PEOPLES FINANCIAL SERVICES CORP.
Form 10-K
March 17, 2014
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

(Mark One)

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

For the fiscal year ended December 31, 2013

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

For the transition period from __________ to __________

Commission file number: 000-23863

Peoples Financial Services Corp.

(Exact name of registrant as specified in its charter)

Pennsylvania	**23-2391852**
State or other jurisdiction of incorporation or organization	**(I.R.S. Employer Identification No.)**

150 North Washington Avenue,

Scranton, PA 18503

(Address of principal executive offices) (Zip Code)

(570) 346-7741

Registrant s telephone number, including area code

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

Title of each class	**Name of each exchange on which registered**
None	

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

Common stock, $2.00 par value

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes ¨ No x

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes ¨ No x

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No ¨

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§ 229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ¨

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

Large accelerated filer	¨	Accelerated filer	x
Non-accelerated filer	¨ (Do not check if a smaller reporting company)	Smaller reporting company	¨

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

The aggregate market value of the registrant s common stock held by non-affiliates of the registrant on June 28, 2013 was approximately $101,076,379 (based on the closing sales price of the registrant s common stock on that date).

The number of shares of the registrant s common stock outstanding as of February 28, 2014 was 7,549,557.

DOCUMENTS INCORPORATED BY REFERENCE

The registrant s definitive proxy statement to be filed in connection with solicitation of proxies for its 2014 annual meeting of shareholders, to be filed within 120 days of the end of registrant s fiscal year, is incorporated by reference into Part III of this Annual Report on Form 10-K.

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Peoples Financial Services Corp.

Form 10K

For the Year Ended December 31, 2013

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Cautionary Note Regarding Forward-Looking Statements.

This Annual Report on Form 10-K contains forward-looking statements within the meaning of Section 27A of the Securities Act, as amended, Section 21E of the Securities Exchange Act of 1934, as amended, which are subject to risks and uncertainties. These statements are based on assumptions and may describe future plans, strategies and expectations of Peoples Financial Services Corp. and its direct and indirect subsidiaries. These forward-looking statements are generally identified by use of the words believe, expect, intend, anticipate, estimate, project or expressions. All statements in this report, other than statements of historical facts, are forward-looking statements.

The ability of Peoples Financial Services Corp. to predict results or the actual effect of future plans or strategies is inherently uncertain. Important factors that could cause actual results of Peoples Financial Services Corp. to differ materially from those in the forward-looking statements include, but are not limited to: the ability to timely and efficiently integrate the operations of the former Penseco Financial Services Corporation, and to achieve the intended benefits of the merger with Penseco Financial Services Corporation; changes in interest rates; economic conditions, particularly in the Peoples Financial Services Corp. 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 the Peoples Financial Services Corp. market area; changes in relevant accounting principles and guidelines; and inability of third party service providers to perform. Additional factors that may affect our results are discussed in Item 1A to this Annual Report on Form 10-K titled Risk Factors .

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.

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Part I

Item 1. Business.
General

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, including its subsidiaries, Peoples Advisors, LLC and Penseco Realty, Inc. On November 30, 2013, Penseco Financial Services Corporation, a financial holding company incorporated under the laws of Pennsylvania, referred to as Penseco, merged with and into Peoples Financial Services Corp., with Peoples Financial Services Corp. being the surviving corporation, pursuant to an Agreement and Plan of Merger dated June 28, 2013. Such transaction is sometimes referred to in this annual report as the Penseco merger and such agreement as the Penseco merger agreement. In connection with the Penseco merger, on December 1, 2013, Penseco s former banking subsidiary, Penn Security Bank and Trust Company, merged with and into Peoples Neighborhood Bank, and the resulting institution adopted the name, Peoples Security Bank and Trust Company.

Unless the context indicates otherwise, all references in this annual report to the Peoples, we, us and our refer to Peoples Financial Services Corp., its direct and indirect subsidiaries and its and their respective predecessors. Peoples Security Bank and Trust Company is sometimes referred to as Peoples Bank.

Peoples Bank is a state-chartered bank and trust company under the jurisdiction of the Pennsylvania Department of Banking and Securities and the Federal Deposit Insurance Corporation, or FDIC. Peoples Bank s twenty-six community banking offices, all similar with respect to economic characteristics, share a majority of the following aggregation criteria: products and services; operating processes; customer bases; delivery systems; and regulatory oversight. Accordingly, they are aggregated into a single operating segment.

Peoples Advisors, LLC, provides investment advisory services through a third party to individuals and small businesses. Penseco Realty, Inc. holds and manages real estate assets on behalf of Peoples Bank. Neither Peoples Advisors, LLC nor Penseco Realty, Inc. met the quantitative thresholds for required segment disclosure.

Market Areas

Our principal market area consists of Lackawanna, Luzerne, Monroe, Susquehanna, Wayne and Wyoming Counties in Pennsylvania and Broome County in New York. In addition, parts of Bradford County in Pennsylvania that borders Susquehanna and Wyoming Counties are also considered part of the market area.

Specifically, our market area is situated between:

Binghamton, Broome County, New York, located to the north;

Scranton, Lackawanna County, Pennsylvania, to the south; and

Wilkes-Barre, Luzerne County, Pennsylvania, to the southwest.

Susquehanna County could best be described as a bedroom county with a high percentage of its residents commuting to work in Broome County, New York, or Lackawanna County, Pennsylvania. The southern part of Susquehanna County tends to gravitate south for both employment and shopping, while the northern part of the county goes north to Broome County, New York. The western part of Susquehanna County gravitates south and west to and through Wyoming County. Approximately half of our offices are located in and around Scranton, the largest city in Lackawanna County with the remaining offices located in counties that would be considered sparsely populated, as they are made up of many small towns and villages.

Most recently, the production of natural gas from the Marcellus Shale formation located in the heart of our market area has begun to provide economic benefits to the communities served and as a result to us. Natural gas producers have already invested billions of dollars in Pennsylvania in lease and land acquisition, new well drilling, infrastructure development and community partnerships, with an even greater investment expected in the future. The growth of our deposits, and to a lesser extent, loan portfolio, has been influenced by natural gas drilling activities.

Products and Services

Our primary products are loans to small- and medium-sized businesses. Other lending products include one-to-four family residential mortgages and consumer loans. We fund our loans, primarily, by offering open time deposits to commercial enterprises and individuals. Other deposit products include certificates of deposits and various demand deposit accounts.

Lending Activities

We provide a full range of retail and commercial lending products designed to meet the borrowing needs of consumers and small- and medium-sized businesses in our market areas. A significant amount of our loans are to customers located within our market area. We have no foreign loans or highly leveraged transaction loans, as defined by the Federal Reserve Board. Although we participate in loans originated by other banks, we have originated the majority of loans in our portfolio.

Our retail lending products include the following types of loans, among others: residential real estate; automobiles; manufactured housing; personal; student; home equity, and credit card. Our commercial lending products include the following types of loans, among others: commercial real estate; working capital; equipment and other commercial needs; construction; Small Business Administration, and agricultural and mineral rights. The terms offered on a loan vary depending primarily on the type of loan and credit-worthiness of the borrower.

Payment risk is a function of the economic climate in which our lending activities are conducted. Economic downturns in the economy generally or in a particular sector could cause cash flow problems for customers and make loan payments more difficult. We attempt to minimize this risk by not being exposed to loan concentrations of a single customer or a group of customers, the loss of any one or more of whom would have a materially adverse effect on its financial condition. One element of interest rate risk arises from our fixed rate loans in an environment of changing interest rates. We attempt to mitigate this risk by making adjustable rate commercial loans and by limiting repricing terms to five years or less for customers requiring fixed rate loans. Our lending activity also exposes us to risks that any collateral we take as security is not adequate. We attempt to manage collateral risk by avoiding loan concentrations to particular borrowers, by perfecting liens on collateral and by obtaining appraisals on property prior to extending loans. We attempt to mitigate our exposure to these and other types of risks by stratifying authorization requirements by loan size and complexity.

We generate interest income from our loan and securities portfolios. Other income is generated primarily from merchant transaction fees, trust fees and service charges on deposit accounts. Our primary costs are interest paid on deposits and borrowings and general operating expenses. We provide a variety of commercial and retail banking services to business, non-profits, governmental, municipal agencies and professional customers, as well as retail customers, on a personalized basis. Our primary lending products are real estate, commercial and consumer loans. We also offer ATM access, credit cards, active investment accounts, trust department services and other various lending, depository and related financial services. Our primary deposit products are savings and demand deposit accounts and certificates of deposit. We also offer securities sold under agreements to repurchase as an alternative to conventional savings deposits for our customers. The securities sold under agreements to repurchase are accounted for as a collateralized borrowing with a one day maturity and are collateralized by U.S. Agency securities.

We are not dependent upon a single customer, or a few customers, the loss of one or more of which would have a material adverse effect on our operations. In the ordinary course of our business, our operations and earnings are not materially affected by seasonal changes or by Federal, state or local environmental laws or regulations.

We offer a variety of loans including commercial, residential and consumer loans as described above. The consumer portfolio includes automobile loans, educational loans and lines of credit.

We intend to continue to evaluate commercial real estate, commercial business and governmental lending opportunities, including small business lending. We continue to proactively monitor and manage existing credit relationships.

We have not engaged in sub-prime residential mortgage lending, which is defined as mortgage loans advanced to borrowers who do not qualify for market interest rates because of problems with their credit history. We focus our lending efforts within our market area.

One-to-Four Family Residential Loans. We offer two types of residential mortgage loans: fixed-rate loans, with terms of up to 30 years, and adjustable-rate loans, with interest rates and payments that adjust annually after an initial fixed period of one, three or five years. Interest rates and payments on our adjustable-rate loans generally are adjusted to a rate equal to a percentage above the appropriate U.S. Treasury Security Index. Our adjustable-rate single-family residential real estate loans generally have caps on increases or decreases in the interest rate at any adjustment date, and a maximum adjustment limit over the life of the loan. Although we offer adjustable-rate loans with initial rates below the fully indexed rate, loans tied to the one-year constant maturity treasury are underwritten using methods approved by the Federal Home Loan Mortgage Corporation, which require borrowers to be qualified at a rate equal to 200 basis points above the discounted loan rate under certain conditions.

Borrower demand for adjustable-rate loans compared to fixed-rate loans is a function of the level of interest rates, the expectations of changes in the level of interest rates, and the difference between the interest rates and loan fees offered for fixed-rate mortgage loans as compared to the interest rates and loan fees for adjustable-rate loans, among other factors. The loan fees, interest rates and other provisions of mortgage loans are determined by us on the basis of our own pricing criteria and competitive market conditions.

Most of our residential loans are underwritten to standards established by the secondary market. We also offer VA and FHA loans via a third party lending source.

While one-to-four family residential real estate loans are normally originated with up to 30-year terms, such loans typically remain outstanding for substantially shorter periods because borrowers often prepay their loans in full either upon sale of the property pledged as security or upon refinancing the original loan. Therefore, average loan maturity is a function of, among other factors, the level of purchase and sale activity in the real estate market, prevailing interest rates and the interest rates payable on outstanding loans. We do not offer loans with negative amortization or interest only loans.

We offer home equity loans and lines of credit, typically with a maximum combined loan-to-value ratio of 80%. Home equity loans generally have fixed-rates of interest and are originated with terms of up to 15 years. Home equity lines of credit generally have variable rates and are indexed to the prime rate. Home equity lines of credit generally have draw periods with 20 year repayment periods.

We generally do not make high loan-to-value loans (defined as loans with a loan-to-value ratio in excess of 80%) without private mortgage insurance. The maximum loan-to-value ratio we generally permit is 95% with private mortgage insurance. We require all properties securing mortgage loans to be appraised by a board-approved independent appraiser. We generally require title insurance on all first mortgage loans. Borrowers must obtain hazard insurance, and flood insurance is required for loans on properties located in a flood zone.

Commercial Real Estate Loans. We offer commercial real estate loans secured by real estate primarily with adjustable rates. We originate a variety of commercial real estate loans generally for terms up to 25 years and payments based on an amortization schedule of up to 25 years. These loans are typically based on either the Federal Home Loan Bank borrowing rate or our own pricing criteria and adjust every three to five years. Commercial real estate loans also are originated for the acquisition and development of land, including development for residential use. Conditions of acquisition and development loans originated generally limit the number of model homes and homes built on speculation, and draws are scheduled against executed agreements of sale. Commercial real estate loans for the acquisition and development of land are typically based upon the prime rate. Commercial real estate loans for developed real estate and for real estate acquisition and development are originated generally with loan-to-value ratios up to 75%, while loans for the acquisition of land are originated with a maximum loan to value ratio of 65%.

Commercial Loans. We offer commercial business loans to professionals, sole proprietorships and small businesses in our market area. We offer installment loans for capital improvements, equipment acquisition and long-term working capital. These loans are typically priced at short term fixed rates or variable rates based on the prime rate. These loans are secured by business assets other than real estate, such as business equipment and inventory, and, generally, are backed by personal guarantees of the owner or owners of the business. We originate lines of credit to finance the working capital needs of businesses to be repaid by seasonal cash flows or to provide a period of time during which the business can borrow funds for planned equipment purchases.

When making commercial business loans, we consider the consolidated financial statements of the borrower and any guarantors, the borrower s payment history of both corporate and personal debt, the debt service capabilities of the borrower, the projected cash flows of the business and guarantor, the viability of the industry in which the customer operates and the value of the collateral.

Consumer Loans. We offer a variety of consumer loans, including lines of credit, automobile loans and loans secured by savings accounts and certificates of deposit. We also offer unsecured loans.

We offer loans secured by new and used automobiles, primarily indirectly through dealerships. These loans have fixed interest rates and generally have terms up to six years. We offer automobile loans with loan-to-value ratios of up to 100% of the purchase price of the vehicle depending upon the credit history of the borrower and other factors.

We offer consumer loans secured by savings accounts and certificates of deposit held by us based upon the deposit rates plus a margin with terms up to five years. We offer such loans up to 100% of the principal balance of the certificate of deposit or balance in the savings account. We also offer unsecured loans and lines of credit with terms up to five years. Our unsecured loans and lines of credit bear a substantially higher interest rate than our secured loans and lines of credit.

The procedures for underwriting consumer loans include an assessment of the applicant s payment history on other debts and ability to meet existing obligations and payments on the proposed loan. Although the applicant s creditworthiness is a primary consideration, the underwriting process also includes a comparison of the value of the collateral, if any, to the proposed loan amount.

We have adhered and continue to adhere to credit policies, both prior to and during the recent economic downturn, which management believes are sound. Our loan policies require verification of information provided by loan applicants as well as an assessment of their ability to repay for all loans. At no time have we made loans similar to those commonly referred to as no doc or stated income loans.

While the vast majority of the loans in our loan portfolio are secured by collateral, we have made and will continue to make loans on an unsecured basis. Unsecured commercial loans are only granted to those borrowers exhibiting historically strong cash flow and capacity with seasoned management. Unsecured consumer loans are made for relatively short terms and to borrowers with strong credit histories.

We consider requests to modify, restructure or otherwise change the terms of loans on an individual basis as circumstances and/or reasons for such changes may vary. All such changes in terms must be authorized by the appropriate approval body. Also, our credit policy prohibits the modification of loans or the extension of additional credit to borrowers who are not current on their payments. Exceptions are approved only where our position in the credit relationship is expected to be enhanced by such action.

Adjustable-Rate Loans. While we anticipate that adjustable-rate loans will better offset the adverse effects of an increase in interest rates as compared to fixed-rate mortgages, an increased monthly mortgage payment required of adjustable-rate loan borrowers in a rising interest rate environment could cause an increase in delinquencies and defaults. The marketability of collateral also may be adversely affected in a high interest rate environment. In addition, although adjustable-rate mortgage loans make our asset base more responsive to changes in interest rates, the extent of this interest sensitivity is limited by the annual and lifetime interest rate adjustment limits on residential mortgage loans. We attempt to negotiate floors on most adjustable rate commercial loans. The commercial adjustable rate loans generally provide a fixed rate re-negotiation at the end of the initial fixed rate period. If we and the borrower are unable to agree on a new fixed rate then the rate converts to a floating rate obligation. In addition, some commercial loans adjust to a predetermined index plus a spread at the end of the initial fixed rate period, for a like period of time. To a lesser degree, we have entered into transactions with collars generally for periods of five years or less.

Commercial Real Estate Loans. Loans secured by commercial real estate generally have larger balances and involve a greater degree of risk than one-to-four family residential mortgage loans. Of primary concern in commercial real estate lending is the borrower s and any guarantor s creditworthiness and the feasibility and cash flow potential of the financed project. Additional considerations include: location, market and geographic concentrations, loan to value, strength of guarantors and quality of tenants. Payments on loans secured by income properties often depend on successful operation and management of the properties. As a result, repayment of such loans may be subject to a greater extent than residential real estate loans, to adverse conditions in the real estate market or the economy. To monitor cash flows on income properties, we require borrowers and loan guarantors, if any, to provide annual consolidated financial statements on commercial real estate loans and rent rolls where applicable. In reaching a decision on whether to make a commercial real estate loan, we consider and review a cash flow analysis of the borrower and guarantor, when applicable, and considers the net operating income of the property, the borrower s expertise, credit history and profitability and the value of the underlying property. We have generally required that the properties securing these real estate loans have debt service coverage ratios (the ratio of earnings before debt service to debt service) of at least 1.2 times. An environmental report is obtained when the possibility exists that hazardous materials may have existed on the site, or the site may have been impacted by adjoining properties that handled hazardous materials.

Commercial Business Loans. Unlike residential mortgage loans, which generally are made on the basis of the borrower s ability to make repayment from his or her employment or other income, and which are secured by real property, the value of which tends to be more easily ascertainable, commercial business loans are of higher risk and typically are made on the basis of the borrower s ability to make repayment from the cash flow of the borrower s business. As a result, the availability of funds for the repayment of commercial business loans may depend substantially on the success of the business itself. Further, any collateral securing such loans may depreciate over time, may be difficult to appraise and may fluctuate in value.

Consumer Loans. Consumer loans may entail greater risk than do residential mortgage loans, particularly in the case of consumer loans that are unsecured or secured by assets that depreciate rapidly, such as motor vehicles. In the latter case, repossessed collateral for a defaulted consumer loan may not provide an adequate source of repayment for the outstanding loan and a small remaining deficiency often does not warrant further substantial collection efforts against the borrower. Consumer loan collections depend on the borrower s continuing financial stability, and therefore are likely to be adversely affected by various factors, including job loss, divorce, illness or personal bankruptcy. Furthermore, the application of various federal and state laws, including federal and state insolvency laws, may limit the amount that can be recovered on such loans.

Loan Originations. Loan originations come from a number of sources. The primary sources of loan originations are existing customers, walk-in traffic, advertising and referrals from customers. We also purchase participations in loans from local financial institutions to supplement our lending portfolio. Loan participations are subject to the same credit analysis and loan approvals as the loans we originate. We are permitted to review all of the documentation relating to any loan in which we participate. However, in a purchased participation loan, we do not service the loan and are subject to the policies and practices of the lead lender with regard to monitoring delinquencies, pursuing collections and instituting foreclosure proceedings.

Loan Approval Procedures and Authority. Our lending activities follow written, non-discriminatory, underwriting standards and loan origination procedures established by our board of directors and management. The board of directors has granted loan approval authority to certain officers or groups of officers up to prescribed limits, based on the officer s experience.

Loans to One Borrower. The maximum amount that we may lend to one borrower and the borrower s related entities generally is limited, by regulation, to 15% of the tangible equity of Peoples Bank. At December 31, 2013, our regulatory limit on loans to one borrower was $25.4 million.

Deposit Activities

Our primary source of funds is the cash flow provided by our financing activities, mainly deposit gathering. Other sources of funds are provided by investing activities, including principal and interest payments on loans and investment securities, and operating activities, primarily net income. We offer a variety of deposit accounts with a range of interest rates and terms, including, among others: money market accounts; NOW accounts; savings accounts; certificates of deposit; individual retirement accounts, and demand deposit accounts. These deposits are primarily obtained from areas surrounding our branch offices. We rely primarily on marketing, product innovation, technology, service and long-standing relationships with customers to attract and retain these deposits. Other deposit related services include: remote deposit capture; automatic clearing house transactions; cash management services; automated teller machines; point of sale transactions; safe deposit boxes; night depository services; direct deposit, and official check services.

Trust, Wealth Management and Brokerage and Services

Through our trust department, we offer a broad range of fiduciary and investment services. Our trust and investment services include:

- investment management
- IRA trustee services
- estate administration
- living trusts

- trustee under will
- guardianships
- life insurance trusts
- custodial services / IRA custodial services
- corporate trusts, and
- pension and profit sharing plans.

Peoples Wealth Management, a division of Peoples Advisors, LLC, provides a comprehensive array of wealth management products and services to individuals, small businesses and nonprofit entities. These products and

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services include the following, among others: investment portfolio management; estate planning; annuities; business succession planning; insurances; education funding strategies, and tax planning.

We have a third party marketing agreement with a broker-dealer that allows us to offer a full range of securities, brokerage services and annuity sales to our customers. Our investor services division is located in our headquarters building and the services are offered throughout the entire branch system. Through this relationship, our clients have access to a wide array of financial and wealth management strategies, including services such as professional money management, retirement and education planning, and investment products including stocks, bonds, mutual funds, annuities and insurance products.

Merchant Services

We offer credit card processing and a variety of other products and services to our merchant customers, including:

- small business checking accounts
- merchant money market account
- online banking
- telephone banking
- business credit cards
- merchant line of credit
- business profitability and peer analysis, and
- financial checkup.

Competition

We compete primarily with commercial banks, thrift institutions and credit unions, many of which are substantially larger in terms of assets and available resources. Certain of these institutions have significantly higher lending limits than we do, and may provide various services for their customers that we presently do not. In addition, we experience competition for deposits from mutual funds and security brokers, while consumer discount, mortgage and insurance companies compete for various types of loans. Credit unions, finance companies and mortgage companies enjoy certain competitive advantages over us, as they are not subject to the same regulatory restrictions and taxations as commercial banks. Principal methods of competing for bank products, permitted nonbanking services and financial activities include price, nature of product, quality of service and convenience of location.

