424,767	1,425,558
Short-term borrowings	25,860	19,557
Long-term debt	31,663	33,140
Accrued interest payable	443	574
Other liabilities	14,618	16,061
Total liabilities	1,497,351	1,494,890
Stockholders equity:		
Common stock: par value $2.00, authorized 25,000,000 shares; June 30, 2015, issued and outstanding 7,542,725 shares; December 31, 2014, issued and	15,086	15,097

outstanding 7,548,358 shares		
Capital surplus	140,045	140,214
Retained earnings	97,093	92,297
Accumulated other comprehensive loss	(1,820)	(829)
Total stockholders equity	250,404	246,779
Total liabilities and stockholders equity	$ 1,747,755	$ 1,741,669

See notes to consolidated financial statements

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Peoples Financial Services Corp.

CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME (UNAUDITED)

(Dollars in thousands, except per share data)

	Three Months Ended		Six Months Ended	
June 30,	**2015**	**2014**	**2015**	**2014**
Interest income:				
Interest and fees on loans:				
Taxable	$ 13,391	$ 13,159	$ 26,731	$ 27,159
Tax-exempt	570	507	1,129	1,142
Interest and dividends on investment securities:				
Taxable	816	942	1,716	1,870
Tax-exempt	835	817	1,640	1,646
Dividends	6	14	15	30
Interest on interest-bearing deposits in other banks	15	9	26	19
Interest on federal funds sold	5	34	9	48
Total interest income	15,638	15,482	31,266	31,914
Interest expense:				
Interest on deposits	1,192	1,414	2,460	2,771
Interest on short-term borrowings	4	24	12	58
Interest on long-term debt	252	289	511	585
Total interest expense	1,448	1,727	2,983	3,414
Net interest income	14,190	13,755	28,283	28,500
Provision for loan losses	750	1,201	1,500	2,058
Net interest income after provision for loan losses	13,440	12,554	26,783	26,442
Noninterest income:				
Service charges, fees and commissions	1,542	1,557	3,154	3,181
Merchant services income	963	888	1,753	1,782
Commission and fees on fiduciary activities	487	548	946	1,115
Wealth management income	198	165	403	352
Mortgage banking income	248	193	470	292
Life insurance investment income	188	267	377	456
Net gain on sale of investment securities available-for-sale		160	832	160
Total noninterest income	3,626	3,778	7,935	7,338
Noninterest expense:				

Salaries and employee benefits expense		5,613		4,961		10,846		10,129
Net occupancy and equipment expense		2,149		2,327		4,617		4,060
Merchant services expense		650		495		1,183		1,060
Amortization of intangible assets		295		333		600		676
Acquisition related expense				1,008				1,616
Other expenses		2,804		3,115		5,359		5,985
Total noninterest expense		11,511		12,239		22,605		23,526
Income before income taxes		5,555		4,093		12,113		10,254
Income tax expense		1,124		762		2,638		2,225
Net income		4,431		3,331		9,475		8,029
Other comprehensive income (loss):								
Unrealized gain (loss) on investment securities available-for-sale		(1,459)		1,242		(692)		3,636
Reclassification adjustment for net gain on sales included in net income				(160)		(832)		(160)
Other comprehensive income (loss)		(1,459)		1,082		(1,524)		3,476
Income tax expense (benefit) related to other comprehensive income (loss)		(510)		378		(533)		1,216
Other comprehensive income (loss), net of income taxes		(949)		704		(991)		2,260
Comprehensive income	$	3,482	$	4,035	$	8,484	$	10,289
Per share data:								
Net income:								
Basic	$	0.59	$	0.44	$	1.26	$	1.06
Diluted	$	0.59	$	0.44	$	1.26	$	1.06
Average common shares outstanding:								
Basic		7,546,198		7,548,358		7,547,272		7,549,300
Diluted		7,546,198		7,570,883		7,547,272		7,575,655
Dividends declared	$	0.31	$	0.31	$	0.62	$	0.62

See notes to consolidated financial statements

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Peoples Financial Services Corp.

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS EQUITY (UNAUDITED)

(Dollars in thousands, except per share data)

	Common Stock	Capital Surplus	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Treasury Stock	Total
Balance, January 1, 2015	$ 15,097	$ 140,214	$ 92,297	$ (829)	$	$ 246,779
Stock based compensation		35				35
Net income			9,475			9,475
Other comprehensive loss, net of income taxes				(991)		(991)
Dividends declared: $0.62 per share			(4,679)			(4,679)
Shares retired: 5,633 shares	(11)	(204)				(215)
Balance, June 30, 2015	$ 15,086	$ 140,045	$ 97,093	$ (1,820)	$	$ 250,404
Balance, January 1, 2014	$ 15,614	$ 146,109	$ 84,008	$ (698)	$ (6,241)	$ 238,792
Net income			8,029			8,029
Other comprehensive income, net of income taxes				2,260		2,260
Dividends declared: $0.62 per share			(4,681)			(4,681)
Shares retired: 3,386 shares	(7)	(102)				(109)
Reissuance under option plan: 600 shares		28			11	39
Repurchase and held: 1,800 shares					(70)	(70)
Retirement of stock options		(95)				(95)
Retirement of treasury shares	(510)	(5,790)			6,300	
Balance, June 30, 2014	$ 15,097	$ 140,150	$ 87,356	$ 1,562	$	$ 244,165

See notes to consolidated financial statements

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Peoples Financial Services Corp.

CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

(Dollars in thousands, except per share data)

For the Six Months Ended June 30	**2015**	**2014**
Cash flows from operating activities:		
Net income	$ 9,475	$ 8,029
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation of premises and equipment	784	947
Amortization of deferred loan costs	284	78
Amortization of intangibles	600	676
Net accretion of purchase accounting adjustments on tangible assets	(501)	(1,965)
Provision for loan losses	1,500	2,058
Net gain on sale of other real estate owned	(110)	(41)
Net loss on disposal of equipment		63
Net amortization of investment securities	2,054	2,116
Loans originated for sale	(14,079)	(4,866)
Proceeds from sale of loans originated for sale	15,155	3,527
Net (gain) loss on sale of loans originated for sale	(469)	339
Net gain on sale of investment securities	(832)	(160)
Life insurance investment income	(377)	(395)
Deferred income tax expense (benefit)	119	
Stock based compensation	35	11
Net change in:		
Accrued interest receivable	73	290
Other assets	(3,235)	(4,764)
Accrued interest payable	(131)	(143)
Stock appreciation rights		301
Other liabilities	(1,478)	3,841
Net cash provided by operating activities	8,867	9,942
Cash flows from investing activities:		
Proceeds from sales of investment securities available-for-sale	50,981	4,984
Proceeds from repayments of investment securities:		
Available-for-sale	28,253	18,245
Held-to-maturity	1,016	1,352
Purchases of investment securities:		
Available-for-sale	(61,162)	(34,289)
Held-to-maturity		
Net redemption of restricted equity securities	330	182
Net increase in lending activities	(22,414)	(3,223)
Purchases of premises and equipment	(1,953)	(636)
Proceeds from the sale of premises and equipment		25

Proceeds from sale of other real estate owned	463	321
Net cash used in investing activities	(4,486)	(13,039)
Cash flows from financing activities:		
Net increase (decrease) in deposits	(424)	43,866
Repayment of long-term debt	(1,450)	(1,791)
Net increase (decrease) in short-term borrowings	6,303	(7,964)
Redemption of common stock		(70)
Retirement of stock options		(95)
Purchase of treasury stock		(70)
Cash dividends paid	(4,679)	(4,681)
Net cash provided by (used in) financing activities	(250)	29,195
Net increase (decrease) in cash and cash equivalents	4,131	26,098
Cash and cash equivalents at beginning of year	31,426	51,310
Cash and cash equivalents at end of year	$ 35,557	$ 77,408

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Peoples Financial Services Corp.

CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

(Dollars in thousands, except per share data)

For the Six Months Ended June 30	**2015**	**2014**
Supplemental disclosures:		
Cash paid during the period for:		
Interest	$ 3,114	$ 3,557
Income taxes	1,800	1,300
Noncash items:		
Transfers of loans to other real estate	$ 247	$ 258
Retirement of treasury shares		6,300
Acquisition:		
Fair value of assets acquired:		
Loans, net	$ 157	$ 1,417
Premises and equipment	(50)	(50)
Core deposit and other intangible assets	(600)	(676)
	$ (493)	$ 691
Fair value of liabilities assumed:		
Deposits	$ 367	$ 571
Long-term debt	27	27
	$ 394	$ 598

See notes to consolidated financial statements

Peoples Financial Services Corp.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Dollars in thousands, except per share data)

1. Summary of significant accounting policies:

Nature of operations:

Peoples Financial Services Corp., a bank holding company incorporated under the laws of Pennsylvania, provides a full range of financial services through its wholly-owned subsidiary, Peoples Security Bank and Trust Company (Peoples Bank), including its subsidiaries, Peoples Advisors, LLC and Penseco Realty, Inc. (collectively, the Company or Peoples). The Company services its retail and commercial customers through twenty-six full-service community banking offices located within the Lackawanna, Lehigh, Luzerne, Monroe, Susquehanna, Wayne and Wyoming Counties of Pennsylvania and Broome County of New York.

Basis of presentation:

The accompanying unaudited consolidated financial statements of the Company have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) for interim financial information and with the instructions to Form 10-Q and Article 10-01 of Regulation S-X. In the opinion of management, all normal recurring adjustments necessary for a fair presentation of the financial position and results of operations for the periods presented have been included. All significant intercompany balances and transactions have been eliminated in consolidation. Prior-period amounts are reclassified when necessary to conform to the current year s presentation. These reclassifications did not have any effect on the operating results or financial position of the Company. The operating results and financial position of the Company for the three and six months ended and as of June 30, 2015, are not necessarily indicative of the results of operations and financial position that may be expected in the future.

The preparation of consolidated financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Significant estimates that are particularly susceptible to material change in the near term relate to the determination of the allowance for loan losses, fair value of financial instruments, the valuation of real estate acquired in connection with foreclosures or in satisfaction of loans, the valuation of deferred tax assets, determination of other-than-temporary impairment losses on securities, impairment of goodwill and fair value of assets acquired and liabilities assumed in business combinations. Actual results could differ from those estimates. For additional information and disclosures required under GAAP, reference is made to the Company s Annual Report on Form 10-K for the period ended December 31, 2014.

The Company has evaluated events and transactions occurring subsequent to the balance sheet date of June 30, 2015, for items that should potentially be recognized or disclosed in these consolidated financial statements. The evaluation was conducted through the date these consolidated financial statements were issued.

