

PEOPLES FINANCIAL SERVICES CORP.

Form 10-Q

May 08, 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 March 31, 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**  
**(State of incorporation)**

**23-2391852**  
**(IRS Employer ID Number)**

**150 North Washington Avenue, Scranton, PA**  
**(Address of principal executive offices)**

**18503**  
**(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  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  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

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

**APPLICABLE ONLY TO CORPORATE ISSUERS:**

Indicate the number of shares outstanding of the registrant's common stock, as of the latest practicable date: 7,548,358 at April 30, 2015.

Exhibit index on page 48

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PEOPLES FINANCIAL SERVICES CORP.

FORM 10-Q

For the Quarter Ended March 31, 2015

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**Table of Contents****Peoples Financial Services Corp.****CONSOLIDATED BALANCE SHEETS (UNAUDITED)****(Dollars in thousands, except share data)**

	<b>March 31, 2015</b>	<b>December 31, 2014</b>
<b>Assets:</b>		
Cash and due from banks	\$ 24,193	\$ 24,656
Interest-bearing deposits in other banks	6,813	6,770
Federal funds sold	8,625	
Investment securities:		
Available-for-sale	280,300	339,586
Held-to-maturity: Fair value March 31, 2015, \$14,729; December 31, 2014, \$15,215	14,172	14,665
Total investment securities	294,472	354,251
Loans held for sale	3,101	3,486
Loans, net	1,237,168	1,209,894
Less: allowance for loan losses	10,803	10,338
Net loans	1,226,365	1,199,556
Premises and equipment, net	26,117	25,433
Accrued interest receivable	4,922	5,580
Goodwill	63,370	63,370
Intangible assets	5,197	5,501
Other assets	50,786	53,066
Total assets	\$ 1,713,961	\$ 1,741,669
<b>Liabilities:</b>		
Deposits:		
Noninterest-bearing	\$ 305,037	\$ 313,498
Interest-bearing	1,111,241	1,112,060
Total deposits	1,416,278	1,425,558
Short-term borrowings		19,557
Long-term debt	32,318	33,140
Accrued interest payable	460	574
Other liabilities	15,447	16,061
Total liabilities	1,464,503	1,494,890
<b>Stockholders equity:</b>		
Common stock: par value \$2.00, authorized 25,000,000 shares; issued 7,548,358 shares	15,097	15,097

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Capital surplus	140,232	140,214
Retained earnings	95,000	92,297
Accumulated other comprehensive loss	(871)	(829)
Total stockholders' equity	249,458	246,779
Total liabilities and stockholders' equity	\$ 1,713,961	\$ 1,741,669

See notes to consolidated financial statements

**Table of Contents****Peoples Financial Services Corp.****CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME (UNAUDITED)****(Dollars in thousands, except per share data)**

<b>For the Three Months Ended March 31,</b>	<b>2015</b>	<b>2014</b>
<b>Interest income:</b>		
Interest and fees on loans:		
Taxable	\$ 13,340	\$ 14,000
Tax-exempt	559	635
Interest and dividends on investment securities:		
Taxable	900	928
Tax-exempt	805	829
Dividends	9	16
Interest on interest-bearing deposits in other banks	8	10
Interest on federal funds sold	7	14
<b>Total interest income</b>	<b>15,628</b>	<b>16,432</b>
<b>Interest expense:</b>		
Interest on deposits	1,268	1,357
Interest on short-term borrowings	8	34
Interest on long-term debt	259	296
<b>Total interest expense</b>	<b>1,535</b>	<b>1,687</b>
<b>Net interest income</b>	<b>14,093</b>	<b>14,745</b>
Provision for loan losses	750	857
<b>Net interest income after provision for loan losses</b>	<b>13,343</b>	<b>13,888</b>
<b>Noninterest income:</b>		
Service charges, fees and commissions	1,612	1,624
Merchant services income	790	894
Commission and fees on fiduciary activities	459	567
Wealth management income	205	187
Mortgage banking income	222	99
Life insurance investment income	189	189
Net gain on sale of investment securities available-for-sale	832	
<b>Total noninterest income</b>	<b>4,309</b>	<b>3,560</b>
<b>Noninterest expense:</b>		
Salaries and employee benefits expense	5,233	5,168
Net occupancy and equipment expense	2,468	1,733

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Merchant services expense	533	565
Amortization of intangible assets	305	343
Acquisition related expense		608
Other expenses	2,555	2,870
Total noninterest expense	11,094	11,287
Income before income taxes	6,558	6,161
Income tax expense	1,514	1,463
Net income	5,044	4,698
<b>Other comprehensive income (loss):</b>		
Unrealized gain on investment securities available-for-sale	767	2,394
Reclassification adjustment for net gain on sales included in net income	(832)	
Other comprehensive income (loss)	(65)	2,394
Income tax expense (benefit) related to other comprehensive income (loss)	(23)	838
Other comprehensive income (loss), net of income taxes	(42)	1,556
Comprehensive income	\$ 5,002	\$ 6,254
<b>Per share data:</b>		
Net income:		
Basic	\$ 0.67	\$ 0.62
Diluted	\$ 0.67	\$ 0.62
Average common shares outstanding:		
Basic	7,548,358	7,550,253
Diluted	7,548,358	7,580,480
Dividends declared	\$ 0.31	\$ 0.31
See notes to consolidated financial statements		



**Table of Contents****Peoples Financial Services Corp.****CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS EQUITY (UNAUDITED)**

(Dollars in thousands, except per share data)

	<b>Common Stock</b>	<b>Capital Surplus</b>	<b>Retained Earnings</b>	<b>Accumulated Other Comprehensive Income (Loss)</b>	<b>Treasury Stock</b>	<b>Total</b>
Balance, January 1, 2015	\$ 15,097	\$ 140,214	\$ 92,297	\$ (829)		\$ 246,779
Net income			5,044			5,044
Other comprehensive loss, net of income taxes				(42)		(42)
Dividends declared: \$0.31 per share			(2,341)			(2,341)
Stock based compensation		18				18
Balance, March 31, 2015	\$ 15,097	\$ 140,232	\$ 95,000	(871)		\$ 249,458
Balance, January 1, 2014	\$ 15,614	\$ 146,109	\$ 84,008	\$ (698)	\$ (6,241)	\$ 238,792
Net income			4,698			4,698
Other comprehensive income, net of income taxes				1,556		1,556
Dividends declared: \$0.31 per share			(2,341)			(2,341)
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)
Balance, March 31, 2014	\$ 15,607	\$ 146,035	\$ 86,365	\$ 858	\$ (6,300)	\$ 242,565