In our market area, interest rates on deposits, especially time deposits, and interest rates and fees charged to customers on loans are very competitive. In the current economic environment there is increased competition in view of weaker loan demand.

We believe that our most significant competitive advantage originates from our business philosophy which includes offering direct access to senior management and other officers and providing friendly, informed and courteous service, local and timely decision making, flexible and reasonable operating procedures and consistently applied credit policies. In addition, our success has been, and will continue to be, a result of our emphasis on community involvement and customer relationships. With consolidation continuing in the financial industry, and particularly in our market area, smaller community banks like us are gaining opportunities and market share as larger institutions reduce their emphasis on or exit the markets.

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Seasonality

Generally, our operations are not seasonal in nature. Our business activities, however, have been somewhat influenced by the recent increase in activities related to natural gas drilling in our market area, which are to some extent seasonal in nature.

Supervision and Regulation

We are extensively regulated under federal and state laws. Generally, these laws and regulations are intended to protect consumers, not shareholders. The following is a summary description of certain provisions of law that affect the regulation of bank holding companies and banks. This discussion is qualified in its entirety by reference to applicable laws and regulations. Changes in law and regulation may have a material effect on our business and prospects.

Peoples is a bank holding company within the meaning of the Bank Holding Company Act of 1956, as amended, and is subject to regulation, supervision, and examination by the Board of Governors of the Federal Reserve System, referred to as the Federal Reserve Board or the FRB. We are required to file annual and quarterly reports with the FRB and to provide the FRB with such additional information as the FRB may require. The FRB also conducts examinations of Peoples.

With certain limited exceptions, we are required to obtain prior approval from the FRB before acquiring direct or indirect ownership or control of more than 5% of any voting securities or substantially all of the assets of a bank or bank holding company, or before merging or consolidating with another bank holding company. Additionally, with certain exceptions, any person or entity proposing to acquire control through direct or indirect ownership of 25% or more of our voting securities is required to give 60 days written notice of the acquisition to the FRB, which may prohibit the transaction, and to publish notice to the public.

Peoples Bank is regulated by the Pennsylvania Department of Banking and Securities (the Department of Banking) and the FDIC. The Department of Banking may prohibit an institution over which it has supervisory authority from engaging in activities or investments that the agency believes constitute unsafe or unsound banking practices. Federal banking regulators have extensive enforcement authority over the institutions they regulate to prohibit or correct activities that violate law, regulation or a regulatory agreement or which are deemed to constitute unsafe or unsound practices.

Enforcement actions may include:

- the appointment of a conservator or receiver;
- the issuance of a cease and desist order;
- the termination of deposit insurance, the imposition of civil money penalties on the institution, its directors, officers, employees and institution affiliated parties;

- the issuance of directives to increase capital;
- the issuance of formal and informal agreements and orders;
- the removal of or restrictions on directors, officers, employees and institution-affiliated parties; and
- the enforcement of any such mechanisms through restraining orders or any other court actions.

We are subject to certain restrictions on extensions of credit to executive officers, directors, principal shareholders or any related interests of such persons which generally require that such credit extensions be made on substantially the same terms as are available to third persons dealing with us, and not involving more than the normal risk of repayment. Other laws tie the maximum amount that may be loaned to any one customer and its related interests to our capital levels.

Limitations on Dividends and Other Payments

Our ability to pay dividends is largely dependent upon the receipt of dividends from Peoples Bank. Both federal and state laws impose restrictions on our ability and the ability of Peoples Bank to pay dividends. Under such restrictions, Peoples Bank may only declare and pay dividends out of accumulated net earnings, including accumulated net earnings acquired as a result of a merger within seven years. Further, Peoples Bank may not declare or pay any dividend unless Peoples Bank s surplus would not be reduced by the payment of the dividend. Pennsylvania law requires that each year Peoples Bank set aside as surplus, a sum equal to not less than 10 percent of its net earnings to maintain the surplus funds equal 100 percent of our capital stock. In addition to these specific restrictions, bank regulatory agencies, in general, also have the ability to prohibit proposed dividends by a financial institution that would otherwise be permitted under applicable regulations if the regulatory body determines that such distribution would constitute an unsafe or unsound practice.

Permitted Non-Banking Activities

Generally, a bank holding company may not engage in any activities other than banking, managing, or controlling its bank and other authorized subsidiaries, and providing service to those subsidiaries. With prior approval of the FRB, we may acquire more than 5% of the assets or outstanding shares of a company engaging in non-bank activities determined by the FRB to be closely related to the business of banking or of managing or controlling banks. The FRB provides expedited procedures for expansion into approved categories of non-bank activities.

Subsidiary banks of a bank holding company are subject to certain quantitative and qualitative restrictions on extensions of credit to the bank holding company or its subsidiaries, and on the use of their securities as collateral for loans to any borrower. These regulations and restrictions may limit our ability to obtain funds from Peoples Bank for our cash needs, including funds for the payment of dividends, interest and operating expenses. Further, subject to certain exceptions, a bank holding company and its subsidiaries are prohibited from engaging in certain tie-in arrangements in connection with any extension of credit, lease or sale of property or furnishing of services.

Under FRB policy, a bank holding company is expected to act as a source of financial strength to its subsidiary banks and to make capital injections into a troubled subsidiary bank, and the FRB may charge the bank holding company with engaging in unsafe and unsound practices for failure to commit resources to a subsidiary bank when required. A required capital injection may be called for at a time when the holding company does not have the resources to provide it. In addition, depository institutions insured by the FDIC can be held liable for any losses incurred by, or reasonably anticipated to be incurred by, the FDIC in connection with the default of or assistance provided to, a commonly controlled FDIC-insured depository institution. Accordingly, in the event that any insured subsidiary of a bank holding company causes a loss to the FDIC, other insured subsidiaries of a bank holding company could be required to compensate the FDIC by reimbursing it for the estimated amount of such loss. Such cross guarantee liabilities generally are superior in priority to the obligation of the depository institutions to its shareholders due solely to their status as shareholders and obligations to other affiliates.

Pennsylvania Law

As a Pennsylvania bank holding company, Peoples is subject to various restrictions on its activities as set forth in Pennsylvania law. This is in addition to those restrictions set forth in federal law. Under Pennsylvania law, a bank holding company that desires to acquire a bank or bank holding company that has its principal place of business in Pennsylvania must obtain permission from the Department of Banking.

Financial Institution Reform, Recovery, and Enforcement Act (FIRREA)

FIRREA was enacted into law in order to address the financial condition of the Federal Savings and Loan Insurance Corporation, to restructure the regulation of the thrift industry, and to enhance the supervisory and

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enforcement powers of the federal bank and thrift regulatory agencies. As the primary federal regulator of Peoples Bank, the FDIC, in conjunction with the Department of Banking, is responsible for its supervision. When dealing with capital requirements, those regulatory bodies have the flexibility to impose supervisory agreements on institutions that fail to comply with regulatory requirements. The imposition of a capital plan, termination of deposit insurance, and removal or temporary suspension of an officer, director or other institution-affiliated person may cause enforcement actions.

There are three levels of civil penalties under FIRREA.

The first tier provides for civil penalties of up to $5,000 per day for any violation of law or regulation.

The second tier provides for civil penalties of up to $25,000 per day if more than a minimal loss or a pattern is involved.

Finally, civil penalties of up to $1 million per day may be assessed for knowingly or recklessly causing a substantial loss to an institution or taking action that results in a substantial pecuniary gain or other benefit.

Criminal penalties are increased to $1 million per violation and may be up to $5 million for continuing violations or for the actual amount of gain or loss. These penalties may be combined with prison sentences of up to five years.

Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA)

FDICIA provides for, among other things:

publicly available annual financial condition and management reports for financial institutions, including audits by independent accountants;

the establishment of uniform accounting standards by federal banking agencies;

the establishment of a prompt corrective action system of regulatory supervision and intervention, based on capitalization levels, with more scrutiny and restrictions placed on depository institutions with lower levels of capital;

additional grounds for the appointment of a conservator or receiver; and

restrictions or prohibitions on accepting brokered deposits, except for institutions which significantly exceed minimum capital requirements.

A central feature of FDICIA is the requirement that the federal banking agencies take prompt corrective action with respect to depository institutions that do not meet minimum capital requirements. Pursuant to FDICIA, the federal bank regulatory authorities have adopted regulations setting forth a five-tiered system for measuring the capital adequacy of the depository institutions that they supervise. Under these regulations, a depository institution is classified in one of the following capital categories:

- well capitalized ;
- adequately capitalized ;
- under capitalized ;
- significantly undercapitalized ; and
- critically undercapitalized .

Peoples Bank was categorized as well capitalized under the regulatory framework for prompt corrective action at December 31, 2013, based on the most recent notification from the FDIC. An institution may be deemed by the regulators to be in a capitalization category that is lower than is indicated by its actual capital position if, among other things, it receives an unsatisfactory examination rating with respect to asset quality, management, earnings or liquidity.

FDICIA generally prohibits a depository institution from making any capital distribution including payment of a cash dividend or paying any management fees to its holding company, if the depository institution would thereafter be undercapitalized. Undercapitalized depository institutions are subject to growth limitations and are required to submit capital restoration plans. If a depository fails to submit an acceptable plan, it is treated as if it is significantly undercapitalized . Significantly undercapitalized depository institutions may be subject to a number of other requirements and restrictions, including orders to sell sufficient voting stock to become adequately capitalized, requirements to reduce total assets and stop accepting deposits from correspondent banks. Critically undercapitalized institutions are subject to the appointment of a receiver or conservator; generally within 90 days of the date such institution is determined to be critically undercapitalized.

FDICIA provides the federal banking agencies with significantly expanded powers to take enforcement action against institutions that fail to comply with capital or other standards. Such actions may include the termination of deposit insurance by the FDIC or the appointment of a receiver or conservator for the institution. FDICIA also limits the circumstances under which the FDIC is permitted to provide financial assistance to an insured institution before appointment of a conservator or receiver.

Under FDICIA, each federal banking agency is required to prescribe, by regulation, non-capital safety and soundness standards for institutions under its authority. The federal banking agencies, including the FDIC, have adopted standards covering:

- internal controls;
- information systems and internal audit systems;
- loan documentation;
- credit underwriting;
- interest rate exposure;
- asset growth; and
- compensation fees and benefits.

Any institution that fails to meet these standards may be required to develop an acceptable plan, specifying the steps that the institutions will take to meet the standards. Failure to submit or implement such a plan may subject the institution to regulatory sanctions. Peoples believes that it meets substantially all the standards that have been adopted.

FDICIA also imposed new capital standards on insured depository institutions. Before establishing new branch offices, Peoples Bank must meet certain minimum capital stock and surplus requirements and must obtain State approval.

Risk-Based Capital Requirements

The federal banking regulators have adopted certain risk-based capital guidelines to assist in the assessing capital adequacy of a banking organization s operations for both transactions reported on the balance sheet as assets and transactions, such as letters of credit, and recourse agreements, which are recorded as off-balance sheet items. Under these guidelines, nominal dollar amounts of assets and credit-equivalent amounts of off-balance sheet items are multiplied by one of several risk adjustment percentages, which range from 0% for assets with low credit risk, such as certain US Treasury securities, to 100% for assets with relatively high credit risk, such as business loans.

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A banking organization s risk-based capital ratios are obtained by dividing its qualifying capital by its total risk adjusted assets. The regulators measure risk-adjusted assets, which include off-balance-sheet items, against both total qualifying capital, the sum of Tier 1 capital and limited amounts of Tier 2 capital, and Tier 1 capital.

Tier 1 , or core capital, includes common equity, perpetual preferred stock and minority interest in equity accounts of consolidated subsidiaries, less goodwill and other intangibles, subject to certain exceptions.

Tier 2 , or supplementary capital, includes, among other things, limited life preferred stock, hybrid capital instruments, mandatory convertible securities, qualifying subordinated debt, and the allowance for loan and lease losses, subject to certain limitations and less restricted deductions. The inclusion of elements of Tier 2 capital is subject to certain other requirements and limitations of the federal banking agencies.

Banks and bank holding companies subject to the risk-based capital guidelines are required to maintain a ratio of Tier 1 capital to risk-weighted assets of at least 4.00% and a ratio of total capital to risk-weighted assets of at least 8%. The appropriate regulatory authority may set higher capital requirements when particular circumstances warrant. At December 31, 2013, Peoples met both requirements with Tier 1 and Total capital ratios of 13.59% and 14.26%. In addition to risk-based capital, banks and bank holding companies are required to maintain a minimum amount of Tier 1 capital to total assets, referred to as the leverage capital ratio, of at least 4.00%. At December 31, 2013, Peoples leverage ratio was 10.09%.

Failure to meet applicable capital guidelines could subject a banking organization to a variety of enforcement actions including:

limitations on its ability to pay dividends;

the issuance by the applicable regulatory authority of a capital directive to increase capital, and in the case of depository institutions, the termination of deposit insurance by the FDIC, as well as to the measures described under FDICIA as applicable to undercapitalized institutions.

In addition, future changes in regulations or practices could further reduce the amount of capital recognized for purposes of capital adequacy. Such a change could affect the ability of Peoples Bank to grow and could restrict the amount of profits, if any, available for the payment of dividends to Peoples.

Regulatory Capital Changes

In July 2013, the federal banking agencies issued final rules to implement the Basel III regulatory capital reforms and changes required by the Dodd-Frank Act. The phase-in period for community banking organizations begins January 1, 2015, while larger institutions (generally those with assets of $250 billion or more) began compliance on January 1, 2014. The final rules call for the following capital requirements:

A minimum ratio of common equity tier 1 capital to risk-weighted assets of 4.5%.

- A minimum ratio of tier 1 capital to risk-weighted assets of 6%.
- A minimum ratio of total capital to risk-weighted assets of 8% (no change from the current rule).
- A minimum leverage ratio of 4%.

In addition, the final rules establish a common equity tier 1 capital conservation buffer of 2.5% of risk-weighted assets applicable to all banking organizations. If a banking organization fails to hold capital above the minimum capital ratios and the capital conservation buffer, it will be subject to certain restrictions on capital distributions and discretionary bonus payments. The phase-in period for the capital conservation and countercyclical capital buffers for all banking organizations will begin on January 1, 2016.

Under the proposed rules, accumulated other comprehensive income (AOCI) would have been included in a banking organization s common equity tier 1 capital. The final rules allow community banks to make a one-time election not to include these additional components of AOCI in regulatory capital and instead use the existing treatment under the general risk-based capital rules that excludes most AOCI components from regulatory capital. The opt-out election must be made in the first call report or FR Y-9 series report that is filed after the financial institution becomes subject to the final rule.

The final rules permanently grandfather non-qualifying capital instruments (such as trust preferred securities and cumulative perpetual preferred stock) issued before May 19, 2010 for inclusion in the tier 1 capital of banking organizations with total consolidated assets less than $15 billion as of December 31, 2009 and banking organizations that were mutual holding companies as of May 19, 2010.

The proposed rules would have modified the risk-weight framework applicable to residential mortgage exposures to require banking organizations to divide residential mortgage exposures into two categories in order to determine the applicable risk weight. In response to commenter concerns about the burden of calculating the risk weights and the potential negative effect on credit availability, the final rules do not adopt the proposed risk weights but retain the current risk weights for mortgage exposures under the general risk-based capital rules.

Consistent with the Dodd-Frank Act, the new rules replace the ratings-based approach to securitization exposures, which is based on external credit ratings, with the simplified supervisory formula approach in order to determine the appropriate risk weights for these exposures. Alternatively, banking organizations may use the existing gross-up approach to assign securitization exposures to a risk weight category or choose to assign such exposures a 1,250 percent risk weight.

Under the new rules, mortgage servicing assets (MSAs) and certain deferred tax assets (DTAs) are subject to stricter limitations than those applicable under the current general risk-based capital rule. The new rules also increase the risk weights for past-due loans, certain commercial real estate loans, and some equity exposures, and makes selected other changes in risk weights and credit conversion factors.

Peoples is in the process of assessing the impact of these changes on the regulatory ratios of Peoples and Peoples Bank on the capital, operations, liquidity and earnings of Peoples and Peoples Bank.

Interest Rate Risk

Regulatory agencies include, in their evaluations of a bank s capital adequacy, an assessment of the bank s interest rate risk exposure. The standards for measuring the adequacy and effectiveness of a banking organization s interest rate risk management includes a measurement of board of directors and senior management oversight, and a determination of whether a banking organization s procedures for comprehensive risk management are appropriate to the circumstances of the specific banking organization. We utilize internal interest rate risk models to measure and monitor interest rate risk. In addition, we employ an independent consultant to provide a quarterly assessment of our interest rate risk. Finally, regulatory agencies, as part of the scope of their periodic examinations, evaluate our interest rate risk.

Community Reinvestment Act (CRA)

The Community Reinvestment Act of 1977 is designed to create a system for bank regulatory agencies to evaluate a depository institution s record in meeting the credit needs of its community. The CRA regulations were completely revised as of July 1, 1995, to establish performance-based standards for use in examining for compliance. Peoples Bank had its last CRA compliance examination in 2013 and received a satisfactory rating.

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USA Patriot Act of 2001

The Patriot Act contains anti-money laundering and financial transparency laws and imposes various regulations, including standards for verifying client identification at account opening, and rules to promote cooperation among financial institutions, regulators and law enforcement entities in identifying parties that may be involved in terrorism or money laundering.

Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank)

In 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act was signed into law. Dodd-Frank is intended to effect a fundamental restructuring of federal banking regulation. Among other things, Dodd-Frank created the Financial Stability Oversight Council to identify systemic risks in the financial system and gives federal regulators authority to take control of and liquidate financial firms. Dodd-Frank additionally created an independent federal regulator to administer federal consumer protection laws. Dodd-Frank has and is expected to continue to have a significant impact on our business operations as its provisions take effect. It is expected that, as various implementing rules and regulations are released, they will increase our operating and compliance costs and could increase our interest expense. Among the provisions that affect us or are likely to affect us are the following:

Holding Company Capital Requirements

Dodd-Frank requires the FRB to apply consolidated capital requirements to bank holding companies that are no less stringent than those currently applied to depository institutions. Under these standards, trust preferred securities will be excluded from Tier 1 capital unless such securities were issued prior to May 19, 2010, by a bank holding company with less than $15 billion in assets. Dodd-Frank additionally requires that bank regulators issue countercyclical capital requirements so that the required amount of capital increases in times of economic expansion, consistent with safety and soundness.

Deposit Insurance

Dodd-Frank permanently increases the maximum deposit insurance amount for banks, savings institutions and credit unions to $250,000 per depositor. Dodd-Frank also broadens the base for FDIC insurance assessments. Assessments are now based on the average consolidated total assets less tangible equity capital of a financial institution. Dodd-Frank requires the FDIC to increase the reserve ratio of the Deposit Insurance Fund from 1.15% to 1.35% of insured deposits by 2020 and eliminates the requirement that the FDIC pay dividends to insured depository institutions when the reserve ratio exceeds certain thresholds. Further, Dodd-Frank eliminated the federal statutory prohibition against the payment of interest on business checking accounts.

Corporate Governance

Dodd-Frank requires publicly-traded companies to give stockholders a non-binding vote on executive compensation at least every three years, a non-binding vote regarding the frequency of the vote on executive compensation at least every six years, and a non-binding vote on golden parachute payments in connection with approvals of mergers and acquisitions unless previously voted on by stockholders. Additionally, Dodd-Frank directs the federal banking regulators to promulgate rules prohibiting excessive compensation paid to executives of depository institutions and their holding companies with assets in excess of $1.0 billion, regardless of whether the company is publicly traded. Dodd-Frank also gives the SEC authority to prohibit broker discretionary voting on elections of directors and executive compensation matters.

Prohibition Against Charter Conversions of Troubled Institutions

Dodd-Frank prohibits a depository institution from converting from a state to a federal charter, or vice versa, while it is the subject of a cease and desist order or other formal enforcement action or a memorandum of

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understanding with respect to a significant supervisory matter unless the appropriate federal banking agency gives notice of the conversion to the federal or state authority that issued the enforcement action and that agency does not object within 30 days. The notice must include a plan to address the significant supervisory matter. The converting institution must also file a copy of the conversion application with its current federal regulator, which must notify the resulting federal regulator of any ongoing supervisory or investigative proceedings that are likely to result in an enforcement action and provide access to all supervisory and investigative information relating thereto.

Interstate Branching

Dodd-Frank authorizes national and state banks to establish branches in other states to the same extent as a bank chartered by that state would be permitted. Previously, banks could only establish branches in other states if the host state expressly permitted out-of-state banks to establish branches in that state. Accordingly, banks are able to enter new markets more freely.

Limits on Interstate Acquisitions and Mergers

Dodd-Frank precludes a bank holding company from engaging in an interstate acquisition the acquisition of a bank outside its home state unless the bank holding company is both well capitalized and well managed. Furthermore, a bank may not engage in an interstate merger with another bank headquartered in another state unless the surviving institution will be well capitalized and well managed. The previous standard in both cases was adequately capitalized and adequately managed.

Limits on Interchange Fees

Dodd-Frank amended the Electronic Fund Transfer Act to, among other things, give the Federal Reserve the authority to establish rules regarding interchange fees charged for electronic debit transactions by payment card issuers having assets over $10 billion and to enforce a statutory requirement that such fees be reasonable and proportional to the actual cost of a transaction to the issuer. The Federal Reserve issued its final rule, Regulation II, effective October 1, 2011. Consistent with Dodd-Frank, issuers with less than $10 billion in assets are exempt from debit card interchange fee standards.

