

PEOPLES FINANCIAL SERVICES CORP.

Form 10-Q

May 06, 2016

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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

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Form 10-Q

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Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934  
for the quarterly period ended March 31, 2016

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)

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PEOPLES FINANCIAL SERVICES CORP.

(Exact name of registrant as specified in its charter)

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|   |                             |
|---|-----------------------------|
| (State of<br>incorporation)   | (IRS Employer<br>ID Number) |
| 150 North Washington Avenue, Scranton, PA<br>(Address of principal executive offices) | 18503<br>(Zip code)         |

(570) 346-7741

(Registrant's telephone number, including area code)

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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: 7,396,404 at April 30, 2016.

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FORM 10-Q

For the Quarter Ended March 31, 2016

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Peoples Financial Services Corp.

## CONSOLIDATED BALANCE SHEETS (UNAUDITED)

(Dollars in thousands, except share data)

|   | March 31, 2016 | December 31, 2015 |
|---|----------------|-------------------|
| Assets:   |                |                   |
| Cash and due from banks   | \$ 23,699      | \$ 28,218         |
| Interest-bearing deposits in other banks  | 299            | 4,699             |
| Federal funds sold  |                |                   |
| Investment securities:  |                |                   |
| Available-for-sale  | 264,175        | 284,935           |
| Held-to-maturity: Fair value March 31, 2016, \$12,322; December 31, 2015, \$12,606  | 11,681         | 12,109            |
| Total investment securities   | 275,856        | 297,044           |
| Loans held for sale   | 78             |                   |
| Loans, net  | 1,409,691      | 1,340,865         |
| Less: allowance for loan losses   | 14,158         | 12,975            |
| Net loans   | 1,395,533      | 1,327,890         |
| Premises and equipment, net   | 29,386         | 28,157            |
| Accrued interest receivable   | 5,455          | 5,796             |
| Goodwill  | 63,370         | 63,370            |
| Intangible assets   | 5,091          | 5,397             |
| Other assets  | 63,603         | 58,487            |
| Total assets  | \$ 1,862,370   | \$ 1,819,058      |
| Liabilities:  |                |                   |
| Deposits:   |                |                   |
| Noninterest-bearing   | \$ 323,456     | \$ 320,978        |
| Interest-bearing  | 1,152,003      | 1,134,832         |
| Total deposits  | 1,475,459      | 1,455,810         |
| Short-term borrowings   | 60,350         | 38,325            |
| Long-term debt  | 59,773         | 60,354            |
| Accrued interest payable  | 506            | 560               |
| Other liabilities   | 14,837         | 15,241            |
| Total liabilities   | 1,610,925      | 1,570,290         |
| Stockholders' equity:   |                |                   |
| Common stock, par value \$2.00, authorized 25,000,000 shares, issued 7,399,298 shares at March 31, 2016 and 7,410,606 shares at December 31, 2015 | 14,799         | 14,821            |
| Capital surplus   | 134,994        | 135,371           |
| Retained earnings   | 103,288        | 100,701           |
| Accumulated other comprehensive loss  | (1,636)        | (2,125)           |
| Total stockholders' equity  | 251,445        | 248,768           |

|  |              |              |
|--|--------------|--------------|
| Total liabilities and stockholders' equity | \$ 1,862,370 | \$ 1,819,058 |
|--|--------------|--------------|

See notes to consolidated financial statements

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Peoples Financial Services Corp.

## CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME (UNAUDITED)

(Dollars in thousands, except per share data)

| For the Three Months Ended March 31,                         | 2016      | 2015      |
|--|-----------|-----------|
| Interest income:   |           |           |
| Interest and fees on loans:                                  |           |           |
| Taxable  | \$ 14,346 | \$ 13,340 |
| Tax-exempt   | 751       | 559       |
| Interest and dividends on investment securities:             |           |           |
| Taxable  | 687       | 900       |
| Tax-exempt   | 875       | 805       |
| Dividends  | 10        | 9         |
| Interest on interest-bearing deposits in other banks         | 17        | 8         |
| Interest on federal funds sold                               |           | 7         |
| Total interest income  | 16,686    | 15,628    |
| Interest expense:  |           |           |
| Interest on deposits   | 1,283     | 1,268     |
| Interest on short-term borrowings                            | 77        | 8         |
| Interest on long-term debt                                   | 360       | 259       |
| Total interest expense                                       | 1,720     | 1,535     |
| Net interest income  | 14,966    | 14,093    |
| Provision for loan losses                                    | 1,200     | 750       |
| Net interest income after provision for loan losses          | 13,766    | 13,343    |
| Noninterest income:  |           |           |
| Service charges, fees and commissions                        | 1,444     | 1,612     |
| Merchant services income                                     | 914       | 790       |
| Commission and fees on fiduciary activities                  | 482       | 459       |
| Wealth management income                                     | 412       | 205       |
| Mortgage banking income                                      | 204       | 222       |
| Life insurance investment income                             | 193       | 189       |
| Net gain on sale of investment securities available-for-sale | 242       | 832       |
| Total noninterest income                                     | 3,891     | 4,309     |
| Noninterest expense:   |           |           |
| Salaries and employee benefits expense                       | 5,332     | 5,233     |
| Net occupancy and equipment expense                          | 2,437     | 2,468     |
| Merchant services expense                                    | 632       | 533       |
| Amortization of intangible assets                            | 305       | 305       |
| Other expenses   | 2,912     | 2,555     |
| Total noninterest expense                                    | 11,618    | 11,094    |
| Income before income taxes                                   | 6,039     | 6,558     |



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|  |           |           |
|--|-----------|-----------|
| Income tax expense   | 1,157     | 1,514     |
| Net income   | 4,882     | 5,044     |
| Other comprehensive income (loss):                                       |           |           |
| Unrealized gain on investment securities available-for-sale              | 995       | 767       |
| Reclassification adjustment for net gain on sales included in net income | (242)     | (832)     |
| Other comprehensive income (loss)  | 753       | (65)      |
| Income tax expense (benefit) related to other comprehensive loss         | 264       | (23)      |
| Other comprehensive income (loss), net of income taxes                   | 489       | (42)      |
| Comprehensive income   | \$ 5,371  | \$ 5,002  |
| Per share data:  |           |           |
| Net income:  |           |           |
| Basic  | \$ 0.66   | \$ 0.67   |
| Diluted  | \$ 0.66   | \$ 0.67   |
| Average common shares outstanding:                                       |           |           |
| Basic  | 7,403,510 | 7,548,358 |
| Diluted  | 7,403,510 | 7,548,358 |
| Dividends declared   | \$ 0.31   | \$ 0.31   |

See notes to consolidated financial statements

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Peoples Financial Services Corp.

## CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY (UNAUDITED)

(Dollars in thousands, except per share data)

|  | Common<br>Stock | Capital<br>Surplus | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Loss | Total      |
|--|-----------------|--------------------|----------------------|---|------------|
| Balance, January 1, 2016                           | \$ 14,821       | \$ 135,371         | \$ 100,701           | \$ (2,125)                                    | \$ 248,768 |
| Stock based compensation                           |                 | 18                 |                      |   | 18         |
| Net income   |                 |                    | 4,882                |   | 4,882      |
| Other comprehensive income, net of<br>income taxes |                 |                    |                      | 489   | 489        |
| Dividends declared: \$0.31 per share               |                 |                    | (2,295)              |   | (2,295)    |
| Shares retired: 11,308 shares                      | (22)            | (395)              |                      |   | (417)      |
| Balance, March 31, 2016                            | 14,799          | 134,994            | 103,288              | (1,636)                                       | 251,445    |
| Balance, January 1, 2015                           | 15,097          | 140,214            | 92,297               | (829)   | 246,779    |
| Stock based compensation                           |                 | 18                 |                      |   | 18         |
| Net income   |                 |                    | 5,044                |   | 5,044      |
| Other comprehensive loss, net of income<br>taxes   |                 |                    |                      | (42)  | (42)       |
| Dividends declared: \$0.31 per share               |                 |                    | (2,341)              |   | (2,341)    |
| Balance, March 31, 2015                            | \$ 15,097       | \$ 140,232         | \$ 95,000            | \$ (871)                                      | \$ 249,458 |

See notes to consolidated financial statements

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Peoples Financial Services Corp.

## CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

(Dollars in thousands, except per share data)

| For the Three Months Ended March 31,  | 2016     | 2015     |
|---|----------|----------|
| Cash flows from operating activities:   |          |          |
| Net income  | \$ 4,882 | \$ 5,044 |
| Adjustments to reconcile net income to net cash provided by operating activities: |          |          |
| Depreciation of premises and equipment  | 392      | 388      |
| Amortization of deferred loan costs   | 169      | 132      |
| Amortization of intangibles   | 305      | 305      |
| Net accretion of purchase accounting adjustments on tangible assets               | (275)    | (292)    |
| Amortization of loss on investment tax credits                                    | 125      | 151      |
| Provision for loan losses   | 1,200    | 750      |
| Net gain on sale of other real estate owned                                       | (11)     | (30)     |
| Loans originated for sale   | (5,268)  | (5,300)  |
| Proceeds from sale of loans originated for sale                                   | 5,394    | 5,907    |
| Net gain on sale of loans originated for sale                                     | (204)    | (222)    |
| Net amortization of investment securities   | 1,041    | 1,022    |
| Net gain on sale of investment securities   | (242)    | (832)    |
| Life insurance investment income  | (193)    | (189)    |
| Deferred income tax expense (benefit)   |          | (142)    |
| Stock based compensation  | 18       | 18       |
| Net change in:  |          |          |
| Accrued interest receivable   | 341      | 658      |
| Other assets  | (583)    | 559      |
| Accrued interest payable  | (54)     | (114)    |
| Other liabilities   | (404)    | (452)    |
| Net cash provided by operating activities   | 6,633    | 7,361    |
| Cash flows from investing activities:   |          |          |
| Proceeds from sales of investment securities available-for-sale                   | 10,271   | 50,981   |
| Proceeds from repayments of investment securities:                                |          |          |
| Available-for-sale  | 10,453   | 9,835    |
| Held-to-maturity  | 418      | 482      |
| Purchases of investment securities:   |          |          |
| Available-for-sale  |          | (1,774)  |
| Held-to-maturity  |          |          |
| Net (purchase) redemption of restricted equity securities                         | (798)    | 1,555    |
| Net increase in lending activities  | (69,321) | (27,689) |
| Investment in low income housing investment tax credits                           | (2,050)  |          |
| Purchases of premises and equipment   | (1,646)  | (1,097)  |
| Purchase of investment in life insurance  | (1,500)  |          |
| Proceeds from sale of other real estate owned                                     | 83       | 338      |
| Net cash (used in) provided by investing activities                               | (54,090) | 32,631   |

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|  |           |           |
|--|-----------|-----------|
| Cash flows from financing activities:                |           |           |
| Net increase (decrease) in deposits                  | 19,798    | (9,081)   |
| Repayment of long-term debt                          | (573)     | (808)     |
| Net increase (decrease) in short-term borrowings     | 22,025    | (19,557)  |
| Retirement of common stock                           | (417)     |           |
| Cash dividends paid                                  | (2,295)   | (2,341)   |
| Net cash provided by financing activities            | 38,538    | (31,787)  |
| Net increase (decrease) in cash and cash equivalents | (8,919)   | 8,205     |
| Cash and cash equivalents at beginning of year       | 32,917    | 31,426    |
| Cash and cash equivalents at end of year             | \$ 23,998 | \$ 39,631 |

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Peoples Financial Services Corp.

## CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

(Dollars in thousands, except per share data)

| For the Three Months Ended March 31,     | 2016     | 2015     |
|--|----------|----------|
| Supplemental disclosures:                |          |          |
| Cash paid during the period for:         |          |          |
| Interest                                 | \$ 1,931 | \$ 1,649 |
| Income taxes                             |          |          |
| Noncash items:                           |          |          |
| Transfers of loans to other real estate  | \$ 524   | \$ 71    |
| Acquisition:                             |          |          |
| Fair value of assets acquired:           |          |          |
| Loans, net                               | \$ 143   | \$ 104   |
| Premises and equipment                   | (25)     | (25)     |
| Core deposit and other intangible assets | (267)    | (304)    |
|  | \$ (149) | \$ (225) |
| Fair value of liabilities assumed:       |          |          |
| Deposits                                 | \$ 149   | \$ 199   |
| Long-term debt                           | 8        | 14       |
|  | \$ 157   | \$ 213   |

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 subsidiary, Peoples Advisors, LLC (collectively, the “Company” or “Peoples”). The Company services its retail and commercial customers through twenty-four full-service community banking offices located within the Bucks, Lackawanna, Lehigh, Luzerne, Monroe, Montgomery, Susquehanna, Wayne and Wyoming Counties of Pennsylvania and Broome County of New York.

Basis of presentation:

The accompanying unaudited consolidated financial statements of the Company have been prepared in accordance with accounting principles generally accepted in the United States of America (“GAAP”) for interim financial information and with the instructions to Form 10-Q and Article 10-01 of Regulation S-X. In the opinion of management, all normal recurring adjustments necessary for a fair presentation of the financial position and results of operations for the periods presented have been included. All significant intercompany balances and transactions have been eliminated in consolidation. Prior-period amounts are reclassified when necessary to conform to the current year’s presentation. These reclassifications did not have any effect on the operating results or financial position of the Company. The operating results and financial position of the Company for the three months ended and as of March 31, 2016, 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, 2015.

Recent accounting standards:

In March 2016, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2016-03, "Intangibles—Goodwill and Other, Business Combinations, Consolidation, Derivatives and Hedging: Effective Date and Transition Guidance." The mandate removes the effective dates from the private company accounting alternatives for goodwill, intangible assets, consolidation, and derivatives and hedging. This allows private companies to elect the accounting alternatives at any time without a preferability assessment. However, any subsequent change to an accounting policy election would require justification that the change is preferable under Topic 250. The ASU also extends certain favorable transition provisions of the accounting alternatives. The amendments became effective immediately upon issuance of the ASU. The adoption of this ASU has not had a significant impact on the Company's financial condition or results of operations.

In March 2016, the FASB issued ASU 2016-04, "Liabilities—Extinguishments of Liabilities: Recognition of Breakage for Certain Prepaid Stored-Value Products" The standard amends exempting gift cards and other prepaid stored-value products from the guidance on extinguishing financial liabilities. Rather, they will be subject to breakage accounting consistent with the new revenue guidance in Topic 606. However, the exemption only applies to breakage liabilities that are not subject to unclaimed property laws or that are attached to segregated bank accounts (e.g., consumer debit cards). In this context, if an entity expects to be entitled to breakage, it should derecognize the amount of the liability in proportion to the pattern of rights expected to be exercised by the product holder. In addition, breakage should only be recognized to

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Peoples Financial Services Corp.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Dollars in thousands, except per share data)

the extent that it is probable that a significant reversal of the recognized breakage amount will not subsequently occur. The amendments also require entities to update their estimates of breakage at the end of each reporting period, with changes accounted for as a change in accounting estimate. If an entity does not expect to be entitled to breakage, the entity should derecognize such liabilities within the scope of the ASU when the likelihood of the product holder exercising its remaining rights becomes remote. The amendments are effective for public business entities for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years. The amendments are effective for all other entities for fiscal years beginning after December 15, 2018, and interim periods within fiscal years beginning after December 15, 2019. Early adoption is permitted. The Company does not expect the adoption of this ASU to have a significant impact on its financial condition or results of operations.

In March 2016, the FASB issued ASU 2016-05, “Derivatives and Hedging: Effect of Derivative Contract Novations on Existing Hedge Accounting Relationships,” which requires an entity to discontinue a designated hedging relationship in certain circumstances, including termination of the derivative hedging instrument or if the entity wishes to change any of the critical terms of the hedging relationship. The mandate clarifies that novation of a derivative (replacing one of the parties to a derivative instrument with a new party) designated as the hedging instrument would not, in and of itself, be considered a termination of the derivative instrument or a change in critical terms requiring discontinuation of the designated hedging relationship. The amendments are effective for public business entities for fiscal years beginning after December 15, 2016, and interim periods within those fiscal years. For all other entities, the amendments are effective for fiscal years beginning after December 15, 2017, and interim periods within fiscal years beginning after December 15, 2018. Early adoption is permitted. The Company does not expect the adoption of this ASU to have a significant impact on its financial condition or results of operations.

In March 2016, the FASB issued ASU 2016-06, “Derivatives and Hedging: Contingent Put and Call Options in Debt Instruments”. The guidance in this ASU addresses how an entity should assess whether contingent call (put) options that can accelerate the payment of debt instruments are clearly and closely related to their debt hosts. This assessment is necessary to determine if the option(s) must be separately accounted for as a derivative. The ASU clarifies that an entity is required to assess the embedded call (put) options solely in accordance with a specific four-step decision sequence. This means entities are not also required to assess whether the contingency for exercising the option(s) is indexed to interest rates or credit risk. For example, when evaluating debt instruments puttable upon a change in control, the event triggering the change in control is not relevant to the assessment. Only the resulting settlement of debt is subject to the four-step decision sequence. The amendments are effective for public business entities for fiscal years beginning after December 15, 2016, and interim periods within those fiscal years. For all other entities, the amendments are effective for fiscal years beginning after December 15, 2017, and interim periods within fiscal years beginning after December 15, 2018. Early adoption is permitted. However, if an entity early adopts the amendments in an interim period, any adjustments should be reflected as of the beginning of that fiscal year. The Company does not expect the adoption of this ASU to have a significant impact on its financial condition or results of operations.

In March 2016, the FASB issued ASU 2016-07, “Investments—Equity Method and Joint Ventures: Simplifying the Transition to the Equity Method of Accounting.” This mandate requires an investor to initially apply the equity method of accounting from the date it qualifies for that method, for example, the date the investor obtains significant influence over the operating and financial policies of an investee. The ASU eliminates the previous requirement to retroactively



adjust the investment and record a cumulative catch up for the periods that the investment had been held, but did not qualify for the equity method of accounting. The amendments are effective for all entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2016. The amendments should be applied prospectively upon their effective date to increases in the level of ownership interest or degree of influence that result in the application of the equity method. Early adoption is permitted. The Company does not expect the adoption of this ASU to have a significant impact on its financial condition or results of operations.

In March 2016, the FASB issued ASU 2016-08 “Revenue from Contracts with Customers: Principal versus Agent Considerations (Reporting Revenue Gross versus Net).” This amendment updates the new revenue standard by clarifying the principal versus agent implementation guidance, but does not change the core principle of the new standard. The updates to the principal versus agent guidance: (1) require an entity to determine whether it is a principal or an agent for each distinct good or service (or a distinct bundle of goods or services) to be provided to the customer; (2) illustrate how

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Peoples Financial Services Corp.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Dollars in thousands, except per share data)

an entity that is a principal might apply the control principle to goods, services, or rights to services, when another party is involved in providing goods or services to a customer; (3) clarify that the purpose of certain specific control indicators is to support or assist in the assessment of whether an entity controls a good or service before it is transferred to the customer, provide more specific guidance on how the indicators should be considered, and clarify that their relevance will vary depending on the facts and circumstances; and (4) revise existing examples and add two new ones to more clearly depict how the guidance should be applied. The effective date and transition requirements for ASU 2016-08 are the same as the effective date and transition requirements of Topic 606. The Company does not expect the adoption of this ASU to have a significant impact on its financial condition or results of operations.

In March 2016, the FASB issued ASU 2016-09, “Compensation—Stock Compensation: Improvements to Employee Share-Based Payment Accounting.” The new standard introduces targeted amendments intended to simplify the accounting for stock compensation. Specifically, the ASU requires all excess tax benefits and tax deficiencies (including tax benefits of dividends on share-based payment awards) to be recognized as income tax expense or benefit in the income statement. The tax effects of exercised or vested awards should be treated as discrete items in the reporting period in which they occur. An entity also should recognize excess tax benefits, and assess the need for a valuation allowance, regardless of whether the benefit reduces taxes payable in the current period. That is, off balance sheet accounting for net operating losses stemming from excess tax benefits would no longer be required and instead such net operating losses would be recognized when they arise. Existing net operating losses that are currently tracked off balance sheet would be recognized, net of a valuation allowance if required, through an adjustment to opening retained earnings in the period of adoption. Entities will no longer need to maintain and track an “APIC pool.” The ASU also requires excess tax benefits to be classified along with other income tax cash flows as an operating activity in the statement of cash flows. In addition, the ASU elevates the statutory tax withholding threshold to qualify for equity classification up to the maximum statutory tax rates in the applicable jurisdiction(s). The ASU also clarifies that cash paid by an employer when directly withholding shares for tax withholding purposes should be classified as a financing activity. The ASU provides an optional accounting policy election (with limited exceptions), to be applied on an entity-wide basis, to either estimate the number of awards that are expected to vest (consistent with existing U.S. GAAP) or account for forfeitures when they occur. Further, the ASU provides two accounting alternatives to nonpublic entities: A nonpublic entity can make an accounting policy election to apply a practical expedient to estimate the expected term for all awards with performance or service conditions that meet certain conditions and a nonpublic entity can make a one-time accounting policy election to switch from measuring all liability-classified awards at fair value to intrinsic value. The amendments are effective for public business entities for annual periods beginning after December 15, 2016, and interim periods within those annual periods. For all other entities, the amendments are effective for annual periods beginning after December 15, 2017, and interim periods within annual periods beginning after December 15, 2018. Early adoption is permitted. The Company does not expect the adoption of this ASU to have a significant impact on its financial condition or results of operations.

2. Other comprehensive income (loss):

The components of other comprehensive loss and their related tax effects are reported in the Consolidated Statements of Income and Comprehensive Income. The accumulated other comprehensive 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, 2016 and December 31, 2015 is as follows:

|   | March 31, 2016 | December 31, 2015 |
|---|----------------|-------------------|
| Net unrealized gain on investment securities available-for-sale | \$ 5,346       | \$ 4,593          |
| Income tax expense  | 1,871          | 1,607             |
| Net of income taxes   | 3,475          | 2,986             |
| Benefit plan adjustments  | (7,863)        | (7,863)           |
| Income tax benefit  | (2,752)        | (2,752)           |
| Net of income taxes   | (5,111)        | (5,111)           |
| Accumulated other comprehensive loss                            | \$ (1,636)     | \$ (2,125)        |

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(Dollars in thousands, except per share data)

Other comprehensive income (loss) and related tax effects for the three months ended March 31, 2016 and 2015 is as follows:

| Three Months Ended March 31,  | 2016   | 2015    |
|---|--------|---------|
| Unrealized gain on investment securities available-for-sale         | \$ 995 | \$ 767  |
| Net gain on the sale of investment securities available-for-sale(1) | (242)  | (832)   |
| Other comprehensive income (loss) gain before taxes                 | 753    | (65)    |
| Income tax expense (benefit)  | 264    | (23)    |
| Other comprehensive income (loss)                                   | \$ 489 | \$ (42) |

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

## 3. Earnings per share:

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

There were no shares considered anti-dilutive for the three month periods ended March 31, 2016 and 2015.

| Three Months Ended March 31       | 2016      |           | 2015      |           |
|-----------------------------------|-----------|-----------|-----------|-----------|
|                                   | Basic     | Diluted   | Basic     | Diluted   |
| Net Income                        | \$ 4,882  | \$ 4,882  | \$ 5,044  | \$ 5,044  |
| Average common shares outstanding | 7,403,510 | 7,403,510 | 7,548,358 | 7,548,358 |
| Earnings per share                | \$ 0.66   | \$ 0.66   | \$ 0.67   | \$ 0.67   |