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Peoples Financial Services Corp.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Dollars in thousands, except per share data)

Recent accounting standards:

In May 2015, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2015-08, Business Combinations (Topic 805): Pushdown Accounting Amendments to SEC Paragraphs Pursuant to Staff Accounting Bulletin (SAB) 115. This ASU rescinds certain SEC guidance in order to conform with ASU 2014-17, Pushdown Accounting. ASU 2014-17 was issued in November 2014 and provides a reporting entity that is a business or nonprofit activity (an acquiree) the option to apply pushdown accounting to its separate financial statements when an acquirer obtains control of the acquiree. SAB 115 became effective November 21, 2014. The adoption of ASU 2015-18 did not have a material effect on the operating results or financial position of the Company.

2. Other comprehensive income (loss):

The components of other comprehensive loss and their related tax effects are reported in the Consolidated Statements of Income and Comprehensive Income. The accumulated other comprehensive income (loss) included in the Consolidated Balance Sheets relates to net unrealized gains and losses on investment securities available-for-sale and benefit plan adjustments.

The components of accumulated other comprehensive loss included in stockholders equity at June 30, 2015 and December 31, 2014 is as follows:

	June 30, 2015	December 31, 2014
Net unrealized gain on investment securities available-for-sale	$ 4,768	$ 6,292
Related income taxes	1,669	2,202
Net of income taxes	3,099	4,090
Benefit plan adjustments	(7,567)	(7,567)
Related income taxes	(2,648)	(2,648)
Net of income taxes	(4,919)	(4,919)
Accumulated other comprehensive loss	$ (1,820)	$ (829)

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Peoples Financial Services Corp.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Dollars in thousands, except per share data)

2. Other comprehensive income (loss) continued:

Other comprehensive income (loss) and related tax effects for the three and six months ended June 30, 2015 and 2014 is as follows:

Three months ended June 30	**2015**	**2014**
Unrealized gain (loss) on investment securities available-for-sale	$ (1,459)	$ 1,242
Net gain on the sale of investment securities available-for-sale (1)		(160)
Other comprehensive income (loss) gain before taxes	(1,459)	1,082
Income tax expense (benefit)	(510)	378
Other comprehensive income (loss)	$ (949)	$ 704

Six months ended June 30	**2015**	**2014**
Unrealized gain (loss) on investment securities available-for-sale	$ (692)	$ 3,636
Net gain on the sale of investment securities available-for-sale (1)	(832)	(160)
Other comprehensive income (loss) gain before taxes	(1,524)	3,476
Income tax expense (benefit)	(533)	1,216
Other comprehensive income (loss)	$ (991)	$ 2,260

(1) Represents amounts reclassified out of accumulated comprehensive income and included in gains on sale of investment securities on the consolidated statements of income and comprehensive income.

3. Earnings per share:

Basic earnings per share represent income available to common stockholders divided by the weighted-average number of common shares outstanding during the period. Diluted earnings per share reflect additional common shares that would have been outstanding if dilutive potential common shares had been issued, as well as any adjustment to income that would result from the assumed issuance. Potential common shares that may be issued by the Company relate solely to outstanding stock options, and are determined using the treasury stock method.

There were no shares considered anti-dilutive for the three and six month periods ended June 30, 2015 and 2014.

	2015		2014	
For the three months ended June 30	**Basic**	**Diluted**	**Basic**	**Diluted**
Net Income (Numerator)	$ 4,431	$ 4,431	$ 3,331	$ 3,331
Average common shares outstanding (Denominator)	7,546,198	7,546,198	7,548,358	7,570,883
Earnings per share	$ 0.59	$ 0.59	$ 0.44	$ 0.44

	2015		2014	
For the six months ended June 30	**Basic**	**Diluted**	**Basic**	**Diluted**
Net Income (Numerator)	$ 9,475	$ 9,475	$ 8,029	$ 8,029
Average common shares outstanding (Denominator)	7,547,272	7,547,272	7,549,300	7,575,655
Earnings per share	$ 1.26	$ 1.26	$ 1.06	$ 1.06

Peoples Financial Services Corp.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Dollars in thousands, except per share data)

4. Investment securities:

The amortized cost and fair value of investment securities aggregated by investment category at June 30, 2015 and December 31, 2014 are summarized as follows:

June 30 2015	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available-for-sale:				
U.S. Treasury securities	$ 30,631	$ 84	$ 30	$ 30,685
U.S. Government-sponsored enterprises	85,377	490	5	85,862
State and municipals:				
Taxable	15,930	804	22	16,712
Tax-exempt	109,241	3,886	613	112,514
Mortgage-backed securities:				
U.S. Government agencies	32,995	156	62	33,089
U.S. Government-sponsored enterprises	39,848	250	170	39,928
Total	$ 314,022	$ 5,670	$ 902	$ 318,790
Held-to-maturity:				
State and municipals Tax-exempt	$ 7,369	$ 103	$ 53	$ 7,419
Mortgage-backed securities:				
U.S. Government agencies	93	1		94
U.S. Government-sponsored enterprises	6,164	427		6,591
Total	$ 13,626	$ 531	$ 53	$ 14,104

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Peoples Financial Services Corp.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Dollars in thousands, except per share data)

4. Investment securities (continued):

December 31, 2014	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available-for-sale:				
U.S. Treasury securities	$ 48,393	$ 157		$ 48,550
U.S. Government-sponsored enterprises	95,990	337	$ 82	96,245
State and municipals:				
Taxable	16,490	943	26	17,407
Tax-exempt	87,954	4,971	24	92,901
Mortgage-backed securities:				
U.S. Government agencies	37,511	132	167	37,476
U.S. Government-sponsored enterprises	46,956	277	226	47,007
Total	$ 333,294	$ 6,817	$ 525	$ 339,586
Held-to-maturity:				
Tax-exempt state and municipals	$ 7,370	$ 105	$ 38	$ 7,437
Mortgage-backed securities:				
U.S. Government agencies	100	2		102
U.S. Government-sponsored enterprises	7,195	481		7,676
Total	$ 14,665	$ 588	$ 38	$ 15,215

The maturity distribution of the fair value, which is the net carrying amount, of the debt securities classified as available-for-sale at June 30, 2015, is summarized as follows:

June 30, 2015	Fair Value
Within one year	$ 28,289
After one but within five years	108,675
After five but within ten years	54,059
After ten years	54,750
	245,773

Mortgage-backed securities	73,017
Total	$ 318,790

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Peoples Financial Services Corp.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Dollars in thousands, except per share data)

4. Investment securities (continued):

The maturity distribution of the amortized cost and fair value, of debt securities classified as held-to-maturity at June 30, 2015, is summarized as follows:

June 30, 2015	Amortized Cost	Fair Value
Within one year		
After one but within five years	$ 326	$ 330
After five but within ten years	176	180
After ten years	6,867	6,909
	7,369	7,419
Mortgage-backed securities	6,257	6,685
Total	$ 13,626	$ 14,104

Securities with a carrying value of $191,687 and $216,192 at June 30, 2015 and December 31, 2014, respectively, were pledged to secure public deposits and repurchase agreements as required or permitted by law.

Securities and short-term investment activities are conducted with a diverse group of government entities, corporations and state and local municipalities. The counterparty s creditworthiness and type of collateral is evaluated on a case-by-case basis. At June 30, 2015 and December 31, 2014, there were no significant concentrations of credit risk from any one issuer, with the exception of U.S. Government agencies and sponsored enterprises that exceeded 10.0 percent of stockholders equity.

The fair value and gross unrealized losses of investment securities with unrealized losses for which an other-than-temporary impairment (OTTI) has not been recognized at June 30, 2015 and December 31, 2014, aggregated by investment category and length of time that the individual securities have been in a continuous unrealized loss position, are summarized as follows:

	Less Than 12 Months	12 Months or More	Total
June 30, 2015			

	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
U.S. Treasury securities	$ 10,044	$ 30			$ 10,044	$ 30
U.S. Government-sponsored enterprises	3,003	5			3,003	5
State and municipals:						
Taxable			$ 545	$ 22	545	22
Tax-exempt	44,196	636	786	30	44,982	666
Mortgage-backed securities:						
U.S. Government agencies	7,457	26	5,402	36	12,859	62
U.S. Government-sponsored enterprises	13,785	68	3,721	102	17,506	170
Total	$ 78,485	$ 765	$ 10,454	$ 190	$ 88,939	$ 955

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Peoples Financial Services Corp.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Dollars in thousands, except per share data)

4. Investment securities (continued):

	Less Than 12 Months		12 Months or More		Total	
December 31, 2014	**Fair Value**	**Unrealized Losses**	**Fair Value**	**Unrealized Losses**	**Fair Value**	**Unrealized Losses**
U.S. Government-sponsored enterprises	$ 21,228	$ 33	$ 7,954	$ 49	$ 29,182	$ 82
State and municipals:						
Taxable			544	26	544	26
Tax-exempt	4,702	23	2,423	39	7,125	62
Mortgage-backed securities:						
U.S. Government agencies	20,148	167			20,148	167
U.S. Government-sponsored enterprises	22,870	226			22,870	226
Total	$ 68,948	$ 449	$ 10,921	$ 114	$ 79,869	$ 563

The Company had 110 investment securities, consisting of 84 tax-exempt state and municipal obligations, two U.S. Treasury Securities, one taxable state and municipal obligation, one U.S. Government-sponsored enterprise securities, and 22 mortgage-backed securities that were in unrealized loss positions at June 30, 2015. Of these securities, one taxable state and municipal obligation, six mortgage-backed securities and three tax-exempt state and municipal securities were in a continuous unrealized loss position for twelve months or more. Management does not consider the unrealized losses on the debt securities, as a result of changes in interest rates, to be OTTI based on historical evidence that indicates the cost of these securities is recoverable within a reasonable period of time in relation to normal cyclical changes in the market rates of interest. Moreover, because there has been no material change in the credit quality of the issuers or other events or circumstances that may cause a significant adverse impact on the fair value of these securities, and management does not intend to sell these securities and it is unlikely that the Company will be required to sell these securities before recovery of their amortized cost basis, which may be maturity, the Company does not consider the unrealized losses to be OTTI at June 30, 2015. There was no OTTI recognized for the three or six months ended June 30, 2015 and 2014.

The Company had 52 investment securities, consisting of 16 tax-exempt state and municipal obligations, one taxable state and municipal obligation, nine U.S. Government-sponsored enterprise securities and 26 mortgage-backed securities that were in unrealized loss positions at December 31, 2014. Of these securities, two U.S. Government-sponsored enterprise securities, four tax-exempt state and municipal securities, and one taxable state and municipal obligation were in a continuous unrealized loss position for twelve months or more.

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Peoples Financial Services Corp.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Dollars in thousands, except per share data)

5. Loans, net and allowance for loan losses:

The major classifications of loans outstanding, net of deferred loan origination fees and costs at June 30, 2015 and December 31, 2014 are summarized as follows. Net deferred loan costs were $700 and $651 at June 30, 2015 and December 31, 2014.