Consumer Financial Protection Bureau

Dodd-Frank created the Consumer Financial Protection Bureau (CFPB), which is granted broad rulemaking, supervisory and enforcement powers under various federal consumer financial protection laws, including the Equal Credit Opportunity Act, Truth in Lending Act, Real Estate Settlement Procedures Act, Fair Credit Reporting Act, Fair Debt Collection Act, Consumer Financial Privacy provisions of the Gramm-Leach-Bliley Act, and certain other statutes. The CFPB has examination and primary enforcement authority with respect to depository institutions with $10 billion or more in assets. Smaller institutions are subject to rules promulgated by the CFPB, but continue to be examined and supervised by federal banking regulators for consumer compliance purposes. The CFPB has authority to prevent unfair, deceptive or abusive practices in connection with the offering of consumer financial products. Dodd-Frank authorizes the CFPB to establish certain minimum standards for the origination of residential mortgages including a determination of the borrower s ability to repay. In addition, Dodd-Frank allows borrowers to raise certain defenses to foreclosure if they receive any loan other than a qualified mortgage as defined by the CFPB. Dodd-Frank permits states to adopt consumer protection laws and standards that are more stringent than those adopted at the federal level and, in certain circumstances, permits state attorneys general to enforce compliance with both the state and federal laws and regulations.

Ability to Repay and Qualified Mortgage Rule

Pursuant to the Dodd Frank Act, the Consumer Financial Protection Bureau issued a final rule on January 10, 2013, which became effective January 10, 2014, amending Regulation Z as implemented by the Truth in Lending

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Act, requiring mortgage lenders to make a reasonable and good faith determination based on verified and documented information that a consumer applying for a mortgage loan has a reasonable ability to repay the loan according to its terms. Mortgage lenders are required to determine consumers ability to repay in one of two ways. The first alternative requires the mortgage lender to consider the following eight underwriting factors when making the credit decision:

- current or reasonably expected income or assets;
- current employment status;
- the monthly payment on the covered transaction;
- the monthly payment on any simultaneous loan;
- the monthly payment for mortgage-related obligations;
- current debt obligations, alimony, and child support;
- the monthly debt-to-income ratio or residual income; and
- credit history.

Alternatively, the mortgage lender can originate qualified mortgages, which are entitled to a presumption that the creditor making the loan satisfied the ability-to-repay requirements. In general, a qualified mortgage is a mortgage loan without negative amortization, interest-only payments, balloon payments, or terms exceeding 30 years. In addition, to be a qualified mortgage, the points and fees paid by a consumer cannot exceed 3% of the total loan amount. Loans which meet these criteria will be considered qualified mortgages, and as a result generally protect lenders from fines or litigation in the event of foreclosure. Qualified mortgages that are higher-priced (e.g. subprime loans) garner a rebuttable presumption of compliance with the ability-to-repay rules, while qualified mortgages that are not higher-priced (e.g. prime loans) are given a safe harbor of compliance. The final rule, as issued, is not expected to have a material impact on our lending activities or our results of operations or financial condition.

Future Legislation

Proposed legislation is introduced in almost every legislative session that would dramatically affect the regulation of the banking industry. We cannot predict if any such legislation will be adopted nor if adopted how it would affect our business. Past history has demonstrated that new legislation or changes to existing laws or regulations usually results in greater compliance burden and therefore generally increases the cost of doing business.

Employees

As of December 31, 2013, we had 354 full-time-equivalent employees. We are not parties to any collective bargaining agreements and we consider our employee relations to be good.

Availability of Securities Filings

We file annual, quarterly, and current reports, proxy statements, and other documents with the SEC under the Exchange Act. The public may read and copy any materials that we file with the SEC at the SEC s Public Reference Room at Station Place, 100 F Street, N.E., Washington, DC 20549. The public may obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. Also, the SEC maintains an Internet website that contains reports, proxy and information statements, and other information regarding issuers, including us, that file electronically with the SEC. The public can obtain any documents that we file with the SEC at http://www.sec.gov.

In addition, we maintain an Internet website at www.peoplesnatbank.com. We make available free of charge through the Investor Relations link on our Internet website, our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Exchange Act as soon as reasonably practicable after we electronically file such material with, or furnish it to, the SEC.

Item 1A. Risk Factors.

In addition to the other information set forth in this report, one should carefully consider the factors discussed below, which could materially affect our business, financial condition or future results. The risks described below are not the only risks that we face. Additional risks and uncertainties not currently known to us or that we currently deem to be insignificant also may materially adversely affect our business, financial condition and/or operating results.

Risks Relating to Peoples and Its Business

We are subject to credit risk in connection with our lending activities, and our financial condition and results of operations may be negatively impacted by economic conditions and other factors that adversely affect our borrowers.

Lending money is a significant part of the banking business and interest income on our loan portfolio is the principle component of our revenue. Our financial condition and results of operations are affected by the ability of our borrowers to repay their loans, and in a timely manner. Borrowers, however, do not always repay their loans. The risk of non-payment is assessed through our underwriting and loan review procedures based on several factors including credit risks of a particular borrower, changes in economic conditions, the duration of the loan and in the case of a collateralized loan, uncertainties as to the future value of the collateral and other factors. Despite our efforts, we do and will experience loan and lease losses, and our financial condition and results of operations will be adversely affected. Our loans which were between thirty and eighty-nine days delinquent totaled $8.6 million on December 31, 2013. Our non-performing assets were approximately $16.8 million on December 31, 2013, including $7.4 million of loans acquired as part of the merger net of the remaining credit adjustment of $7.8 million. Our allowance for loan and lease losses was approximately $8.7 million on December 31, 2013.

Our emphasis on the Northeastern Pennsylvania and Southern New York market area exposes us to a risk of loss associated with the region.

At December 31, 2013, $322.1 million or 27.4 %, of our loan portfolio consisted of residential mortgage loans and $413.1 million or 35.1%, of our loan portfolio consisted of commercial real estate loans. A significant majority of these loans are made to borrowers or secured by properties located in Northeastern Pennsylvania and Broome County, New York. As a result of this concentration, a sustained downturn in the regional economy could significantly increase non-performing loans, which would hurt our net income. Future declines in real estate values in the region could also cause some of our mortgage and commercial real estate loans to be inadequately collateralized, which would expose us to a greater risk of loss if we seek to recover on defaulted loans by selling the real estate collateral.

We make commercial and industrial, construction, and commercial real estate loans, which present greater risks than other types of loans.

As of December 31, 2013, approximately 64.9% of our loan portfolio consisted of commercial and industrial, construction, and commercial real estate loans. These types of loans are generally viewed as having more risk of default than residential real estate loans or consumer loans. These types of loans are also typically larger than residential real estate loans and consumer loans. Because our loan portfolio contains a significant number of commercial and industrial, construction, and commercial real estate loans some of which have large balances, the deterioration of one or a few of these loans could cause a significant increase in non-performing loans. An increase in non-performing loans could result in a net loss of earnings from these loans, an increase in the provision for loan losses, and an increase in loan charge-offs, all of which could have a material adverse effect on our financial condition and results of operations.

The commercial real estate market is cyclical and poses risks of loss to us because of the concentration of commercial real estate loans in our loan portfolio, and the lack of diversity in risk associated with such a concentration. Banking regulators have been giving and continue to give commercial real estate lending greater scrutiny, and banks with larger commercial real estate loan portfolios are expected by their regulators to implement improved underwriting, internal controls, risk management policies and portfolio stress-testing practices to manage risks associated with commercial real estate lending. In addition, commercial real estate lenders have made greater provisions for loan and lease losses as a result of commercial real estate lending exposures. Additional losses or regulatory requirements related to our commercial real estate loan concentration could materially adversely affect our business, financial condition and results of operations.

Our allowance for loan and lease losses may not be adequate to absorb actual loan and lease losses, and we may be required to make further provisions for loan and lease losses and charge off additional loans in the future, which could materially and adversely affect our business.

We attempt to maintain an allowance for loan and lease losses, established through a provision for loan and lease losses accounted for as an expense, which is adequate to absorb losses inherent in our loan portfolio. If our allowance for loan and lease losses is inadequate, it may have a material adverse effect on our financial condition and results of operations.

The determination of the allowance for loan and lease losses inherently involves a high degree of subjectivity and judgment and requires us to make significant estimates of current credit risks and future trends, all of which may undergo material changes. Changes in economic conditions affecting borrowers, new information regarding existing loans, identification of additional problem loans and other factors, both within and outside of our control, may require us to increase our allowance for loan and lease losses. Increases in non-performing loans have a significant impact on our allowance for loan and lease losses. Our allowance for loan and lease losses may not be adequate to absorb actual loan and lease losses. If conditions in our regional real estate markets continue, we could continue to experience increased delinquencies and credit losses, particularly with respect to real estate construction and land acquisition and development loans and one-to-four family residential mortgage loans. Moreover, we expect that the current economy will negatively impact our market areas and that we could experience higher delinquencies and credit losses. As a result, we will continue to make provisions for loan and lease losses and to charge off additional loans in the future, which could materially adversely affect our financial conditions and results of operations.

In addition to our internal processes for determining loss allowances, bank regulatory agencies periodically review our allowance for loan and lease losses and may require us to increase the provision for loan and lease losses, to recognize further loan charge-offs, or to take other actions, based on judgments that differ from those of our management. If loan charge-offs in future periods exceed the allowance for loan and lease losses, we will need to increase our allowance for loan lease losses. Furthermore, growth in our loan portfolio would generally lead to an increase in the provision for loan and lease losses. Any increases in our allowance for loan and lease losses will result in a decrease in net income and capital, and may have a material adverse effect on our financial condition, results of operations and cash flows.

Changes in interest rates could adversely impact our financial condition and results of operations.

Our ability to generate net income substantially depends upon our net interest income, which is the difference between the interest income earned on interest-earning assets, such as loans and investment securities, and the interest expense paid on interest-bearing liabilities, such as deposits and borrowings. Certain assets and liabilities react differently to changes in market interest rates. Further, interest rates on some types of assets and liabilities may fluctuate prior to changes in broader market interest rates, while rates on other types of assets may lag behind. Additionally, some assets such as adjustable-rate mortgages have features, and rate caps, which restrict changes in their interest rates.

Factors such as inflation, recession, unemployment, money supply, global disorder, terrorist activity, instability in domestic and foreign financial markets, and other factors beyond our control, may affect interest rates. Changes in market interest rates will also affect the level of voluntary prepayments on loans and the receipt of payments on mortgage-backed securities, resulting in the receipt of proceeds that may have to be reinvested at a lower rate than the loan or mortgage-backed security being prepaid. Although we pursue an asset-liability management strategy designed to manage our risk from changes in market interest rates, changes in interest rates can still have a material adverse effect on our profitability.

Changes in interest rates could affect our investment values and impact comprehensive income and stockholders equity.

At December 31, 2013, we had approximately $299.7 million of securities available-for-sale. These securities are carried at fair value on our consolidated balance sheets. Unrealized gains or losses on these securities, that is, the difference between the fair value and the amortized cost of these securities, are reflected in stockholders equity, net of deferred taxes. As of December 31, 2013, our available-for-sale securities had an unrealized gain, net of taxes, of $1.8 million. The fair value of our available-for-sale securities is subject to interest rate change, which would not affect recorded earnings, but would increase or decrease comprehensive income and stockholders equity.

Our results of operations may be materially and adversely affected by other-than-temporary impairment charges relating to our investment portfolio.

Numerous factors, including the lack of liquidity for re-sales of certain investment securities, the absence of reliable pricing information for investment securities, adverse changes in the business climate, adverse regulatory actions or unanticipated changes in the competitive environment, could have a negative effect on our investment portfolio in future periods. Investments are evaluated periodically to determine whether a decline in their value is other than temporary. Management utilizes criteria such as the magnitude and duration of the decline, in addition to the reasons underlying the decline, to determine whether the loss in value is other than temporary. The term other than temporary indicates that the prospects for a near term recovery of value are not necessarily favorable, or that there is a lack of evidence to support fair values equal to, or greater than, the carrying value of the investment.

Once a decline in value is determined to be other than temporary, the value of the security is reduced and a corresponding charge to earnings is recognized. If an impairment charge is significant enough, it could affect our ability to pay dividends, which could materially adversely affect us and our ability to pay dividends to shareholders. Significant impairment charges could also negatively impact our regulatory capital ratios and result in us not being classified as well-capitalized for regulatory purposes.

The requirement to record certain assets and liabilities at fair value may adversely affect our financial results.

We report certain assets, including available-for-sale investment securities, at fair value. Generally, for assets that are reported at fair value we use quoted market prices or valuation models that utilize market data inputs to estimate fair value. Because we record these assets at their estimated fair value, we may incur losses even if the asset in question presents minimal credit risk. The level of interest rates can impact the estimated fair value of investment securities. Disruptions in the capital markets may require us to recognize other-than-temporary impairments in future periods with respect to investment securities in our portfolio. The amount and timing of any impairment recognized will depend on the severity and duration of the decline in fair value of our investment securities and our estimation of the anticipated recovery period.

Changes in the value of goodwill and intangible assets could reduce our earnings.

We account for goodwill and other intangible assets in accordance with GAAP, which, in general, requires that goodwill not be amortized, but rather that it be tested for impairment at least annually at the reporting unit level using the two step approach. Testing for impairment of goodwill and intangible assets is performed annually and involves the identification of reporting units and the estimation of fair values. The estimation of fair values involves a high degree of judgment and subjectivity in the assumptions used. As of December 31, 2013, the fair value of our shares exceeded the recorded book value. Changes in the local and national economy, the federal and state legislative and regulatory environments for financial institutions, the stock market, interest rates and other external factors (such as natural disasters or significant world events) may occur from time to time, often with great unpredictability, and may materially impact the fair value of publicly traded financial institutions and could result in an impairment charge at a future date.

Our results of operations, financial condition or liquidity may be adversely impacted by issues arising from certain industry deficiencies in foreclosure practices, including delays and challenges in the foreclosure process.

Over the past few years, foreclosure time lines have increased due to, among other reasons, delays associated with the significant increase in the number of foreclosure cases as a result of the economic downturn, federal and state legal and regulatory actions, including additional consumer protection initiatives related to the foreclosure process and voluntary and, in some cases, mandatory programs intended to permit or require lenders to consider loan modifications or other alternatives to foreclosure. Further increases in the foreclosure time-line may have an adverse effect on collateral values and our ability to minimize our losses.

Difficult market conditions have adversely affected our industry.

We are operating in a challenging economic environment, including generally uncertain national and local conditions. Additional concerns from some of the countries in the European Union and elsewhere have also strained the financial markets both abroad and domestically. Although there has been some improvement in the overall global macroeconomic conditions in 2013, financial institutions continue to be affected by conditions in the real estate market and the constrained financial markets. In recent years, declines in the housing market, increases in unemployment and under-employment have negatively impacted the credit performance of loans and resulted in significant write-downs of asset values by financial institutions. Reflecting concern over economic conditions, many lenders and institutional investors have reduced or ceased providing funding to borrowers. A worsening of economic conditions may impact our results of operations and financial condition. In particular, we may face the following risks in connection with these events:

- Loan delinquencies could increase further;
- Problem assets and foreclosures could increase further;
- Demand for our products and services could decline;

- Collateral for loans made by us, especially real estate, could decline further in value, in turn reducing a customer s borrowing power, and reducing the value of assets and collateral associated with our loans; and

- Investments in mortgage-backed securities could decline in value as a result of performance of the underlying loans or the diminution of the value of the underlying real estate collateral pressing the government sponsored agencies to honor its guarantees to principal and interest.

Our operations are concentrated in northeastern Pennsylvania and southern New York. As a result of this geographic concentration, our financial results may correlate to the economic conditions in these areas. Deterioration in economic conditions in this market area, particularly in the industries on which this geographic area depend, or a general decline in economic conditions may adversely affect the quality of our loan portfolio (including the level of non-performing assets, charge offs and provision expense) and demand for our products and services, and, accordingly, our results of operations.

Strong competition within our market area may limit our growth and profitability.

Competition in the banking and financial services industry is intense. We compete actively with other northeastern Pennsylvania and southern New York financial institutions, many larger than us, as well as with financial and non-financial institutions headquartered elsewhere. Commercial banks, savings banks, savings and loan associations, credit unions, and money market funds actively compete for deposits and loans. Such institutions, as well as consumer finance, insurance companies and brokerage firms, may be considered competitors with respect to one or more services they render. Many of the institutions with which we compete have substantially greater resources and lending limits and may offer certain services that we do not or cannot provide. Our profitability depends upon our ability to successfully compete in our market area.

A major portion of our net income comes from our interest rate spread, which is the difference between the interest rates paid by us on amounts used to fund assets and the interest rates and fees we receive on our interest-earning assets. Our interest-earning assets include outstanding loans extended to our customers and securities held in our investment portfolio. We fund assets using deposits and other borrowings. Our goal has been to maintain noninterest-bearing deposits in the range of 15.0% to 30.0% of total deposits and, as of December 31, 2013, approximately 20.3% of our deposits were noninterest bearing.

On July 14, 2011, the Federal Reserve issued final rules to repeal Regulation Q, which had prohibited the payment of interest on demand deposits by institutions that are member banks of the Federal Reserve System. The final rules implement Section 627 of the Dodd-Frank Act, which repealed Section 19(i) of the Federal Reserve Act in its entirety effective July 21, 2011. As a result, banks and thrifts are now permitted to offer interest-bearing demand deposit accounts to commercial customers, which were previously forbidden under Regulation Q. The repeal of Regulation Q may cause increased competition from other financial institutions for these deposits. If we decide to pay interest on demand accounts, we would expect our interest expense to increase.

Increased needs for disbursement of funds on loans and deposits can affect our liquidity.

We manage our liquidity with an objective of maintaining a balance between sources and uses of funds in such a way that the cash requirements of customers for loans and deposit withdrawals are met in the most economical manner. If we do not properly manage our liquidity, our business, financial condition, results of operations and cash flows may be materially and adversely affected.

Our future pension plan costs and contributions could be unfavorably impacted by the factors that are used in the actuarial calculations.

As part of the Penseco merger, we assumed Penseco s legacy non-contributory defined benefit pension plan, which was frozen by Penseco in 2008. The costs for this legacy pension plan are dependent upon a number of factors, such as the rates of return on plan assets, discount rates, the level of interest rates used to measure the required minimum funding levels of the plans, future government regulation and required or voluntary contributions made to the plans. Without sustained growth in the pension investments over time to increase the value of our plan assets and depending upon the other factors impacting our costs as listed above, we could be required to fund the plan with higher amounts of cash than are anticipated by our actuaries. Such increased funding obligations could have a material impact on our liquidity by reducing our cash flows.

Our holding company is dependent for liquidity on payments from Peoples Bank, which payments are subject to restrictions.

We depend on dividends, distributions and other payments from Peoples Bank to fund dividend payments to our shareholders, if any, and to fund all payments on obligations of our holding company. Peoples Bank is subject to

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laws that restrict dividend payments or authorize regulatory bodies to block or reduce the flow of funds from Peoples Bank to us. Restrictions or regulatory actions of that kind could impede our access to funds that we may need to make payments on our obligations or dividend payments, if any. In addition, our right to participate in a distribution of assets upon a subsidiary s liquidation or reorganization is subject to the prior claims of the subsidiary s creditors. Holders of our common stock are entitled to receive dividends if and when declared from time to time by our board of directors in its sole discretion out of funds legally available for that purpose.

We need to continually attract and retain qualified personnel for our operations.

Our ability to provide high-quality customer service and to operate efficiently and profitably is dependent on our ability to attract and retain qualified individuals for key positions within the organization. We rely heavily on our executive officers and employees. The loss of certain executive officers or employees could have an adverse effect on us because, as a community bank, the executive officers and employees typically have more responsibility than would be typical at a larger financial institution with more employees. In addition, due to our size as a community bank, we have fewer management-level and other personnel who are in position to succeed to and assume the responsibilities of certain existing executive officers and employees. If we expand geographically or expand to provide non-banking services, current management may not have the necessary experience for successful operation in these new areas. There is no guarantee that management would be able to meet these new challenges or that we would be able to retain new directors or personnel with the appropriate background and expertise.

Our financial performance may suffer if our information technology is unable to keep pace with growth or industry developments.

Effective and competitive delivery of our products and services is increasingly dependent upon information technology resources and processes, both those provided internally as well as those provided through third party vendors. In addition to better serving customers, the effective use of technology increases efficiency and enables us to reduce costs. Our future success will depend, in part, upon our ability to address the needs of our customers by using technology to provide products and services to enhance customer convenience, as well as to create additional efficiencies in our operations. Many of our competitors have greater resources to invest in technological improvements. Additionally, as technology in the financial services industry changes and evolves, keeping pace becomes increasingly complex and expensive for us. There can be no assurance that we will be able to effectively implement new technology-driven products and services, which could reduce our ability to compete effectively.

A failure in or a breach of our information systems or infrastructure, including as a result of cyber-attacks, could disrupt our business, damage our reputation, and could have a material adverse effect on our business, financial condition and results of operations.

In the ordinary course of our business activities, including the ongoing maintenance of deposits, loan and other account relationships for our customers, receiving instructions and effecting transactions for those customers and other users of our products and services, we regularly collect, process, transmit and store significant amounts of confidential information regarding our customers, employees and others. In addition to confidential information regarding our customers, employees and others, we, and in some cases a third party, compile, process, transmit and store proprietary, non-public information concerning our business, operations, plans and strategies.

Information security risks have significantly increased in recent years in part because of the proliferation of new technologies, the use of the Internet and telecommunications technologies to conduct financial transactions, and the increased sophistication and activities of organized crime, hackers, terrorists and other external parties. We rely on digital technologies, computer and email systems, software, and networks to conduct secure processing, transmission and storage of confidential information. In addition, to access our products and services, our customers may use personal smart phones, tablet PCs and other mobile devices that are beyond our control systems. Our technologies, systems, networks and our customers devices have been subject to, and are likely to continue to be the target of, cyber-attacks, computer viruses, malicious code, phishing attacks or information security breaches that could result in the unauthorized use, loss or destruction of our or our customers confidential information, or otherwise disrupt our or our customers or other third parties business operations. We believe that it is more likely than not that such attempted attacks may continue.