## 4. Investment securities:

The amortized cost and fair value of investment securities aggregated by investment category at March 31, 2016 and December 31, 2015 are summarized as follows:

| March 31, 2016                        | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value |
|---------------------------------------|-------------------|------------------------------|-------------------------------|---------------|
| Available-for-sale:                   |                   |                              |                               |               |
| U.S. Government-sponsored enterprises | \$ 64,562         | \$ 499                       | \$ 7                          | \$ 65,054     |
| State and municipals:                 |                   |                              |                               |               |
| Taxable                               | 14,801            | 993                          | 11                            | 15,783        |
| Tax-exempt                            | 120,232           | 3,815                        | 33                            | 124,014       |
| Mortgage-backed securities:           |                   |                              |                               |               |
| U.S. Government agencies              | 29,156            | 97                           | 45                            | 29,208        |
| U.S. Government-sponsored enterprises | 30,078            | 145                          | 107                           | 30,116        |
| Total                                 | \$ 258,829        | \$ 5,549                     | \$ 203                        | \$ 264,175    |
| Held-to-maturity:                     |                   |                              |                               |               |
| Tax-exempt state and municipals       | \$ 6,864          | \$ 333                       | \$ 1                          | \$ 7,196      |
| Mortgage-backed securities:           |                   |                              |                               |               |
| U.S. Government agencies              | 81                | 1                            |                               | 82            |
| U.S. Government-sponsored enterprises | 4,736             | 308                          |                               | 5,044         |
| Total                                 | \$ 11,681         | \$ 642                       | \$ 1                          | \$ 12,322     |

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| December 31, 2015  | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value |
|--|-------------------|------------------------------|-------------------------------|---------------|
| Available-for-sale:  |                   |                              |                               |               |
| U.S. Treasury securities                                       | \$ 10,030         |                              | \$ 31                         | \$ 9,999      |
| U.S. Government-sponsored enterprises<br>State and municipals: | 68,831            | \$ 291                       | 62                            | 69,060        |
| Taxable  | 15,842            | 735                          | 32                            | 16,545        |
| Tax-exempt   | 121,099           | 3,915                        | 90                            | 124,924       |
| Mortgage-backed securities:                                    |                   |                              |                               |               |
| U.S. Government agencies                                       | 31,612            | 73                           | 117                           | 31,568        |
| U.S. Government-sponsored enterprises                          | 32,928            | 119                          | 208                           | 32,839        |
| Total  | \$ 280,342        | \$ 5,133                     | \$ 540                        | \$ 284,935    |
| Held-to-maturity:  |                   |                              |                               |               |
| Tax-exempt state and municipals                                | \$ 6,865          | \$ 186                       | \$ 16                         | \$ 7,035      |
| Mortgage-backed securities:                                    |                   |                              |                               |               |
| U.S. Government agencies                                       | 84                | 1                            |                               | 85            |
| U.S. Government-sponsored enterprises                          | 5,160             | 326                          |                               | 5,486         |
| Total  | 12,109            | \$ 513                       | \$ 16                         | \$ 12,606     |

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, 2016, is summarized as follows:

| March 31, 2016                  | Fair<br>Value |
|---------------------------------|---------------|
| Within one year                 | \$ 26,168     |
| After one but within five years | 91,064        |
| After five but within ten years | 49,258        |
| After ten years                 | 38,361        |
|                                 | 204,851       |
| Mortgage-backed securities      | 59,324        |
| Total                           | \$ 264,175    |

The maturity distribution of the amortized cost and fair value, of debt securities classified as held-to-maturity at March 31, 2016, is summarized as follows:

| March 31, 2016                  | Amortized<br>Cost | Fair<br>Value |
|---------------------------------|-------------------|---------------|
| Within one year                 |                   |               |
| After one but within five years |                   |               |
| After five but within ten years |                   |               |
| After ten years                 | \$ 6,864          | \$ 7,196      |
|                                 | 6,864             | 7,196         |
| Mortgage-backed securities      | 4,817             | 5,126         |
| Total                           | \$ 11,681         | \$ 12,322     |

Securities with a carrying value of \$163,514 and \$180,478 at March 31, 2016 and December 31, 2015, respectively, were pledged to secure public deposits and repurchase agreements as required or permitted by law.

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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, 2016 and December 31, 2015, 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, 2016 and December 31, 2015, aggregated by investment category and length of time that the individual securities have been in a continuous unrealized loss position, are summarized as follows:

|                                       | Less Than 12 Months |                   | 12 Months or More |                   | Total      |                   |
|---------------------------------------|---------------------|-------------------|-------------------|-------------------|------------|-------------------|
|                                       | Fair Value          | Unrealized Losses | Fair Value        | Unrealized Losses | Fair Value | Unrealized Losses |
| March 31, 2016                        |                     |                   |                   |                   |            |                   |
| U.S. Government-sponsored enterprises | \$ 10,987           | \$ 7              |                   |                   | \$ 10,987  | \$ 7              |
| State and municipals:                 |                     |                   |                   |                   |            |                   |
| Taxable                               |                     |                   | \$ 551            | \$ 11             | 551        | 11                |
| Tax-exempt                            | 14,675              | 29                | 1,366             | 5                 | 16,041     | 34                |
| Mortgage-backed securities:           |                     |                   |                   |                   |            |                   |
| U.S. Government agencies              | 5,435               | 11                | 5,164             | 34                | 10,599     | 45                |
| U.S. Government-sponsored enterprises | 13,479              | 27                | 2,902             | 80                | 16,381     | 107               |
| Total                                 | \$ 44,576           | \$ 74             | \$ 9,983          | \$ 130            | \$ 54,559  | \$ 204            |

|                                       | Less Than 12 Months |                   | 12 Months or More |                   | Total      |                   |
|---------------------------------------|---------------------|-------------------|-------------------|-------------------|------------|-------------------|
|                                       | Fair Value          | Unrealized Losses | Fair Value        | Unrealized Losses | Fair Value | Unrealized Losses |
| December 31, 2015                     |                     |                   |                   |                   |            |                   |
| U.S. Treasury securities              | \$ 9,999            | \$ 31             |                   |                   | \$ 9,999   | \$ 31             |
| U.S. Government-sponsored enterprises | 34,159              | 62                |                   |                   | 34,159     | 62                |
| State and municipals:                 |                     |                   |                   |                   |            |                   |



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|                                       |           |        |           |        |            |        |
|---------------------------------------|-----------|--------|-----------|--------|------------|--------|
| Taxable                               |           |        | \$ 532    | \$ 32  | 532        | 32     |
| Tax-exempt                            | 21,341    | 87     | 1,952     | 19     | 23,293     | 106    |
| Mortgage-backed securities:           |           |        |           |        |            |        |
| U.S. Government agencies              | 15,114    | 56     | 5,477     | 61     | 20,591     | 117    |
| U.S. Government-sponsored enterprises | 17,647    | 104    | 6,030     | 104    | 23,677     | 208    |
| Total                                 | \$ 98,260 | \$ 340 | \$ 13,991 | \$ 216 | \$ 112,251 | \$ 556 |

The Company had 60 investment securities, consisting of 31 tax-exempt state and municipal obligations, one taxable state and municipal obligation, three U.S. Government-sponsored enterprise securities, and 25 mortgage-backed securities that were in unrealized loss positions at March 31, 2016. Of these securities, one taxable state and municipal obligation, six mortgage-backed securities and three tax-exempt state and municipal securities were in a continuous unrealized loss position for twelve months or more. Management does not consider the unrealized losses on the debt securities, as a result of changes in interest rates, to be OTTI based on historical evidence that indicates the cost of these securities is recoverable within a reasonable period of time in relation to normal cyclical changes in the market rates of interest. Moreover, because there has been no material change in the credit quality of the issuers or other events or circumstances that may cause a significant adverse impact on the fair value of these securities, and management does not intend to sell these securities and it is unlikely that the Company will be required to sell these securities before recovery of their amortized cost basis, which may be maturity, the Company does not consider the unrealized losses to be OTTI at March 31, 2016. There was no OTTI recognized for the three months ended March 31, 2016 and 2015.

The Company had 88 investment securities, consisting of 38 tax-exempt state and municipal obligations, one taxable state and municipal obligation, one U.S. Treasury security, 12 U.S. Government-sponsored enterprise securities and 36 mortgage-backed securities that were in unrealized loss positions at December 31, 2015. Of these securities, seven

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mortgage-backed 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.

## 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, 2016 and December 31, 2015 are summarized as follows. Net deferred loan costs were \$757 and \$690 at March 31, 2016 and December 31, 2015.

|              | March 31, 2016 | December 31, 2015 |
|--------------|----------------|-------------------|
| Commercial   | \$ 395,407     | \$ 365,767        |
| Real estate: |                |                   |
| Commercial   | 598,875        | 567,277           |
| Residential  | 301,686        | 306,218           |
| Consumer     | 113,723        | 101,603           |
| Total        | \$ 1,409,691   | \$ 1,340,865      |

The changes in the allowance for loan losses account by major classification of loan for the three months ended March 31, 2016 and 2015 are summarized as follows:

| March 31, 2016             | Commercial | Real estate |             | Consumer | Unallocated | Total     |
|----------------------------|------------|-------------|-------------|----------|-------------|-----------|
|                            |            | Commercial  | Residential |          |             |           |
| Allowance for loan losses: |            |             |             |          |             |           |
| Beginning Balance          | \$ 3,042   | \$ 4,245    | \$ 4,082    | \$ 1,583 | \$ 23       | \$ 12,975 |
| Charge-offs                | (3)        | (55)        |             | (65)     |             | (123)     |
| Recoveries                 | 2          | 16          | 25          | 63       |             | 106       |
| Provisions                 | 281        | 410         | 252         | 65       | 192         | 1,200     |
| Ending balance             | \$ 3,322   | \$ 4,616    | \$ 4,359    | \$ 1,646 | \$ 215      | \$ 14,158 |

| March 31, 2015             | Commercial | Real estate |             | Consumer | Unallocated | Total |
|----------------------------|------------|-------------|-------------|----------|-------------|-------|
|                            |            | Commercial  | Residential |          |             |       |
| Allowance for loan losses: |            |             |             |          |             |       |

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|                   |          |          |          |          |    |           |
|-------------------|----------|----------|----------|----------|----|-----------|
| 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 |

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The allocation of the allowance for loan losses and the related loans by major classifications of loans at March 31, 2016 and December 31, 2015 is summarized as follows:

| March 31, 2016  | Commercial | Real estate<br>Commercial | Residential | Consumer   | Unallocated | Total        |
|---|------------|---------------------------|-------------|------------|-------------|--------------|
| Allowance for loan losses:                                      |            |                           |             |            |             |              |
| Ending balance  | \$ 3,322   | \$ 4,616                  | \$ 4,359    | \$ 1,646   | \$ 215      | \$ 14,158    |
| Ending balance: individually evaluated for impairment           | 1,040      | 434                       | 533         | 89         |             | 2,096        |
| Ending balance: collectively evaluated for impairment           | 2,282      | 4,075                     | 3,826       | 1,557      | 215         | 11,955       |
| Ending balance: loans acquired with deteriorated credit quality | \$         | \$ 107                    | \$          | \$         | \$          | \$ 107       |
| Loans receivable:   |            |                           |             |            |             |              |
| Ending balance  | \$ 395,407 | \$ 598,875                | \$ 301,686  | \$ 113,723 | \$          | \$ 1,409,691 |
| Ending balance: individually evaluated for impairment           | 1,399      | 4,827                     | 3,162       | 178        |             | 9,566        |
| Ending balance: collectively evaluated for impairment           | 393,093    | 592,685                   | 298,478     | 113,545    |             | 1,397,801    |
| Ending balance: loans acquired with deteriorated credit quality | \$ 915     | \$ 1,363                  | \$ 46       | \$         | \$          | \$ 2,324     |

| December 31, 2015          | Commercial | Real estate<br>Commercial | Residential | Consumer | Unallocated | Total |
|----------------------------|------------|---------------------------|-------------|----------|-------------|-------|
| Allowance for loan losses: |            |                           |             |          |             |       |

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|   |            |            |            |            |       |              |
|---|------------|------------|------------|------------|-------|--------------|
| Ending balance  | \$ 3,042   | \$ 4,245   | \$ 4,082   | \$ 1,583   | \$ 23 | \$ 12,975    |
| Ending balance:<br>individually evaluated for<br>impairment           | 759        | 126        | 1,138      | 117        |       | 2,140        |
| Ending balance:<br>collectively evaluated for<br>impairment           | 2,283      | 4,012      | 2,944      | 1,466      | 23    | 10,728       |
| Ending balance: loans<br>acquired with deteriorated<br>credit quality | \$         | \$ 107     | \$         | \$         | \$    | \$ 107       |
| Loans receivable:<br>Ending balance                                   | \$ 365,767 | \$ 567,277 | \$ 306,218 | \$ 101,603 | \$    | \$ 1,340,865 |
| Ending balance:<br>individually evaluated for<br>impairment           | 1,196      | 4,006      | 4,917      | 148        |       | 10,267       |
| Ending balance:<br>collectively evaluated for<br>impairment           | 363,620    | 561,903    | 301,252    | 101,455    |       | 1,328,230    |
| Ending balance: loans<br>acquired with deteriorated<br>credit quality | \$ 951     | \$ 1,368   | \$ 49      | \$         | \$    | \$ 2,368     |

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

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or in the institution's credit position at some future date. Special Mention loans are not adversely classified since they do not expose the Company to sufficient risk to warrant adverse classification.