See notes to consolidated financial statements

**Table of Contents****Peoples Financial Services Corp.****CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)****(Dollars in thousands, except per share data)**

<b>For the Three Months Ended March 31,</b>	<b>2015</b>	<b>2014</b>
<b>Cash flows from operating activities:</b>		
Net income	\$ 5,044	\$ 4,698
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation of premises and equipment	388	574
Amortization of deferred loan costs	132	22
Amortization of intangibles	305	343
Net accretion of purchase accounting adjustments on tangible assets	(292)	(864)
Provision for loan losses	750	857
Net gain on sale of other real estate owned	(30)	(22)
Net loss on disposal of equipment		63
Loans originated for sale	(5,300)	(2,169)
Proceeds from sale of loans originated for sale	5,907	2,104
Net loss (gain) on sale of loans originated for sale	(222)	6
Net amortization of investment securities	1,022	1,043
Net gain on sale of investment securities	(832)	
Life insurance investment income	(189)	(189)
Deferred income tax benefit	(142)	
Stock based compensation	18	
Net change in:		
Accrued interest receivable	658	500
Other assets	710	(1,962)
Accrued interest payable	(114)	(113)
Other liabilities	(452)	2,239
Net cash provided by operating activities	7,361	7,130
<b>Cash flows from investing activities:</b>		
Proceeds from sales of investment securities available-for-sale	50,981	60
Proceeds from repayments of investment securities:		
Available-for-sale	9,835	12,634
Held-to-maturity	482	675
Purchases of investment securities:		
Available-for-sale	(1,774)	(13,841)
Held-to-maturity		
Net redemption of restricted equity securities	1,555	
Net increase in lending activities	(27,689)	(798)
Purchases of premises and equipment	(1,097)	(122)
Proceeds from sale of other real estate owned	338	193

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Net cash provided by (used in) investing activities	32,631	(1,199)
<b>Cash flows from financing activities:</b>		
Net (decrease) increase in deposits	(9,081)	24,855
Repayment of long-term debt	(808)	(890)
Net increase (decrease) in short-term borrowings	(19,557)	487
Redemption of common stock		(70)
Purchase of treasury stock		(70)
Cash dividends paid	(2,341)	(2,341)
Net cash provided by (used in) financing activities	(31,787)	21,971
Net increase in cash and cash equivalents	8,205	27,902
Cash and cash equivalents at beginning of year	31,426	51,310
Cash and cash equivalents at end of year	\$ 39,631	\$ 79,212

**Table of Contents****Peoples Financial Services Corp.****CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)****(Dollars in thousands, except per share data)**

<b>For the Three Months Ended March 31,</b>	<b>2015</b>	<b>2014</b>
<b>Supplemental disclosures:</b>		
Cash paid during the period for:		
Interest	\$ 1,649	\$ 2,110
Income taxes		
Noncash items:		
Transfers of loans to other real estate	\$ 71	\$ 201
Retirement of treasury shares		
<b>Acquisition:</b>		
Fair value of assets acquired:		
Loans, net	\$ 104	\$ 580
Premises and equipment	(25)	(25)
Core deposit and other intangible assets	(304)	(343)
	\$ (225)	\$ 212
Fair value of liabilities assumed:		
Deposits	\$ 199	\$ 296
Long-term debt	14	13
	\$ 213	\$ 309

See notes to consolidated financial statements

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**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 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 months ended and as of March 31, 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 March 31, 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 January 2015, the Financial Accounting Standards Board ( FASB ) issued Accounting Standards Update ( ASU ) 2015-01 which eliminates the requirement in Subtopic 225-20 to consider whether an underlying event or transaction is extraordinary, and if so, to separately present the item in the income statement net of tax, after income from continuing operations. Items that are either unusual in nature or infrequently occurring will continue to be reported as a separate component of income from continuing operations. Alternatively, these amounts may still be disclosed in the notes to the financial statements. The same requirement has been expanded to include items that are both unusual and infrequent, i.e., they should be separately presented as a component of income from continuing operations or disclosed in the footnotes. The ASU is effective for all entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2015. Early adoption is permitted from the beginning of the fiscal year of adoption. The adoption of ASU 2015-01 is not expected to have a material effect on the operating results or financial position of the Company.

In February 2015, the FASB issued ASU 2015-02 which changes the consolidation analysis for all reporting entities. The changes primarily affect the consolidation of limited partnerships and their equivalents (e.g., limited liability corporations), as well as structured vehicles such as collateralized debt obligations. The ASU simplifies U.S. GAAP by eliminating entity specific consolidation guidance for limited partnerships. It also revises other aspects of the consolidation analysis, including how kick-out rights, fee arrangements and related parties are assessed. The amendments rescind the indefinite deferral of FASB Statement 167 for certain investment funds and replace it with a permanent scope exception for money market funds. The ASU is effective for public business entities for fiscal years, and for interim periods within those fiscal years, beginning after December 15, 2015. Early adoption is permitted. The adoption of ASU 2015-02 is not expected to have a material effect on the operating results or financial position of the Company.

**Table of Contents****Peoples Financial Services Corp.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****(Dollars in thousands, except per share data)****2. Other comprehensive income (loss):**

The components of other comprehensive income (loss) and their related tax effects are reported in the Consolidated Statements of Income and Comprehensive Income. The accumulated other comprehensive 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 March 31, 2015 and December 31, 2014 is as follows:

	<b>March 31, 2015</b>	<b>December 31, 2014</b>
Net unrealized gain on investment securities available-for-sale	\$ 6,227	\$ 6,292
Related income taxes	2,179	2,202
Net of income taxes	4,048	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	\$ (871)	\$ (829)

Other comprehensive income (loss) and related tax effects for the three months ended March 31, 2015 and 2014 is as follows:

<b>Three months ended March 31</b>	<b>2015</b>	<b>2014</b>
Unrealized gain on investment securities available-for-sale	\$ 767	\$ 2,394
Net gain on the sale of investment securities available-for-sale (1)	(832)	
Other comprehensive income (loss) gain before taxes	(65)	2,394
Income taxes expense (benefit)	(23)	838

Other comprehensive income (loss)	\$ (42)	\$ 1,556
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- (1) Represents amounts reclassified out of accumulated comprehensive income and included in gains on sale of investment securities on the consolidated statements of income.