Although we use a variety of physical, procedural and technological safeguards to protect confidential information from mishandling, misuse or loss, these safeguards cannot provide assurance that mishandling, misuse or loss of the information will not occur, and that if mishandling, misuse or loss of the information did occur, those events will be promptly detected and addressed. A failure in or breach of our operational or information security system, or those of a third-party service provider, as a result of cyber-attacks or information security breaches could have a material adverse effect on our business, damage our reputation, increase our costs and/or cause significant losses. As information security risks and cyber threats continue to evolve, we may be required to expend substantial resources to further enhance our information security measures and/or to investigate and remediate any information security vulnerabilities.

If information security is breached, despite the controls we and our third-party vendors have instituted, information can be lost or misappropriated, resulting in financial loss or costs to us or damages to others. These costs or losses could materially exceed the amount of insurance coverage, if any, which would adversely affect our earnings. In addition, our reputation could be damaged which could result in loss of customers, greater difficulty in attracting new customers, or an adverse effect on the value of our common stock.

Our disclosure controls and procedures and our internal control over financial reporting may not achieve their intended objectives.

We maintain disclosure controls and procedures designed to ensure that we timely report information as specified in the rules and forms of the Securities and Exchange Commission. We also maintain a system of internal control over financial reporting. These controls may not achieve their intended objectives. Control processes that involve human diligence and compliance, such as our disclosure controls and procedures and internal control over financial reporting, are subject to lapses in judgment and breakdowns resulting from human failures. Controls can also be circumvented by collusion or improper management override. Because of such limitations, there are risks that material misstatements due to error or fraud may not be prevented or detected and that information may not be reported on a timely basis. If our controls are not effective, it could have a material adverse effect on our financial condition, results of operations, and market for our common stock, and could subject us to regulatory scrutiny.

We are exposed to environmental liabilities with respect to real estate.

We currently operate twenty-six branch offices, and own additional real estate. In addition, a significant portion of our loan portfolio is secured by real property. In the course of our business, we may foreclose, accept deeds in lieu of foreclosure, or otherwise acquire real estate, and in doing so could become subject to environmental liabilities with respect to these properties. We may become responsible to a governmental agency or third parties for property damage, personal injury, investigation and clean-up costs incurred by those parties in connection with environmental contamination, or may be required to investigate or clean-up hazardous or toxic substances, or chemical releases at a property. The costs associated with environmental investigation or remediation activities could be substantial. In addition, as the owner or former owner of a contaminated site, we may be subject to common law claims by third parties based on damages and costs resulting from environmental contamination emanating from the property. Although we have policies and procedures to perform an environmental review before acquiring title to any real property, these may not be sufficient to detect all potential environmental hazards. If we were to become subject to significant environmental liabilities, it could materially and adversely affect us.

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The soundness of other financial services institutions may adversely affect our credit risk.

We rely on other financial services institutions through trading, clearing, counterparty, and other relationships. We maintain limits and monitor concentration levels of our counterparties as specified in our internal policies. Our reliance on other financial services institutions exposes us to credit risk in the event of default by these institutions or counterparties. These losses could adversely affect our results of operations and financial condition.

Risks Related to Our Common Stock

Our ability to pay dividends or repurchase shares is subject to limitations.

The Penseco merger agreement 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.

Our ability to pay dividends on our stock depends upon our receipt of dividends from Peoples Bank and its subsidiaries. As a state-chartered bank, Peoples Bank is subject to regulatory restrictions on the payment and amounts of dividends under the Pennsylvania Banking Code.

Further, Peoples Bank s ability to pay dividends is also subject to its profitability, financial condition, capital expenditures and other cash flow requirements. There is no assurance that Peoples Bank will be able to pay the dividends contemplated by the Penseco merger agreement or other dividends. Our failure to pay dividends could have a material adverse effect on the market price of our common stock.

There is a limited trading market for our common stock, which may adversely affect our stock price.

Our common stock is quoted on the OTCQB market place maintained by OTC Market Groups, Inc., and there has been very limited trading in our shares. If an active trading market for our common stock does not exist, you may not be able to sell all of your shares of common stock on short notice, and the sale of a large number of shares at one time could temporarily depress the market price. There also may be a wide spread between the bid and ask price for our common stock. When there is a wide spread between the bid and ask price, the price at which you may be able to sell our common stock may be significantly lower than the price at which you could buy it at that time.

A significant percentage of our common stock is held by our directors and executive officers, which could enable insiders to prevent a merger or other transaction that may provide stockholders a premium for their shares.

At February 28, 2014, our directors and executive officers beneficially owned approximately 9.4% of our common stock. If these individuals were to act together, they could have a significant influence over the outcome of any shareholder vote.

Risks Related to the Penseco Merger and Potential Future Transactions

Integration of Penseco and changes in our historical business may fail to achieve expected results.

The success of our merger with Penseco depends, in part, on a smooth integration and post-merger operations of the combined Peoples Bank. Benefits of the transaction to shareholders may not be realized if the post-merger integration is not well executed or well received by each bank s historical customers. This risk is exacerbated by a material change in the business processes that have been historically operated by Penseco and Peoples.

The integration of Peoples and Penseco could result in the loss of key employees, the disruption of our ongoing business, inconsistencies in standards, controls, procedures and policies that adversely affect our ability to maintain relationships with clients and employees or achieve the anticipated benefits of the merger. As with any merger of financial institutions, there also may be disruptions that cause us to lose customers or cause customers to withdraw their deposits from Peoples Bank, or other unintended consequences that could have a material adverse effect on our results of operations or financial condition.

The success of the merger will depend, in part, on our ability to realize the estimated cost savings from combining the businesses of Peoples and Penseco. The potential cost savings could be more difficult to achieve than we anticipate. If our estimates are incorrect or we are unable to combine the two companies successfully, the anticipated cost savings may not be realized fully or at all, or may take longer to realize than expected.

Future acquisitions by us could dilute existing shareholders ownership of Peoples and may cause us to become more susceptible to adverse economic events.

We may issue shares of our common stock in connection with future acquisitions and other investments, which would dilute existing shareholders ownership interests in Peoples. While there is no assurance that these transactions will occur, or that they will occur on terms favorable to us, future business acquisitions could be material to us, and the degree of success achieved in acquiring and integrating these businesses could have a material effect on the value of our common stock. In addition, these acquisitions could require us to expend substantial cash or other liquid assets or to incur debt, which could cause us to become more susceptible to economic downturns and competitive pressures.

Our governing documents, Pennsylvania law, and current policies of our board of directors contain provisions which may reduce the likelihood of a change in control transaction that may otherwise be available and attractive to shareholders.

Our articles of incorporation and bylaws contain certain anti-takeover provisions that may make it more difficult or expensive or may discourage a tender offer, change in control or takeover attempt that is opposed by our board of directors. In particular, the articles of incorporation and bylaws: classify our board of directors into three groups, so that shareholders elect only approximately one-third of the board each year; require our shareholders to give us advance notice to nominate candidates for election to the board of directors or to make shareholder proposals at a shareholders meeting; and require the affirmative vote of the holders of at least 75 percent of our common stock to approve certain business combinations that have not received the support of two-thirds of our board of directors. These provisions of our articles of incorporation and bylaws could discourage potential acquisition proposals and could delay or prevent a change in control, even though a majority of our shareholders may consider such proposals desirable. Such provisions could also make it more difficult for third parties to remove and replace the members of our board of directors. Moreover, these provisions could diminish the opportunities for shareholders to participate in certain tender offers, including tender offers at prices above the then-current market value of our common stock, and may also inhibit increases in the trading price of our common stock that could result from takeover attempts or speculation.

In addition, anti-takeover provisions in Pennsylvania law could make it more difficult for a third party to acquire control of us. These provisions could adversely affect the market price of our common stock and could reduce the amount that shareholders might receive if we are sold. For example, Pennsylvania law may restrict a third party s ability to obtain control of Peoples and may prevent shareholders from receiving a premium for their shares of our common stock. Pennsylvania law also provides that our shareholders are not entitled by statute to propose amendments to our articles of incorporation.

Our ability to make opportunistic acquisitions is subject to significant risks, including the risk that regulators will not provide the requisite approvals.

We may make opportunistic whole or partial acquisitions of other banks, branches, financial institutions, or related businesses from time to time that we expect may further our business strategy. Any possible acquisition will be subject to regulatory approval, and there can be no assurance that we will be able to obtain such approval in a timely manner or at all. Even if we obtain regulatory approval, these acquisitions could involve numerous risks, including lower than expected performance or higher than expected costs, difficulties related to integration, diversion of management s attention from other business activities, changes in relationships with customers, and the potential loss of key employees. In addition, we may not be successful in identifying acquisition candidates, integrating acquired institutions, or preventing deposit erosion or loan quality deterioration at acquired institutions. Competition for acquisitions can be highly competitive, and we may not be able to acquire other institutions on attractive terms. There can be no assurance that we will be successful in completing or will even pursue future acquisitions, or if such transactions are completed, that we will be successful in integrating acquired businesses into operations. Our ability to grow may be limited if we choose not to pursue or are unable to successfully make acquisitions in the future.

Risks Related to Government Regulation

We operate in a highly regulated environment and may be adversely affected by changes in laws and regulations.

We are subject to extensive regulation, supervision and examination by certain state and federal agencies including the Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System and the Pennsylvania Department of Banking and Securities. Such regulation and supervision govern the activities in which we may engage and are intended primarily to ensure the safety and soundness of financial institutions. Regulatory authorities have extensive discretion in their supervisory and enforcement activities, including the imposition of restrictions on operations, the classification of assets and determination of the level of the allowance for loan losses. Any change in such regulation and oversight, whether in the form of regulatory policy, regulations, legislation or supervisory action, may have a material impact on us and our operations. There also are several federal and state statutes which regulate the obligation and liabilities of financial institutions pertaining to environmental issues. In addition to the potential for attachment of liability resulting from our own actions, we may be held liable under certain circumstances for the actions of our borrowers, or third parties, when such actions result in environmental problems on properties that collateralize loans held by us. Further, the liability has the potential to far exceed the original amount of a loan.

We will be subject to more stringent capital and liquidity requirements in the future, which may adversely affect our net income and future growth.

In July 2013, the federal banking agencies issued final rules to implement the Basel III regulatory capital reforms and changes required by the Dodd-Frank Act. U.S. implementation of Basel III will lead to significantly higher capital requirements and more restrictive leverage and liquidity ratios than those currently in place.

Future increases in minimum capital requirements could adversely affect our net income. Furthermore, our failure to comply with the minimum capital requirements could result in our regulators taking formal or informal actions against us which could restrict our future growth or operations.

The Dodd-Frank Act, among other things, created the Consumer Financial Protection Bureau and has resulted and will result in new regulations that are expected to increase our costs of operations.

On July 21, 2010, the Dodd-Frank Act became law. This law continues to have a significant impact on the bank regulatory structure and the lending, deposit, investment, trading and operating activities of financial institutions and their holding companies. The Dodd-Frank Act requires various federal agencies to adopt a broad range of new implementing rules and regulations, and to prepare numerous studies and reports for Congress. The federal agencies are given significant discretion in drafting the implementing rules and regulations, and consequently, many of the details and much of the impact of the Dodd-Frank Act may not be known for many years.

The Dodd-Frank Act creates a new Consumer Financial Protection Bureau with broad powers to supervise and enforce consumer protection laws. The Consumer Financial Protection Bureau has broad rule-making authority

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for a wide range of consumer protection laws that apply to all banks and savings institutions, including the authority to prohibit unfair, deceptive or abusive acts and practices. The Consumer Financial Protection Bureau has examination and enforcement authority over all banks and savings institutions with more than $10 billion in assets. Banks with $10 billion or less in assets, like us, will continue to be examined for compliance with the consumer laws by their primary bank regulators. Dodd-Frank permits states to adopt consumer protection laws and standards that are more stringent than those adopted at the federal level and, in certain circumstances, permits state attorneys general to enforce compliance with both the state and federal laws and regulations.

It is difficult to quantify at this time what specific impact the Dodd-Frank Act and the implementing rules and regulations will have on community banks.

Increases in FDIC insurance premiums may adversely affect our earnings.

Our deposits are insured by the FDIC up to legal limits and, accordingly, we are subject to FDIC deposit insurance assessments. In order to maintain a strong funding position and restore reserve ratios of the deposit insurance fund depleted during the financial crisis, the FDIC has increased assessment rates of insured institutions. Under the Dodd-Frank Act, the FDIC must undertake several initiatives that will result in higher deposit insurance fees being paid to the FDIC. For example, an FDIC final rule issued on February 7, 2011 revises the assessment system applicable to large banks and implements the use of assets as the base for deposit insurance assessments instead of domestic deposits. We are generally unable to control the amount of premiums that we are required to pay for FDIC insurance. These announced increases and any future increases or required prepayments of FDIC insurance premiums or special assessments may adversely impact our earnings.

Item 1B. Unresolved Staff Comments.

None.

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Item 2. Properties.

Our corporate headquarters is located at 150 N. Washington Avenue, Scranton, Pennsylvania, which houses our finance and planning, trust, merchant services, commercial lending, marketing, human resources and investor services divisions, as well as our executive offices. Our operations division is located at 82 Franklin Avenue, Hallstead, Pennsylvania.

We operate 26 full-service community banking offices located within the Lackawanna, Luzerne, Monroe, Susquehanna, Wayne and Wyoming Counties of Northeastern Pennsylvania and Broome County of New York. Two offices are leased and the balance are owned by Peoples Bank or its subsidiary, Penseco Realty, Inc., with the exception of the Mount Pocono Office, which is owned by Peoples Bank but is located on land occupied under a long-term lease. We have received regulatory approval for a new office in Kingston, Pennsylvania, which is expected to be operational during 2014. We also own an office building located at 241 Main Street, Hallstead, Susquehanna County, Pennsylvania, which serves as our Bank Secrecy Act facility, and property in the Borough of Dalton, Lackawanna County, which may be used for potential future expansion. We lease an office building located in Scranton, Lackawanna County, Pennsylvania, which serves as a loan production office.

We lease several remote ATM locations throughout Northeastern Pennsylvania and Southern New York. All branches and ATM locations are equipped with closed circuit television monitoring.

We consider our properties to be suitable and adequate for our current and immediate future purposes.

Item 3. Legal Proceedings.

There are no material pending legal proceedings, other than ordinary routine litigation incidental to our business, as to which we are a party or of which any of our property is subject.

Item 4. Mine Safety Disclosures.

Not applicable.

Part II

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

As of February 28, 2014, there were approximately 2,678 holders of our common stock, $2.00 par value, including individual participants in security position listings. Our common stock is quoted on the OTCQB market place maintained by OTC Market Groups, Inc. and trades under the symbol PFIS. As contemplated by the merger agreement, we have applied for listing on The Nasdaq Stock Market LLC.

Peoples has paid cash dividends since its incorporation in 1986. The Penseco merger agreement states 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. The payment of future dividends must necessarily depend upon earnings, financial position, appropriate restrictions under applicable laws and other factors relevant at the time our board of directors considers any declaration of dividends. For information on dividend restrictions on the Company and Peoples Bank, refer to the consolidated financial statements and notes to these statements filed at Item 8 to this report and incorporated in their entirety by reference under this Item 5.

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The high and low closing sale prices and dividends per share of the Company s common stock for the four quarters of 2013 and 2012 are summarized in the following table:

	2013			2012		
	Low	High	Dividends Declared	Low	High	Dividends Declared
First Quarter	$ 30.05	$ 34.00	$ 0.23	$ 27.50	$ 29.00	$ 0.22
Second Quarter	33.00	39.90	0.23	28.00	30.00	0.22
Third Quarter	33.50	35.50	0.23	28.80	31.00	0.22
Fourth Quarter	$ 33.50	$ 39.50	$ 0.23	$ 29.50	$ 31.00	$ 0.22

The following table presents information with respect to purchases 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 three months ended December 31, 2013:

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)
October 31, 2013				
November 30, 2013				
December 31, 2013				
Total				

(1) On January 31, 2014, the Board of Directors authorized the purchase of up to 370,000 shares of the Company s common stock.

During 2013, prior to October 10, 2013, we were not subject to the reporting requirements of section 13 or 15(d) of the Securities and Exchange Act of 1934. Between January 29, 2013 and September 11, 2013, we sold 3,150 shares of our common stock upon exercise of outstanding options for aggregate consideration of $89,580. The shares were sold to certain employees and directors who had received options under our 1998 Stock Option Plan in reliance upon the exemption from registration set forth in Rule 701 under the Securities Act of 1933.

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The following line graph compares the cumulative total stockholder return on the Company s common stock, based on the market price change and assumes reinvestment of dividends, with the cumulative total return of the index for The NASDAQ Bank Stocks and the index for the Russell 2000 Stocks during the five-year period ended December 31, 2013. The stockholder return shown on the graph and table below is not necessarily indicative of future performance.

Comparison of Five-Year Cumulative Total Returns

Performance Graph of

PEOPLES FINANCIAL SERVICES CORP

	Period Ending					
Index	**12/31/08**	**12/31/09**	**12/31/10**	**12/31/11**	**12/31/12**	**12/31/13**
Peoples Financial Services Corp.	100.00	102.00	155.29	169.89	188.98	241.98
NASDAQ Bank	100.00	83.70	95.55	85.52	101.50	143.84
Russell 2000	100.00	127.17	161.32	154.59	179.86	249.69

Source : SNL Financial LC,

Charlottesville, VA

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Item 6. Selected Financial Data.
Consolidated Selected Financial Data

(Dollars in thousands, except per share data)

Year Ended December 31	2013	2012	2011	2010	2009
Condensed statements of financial performance:					
Interest income	$ 37,370	$ 37,591	$ 39,707	$ 41,745	$ 40,151
Interest expense	4,169	5,362	7,339	8,356	9,580
Net interest income	33,201	32,229	32,368	33,389	30,571
Provision for loan losses	2,361	924	2,381	1,999	2,260
Net interest income after provision for loan losses	30,840	31,305	29,987	31,390	28,311
Noninterest income	11,762	11,441	12,619	12,152	10,369
Noninterest expense	36,396	29,099	29,041	28,689	28,640
Income before income taxes	6,206	13,647	13,565	14,853	10,040
Provision for income tax expense	485	3,058	3,034	3,287	1,813
Net income	$ 5,721	$ 10,589	$ 10,531	$ 11,566	$ 8,227
Condensed statements of financial position:					
Investment securities	$ 317,010	$ 177,293	$ 191,208	$ 217,044	$ 195,930
Net loans	1,167,966	616,580	624,811	608,605	597,670
Other assets	203,245	124,169	109,513	91,188	90,434
Total assets	$ 1,688,221	$ 918,042	$ 925,532	$ 916,837	$ 884,034
Deposits	$ 1,379,507	$ 721,948	$ 720,518	$ 691,032	$ 645,434
Short-term borrowings	22,052	8,019	9,981	28,082	45,598
Long-term debt	36,743	45,397	58,220	68,835	68,094
Other liabilities	11,127	10,232	9,480	8,422	8,884
Stockholders equity	238,792	132,446	127,333	120,466	116,024
Total liabilities and stockholders equity	$ 1,688,221	$ 918,042	$ 925,532	$ 916,837	$ 884,034
Per share data:					
Net income	$ 1.21	$ 2.37	$ 2.36	$ 2.59	$ 2.01
Cash dividends declared	1.23	1.23	1.23	1.23	1.23
Stockholders equity	$ 31.62	$ 29.65	$ 28.51	$ 26.97	$ 25.98
Cash dividends declared as a percentage of net income	96.33%	51.98%	52.26%	47.59%	61.09%

Average common shares outstanding	4,733,059	4,467,261	4,467,261	4,467,261	4,082,699
Selected ratios (based on average balances):					
Net income as a percentage of total assets	0.58%	1.14%	1.13%	1.30%	1.02%
Net income as a percentage of stockholders equity	4.01	8.07	8.45	9.73	7.89
Stockholders equity as a percentage of total assets	14.43	14.18	13.37	13.38	12.94
Tier I capital as a percentage of adjusted total assets	10.09	11.50	10.82	10.68	11.48
Net interest income as a percentage of earning assets	3.91	4.08	4.04	4.39	4.50
Loans, net, as a percentage of deposits	87.72%	88.69%	87.04%	89.17%	89.39%
Selected ratios and data (based on period end balances):					
Tier I capital as a percentage of risk-weighted assets	13.59%	16.80%	15.77%	15.30%	15.79%
Total capital as a percentage of risk-weighted assets	14.26	17.96	16.87	16.42	16.90
Allowance for loan losses as a percentage of loans, net	0.74	1.11	1.06	1.07	1.05
Nonperforming loans as a percentage of loans, net	1.38%	0.50%	0.68%	0.99%	0.67%

Note: Average balances were calculated using average daily balances. Average balances for loans include nonaccrual loans. Tax-equivalent adjustments were calculated using the prevailing statutory rate of 34.0 percent

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Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations.
Management s Discussion and Analysis 2013 versus 2012

(Dollars in thousands, except per share data)

Management s Discussion and Analysis appearing on the following pages should be read in conjunction with the Consolidated Financial Statements and Management s Discussion and Analysis 2012 versus 2011 contained in this Annual Report on Form 10-K.

Forward-Looking Discussion:

In addition to the historical information contained in this document, the discussion presented may contain and, from time to time, may make, certain statements that constitute forward-looking statements. Words such as expects, anticipates, believes, estimates and other similar expressions or future or conditional verbs such as will, should, and could are intended to identify such forward-looking statements. These statements are not historical facts, but instead represent the current expectations, plans or forecasts of Peoples Financial Services Corp. and its subsidiaries regarding its future operating results, financial position, asset quality, credit reserves, credit losses, capital levels, dividends, liquidity, service charges, cost savings, effective tax rate, impact of changes in fair value of financial assets and liabilities, impact of new accounting and regulatory guidance, legal proceedings and other matters relating to us and the securities that we may offer from time to time. These statements are not guarantees of future results or performance and involve certain risks, uncertainties and assumptions that are difficult to predict, change over time and are often beyond our control. Actual outcomes and results may differ materially from those expressed in, or implied by, forward-looking statements.