- Substandard- A loan that is inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Loans so classified must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the bank will sustain some loss if the deficiencies are not corrected.
- Doubtful – A loan classified as Doubtful has all the weaknesses inherent in one classified Substandard with the added characteristic that the weaknesses make the collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable.
- Loss- A loan classified as Loss is considered uncollectible and of such little value that its continuance as bankable loan is not warranted. This classification does not mean that the loan has absolutely no recovery or salvage value, but rather it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may be affected in the future.

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, 2016 and December 31, 2015:

| March 31, 2016 | Pass         | Special<br>Mention | Substandard | Doubtful | Total        |
|----------------|--------------|--------------------|-------------|----------|--------------|
| Commercial     | \$ 388,364   | \$ 3,564           | \$ 3,479    | \$       | \$ 395,407   |
| Real estate:   |              |                    |             |          |              |
| Commercial     | 559,346      | 20,401             | 19,128      |          | 598,875      |
| Residential    | 293,467      | 1,775              | 6,444       |          | 301,686      |
| Consumer       | 113,577      |                    | 146         |          | 113,723      |
| Total          | \$ 1,354,754 | \$ 25,740          | \$ 29,197   | \$       | \$ 1,409,691 |

| December 31, 2015 | Pass | Special<br>Mention | Substandard | Doubtful | Total |
|-------------------|------|--------------------|-------------|----------|-------|
|-------------------|------|--------------------|-------------|----------|-------|

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|              |              |           |           |    |              |
|--------------|--------------|-----------|-----------|----|--------------|
| Commercial   | \$ 357,894   | \$ 3,566  | \$ 4,307  | \$ | \$ 365,767   |
| Real estate: |              |           |           |    |              |
| Commercial   | 538,130      | 10,150    | 18,997    |    | 567,277      |
| Residential  | 296,587      | 983       | 8,648     |    | 306,218      |
| Consumer     | 101,486      |           | 117       |    | 101,603      |
| Total        | \$ 1,294,097 | \$ 14,699 | \$ 32,069 | \$ | \$ 1,340,865 |

Information concerning nonaccrual loans by major loan classification at March 31, 2016 and December 31, 2015 is summarized as follows:

|              | March 31, 2016 | December 31, 2015 |
|--------------|----------------|-------------------|
| Commercial   | \$ 1,813       | \$ 1,632          |
| Real estate: |                |                   |
| Commercial   | 4,683          | 3,859             |
| Residential  | 2,977          | 4,732             |
| Consumer     | 178            | 148               |
| Total        | \$ 9,651       | \$ 10,371         |

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

|                | 30-59 Days<br>Past Due | 60-89 Days<br>Past Due | Greater<br>than 90<br>Days | Total Past<br>Due | Current      | Total Loans  | Loans > 90<br>Days and<br>Accruing |
|----------------|------------------------|------------------------|----------------------------|-------------------|--------------|--------------|------------------------------------|
| March 31, 2016 |                        |                        |                            |                   |              |              |                                    |
| Commercial     | \$ 383                 | \$ 56                  | \$ 1,813                   | \$ 2,252          | \$ 393,155   | \$ 395,407   |                                    |
| Real estate:   |                        |                        |                            |                   |              |              |                                    |
| Commercial     | 2,837                  | 381                    | 4,683                      | 7,901             | 590,974      | 598,875      |                                    |
| Residential    | 5,472                  | 191                    | 3,680                      | 9,343             | 292,343      | 301,686      | \$ 703                             |
| Consumer       | 921                    | 234                    | 452                        | 1,607             | 112,116      | 113,723      | 274                                |
| Total          | \$ 9,613               | \$ 862                 | \$ 10,628                  | \$ 21,103         | \$ 1,388,588 | \$ 1,409,691 | \$ 977                             |

|                   | 30-59 Days<br>Past Due | 60-89 Days<br>Past Due | Greater<br>than 90<br>Days | Total Past<br>Due | Current      | Total Loans  | Loans > 90<br>Days and<br>Accruing |
|-------------------|------------------------|------------------------|----------------------------|-------------------|--------------|--------------|------------------------------------|
| December 31, 2015 |                        |                        |                            |                   |              |              |                                    |
| Commercial        | \$ 126                 | \$                     | \$ 1,632                   | \$ 1,758          | \$ 364,009   | \$ 365,767   |                                    |
| Real estate:      |                        |                        |                            |                   |              |              |                                    |
| Commercial        | 1,364                  | 165                    | 3,859                      | 5,388             | 561,889      | 567,277      |                                    |
| Residential       | 3,891                  | 1,067                  | 5,257                      | 10,215            | 296,003      | 306,218      | \$ 525                             |
| Consumer          | 705                    | 353                    | 386                        | 1,444             | 100,159      | 101,603      | 238                                |
| Total             | \$ 6,086               | \$ 1,585               | \$ 11,134                  | \$ 18,805         | \$ 1,322,060 | \$ 1,340,865 | \$ 763                             |

The following tables summarize information concerning impaired loans as of and for the three months ended March 31, 2016 and March 31, 2015, and as of and for the year ended, December 31, 2015 by major loan classification:

|                            | Recorded<br>Investment | Unpaid<br>Principal<br>Balance | Related<br>Allowance | For the Quarter Ended<br>Average<br>Recorded<br>Investment | Interest<br>Income<br>Recognized |
|----------------------------|------------------------|--------------------------------|----------------------|--|----------------------------------|
| March 31, 2016             |                        |                                |                      |  |                                  |
| With no related allowance: |                        |                                |                      |  |                                  |
| Commercial                 | \$ 1,173               | \$ 2,383                       |                      | \$ 1,263   | \$ 17                            |
| Real estate:               |                        |                                |                      |  |                                  |



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|                             |           |           |          |           |       |
|-----------------------------|-----------|-----------|----------|-----------|-------|
| Commercial                  | 3,162     | 3,832     |          | 2,947     | 32    |
| Residential                 | 2,216     | 2,399     |          | 2,632     | 1     |
| Consumer                    | 89        | 89        |          | 60        |       |
| Total                       | 6,640     | 8,703     |          | 6,902     | 50    |
| With an allowance recorded: |           |           |          |           |       |
| Commercial                  | 1,141     | 1,141     | \$ 1,040 | 968       |       |
| Real estate:                |           |           |          |           |       |
| Commercial                  | 3,028     | 3,028     | 541      | 2,836     |       |
| Residential                 | 992       | 992       | 533      | 1,455     | 2     |
| Consumer                    | 89        | 89        | 89       | 103       |       |
| Total                       | 5,250     | 5,250     | 2,203    | 5,362     | 2     |
| Commercial                  | 2,314     | 3,524     | 1,040    | 2,231     | 17    |
| Real estate:                |           |           |          |           |       |
| Commercial                  | 6,190     | 6,860     | 541      | 5,783     | 32    |
| Residential                 | 3,208     | 3,391     | 533      | 4,087     | 3     |
| Consumer                    | 178       | 178       | 89       | 163       |       |
| Total                       | \$ 11,890 | \$ 13,953 | \$ 2,203 | \$ 12,264 | \$ 52 |

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| December 31, 2015           | Recorded<br>Investment | Unpaid<br>Principal<br>Balance | Related<br>Allowance | For the Year Ended<br>Average<br>Recorded<br>Investment | Interest<br>Income<br>Recognized |
|-----------------------------|------------------------|--------------------------------|----------------------|---|----------------------------------|
| With no related allowance:  |                        |                                |                      |   |                                  |
| Commercial                  | \$ 1,352               | \$ 2,720                       |                      | \$ 1,848  | \$ 87                            |
| Real estate:                |                        |                                |                      |   |                                  |
| Commercial                  | 2,731                  | 3,408                          |                      | 2,394   | 95                               |
| Residential                 | 3,048                  | 3,231                          |                      | 2,664   | 4                                |
| Consumer                    | 31                     | 31                             |                      | 17  |                                  |
| Total                       | 7,162                  | 9,390                          |                      | 6,923   | 186                              |
| With an allowance recorded: |                        |                                |                      |   |                                  |
| Commercial                  | 795                    | 795                            | \$ 759               | 1,680   | 40                               |
| Real estate:                |                        |                                |                      |   |                                  |
| Commercial                  | 2,643                  | 2,643                          | 233                  | 4,155   | 86                               |
| Residential                 | 1,918                  | 1,918                          | 1,138                | 1,776   | 30                               |
| Consumer                    | 117                    | 117                            | 117                  | 126   |                                  |
| Total                       | 5,473                  | 5,473                          | 2,247                | 7,737   | 156                              |
| Commercial                  | 2,147                  | 3,515                          | 759                  | 3,528   | 127                              |
| Real estate:                |                        |                                |                      |   |                                  |
| Commercial                  | 5,374                  | 6,051                          | 233                  | 6,549   | 181                              |
| Residential                 | 4,966                  | 5,149                          | 1,138                | 4,440   | 34                               |
| Consumer                    | 148                    | 148                            | 117                  | 143   |                                  |
| Total                       | \$ 12,635              | \$ 14,863                      | \$ 2,247             | \$ 14,660   | \$ 342                           |

| March 31, 2015             | Recorded<br>Investment | Unpaid<br>Principal<br>Balance | Related<br>Allowance | For the Quarter Ended<br>Average<br>Recorded<br>Investment | Interest<br>Income<br>Recognized |
|----------------------------|------------------------|--------------------------------|----------------------|--|----------------------------------|
| 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   |                                  |
| Total                      | 6,800                  | 9,303                          |                      | 7,433  | 40                               |

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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        |       |
| Total        | 7,293     | 7,293     | 3,131    | 6,909     | 41    |
| 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       |       |
| Total        | \$ 14,093 | \$ 16,596 | \$ 3,131 | \$ 14,342 | \$ 81 |

Included in the commercial loan and commercial and residential real estate categories are troubled debt restructurings that are classified as impaired. Troubled debt restructurings totaled \$2,834 at March 31, 2016, \$2,861 at December 31, 2015 and \$2,967 at March 31, 2015.

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Peoples Financial Services Corp.