**Table of Contents****Peoples Financial Services Corp.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Dollars in thousands, except per share data)

**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.

For the three months ended March 31	2015		2014	
	Basic	Diluted	Basic	Diluted
Net Income (Numerator)	\$ 5,044	\$ 5,044	\$ 4,698	\$ 4,698
Average common shares outstanding (Denominator)	7,548,358	7,548,358	7,550,253	7,580,480
Earnings per share	\$ 0.67	\$ 0.67	\$ 0.62	\$ 0.62

**4. Investment securities:**

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

March 31, 2015	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available-for-sale:				
U.S. Government-sponsored enterprises	\$ 95,683	\$ 487	\$ 22	\$ 96,148
State and municipals:				
Taxable	16,447	1,063	15	17,495
Tax-exempt	83,133	4,563	47	87,649
Mortgage-backed securities:				
U.S. Government agencies	35,339	154	93	35,400
U.S. Government-sponsored enterprises	43,471	286	149	43,608
<b>Total</b>	<b>\$ 274,073</b>	<b>\$ 6,553</b>	<b>\$ 326</b>	<b>\$ 280,300</b>
Held-to-maturity:				
Tax-exempt state and municipals	\$ 7,370	\$ 103	\$ 33	\$ 7,440
Mortgage-backed securities:				

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U.S. Government agencies	96	1	97	
U.S. Government-sponsored enterprises	6,706	486	7,192	
Total	\$ 14,172	\$ 590	\$ 33	\$ 14,729

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(Dollars in thousands, except per share data)

**4. Investment securities (continued):**

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

The maturity distribution of the fair value, which is the net carrying amount, of the debt securities classified as available-for-sale at March 31, 2015, is summarized as follows:

<b>March 31, 2015</b>	<b>Fair Value</b>
Within one year	\$ 32,644
After one but within five years	80,316
After five but within ten years	28,954
After ten years	59,378
	<b>201,292</b>

Mortgage-backed securities 79,008

**Total \$ 280,300**

**Table of Contents****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 March 31, 2015, is summarized as follows:

<b>March 31, 2015</b>	<b>Amortized Cost</b>	<b>Fair Value</b>
Within one year		
After one but within five years	\$ 326	\$ 334
After five but within ten years	176	182
After ten years	6,868	6,924
	7,370	7,440
Mortgage-backed securities	6,802	7,289
<b>Total</b>	<b>\$ 14,172</b>	<b>\$ 14,729</b>

Securities with a carrying value of \$207,895 and \$216,192 at March 31, 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 March 31, 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 March 31, 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:

	<b>Less Than 12 Months</b>	<b>12 Months or More</b>	<b>Total</b>
<b>March 31, 2015</b>			

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	<b>Fair Value</b>	<b>Unrealized Losses</b>	<b>Fair Value</b>	<b>Unrealized Losses</b>	<b>Fair Value</b>	<b>Unrealized Losses</b>
U.S. Government-sponsored enterprises	\$ 7,970	\$ 12	\$ 2,999	\$ 10	\$ 10,969	\$ 22
State and municipals:						
Taxable			554	15	554	15
Tax-exempt	14,234	61	787	19	15,021	80
Mortgage-backed securities:						
U.S. Government agencies	14,885	62	3,790	31	18,675	93
U.S. Government-sponsored enterprises	19,098	149			19,098	149
Total	\$ 56,187	\$ 284	\$ 8,130	\$ 75	\$ 64,317	\$ 359

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(Dollars in thousands, except per share data)

**4. Investment securities (continued):**

	Less Than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
<b>December 31, 2014</b>						
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 63 investment securities, consisting of 36 tax-exempt state and municipal obligations, one taxable state and municipal obligation, three U.S. Government-sponsored enterprise securities, and 23 mortgage-backed securities that were in unrealized loss positions at March 31, 2015. Of these securities, one U.S.

Government-sponsored enterprise security, one taxable state and municipal obligation, two mortgage-backed securities and two 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 March 31, 2015. There was no OTTI recognized for the three months ended March 31, 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.





**Table of Contents****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 March 31, 2015 and December 31, 2014 are summarized as follows. Net deferred loan costs were \$648 and \$651 at March 31, 2015 and December 31, 2014.

	<b>March 31, 2015</b>	<b>December 31, 2014</b>
Commercial	\$ 319,468	\$ 319,590
Real estate:		
Commercial	522,432	493,481
Residential	305,663	310,667
Consumer	89,605	86,156
Total	\$ 1,237,168	\$ 1,209,894

The changes in the allowance for loan losses account by major classification of loan for the three months ended March 31, 2015 and 2014 are summarized as follows:

<b>March 31, 2015</b>	<b>Real estate</b>				<b>Total</b>
	<b>Commercial</b>	<b>Commercial</b>	<b>Residential</b>	<b>Consumer</b>	
Allowance for loan losses:					
Beginning Balance	\$ 2,321	\$ 3,037	\$ 3,690	\$ 1,290	\$ 10,338
Charge-offs	(37)	(49)	(199)	(80)	(365)
Recoveries	61	1	5	13	80
Provisions	75	98	413	164	750
Ending balance	\$ 2,420	\$ 3,087	\$ 3,909	\$ 1,387	\$ 10,803

<b>March 31, 2014</b>	<b>Real estate</b>				<b>Total</b>
	<b>Commercial</b>	<b>Commercial</b>	<b>Residential</b>	<b>Consumer</b>	
Allowance for loan losses:					
Beginning Balance	\$ 2,008	\$ 2,394	\$ 3,135	\$ 1,114	\$ 8,651
Charge-offs	(347)	(28)	(240)	(68)	(683)
Recoveries			3	31	34