	June 30, 2015	December 31, 2014
Commercial	$ 322,418	$ 319,590
Real estate:		
Commercial	511,835	493,481
Residential	312,567	310,667
Consumer	84,721	86,156
Total	$ 1,231,541	$ 1,209,894

The changes in the allowance for loan losses account by major classification of loan for the three and six months ended June 30, 2015 and 2014 are summarized as follows:

		Real estate			
June 30, 2015	**Commercial**	**Commercial**	**Residential**	**Consumer**	**Total**
Allowance for loan losses:					
Beginning Balance April 1, 2015	$ 2,420	$ 3,087	$ 3,909	$ 1,387	$ 10,803
Charge-offs	(3)	(30)	(35)	(106)	(174)
Recoveries	3	5	3	38	49
Provisions	15	128	150	457	750
Ending balance	$ 2,435	$ 3,190	$ 4,027	$ 1,776	$ 11,428

		Real estate			
June 30, 2015	**Commercial**	**Commercial**	**Residential**	**Consumer**	**Total**
Allowance for loan losses:					
Beginning Balance January 1, 2015	$ 2,321	$ 3,037	$ 3,690	$ 1,290	$ 10,338
Charge-offs	(40)	(79)	(234)	(186)	(539)
Recoveries	64	6	8	51	129

Provisions	90	226	563	621	1,500
Ending balance	$ 2,435	$ 3,190	$ 4,027	$ 1,776	$ 11,428

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Peoples Financial Services Corp.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Dollars in thousands, except per share data)

5. Loans, net and allowance for loan losses (continued):

June 30, 2014	Commercial	Real estate Commercial	Real estate Residential	Consumer	Total
Allowance for loan losses:					
Beginning Balance April 1, 2014	$ 1,961	$ 2,473	$ 3,248	$ 1,177	$ 8,859
Charge-offs	(29)	(404)	(270)	(87)	(790)
Recoveries	1	269	35	47	352
Provisions	268	337	445	151	1,201
Ending balance	$ 2,201	$ 2,675	$ 3,458	$ 1,288	$ 9,622

June 30, 2014	Commercial	Real estate Commercial	Real estate Residential	Consumer	Total
Allowance for loan losses:					
Beginning Balance January 1, 2014	$ 2,008	$ 2,394	$ 3,135	$ 1,114	$ 8,651
Charge-offs	(376)	(432)	(510)	(155)	(1,473)
Recoveries	1	269	38	78	386
Provisions	568	444	795	251	2,058
Ending balance	$ 2,201	$ 2,675	$ 3,458	$ 1,288	$ 9,622

The allocation of the allowance for loan losses and the related loans by major classifications of loans at June 30, 2015 and December 31, 2014 is summarized as follows:

June 30, 2015	Commercial	Real estate Commercial	Real estate Residential	Consumer	Unallocated	Total
Allowance for loan losses:						
Ending balance	$ 2,435	$ 3,190	$ 4,027	$ 1,776	$	$ 11,428
Ending balance: individually evaluated for impairment	1,209	1,338	796	137		3,480
Ending balance: collectively evaluated for impairment	1,226	1,745	3,231	1,639		7,841

Ending balance: loans acquired with deteriorated credit quality	$	$ 107	$	$		$ 107
Loans receivable:						
Ending balance	$ 322,418	$ 511,835	$ 312,567	$ 84,721	$	$ 1,231,541
Ending balance: individually evaluated for impairment	1,948	6,080	4,385	137		12,550
Ending balance: collectively evaluated for impairment	319,448	504,379	308,127	$ 84,584		1,216,538
Ending balance: loans acquired with deteriorated credit quality	$ 1,022	$ 1,376	$ 55		$	$ 2,453

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Peoples Financial Services Corp.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Dollars in thousands, except per share data)

5. Loans, net and allowance for loan losses (continued):

		Real estate				
December 31, 2014	**Commercial**	**Commercial**	**Residential**	**Consumer**	**Unallocated**	**Total**
Allowance for loan losses:						
Ending balance	$ 2,321	$ 3,037	$ 3,690	$ 1,290	$	$ 10,338
Ending balance: individually evaluated for impairment	1,072	805	767	38		2,682
Ending balance: collectively evaluated for impairment	1,081	2,125	2,921	1,252		7,379
Ending balance: loans acquired with deteriorated credit quality	$ 168	$ 107	$ 2			$ 277
Loans receivable:						
Ending balance	$ 319,590	$ 493,481	$ 310,667	$ 86,156	$	$ 1,209,894
Ending balance: individually evaluated for impairment	2,595	5,084	4,001	127		11,807
Ending balance: collectively evaluated for impairment	315,642	487,024	306,608	$ 86,029		1,195,303
Ending balance: loans acquired with deteriorated credit quality	$ 1,353	$ 1,373	$ 58		$	$ 2,784

The Company segments loans into risk categories based on relevant information about the ability of borrowers to service their debt such as current financial information, historical payment experience, credit documentation, public information, and current economic trends, among other factors. Loans are individually analyzed for credit risk by classifying them within the Company s internal risk rating system. The Company s risk rating classifications are defined as follows:

Pass- A loan to borrowers with acceptable credit quality and risk that is not adversely classified as Substandard, Doubtful, Loss nor designated as Special Mention.

Special Mention- A loan that has potential weaknesses that deserves management s close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the loan or in the institution s credit position at some future date. Special Mention loans are not adversely classified since they do not expose the Company to sufficient risk to warrant adverse classification.

Substandard- A loan that is inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Loans so classified must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the bank will sustain some loss if the deficiencies are not corrected.

Doubtful A loan classified as Doubtful has all the weaknesses inherent in one classified Substandard with the added characteristic that the weaknesses make the collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable.

Loss- A loan classified as Loss is considered uncollectible and of such little value that its continuance as bankable loan is not warranted. This classification does not mean that the loan has absolutely no recovery or salvage value, but rather it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may be affected in the future.

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Peoples Financial Services Corp.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Dollars in thousands, except per share data)

5. Loans, net and allowance for loan losses (continued):

The following tables present the major classification of loans summarized by the aggregate pass rating and the classified ratings of special mention, substandard and doubtful within the Company s internal risk rating system at June 30, 2015 and December 31, 2014:

June 30, 2015	Pass	Special Mention	Substandard	Doubtful	Total
Commercial	$ 309,696	$ 6,171	$ 6,551	$	$ 322,418
Real estate:					
Commercial	486,289	13,280	12,266		511,835
Residential	301,962	1,865	8,740		312,567
Consumer	84,583		138		84,721
Total	$ 1,182,530	$ 21,316	$ 27,695	$	$ 1,231,541

December 31, 2014:	Pass	Special Mention	Substandard	Doubtful	Total
Commercial	$ 306,066	$ 6,135	$ 7,389	$	$ 319,590
Real estate:					
Commercial	472,270	9,858	11,353		493,481
Residential	300,299	2,123	8,245		310,667
Consumer	86,037	13	106		86,156
Total	$ 1,164,672	$ 18,129	$ 27,093	$	$ 1,209,894

Information concerning nonaccrual loans by major loan classification at June 30, 2015 and December 31, 2014 is summarized as follows:

	June 30, 2015	December 31, 2014
Commercial	$ 1,499	$ 1,322
Real estate:		

Commercial	3,468	3,732
Residential	3,881	3,523
Consumer	135	122
Total	$ 8,983	$ 8,699

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Peoples Financial Services Corp.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Dollars in thousands, except per share data)

5. Loans, net and allowance for loan losses (continued):

The major classifications of loans by past due status are summarized as follows:

June 30, 2015	30-59 Days Past Due	60-89 Days Past Due	Greater than 90 Days	Total Past Due	Current	Total Loans	Loans > 90 Days and Accruing
Commercial	$ 426	$ 61	$ 1,499	$ 1,986	$ 320,432	$ 322,418	
Real estate:							
Commercial	3,000	205	3,468	6,673	505,162	511,835	
Residential	1,098	1,708	4,611	7,417	305,150	312,567	$ 730
Consumer	654	232	477	1,363	83,358	84,721	342
Total	$ 5,178	$ 2,206	$ 10,055	$ 17,439	$ 1,214,102	$ 1,231,541	$ 1,072

December 31, 2014	30-59 Days Past Due	60-89 Days Past Due	Greater than 90 Days	Total Past Due	Current	Total Loans	Loans > 90 Days and Accruing
Commercial	$ 898	$ 117	$ 1,322	$ 2,337	$ 317,253	$ 319,590	
Real estate:							
Commercial	2,100	888	3,868	6,856	486,625	493,481	$ 136
Residential	3,154	1,239	4,585	8,978	301,689	310,667	1,062
Consumer	848	247	547	1,642	84,514	86,156	425
Total	$ 7,000	$ 2,491	$ 10,322	$ 19,813	$ 1,190,081	$ 1,209,894	$ 1,623

The following tables summarize information concerning impaired loans as of and for the three and six months ended June 30, 2015 and June 30, 2014, and as of and for the year ended, December 31, 2014 by major loan classification:

	This Quarter	Year-to-Date

June 30, 2015	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
With no related allowance:							
Commercial	$ 1,658	$ 3,184		$ 1,989	$ 17	$ 2,168	$ 37
Real estate:							
Commercial	2,140	2,852		2,169	28	2,366	47
Residential	2,734	2,917		2,503	1	2,488	2
Consumer				6		26	
Total	6,532	8,953		6,667	46	7,048	86
With an allowance recorded:							
Commercial	1,312	1,312	$ 1,209	1,469	13	1,533	27
Real estate:							
Commercial	5,316	5,316	1,445	4,628	48	4,182	65
Residential	1,706	1,706	796	1,673	7	1,593	17
Consumer	137	137	137	114		91	
Total	8,471	8,471	3,587	7,884	68	7,399	109
Commercial	2,970	4,496	1,209	3,458	30	3,701	64
Real estate:							
Commercial	7,456	8,168	1,445	6,797	76	6,548	112
Residential	4,440	4,623	796	4,176	8	4,081	19
Consumer	137	137	137	120		117	
Total	$ 15,003	$ 17,424	$ 3,587	$ 14,551	$ 114	$ 14,447	$ 195

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Peoples Financial Services Corp.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Dollars in thousands, except per share data)