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(Dollars in thousands, except per share data)

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

- Rate Modification - A modification in which the interest rate is changed to a below market rate.
- Term Modification - A modification in which the maturity date, timing of payments or frequency of payments is changed.
- Interest Only Modification - A modification in which the loan is converted to interest only payments for a period of time.
- Payment Modification - A modification in which the dollar amount of the payment is changed, other than an interest only modification described above.
- Combination Modification - Any other type of modification, including the use of multiple categories above.

There was one loan modified as a troubled debt restructuring for the three months ended March 31, 2016, in the amount of \$75. There were four loans modified as troubled debt restructurings for the three months ended March 31, 2015, in the amount of \$384. During the three months ended March 31, 2016, there were two payment defaults on restructured residential real estate loans totaling \$208; there were no payment defaults during the three months ended March 31, 2015.

6. Other assets:

The components of other assets at March 31, 2016, and December 31, 2015 are summarized as follows:

|   | March 31, 2016 | December 31, 2015 |
|---|----------------|-------------------|
| Other real estate owned                   | \$ 1,409       | \$ 957            |
| Investment in residential housing program | 8,669          | 6,744             |
| Mortgage servicing rights                 | 669            | 465               |
| Bank owned life insurance                 | 32,476         | 30,782            |
| Restricted equity securities              | 6,201          | 5,403             |
| Other assets                              | 14,179         | 14,136            |
| Total                                     | \$ 63,603      | \$ 58,487         |

#### 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

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Peoples Financial Services Corp.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Dollars in thousands, except per share data)

regard, the derived fair value estimates cannot be substantiated by comparison to independent markets. In many cases, these values cannot be realized in immediate settlement of the instrument.

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

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

- Level 1: Unadjusted quoted prices of identical assets or liabilities in active markets that the entity has the ability to access as of the measurement date.
- Level 2: Significant other observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data.
- Level 3: Significant unobservable inputs that reflect a reporting entity's own assumptions about the assumptions that market participants would use in pricing an asset or liability.

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

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

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

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

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

**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.

Loans acquired in connection with business combinations are 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

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adjustment on distressed loans represents the portion of the loan balance that has been deemed uncollectible based on the management's expectations of future cash flows for each respective loan.

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

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

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

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

The fair value assigned to the core deposit intangible asset represents the future economic benefit of the potential cost savings from acquiring core deposits in the 2013 Pensco merger compared to the cost of obtaining alternative funding such as brokered deposits from market sources. Management utilized an income valuation approach to present value the estimated future cash savings in order to determine the fair value of the intangible asset.

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



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

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

Off-balance sheet financial instruments:

The majority of commitments to extend credit, unused portions of lines of credit and standby letters of credit carry current market interest rates if converted to loans. Because such commitments are generally unassignable of either the Company or the borrower, they only have value to the Company and the borrower. None of the commitments are subject to undue credit risk. The estimated fair values of off-balance sheet financial instruments are based on fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the counterparties' credit standing. The fair value of off-balance sheet financial instruments was not material at March 31, 2016 and December 31, 2015.

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## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Dollars in thousands, except per share data)

Assets and liabilities measured at fair value on a recurring basis at March 31, 2016 and December 31, 2015 are summarized as follows:

|  | Fair Value Measurement Using |   |  |  |
|--|------------------------------|---|--|--|
|  | Amount                       | Quoted Prices in<br>Active Markets for<br>Identical Assets<br>(Level 1) | Significant<br>Other Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| March 31, 2016   |                              |   |  |  |
| U.S. Government-sponsored enterprises<br>State and Municipals: | \$ 65,054                    | \$  | \$ 65,054  | \$   |
| Taxable  | 15,783                       |   | 15,783   |  |
| Tax-exempt   | 124,014                      |   | 124,014  |  |
| Mortgage-backed securities:                                    |                              |   |  |  |
| U.S. Government agencies                                       | 29,208                       |   | 29,208   |  |
| U.S. Government-sponsored enterprises                          | 30,116                       |   | 30,116   |  |
| Total  | \$ 264,175                   | \$  | \$ 264,175   | \$   |

|  | Fair Value Measurement Using |   |  |  |
|--|------------------------------|---|--|--|
|  | Amount                       | Quoted Prices in<br>Active Markets for<br>Identical Assets<br>(Level 1) | Significant<br>Other Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| December 31, 2015  |                              |   |  |  |
| U.S. Treasury securities                                       | \$ 9,999                     | \$ 9,999  |  | \$   |
| U.S. Government-sponsored enterprises<br>State and Municipals: | 69,060                       |   | \$ 69,060  |  |
| Taxable  | 16,545                       |   | 16,545   |  |
| Tax-exempt   | 124,924                      |   | 124,924  |  |
| Mortgage-backed securities:                                    |                              |   |  |  |
| U.S. Government agencies                                       | 31,568                       |   | 31,568   |  |
| U.S. Government-sponsored enterprises                          | 32,839                       |   | 32,839   |  |
| Total  | \$ 284,935                   | \$ 9,999  | \$ 274,936   | \$   |

Assets and liabilities measured at fair value on a nonrecurring basis at March 31, 2016 and December 31, 2015 are summarized as follows:

|                         | Fair Value Measurement Using | Quoted Prices in   | Significant      | Significant  |
|-------------------------|------------------------------|--------------------|------------------|--------------|
|                         | Amount                       | Active Markets for | Other Observable | Unobservable |
|                         |                              | Identical Assets   | Inputs           | Inputs       |
|                         |                              | (Level 1)          | (Level 2)        | (Level 3)    |
| March 31, 2016          |                              |                    |                  |              |
| Impaired loans          | \$ 4,549                     |                    |                  | \$ 4,549     |
| Other real estate owned | \$ 1,242                     |                    |                  | \$ 1,242     |

|                         | Fair Value Measurement Using | Quoted Prices in   | Significant Other | Significant  |
|-------------------------|------------------------------|--------------------|-------------------|--------------|
|                         | Amount                       | Active Markets for | Observable        | Unobservable |
|                         |                              | Identical Assets   | Inputs            | Inputs       |
|                         |                              | (Level 1)          | (Level 2)         | (Level 3)    |
| December 31, 2015       |                              |                    |                   |              |
| Impaired loans          | \$ 4,944                     |                    |                   | \$ 4,944     |
| Other real estate owned | \$ 878                       |                    |                   | \$ 878       |

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.

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Peoples Financial Services Corp.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Dollars in thousands, except per share data)

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

|                         | Quantitative Information about Level 3 Fair Value Measurements |                         |                       |                       |
|-------------------------|--|-------------------------|-----------------------|-----------------------|
|                         | Fair Value   |                         |                       | Range                 |
| March 31, 2016          | Estimate   | Valuation Techniques    | Unobservable Input    | (Weighted Average)    |
| Impaired loans          | \$ 4,549   | Appraisal of collateral | Appraisal adjustments | 3.6% to 97.0% (59.7)% |
|                         |  |                         | Liquidation expenses  | 3.0% to 6.0% (5.4)%   |
| Other real estate owned | \$ 1,242   | Appraisal of collateral | Appraisal adjustments | 19.8% to 77.3%        |
|                         |  |                         | Liquidation expenses  | (27.9)%               |
|                         |  |                         |                       | 3.0% to 6.0% (5.0)%   |

|                         | Quantitative Information about Level 3 Fair Value Measurements |                         |                       |                       |
|-------------------------|--|-------------------------|-----------------------|-----------------------|
|                         | Fair Value   |                         |                       | Range                 |
| December 31, 2015       | Estimate   | Valuation Techniques    | Unobservable Input    | (Weighted Average)    |
| Impaired loans          | \$ 4,944   | Appraisal of collateral | Appraisal adjustments | 3.3% to 97.0% (61.7)% |
|                         |  |                         | Liquidation expenses  | 3.0% to 6.0% (5.4)%   |
| Other real estate owned | \$ 878   | Appraisal of collateral | Appraisal adjustments | 20.0% to 77.3%        |
|                         |  |                         | Liquidation expenses  | (30.3)%               |
|                         |  |                         |                       | 3.0% to 6.0% (5.0)%   |

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

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

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The carrying and fair values of the Company's financial instruments at March 31, 2016 and December 31, 2015 and their placement within the fair value hierarchy are as follows:

|                              | 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) |
| March 31, 2016               |                |              |  |   |   |
| Financial assets:            |                |              |  |   |   |
| Cash and cash equivalents    | \$ 23,998      | \$ 23,998    | \$ 23,998  |   |   |
| Investment securities:       |                |              |  |   |   |
| Available-for-sale           | 264,175        | 264,175      |  | \$ 264,175                                    |   |
| Held-to-maturity             | 11,681         | 12,322       |  | 12,322  |   |
| Loans held for sale          |                |              |  |   |   |
| Net loans                    | 1,395,533      | 1,406,148    |  |   | \$ 1,406,148                              |
| Accrued interest receivable  | 5,455          | 5,455        |  | 5,455   |   |
| Mortgage servicing rights    | 669            | 1,543        |  | 1,543   |   |
| Restricted equity securities | 6,201          | 6,201        |  | 6,201   |   |
| Total                        | \$ 1,707,712   | \$ 1,719,842 |  |   |   |
| Financial liabilities:       |                |              |  |   |   |
| Deposits                     | \$ 1,475,459   | \$ 1,477,233 |  | 1,477,233                                     |   |
| Short-term borrowings        | 60,350         | 60,338       |  | 60,338  |   |
| Long-term debt               | 59,773         | 61,681       |  | 61,681  |   |
| Accrued interest payable     | 506            | 506          |  | \$ 506  |   |
| Total                        | \$ 1,596,088   | \$ 1,599,758 |  |   |   |

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Peoples Financial Services Corp.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Dollars in thousands, except per share data)

|                              | Carrying<br>Value | Fair<br>Value | Fair Value Hierarchy   |   |  |
|------------------------------|-------------------|---------------|--|---|--|
|                              |                   |               | Quoted<br>Prices in<br>Active<br>Markets for<br>Identical<br>Assets<br>(level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| December 31, 2015            |                   |               |  |   |  |
| Financial assets:            |                   |               |  |   |  |
| Cash and cash equivalents    | \$ 32,917         | \$ 32,917     | \$ 32,917  |   |  |
| Investment securities:       |                   |               |  |   |  |
| Available-for-sale           | 284,935           | 284,935       | \$ 9,999   | \$ 274,936  |  |
| Held-to-maturity             | 12,109            | 12,606        |  | 12,606  |  |
| Loans held for sale          |                   |               |  |   |  |
| Net loans                    | 1,327,890         | 1,330,900     |  |   | \$ 1,330,900                                       |
| Accrued interest receivable  | 5,796             | 5,796         |  | 5,796   |  |
| Mortgage servicing rights    | 465               | 1,543         |  | 1,543   |  |
| Restricted equity securities | 5,403             | 5,403         |  | 5,403   |  |
| Total                        | \$ 1,669,515      | \$ 1,674,100  |  |   |  |
| Financial liabilities:       |                   |               |  |   |  |
| Deposits                     | \$ 1,455,810      | \$ 1,455,979  |  | 1,455,979   |  |
| Short-term borrowings        | 38,325            | 38,325        |  | 38,325  |  |
| Long-term debt               | 60,354            | 61,412        |  | 61,412  |  |
| Accrued interest payable     | 560               | 560           |  | \$ 560  |  |
| Total                        | \$ 1,555,049      | \$ 1,556,276  |  |   |  |

## 8. Employee benefit plans:

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

For the three months ended March 31, salaries and employee benefits expense includes approximately \$274 in 2016 and \$279 in 2015 relating to the employee benefit plans.

Components of net periodic benefit cost are as follows:

| Three Months Ended March 31,<br>Components of net periodic pension cost: | Pension Benefits |        |
|--|------------------|--------|
|  | 2016             | 2015   |
| Service cost   | \$ 166           | \$ 174 |
| Interest cost  | (223)            | (233)  |
| Amortization of unrecognized net gain                                    | 52               | 50     |
| Net periodic other benefit cost  | \$ (5)           | \$ (9) |

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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, 2015.