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Provisions	300	107	350	100	857
Ending balance	\$ 1,961	\$ 2,473	\$ 3,248	\$ 1,177	\$ 8,859

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(Dollars in thousands, except per share data)

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

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

<b>March 31, 2015</b>	<b>Real estate</b>				<b>Unallocated</b>	<b>Total</b>
	<b>Commercial</b>	<b>Commercial</b>	<b>Residential</b>	<b>Consumer</b>		
Allowance for loan losses:						
Ending balance	\$ 2,420	\$ 3,087	\$ 3,909	\$ 1,387		\$ 10,803
Ending balance: individually evaluated for impairment	1,263	625	843	90		2,821
Ending balance: collectively evaluated for impairment	954	2,355	3,066	1,297		7,672
Ending balance: loans acquired with deteriorated credit quality	\$ 203	\$ 107	\$	\$		\$ 310
Loans receivable:						
Ending balance	\$ 319,468	\$ 522,432	\$ 305,663	\$ 89,605		\$ 1,237,168
Ending balance: individually evaluated for impairment	2,631	4,757	3,853	101		11,342
Ending balance: collectively evaluated for impairment	315,524	516,295	301,752	\$ 89,504		1,223,075
Ending balance: loans acquired with deteriorated credit quality	\$ 1,313	\$ 1,380	\$ 58			\$ 2,751

<b>December 31, 2014</b>	<b>Real estate</b>				<b>Unallocated</b>	<b>Total</b>
	<b>Commercial</b>	<b>Commercial</b>	<b>Residential</b>	<b>Consumer</b>		

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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

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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 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 loans 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.

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 March 31, 2015 and December 31, 2014:

<b>March 31, 2015:</b>	<b>Pass</b>	<b>Special Mention</b>	<b>Substandard</b>	<b>Doubtful</b>	<b>Total</b>
Commercial	\$ 307,690	\$ 6,802	\$ 4,976		\$ 319,468
Real estate:					
Commercial	503,620	9,885	8,927		522,432
Residential	296,500	1,065	8,098		305,663
Consumer	89,504		101		89,605
Total	\$ 1,197,314	\$ 17,752	\$ 22,102		\$ 1,237,168

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(Dollars in thousands, except per share data)

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

<b>December 31, 2014:</b>	<b>Pass</b>	<b>Special Mention</b>	<b>Substandard</b>	<b>Doubtful</b>	<b>Total</b>
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
<b>Total</b>	<b>\$ 1,164,672</b>	<b>\$ 18,129</b>	<b>\$ 27,093</b>		<b>\$ 1,209,894</b>

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

	<b>March 31, 2015</b>	<b>December 31, 2014</b>
Commercial	\$ 2,366	\$ 1,322
Real estate:		
Commercial	3,781	3,732
Residential	3,331	3,523
Consumer	97	122
<b>Total</b>	<b>\$ 9,575</b>	<b>\$ 8,699</b>

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

	<b>30-59 Days Past Due</b>	<b>60-89 Days Past Due</b>	<b>Greater than 90 Days</b>	<b>Total Past Due</b>	<b>Current</b>	<b>Total Loans</b>	<b>Loans &gt; 90 Days and Accruing</b>
<b>March 31, 2015</b>							
Commercial	\$ 543	\$ 43	\$ 2,366	\$ 2,952	\$ 316,516	\$ 319,468	
Real estate:							
Commercial	1,689	220	3,781	5,690	516,742	522,432	

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Residential	3,811	1,065	4,106	8,982	296,681	305,663	\$ 775
Consumer	679	170	559	1,408	88,197	89,605	462
Total	\$ 6,722	\$ 1,498	\$ 10,812	\$ 19,032	\$ 1,218,136	\$ 1,237,168	\$ 1,237

December 31, 2014	30-59 Days	60-89 Days	Greater	Total Past	Current	Total	Loans > 90
	Past Due	Past Due	than 90 Days	Due			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



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(Dollars in thousands, except per share data)

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

The following tables summarize information concerning impaired loans at and for the period ended March 31, 2015, December 31, 2014 and March 31, 2014, by major loan classification:

	Recorded Investment	Unpaid Principal Balance	Related Allowance	For the Quarter Ended	
				Average Recorded Investment	Interest Income Recognized
<b>March 31, 2015</b>					
With no related allowance:					
Commercial	\$ 2,319	\$ 3,900		\$ 2,349	\$ 20
Real estate:					
Commercial	2,198	2,936		2,565	19
Residential	2,272	2,456		2,472	1
Consumer	11	11		47	
<b>Total</b>	<b>6,800</b>	<b>9,303</b>		<b>7,433</b>	<b>40</b>
With an allowance recorded:					
Commercial	1,625	1,625	\$ 1,466	1,597	\$ 14
Real estate:					
Commercial	3,939	3,939	732	3,732	17
Residential	1,639	1,639	843	1,513	10
Consumer	90	90	90	67	
<b>Total</b>	<b>7,293</b>	<b>7,293</b>	<b>3,131</b>	<b>6,909</b>	<b>41</b>
Commercial	3,944	5,525	1,466	3,946	34
Real estate:					
Commercial	6,137	6,875	732	6,297	36
Residential	3,911	4,095	843	3,985	11
Consumer	101	101	90	114	
<b>Total</b>	<b>\$ 14,093</b>	<b>\$ 16,596</b>	<b>\$ 3,131</b>	<b>\$ 14,342</b>	<b>\$ 81</b>



**Table of Contents****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):**

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

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(Dollars in thousands, except per share data)