5. Loans, net and allowance for loan losses (continued):

December 31, 2014	Recorded Investment	Unpaid Principal Balance	Related Allowance	For the Year Ended Average Recorded Investment	For the Year Ended Interest Income Recognized
With no related allowance:					
Commercial	$ 2,379	$ 4,084		$ 2,669	141
Real estate:					
Commercial	2,932	3,690		7,944	120
Residential	2,672	2,857		2,731	4
Consumer	83	83		94	
Total	8,066	10,714		13,438	265
With an allowance recorded:					
Commercial	1,569	1,569	$ 1,240	1,787	$ 58
Real estate:					
Commercial	3,525	3,525	912	2,293	28
Residential	1,387	1,387	769	590	10
Consumer	44	44	38	10	1
Total	6,525	6,525	2,959	4,680	97
Commercial	3,948	5,653	1,240	4,456	199
Real estate:					
Commercial	6,457	7,215	912	10,237	148
Residential	4,059	4,244	769	3,321	14
Consumer	127	127	38	104	1
Total	$ 14,591	$ 17,239	$ 2,959	$ 18,118	$ 362

June 30, 2014	Recorded Investment	Unpaid Principal Balance	Related Allowance	This Quarter Average Recorded Investment	This Quarter Interest Income Recognized	Year-to-Date Average Recorded Investment	Year-to-Date Interest Income Recognized

With no related allowance:							
Commercial	$ 2,649	$ 4,470		$ 2,329	$ 28	$ 2,908	$ 52
Real estate:							
Commercial	9,899	12,619		9,929	19	10,077	38
Residential	2,720	2,908		2,730	1	2,801	2
Consumer	97	97		113		111	
Total	15,365	20,094		15,101	48	15,897	92
With an allowance recorded:							
Commercial	1,757	1,757	$ 1,157	1,743	23	1,853	43
Real estate:							
Commercial	1,387	1,387	527	1,395	14	1,397	29
Residential	257	257	162	259		390	
Consumer							
Total	3,401	3,401	1,846	3,397	37	3,640	72
Commercial	4,406	6,227	1,157	4,072	51	4,761	95
Real estate:							
Commercial	11,286	14,006	527	11,324	33	11,474	67
Residential	2,977	3,165	162	2,989	1	3,191	2
Consumer	97	97		113		111	
Total	$ 18,766	$ 23,495	$ 1,846	$ 18,498	$ 85	$ 19,537	$ 164

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Peoples Financial Services Corp.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Dollars in thousands, except per share data)

5. Loans, net and allowance for loan losses (continued):

Included in the commercial loan and commercial and residential real estate categories are troubled debt restructurings that are classified as impaired. Troubled debt restructurings totaled $3,046 at June 30, 2015, $2,933 at December 31, 2014 and $1,900 at June 30, 2014.

Troubled debt restructured loans are loans with original terms, interest rate, or both, that have been modified as a result of a deterioration in the borrower s financial condition and a concession has been granted that the Company would not otherwise consider. Unless on nonaccrual, interest income on these loans is recognized when earned, using the interest method. The Company offers a variety of modifications to borrowers that would be considered concessions. The modification categories offered generally fall within the following categories:

Rate Modification - A modification in which the interest rate is changed to a below market rate.

Term Modification - A modification in which the maturity date, timing of payments or frequency of payments is changed.

Interest Only Modification - A modification in which the loan is converted to interest only payments for a period of time.

Payment Modification - A modification in which the dollar amount of the payment is changed, other than an interest only modification described above.

Combination Modification - Any other type of modification, including the use of multiple categories above. There were four loans modified as a troubled debt restructuring for the three months ended June 30, 2015, in the amount of $170. There were eight loans modified as troubled debt restructurings for the first six months ended June 30, 2015, in the amount of $554. There were no loans modified as troubled debt restructurings for the three or six months ended June 30, 2014. During the three and six months ended June 30, 2015 and 2014, there were no defaults on loans restructured within the last twelve months.

6. Other assets:

The components of other assets at June 30, 2015, and December 31, 2014 are summarized as follows:

	June 30, 2015	December 31, 2014
Other real estate owned	$ 334	$ 561
Investment in residential housing program	7,044	4,329
Mortgage servicing rights	566	676
Bank owned life insurance	30,374	29,983
Restricted equity securities	3,357	3,687
Other assets	14,785	13,830
Total	$ 56,460	$ 53,066

7. Fair value estimates:

The Company uses fair value measurements to record fair value adjustments to certain assets and liabilities and to determine fair value disclosure under GAAP. Fair value estimates are calculated without attempting to estimate the value of anticipated future business and the value of certain assets and liabilities that are not considered financial. Accordingly, such assets and liabilities are excluded from disclosure requirements.

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Peoples Financial Services Corp.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Dollars in thousands, except per share data)

7. Fair value estimates (continued):

In accordance with FASB ASC 820, Fair Value Measurements and Disclosures, fair value is the price that would be received to sell an asset or transfer a liability in an orderly transaction between market participants at the measurement date. Fair value is best determined based upon quoted market prices. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. In that regard, the derived fair value estimates cannot be substantiated by comparison to independent markets. In many cases, these values cannot be realized in immediate settlement of the instrument.

Current fair value guidance provides a consistent definition of fair value, which focuses on exit price in an orderly transaction that is not a forced liquidation or distressed sale between participants at the measurement date under current market conditions. If there has been a significant decrease in the volume and level of activity for the asset or liability, a change in valuation technique or the use of multiple valuation techniques may be appropriate. In such instances, determining the price at which willing market participants would transact at the measurement date under current market conditions depends on the facts and circumstances and requires the use of significant judgment. The fair value is a reasonable point within the range that is most representative of fair value under current market conditions.

In accordance with GAAP, the Company groups its assets and liabilities generally measured at fair value into three levels based on market information or other fair value estimates in which the assets and liabilities are traded or valued and the reliability of the assumptions used to determine fair value. These levels include:

Level 1: Unadjusted quoted prices of identical assets or liabilities in active markets that the entity has the ability to access as of the measurement date.

Level 2: Significant other observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data.

Level 3: Significant unobservable inputs that reflect a reporting entity s own assumptions about the assumptions that market participants would use in pricing an asset or liability.

An asset s or liability s placement in the fair value hierarchy is based on the lowest level of input that is significant to the fair value estimate.

The following methods and assumptions were used by the Company to calculate fair values and related carrying amounts of financial instruments:

Cash and cash equivalents: The carrying values of cash and cash equivalents as reported on the balance sheet approximate fair value.

Investment securities: The fair values of U.S. Treasury securities and marketable equity securities are based on quoted market prices from active exchange markets. The fair values of debt securities are based on pricing from a matrix pricing model.

Loans held for sale: The fair values of loans held for sale are based upon current delivery prices in the secondary mortgage market.

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(Dollars in thousands, except per share data)

7. Fair value estimates (continued):

Net loans: For adjustable-rate loans that re-price frequently and with no significant credit risk, fair values are based on carrying values. The fair values of other non-impaired loans are estimated using discounted cash flow analysis, using interest rates currently offered in the market for loans with similar terms to borrowers of similar credit risk. Fair values for impaired loans are estimated using discounted cash flow analysis determined by the loan review function or underlying collateral values, where applicable.

In conjunction with the Merger, the loans purchased were recorded at their acquisition date fair value. In order to record the loans at fair value, management made three different types of fair value adjustments. A market rate adjustment was made to adjust for the movement in market interest rates, irrespective of credit adjustments, compared to the stated rates of the acquired loans. A credit adjustment was made on pools of homogeneous loans representing the changes in credit quality of the underlying borrowers from the loan inception to the acquisition date. The credit adjustment on distressed loans represents the portion of the loan balance that has been deemed uncollectible based on the management s expectations of future cash flows for each respective loan.

Mortgage servicing rights: To determine the fair value, the Company estimates the present value of future cash flows incorporating assumptions such as cost of servicing, discount rates, prepayment speeds and default rates.

Accrued interest receivable: The carrying value of accrued interest receivable as reported on the balance sheet approximates fair value.

Restricted equity securities: The carrying values of restricted equity securities approximate fair value, due to the lack of marketability for these securities.

Deposits: The fair values of noninterest-bearing deposits and savings, NOW and money market accounts are the amounts payable on demand at the reporting date. The fair value estimates do not include the benefit that results from such low-cost funding provided by the deposit liabilities compared to the cost of borrowing funds in the market. The carrying values of adjustable-rate, fixed-term time deposits approximate their fair values at the reporting date. For fixed-rate time deposits, the present value of future cash flows is used to estimate fair values. The discount rates used are the current rates offered for time deposits with similar maturities.

The fair value assigned to the core deposit intangible asset represents the future economic benefit of the potential cost savings from acquiring core deposits in the Merger compared to the cost of obtaining alternative funding such as brokered deposits from market sources. Management utilized an income valuation approach to present value the estimated future cash savings in order to determine the fair value of the intangible asset.

Short-term borrowings: The carrying values of short-term borrowings approximate fair value.

Long-term debt: The fair value of fixed-rate long-term debt is based on the present value of future cash flows. The discount rate used is the current rate offered for long-term debt with the same maturity.

Accrued interest payable: The carrying value of accrued interest payable as reported on the balance sheet approximates fair value.

Off-balance sheet financial instruments:

The majority of commitments to extend credit, unused portions of lines of credit and standby letters of credit carry current market interest rates if converted to loans. Because such commitments are generally unassignable of either the Company or the borrower, they only have value to the Company and the borrower. None of the commitments are subject to undue credit risk. The estimated fair values of off-balance sheet financial instruments are based on fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the counterparties credit standing. The fair value of off-balance sheet financial instruments was not material at June 30, 2015 and December 31, 2014.

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Peoples Financial Services Corp.

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(Dollars in thousands, except per share data)

7. Fair value estimates (continued):

Assets and liabilities measured at fair value on a recurring basis at June 30, 2015 and December 31, 2014 are summarized as follows:

		Fair Value Measurement Using		
June 30, 2015	**Amount**	**Quoted Prices in Active Markets for Identical Assets (Level 1)**	**Significant Other Observable Inputs (Level 2)**	**Significant Unobservable Inputs (Level 3)**
U.S. Treasury securities	$ 30,685	$ 30,685		$
U.S. Government-sponsored enterprises	85,862		$ 85,862	
State and Municipals:				
Taxable	16,712		16,712	
Tax-exempt	112,514		112,514	
Corporate debt securities				
Mortgage-backed securities:				
U.S. Government agencies	33,089		33,089	
U.S. Government-sponsored enterprises	39,928		39,928	
Total	$ 318,790	$ 30,685	$ 288,105	$

		Fair Value Measurement Using		
December 31, 2014	**Amount**	**Quoted Prices in Active Markets for Identical Assets (Level 1)**	**Significant Other Observable Inputs (Level 2)**	**Significant Unobservable Inputs (Level 3)**
U.S. Treasury securities	$ 48,550	$ 48,550		$

U.S. Government-sponsored enterprises	96,245			$	96,245		
State and Municipals:							
Taxable	17,407				17,407		
Tax-exempt	92,901				92,901		
Corporate debt securities							
Mortgage-backed securities:							
U.S. Government agencies	37,476				37,476		
U.S. Government-sponsored enterprises	47,007				47,007		
Total	$ 339,586	$	48,550	$	291,036	$	

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Peoples Financial Services Corp.