You should not place undue reliance on any forward-looking statement and should consider the uncertainties and risks discussed in the Risk Factors in Part I, Item 1A of this annual report, among others, and in any of our subsequent Securities and Exchange Commission (SEC) filings. Forward-looking statements speak only as of the date they are made, and we undertake no obligation to update any forward-looking statement to reflect the impact of circumstances or events that arise after the date the forward-looking statement was made. 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 have been reclassified to conform with the current year s presentation.

Critical Accounting Policies:

Our consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States of America (GAAP). The preparation of consolidated financial statements in conformity with GAAP requires us to establish critical accounting policies and make accounting estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the consolidated financial statements, as well as the reported amounts of revenues and expenses during those reporting periods.

For a discussion of the recent Accounting Standards Updates (ASU) issued by the Financial Accounting Standards Board (FASB) refer to Note 1 entitled Summary of significant accounting policies Recent accounting standards, in the Notes to Consolidated Financial Statements included in Part II, Item 8 of this Annual Report.

An accounting estimate requires assumptions about uncertain matters that could have a material effect on the consolidated financial statements if a different amount within a range of estimates were used or if estimates changed from period to period. Readers of this report should understand that estimates are made considering facts and circumstances at a point in time, and changes in those facts and circumstances could produce results that differ from when those estimates were made. Significant estimates that are particularly susceptible to material change within the near term relate to the determination of allowance for loan losses, determination of

Management s Discussion and Analysis 2013 versus 2012

(Dollars in thousands, except per share data)

other-than-temporary impairment, fair value of financial instruments, the valuations of real estate acquired in connection with foreclosures or satisfaction of loans, acquired assets and liabilities assumed in business combinations and the valuation of loans deferred tax assets and liabilities. Actual amounts could differ from those estimates.

We maintain the allowance for loan losses at a level we believe adequate to absorb probable credit losses related to individually evaluated loans, as well as probable incurred losses inherent in the remainder of the loan portfolio as of the balance sheet date. The balance in the allowance for loan losses account is based on past events and current economic conditions.

The allowance for loan losses account consists of an allocated element and an unallocated element. The allocated element consists of a specific portion for the impairment of loans individually evaluated and a formula portion for loss contingencies on those loans collectively evaluated. The unallocated element, if any, is used to cover inherent losses that exist as of the evaluation date, but which have not been identified as part of the allocated allowance using our impairment evaluation methodology due to limitations in the process.

We monitor the adequacy of the allocated portion of the allowance quarterly and adjust the allowance as necessary through normal operations. This ongoing evaluation reduces potential differences between estimates and actual observed losses. The determination of the level of the allowance for loan losses is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available. Accordingly, management cannot ensure that charge-offs in future periods will not exceed the allowance for loan losses or that additional increases in the allowance for loan losses will not be required, resulting in an adverse impact on operating results.

In determining the requirement to record an other-than-temporary impairment on securities owned by us, four main characteristics are considered including: (i) the length of time and the extent to which the fair value has been less than amortized cost; (ii) the financial condition and near-term prospects of the issuer; (iii) whether the market decline was affected by macroeconomic conditions and (iv) whether the Company has the intent to sell the debt security or more likely than not will be required to sell the debt security before its anticipated recovery. The assessment of whether an other-than-temporary impairment exists involves a high degree of subjectivity and judgment and is based on information available to us at a point in time.

Fair values of financial instruments, in cases where quoted market prices are not available, are based on estimates using present value or other valuation techniques which are subject to change.

Real estate acquired in connection with foreclosures or in satisfaction of loans is adjusted to fair value based upon current estimates derived through independent appraisals less cost to sell. However, proceeds realized from sales may ultimately be higher or lower than those estimates.

Deferred tax assets and liabilities are recognized for the estimated future tax effects of temporary differences by applying enacted statutory tax rates to differences between the financial statement carrying amounts and the tax bases of existing assets and liabilities. The amount of deferred tax assets is reduced, if necessary, to the amount that, based on available evidence, will more likely than not be realized. As changes in tax laws or rates are enacted, deferred tax assets and liabilities are adjusted through the provision for income taxes.

The acquired assets and liabilities assumed in business combinations are measured at fair value as of the acquisition date. In many cases, determining the fair value of the acquired assets and assumed liabilities requires the Company to estimate cash flows expected to result from those assets and liabilities and to discount those cash flows at appropriate rates of interest, which required the utilization of significant estimates and judgment in accounting for the acquisition.

Management s Discussion and Analysis 2013 versus 2012

(Dollars in thousands, except per share data)

For a further discussion of our critical accounting policies, refer to Note 1 entitled, Summary of significant accounting policies, in the Notes to Consolidated Financial Statements to this Annual Report. This note lists the significant accounting policies used by us in the development and presentation of the consolidated financial statements. This MD&A, the Notes to Consolidated Financial Statements and other financial statement disclosures identify and address key variables and other qualitative and quantitative factors that are necessary for the understanding and evaluation of our financial position, results of operations and cash flows.

Operating Environment:

The United States economy continued to expand moderately in 2013, as the gross domestic product (GDP), the value of all goods and services produced in the Nation, increased at an annual rate of 1.9 percent, compared to 2.8 percent in 2012. As a result of the tepid economic growth in 2013, the Federal Open Market Committee (FOMC) maintained the federal funds target range of 0 to 25 basis points throughout the year and further signaled that they intend to keep short-term rates at extraordinarily low levels through at least late 2014. Despite experiencing an improvement in 2013, many areas of the economy such as employment conditions and the housing market remained weak compared to historical standards. Given these weaknesses, the FOMC decided that this extraordinary monetary policy stance was necessary to support the recovery. At their most recent meeting, the FOMC indicated that economic conditions will continue to warrant policy accommodation for an extended period.

Inflationary concerns continue to be relatively tame, as the consumer price index (CPI) at 1.3 percent for 2013 continued to be below the FOMC s benchmark of 2.0 percent. The CPI was 1.5 percent in 2012. Moreover, the core personal consumption expenditure price index, which ignores food and energy, ranged from -0.50 percent to 2.4 percent and averaged 1.0 percent in 2013.

Employment conditions improved moderately in 2013. The civilian labor force decreased 548 thousand, while the number of people employed increased 1.4 million in 2013. As a result, the annual unemployment rate for the Nation fell to 7.4 percent in 2013 from 8.1 percent in 2012. All sectors of employment, with the exception of the government sector, reported employment gains from the end of 2012.

National, Pennsylvania, New York and our market area s non-seasonally-adjusted annual unemployment rates in 2013 and 2012, are summarized as follows:

	2013	2012
United States	7.4%	8.1%
New York	8.3%	8.5%
Pennsylvania	8.0%	7.9%
Broome County	8.0%	8.8%
Lackawanna County	7.9%	9.0%
Luzerne County	9.5%	9.7%
Monroe County	9.4%	9.8%

Susquehanna County	7.0%	7.5%
Wayne County	7.2%	7.6%
Wyoming County	9.4%	9.6%

Employment conditions in 2013 were relatively unchanged at 8.0 percent for the Commonwealth of Pennsylvania. The unemployment rate for New York State dropped to 8.3 percent in 2013, from 8.5 percent in 2012. With respect to the markets we serve, the unemployment rate decreased in all of the seven counties. Lackawanna County experienced the most significant improvement declining from 9.0 percent in 2012 to

Management s Discussion and Analysis 2013 versus 2012

(Dollars in thousands, except per share data)

7.9 percent in 2013. The lowest unemployment rate in 2013, for all of counties we serve, was Susquehanna County at 7.0 percent. The marked improvements in unemployment rates could impact the rate of economic growth and may cause interest rates to rise in the near term.

With respect to the banking industry, net income for all Federal Deposit Insurance Corporation (FDIC)-insured banks in 2013 totaled $154.7 billion, an increase of $13.6 billion or 9.6 percent over 2012. This is the fourth consecutive year that earnings have risen. Approximately 54.2 percent of all institutions reported higher net income in 2013, while only 7.8 percent reported net losses. This is the lowest annual proportion of unprofitable institutions for the industry since 2005. Loan loss provisions of $32.1 billion in 2013 were $25.7 billion or 44.4 percent less than banks set aside in 2012. This is the fourth year in a row that loan loss provisions have been lower, and the total allocation for 2013 was the smallest amount since 2006. Net interest income declined for a third consecutive year, falling by $3.7 billion or 0.9 percent, as interest income fell more rapidly than interest expense. Noninterest income was $3.2 billion or 1.3 percent above the level of 2012, as trading revenue increased by $4.3 billion or 23.7 percent, and servicing fee income rose by $3.9 billion or 27.5 percent. Realized gains on securities were $5.2 billion or 53.7 percent lower than a year ago. Total noninterest expense declined $4.5 billion or 1.1 percent comparing 2013 and 2012. The average return on average assets for 2013 was 1.07 percent, the highest annual average for the industry since 2006.

The United States economy is expected to grow at a faster pace in 2014 as compared to the past few years. This rate of growth could change interest rates which may adversely impact bank earnings as net interest margins compress from the inability of management to further reduce fund costs. Continuous expense control, sound balance sheet management and lower loan loss provisions could offset some of the negative impact of the reduction in net interest margins.

Review of Financial Position:

Peoples Financial Services Corp., a bank holding company incorporated under the laws of Pennsylvania, provides a full range of financial services through its wholly-owned subsidiary, Peoples Security Bank and Trust Company (Peoples Bank), including its subsidiaries, Peoples Advisors, LLC and Penseco Realty, Inc. (collectively, the Company or Peoples). On November 30, 2013, Penseco Financial Services Corporation, a financial holding company incorporated under the laws of Pennsylvania (Penseco), merged with and into Peoples Financial Services Corp., with Peoples Financial Services Corp. being the surviving corporation (the Merger), pursuant to an Agreement and Plan of Merger dated June 28, 2013 (the Merger Agreement). In connection with the Merger, on December 1, 2013, Penseco s former banking subsidiary, Penn Security Bank and Trust Company, merged with and into Peoples Neighborhood Bank (the Bank Merger), and the resulting institution adopted the name, Peoples Security Bank and Trust Company. The Company services its retail and commercial customers through twenty-six full-service community banking offices located within the Lackawanna, Luzerne, Monroe, Susquehanna, Wayne and Wyoming Counties of Northeastern Pennsylvania and Broome County of New York.

Peoples Bank is a state-chartered bank and trust company under the jurisdiction of the Pennsylvania Department of Banking and Securities and the Federal Deposit Insurance Corporation. Peoples Bank s primary product is loans to small- and medium-sized businesses. Other lending products include one-to-four family residential mortgages and consumer loans. Peoples Bank primarily funds its loans by offering open time deposits to commercial enterprises and individuals. Other deposit product offerings include certificates of deposits and various demand deposit accounts.

Peoples Advisors, LLC, a member-managed limited liability company, provides investment advisory services through a third party to individuals and small businesses. Penseco Realty, Inc. holds and manages real estate assets on behalf of Peoples Bank.

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Peoples Advisors, LLC and Penseco Realty, Inc. did not meet the quantitative thresholds for required segment disclosure in conformity with accounting principles generally accepted in the United States of America (GAAP). Peoples Bank s twenty-six community banking offices, all similar with respect to economic characteristics, share a majority of the following aggregation criteria: (i) products and services; (ii) operating processes; (iii) customer bases; (iv) delivery systems; and (v) regulatory oversight. Accordingly, they were aggregated into a single operating segment.

The Company faces competition primarily from commercial banks, thrift institutions and credit unions within the Northeastern Pennsylvania market, many of which are substantially larger in terms of assets and capital. In addition, mutual funds and security brokers compete for various types of deposits, and consumer, mortgage, leasing and insurance companies compete for various types of loans and leases. Principal methods of competing for banking and permitted nonbanking services include price, nature of product, quality of service and convenience of location.

The Company and Peoples Bank are subject to regulations of certain federal and state regulatory agencies and undergo periodic examinations.

The aforementioned merger between the Company and Penseco was considered a merger of equals and is accounted for as a reverse merger using the acquisition method of accounting. As a result of the reverse merger, Peoples is the legal acquirer and Penseco is the accounting acquirer. In a reverse merger the historical consolidated financial statements are those of the accounting acquirer, Penseco and, consequently, comparisons may not be particularly meaningful. The results for the year ended December 31, 2013, include the operating results of Penseco for the entire year and the operating results of Peoples since November 30, 2013. The merger with Penseco had a significant impact on the results of operations for the year ended December 31, 2013.

Readers of this Management Discussion and Analysis are encouraged to refer to the note entitled Merger accounting, in the Notes to the Consolidated Financial Statements to more fully understand the impact that the merger had on the Company s financial position and results of operations.

Total assets, loans and deposits were $1.7 billion, $1.2 billion and $1.4 billion, respectively, at December 31, 2013. Although loans, net and deposits increased 6.7 percent and 2.7 percent, respectively, considering only historical Penseco information, the majority of the total 2013 increases over the 2012 year-end balances were the result of the merger. In accordance with the acquisition accounting for the merger, the historical assets and liabilities of Peoples have been recorded at their respective estimated fair values on the date of the merger. The estimated fair values are subject to change for up to one year after the date of the merger if information unknown relative to closing date fair values becomes available.

Total investment securities were $317.0 million at December 31, 2013, including $299.7 million of investment securities classified as available-for sale and $17.3 million classified as held-to-maturity. Total deposits consisted of $279.9 million in noninterest-bearing and $1.1 billion in interest-bearing deposits at December 31, 2013.

Stockholders equity equaled $238.8 million or $31.62 per share at December 31, 2013, and $132.5 million or $29.65 per share at December 31, 2012. Dividends declared for the 2013 amounted to $1.23 per share, as adjusted for the merger exchange ratio of 1.3636.

Nonperforming assets equaled $16.8 million or 1.42 percent of loans, net and foreclosed assets at December 31, 2013. The allowance for loan losses equaled $8.7 million or 0.74 percent of loans, net, at December 31, 2013, compared to $7.0 million or 1.11 percent at year-end 2012. The decrease in the ratio of the allowance for loan losses as a percentage of loans, net, is primarily a function of acquisition accounting, whereby the historical loan

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portfolio of Peoples was recorded at its estimated fair value, including a discount to reflect credit risk, and the Peoples historical allowance for loan losses was eliminated. Loans charged-off, net of recoveries, for the twelve months ended December 31, 2013, equaled $660.0 thousand or 0.10 percent of average loans, compared to $685.0 thousand or 0.11 percent of average loans in 2012.

Investment Portfolio:

Primarily, our investment portfolio provides a source of liquidity needed to meet expected loan demand and generates a reasonable return in order to increase our profitability. Additionally, we utilize the investment portfolio to meet pledging requirements and reduce income taxes. At December 31, 2013, our portfolio consisted primarily of short-term U.S. Government agency and mortgage-backed securities, which provide a source of liquidity and intermediate-term, tax-exempt state and municipal obligations, which mitigate our tax burden.

Our investment portfolio is subject to various risk elements that may negatively impact our liquidity and profitability. The greatest risk element affecting our portfolio is market risk or interest rate risk (IRR). Understanding IRR, along with other inherent risks and their potential effects, is essential in effectively managing the investment portfolio.

Market risk or IRR relates to the inverse relationship between bond prices and market yields. It is defined as the risk that increases in general market interest rates will result in market value depreciation. A marked reduction in the value of the investment portfolio could subject us to liquidity strains and reduced earnings if we are unable or unwilling to sell these investments at a loss. Moreover, the inability to liquidate these assets could require us to seek alternative funding, which may further reduce profitability and expose us to greater risk in the future. In addition, since the majority of our investment portfolio is designated as available-for-sale and carried at estimated fair value, with net unrealized gains and losses reported as a separate component of stockholders equity, market value depreciation could negatively impact our capital position.

During 2013, the FOMC indicated that economic conditions warrant maintaining exceptionally low levels for the federal funds rate for an extended period. Yields on short-term U.S. Treasury securities hovered around the target range for the federal funds rate of 0 to 25 basis points in 2013, as economic data suggested weak employment conditions and relatively low inflation. Our investment portfolio consists primarily of fixed-rate bonds. As a result, changes in general market interest rates have a significant influence on the fair value of our portfolio. Specifically, the parts of the yield curve most closely related to our investments include the 2-year and 10-year U.S. Treasury securities. The yield on the 2-year U.S. Treasury note affects the values of our U.S. Government agency and mortgage-backed securities, whereas the 10-year U.S. Treasury note influences the value of tax-exempt state and municipal obligations. The yield on the 2-year U.S. Treasury increased from 0.25 percent at year-end 2012 to 0.28 percent at year-end 2013. Similarly, the yield on the 10-year U.S. Treasury increased 126 basis points from 1.78 percent at December 31, 2012, to 3.04 percent at December 31, 2013. Since bond prices move inversely to yields, we experienced a decrease in the aggregate fair value of our investment portfolio. We reported net unrealized holding gains, included as a separate component of stockholders equity of $1.8 million, net of income taxes of $1.0 million, at December 31, 2013, and $4.5 million, net of income taxes of $2.3 million, at December 31, 2012.

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The carrying values of the major classifications of investment securities and their respective percentages of total investment securities for the past three years are summarized as follows:

Distribution of investment securities

	2013		2012		2011	
December 31	**Amount**	**%**	**Amount**	**%**	**Amount**	**%**
U.S. Government agencies	$ 204	0.06%				
U.S. Government-sponsored enterprises	113,045	35.66	$ 84,682	47.76%	$ 77,985	40.79%
State and municipals:						
Taxable	16,698	5.27				
Tax-exempt	105,453	33.26	59,920	33.80	67,198	35.14
Corporate debt securities	4,387	1.38			1,004	0.53
Mortgage-backed securities:						
U.S. Government agencies	20,346	6.42	136	0.08	155	0.08
U.S. Government-sponsored enterprises	55,780	17.60	31,484	17.76	43,923	22.97
Equity securities:						
Preferred						
Common	1,097	0.35	1,071	0.60	943	0.49
Total	$ 317,010	100.00%	$ 177,293	100.00%	$ 191,208	100.00%

Investment securities totaled $317.0 million at December 31, 2013 and $177.3 million at December 31, 2012. At December 31, 2013, the investment portfolio consisted of $299.7 million of investment securities classified as available-for-sale and $17.3 million classified as held-to-maturity. Excess deposited funds not used to fund loans were directed into the investment portfolio. Security purchases totaled $22.1 million in 2013, with the majority of the purchases consisted of U.S. Government agency and U.S. Government-sponsored enterprise mortgage-backed securities and tax-exempt state and municipal obligations. Investment purchases in 2012 amounted to $46.3 million.

Repayments of investment securities totaled $29.6 million in 2013 and $55.2 million in 2012. We received proceeds of $4.6 million from the sale of investment securities in 2013 and $5.8 million in 2012. Net gains recognized on the sale of investment securities available-for-sale totaled $163 in 2013 and $317 in 2012.

There were no other-than-temporary impairments (OTTI) recognized for the years ended December 31, 2013 and 2012. For additional information related to OTTI refer to Note 4 entitled Investment securities in the Notes to Consolidated Financial Statements to this Annual Report.

Investment securities averaged $185.0 million and equaled 20.4 percent of average earning assets in 2013, compared to $187.0 million and 22.1 percent in 2012. The tax-equivalent yield on the investment portfolio decreased 24 basis points to 3.17 percent in 2013 from 3.41 percent in 2012.

At December 31, 2013 and 2012, there were no securities of any individual issuer, except for U.S. Government agency mortgage-backed securities, that exceeded 10.0 percent of stockholders equity.

The maturity distribution based on the carrying value and weighted-average, tax-equivalent yield of the investment portfolio at December 31, 2013, is summarized as follows. The weighted-average yield, based on amortized cost, has been computed for tax-exempt state and municipals on a tax-equivalent basis using the prevailing federal statutory tax rate of 34.0 percent. The distributions are based on contractual maturity with the

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exception of equity securities. Equity securities with no stated contractual maturities are included in the After ten years maturity distribution. Expected maturities may differ from contractual maturities because borrowers have the right to call or prepay obligations with or without call or prepayment penalties.

Maturity distribution of investment securities

	Within one year		After one but within five years		After five but within ten years		After ten years		Total	
December 31, 2013	**Amount**	**Yield**	**Amount**	**Yield**	**Amount**	**Yield**	**Amount**	**Yield**	**Amount**	**Yield**
U.S. Government agencies							$ 204	3.85%	$ 204	3.85%
U.S. Government-sponsored enterprises	$ 16,093	1.17%	$ 86,407	0.89%	$ 10,545	2.25%			113,045	1.05
State and municipals:										
Taxable			918	3.64	7,300	3.44	8,480	4.33	16,698	3.91
Tax-exempt	6,451	0.68	13,129	1.29	11,563	4.42	74,310	6.08	105,453	4.97
Corporate debt securities			4,387	3.14					4,387	3.14
Mortgage-backed securities:										
U.S. Government agencies			1,485	1.23	17,677	2.36	1,184	2.10	20,346	1.86
U.S. Government-sponsored enterprises			12,784	1.15	25,503	2.25	17,493	3.62	55,780	1.43
Equity securities:										
Preferred										
Common							1,097	2.59	1,097	2.59
Total	$ 22,544	0.97%	$ 119,110	1.07%	$ 72,588	2.74%	$ 102,768	5.43%	$ 317,010	2.66%

Loan Portfolio:

Economic factors and how they affect loan demand are of extreme importance to us and the overall banking industry, as lending is a primary business activity. Loans are the most significant component of earning assets and they generate the greatest amount of revenue for us. Similar to the investment portfolio, there are risks inherent in the loan portfolio that must be understood and considered in managing the lending function. These risks include IRR, credit concentrations and fluctuations in demand. Changes in economic conditions and interest rates affect these risks which influence loan demand, the composition of the loan portfolio and profitability of the lending function.