Cautionary Note Regarding Forward-Looking Statements:

This report contains forward-looking statements within the meaning of Section 27A of the Securities Act, as amended, and 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 Financial Services Corporation or other risks associated with business combinations; 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; inability of third party service providers to perform; and our ability to prevent, detect and respond to cyberattacks. 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, 2015, and in reports we file with the Securities and Exchange Commission from time to time.



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

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

#### Critical Accounting Policies:

Disclosure of our significant accounting policies are included in Note 1 to the consolidated financial statements of the Annual Report on Form 10-K for the year ended December 31, 2015. Some of these policies are particularly sensitive requiring significant judgments, estimates and assumptions.

#### Operating Environment:

The Federal Open Market Committee ("FOMC") remained on hold during the first quarter of 2016 citing global conditions, soft business investment, and weak exports as areas of concern. The FOMC noted improvement in labor markets. However, moderation to household spending was also noted although household real income has risen and consumer sentiment remains high. First quarter gross domestic product ("GDP"), the value of all goods and services produced in the Nation, came in at an annualized rate of 0.5% for the first quarter of 2016, down from 1.4% in the fourth quarter of 2015 while the consumer price index ("CPI") increased only moderately for the 12 months ended March 31, 2016 at 2.2% from 2.1% for the 12 months ended December 31, 2015.

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Peoples Financial Services Corp.

Management's Discussion and Analysis

(Dollars in thousands, except per share data)

Review of Financial Position:

Total assets increased \$43,312, or 9.6% annualized, to \$1,862,370 at March 31, 2016, from \$1,819,058 at December 31, 2015. Loans, net increased to \$1,409,691 at March 31, 2016, compared to \$1,340,865 at December 31, 2015, an increase of \$68,826 or 20.6% annualized. The increase in loans, net during 2016 has been funded through a decrease of investment securities available-for-sale and increases in deposits and short-term borrowings. Investment securities decreased \$21,188 or 7.1% in 2016. Interest-bearing deposits increased \$17,171; noninterest-bearing deposits increased \$2,478. Total stockholders' equity increased \$2,677 or at an annual rate of 4.4%, from \$248,768 at year-end 2015 to \$251,445 at March 31, 2016. For the three months ended March 31, 2016, total assets averaged \$1,851,643, an increase of \$140,304 from \$1,711,339 for the same period of 2015.

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 \$264,175 at March 31, 2016, a decrease of \$20,760, or 7.3% from \$284,935 at December 31, 2015. 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 maturing and called bonds, as well as payments from mortgage backed holdings. The proceeds were utilized to fund loan demand. Investment securities held-to-maturity totaled \$11,681 at March 31, 2016, a decrease of \$428 or 3.5% from \$12,109 at December 31, 2015 due to payments received from mortgage backed holdings.

For the three months ended March 31, 2016, the investment portfolio averaged \$287,207, a decrease of \$25,868 or 8.3% compared to \$313,075 for the same period last year. The tax-equivalent yield on the investment portfolio increased 8 basis points to 2.86% for the three months ended March 31, 2016, from 2.78% for the comparable period of 2015.

Securities available-for-sale are carried at fair value, with unrealized gains or losses net of deferred income taxes reported in the accumulated other comprehensive income (loss) component of stockholders' equity. We reported net

unrealized gains, included as a separate component of stockholders' equity of \$3,475, net of deferred income taxes of \$1,871, at March 31, 2016, and \$2,986, net of deferred income taxes of \$1,607, at December 31, 2015.

Our 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 endeavor to maintain sufficient liquidity to satisfy depositor requirements and meet the credit needs of our customers.

#### Loan Portfolio:

Loan growth continued to be strong in the three month period ended March 31, 2016. Loans, net increased to \$1,409,691 at March 31, 2016 from \$1,340,865 at December 31, 2015, an increase of \$68,826 or 20.6% annualized. The growth reflected increases in commercial loans, commercial real estate loans and consumer loans, partially offset by a decrease in residential real estate loans. Commercial loans increased \$29,640, or 32.6% annualized, to \$395,407 at March 31, 2016 compared to \$365,767 at December 31, 2015. Commercial real estate loans increased \$31,598 or 22.4% annualized, to \$598,875 at March 31, 2016 compared to \$567,277 at December 31, 2015. Consumer loans increased \$12,120, or 48.0% on an annualized basis, to \$113,723 at March 31, 2016 compared to \$101,603 at December 31, 2015. The primary contributor to the growth in consumer loans was our indirect loan portfolio which increased \$13,615.

Residential real estate loans decreased \$4,532, or 6.0% on an annualized basis, to \$301,686 at March 31, 2016 compared to \$306,218 at December 31, 2015. The majority of residential real estate loans originated were sold into the secondary market instead of carried in the portfolio to mitigate interest rate risk in the current low rate environment.

For the three months ended March 31, 2016, loans, net averaged \$1,380,817, an increase of \$155,048 or 12.7% compared to \$1,225,769 for the same period of 2015. The tax-equivalent yield on the loan portfolio was 4.52% for the three months ended March 31, 2016, an 18 basis point decrease from the comparable period last year. Loan accretion income in the first three months of 2016 and 2015, which we recognized as a result of the 2013 Pensco merger, was \$215 and \$225. As a result, the tax-equivalent yield on the loan portfolio would have decreased 17 basis points

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comparing the three month ended March 31, 2016 and 2015. The tax-equivalent yield on the loan portfolio remained constant at 4.52% for the first quarter of 2016 as compared to the fourth quarter of 2015.

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

Unused commitments at March 31, 2016, totaled \$375,197, consisting of \$352,917 in unfunded commitments of existing loan facilities and \$22,280 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, 2015 totaled \$329,822, consisting of \$309,805 in unfunded commitments of existing loans and \$20,017 in standby letters of credit.

Asset Quality:

National, Pennsylvania, New York and market area unemployment rates at March 31, 2016 and 2015, are summarized as follows:

|                   | March 31, 2016 |   | March 31, 2015 |   |
|-------------------|----------------|---|----------------|---|
| United States     | 5.0            | % | 5.5            | % |
| New York          | 5.3            |   | 6.1            |   |
| Pennsylvania      | 5.3            |   | 5.7            |   |
| Broome County     | 6.0            |   | 7.1            |   |
| Bucks County      | 4.5            |   | 5.1            |   |
| Lackawanna County | 5.7            |   | 6.5            |   |
| Lehigh County     | 5.3            |   | 5.9            |   |
| Luzerne County    | 6.5            |   | 7.3            |   |

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|                    |     |   |     |   |
|--------------------|-----|---|-----|---|
| Monroe County      | 6.2 |   | 7.2 |   |
| Montgomery County  | 4.0 |   | 4.5 |   |
| Susquehanna County | 6.4 |   | 6.6 |   |
| Wayne County       | 6.7 |   | 7.5 |   |
| Wyoming County     | 7.0 | % | 6.8 | % |

The employment conditions improved for the Nation, Pennsylvania, and New York and in all but one of the ten counties representing our market areas in Pennsylvania and New York from one year ago. Unemployment rates remained elevated relative to historical levels within many of our market areas.

Our asset quality improved slightly in the first quarter of 2016. Nonperforming assets decreased \$58 or 0.5% to \$12,406 at March 31, 2016, from \$12,464 at December 31, 2015. We experienced a decrease in nonaccrual and restructured loans, which was partially offset by an increase in other real estate owned and accruing loans past due 90 days or more. As a percentage of loans, net and foreclosed assets, nonperforming assets equaled 0.88% at March 31, 2016 compared to 0.93% at December 31, 2015.

Loans on nonaccrual status decreased \$720 to \$9,651 at March 31, 2016 from \$10,371 at December 31, 2015. The majority of the decrease from year end was due to a decrease of \$1,755 in residential real estate loans. Nonaccrual commercial loans increased \$181, commercial real estate loans increased \$824, and nonaccrual consumer loans increased \$30. Other real estate owned increased \$452 to \$1,409 at March 31, 2016 from \$957 at December 31, 2015, as loans were transferred from non-accrual status.

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

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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 \$1,183 to \$14,158 at March 31, 2016, from \$12,975 at the end of 2015. For the three months ended March 31, 2016, net charge-offs were \$17 or 0.01% of average loans outstanding, a \$268 decrease compared to \$285 or 0.09% of average loans outstanding in the same period of 2015.

Deposits:

We attract the majority of our deposits from within our ten county market area that stretches from Montgomery County in Pennsylvania to Broome County in the Southern Tier of New York State through the offering of various deposit instruments including demand deposit accounts, NOW accounts, money market deposit accounts, savings

accounts, and time deposits, including certificates of deposit and IRA's. For the three months ended March 31, 2016, total deposits increased to \$1,475,459 from \$1,455,810 at December 31, 2015. Interest-bearing deposits increased \$17,171 and noninterest-bearing deposits increased \$2,478. Interest-bearing transaction accounts, including NOW and money market accounts, increased \$11,417, or 9.7% annualized, to \$487,679 at March 31, 2016, from \$476,262 at December 31, 2015. Time deposits less than \$100 decreased \$434, or 1.0% annualized, to \$183,460 at March 31, 2016, from \$183,894 at December 31, 2015. Increases in savings accounts of \$3,631 and time deposits \$100 or more of \$2,557 were recorded in the three months ended March 31, 2016.

For the three months ended March 31, 2016 interest-bearing deposits averaged \$1,159,159 in 2016 compared to \$1,109,914 in 2015. The cost of interest-bearing deposits was 0.45% in 2016 compared to 0.46% for the same period last year. For the first three months, the overall cost of interest-bearing liabilities including the cost of borrowed funds, was 0.54% in both 2016 and 2015.

#### Borrowings:

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

Total short-term borrowings at March 31, 2016, totaled \$60,350 compared to \$38,325 at December 31, 2015, an increase of \$22,025. Long-term debt was \$59,773 at March 31, 2016, compared to \$60,354 at year end 2015. The increase in short-term borrowing was a function of strong loan demand whereas the decline in long-term debt was a product of monthly contractual amortized payments made during the three months ended March 31, 2016.

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Market Risk Sensitivity:

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

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

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



RSA/RSL ratio of less than 1.0. A positive gap implies that earnings will be impacted favorably if interest rates rise and adversely if interest rates fall during the period. A negative gap tends to indicate that earnings will be affected inversely to interest rate changes.

Our cumulative one-year RSA/RSL ratio equaled 1.87% at March 31, 2016. Given the length of time that market rates have been at historical lows and the potential for rates to increase in the future, the focus of ALCO has been to create a positive static gap position. With regard to RSA, we predominantly offer medium-term, fixed-rate loans as well as adjustable rate loans. With respect to RSL, we offer longer term promotional certificates of deposit in an attempt to increase duration. The current position at March 31, 2016, indicates that the amount of RSA repricing within one year would exceed that of RSL, thereby causing net interest income to increase as market rates increase. However, these forward-looking statements are qualified in the aforementioned section entitled "Forward-Looking Discussion" in this Management's Discussion and Analysis.

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

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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, 2016, 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 2016 and endeavor to employ deposit and loan pricing strategies and direct the reinvestment of loan and investment repayments in order to manage our IRR position.

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

Liquidity:

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

- Funding new and existing loan commitments;
- Payment of deposits on demand or at their contractual maturity;
- Repayment of borrowings as they mature;
- Payment of lease obligations; and
- Payment of operating expenses.

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

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

We employ a number of analytical techniques in assessing the adequacy of our liquidity position. One such technique is the use of ratio analysis to determine the extent of our reliance on noncore funds to fund our investments and loans maturing after March 31, 2016. Our noncore funds at March 31, 2016, were comprised of time deposits in denominations of \$100 or more and other borrowings. These funds are not considered to be a strong source of liquidity because they are very interest rate sensitive and are considered to be highly volatile. At March 31, 2016, our net noncore funding dependence ratio, the difference between noncore funds and short-term investments to long-term assets, was 13.9%, while our net short-term noncore funding dependence ratio, noncore funds maturing within one-year, less short-term investments to long-term assets equaled 6.6%. Comparatively, our overall noncore dependence ratio at year-end 2015 was 11.3% and our net short-term noncore funding dependence ratio was 4.1%, indicating that our reliance on noncore funds has increased.