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(Dollars in thousands, except per share data)

7. Fair value estimates (continued):

Assets and liabilities measured at fair value on a nonrecurring basis at June 30, 2015 and December 31, 2014 are summarized as follows:

		Fair Value Measurement Using		
June 30, 2015	**Amount**	**Quoted Prices in Active Markets for Identical Assets (Level 1)**	**Significant Other Observable Inputs (Level 2)**	**Significant Unobservable Inputs (Level 3)**
Impaired loans	$ 6,448			$ 6,448
Other real estate owned	$ 88			$ 88

		Fair Value Measurement Using		
December 31, 2014	**Amount**	**Quoted Prices in Active Markets for Identical Assets (Level 1)**	**Significant Other Observable Inputs (Level 2)**	**Significant Unobservable Inputs (Level 3)**
Impaired loans	$ 4,414			$ 4,414
Other real estate owned	$ 218			$ 218

Fair values of impaired loans are based on the present value of expected future cash flows discounted at the loan s effective interest rate or the fair value of the collateral if the loan is collateral dependent.

The following table presents additional quantitative information about assets measured at fair value on a nonrecurring basis and for which the Company has utilized Level 3 inputs to determine fair value:

	Quantitative Information about Level 3 Fair Value Measurements			
June 30, 2015	**Fair Value Estimate**	**Valuation Techniques**	**Unobservable Input**	**Range (Weighted Average)**
Impaired loans	$ 6,448	Appraisal of collateral	Appraisal adjustments	14.0% to 63.0% (24.2%)
			Liquidation expenses	3.0% to 6.0% (5.4%)
Other real estate owned	$ 88	Appraisal of collateral	Appraisal adjustments	20.0% to 73.5% (53.4%)
			Liquidation expenses	3.0% to 6.0% (5.0%)

		Quantitative Information about Level 3 Fair Value Measurements		
December 31, 2014	**Fair Value Estimate**	**Valuation Techniques**	**Unobservable Input**	**Range (Weighted Average)**
Impaired loans	$ 4,414	Appraisal of collateral	Appraisal adjustments	2.6% to 61.1% (24.5%)
			Liquidation expenses	3.0% to 6.0% (5.5%)
Other real estate owned	$ 218	Appraisal of collateral	Appraisal adjustments	19.7% to 47.8% (30.5%)
			Liquidation expenses	3.0% to 6.0% (5.0%)

Fair value is generally determined through independent appraisals of the underlying collateral, which generally include various Level 3 Inputs which are not identifiable.

Appraisals may be adjusted by management for qualitative factors such as economic conditions and estimated liquidation expenses. The range and weighted average of liquidation expenses and other appraisal adjustments are presented as a percent of the appraisal.

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Peoples Financial Services Corp.

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7. Fair value estimates (continued):

The carrying and fair values of the Company s financial instruments at June 30, 2015 and December 31, 2014 and their placement within the fair value hierarchy are as follows:

			Fair Value Hierarchy		
June 30, 2015	**Carrying Value**	**Fair Value**	**Quoted Prices in Active Markets for Identical Assets (level 1)**	**Significant Other Observable Inputs (level 2)**	**Significant Unobservable Inputs (Level 3)**
Financial assets:					
Cash and cash equivalents	$ 35,557	$ 35,557	$ 35,557		
Investment securities:					
Available-for-sale	318,790	318,790	$ 30,685	$ 288,105	
Held-to-maturity	13,626	14,104		14,104	
Loans held for sale	2,879	2,883		2,883	
Net loans	1,220,113	1,229,055			$ 1,229,055
Accrued interest receivable	5,507	5,507		5,507	
Mortgage servicing rights	566	1,227		1,227	
Restricted equity securities	3,357	3,357		3,357	
Total	$ 1,600,395	$ 1,610,480			
Financial liabilities:					
Deposits	$ 1,424,767	$ 1,425,821		1,425,821	
Short-term borrowings	25,860	25,860		25,860	
Long-term debt	31,663	33,145		33,145	
Accrued interest payable	443	443		$ 443	
Total	$ 1,482,733	$ 1,485,269			

Fair Value Hierarchy

December 31, 2014	**Carrying Value**	**Fair Value**	**Quoted Prices in Active Markets for Identical Assets (level 1)**	**Significant Other Observable Inputs (level 2)**	**Significant Unobservable Inputs (Level 3)**
Financial assets:					
Cash and cash equivalents	$ 31,426	$ 31,426	$ 31,426		
Investment securities:					
Available-for-sale	339,586	339,586	$ 48,550	$ 291,036	
Held-to-maturity	14,665	15,215		15,215	
Loans held for sale	3,486	3,492		3,492	
Net loans	1,199,556	1,210,369			$ 1,210,369
Accrued interest receivable	5,580	5,580		5,580	
Mortgage servicing rights	676	1,466		1,466	
Restricted equity securities	3,687	3,687		3,687	
Total	$ 1,598,662	$ 1,610,821			
Financial liabilities:					
Deposits	$ 1,425,558	$ 1,427,081		1,427,081	
Short-term borrowings	19,557	19,557		19,557	
Long-term debt	33,140	34,772		34,772	
Accrued interest payable	574	574		$ 574	
Total	$ 1,478,829	$ 1,481,984			

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8. Employee benefit plans:

The Company provides an Employee Stock Ownership Plan (ESOP) and a Retirement Profit Sharing Plan. The Company also maintains a Supplemental Executive Retirement Plan (SERP), an Employees Pension Plan, which is currently frozen, and a Postretirement Plan Life Insurance plan which was curtailed in 2013.

For the three and six months ended June 30, salaries and employee benefits expense includes approximately $173 and $452 in 2015 and $584 and $834 in 2014 relating to the employee benefit plans.

Components of net periodic benefit cost are as follows:

	Pension Benefits	
Three months ended June 30,	**2015**	**2014**
Net periodic pension cost:		
Service cost		
Interest cost	$ 174	$ 169
Expected return on plan assets	(233)	(227)
Amortization of prior service cost		
Amortization of unrecognized net loss	50	23
Net periodic pension cost	$ (9)	$ (35)

	Pension Benefits	
Six months ended June 30,	**2015**	**2014**
Net periodic pension cost:		
Service cost		
Interest cost	$ 348	$ 338
Expected return on plan assets	(466)	(454)
Amortization of prior service cost		
Amortization of unrecognized net loss	100	46
Net periodic pension cost	$ (18)	$ (70)

Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations

The following discussion and analysis should be read in conjunction with the unaudited consolidated interim financial statements contained in Part I, Item 1 of this report, and with our audited consolidated financial statements and

Management s Discussion and Analysis of Financial Condition and Results of Operations presented in our Annual Report on Form 10-K for the year ended December 31, 2014.

Cautionary Note Regarding Forward-Looking Statements:

This report contains forward-looking statements within the meaning of Section 27A of the Securities Act, as amended, Section 21E of the Securities Exchange Act of 1934, as amended, which are subject to risks and uncertainties. These statements are based on assumptions and may describe future plans, strategies and expectations of Peoples Financial Services Corp. and its direct and indirect subsidiaries. These forward-looking statements are generally identified by use of the words believe, expect, intend, anticipate, estimate, project or similar expressions. All statements in report, other than statements of historical facts, are forward-looking statements.

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Our ability to predict results or the actual effect of future plans or strategies is inherently uncertain. Important factors that could cause our actual results to differ materially from those in the forward-looking statements include, but are not limited to: our ability to achieve the intended benefits of the 2013 merger with Penseco Financial Services Corporation; changes in interest rates; economic conditions, particularly in our market area; legislative and regulatory changes and the ability to comply with the significant laws and regulations governing the banking and financial services business; monetary and fiscal policies of the U.S. government, including policies of the U.S. Department of Treasury and the Federal Reserve System; credit risk associated with lending activities and changes in the quality and composition of our loan and investment portfolios; demand for loan and other products; deposit flows; competition; changes in the values of real estate and other collateral securing the loan portfolio, particularly in our market area; changes in relevant accounting principles and guidelines; and inability of third party service providers to perform. Additional factors that may affect our results are discussed in Part I, Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2014, and in reports we file with the Securities and Exchange Commission from time to time.

These risks and uncertainties should be considered in evaluating forward-looking statements and undue reliance should not be placed on such statements. Except as required by applicable law or regulation, Peoples Financial Services Corp. does not undertake, and specifically disclaims any obligation, to release publicly the result of any revisions that may be made to any forward-looking statements to reflect events or circumstances after the date of the statements or to reflect the occurrence of anticipated or unanticipated events.

Notes to the Consolidated Financial Statements referred to in the Management s Discussion and Analysis of Financial Condition and Results of Operations (MD&A) are incorporated by reference into the MD&A. Certain prior period amounts may have been reclassified to conform with the current year s presentation. Any reclassifications did not have any effect on the operating results or financial position of the Company.

Critical Accounting Policies:

Disclosure of our significant accounting policies are included in Note 1 to the consolidated financial statements of the Annual Report on Form 10-K for the year ended December 31, 2014. Some of these policies are particularly sensitive requiring significant judgments, estimates and assumptions.

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Operating Environment:

With no new fiscal policy initiatives enacted during the second quarter of 2015, the focus of the Federal Open Market Committee (FOMC) was limited to issuing policy statements regarding the state of the economy. The FOMC noted improvement in labor markets, housing and household spending. Despite improvement to the unemployment rate, the historically low work force participation rate and slow wage growth continue to be a drag on the economy. The Federal Reserve s estimate for the gross domestic product (GDP), the value of all goods and services produced in the Nation, was downgraded to 1.8% to 2.0% for 2015. GDP rebounded in the second quarter of 2015 to a seasonally adjusted growth rate of 2.3%, comparable with the 2.4% experienced in 2014. The consumer price index (CPI) increased 3.2% annualized during the second quarter of 2015. Expectations are that the FOMC will begin to raise the federal funds rate starting late in the third quarter of 2015.

Review of Financial Position:

Total assets increased $6,086, or 0.7% annualized, to $1,747,755 at June 30, 2015, from $1,741,669 at December 31, 2014. Loans, net increased to $1,231,541 at June 30, 2015, compared to $1,209,894 at December 31, 2014, an increase of $21,647 or 3.6% annualized. The increase in loans, net during 2015 has been directly correlated to a decrease in investment securities available-for-sale. Investment securities decreased $21,835 or 6.2% in the first six months of 2015. Interest-bearing deposits increased $15,884, while noninterest-bearing deposits decreased $16,675. Total stockholders equity increased $3,625 or at an annual rate of 3.0%, from $246,779 at year-end 2014 to $250,404 at June 30, 2015. Compared to March 31, 2015, total assets increased $33,794 or 2.0% while loans, net decreased $5,627 or 0.5% and deposits increased $8,489 or 0.6%. For the six months ended June 30, 2015, total assets averaged $1,718,850, an increase of $17,059 from $1,701,791 for the same period of 2014.