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

				<b>For the Quarter Ended</b>	
	<b>Recorded Investment</b>	<b>Unpaid Principal Balance</b>	<b>Related Allowance</b>	<b>Average Recorded Investment</b>	<b>Interest Income Recognized</b>
<b>March 31, 2014</b>					
With no related allowance:					
Commercial	\$ 2,008	\$ 4,762		\$ 3,493	
Real estate:					
Commercial	9,958	12,746		10,227	
Residential	2,740	3,144		2,872	
Consumer	128	128		109	
<b>Total</b>	<b>14,834</b>	<b>20,780</b>		<b>16,701</b>	
With an allowance recorded:					
Commercial	1,728	1,728	\$ 1,128	1,964	\$ 26
Real estate:					
Commercial	1,404	1,404	542	1,399	18
Residential	261	261	162	523	
Consumer					
<b>Total</b>	<b>3,393</b>	<b>3,393</b>	<b>1,832</b>	<b>3,886</b>	<b>44</b>
<b>Commercial</b>	<b>3,736</b>	<b>6,490</b>	<b>1,128</b>	<b>5,457</b>	<b>26</b>
Real estate:					
Commercial	11,362	14,150	542	11,626	18
Residential	3,001	3,405	162	3,395	
Consumer	128	128		109	
<b>Total</b>	<b>\$ 18,227</b>	<b>\$ 24,173</b>	<b>\$ 1,832</b>	<b>\$ 20,587</b>	<b>\$ 44</b>

Included in the commercial loan and residential and commercial real estate categories are troubled debt restructurings that are classified as impaired. Trouble debt restructurings totaled \$2,967 at March 31, 2015, \$2,933 at December 31, 2014 and \$1,924 at March 31, 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 can 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.

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There were four loans modified as troubled debt restructurings for the three months ended March 31, 2015, in the amount of \$384. There were no loans modified as troubled debt restructurings for the three months ended March 31, 2014. During the three months ended March 31, 2015 and 2014, there were no defaults on loans restructured within the last twelve months.

**6. Other assets:**

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

	<b>March 31, 2015</b>	<b>December 31, 2014</b>
Other real estate owned	\$ 324	\$ 561
Investment in residential housing program	4,178	4,329
Mortgage servicing rights	623	676
Bank owned life insurance	30,177	29,983
Restricted equity securities	2,132	3,687
Other assets	13,352	13,830
<b>Total</b>	<b>\$ 50,786</b>	<b>\$ 53,066</b>

**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.

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.

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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 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 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.

**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 2013 merger with Pensco Financial Services Corporation ( Pensco ), 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.

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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):**

**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 2013 merger with Pensco 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 to 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 March 31, 2015 and December 31, 2014.

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

	Amount	Fair Value Measurement Using		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<b>March 31, 2015</b>				
U.S. Government-sponsored enterprises	\$ 96,148	\$	\$ 96,148	\$
State and Municipals:				
Taxable	17,495		17,495	
Tax-exempt	87,649		87,649	
Mortgage-backed securities:				
U.S. Government agencies	35,400		35,400	
U.S. Government-sponsored enterprises	43,608		43,608	
Total	\$ 280,300	\$	\$ 280,300	\$

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(Dollars in thousands, except per share data)

**7. Fair value estimates (continued):**

	Amount	Fair Value Measurement Using		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<b>December 31, 2014</b>				
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	\$

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

	Amount	Fair Value Measurement Using		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<b>March 31, 2015</b>				
Impaired loans	\$ 4,862			\$ 4,862
Other real estate owned	\$ 159			\$ 159
<b>December 31, 2014</b>				
	Amount	Quoted Prices in Active Markets for Identical Assets	Significant Other Observable Inputs	Significant Unobservable Inputs

	(Level 1)	(Level 2)	(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:

<b>Quantitative Information about Level 3 Fair Value Measurements</b>				
	<b>Fair Value</b>	<b>Valuation</b>	<b>Unobservable Input</b>	<b>Range</b>
<b>March 31, 2015</b>	<b>Estimate</b>	<b>Techniques</b>		<b>(Weighted Average)</b>
Impaired loans	\$ 4,862	Appraisal of collateral	Appraisal adjustments	13.3% to 51.1% (23.0%)
			Liquidation expenses	3.0% to 6.0% (5.4%)
Other real estate owned	\$ 159	Appraisal of collateral	Appraisal adjustments	19.7% to 77.9% (37.3%)
			Liquidation expenses	3.0% to 6.0% (5.0%)

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(Dollars in thousands, except per share data)

**7. Fair value estimates (continued):**

December 31, 2014	Quantitative Information about Level 3 Fair Value Measurements			
	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.

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

March 31, 2015	Carrying Value	Fair Value	Fair Value Hierarchy		
			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	\$ 39,631	\$ 39,631	\$ 39,631		
Investment securities:					
Available-for-sale	280,300	280,300		\$ 280,300	
Held-to-maturity	14,172	14,729		14,729	
Loans held for sale	3,101	3,107		3,107	
Net loans	1,226,365	1,238,915			\$ 1,238,915
Accrued interest receivable	4,922	4,922		4,922	

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Mortgage servicing rights	623	1,466	1,466
Restricted equity securities	2,132	2,132	2,132
<b>Total</b>	<b>\$ 1,571,246</b>	<b>\$ 1,585,202</b>	
Financial liabilities:			
Deposits	\$ 1,416,278	\$ 1,418,370	1,418,370
Long-term debt	32,318	34,133	34,133
Accrued interest payable	460	460	\$ 460
<b>Total</b>	<b>\$ 1,449,056</b>	<b>\$ 1,452,963</b>	

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(Dollars in thousands, except per share data)

**7. Fair value estimates (continued):**

December 31, 2014	Carrying Value	Fair Value	Fair Value Hierarchy		
			Quoted Prices in Active Markets for Identical Assets (level 1)	Significant Other Observable Inputs (level 2)	Significant Unobservable Inputs (Level 3)
<b>Financial assets:</b>					
Cash and cash equivalents	\$ 31,426	\$ 31,426	\$ 31,426		
<b>Investment securities:</b>					
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	
<b>Total</b>	<b>\$ 1,598,662</b>	<b>\$ 1,610,821</b>			
<b>Financial liabilities:</b>					
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	
<b>Total</b>	<b>\$ 1,478,829</b>	<b>\$ 1,481,984</b>			

**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.



Salaries and employee benefits expense includes approximately \$279 and \$250 relating to the employee benefit plans for the three months ended March 31, 2015 and 2014.