Management s Discussion and Analysis 2013 versus 2012

(Dollars in thousands, except per share data)

The composition of the loan portfolio at year-end for the past five years is summarized as follows:

Distribution of loan portfolio

	2013		2012		2011		2010		2009	
December 31	**Amount**	**%**	**Amount**	**%**	**Amount**	**%**	**Amount**	**%**	**Amount**	**%**
Commercial	$ 350,680	29.80%	$ 91,724	14.71%	$ 88,188	13.96%	$ 55,978	9.10%	$ 41,178	6.82%
Real estate:										
Commercial	413,058	35.11	217,496	34.88	208,875	33.07	207,964	33.81	194,935	32.28
Residential	322,062	27.37	261,912	42.00	281,643	44.60	295,301	48.01	308,068	51.01
Consumer	90,817	7.72	52,398	8.40	52,816	8.36	55,862	9.08	59,789	9.90
Loans, net	1,176,617	100.00%	623,530	100.00%	631,522	100.00%	615,105	100.00%	603,970	100.00%
Less: allowance for loan loss	8,651		6,950		6,711		6,500		6,300	
Net loans	$ 1,167,966		$ 616,580		$ 624,811		$ 608,605		$ 597,670	

Loans, net totaled $1.2 billion at December 31, 2013 and $623.5 million at the end of 2012. Business loans, including commercial loans and commercial mortgages, were $763.7 million at December 31, 2013, and $309.2 million at year-end 2012. Residential mortgages and consumer loans were $322.1 million and $90.8 million at year end 2013 and $261.9 million and $52.4 million at year end 2012.

Loans averaged $689.4 million in 2013, compared to $635.8 million in 2012. Taxable loans averaged $637.2 million, while tax-exempt loans averaged $52.2 million at December 31, 2013. Due to the increase in loan demand, the loan portfolio played a more prominent role in our earning asset mix. As a percentage of earning assets, average loans equaled 76.0 percent in 2013 compared to 75.2 percent in 2012.

The prime rate was unchanged at 3.25 percent for 2013. The continuation of low interest rates caused the tax-equivalent yield on our loan portfolio to decrease 37 basis points to 4.88 percent in 2013 from 5.25 percent in 2012. The effect of market rates on our loan portfolio s yield can be further evidenced by evaluating quarterly loan yields, which continued to decline during 2013. After being relatively unchanged in the first quarter at 5.14 percent, the tax-equivalent yield on the loan portfolio fell 23 basis points to 4.91 percent in the second quarter. Loan yields declined further in the third quarter, decreasing 15 basis points. The yield on the loan portfolio remained at the third quarter level during the final quarter of 2013. With no anticipated date for change in general market rates in the near term, the yield on the loan portfolio may continue to decline as there are adjustable-rate loans in the portfolio that will reprice downward throughout the year. Moreover, increased competition will prompt more aggressive pricing for fixed rate intermediate term loans and lower yields further.

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The maturity distribution and sensitivity information of the loan portfolio by major classification at December 31, 2013, is summarized as follows:

Maturity distribution and interest sensitivity of loan portfolio

December 31, 2013	**Within one year**	**After one but within five years**	**After five years**	**Total**
Maturity schedule:				
Commercial	$ 45,097	$ 89,136	$ 216,447	$ 350,680
Real estate:				
Commercial	29,456	65,075	318,527	413,058
Residential	12,057	29,398	280,607	322,062
Consumer	11,216	36,824	42,777	90,817
Total	$ 97,826	$ 220,433	$ 858,358	$ 1,176,617
Predetermined interest rates	$ 50,416	$ 133,477	$ 223,772	$ 407,665
Floating or adjustable interest rates	47,410	86,956	634,586	768,952
Total	$ 97,826	$ 220,433	$ 858,358	$ 1,176,617

As previously mentioned, there are numerous risks inherent in the loan portfolio. We manage the portfolio by employing sound credit policies and utilizing various modeling techniques in order to limit the effects of such risks. In addition, we utilize private mortgage insurance (PMI) and guaranteed Small Business Administration and Federal Home Loan Bank of Pittsburgh (FHLB-Pgh) loan programs to mitigate credit risk in the loan portfolio.

In an attempt to limit IRR and liquidity strains, we continually examine the maturity distribution and interest rate sensitivity of the loan portfolio. For 2013, market interest rates remained at historically low levels. Given the potential for rates to rise in the future, we continued to place emphasis on originating short term fixed-rate and adjustable-rate loans. Fixed-rate loans represented 34.6 percent of the loan portfolio at December 31, 2013, compared to floating or adjustable-rate loans at 65.4 percent. Approximately 51.2 percent of the loan portfolio is expected to reprice within the next 12 months.

Additionally, our secondary market mortgage banking program provides us with an additional source of liquidity and a means to limit our exposure to IRR. Through this program, we are able to competitively price conforming one-to-four family residential mortgage loans without taking on IRR which would result from retaining these long-term, low fixed-rate loans on our books. The loans originated are subsequently sold in the secondary market, with the sales price locked in at the time of commitment, thereby greatly reducing our exposure to IRR.

Loan concentrations are considered to exist when the total amount of loans to any one borrower, or a multiple number of borrowers engaged in similar business activities or having similar characteristics, exceeds 10.0 percent of loans outstanding in any one category. We provide deposit and loan products and other financial services to individual and corporate customers in our seven-county market area. There are no significant concentrations of credit risk from any individual counterparty or groups of counterparties, except for geographic concentrations.

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, and may involve, to varying degrees, elements of credit risk and IRR in excess of the amount recognized in the consolidated financial statements.

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Credit risk is the principal risk associated with these instruments. Our involvement and exposure to credit loss in the event that the instruments are fully drawn upon and the customer defaults is represented by the contractual amounts of these instruments. In order to control credit risk associated with entering into commitments and issuing letters of credit, we employ the same credit quality and collateral policies in making commitments that we use in other lending activities. We evaluate each customer s creditworthiness on a case-by-case basis, and if deemed necessary, obtain collateral. The amount and nature of the collateral obtained is based on our credit evaluation.

The contractual amounts of off-balance sheet commitments at year-end for the past three years are summarized as follows:

Distribution of off-balance sheet commitments

December 31	2013	2012	2011
Commitments to extend credit	$ 221,138	$ 128,540	$ 124,623
Unused portions of lines of credit	52,257	46,377	47,026
Commercial letters of credit	29,914	14,440	19,054
Total	$ 303,309	$ 189,357	$ 190,703

We record an allowance for off-balance sheet credit losses, if deemed necessary, separately as a liability. No allowance was deemed necessary at December 31, 2013 and 2012. We do not anticipate that losses, if any, that may occur as a result of funding off-balance sheet commitments, would have a material adverse effect on our operating results or financial position.

Asset Quality:

We are committed to developing and maintaining sound, quality assets through our credit risk management policies and procedures. Credit risk is the risk to earnings or capital which arises from a borrower s failure to meet the terms of their loan agreement. We manage credit risk by diversifying the loan portfolio and applying policies and procedures designed to foster sound lending practices. These policies include certain standards that assist lenders in making judgments regarding the character, capacity, capital structure and collateral of the borrower.

With regard to managing our exposure to credit risk in light of general devaluations in real estate values, we have established maximum loan-to-value ratios for commercial mortgage loans not to exceed 75.0 percent of the lower of cost or appraised value. With regard to residential mortgages, customers with loan-to-value ratios between 80.0 percent and 100.0 percent are required to obtain PMI. There are no residential mortgage loans outstanding with loan-to-value ratios in excess of 100.0 percent. The 80.0 percent loan-to-value threshold provides a cushion in the event the property is devalued. PMI is used to protect us from loss in the event loan-to-value ratios exceed 80.0 percent and the customer defaults on the loan. Written appraisals are obtained prior to final approval for all real estate loans. Appraisals are performed by an independent appraiser engaged by us, not the customer, who is either state certified or state licensed depending upon collateral type and loan amount.

With respect to lending procedures, lenders must determine the borrower s ability to repay the credit based on prevailing and expected market conditions prior to requesting approval for the loan. The Board of Directors establishes and reviews, at least annually, the lending authority for all loan officers and branch managers. Credits beyond the scope of the loan officers and branch managers are forwarded to the Loan Committee. This Committee, comprised of senior management, attempts to assure the quality of the loan portfolio through careful analysis of credit applications, adherence to credit policies and the examination of outstanding loans and

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delinquencies. These procedures assist in the early detection and timely follow-up of problem loans. Credits having an aggregated relationship of $2.5 million are subject to approval by our Board of Directors.

Credit risk is also minimized by quarterly internal reviews of our loan portfolio by the loan quality committee. These reviews aid us in identifying deteriorating financial conditions of borrowers, allowing us to assist customers in remedying these situations.

Nonperforming assets consist of nonperforming loans and foreclosed assets. Nonperforming loans include nonaccrual loans, troubled debt restructured loans and accruing loans past due 90 days or more. For a discussion of our policy regarding nonperforming assets and the recognition of interest income on impaired loans, refer to the notes entitled, Summary of significant accounting policies Nonperforming assets, and Loans, net and allowance for loan losses in the Notes to Consolidated Financial Statements to this Annual Report.

Information concerning nonperforming assets for the past five years is summarized as follows. The table includes credits classified for regulatory purposes and all material credits that cause us to have serious doubts as to the borrower s ability to comply with present loan repayment terms.

Distribution of nonperforming assets

December 31	**2013**	**2012**	**2011**	**2010**	**2009**
Nonaccrual loans:					
Commercial	$ 4,038	$ 304	$ 477	$ 977	$ 199
Real estate:					
Commercial	4,503	145	591	1,385	672
Residential	3,535	1,800	2,006	1,579	1,273
Consumer	90	31	92	93	195
Total nonaccrual loans	12,166	2,280	3,166	4,034	2,339
Troubled debt restructured loans:					
Commercial	2,487	351	368	401	
Real estate:					
Commercial					
Residential					
Consumer					
Total troubled debt restructured loans	2,487	351	368	401	
Accruing loans past due 90 days or more:					
Commercial	6			100	

Real estate:					
Commercial	200		11		41
Residential	678	243	641	1,236	1,415
Consumer	571	214	122	294	241
Total accruing loans past due 90 days or more	1,455	457	774	1,630	1,697
Total nonperforming loans	16,108	3,088	4,308	6,065	4,036
Foreclosed assets	648	656	1,571	803	405
Total nonperforming assets	$ 16,756	$ 3,744	$ 5,879	$ 6,868	$ 4,441
Nonperforming loans as a percentage of loans, net	1.38%	0.50%	0.68%	0.99%	0.67%
Nonperforming assets as a percentage of loans, net and foreclosed assets	1.43%	0.60%	0.93%	1.12%	0.73%

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For a further discussion of assets classified as nonperforming assets, refer to the note entitled, Loans, net and the allowance for loan losses, in the Notes to Consolidated Financial Statements to this Annual Report.

We maintain the allowance for loan losses at a level we believe adequate to absorb probable credit losses related to individually evaluated loans, as well as probable incurred losses inherent in the remainder of the loan portfolio as of the balance sheet date. The balance in the allowance for loan losses account is based on past events and current economic conditions. We employ the FFIEC Interagency Policy Statement, as amended, 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 FASB Accounting Standards Codification (ASC) 310 for loans specifically identified to be individually evaluated for impairment and the requirements of FASB ASC 450, 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, our loan review division identifies those loans to be individually evaluated for impairment and those to be 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 to assure directional consistency of the allowance for loan loss account. Regulators, in reviewing the loan portfolio as part of the scope of a regulatory examination, may require us to increase our allowance for loan losses or take other actions that would require increases to our allowance for loan losses.

For a further discussion of our accounting policies for determining the amount of the allowance and a description of the systematic analysis and procedural discipline applied, refer to the note entitled, Summary of significant accounting policies Allowance for loan losses, in the Notes to Consolidated Financial Statements to this Annual Report.

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A reconciliation of the allowance for loan losses and an illustration of charge-offs and recoveries by major loan category for the past five years are summarized as follows:

Reconciliation of allowance for loan losses

December 31	**2013**	**2012**	**2011**	**2010**	**2009**
Allowance for loan losses at beginning of period	$ 6,950	$ 6,711	$ 6,500	$ 6,300	$ 5,275
Loans charged-off:					
Commercial	5	78	100	1,138	610
Real estate:					
Commercial	15	33	663		188
Residential	508	431	1,275	213	161
Consumer	313	275	262	487	341
Total	841	817	2,300	1,838	1,300
Loans recovered:					
Commercial	1	1	3		
Real estate:					
Commercial	20	6	18	1	
Residential	111	67	58	19	42
Consumer	49	58	51	19	23
Total	181	132	130	39	65
Net loans charged-off	660	685	2,170	1,799	1,235
Provision for loan losses	2,361	924	2,381	1,999	2,260
Allowance for loan losses at end of period	$ 8,651	$ 6,950	$ 6,711	$ 6,500	$ 6,300
Ratios:					
Net loans charged-off as a percentage of average loans outstanding	0.10%	0.11%	0.35%	0.30%	0.22%
Allowance for loan losses as a percentage of period end loans	0.74%	1.11%	1.06%	1.06%	1.04%

The allowance for loan losses increased $1.7 million to $8.7 million at December 31, 2013, from $7.0 million at the end of 2012. The increase resulted from a provision for loan losses of $2,361 exceeding net loans charged-off of $660. The allowance for loan losses, as a percentage of loans, net of unearned income, was 0.74 percent at the end of 2013, compared to 1.11 percent at the end of 2012. The reduction in this ratio was a result of following the accounting guidance for loans that we acquired in connection with the merger whereby there is no carryover of the related allowance for credit losses attributable to those loans. However, the guidance does require a credit quality adjustment be established as of the merger date. For a further discussion of the credit quality adjustment for loans acquired in the merger, refer to the Notes to the Consolidated Financial Statements to this Annual Report.

Past due loans not satisfied through repossession, foreclosure or related actions are evaluated individually to determine if all or part of the outstanding balance should be charged against the allowance for loan losses account. Any subsequent recoveries are credited to the allowance account. Net loans charged-off decreased $25 to $660 in 2013 from $685 in 2012. Net charge-offs, as a percentage of average loans outstanding, equaled 0.10 percent in 2013 and 0.11 percent in 2012.

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Allocation of the allowance for loan losses

The allocation of the allowance for loan losses for the past five years is summarized as follows:

	2013		2012		2011		2010		2009	
December 31	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%
Allocated allowance:										
Specific:										
Commercial	$ 1,500	0.68%	$ 351	0.10%	$ 443	0.13%	$ 921	0.19%		
Real Estate:										
Commercial	300	0.81	550	0.35		0.09	225	0.22		
Residential	224	0.35	325	0.39	215	0.32	269	0.30		
Consumer		0.01		0.01		0.02		0.02		
Total specific	2,024	1.85	1,226	0.85	658	0.56	1,415	0.73		
Formula:										
Commercial	508	29.12	448	14.60	350	13.83	1,036	8.91	$ 1,440	5.09%
Real Estate:										
Commercial	2,094	34.30	1,754	34.53	2,294	32.98	1,842	33.58	2,560	32.27
Residential	2,911	27.02	2,656	41.62	2,640	44.28	484	47.71	1,200	51.01
Consumer	1,114	7.71	866	8.40	769	8.35	1,723	9.07	1,100	11.63
Total formula	6,627	98.15	5,724	99.15	6,053	99.44	5,085	99.27	6,300	100.00
Total allocated allowance	8,651	100.00%	6,950	100.00%	6,711	100.00%	6,500	100.00%	6,300	100.00%
Unallocated allowance										
Total	$ 8,651		$ 6,950		$ 6,711		$ 6,500		$ 6,300	

The allocated element of the allowance for loan losses account increased $1,701 to $8,651 at December 31, 2013, compared to $6,950 at December 31, 2012. Both the specific and formula portions of the allowance for loan losses increased from the end of 2012. The specific portion of the allowance for impairment of loans individually evaluated under FASB ASC 310, increased $798 to $2,024 at December 31, 2013, from $1,226 at year-end 2012. In addition, the formula portion of the allowance for loans collectively evaluated for impairment under FASB ASC 450, increased

$903 to $6,627 at December 31, 2013, from $5,724 at December 31, 2012. The total loss factor for collectively evaluated loans increased from year-end 2012 due to an increase in the qualitative factors related to the continued unrest in the economic climate.

The coverage ratio, the allowance for loan losses account, as a percentage of nonperforming loans, is an industry ratio used to test the ability of the allowance account to absorb potential losses arising from nonperforming loans. The coverage ratio was 51.6 percent at December 31, 2013. We believe that our allowance was adequate to absorb probable credit losses at December 31, 2013.

Deposits:

Our deposit base is the primary source of funds to support our operations. We offer a variety of deposit products to meet the needs of our individual and commercial customers. Deposits totaled $1.4 billion at December 31, 2013 and $721.9 million at December 31, 2012. Noninterest-bearing deposits represented 20.3 percent of total deposits at December 31, 2013, compared to interest-bearing deposits at 79.7 percent. Comparatively, noninterest-bearing deposits and interest-bearing deposits represented 20.9 percent and 79.1 percent of total deposits at year end 2012.

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The average amount of, and the rate paid on, the major classifications of deposits for the past three years are summarized as follows:

Deposit distribution

	2013		2012		2011	
Year Ended December 31	**Average Balance**	**Average Rate**	**Average Balance**	**Average Rate**	**Average Balance**	**Average Rate**
Interest-bearing:						
Money market accounts	$ 175,675	0.25%	$ 162,775	0.33%	$ 158,115	0.46%
NOW accounts	116,242	0.23	93,151	0.25	72,283	0.34
Savings accounts	150,083	0.11	124,692	0.13	117,928	0.26
Time deposits less than $100	97,826	0.97	114,050	1.13	162,003	1.38
Time deposits $100 or more	87,277	1.22	82,196	1.44	83,948	1.71
Total interest-bearing	627,103	0.46%	576,864	0.59%	594,277	0.83%
Noninterest-bearing	158,790		140,001		120,952	
Total deposits	$ 785,893		$ 716,865		$ 715,229	

Total deposits averaged $785.9 million in 2013, an increase of $69.0 million or 9.6 percent, compared to $716.9 million in 2012. Average noninterest-bearing deposits increased $18.8 million or 13.4 percent, while average interest-bearing accounts grew $50.2 million or 8.7 percent. Average interest-bearing transaction deposits, including money market, NOW and savings accounts, increased $61.4 million while average total time deposits decreased $11.2 million comparing 2013 and 2012. We continued to experience strong growth in these account types, as customers continued to receive lease payments and royalties from gas companies for drilling rights to their properties.

Our cost of deposits decreased 13 basis points from 0.59 percent in 2012 to 0.46 percent in 2013. Deposit costs declined 6 basis points in the first quarter of 2013 but remained relatively constant throughout the rest of the year ending the final quarter of 2013 at 0.48 percent.

Volatile deposits, time deposits $100 or more, were $134.8 million at December 31, 2013, compared to $81.9 million at the end of 2012. Large denomination time deposits averaged $87.3 million in 2013, an increase of $5.1 million or 6.2 percent from $82.2 million in 2012. Our average cost of these funds decreased 22 basis points to 1.22 percent in 2013, from 1.44 percent in 2012. This type of funding is susceptible to withdrawal by the depositor as they are particularly price sensitive and are therefore not considered to be a strong source of liquidity.

Maturities of time deposits $100 or more for the past three years are summarized as follows:

Maturity distribution of time deposits $100 or more

December 31	**2013**	**2012**	**2011**
Within three months	$ 33,377	$ 15,402	$ 14,033
After three months but within six months	26,320	26,518	19,228
After six months but within twelve months	26,000	10,693	16,615
After twelve months	49,125	29,242	34,952
Total	$ 134,822	$ 81,855	$ 84,828

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We recorded a core deposit intangible related to a value ascribed to demand, interest checking, money market and saving accounts as well as a fair value adjustment for time deposits assumed in applying the purchase accounting guidance for the merger. For a further discussion of the fair value adjustments related to deposits assumed in the merger, refer to the Notes to the Consolidated Financial Statements to this Annual Report.

In addition to deposit gathering, we have in place a secondary source of liquidity to fund operations through exercising existing credit arrangements with the FHLB-Pgh. We had only minimal reliance on this type of funding in 2013 and 2012. For a further discussion of our borrowings and their terms, refer to the note entitled, Short-term borrowings, in the Notes to Consolidated Financial Statements included in Part II, Item 8 of this Annual Report.

Market Risk Sensitivity:

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 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 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. 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. 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.

The FOMC has maintained the target range for the federal funds rate at 0 to 25 basis points and has indicated that economic conditions are likely to continue to warrant these exceptionally low interest rate levels for some time. Given these conditions, IRR and the ability to effectively manage it, are extremely critical to both bank management and regulators. The FFIEC recently issued an advisory reiterating the importance of effective corporate governance, policies and procedures, risk measuring and monitoring systems, stress testing and internal controls related to the IRR exposure of depository institutions. According to the advisory, the bank regulators believe that the current financial market and economic conditions present significant risk management challenges to all financial institutions. Although the bank regulators recognize that some degree of IRR is inherent in banking, they expect institutions to have sound risk management practices in place to measure, monitor and control IRR exposure. The advisory states that the adequacy and effectiveness of an institution s IRR management process and the level of IRR exposure are critical factors in the bank regulators evaluation of an institution s sensitivity to changes in interest rates and capital adequacy. Material weaknesses in risk management processes or high levels of IRR exposure relative to capital will require corrective action. We believe our risk management practices with regard to IRR were sound, suitable and adequate given the level of IRR exposure at December 31, 2013.

The Asset/Liability Committee (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 several 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), rate sensitive liabilities (RSL) and overall operating results and financial position.