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Investment Portfolio:

The majority of the investment portfolio is held as available-for-sale, which allows for greater flexibility in using the investment portfolio for liquidity purposes by allowing securities to be sold when market opportunities occur. Investment securities available-for-sale totaled $318,790 at June 30, 2015, a decrease of $20,796, or 6.1% from $339,586 at December 31, 2014. The decrease was primarily a result of the sale of U.S. Treasury securities in response to changes in the slope of the yield curve and in order to fund loan demand. Investment securities held-to-maturity totaled $13,626 at June 30, 2015, a decrease of $1,039 or 7.1% from $14,665 at December 31, 2014 due to payments received from mortgage backed holdings. For the three months ended June 30, 2015, total investments increased $37,944 resulting primarily from the purchase of short-term U.S. Treasury securities.

For the six months ended June 30, 2015, the investment portfolio averaged $310,481, a decrease of $9,971 or 3.1% compared to $320,452 for the same period last year. The tax-equivalent yield on the investment portfolio decreased 3 basis points to 2.76% for the six months ended June 30, 2015, from 2.79% for the comparable period of 2014. The yield decline is the result of decreasing reinvestment yields. The tax-equivalent yield decreased from 2.78% in the first quarter of 2015 to 2.74% in the second quarter of 2015.

Securities available-for-sale are carried at fair value, with unrealized gains or losses net of deferred income taxes reported in the accumulated other comprehensive income (loss) component of stockholders equity. We reported net unrealized holding gains, included as a separate component of stockholders equity of $3,099, net of deferred income taxes of $1,669, at June 30, 2015, and $4,090, net of deferred income taxes of $2,202, at December 31, 2014.

The Asset/Liability Committee (ALCO) reviews the performance and risk elements of the investment portfolio monthly. Through active balance sheet management and analysis of the securities portfolio, we endeavor to maintain sufficient liquidity to satisfy depositor requirements and meet the credit needs of our customers.

Loan Portfolio:

Following two consecutive quarters of strong loan growth in the fourth quarter of 2014 and first quarter of 2015, loans, net decreased slightly in the second quarter of 2015, but maintained an increase during the six month period. Loans, net increased to $1,231,541 at June 30, 2015 from $1,209,894 at December 31, 2014, an increase of $21,647 or 3.6% annualized. The growth reflected increases in commercial loans, commercial real estate loans and residential real estate loans, partially offset by a decrease in consumer loans. Commercial loans increased $2,828, or 1.8% annualized, to $322,418 at June 30, 2015 compared to $319,590 at December 31, 2014. Commercial real estate loans increased $18,354 or 7.5% annualized, to $511,835 at June 30, 2015 compared to $493,481 at December 31, 2014. Residential real estate loans increased $1,900, or 1.2% on an annualized basis, to $312,567 at June 30, 2015 compared to $310,667 at December 31, 2014.

The second quarter included the reclassification of $11,780 in loans previously classified as consumer into residential real estate loans based on the underlying collateral of the loans. Consumer loans decreased $1,435, or 3.4% on an annualized basis, to $84,721 at June 30, 2015 compared to $86,156 at December 31, 2014. For the quarter ended June 30, 2015, loans, net in aggregate decreased $5,627.

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For the six months ended June 30, 2015, loans, net averaged $1,230,623, an increase of $46,082 or 3.9% compared to $1,184,541 for the same period of 2014. The tax-equivalent yield on the loan portfolio was 4.66% for the six months ended June 30, 2015, a 26 basis point decrease from the comparable period last year. Loan interest income in the first six months of 2015 and 2014, which we recognized as a result of the 2013 Penseco merger, were $347 and $1,430. As a result, the tax-equivalent yield on the loan portfolio would have decreased 10 basis points comparing the six month ended June 30, 2015 and 2014. The tax-equivalent yield on the loan portfolio decreased 8 basis points in the second quarter of 2015 from 4.71% in the second quarter of 2014. The tax-equivalent yield decreased 7 basis points comparing the first and second quarters of 2015.

In addition to the risks inherent in our loan portfolio, in the normal course of business, we are also a party to financial instruments with off-balance sheet risk to meet the financing needs of our customers. These instruments include legally binding commitments to extend credit, unused portions of lines of credit and commercial letters of credit made under the same underwriting standards as on-balance sheet instruments, and may involve, to varying degrees, elements of credit risk and interest rate risk (IRR) in excess of the amount recognized in the financial statements.

Unused commitments at June 30, 2015, totaled $284,352, consisting of $261,135 in unfunded commitments of existing loan facilities and $23,217 in standby letters of credit. Due to fixed maturity dates, specified conditions within these instruments, and the ultimate needs of our customers, many will expire without being drawn upon. We believe that amounts actually drawn upon can be funded in the normal course of operations and therefore, do not represent a significant liquidity risk to us. In comparison, unused commitments, at December 31, 2014, totaled $266,570, consisting of $235,961 in unfunded commitments of existing loans and $30,609 in standby letters of credit.

Asset Quality:

National, Pennsylvania, New York and market area unemployment rates at June 30, 2015 and 2014, are summarized as follows:

	June 30, 2015	June 30, 2014
United States	5.3%	6.1%
Pennsylvania (statewide)	5.5%	6.0%
Lackawanna County	5.9%	6.7%
Lehigh County	5.6%	6.2%
Luzerne County	6.5%	7.3%
Monroe County	6.8%	7.4%
Susquehanna County	5.4%	5.7%
Wayne County	5.4%	5.8%
Wyoming County	6.2%	6.7%
New York (statewide)	5.3%	6.2%

Broome County	5.8%	6.4%

The employment conditions improved for the Nation, Pennsylvania, New York as well as all seven counties representing our market areas in Pennsylvania and New York from one year ago. Despite the overall improvements, employment conditions continued to be weak as unemployment rates remained elevated relative to historical levels.

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Our asset quality improved in the second quarter of 2015. Nonperforming assets decreased $334 or 3.1% to $10,549 at June 30, 2015, from $10,883 at December 31, 2014. We experienced an increase in nonaccrual and restructured loans, which was more than offset by declines in accruing loans past due 90 days or more and other real estate owned. As a percentage of loans, net and foreclosed assets, nonperforming assets equaled 0.86% at June 30, 2015 compared to 0.90% at December 31, 2014.

Loans on nonaccrual status increased $284 to $8,983 at June 30, 2015 from $8,699 at December 31, 2014. The majority of the increase from year end was due to an increase of $358 in residential real estate loans and an increase of $177 in commercial loans on nonaccrual status. Commercial real estate loans on nonaccrual status decreased $264 while consumer loans on nonaccrual status increased $13. Other real estate owned decreased $227 to $334 at June 30, 2015 from $561 at December 31, 2014.

For the three months ended June 30, 2015, nonperforming assets improved to $10,549, a decrease of $748 from $11,297 at March 31, 2015. Decreases in nonaccrual and restructured loans of $593 and accruing loans past due 90 days or more of $165 more than offset a $10 increase in other real estate owned.

Generally, maintaining a high loan to deposit ratio is our primary goal in order to maximize profitability. However, this objective is superseded by our attempts to assure that asset quality remains strong. We continued our efforts to maintain sound underwriting standards for both commercial and consumer credit. Most commercial lending is done primarily with locally owned small businesses.

We maintain the allowance for loan losses at a level we believe adequate to absorb probable credit losses related to specifically identified loans, as well as probable incurred loan losses inherent in the remainder of the loan portfolio as of the balance sheet date. The allowance for loan losses is based on past events and current economic conditions. We employ the Federal Financial Institutions Examination Council Interagency Policy Statement, as amended December 13, 2006, and GAAP in assessing the adequacy of the allowance account. Under GAAP, the adequacy of the allowance account is determined based on the provisions of Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 310, Receivables, for loans specifically identified to be individually evaluated for impairment and the requirements of FASB ASC 450, Contingencies, for large groups of smaller-balance homogeneous loans to be collectively evaluated for impairment.

We follow our systematic methodology in accordance with procedural discipline by applying it in the same manner regardless of whether the allowance is being determined at a high point or a low point in the economic cycle. Each quarter, loan review identifies those loans to be individually evaluated for impairment and those loans collectively evaluated for impairment utilizing a standard criteria. Internal loan review grades are assigned quarterly to loans identified to be individually evaluated. A loan s grade may differ from period to period based on current conditions and events, however, we consistently utilize the same grading system each quarter. We consistently use loss experience from the latest twelve quarters in determining the historical loss factor for each pool collectively evaluated for impairment. Qualitative factors are evaluated in the same manner each quarter and are adjusted within a relevant range of values based on current conditions. For additional disclosure related to the allowance for loan losses refer to the note entitled, Loans, net and Allowance for Loan Losses, in the Notes to Consolidated Financial Statements to this Quarterly Report.

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The allowance for loan losses increased $1,090 to $11,428 at June 30, 2015, from $10,338 at the end of 2014. For the six months ended June 30, 2015, net charge-offs were $410 or 0.07% of average loans outstanding, a $677 decrease compared to $1,087 or 0.19% of average loans outstanding in the same period of 2014. Net charge-offs were $125 or 0.04% of average loans outstanding in the second quarter of 2015, a $313 decrease compared to $438 or 0.15% of average loans outstanding in the second quarter of 2014.

Deposits:

We attract the majority of our deposits from within our eight county market area that stretches from the Lehigh Valley in Pennsylvania to Broome County in the Southern Tier of New York State through the offering of various deposit instruments including demand deposit accounts, NOW accounts, money market deposit accounts, savings accounts, and time deposits, including certificates of deposit and IRA s. For the six months ended June 30, 2015, total deposits decreased slightly to $1,424,767 from $1,425,558 at December 31, 2014. Growth was experienced in savings accounts and interest-bearing transaction accounts while the other classifications declined. Interest-bearing transaction accounts, including NOW and money market accounts, increased $14,831, or 6.6% annualized, to $467,197 at June 30, 2015, from $452,366 at December 31, 2014. Savings deposits increased $8,035, or 4.1% annualized, to $399,987 at June 30, 2015, from $391,952 at December 31, 2014. All other deposit categories decreased in the first six months of 2015 due to cyclical trends. Demand deposits, decreased $16,675, or 10.7% annualized, to $296,823 at June 30, 2015, compared to $313,498 at December 31, 2014. Time deposits less than $100 decreased $626, or 0.7% annualized, while time deposits of $100 or more declined $6,356, or 16.9% annualized.

For the three months ended June 30, 2015, total deposits increased $8,489 or 2.4% annualized. Growth in interest-bearing and noninterest-bearing demand deposits, as well as time deposits less than $100, more than offset declines in demand deposits, savings deposits and time deposits of $100 or more.