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, decreased \$8,919 during the three months ended March 31, 2016. Cash and cash equivalents increased \$8,205 for the same period last year. For the three months ended March 31, 2016, net cash inflows of \$6,633 from operating activities and \$38,538 from financing activities were more than offset by net cash outflows of \$54,090 from investing activities. For the same period of 2015, net cash inflows of \$7,361 from

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operating activities and \$32,631 from investing activities were partially offset by net cash outflows of \$31,787 from financing activities.

Operating activities provided net cash of \$6,633 for the three months ended March 31, 2016, and \$7,361 for the corresponding three months of 2015. Net income, adjusted for the effects of gains and losses along with noncash transactions such as depreciation and the provision for loan losses, is the primary source of funds from operations.

Investing activities primarily include transactions related to our lending activities and investment portfolio. Investing activities used net cash of \$54,090 for the three months ended March 31, 2016, compared to providing \$32,631 for the same period of 2015. In 2016, an increase in lending activities was the primary factor causing the net cash outflow from investing activities. Investment portfolio activities was the predominant factor causing the net cash inflow from investing activities in 2015.

Financing activities provided net cash of \$38,538 for the three months ended March 31, 2016, and used net cash of \$31,787 for the corresponding three months of 2015. Deposit gathering is our predominant financing activity. Deposits increased for the three months ended March 31, 2016 and decreased during the three months ended March 31, 2015. The net increase in deposits totaled \$19,798 in the three months ended March 31, 2016. Comparatively, deposit runoff used net cash of \$9,081 for the same period of 2015. We continued to attract deposits from new markets and customers as well as existing customers, including municipalities and school districts, and deposits gathered in relation to natural gas activity within existing markets in Susquehanna and Wyoming Counties of Pennsylvania. Another source of financing is our short term borrowings which increased \$22,025 in the three months ended March 31, 2016 compared to a net decrease of \$19,557 in the first quarter of 2015.

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 \$251,445 or \$33.98 per share at March 31, 2016, compared to \$248,768 or \$32.57 per share at December 31, 2015. Net income of \$4,882 for the three months ended March 31, 2016 was the primary factor leading to the improved capital position. Stockholders' equity was also affected by cash dividends declared of \$2,295, shares retired of \$417, stock based compensation of \$18, and other comprehensive income resulting from market value fluctuations in the investment portfolio of \$489.

Dividends declared equaled \$0.31 per share for the first quarter of 2016 and 2015. The dividend payout ratio was 47.0% for the three months ended March 31, 2016 and 46.4% for the same period of 2015. 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.

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 quarter ended March 31, 2015. Under the final capital rules that became effective on January 1, 2015, there was a requirement for a CET1 capital conservation buffer of 2.5% of risk-weighted assets which is in addition to the other minimum risk-based capital

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standards in the rule. Institutions that do not maintain this required capital buffer will become subject to progressively more stringent limitations on the percentage of earnings that can be paid out in dividends or used for stock repurchases and on the payment of discretionary bonuses to senior executive management. The capital buffer requirement is being phased in over three years beginning in 2016.

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, 2016, the Bank's Tier 1 capital to total average assets was 10.17% as compared to 10.48% at December 31, 2015. The Bank's Tier 1 capital to risk weighted asset ratio was 12.52% and the total capital to risk weighted asset ratio was 13.50% at March 31, 2016. These ratios were 13.11% and 14.05% at December 31, 2015. The Bank's common equity Tier 1 to risk weighted asset ratio was 12.52% at March 31, 2016 compared to 13.11% at December 31, 2015. The Bank was deemed to be well-capitalized under regulatory standards at March 31, 2016. Additionally, as of March 31, 2016, the Bank would meet all capital adequacy requirements under the Basel III Capital Rules on a fully phased-in basis as if all such requirements were currently in effect.

Review of Financial Performance:

Net income for the first quarter of 2016 equaled \$4,882 or \$0.66 per share compared to \$5,044 or \$0.67 per share for the first quarter of 2015. Return on average assets ("ROA") measures our net income in relation to total assets. Our ROA was 1.06% for the first quarter of 2016 compared to 1.20% for the same period of 2015. Return on average equity ("ROE") indicates how effectively we can generate net income on the capital invested by stockholders. Our ROE was 7.85% for the first quarter of 2016 compared to 8.28% for the comparable period in 2015. Gains on sale of investment securities were \$242 for the three months ended March 31, 2016 and \$832 for the same period in 2015.

Net Interest Income:

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

interest-bearing deposits, short-term and long-term borrowings comprise interest-bearing liabilities. Net interest income is impacted by:

- Variations in the volume, rate and composition of earning assets and interest-bearing liabilities;
- Changes in general market rates; and
- The level of nonperforming assets.

Changes in net interest income are measured by the net interest spread and net interest margin. Net interest spread, the difference between the average yield earned on earning assets and the average rate incurred on interest-bearing liabilities, illustrates the effects changing interest rates have on profitability. Net interest margin, net interest income as a percentage of earning assets, is a more comprehensive ratio, as it reflects not only the spread, but also the change in the composition of interest-earning assets and interest-bearing liabilities. Tax-exempt loans and investments carry pre-tax yields lower than their taxable counterparts. Therefore, in order to make the analysis of net interest income more comparable, tax-exempt income and yields are reported herein on a tax-equivalent basis using the prevailing federal statutory tax rate of 35.0% in 2016 and 2015.

For the three months ended March 31, tax-equivalent net interest income increased \$1,014 to \$15,841 in 2016 from \$14,827 in 2015. The net interest spread decreased to 3.68% for the three months ended March 31, 2016 from 3.74% for the three months ended March 31, 2015. The tax-equivalent net interest margin decreased to 3.81% for the first quarter of 2016 from 3.88% for the comparable period of 2015. The tax-equivalent net interest margin for the fourth quarter of 2015 was 3.79%. Loan accretion in the first quarter of 2016 related to loans acquired in the 2013 Pensco merger was \$215, resulting in an increase in the tax-equivalent net interest margin of 5 basis points. Comparatively, loan accretion recognized on these loans in the first quarter of 2015 was \$225 resulting in an increase in the tax-equivalent net interest

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margin of 6 basis points. Without such interest income, the tax equivalent net interest margin for the three months ended March 31 would have been 3.76% in 2016 and 3.82% in 2015.

For the three months ended March 31, tax-equivalent interest income on earning assets increased \$1,199, to \$17,561 in 2016 as compared to \$16,362 in 2015. The overall yield on earning assets, on a fully tax-equivalent basis, decreased 6 basis points for the three months ended March 31, 2016 59 4.22% as compared to 4.28% for the three months ended March 31, 2015. The decrease in the yield on earning assets resulted from loans being originated or renewed at market rates, which are lower than those maturing and amortizing. The overall yield earned on loans decreased 18 basis points for the first quarter of 2016 to 4.52% from 4.70% for the first quarter of 2015. Average loans increased to \$1,380,817 for the quarter ended March 31, 2016 compared to \$1,225,769 for the same period in 2015. The resulting tax-equivalent interest earned on loans was \$15,501 for the three month period ended March 31, 2016 compared to \$14,200 for the same period in 2015, an increase of \$1,300.

Total interest expense increased \$185, to \$1,720 for the three months ended March 31, 2016 from \$1,535 for the three months ended March 31, 2015. An unfavorable volume variance caused the increase. An increase in the average volume of interest bearing liabilities of \$119,646 coupled with the unchanged cost of funds comparing the three months ended March 31, 2016 and 2015 caused the increase.

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



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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%.

|                                       | Three months ended |                             |                |  | March 2015         |                             |                |
|---------------------------------------|--------------------|-----------------------------|----------------|--|--------------------|-----------------------------|----------------|
|                                       | March 2016         |                             |                |  | March 2015         |                             |                |
|                                       | Average<br>Balance | Interest<br>Income/Interest | Yield/<br>Rate |  | Average<br>Balance | Interest<br>Income/Interest | Yield/<br>Rate |
| Assets:                               |                    |                             |                |  |                    |                             |                |
| Earning assets:                       |                    |                             |                |  |                    |                             |                |
| Loans:                                |                    |                             |                |  |                    |                             |                |
| Taxable                               | \$ 1,276,491       | \$ 14,346                   | 4.52 %         |  | \$ 1,155,435       | \$ 13,340                   | 4.68 %         |
| Tax-exempt                            | 104,326            | 1,155                       | 4.45           |  | 70,334             | 860                         | 4.96           |
| Investments:                          |                    |                             |                |  |                    |                             |                |
| Taxable                               | 159,584            | 697                         | 1.76           |  | 219,360            | 909                         | 1.68           |
| Tax-exempt                            | 127,623            | 1,346                       | 4.24           |  | 93,715             | 1,238                       | 5.36           |
| Interest-bearing deposits             | 4,686              | 17                          | 1.46           |  | 2,718              | 8                           | 1.19           |
| Federal funds sold                    |                    |                             |                |  | 8,674              | 7                           | 0.33           |
| Total earning assets                  | 1,672,710          | 17,561                      | 4.22 %         |  | 1,550,236          | 16,362                      | 4.28 %         |
| Less: allowance for loan losses       | 13,410             |                             |                |  | 10,447             |                             |                |
| Other assets                          | 192,343            |                             |                |  | 171,550            |                             |                |
| Total assets                          | \$ 1,851,643       |                             |                |  | \$ 1,711,339       |                             |                |
| Liabilities and Stockholders' Equity: |                    |                             |                |  |                    |                             |                |
| Interest-bearing liabilities:         |                    |                             |                |  |                    |                             |                |
| Money market accounts                 | \$ 206,602         | 177                         | 0.34 %         |  | \$ 251,628         | 225                         | 0.36 %         |
| NOW accounts                          | 293,002            | 278                         | 0.38           |  | 399,069            | 250                         | 0.25           |
| Savings accounts                      | 389,230            | 175                         | 0.18           |  | 197,795            | 188                         | 0.39           |
| Time deposits less than \$100         | 165,389            | 435                         | 1.06           |  | 170,998            | 449                         | 1.06           |
| Time deposits \$100 or more           | 104,936            | 218                         | 0.84           |  | 90,424             | 156                         | 0.70           |
| Short-term borrowings                 | 53,436             | 77                          | 0.58           |  | 10,373             | 8                           | 0.31           |
| Long-term debt                        | 60,064             | 360                         | 2.41           |  | 32,726             | 259                         | 3.21           |
| Total interest-bearing liabilities    | 1,272,659          | 1,720                       | 0.54           |  | 1,153,013          | 1,535                       | 0.54           |
|                                       | 313,908            |                             |                |  | 298,166            |                             |                |

|  |              |      |   |              |        |
|--|--------------|------|---|--------------|--------|
| Noninterest-bearing deposits               |              |      |   |              |        |
| Other liabilities                          | 15,755       |      |   | 13,240       |        |
| Stockholders' equity                       | 249,321      |      |   | 246,920      |        |
| Total liabilities and stockholders' equity | \$ 1,851,643 |      |   | \$ 1,711,339 |        |
| Net interest income/spread                 | \$ 15,841    | 3.68 | % | \$ 14,827    | 3.74 % |
| Net interest margin                        |              | 3.81 | % |              | 3.88 % |
| Tax-equivalent adjustments:                |              |      |   |              |        |
| Loans                                      | \$ 404       |      |   | \$ 301       |        |
| Investments                                | 471          |      |   | 433          |        |
| Total adjustments                          | \$ 875       |      |   | \$ 734       |        |

Provision for Loan Losses:

We evaluate the adequacy of the allowance for loan losses account on a quarterly basis utilizing our systematic analysis in accordance with procedural discipline. We take into consideration certain factors such as composition of the loan portfolio, volumes of nonperforming loans, volumes of net charge-offs, prevailing economic conditions and other relevant factors when determining the adequacy of the allowance for loan losses account. We make monthly provisions to the allowance for loan losses account in order to maintain the allowance at the appropriate level indicated by our evaluations. Based on our most current evaluation, we believe that the allowance is adequate to absorb any known and inherent losses in the portfolio as of March 31, 2016.