Components of net periodic benefit income are as follows:

<b>Three months ended March 31,</b>	<b>Pension Benefits</b>	
	<b>2015</b>	<b>2014</b>
Net periodic pension income:		
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
<b>Net periodic pension income</b>	<b>\$ (9)</b>	<b>\$ (35)</b>

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**Peoples Financial Services Corp.**

**MANAGEMENT'S DISCUSSION AND ANALYSIS**

**(Dollars in thousands, except per share data)**

**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 this report, other than statements of historical facts, are forward-looking statements.

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 Pensco; 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.



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**Peoples Financial Services Corp.**

**MANAGEMENT'S DISCUSSION AND ANALYSIS**

**(Dollars in thousands, except per share data)**

**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.

**Operating Environment:**

Fiscal policy initiatives enacted by the Federal Open Market Committee ( FOMC ) during the first quarter of 2015 were limited to changing of language used in its policy statements. The FOMC dropped the word "patient" when discussing a move toward normalizing monetary policy from the March minutes, replacing it with "reasonable confidence" when referring to attaining their inflation target of 2.0 percent. Economic performance for the first quarter of 2015 was sluggish. Economic indicators throughout the latter part of 2014 and into 2015 pointed to an improving economy. However, the tough winter experienced throughout much of the country caused the gross domestic product ( GDP ), the value of all goods and services produced in the Nation, to slow in the first quarter of 2015 to a seasonally adjusted growth rate of 0.2 percent, much weaker than the 2.4 percent experienced in 2014 and the 2.2 percent in 2013. In light of the disappointing economic indicators and lack of inflationary pressure, the FOMC moderated its assessment of the pace of economic expansion. The consumer price index ( CPI ) declined 1.3 percent annualized during the first quarter of 2015. While a majority of economists expect the FOMC to raise short-term rates as early as June, the mixed to negative economic data has pushed longer term treasury yields down. Accordingly, a flat yield curve would increase the pressure on bank margins.

**Review of Financial Position:**

Total assets declined \$27,708 or at an annual rate of 6.5% to \$1,713,961 at March 31, 2015, from \$1,741,669 at December 31, 2014. The balance sheet decline during the first quarter of 2015 was centered mainly on decreases in investment securities. Investment securities available-for-sale decreased \$59,286 in the first quarter of 2015. Loans, net increased to \$1,237,168 at March 31, 2015, compared to \$1,209,894 at December 31, 2014, an increase of \$27,274 or 9.1% annualized. Total deposits decreased \$9,280, to \$1,416,278 at March 31, 2015 from \$1,425,558 at year-end December 31, 2014. Interest-bearing deposits decreased \$819, while noninterest-bearing deposits declined \$8,461. Total stockholders' equity increased \$2,679 from \$246,779 at year-end 2014 to \$249,458 at March 31, 2015. For the three months ended March 31, 2015, total assets averaged \$1,711,339, an increase of \$16,269 or 0.95%, from \$1,695,070 for the same period of 2014.

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**Peoples Financial Services Corp.**

**MANAGEMENT'S DISCUSSION AND ANALYSIS**

**(Dollars in thousands, except per share data)**

**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 \$280,300 at March 31, 2015, a decrease of \$59,286, or 17.5% 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 increased loan demand. Investment securities held-to-maturity totaled \$14,172 at March 31, 2015, a decrease of \$493, or 3.4% from \$14,665 at December 31, 2014 due to payments received from mortgage backed holdings.

For the three months ended March 31, 2015, the investment portfolio averaged \$313,075, a decrease of \$6,723 or 2.1% compared to \$319,798 for the same period last year. The tax-equivalent yield on the investment portfolio decreased 3 basis points to 2.78% for the three months ended March 31, 2015, from 2.81% for the comparable period of 2014. The yield decline is the result of decreasing reinvestment yields.

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 \$4,048, net of income taxes of \$2,179, at March 31, 2015, and \$4,090, net of income taxes of \$2,202, at December 31, 2014.

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

**Loan Portfolio:**

Continuing the momentum of a strong fourth quarter in 2014, loan growth was again robust in the first quarter of 2015. Loans, net increased to \$1,237,168 at March 31, 2015 from \$1,209,894 at December 31, 2014, an increase of \$27,274 or 9.1% annualized. The growth reflected increases in commercial real estate loans and consumer loans, partially offset by decreases in commercial loans and residential real estate loans. Commercial real estate loans increased \$28,951 or 23.8% annualized, to \$522,432 at March 31, 2015 compared to \$493,481 at December 31, 2014. Commercial loans decreased \$122, or 0.2% annualized, to \$319,468 at March 31, 2015 compared to \$319,590 at December 31, 2014.

Weakness in residential real estate markets have further cut into the wealth of consumers. Home sales were hampered in the first quarter of 2015 due to severe winter conditions throughout much of the nation. Residential real estate loans decreased \$5,004, or 6.5% annualized, to \$305,663 at March 31, 2015 compared to \$310,667 at December 31, 2014. Conversely, consumer loans increased \$3,449, or 16.2% annualized, to \$89,605 at March 31, 2015 compared to \$86,156 at December 31, 2014.



**Table of Contents****Peoples Financial Services Corp.****MANAGEMENT'S DISCUSSION AND ANALYSIS****(Dollars in thousands, except per share data)**

For the three months ended March 31, 2015, loans, net averaged \$1,225,769, an increase of \$44,288 or 3.7% compared to \$1,181,481 for the same period of 2014. The tax-equivalent yield on the loan portfolio was 4.70% for the three months ended March 31, 2015, which was 44 basis points less than the comparable period last year. Interest income on loans included accretion recognized on loans acquired as part of the 2013 merger with Pensco of \$225 in the first quarter of 2015 and \$1,055 in the comparable period of 2014.

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 March 31, 2015, totaled \$260,105, consisting of \$234,783 in unfunded commitments of existing loan facilities and \$25,322 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 March 31, 2015 and 2014, are summarized as follows:

	<b>March 31, 2015</b>	<b>March 31, 2014</b>
United States	5.5%	6.6%
Pennsylvania (statewide)	5.7%	6.6%
Lackawanna County	6.3%	7.7%
Lehigh County	5.9%	6.7%
Luzerne County	7.1%	8.5%
Monroe County	7.0%	8.5%
Susquehanna County	6.4%	6.5%
Wayne County	7.4%	7.4%
Wyoming County	6.8%	8.8%
New York (statewide)	6.4%	7.1%
Broome County	6.9%	7.4%

The employment conditions improved for the Nation, Pennsylvania, New York as well as seven of the eight counties representing our market areas in Pennsylvania and New York from one year ago. Despite the overall improvements,

employment conditions continued to be somewhat weak as unemployment levels remained elevated compared to historical levels.