For the six months ended June 30, 2015 interest-bearing deposits averaged $1,116,900 in 2015 compared to $1,113,621 in 2014. The cost of interest-bearing deposits was 0.44% in 2015 compared to 0.50% for the same period last year. For the first six months, the overall cost of interest-bearing liabilities including the cost of borrowed funds, was 0.52% in 2015 compared to 0.59% in 2014. The cost of interest-bearing liabilities decreased 4 basis points when comparing the first and second quarters of 2015.

Interest rates have been at historic lows for an extended period. Short term and core deposit rates have remained flat. As such, deposits have been attracted by offering rates on longer term time deposit products and core savings accounts which are higher than other investment alternatives available to customers elsewhere in the market place.

Borrowings:

The Bank utilizes borrowings as a secondary source of liquidity for its asset/liability management. Advances are available from the Federal Home Loan Bank of Pittsburgh (FHLB) provided certain standards related to credit worthiness have been met. Repurchase and term agreements are also available from the FHLB.

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Total short-term borrowings at June 30, 2015, totaled $25,860 compared to $19,557 at December 31, 2014, an increase of $6,303. Long-term debt was $31,663 at June 30, 2015, compared to $33,140 at year end 2014. The reduction was a product of monthly contractual amortized payments made during the six months ended June 30, 2015.

Market Risk Sensitivity:

Market risk is the risk to our earnings or financial position resulting from adverse changes in market rates or prices, such as interest rates, foreign exchange rates or equity prices. Our exposure to market risk is primarily IRR associated with our lending, investing and deposit-gathering activities. During the normal course of business, we are not exposed to foreign exchange risk or commodity price risk. Our exposure to IRR can be explained as the potential for change in our reported earnings and/or the market value of our net worth. Variations in interest rates affect earnings by changing net interest income and the level of other interest-sensitive income and operating expenses. Interest rate changes also affect the underlying economic value of our assets, liabilities and off-balance sheet items. These changes arise because the present value of future cash flows, and often the cash flows themselves, change with interest rates. The effects of the changes in these present values reflect the change in our underlying economic value and provide a basis for the expected change in future earnings related to interest rates. IRR is inherent in the role of banks as financial intermediaries. However, a bank with a high degree of IRR may experience lower earnings, impaired liquidity and capital positions, and most likely, a greater risk of insolvency. Therefore, banks must carefully evaluate IRR to promote safety and soundness in their activities.

As a result of economic uncertainty and a prolonged era of historically low market rates, it has become challenging to manage IRR. Due to these factors, IRR and effectively managing it are very important to both bank management and regulators. Bank regulations require us to develop and maintain an IRR management program, overseen by the Board of Directors and senior management, that involves a comprehensive risk management process in order to effectively identify, measure, monitor and control risk. Should bank regulatory agencies identify a material weakness in our risk management process or high exposure relative to our capital, bank regulatory agencies may take action to remedy these shortcomings. Moreover, the level of IRR exposure and the quality of our risk management process is a determining factor when evaluating capital adequacy.

The ALCO, comprised of members of our Board of Directors, senior management and other appropriate officers, oversees our IRR management program. Specifically, ALCO analyzes economic data and market interest rate trends, as well as competitive pressures, and utilizes computerized modeling techniques to reveal potential exposure to IRR. This allows us to monitor and attempt to control the influence these factors may have on our rate-sensitive assets (RSA) and rate-sensitive liabilities (RSL), and overall operating results and financial position. One such technique utilizes a static gap model that considers repricing frequencies of RSA and RSL in order to monitor IRR. Gap analysis attempts to measure our interest rate exposure by calculating the net amount of RSA and RSL that reprice within specific time intervals. A positive gap occurs when the amount of RSA repricing in a specific period is greater than the amount of RSL repricing within that same time frame and is indicated by a RSA/RSL ratio greater than 1.0. A negative gap occurs when the amount of RSL repricing is greater than the amount of RSA and is indicated by a RSA/RSL ratio of less than 1.0. A positive gap implies that earnings will be impacted favorably if interest rates rise and adversely if interest rates fall during the period. A negative gap tends to indicate that earnings will be affected inversely to interest rate changes.

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Our cumulative one-year RSA/RSL ratio equaled 2.01% at June 30, 2015. Given the length of time that market rates have been at historical lows and the potential for rates to increase in the future, the focus of ALCO has been to create a positive static gap position. With regard to RSA, we predominantly offer medium- term, fixed-rate loans as well as adjustable rate loans. With respect to RSL, we offer longer term promotional certificates of deposit in an attempt to increase duration. The current position at June 30, 2015, indicates that the amount of RSA repricing within one year would exceed that of RSL, thereby causing increases in market rates, to increase net interest income. However, these forward-looking statements are qualified in the aforementioned section entitled Forward-Looking Discussion in this Management s Discussion and Analysis.

Static gap analysis, although a standard measuring tool, does not fully illustrate the impact of interest rate changes on future earnings. First, market rate changes normally do not equally or simultaneously affect all categories of assets and liabilities. Second, assets and liabilities that can contractually reprice within the same period may not do so at the same time or to the same magnitude. Third, the interest rate sensitivity table presents a one-day position. Variations occur daily as we adjust our rate sensitivity throughout the year. Finally, assumptions must be made in constructing such a table.

As the static gap report fails to address the dynamic changes in the balance sheet composition or prevailing interest rates, we utilize a simulation model to enhance our asset/liability management. This model is used to create pro forma net interest income scenarios under various interest rate shocks. Model results at June 30, 2015, produced results similar to those indicated by the one-year static gap position. In addition, parallel and instantaneous shifts in interest rates under various interest rate shocks resulted in changes in net interest income that were well within ALCO policy limits. We will continue to monitor our IRR throughout 2015 and endeavor to employ deposit and loan pricing strategies and direct the reinvestment of loan and investment repayments in order to manage our IRR position.

Financial institutions are affected differently by inflation than commercial and industrial companies that have significant investments in fixed assets and inventories. Most of our assets are monetary in nature and change correspondingly with variations in the inflation rate. It is difficult to precisely measure the impact inflation has on us, however we believe that our exposure to inflation can be mitigated through asset/liability management.

Liquidity:

Liquidity management is essential to our continuing operations and enables us to meet financial obligations as they come due, as well as to take advantage of new business opportunities as they arise. Financial obligations include, but are not limited to, the following:

- Funding new and existing loan commitments;

Payment of deposits on demand or at their contractual maturity;

Repayment of borrowings as they mature;

Payment of lease obligations; and

Payment of operating expenses.

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These obligations are managed daily, thus enabling us to effectively monitor fluctuations in our liquidity position and to adapt that position according to market influences and balance sheet trends. Future liquidity needs are forecasted and strategies are developed to ensure adequate liquidity at all times.

Historically, core deposits have been the primary source of liquidity because of their stability and lower cost, in general, than other types of funding. Providing additional sources of funds are loan and investment payments and prepayments and the ability to sell both available for sale securities and mortgage loans held for sale. We believe liquidity is adequate to meet both present and future financial obligations and commitments on a timely basis.

We employ a number of analytical techniques in assessing the adequacy of our liquidity position. One such technique is the use of ratio analysis to determine the extent of our reliance on noncore funds to fund our investments and loans maturing after June 30, 2015. Our noncore funds at June 30, 2015, were comprised of time deposits in denominations of $100 or more and other borrowings. These funds are not considered to be a strong source of liquidity since they are very interest rate sensitive and are considered to be highly volatile. At June 30, 2015, our net noncore funding dependence ratio, the difference between noncore funds and short-term investments to long-term assets, was 6.2%, while our net short-term noncore funding dependence ratio, noncore funds maturing within one-year, less short-term investments to long-term assets equaled 2.7%. Comparatively, our overall noncore dependence ratio improved from year-end 2014 when it was 8.5%. Similarly, our net short-term noncore funding dependence ratio was 3.0% at year-end, indicating that our reliance on noncore funds has decreased.

The Consolidated Statements of Cash Flows present the changes in cash and cash equivalents from operating, investing and financing activities. Cash and cash equivalents, consisting of cash on hand, cash items in the process of collection, deposit balances with other banks and federal funds sold, increased $4,131 during the six months ended June 30, 2015. Cash and cash equivalents increased $26,098 for the same period last year. For the six months ended June 30, 2015, net cash inflows of $8,867 from operating activities were partially offset by net cash outflows of $4,486 from investing activities and $250 from financing activities. For the same period of 2014, net cash inflows of $9,942 from operating activities and $29,195 from financing activities were partially offset by net cash outflows of $13,039 from investing activities.

Operating activities provided net cash of $8,867 for the six months ended June 30, 2015, and $9,942 for the corresponding six months of 2014. Net income, adjusted for the effects of gains and losses along with noncash transactions such as depreciation and the provision for loan losses, is the primary source of funds from operations.

Investing activities primarily include transactions related to our lending activities and investment portfolio. Investing activities used net cash of $4,486 for the six months ended June 30, 2015, compared to $13,039 for the same period of 2014. In 2015, an increase in lending activities was the primary factor causing the net cash outflow from investing activities. Investment portfolio activities was the predominant factor causing the net cash outflow from investing activities in 2014.

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Financing activities used net cash of $250 for the six months ended June 30, 2015, and provided net cash of $29,195 for the corresponding six months of 2014. Deposit gathering is our predominant financing activity. During the six months ended June 30, 2015, deposits decreased compared to an increase in deposits during the same period last year. The net decrease in deposits totaled $424 in the six months ended June 30, 2015. Comparatively, deposit gathering provided net cash of $43,866 for the same period of 2014. We continued to attract deposits from new and existing customers, including municipalities and school districts, as well as deposits gathered in relation to natural gas activity within existing markets in Susquehanna and Wyoming Counties of Pennsylvania.

We believe that our future liquidity needs will be satisfied through maintaining an adequate level of cash and cash equivalents, by maintaining readily available access to traditional funding sources, and through proceeds received from the investment and loan portfolios. The current sources of funds will enable us to meet all cash obligations as they come due.

Capital:

Stockholders equity totaled $250,404 or $33.20 per share at June 30, 2015, compared to $246,779 or $32.69 per share at December 31, 2014. Net income of $9,475 for the six months ended June 30, 2015 was the primary factor leading to the improved capital position. Stockholders equity was also affected by cash dividends declared of $4,679, shares retired of $215, stock based compensation of $35, and an other comprehensive loss resulting from market value fluctuations in the investment portfolio of $991.