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Peoples Financial Services Corp.

Management's Discussion and Analysis

(Dollars in thousands, except per share data)

For the three months ended March 31, 2016, the provision for loan losses totaled \$1,200, compared to \$750 for the same period in 2015. The increase in the provision in the first quarter of 2016 was primarily a result of greater loan growth.

Noninterest Income:

For the three months ended March 31, 2016, noninterest income totaled \$3,891, a decrease of \$418 or 9.7% from \$4,309 for the comparable period of 2015. Service charges, fees and commissions decreased \$168, or 10.4% to \$1,444 through three months in 2016 from \$1,612 for the same period in 2015. Merchant services income increased \$124 to \$914 for the three months ended March 31, 2016 from \$790 for the same period last year as a result of an increase in the number of merchant accounts serviced. Income generated from commissions and fees on fiduciary activities increased \$23 to \$482 for the three months ended March 31, 2016 in comparison to \$459 for the same period in 2015 due to additional executor fees generated in 2016. Income generated from our wealth management division increased \$207 to \$412 through the first three months of 2016 in comparison to \$205 over that same period in 2015 due to the addition of retirement plan servicing to the wealth management platform in 2016. Mortgage banking income decreased \$18 to \$204 for the first three months of 2016 compared to \$222 for the comparable period in 2015 as the volume of loans originated for sale declined. Life insurance investment income increased \$4 to \$193 for the three months ended March 31, 2016 from \$189 for the same period in 2015. We purchased an additional \$1,500 of bank owned life insurance in February 2016. Gains from the sale of investment securities available-for-sale decreased to \$242 for the three months ended March 31, 2016 compared to \$832 for the same period in 2015.

Noninterest Expenses:

In general, noninterest expense is categorized into three main groups: employee-related expenses, occupancy and equipment expenses and other expenses. Employee-related expenses are costs associated with providing salaries, including payroll taxes and benefits, to our employees. Occupancy and equipment expenses, the costs related to the maintenance of facilities and equipment, include depreciation, general maintenance and repairs, real estate taxes, rental expense offset by any rental income, and utility costs. Other expenses include general operating expenses such as advertising, contractual services, insurance, including FDIC assessment, other taxes and supplies. Several of these costs and expenses are variable while the remainder are fixed. We utilize budgets and other related strategies in an effort to control the variable expenses.

For the first quarter, noninterest expense increased \$524 or 4.7% to \$11,618 in 2016 from \$11,094 in 2015. Personnel costs increased 1.9%, net occupancy and equipment costs decreased 1.3%, merchant services expense increased 18.6% and other expenses increased by 14.0% comparing year-to-date 2016 and 2015.

Salaries and employee benefits expense, which comprise the majority of noninterest expense, totaled \$5,332 for the first quarter of 2016, an increase of \$99 or 1.9% when compared to the first quarter of 2015. Costs related to our build out of our expansion plan and wealth management group, as well as standard merit increases contributed to the increase.

We experienced a \$31 or 1.3% decrease in net occupancy and equipment expense comparing \$2,437 for the first quarter of 2016 and \$2,468 for the same period in 2015. Unusually mild winter conditions led to a decrease in heating costs as well as a decrease in costs associated with snow removal during the first part of 2016 when compared to the first three months of 2015.

Merchant services expense increased \$99 or 18.6% to \$632 for the three months ended March 31, 2016 from \$533 for the same period in 2015. The increase due to higher volumes correlates directly to the increase in merchant services income for the quarter ended March 31, 2016.

For the three months ended March 31, other expenses increased \$357 or 14.0% to \$2,912 from \$2,555 comparing 2016 to 2015. Higher contributions to the earned income tax credit (EITC) program of \$205, in the current period, along with higher recruiting costs, coupled with gains on other real estate owned in the prior period were the primary reason for the increase.

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Peoples Financial Services Corp.

Management's Discussion and Analysis

(Dollars in thousands, except per share data)

Income Taxes:

We recorded income tax expense of \$1,157 or 19.2% of pre-tax income, and \$1,514 or 23.1% of pre-tax income for the three months ended March 31, 2016 and 2015. The three months ended March 31, 2016 includes before tax investment tax credits of \$306 compared to \$268 for that same period last year.

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## Item 3. Quantitative and Qualitative Disclosures about Market Risk.

Market risk is the risk to our earnings and/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 interest rate risk (“IRR”), which arises from our lending, investing and deposit gathering activities. Our market risk sensitive instruments consist of non-derivative financial instruments, none of which are entered into for trading purposes. 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 reported earnings and/or the market value of net worth. Variations in interest rates affect the underlying economic value of 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. Interest rate changes affect earnings by changing net interest income and the level of other interest-sensitive income and operating expenses. IRR is inherent in the role of banks as financial intermediaries.

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.

The projected impacts of instantaneous changes in interest rates on our net interest income and economic value of equity at March 31, 2016, based on our simulation model, as compared to our ALCO policy limits are summarized as follows:

| Changes in Interest Rates (basis points) | March 31, 2016                     |        |                          |        |
|--|------------------------------------|--------|--------------------------|--------|
|  | % Change in<br>Net Interest Income |        | Economic Value of Equity |        |
|  | Metric                             | Policy | Metric                   | Policy |
| +400                                     | 4.1                                | (20.0) | 8.3                      | (45.0) |
| +300                                     | 3.6                                | (20.0) | 7.7                      | (35.0) |
| +200                                     | 2.6                                | (10.0) | 6.2                      | (25.0) |
| +100                                     | 1.5                                | (10.0) | 4.3                      | (15.0) |
| Static                                   |                                    |        |                          |        |
| -100                                     | (3.3)                              | (10.0) | (13.3)                   | (15.0) |

Our simulation model creates pro forma net interest income scenarios under various interest rate shocks. Given instantaneous and parallel shifts in general market rates of plus 100 basis points, our projected net interest income for the 12 months ending March 31, 2016, would increase slightly at 1.5 percent from model results using current interest rates. Additional disclosures about market risk are included in Part II, Item 7 of our Annual Report on Form 10-K for the year ended December 31, 2015, under the heading “Market Risk Sensitivity,” and are incorporated into this Item 3 by reference. There were no material changes in our market risk from December 31, 2015.

Item 4. Controls and Procedures.

(a) Evaluation of disclosure controls and procedures.

At March 31, 2016, the end of the period covered by this Quarterly Report on Form 10-Q, the Chief Executive Officer (“CEO”) and Interim Principal Financial and Accounting Officer (“IPFAO”) evaluated the effectiveness of the Company’s disclosure controls and procedures as defined in Rule 13a-15(e) under the Exchange Act. Based upon that evaluation, the CEO and IPFAO concluded that the disclosure controls and procedures, at March 31, 2016, were effective to provide reasonable assurance that information required to be disclosed in the Company’s reports filed under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC’s rules

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and forms, and to provide reasonable assurance that information required to be disclosed in such reports is accumulated and communicated to the CEO and IPFAO to allow timely decisions regarding required disclosure.

(b) Changes in internal control.

There were no changes made in the Company's internal control over financial reporting that occurred during the Company's most recent fiscal quarter that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II—OTHER INFORMATION

Item 1. Legal Proceedings.

The nature of the Company's business generates a certain amount of litigation involving matters arising out of the ordinary course of business. In the opinion of management, there were no legal proceedings that had or might have a material effect on the consolidated results of operations, liquidity, or the financial position of the Company during the three-months ended March 31, 2016 and through the date of this quarterly report on Form 10-Q.

Item 1A. Risk Factors.

There have been no material changes from the risk factors previously disclosed in the Company's Annual Report on Form 10-K for the year ended December 31, 2015.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.

On January 30, 2015, we announced a stock repurchase program providing for the purchase of up to 370,000 shares of our outstanding common stock, and on February 2, 2016, we announced a stock repurchase program providing for the



purchase of up to 225,000 shares of our outstanding common stock. The timing, price and volume of repurchases under both programs were, and under the 2016 program will be, based on market conditions, relevant securities laws and other factors.

The following purchases were made by or on behalf of the Company or any “affiliated purchaser,” as defined in the Exchange Act Rule 10b-18(a)(3), of the Company’s common stock during each of the months for the quarter ended March 31, 2016.

| Month Ending      | Total Number of Shares Purchased | Average Price Paid Per Share | Total Number of Shares Purchased as Part of Publicly Announced Programs(1) | Maximum Number of Shares that may yet be Purchased Under the Programs(1) |
|-------------------|----------------------------------|------------------------------|--|--|
| January 31, 2016  | 6,000                            | \$ 37.41                     | 6,000  | 224,448  |
| February 29, 2016 | 2,167                            | 35.23                        | 2,167  | 222,833  |
| March 31, 2016    | 3,141                            | \$ 36.90                     | 3,141  | 219,692  |

Item 3. Defaults upon Senior Securities.

None.

Item 4. Mine Safety Disclosures.

Not applicable.

Item 5. Other Information.

None.



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Peoples Financial Services Corp.

Item 6. Exhibits.

- 10.1 Separation and Release Agreement dated January 5, 2016, by and between Gregory D. Misterman and Peoples Security Bank and Trust Company, incorporated by reference to Exhibit 10.2 to the Registrant's Current Report on Form 8-K filed with the Commission on January 6, 2016.
- 31.1 Chief Executive Officer certification pursuant to Rule 13a-14(a)/15d-14(a).
- 31.2 Interim Principal Financial and Accounting Officer certification pursuant to Rule 13a-14(a)/15d-14(a).
- 32 Chief Executive Officer and Interim Principal Financial and Accounting Officer certifications pursuant to Section 1350.

101+ Interactive Data File

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+ As provided in Rule 406T of Regulation S-T, this information is furnished and not filed for purposes of Sections 11 and 12 of the Securities Act of 1933 and Section 18 of the Securities Exchange Act of 1934.

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Peoples Financial Services Corp.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto, duly authorized.

Peoples Financial Services Corp.  
(Registrant)

Date: May 6, 2016 /s/ Craig W. Best  
Craig W. Best  
President and Chief Executive Officer  
(Principal Executive Officer)

Date: May 6, 2016 /s/ John R. Anderson, III  
John R. Anderson, III  
Interim Principal Financial and Accounting Officer  
(Interim Principal Financial Officer and Principal Accounting Officer)

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EXHIBIT INDEX

| Item Number | Description  | Page |
|-------------|--|------|
| 10.1        | Separation and Release Agreement dated January 5, 2016, by and between Gregory D. Misterman and Peoples Security Bank and Trust Company, incorporated by reference to Exhibit 10.2 to the Registrant's Current Report on Form 8-K filed with the Commission on January 6, 2016.  |      |
| 31.1        | CEO Certification Pursuant to Rule 13a-14 (a) /15d-14 (a).   | 43   |
| 31.2        | IPFAO Certification Pursuant to Rule 13a-14 (a) /15d-14 (a).   | 44   |
| 32          | CEO and IPFAO Certifications Pursuant to Section 1350.   | 45   |
| 101         | The following materials from Peoples Financial Services Corp. Quarterly Report on Form 10-Q for the period ended March 31, 2016, formatted in XBRL: (i) the Consolidated Balance Sheets, (ii) the Consolidated Statements of Income and Comprehensive Income, (iii) the Consolidated Statements of Changes in Stockholders' Equity, (iv) the Consolidated Statements of Cash Flows and (v) the Notes to the Consolidated Financial Statements. |      |