With respect to evaluating our exposure to IRR on earnings, we utilize a gap analysis model that considers repricing frequencies of RSA and RSL. Gap analysis attempts to measure our interest rate exposure by

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calculating the net amount of RSA and RSL that reprice within specific time intervals. A positive gap occurs when the amount of RSA repricing in a specific period is greater than the amount of RSL repricing within that same time frame and is indicated by a RSA/RSL ratio greater than 1.0. A negative gap occurs when the amount of RSL repricing is greater than the amount of RSA and is indicated by a RSA/RSL ratio less than 1.0. A positive gap implies that earnings will be impacted favorably if interest rates rise and adversely if interest rates fall during the period. A negative gap tends to indicate that earnings will be affected inversely to interest rate changes.

Our interest rate sensitivity gap position, illustrating RSA and RSL at their related carrying values, is summarized as follows. The distributions in the table are based on a combination of maturities, call provisions, repricing frequencies and prepayment patterns. Adjustable-rate assets and liabilities are distributed based on the repricing frequency of the instrument. Mortgage instruments are distributed in accordance with estimated cash flows, assuming there is no change in the current interest rate environment.

Interest rate sensitivity

December 31, 2013	Due within three months	Due after three months but within twelve months	Due after one year but within five years	Due after five years	Total
Rate-sensitive assets:					
Interest-bearing deposits in other banks	$ 8,374	992	2,480		$ 11,846
Federal funds sold	9,460				9,460
Investment securities	15,124	$ 41,618	$ 186,957	$ 73,311	317,010
Loans held for sale	1,757				1,757
Loans, net	391,941	210,504	487,259	86,913	1,176,617
Total rate-sensitive assets	$ 426,656	$ 253,114	$ 676,696	$ 160,224	$ 1,516,690
Rate-sensitive liabilities:					
Money market accounts	$ 229,626				$ 229,626
NOW accounts	55,380		$ 139,551		194,931
Savings accounts	12,774		359,327		372,101
Time deposits less than $100	33,070	55,595	63,870	15,550	168,085
Time deposits $100 or more	33,377	52,320	46,110	3,015	134,822
Short-term borrowings	22,052				22,052
Long-term debt	10,229	2,745	15,108	8,661	36,743

Total rate-sensitive liabilities	$ 396,508	$ 110,660	$ 623,966	$ 27,226	$ 1,158,360
Rate-sensitivity gap:					
Period	$ 30,148	$ 142,454	$ 52,730	$ 132,998	
Cumulative	$ 30,148	$ 172,602	$ 225,332	$ 358,330	
RSA/RSL ratio:					
Period	1.08	2.29	1.08	5.88	
Cumulative	1.08	1.34	1.20	1.31	1.31

At December 31, 2013, we were in a positive gap position with a cumulative one-year RSA/RSL ratio of 1.34. Similarly, at December 31, 2012, our cumulative one-year RSA/RSL ratio was 1.26. Given the economic conditions, which included an exceptionally low short-term interest rate environment, the focus of ALCO during 2013 was to maintain the positive gap position in order to safeguard future earning from the potential risk of rising interest rates. Specifically throughout 2013, we attempted to increase the volume of loans with short

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repricing terms in order to maintain over IRR position. In addition, we continued offering preferential rates on longer-term certificates of deposit, including 72- and 84-month maturities. The positive impact on our gap position from implementing these strategic initiatives was partially negated as customer interest in transaction type accounts became more popular as a means of storing funds obtained from natural gas drilling activities. ALCO will reemphasize these strategies in 2014 in an attempt to maintain a positive gap position between RSA and RSL. However, these forward-looking statements are qualified in the aforementioned section entitled Forward-Looking Discussion in this Management s Discussion and Analysis.

Static gap analysis, although a credible measuring tool, does not fully illustrate the impact of interest rate changes on future earnings. First, market rate changes normally do not equally or simultaneously affect all categories of assets and liabilities. Second, assets and liabilities that can contractually reprice within the same period may not do so at the same time or to the same magnitude. Third, the interest rate sensitivity table presents a one-day position and variations occur daily as we adjust our rate sensitivity throughout the year. Finally, assumptions must be made in constructing such a table. For example, the conservative nature of our Asset/Liability Management Policy assigns personal NOW accounts to the Due after three months but within twelve months repricing interval. In reality, these accounts may reprice less frequently and in different magnitudes than changes in general market interest rate levels.

We utilize a simulation model to address the failure of the static gap model to address the dynamic changes in the balance sheet composition or prevailing interest rates and to enhance our asset/liability management. This 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 December 31, 2013, would increase slightly at 0.9 percent from model results using current interest rates.

We will continue to monitor our IRR position in 2014 and employ deposit and loan pricing strategies and direct the reinvestment of loan and investment payments and prepayments in order to maintain a favorable IRR position.

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

Liquidity:

Liquidity management is essential to our continuing operations as it gives us the ability to meet our financial obligations as they come due, as well as to take advantage of new business opportunities as they arise. Our 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.

Our liquidity position is impacted by several factors which include, among others, loan origination volumes, loan and investment maturity structure and cash flows, demand for core deposits and certificate of deposit maturity

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structure and retention. We manage these liquidity risks daily, thus enabling us to effectively monitor fluctuations in our position and to adapt our position according to market influence and balance sheet trends. We also forecast future liquidity needs and develop strategies to ensure adequate liquidity at all times.

Historically, core deposits have been our 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 our liquidity is adequate to meet both present and future financial obligations and commitments on a timely basis.

We maintain a Contingency Funding Plan to address liquidity in the event of a funding crisis. Examples of some of the causes of a liquidity crisis include, among others, natural disasters, war, events causing reputational harm and severe and prolonged asset quality problems. The Plan recognizes the need to provide alternative funding sources in times of crisis that go beyond our core deposit base. As a result, we have created a funding program that ensures the availability of various alternative wholesale funding sources that can be used whenever appropriate. Identified alternative funding sources include:

- FHLB-Pgh liquidity contingency line of credit;
- Federal Reserve Bank discount window;
- Internet certificates of deposit;
- Brokered deposits;
- Institutional Deposit Corporation deposits;
- Repurchase agreements; and
- Federal funds purchased.

Based on our liquidity position at December 31, 2013, we do not anticipate the need to utilize any of these sources in the near term.

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 illustrate our reliance on noncore funds to fund our investments and loans maturing after

2013. At December 31, 2013, our noncore funds consisted of time deposits in denominations of $100 or more, repurchase agreements, short-term borrowings and long-term debt. Large denomination time deposits are particularly not considered to be a strong source of liquidity since they are very interest rate sensitive and are considered to be highly volatile. At December 31, 2013, our net noncore funding dependence ratio, the difference between noncore funds and short-term investments to long-term assets, was 10.0 percent. Our net short-term noncore funding dependence ratio, noncore funds maturing within one year, less short-term investments to long-term assets equaled 4.1 percent. Comparatively, our ratios equaled 6.5 percent and 5.0 percent at the end of 2012, which indicated an increase in our reliance on noncore funds. We believe that by supplying adequate volumes of short-term investments and implementing competitive pricing strategies on deposits, we can ensure adequate liquidity to support future growth.

The Consolidated Statements of Cash Flows present the change in cash and cash equivalents from operating, investing and financing activities. Cash and cash equivalents consist of cash on hand, cash items in the process of collection, noninterest-bearing and interest-bearing deposits with other banks and federal funds sold. Cash and cash equivalents increased $3.5 million for the year ended December 31, 2013. Conversely, for the year ended December 31, 2012, cash and cash equivalents increased $13.4 million. During 2013, cash provided by operating and financing activities more than offset cash used in investing activities.

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Operating activities provided net cash of $9.8 million in 2013 and $12.6 million in 2012. Net income, adjusted for the effects of noncash expenses such as depreciation and the provision for loan losses is the primary source of funds from operations.

Net cash provided by financing activities equaled $8.6 million in 2013. Net cash used in financing activities was $18.9 million in 2012. Deposit gathering, which is our predominant financing activity, increased in both 2013 and 2012. Deposit gathering provided a net cash inflow in 2013 of $28.9 million and $1.4 million in 2012. Partially offsetting the cash provided by deposit gathering in 2013 was a $3.7 million net decrease in short-term borrowings, an $11.1 million repayment of long-term debt and cash dividends paid of $5.5 million.

Our primary investing activities involve transactions related to our investment and loan portfolios. Net cash used in investing activities totaled $14.9 million in 2013. Net cash provided by investing activities was $19.7 million in 2012. Net cash used in lending activities was $50.7 million in 2013. Loan repayments outpaced loan origination in 2012 resulting in net cash provided of $7.3 million. Activities related to our investment portfolio provided net cash of $12.1 million in 2013 and $14.8 million in 2012.

We anticipate our liquidity position to be stable in 2013. Although we are expecting loan demand to continue to be strong, we expect to fund such demand through deposit gathering and payments and prepayments on loans and investments. As the infrastructure for natural gas drilling grows, we anticipate deposit receipts from royalties to increase. Moreover, continued weakness in economic conditions may result in increased interest in bank deposits, as consumers continue to save rather than spend. However, we cannot predict the economic climate or the savings habits of consumers. Should economic conditions improve, deposit gathering may be negatively impacted as depositors seek alternative investments in the market. Regardless of economic conditions and stock market fluctuations, we believe that through constant monitoring and adherence to our liquidity plan, we will have the means to provide adequate cash to fund our normal operations in 2014.

Capital Adequacy:

We believe a strong capital position is essential to our continued growth and profitability. We strive to maintain a relatively high level of capital to provide our depositors and stockholders with a margin of safety. In addition, a strong capital base allows us to take advantage of profitable opportunities, support future growth and provide protection against any unforeseen losses.

Bank regulatory agencies consider capital to be a significant factor in ensuring the safety of a depositor s accounts. These agencies have adopted minimum capital adequacy requirements that include mandatory and discretionary supervisory actions for noncompliance. Our and Peoples Bank s risk-based capital ratios are strong and have consistently exceeded the minimum regulatory capital ratios of 4.0 percent and 8.0 percent required for adequately capitalized institutions. Our ratio of Tier 1 capital to risk-weighted assets and off-balance sheet items was 13.6 percent at December 31, 2013, and 16.8 percent at December 31, 2012. Our Total capital ratio was 14.3 percent at December 31, 2013 and 18.0 percent at December 31, 2012. Similarly, our Leverage ratio, which equaled 10.1 percent at December 31, 2013, and 11.5 percent at December 31, 2012, exceeded the minimum of 4.0 percent for capital adequacy purposes. Peoples Bank reported Tier 1 capital, Total capital and Leverage ratios of 13.0 percent, 13.7 percent and 9.7 percent at December 31, 2013, and 16.2 percent, 17.4 percent and 11.1 percent at December 31, 2012. Based on the most recent notification from the FDIC, Peoples Bank was categorized as well capitalized at December 31, 2013 and 2012. There are no conditions or events since this notification that we believe have changed Peoples Bank s category. For a further discussion of these risk-based capital standards and supervisory actions for noncompliance, refer to the note entitled, Regulatory matters, in the Notes to Consolidated Financial Statements to this Annual Report.

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Stockholders equity was $238.8 million or $31.62 per share at December 31, 2013, and $132.5 million or $29.65 per share at December 31, 2012. Stockholders equity was primarily impacted by recording the fair value of consideration exchanged of $106.5 million as a result of the merger. In addition, net income of $5.7 million was offset by net cash dividends declared of $5.5 million.

We declared dividends of $1.23 per share in 2013 and 2012. The dividend payout ratio, dividends declared as a percent of net income, equaled 96.3 percent in 2013 and 52.0 percent in 2012. Our board of directors intends to continue paying cash dividends in the future. The Penseco merger agreement 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. Our ability to declare and pay dividends in the future, however, is based on our operating results, financial and economic conditions, capital and growth objectives, appropriate dividend restrictions and other relevant factors. We rely on dividends received from our subsidiary, Peoples Bank, for payment of dividends to stockholders. Peoples Bank s ability to pay dividends is subject to federal and state regulations. For a further discussion on our ability to declare and pay dividends in the future and dividend restrictions, refer to the note entitled, Regulatory matters, in the Notes to Consolidated Financial Statements included in Part II, Item 8 of this annual report.

On January 31, 2014, our board of directors adopted a common stock repurchase plan whereby we are authorized to repurchase up to 370,000 shares of our outstanding shares through open market purchases.

Review of Financial Performance:

Net income was $5,721 or $1.21 per share in 2013 and $10,589 or $2.37 per share in 2012. Return on average assets (ROAA) and return on average equity (ROAE) were 0.58 percent and 4.01 percent for the year ended December 31, 2013. ROAA was 1.14 percent and ROAE was 8.07 percent for the year ended December 31, 2012.

Tax-equivalent net interest income was $35,415 in 2013 and $34,468 in 2012. Our net interest margin equaled 3.91 percent in 2013 and 4.08 percent in 2012. Noninterest income totaled $11,762 in 2013 and $11,441 in 2012. Noninterest expense was $36,396 for the year ended December 31, 2013 compared to $29,099 for the year ended December 31 2012.

Net Interest Income:

Net interest income is the fundamental source of earnings for commercial banks. Moreover, fluctuations in the level of noninterest 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 and 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 interest 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

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interest-bearing liabilities, illustrates the effects changing interest rates have on profitability. Net interest margin, net interest income as a percentage of average 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 pretax 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 in this analysis on a tax-equivalent basis using the prevailing federal statutory tax rate of 34.0 percent.

Similar to all banks, we consider the maintenance of an adequate net interest margin to be of primary concern. The current economic environment has been very challenging for the banking industry. In addition to market rates and competition, nonperforming asset levels are of particular concern for the banking industry and may place additional pressure on net interest margins. Nonperforming assets may increase given the state of the economy and soft labor markets. No assurance can be given as to how general market conditions will change or how such changes will affect net interest income. Therefore, we believe through prudent deposit and loan pricing practices, careful investing, and constant monitoring of nonperforming assets, our net interest margin will remain strong.

We analyze interest income and interest expense by segregating rate and volume components of earning assets and interest-bearing liabilities. The impact changes in the interest rates earned and paid on assets and liabilities, along with changes in the volumes of earning assets and interest-bearing liabilities, have on net interest income are summarized as follows. The net change or mix component, attributable to the combined impact of rate and volume changes within earning assets and interest-bearing liabilities categories, has been allocated proportionately to the change due to rate and the change due to volume.

Net interest income changes due to rate and volume

	2013 vs 2012 Increase (decrease) attributable to			2012 vs 2011 Increase (decrease) attributable to		
	Total	**Rate**	**Volume**	**Total**	**Rate**	**Volume**
Interest income:						
Loans:						
Taxable	$ 250	$ (2,609)	$ 2,859	$ (1,546)	$ (1,021)	$ (525)
Tax-exempt	(18)	111	(129)	687	(438)	1,125
Investments:						
Taxable	(464)	(376)	(88)	(443)	(474)	31
Tax-exempt	(55)	(232)	177	(859)	(241)	(618)
Interest-bearing deposits	39	17	22	(12)	15	(27)
Federal funds sold	2		2	(2)	(1)	(1)
Total interest income	(246)	(3,089)	2,843	(2,175)	(2,160)	(15)

Interest expense:						
Money market accounts	(113)	(153)	40	(177)	(198)	21
NOW accounts	27	(27)	54	(12)	(74)	62
Savings accounts	(3)	(34)	31	(146)	(163)	17
Time deposits less than $100	(345)	(174)	(171)	(946)	(357)	(589)
Time deposits $100 or more	(114)	(184)	70	(253)	(224)	(29)
Short-term borrowings	(4)		(4)	(45)	(12)	(33)
Long-term debt	(641)	(131)	(510)	(398)	2	(400)
Total interest expense	(1,193)	(703)	(490)	(1,977)	(1,026)	(951)
Net interest income	$ 947	$ (2,386)	$ 3,333	$ (198)	$ (1,134)	$ 936

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For the year ended December 31, tax-equivalent net interest income was $35,415 in 2013 and $34,468 in 2012. There was a positive volume variance offset partially by a negative rate variance.

Changes in the volumes of earning assets and interest-bearing liabilities contributed to an increase of $947 in net interest income. Average earning assets increased $61.6 million to $906.9 million in 2013 from $845.3 million in 2012 and accounted for a $2,843 increase in interest income. Average loans, net increased $53.6 million or 8.4 percent, which caused interest income to increase $2,730. Average taxable investments decreased $4.8 million or 3.8 percent comparing 2013 and 2012, which resulted in decreased interest income of $88 while average tax-exempt investments increased $2.8 million or 4.5 percent which resulted in an increase to interest income of $177.

Average interest-bearing liabilities rose $34.1 million or 5.3 percent to $674.4 million in 2013 from $640.3 million in 2012. The growth resulted in a net increase in interest expense of $490. Large denomination time deposits averaged $5.1 million more in 2013 and caused interest expense to increase $70. A decrease of $16.2 million in average time deposits less than $100 deducted $171 from interest expense. In addition, interest-bearing transaction accounts, including money market, NOW and savings accounts grew $61.4 million, which in aggregate caused a $125 increase in interest expense. Short-term borrowings averaged $1.3 million less and reduced interest expense $4 while long-term debt averaged $14.9 million less and reduced interest expense by $510 comparing 2013 and 2012.

An unfavorable rate variance occurred as the decrease in the tax-equivalent yield on earning assets was more than the reduction in the cost of funds. As a result, tax-equivalent net interest income decreased $2,386. The tax-equivalent yield on earning assets decreased 35 basis points to 4.36 percent in 2013 from 4.71 percent in 2012, resulting in a reduction in interest income of $3,089. Specifically, the yield on the taxable loan portfolio decreased 43 basis points to 4.88 percent in 2013 from 5.31 percent in 2012. The decline in the yield on the taxable loan portfolio was a reflection of the condition of general market rates. Taxable loan yield reductions caused interest income to decrease $2,609, representing 84.5 percent of the entire reduction in interest income due to changes in rates.

The reduction in interest income was mitigated by a decrease of $703 in interest expense, which resulted from a 22 basis point decrease in the cost of funds to 0.62 percent in 2013 from 0.84 percent in 2012. We experienced reductions in the rates paid on all major categories of interest-bearing liabilities with the exception of short-term borrowings. Specifically, the cost of money market, NOW and savings accounts decreased 8 basis points, 2 basis points and 2 basis points comparing 2013 and 2012. These decreases resulted in a reduction in interest expense of $214. With regard to time deposits, the average rate paid for time deposits less than $100 decreased 16 basis points while time deposits $100 or more decreased 22 basis points, which together resulted in a $358 decrease in interest expense. The average rate paid on short-term borrowings was 33 basis points for 2013 and 2012. Interest expense was reduced $131 from a 27 basis point decline in the average rate paid on long-term debt.

The average balances of assets and liabilities, corresponding interest income and expense and resulting average yields or rates paid are summarized as follows. Averages for earning assets include nonaccrual loans. Investment averages include available-for-sale securities at amortized cost. Income on investment securities and loans is adjusted to a tax-equivalent basis using the prevailing federal statutory tax rate of 34.0 percent.

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Summary of net interest income

	2013			2012		
	Average Balance	Interest Income/ Expense	Average Interest Rate	Average Balance	Interest Income/ Expense	Average Interest Rate
Assets:						
Earning assets:						
Loans:						
Taxable	$ 637,153	$ 31,102	4.88%	$ 580,835	$ 30,852	5.31%
Tax-exempt	52,259	2,536	4.85	54,975	2,554	4.65
Investments:						
Taxable	119,866	1,881	1.57	124,695	2,345	1.88
Tax-exempt	65,073	3,977	6.11	62,278	4,032	6.47
Interest-bearing deposits	31,659	86	0.27	22,518	47	0.21
Federal funds sold	902	2	0.22			
Total earning assets	906,912	39,584	4.36%	845,301	39,830	4.71%
Less: allowance for loan losses	7,311			6,776		
Other assets	89,513			86,289		
Total assets	$ 989,114			$ 924,814		
Liabilities and Stockholders Equity:						
Interest-bearing liabilities:						
Money market accounts	$ 175,675	431	0.25%	$ 162,775	544	0.33%
NOW accounts	116,242	264	0.23	93,151	237	0.25
Savings accounts	150,083	163	0.11	124,692	166	0.13
Time deposits less than $100	97,826	949	0.97	114,050	1,294	1.13
Time deposits $100 or more	87,277	1,069	1.22	82,196	1,183	1.44
Short-term borrowings	10,158	34	0.33	11,484	38	0.33
Long-term debt	37,151	1,259	3.39	51,964	1,900	3.66
Total interest-bearing liabilities	674,412	4,169	0.62%	640,312	5,362	0.84
Noninterest-bearing deposits	158,790			140,001		
Other liabilities	13,159			13,327		
Stockholders equity	142,753			131,174		
Total liabilities and stockholders equity	$ 989,114			$ 924,814		

Net interest income/spread	$	35,415	3.74%	$	34,468	3.87%
Net interest margin			3.91%			4.08%
Tax-equivalent adjustments:						
Loans	$	862		$	867	
Investments		1,352			1,372	
Total adjustments	$	2,214		$	2,239	

Note: Average balances were calculated using average daily balances. Interest income on loans includes fees of $1,125 in 2013, $937 in 2012 and $645 in 2011. Tax-equivalent adjustments were calculated using the prevailing federal statutory tax rate of 34.0 percent.

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Summary of net interest income (continued)

	2011		
	Average Balance	Interest Income/ Expense	Average Interest Rate
Assets:			
Earning assets:			
Loans:			
Taxable	$ 590,499	$ 32,398	5.49%
Tax-exempt	32,054	1,867	5.82
Investments:			
Taxable	123,345	2,788	2.26
Tax-exempt	71,686	4,891	6.82
Interest-bearing deposits	36,759	59	0.16
Federal funds sold	2,994	2	0.07
Total earning assets	857,337	42,005	4.90%
Less: allowance for loan losses	6,565		
Other assets	81,774		
Total assets	$ 932,546		
Liabilities and Stockholders Equity:			
Interest-bearing liabilities:			
Money market accounts	$ 158,115	721	0.46%
NOW accounts	72,283	249	0.34
Savings accounts	117,928	312	0.26
Time deposits less than $100	162,003	2,240	1.38
Time deposits $100 or more	83,948	1,436	1.71
Short-term borrowings	20,845	83	0.40
Long-term debt	62,908	2,298	3.65
Total interest-bearing liabilities	678,030	7,339	1.08%
Noninterest-bearing deposits	120,952		
Other liabilities	8,899		
Stockholders equity	124,665		
Total liabilities and stockholders equity	$ 932,546		

Net interest income/spread	$	34,666	3.82%
Net interest margin			4.04%
Tax-equivalent adjustments:			
Loans	$	680	
Investments		1,618	
Total adjustments	$	2,298	

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

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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 an appropriate level. The provision for loan losses equaled $2,361 in 2013 and $924 in 2012. Based on our most recent evaluation at December 31, 2013, we believe that the allowance was adequate to absorb any known or potential losses in our portfolio.