Dividends declared equaled $0.62 per share in 2015 and 2014. The dividend payout ratio was 49.2% for the six months ended June 30, 2015 and 58.5% for the same period of 2014. The merger agreement pursuant to which we merged with Penseco in 2013 contemplates that, unless 80 percent of our board of directors determines otherwise, we will pay a quarterly cash dividend in an amount no less than $0.31 per share through 2018, provided that sufficient funds are legally available, and that Peoples and Peoples Bank remain Well-capitalized in accordance with applicable regulatory guidelines. It is the intention of the Board of Directors to continue to pay cash dividends in the future. However, these decisions are affected by operating results, financial and economic decisions, capital and growth objectives, appropriate dividend restrictions and other relevant factors.

In July 2013, the Board of Directors of the FRB approved the Basel III interim final rule (Basel III) which is intended to strengthen the quality and increase the required level of regulatory capital for a more stable and resilient banking system. The changes include: (i) a new regulatory capital measure, Common Equity Tier 1 (CET1), which is limited to capital elements of the highest quality; (ii) a new definition and increase of tier 1 capital which is now comprised of CET1 and Additional Tier 1; (iii) changes in calculation of some risk-weighted assets and off-balance sheet exposure; and (iv) a capital conservation buffer that will limit capital distributions, stock redemptions, and certain discretionary bonus payments if the institution does not maintain capital in excess of the minimum capital requirements. These new capital rules took effect for our Bank on January 1, 2015 and reporting began with the March 31, 2015 call report.

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The adequacy of capital is reviewed on an ongoing basis with reference to the size, composition and quality of resources and regulatory guidelines. We seek to maintain a level of capital sufficient to support existing assets and anticipated asset growth, maintain favorable access to capital markets, and preserve high quality credit ratings. At June 30, 2015, the Bank s Tier 1 capital to total average assets was 10.92% as compared to 10.42% at December 31, 2014. The Bank s Tier 1 capital to risk weighted asset ratio was 15.40% and the total capital to risk weighted asset ratio was 16.38% at June 30, 2015. These ratios were 14.28% and 15.15% at December 31, 2014. The Bank s common equity Tier 1 to risk weighted asset ratio was 15.40 at June 30, 2015. The Bank was deemed to be well-capitalized under regulatory standards at June 30, 2015.

Review of Financial Performance:

Net income for the second quarter of 2015 equaled $4,431 or $0.59 per share compared to $3,331 or $0.44 per share for the second quarter of 2014. Return on average assets (ROA) measures our net income in relation to total assets. Our ROA was 1.03% for the second quarter of 2015 compared to 0.78% for the same period of 2014. Return on average equity (ROE) indicates how effectively we can generate net income on the capital invested by stockholders. Our ROE was 7.14% for the second quarter of 2015 compared to 5.60% for the second quarter of 2014. The results for the three months ended June 30, 2014 included pre-tax acquisition related expenses of $1,008. Net income for the six months ended June 30, 2015 equaled $9,475 or $1.26 per share compared to $8,029 or $1.06 per share for the same period of 2014. Our ROA and ROE were 1.11% and 7.71% through six months in 2015 compared to 0.95% and 6.79% for the same period of 2014. Gains on sale of investment securities were $832 for the six months ended June 30, 2015 and $160 for the comparable period in 2014.

Net Interest Income:

Net interest income is the fundamental source of earnings for commercial banks. Fluctuations in the level of net interest income can have the greatest impact on net profits. Net interest income is defined as the difference between interest revenue, interest and fees earned on interest-earning assets, and interest expense, the cost of interest-bearing liabilities supporting those assets. The primary sources of earning assets are loans and investment securities, while interest-bearing deposits, short-term and long-term borrowings comprise interest-bearing liabilities. Net interest income is impacted by:

- Variations in the volume, rate and composition of earning assets and interest-bearing liabilities;

- Changes in general market rates; and

- The level of nonperforming assets.

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Changes in net interest income are measured by the net interest spread and net interest margin. Net interest spread, the difference between the average yield earned on earning assets and the average rate incurred on interest-bearing liabilities, illustrates the effects changing interest rates have on profitability. Net interest margin, net interest income as a percentage of earning assets, is a more comprehensive ratio, as it reflects not only the spread, but also the change in the composition of interest-earning assets and interest-bearing liabilities. Tax-exempt loans and investments carry pre-tax yields lower than their taxable counterparts. Therefore, in order to make the analysis of net interest income more comparable, tax-exempt income and yields are reported herein on a tax-equivalent basis using the prevailing federal statutory tax rate of 35.0% in 2015 and 2014.

For the three months ended June 30, tax-equivalent net interest income increased $479 to $14,947 in 2015 from $14,468 in 2014. The net interest spread increased to 3.72% for the three months ended June 30, 2015 from 3.58% for the three months ended June 30, 2014. The tax-equivalent net interest margin increased to 3.84% for the second quarter of 2015 from 3.73% for the comparable period of 2014. The tax-equivalent net interest margin for the first quarter of 2015 was 3.88%. Loan interest income in the second quarter of 2015 related to loans acquired in the 2013 Penseco merger was $122, resulting in an increase in the tax-equivalent net interest margin of 3 basis points. Comparatively, loan interest recognized on these loans in the second quarter of 2014 was $375 resulting in an increase in the tax-equivalent net interest margin of 10 basis points. Without such interest income, the tax equivalent net interest margin for the three months ended June 30 would have been 3.81% in 2015 and 3.63% in 2014.

For the three months ended June 30, tax-equivalent interest income on earning assets increased $200, to $16,395 in 2015 as compared to $16,195 in 2014. The increase was primarily due to the growth in average earning assets which increased $2,082, to $1,559,644 for the second quarter of 2015 from $1,557,562 for the same period in 2014. The overall yield on earning assets, on a fully tax-equivalent basis, increased 5 basis points for the three months ended June 30, 2015 at 4.22% as compared to 4.17% for the three months ended June 30, 2014. The increase in the yield on earning assets resulted from a shifting of volumes from lower yielding earning assets to loans. The overall yield earned on loans however, decreased 8 basis points for the second quarter of 2015 to 4.63% from 4.71% for the second quarter of 2014. Average loans increased to $1,235,423 for the quarter ended June 30, 2015 compared to $1,187,568 for the same period in 2014. The resulting tax-equivalent interest earned on loans was $14,268 for the three month period ended June 30, 2015 compared to $13,938 for the same period in 2014, an increase of $330.

Total interest expense decreased $279, to $1,448 for the three months ended June 30, 2015 from $1,727 for the three months ended June 30, 2014. A favorable volume variance caused the decrease. The average volume of interest bearing liabilities declined to $1,160,031 for the three months ended June 30, 2015, as compared to $1,172,286 for the three months ended June 30, 2014. The cost of funds decreased to 0.50% for the three months ended June 30, 2015 as compared to 0.59% for the same period in 2014.

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For the six months ended June 30, tax-equivalent net interest income decreased $227 to $29,774 in 2015 from $30,001 in 2014. The net interest spread decreased to 3.73% for the six months ended June 30, 2015 from 3.76% for the six months ended June 30, 2014. The tax-equivalent net interest margin for the six months ended June 30 was 3.86% in 2015 compared to 3.90% in 2014. Loan interest income in the six months ended June 30, 2015 related to loans acquired in the fourth quarter of 2013 was $347, resulting in an increase in the tax-equivalent net interest margin of 5 basis points. Comparatively, loan interest income on these loans recognized in the first six months of 2014 was $1,430 resulting in an increase in the tax-equivalent net interest margin of 19 basis points. Without such interest income, the tax equivalent net interest margin for the six months ended June 30 would have been 3.81% in 2015 and 3.71% in 2014.

For the six months ended June 30, 2015, tax-equivalent interest income decreased $658, to $32,757 as compared to $33,415 for the six months ended June 30, 2014. A volume variance in interest income of $2,176 attributable to changes in the average balance of earning assets was more than offset by a $2,834 unfavorable rate variance due to a reduction in the yield on earning assets. Specifically, the decrease was primarily due to declining yields on average earning assets which decreased 10 basis points for the first six months of 2015 from the same period in 2014. The overall yield on earning assets, on a fully tax-equivalent basis, decreased for the six months ended June 30, 2015 to 4.25% as compared to 4.35% for the six months ended June 30, 2014. This was a result of the continuation of the low interest rate environment along with increased market competition.

Total interest expense decreased $431 to $2,983 for the six months ended June 30, 2015 from $3,414 for the six months ended June 30, 2014. A favorable volume variance caused interest expenses to decrease $320. The average volume of interest bearing liabilities declined to $1,156,541 for the six months ended June 30, 2015, as compared to $1,169,541 for the six months ended June 30, 2014. The remaining $111 decrease in interest expense was attributable to a favorable rate variance. The cost of funds decreased to 0.52% for the six months ended June 30, 2015 as compared to 0.59% for the same period in 2014.

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The average balances of assets and liabilities, corresponding interest income and expense and resulting average yields or rates paid are summarized as follows. Averages for earning assets include nonaccrual loans. Investment averages include available-for-sale securities at amortized cost. Income on investment securities and loans is adjusted to a tax equivalent basis using the prevailing federal statutory tax rate of 35%.

	Six months ended					
	June 2015			June 2014		
	Average Balance	Interest	Yield/ Rate	Average Balance	Interest	Yield/ Rate
Assets:						
Earning assets:						
Loans						
Taxable	$ 1,159,462	$ 26,731	4.65%	$ 1,110,609	$ 27,159	4.93%
Tax exempt	71,161	1,737	4.92	73,932	1,757	4.79
Investments						
Taxable	212,617	1,731	1.64	219,716	1,900	1.74
Tax exempt	97,864	2,523	5.20	100,736	2,532	5.07
Interest bearing deposits	6,672	26	0.79	5,826	19	0.66
Federal funds sold	7,190	9	0.25	38,532	48	0.25
Total earning assets	1,554,966	32,757	4.25%	1,549,351	33,415	4.35%
Less: allowance for loan losses	(10,746)			(8,791)		
Other assets	174,630			161,231		
Total assets	$ 1,718,850			$ 1,701,791		
Liabilities and Stockholders Equity:						
Interest bearing liabilities:						
Money market accounts	197,354	340	0.35%	215,862	390	0.36%
NOW accounts	260,267	468	0.36	216,962	363	0.34
Savings accounts	401,521	443	0.22	369,471	529	0.29
Time deposits less than $100	169,378	892	1.06	215,041	1,050	0.98
Time deposits $100 or more	88,380	317	0.72	96,285	439	0.92
Short term borrowings	7,286	12	0.33	20,048	58	0.58
Long-term debt	32,355	511	3.18	35,872	585	3.28
Total interest bearing liabilities	1,156,541	2,983	0.52%	1,169,541	3,414	0.59%
Non-interest bearing demand deposits	299,518			281,337		

Other liabilities	14,848	12,556
Stockholders equity	247,943	238,357
Total liabilities and stockholders equity	$ 1,718,850	$ 1,701,791