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**Peoples Financial Services Corp.**

**MANAGEMENT'S DISCUSSION AND ANALYSIS**

**(Dollars in thousands, except per share data)**

Our asset quality declined slightly in the first quarter of 2015. Nonperforming assets increased \$414 or 3.8% to \$11,297 at March 31, 2015, from \$10,883 at December 31, 2014. We experienced decreases in other real estate owned and accruing loans past due 90 days or more. However, those decreases were outweighed by an increase in nonaccrual and restructured loans. As a percentage of loans, net and foreclosed assets, nonperforming assets equaled 0.91% at March 31, 2015 compared to 0.90% at December 31, 2014.

Loans on nonaccrual status increased \$876 to \$9,575 at March 31, 2015 from \$8,699 at December 31, 2014. The increase from year end was due primarily to an increase of \$1,044 in commercial loans on nonaccrual status. Retail loans, including residential real estate and consumer loans on nonaccrual status declined \$217. Accruing loans past due 90 days or more decreased \$386 to \$1,237 at March 31, 2015 when compared to \$1,623 at December 31, 2014. Other real estate owned decreased \$237 to \$324 at March 31, 2015 when compared to \$561 at December 31, 2014.

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.

The allowance for loan losses increased \$465 to \$10,803 at March 31, 2015, from \$10,338 at the end of 2014. For the three months ended March 31, 2015, net charge-offs were \$285 or 0.09% of average loans outstanding in 2015, a \$364 decrease compared to \$649 or 0.22% of average loans outstanding in the first quarter of 2014.



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**Peoples Financial Services Corp.**

**MANAGEMENT'S DISCUSSION AND ANALYSIS**

**(Dollars in thousands, except per share data)**

**Deposits:**

The majority of our deposits are attracted 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 IRAs. During the three months ended March 31, 2015, total deposits decreased \$9,280, or 2.6% annualized, to \$1,416,278 from \$1,425,558 at December 31, 2014. Growth was experienced in savings accounts while the other classifications declined. Savings deposits increased \$10,570, or 10.9% annualized, to \$402,522 at March 31, 2015, from \$391,952 at December 31, 2014. All other deposit categories decreased in the first quarter of 2015 due to cyclical trends. Interest-bearing transaction accounts, including NOW and money market accounts, decreased \$1,624, or 1.5% annualized, to \$450,742 at March 31, 2015, from \$452,366 at December 31, 2014. Demand deposits, decreased \$8,461, or 11.0% annualized, to \$305,037 at March 31, 2015, compared to \$313,498 at December 31, 2014. Time deposits less than \$100 decreased \$4,302, or 9.1% annualized, to \$187,588 at March 31, 2015, compared to \$191,890 at December 31, 2014 while time deposits of \$100 or more were down \$5,463, or 29.2% annualized, to \$70,389 at March 31, 2015, compared to \$75,852 at December 31, 2014.

For the quarter ended March 31, 2015, average total deposits increased \$24,411 to \$1,408,080, compared to \$1,383,669 for the same period of 2014. Average noninterest-bearing deposits grew \$23,582, while average interest-bearing accounts increased \$829. Our cost of interest-bearing deposits decreased 4 basis points to 0.46% for the three months ended March 31, 2015, from 0.50% for the three months ended March 31, 2014.

**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 (FHLB) provided certain standards related to credit worthiness have been met. Repurchase and term agreements are also available from the FHLB.

We had no short-term borrowings at March 31, 2015 as compared to \$19,557 at December 31, 2014. Long-term debt was \$32,318 at March 31, 2015, compared to \$33,140 at December 31, 2014. The reduction was a product of monthly contractual amortized payments made during the first quarter of 2015.

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**Peoples Financial Services Corp.**

**MANAGEMENT'S DISCUSSION AND ANALYSIS**

**(Dollars in thousands, except per share data)**

**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 we have material weaknesses 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 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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**Peoples Financial Services Corp.**

**MANAGEMENT'S DISCUSSION AND ANALYSIS**

**(Dollars in thousands, except per share data)**

Our cumulative one-year RSA/RSL ratio equaled 2.24% at March 31, 2015. Given the length of time that market rates have been at historical lows and the potential for rates to rise 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 March 31, 2015, indicates that the amount of RSA repricing within one year would exceed that of RSL, which would result in an increase in net interest income from rising market rates. 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 credible 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 March 31, 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 employ deposit and loan pricing strategies and direct the reinvestment of loan and investment repayments in order to maintain a favorable 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.

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**Peoples Financial Services Corp.**

**MANAGEMENT'S DISCUSSION AND ANALYSIS**

**(Dollars in thousands, except per share data)**

**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.

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 related to our reliance on noncore funds to fund our investments and loans maturing after March 31, 2015. Our noncore funds at March 31, 2015, were comprised of time deposits in denominations of \$100 or more, repurchase agreements 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 March 31, 2015, our net noncore funding dependence ratio, the difference between noncore funds and short-term investments to long-term assets, was 5.4%, while our net short-term noncore funding dependence ratio, noncore funds maturing within one-year, less short-term investments to long-term assets equaled -0.5%. Comparatively, our overall noncore dependence ratio improved from year-end 2014 when it was 10.0%. Similarly, our net short-term noncore funding dependence ratio was 4.1% at year-end, indicating that our reliance on short-term 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 \$8,205 during the three months ended March 31, 2015. Cash and cash equivalents increased \$27,902 for the same period last year. For the three months ended March 31, 2015, net cash inflows of \$7,361 from operating activities and \$32,631 from investing activities were partially offset by a \$31,787 net cash outflow from financing activities. For the same period of 2014, net cash inflows of \$21,971 from financing activities and \$7,130 from operating activities were partially offset by a \$1,199 net cash outflow from investing activities.



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**MANAGEMENT'S DISCUSSION AND ANALYSIS**

**(Dollars in thousands, except per share data)**

Financing activities used net cash of \$31,787 for the three months ended March 31, 2015, and provided \$21,971 for the same three months of 2014. Deposit gathering is our predominant financing activity. During the first three months of 2015 deposits declined compared to the same period last year. The net decrease in deposits totaled \$9,081 in 2015. Comparatively, deposit gathering provided net cash of \$24,855 for the same period of 2014. Short-term borrowings also declined \$19,557 contributing to the net use of funds.

Operating activities provided net cash of \$7,361 for the three months ended March 31, 2015, and \$7,130 for the same three 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 provided net cash of \$32,631 for the three months ended March 31, 2015, compared to using \$1,199 for the same period of 2014. In 2015, proceeds from the sale of investment securities available-for-sale brought in a significant amount of cash while in 2014, an increase in investment portfolio activities was the primary factor causing a net cash outflow from investing activities.

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 \$249,458 or \$33.05 per share at March 31, 2015, compared to \$246,779 or \$32.69 per share at December 31, 2014. Net income of \$5,044 for the three months ended March 31, 2015 was the primary factor leading to the improved capital position. Stockholders' equity was also affected by cash dividends declared of \$2,341, stock based compensation of \$18, and other comprehensive losses resulting from market value fluctuations in the investment portfolio of \$42.

Dividends declared equaled \$0.31 per share for the first quarter of 2015 and 2014, representing a dividend payout ratio of 46.4% in 2015 and 49.8% in 2014. The merger agreement pursuant to which we merged with Pensco 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.



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**Peoples Financial Services Corp.**

**MANAGEMENT'S DISCUSSION AND ANALYSIS**

**(Dollars in thousands, except per share data)**

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.

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 March 31, 2015, the Bank's Tier 1 capital to total average assets was 10.88% as compared to 10.42% at December 31, 2014. The Bank's Tier 1 capital to risk weighted asset ratio was 15.19% and the total capital to risk weighted asset ratio was 16.11% at March 31, 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 15.19 at March 31, 2015. The Bank was deemed to be well-capitalized under regulatory standards at March 31, 2015.

**Review of Financial Performance:**

Net income for the first quarter of 2015 equaled \$5,044 or \$0.67 per share compared to \$4,698 or \$0.62 per share for the first quarter of 2014. Return on average assets ( ROA ) measures our net income in relation to total assets. Our ROA was 1.20% for the first quarter of 2015 compared to 1.12% for the same period of 2014. Return on average equity ( ROE ) indicates how effectively we generate net income on the capital invested by stockholders. Our ROE was 8.28% for the first quarter of 2015 compared to 8.01% for the first quarter of 2014. The results for the three months ended March 31, 2014 included pre-tax acquisition related expenses of \$608. Gains on sale of investment securities were \$832 thousand for the three months ended March 31, 2015, while there were no gains recognized for the comparable period in 2014.

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**MANAGEMENT'S DISCUSSION AND ANALYSIS**

**(Dollars in thousands, except per share data)**

**Net Interest Income:**

Net interest income is still the fundamental source of earnings for commercial banks. Moreover, 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.

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%.

For the three months ended March 31, 2015, tax-equivalent net interest income decreased \$706 to \$14,827 in 2015 from \$15,533 in 2014. The net interest spread decreased to 3.74% for the three months ended March 31, 2015 from 3.94% for the three months ended March 31, 2014. The tax-equivalent net interest margin for the three months ended March 31 was 3.88% in 2015 compared to 4.09% in 2014. Loan accretion included in loan interest income in the first quarter of 2015 related to loans acquired in the fourth quarter of 2013 was \$225, resulting in an increase in the tax-equivalent net interest margin of 6 basis points. Comparatively, loan accretion recognized in the first quarter of 2014 was \$1,055 resulting in an increase in the tax-equivalent net interest margin of 28 basis points. Adjusting for the accretion, the tax equivalent net interest margin for the three months ended March 31 was 3.82% in 2015 and 3.81% in 2014. The tax-equivalent net interest margin for the fourth quarter of 2014 was 3.79%.

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For the three months ended March 31, 2015, tax-equivalent interest income decreased \$858, to \$16,362 as compared to \$17,220 for the three months ended March 31, 2014. A volume variance in interest income of \$2,766 attributable to changes in the average balance of earning assets was more than offset by a \$3,624 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 25 basis points for the first quarter of 2015 from the same period in 2014. The overall yield on earning assets, on a fully tax-equivalent basis, decreased for the three months ended March 31, 2015 to 4.28% as compared to 4.53% for the three months ended March 31, 2014. This was a result of the continuation of the low interest rate environment along with increased market competition. The yield earned on loans decreased 44 basis points for the first quarter of 2015 to 4.70% from 5.14% for the first quarter of 2014. Average loans increased to \$1,225,769 for the quarter ended March 31, 2015 compared to \$1,181,481 for the same period in 2014. The resulting tax-equivalent interest earned on loans was \$14,200 for the three month period ended March 31, 2015 compared to \$14,978 for the same period in 2014, a decrease of \$778.

Total interest expense decreased \$152 to \$1,535 for the three months ended March 31, 2015 from \$1,687 for the three months ended March 31, 2014. A favorable volume variance caused interest expenses to decrease \$154. The average volume of interest bearing liabilities declined to \$1,153,013 for the three months ended March 31, 2015, as compared to \$1,166,766 for the three months ended March 31, 2014. The cost of funds decreased to 0.54% for the three months ended March 31, 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%.

	<b>March 2015</b>		<b>Three months ended</b>		<b>March 2014</b>	
	<b>Average</b>	<b>Yield/</b>	<b>Average</b>	<b>Yield/</b>	<b>Average</b>	<b>Yield/</b>
	<b>Balance</b>	<b>Interest</b>	<b>Balance</b>	<b>Interest</b>	<b>Balance</b>	<b>Interest</b>
		<b>Rate</b>		<b>Rate</b>		<b>Rate</b>
<b>Assets:</b>						
Earning assets:						