Noninterest Income:

With regard to noninterest income, revenue generated from service charges, fees and commissions was $4,092 or 34.8 percent of total noninterest revenue in 2013 while merchant services income of $3,936 accounted for 33.5 percent of the total noninterest revenue. Commissions and fees on fiduciary activities were $1,735 or 14.7 percent of noninterest revenue. All other categories of noninterest revenue, including wealth management income, mortgage banking income, life insurance investment income and net gains from the sale of investment securities available-for-sale were a combined $1,999 or 17.0 percent of total noninterest revenue in 2013.

Our noninterest income increased $321 or 2.8 percent to $11,762 in 2013 from $11,441 in 2012. Revenue received from Service charges, fees and commissions increased $412 or 11.2 percent comparing 2013 and 2012. Commissions and fees on fiduciary activities increased $254 or 17.2 percent while wealth management income increased $241 or 91.3 percent comparing 2013 and 2012 as investing activity increased. Income from investment in life insurance increased $464 or 92.1 percent to $968 in 2013 from $504 in 2012. Merchant services income decreased $354 or 8.3 percent to $3,936 in 2013 from $4,290 in 2012 from a decrease in the volume of transactions processed. Mortgage banking income decreased $542 or 59.9 percent in 2013 compared to 2012 as mortgage rates increased and fewer customers refinanced through secondary markets.

Noninterest Expense:

In general, our noninterest expense is categorized into three main groups, including employee-related expense, occupancy and equipment expense 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 marketing, other taxes, stationery and supplies, contractual services, insurance, including FDIC assessment and loan collection costs. Several of these costs and expenses are variable while the remainder is fixed. We utilize budgets and other related strategies in an effort to control the variable expenses.

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The major components of noninterest expense for the past three years are summarized as follows:

Noninterest expense

Year Ended December 31	**2013**	**2012**	**2011**
Salaries and employee benefits expense:			
Salaries and payroll taxes	$ 13,276	$ 11,980	$ 11,779
Employee benefits	2,707	2,141	2,172
Salaries and employee benefits expense	15,983	14,121	13,951
Occupancy and equipment expenses:			
Occupancy expense	3,354	2,376	2,616
Equipment expense	634	570	945
Occupancy and equipment expenses	3,988	2,946	3,561
Other expenses:			
Merchant transaction expense	2,490	2,742	3,166
FDIC insurance and assessments	400	458	450
Professional fees and outside services	2,104	2,077	1,498
Other taxes	1,268	1,708	862
Stationery and supplies	359	339	325
Advertising	350	287	494
Amortization of intangible assets	326	267	304
Acquisition of related expenses	4,609		
Other	4,519	4,154	4,430
Other expenses	16,425	12,032	11,529
Total noninterest expense	$ 36,396	$ 29,099	$ 29,041

Salaries and employee benefits expense was the largest component of other expenses at $15,983. Salaries and payroll taxes was the largest component of other expenses at $13,276 or 36.5 percent of total noninterest expenses in 2013 with employee benefits adding $2,707 or 7.4 percent.

Salaries and employee benefits expense increased $1,862 or 13.2 percent to $15,983 in 2013 from $14,121 in 2012. Salaries and payroll taxes increased $1,296 or 10.8 percent, while employee benefits expense increased $566 or 26.4 percent. The increase in the salaries and payroll taxes component was directly related to costs associated with the merger and annual merit increases. The increase in employee benefits expense resulted primarily from an increases in health care costs.

For 2013, occupancy and equipment expense totaled $3,988. Occupancy expense contributed $3,354 or 9.2 percent to noninterest expenses while equipment expense contributed $634 or 1.7 percent. Occupancy and equipment expense increased $1,042 or 35.4 percent to $3,988 in 2013 from $2,946 in 2012. Specifically, building-related costs increased $978 while equipment-related costs increased only $64. The increase in occupancy expense resulted from incurring additional maintenance and leasing expenses associated with our facilities.

Other expenses, which consist of merchant transaction expense, FDIC insurance and assessments, professional fees and outside services, other taxes, stationary and supplies, advertising, amortization of intangible assets, acquisition related expenses and all other expenses were $16,425 in 2013. Within other expenses are acquisition related expenses of $4,609 or 12.7 percent of noninterest expenses, $2,490 in merchant transaction expenses or

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6.8 percent, professional fees, and outside services of $2,104 or 5.8 percent, other taxes amounting to $1,268 or 3.5 percent. All other expense categories not detailed individually are $5,954 or 16.4 percent of total noninterest expenses.

Merchant transaction expenses decreased $252 or 9.2 percent to $2,490 in 2013 compared to $2,742 in 2012 due to a decrease in the volume of transactions processed. This is consistent with the decrease to income generated from merchant services. Other expenses increased $365 or 8.8 percent to $4,519 in 2013 from $4,154 in 2012. We recognized $4,609 of acquisition related expenses in 2013.

Income Taxes:

Our income tax expense was $485 or 7.8 percent of income before income taxes in 2013 and $3,058 or 22.4 percent in 2012. The effective tax rate in 2013 is relatively low due to the fact that tax-exempt income represents a relatively high percentage of income before income taxes. The effect of tax-exempt income was partially offset by nondeductible merger related expenses.

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Review of Financial Position:

Total assets decreased $7.5 million or 0.8 percent to $918.0 million at December 31, 2012, from $925.5 million at December 31, 2011. Total assets averaged $924.8 million in 2012, a decrease of $7.7 million or 0.8 percent from $932.5 million in 2011. Earning assets averaged $845.3 million and equaled 91.4 percent of total average assets in 2012, compared to $857.3 million or 91.9 percent of total average assets in 2011.

The balance sheet growth was driven by an increase in total deposits of $1.4 million or 0.2 percent to $721.9 million at the end of 2012, from $720.5 million at year-end 2011. Total interest-bearing deposits decreased $14.9 million or 2.5 percent, while noninterest-bearing deposits rose $16.3 million or 12.1 percent. A decline in time deposits was primarily responsible for the change in interest-bearing deposits in 2012. Short-term interest rates remained at historically low levels in 2012. As a result, we experienced a 24 basis point reduction in our cost of funds to 0.84 percent in 2012 from 1.08 percent in 2011.

Loans, net decreased $8.0 million or 1.3 percent to $623.5 million at December 31, 2012, from $631.5 million at December 31, 2011. Loans averaged $635.8 million and represented 75.2 percent of average earning assets in 2012, compared to $622.6 million or 72.6 percent in 2011. Corresponding with the reductions in short-term interest rates, the prime rate remained at 3.25 percent over the course of 2012. The tax-equivalent yield on the loan portfolio decreased 25 basis points to 5.25 percent in 2012 from 5.50 percent in 2011. Investment securities decreased $13.9 million to $177.3 million at the end of 2012 from $191.2 million at December 31, 2011. Similar to loan yields, the tax-equivalent yield on the investment portfolio declined 53 basis points in 2012. Overall, we experienced a 19 basis point reduction in the tax-equivalent yield on earning assets to 4.71 percent in 2012 from 4.90 percent in 2011.

Stockholders equity equaled $132.5 million or $29.65 per share at December 31, 2012, and $127.3 million or $28.51 per share at December 31, 2011. Our Leverage ratio improved to 11.5 percent at the end of 2012, compared to 10.8 percent at December 31, 2011. The Leverage ratio, as well as all of our capital ratios, exceeded regulatory standards for well capitalized institutions.

Investment Portfolio:

Investment securities decreased $13.9 million to $177.3 million at December 31, 2012, from $191.2 million at December 31, 2011. Security purchases totaled $46.3 million in 2012. Investment securities averaged $187.0 million and equaled 22.1 percent of average earning assets in 2012, compared to $195.0 million and 22.7 percent in 2011. The tax-equivalent yield on the investment portfolio decreased 53 basis points to 3.41 percent in 2012 from 3.94 percent in 2011.

Repayments of investment securities totaled $55.2 million in 2012. We received proceeds of $5.8 million from the sale of investment securities in 2012. Net gains recognized on the sale of investment securities available-for-sale totaled $317 in 2012 and $666 in 2011. We reported net unrealized holding gains, included as a separate component of stockholders equity of $4.5 million, net of income taxes of $2.3 million, at December 31, 2012, and a net unrealized gain of $3.9 million, net of income taxes of $2.0 million, at December 31, 2011. We recognized other-than-temporary impairments (OTTI) of $78 in 2011 as a result of writing down certain common equity securities.

At December 31, 2012 and 2011, there were no securities of any individual issuer, except for U.S. Government agency mortgage-backed securities, that exceeded 10.0 percent of stockholders equity.

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Loan Portfolio:

Loans, net decreased $8.0 million or 1.3 percent to $623.5 million at December 31, 2012, from $631.5 million at the end of 2011. Reductions in residential mortgages and consumer loans more than offset an increase in business lending. Business loans, including commercial loans and commercial mortgages, increased $12.1 million to $309.2 million at December 31, 2012, from $297.1 million at year-end 2011. Residential mortgage loans decreased $19.7 million to $261.9 million at the close of 2012 from $281.6 million at December 31, 2011. Consumer loans decreased $0.4 million to $52.4 million at December 31, 2012, from $52.8 million at December 31, 2011.

Loans averaged $635.8 million in 2012, an increase of $13.2 million or 2.1 percent compared to $622.6 million in 2011. The loan portfolio played a more prominent role in our earning asset mix, as average loans equaled 75.2 percent of earning assets in 2012 compared to 72.6 percent in 2011. The low interest rate environment caused the tax-equivalent yield on our loan portfolio to decrease 25 basis points to 5.25 percent in 2012 from 5.50 percent in 2011.

Fixed-rate loans represented 41.0 percent of the loan portfolio at December 31, 2012, compared to 44.7 percent at the end of 2011. Fixed-rate loans decreased $26.5 million or 9.4 percent to $255.9 million at December 31, 2012 from $282.4 million at December 31, 2011. Comparatively, floating or adjustable-rate loans increased $18.5 million or 5.3 percent in 2012.

Asset Quality:

We continued to experience asset quality improvements in 2012. The amount of nonperforming assets declined significantly comparing year-end 2012 and 2011. Nonperforming assets decreased to 0.60 percent of loans, net and foreclosed assets at December 31, 2012, from 0.93 percent at the end of 2011. All major categories of nonperforming assets experienced declines in 2012.

We maintain the allowance for loan losses at a level we believe adequate to absorb probable credit losses related to individually evaluated loans, as well as probable incurred losses inherent in the remainder of the loan portfolio as of the balance sheet date. The balance in the allowance for loan losses account is based on past events and current economic conditions. We employ the FFIEC Interagency Policy Statement, as amended, and GAAP in assessing the adequacy of the allowance account.

The allowance for loan losses increased $239 to $6,950 at December 31, 2012, from $6,711 at the end of 2011. The increase resulted from a provision for loan losses of $924 exceeding net loans charged-off of $685. The allowance for loan losses, as a percentage of loans, net of unearned income, was 1.11 percent at the end of 2012, compared to 1.06 percent at the end of 2011. Net loans charged-off decreased $1,485 or 68.4 percent to $685 in 2012 from $2,170 in 2011. Net charge-offs, as a percentage of average loans outstanding, equaled 0.11 percent in 2012 and 0.35 percent in 2011.

The specific allowance for loan losses increased while the formula portion of the allowance for loan losses decreased from the end of 2011. The specific portion of the allowance for impairment of loans individually evaluated under

FASB Accounting Standards Codification (ASC) 310, increased $568 to $1,226 at December 31, 2012, from $658 at year-end 2011 due primarily to an increase in the amount of loans individually evaluated with a corresponding allowance recorded. The amount of impaired loans having insufficient collateral coverage increased to $3.9 million for December 31, 2012 from $2.1 million at the end of 2011. In addition, the formula portion of the allowance for loans collectively evaluated for impairment under FASB ASC 450, decreased $329 to $5,724 at December 31, 2012, from $6,053 at December 31, 2011. The total loss factor for

Management s Discussion and Analysis 2012 versus 2011

(Dollars in thousands, except per share data)

collectively evaluated loans decreased from year-end 2011 due to a lower amount of average net charge-offs for the past twelve quarters and an overall decrease in the qualitative factors.

The coverage ratio, the allowance for loan losses account, as a percentage of nonperforming loans, is an industry ratio used to test the ability of the allowance account to absorb potential losses arising from nonperforming loans. The coverage ratio was 185.6 percent at December 31, 2012, compared to 114.2 percent at December 31, 2011.

Deposits:

Total deposits grew $1.4 million or 0.2 percent to $721.9 million at December 31, 2012, from $720.5 million at the end of 2011. In comparison, total deposits increased $29.5 million or 4.3 percent in 2011. For 2012, interest-bearing accounts decreased $14.9 million or 2.5 percent. Interest-bearing transaction accounts, which include money market, NOW and savings accounts, increased $24.6 million in 2012. Noninterest-bearing accounts rose $16.3 million or 12.1 percent, partially due to the increase in commercial relationships.

Total deposits averaged $716.9 million in 2012, an increase of $1.7 million or 0.2 percent, compared to $715.2 million in 2011. Average noninterest-bearing deposits increased $19.0 million or 15.7 percent, while average interest-bearing accounts decreased $17.3 million or 2.9 percent. With regard to average interest-bearing deposits, average total time deposits decreased $49.7 million. Interest-bearing transaction accounts increased, as average money market, NOW and savings accounts grew $4.7 million, $20.9 million and $6.8 million in 2012.

Volatile deposits, time deposits $100 or more, declined $2.9 million to $81.9 million at December 31, 2012, from $84.8 million at the end of 2011. Large denomination time deposits averaged $82.2 million in 2012, a decrease of $1.7 million or 2.0 percent from $83.9 million in 2011. Our average cost of these funds decreased 27 basis points to 1.44 percent in 2012, from 1.71 percent in 2011.

Market Risk Sensitivity:

With respect to evaluating our exposure to interest rate risk on earnings, we utilize a gap analysis model that considers repricing frequencies of rate sensitive assets (RSA) and rate sensitive liabilities (RSL). Gap analysis attempts to measure our interest rate exposure by calculating the net amount of RSA and RSL that reprice within specific time intervals. A positive gap occurs when the amount of RSA repricing in a specific period is greater than the amount of RSL repricing within that same time frame and is indicated by a RSA/RSL ratio greater than 1.0. A negative gap occurs when the amount of RSL repricing is greater than the amount of RSA and is indicated by a RSA/RSL ratio less than 1.0. A positive gap implies that earnings will be impacted favorably if interest rates rise and adversely if interest rates fall during the period. A negative gap tends to indicate that earnings will be affected inversely to interest rate changes.

At December 31, 2012, we were in a positive gap position with a cumulative one-year RSA/RSL ratio of 1.26. Similarly, at December 31, 2011, our cumulative one-year RSA/RSL ratio was 1.15. The change in our RSA/RSL ratio from the previous year-end resulted primarily from a $14.2 million or 3.6 percent increase in RSA maturing or repricing within one year, coupled with a $18.0 million or 5.2 percent decrease in RSL maturing or repricing within one year. The increase in RSA resulted primarily from an increase in loans, net maturing or repricing within the next 12 months. With regard to RSL, a decrease in interest-bearing transaction accounts and total time deposits explains the majority of the total change in RSL maturing or repricing within one year.

Liquidity:

At December 31, 2012, our noncore funds consisted of time deposits in denominations of $100 or more, repurchase agreements, short-term borrowings and long-term debt. Large denomination time deposits are

Management s Discussion and Analysis 2012 versus 2011

(Dollars in thousands, except per share data)

particularly not considered to be a strong source of liquidity since they are very interest rate sensitive and are considered to be highly volatile. At December 31, 2012, our net noncore funding dependence ratio, the difference between noncore funds and short-term investments to long-term assets, was 6.5 percent. Our net short-term noncore funding dependence ratio, noncore funds maturing within one year, less short-term investments to long-term assets equaled 5.0 percent. Comparatively, our ratios equaled 12.7 percent and 7.7 percent at the end of 2011, which indicated a decrease in our reliance on noncore funds. The decrease in noncore funding reliance resulted primarily from a decrease in borrowed funds and time deposits $100 or more.

The Consolidated Statements of Cash Flows present the change in cash and cash equivalents from operating, investing and financing activities. Cash and cash equivalents consist of cash on hand, cash items in the process of collection, noninterest-bearing and interest-bearing deposits in other banks and federal funds sold. Cash and cash equivalents increased $13.4 million for the year ended December 31, 2012. Similarly, for the year ended December 31, 2011, cash and cash equivalents increased $20.3 million. During 2012, cash provided by operating and investing activities more than offset cash used in investing activities.

Operating activities provided net cash of $12.6 million in 2012 and $13.9 million in 2011. Net income, adjusted for the effects of noncash expenses such as depreciation and the provision for loan losses is the primary source of funds from operations.

Our primary investing activities involve transactions related to our investment and loan portfolios. Net cash provided by investing activities totaled $19.7 million in 2012, an increase of $8.6 million from $11.1 million in 2011. An increase in loan repayments in excess of originations offset partially by a reduction in the net proceeds from investments caused the increase in net cash provided by investing activities.

Net cash used in financing activities equaled $18.9 million in 2012 and $4.9 million in 2011. Deposit gathering, which is our predominant financing activity, decreased significantly comparing 2012 and 2011. Deposit gathering provided a net cash inflow in 2012 of $1.4 million and $29.3 million in 2011. Also impacting the change in net cash used in financing activities was a net decrease in short-term borrowings of $1.9 million in 2012 and $18.1 million in 2011.

Capital Adequacy:

Our and Peoples Bank s risk-based capital ratios are strong and have consistently exceeded the minimum regulatory capital ratios of 4.0 percent and 8.0 percent required for adequately capitalized institutions. Our ratio of Tier I capital to risk-weighted assets and off-balance sheet items was 16.8 percent at December 31, 2012, and 15.8 percent at December 31, 2011. Our Total capital ratio was 18.0 percent at December 31, 2012 and 16.9 percent at December 31, 2011. Similarly, our Leverage ratio, which equaled 11.5 percent at December 31, 2012, and 10.8 percent at December 31, 2011, exceeded the minimum of 4.0 percent for capital adequacy purposes. Peoples Bank reported Tier I capital, Total capital and Leverage ratios of 16.2 percent, 17.4 percent and 11.1 percent at December 31, 2012, and 15.2 percent, 16.3 percent and 10.5 percent at December 31, 2011. Peoples Bank was categorized as well capitalized at December 31, 2012 and 2011.

Stockholders equity increased $5.2 million to $132.5 million at December 31, 2012, from $127.3 million at December 31, 2011. Net income of $10.6 million was offset by cash dividends declared of $5.5 million. We declared dividends of $1.23 per share in 2012 and 2011. The dividend payout ratio, dividends declared as a percent of net income, equaled 52.0 percent in 2012 and 52.2 percent in 2011.

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Management s Discussion and Analysis 2012 versus 2011

(Dollars in thousands, except per share data)

Review of Financial Performance:

Net income increased to $10.6 million or $2.37 per share from $10.5 million or $2.36 per share in 2011. Return on average assets was 1.14 percent for the year ended December 31, 2012, compared to 1.13 percent for the year ended December 31, 2011. Return on average equity was 8.07 percent in 2012 compared to 8.45 percent in 2011. Tax-equivalent net interest income decreased $198 in 2012. Our net interest margin equaled 4.08 percent in 2012, a 4 basis point improvement compared to 4.04 percent in 2011.

Decreases in service charges, fees and commissions of 17.7 percent and merchant services income of 8.1 percent were primarily responsible for the reduction in noninterest income. Partially offsetting these declines was an improvement of $322 in net income generated from our secondary mortgage department in 2012.

Noninterest expense was unchanged comparing 2012 and 2011. Salaries and employee benefits expenses increased $170 or 1.2 percent as a result of normal merit increases. In addition, we experienced a $615 or 17.3 percent decrease in occupancy and equipment expense due to reductions in equipment maintenance and depreciation expenses. Merchant services expense decreased $424 or 13.4 percent in 2012 due to lower transaction volumes. Other expenses increased $964 or 12.0 percent comparing 2012 and 2011. Our productivity improved as evidenced by the change in the operating efficiency ratio. The operating efficiency ratio, defined as noninterest expense divided by the total of net interest income and noninterest income, is an industry ratio used to measure productivity. Our operating efficiency ratio was 66.6 percent in 2012 compared to 64.6 percent in 2011.

Net Interest Income:

For the year ended December 31, 2012, tax-equivalent net interest income decreased $198 to $34,468 from $34,666 in 2011. Changes in the volumes of earning assets and interest-bearing liabilities contributed to an increase of $936 in net interest income. Average earning assets decreased $12.0 million to $845.3 million in 2012 from $857.3 million in 2011 and accounted for a $15 decrease in interest income. Average loans, net increased $13.2 million or 2.1 percent, which caused interest income to increase $601. Conversely, average investments declined $8.0 million or 4.1 percent comparing 2012 and 2011, which resulted in reduced interest income of $587.

Average interest-bearing liabilities declined $37.7 million or 5.6 percent to $640.3 million in 2012 from $678.0 million in 2011. The decline resulted in a net decrease in interest expense of $951. Having the greatest impact was a $47.9 million decrease in time deposits less than $100, which caused interest expense to decrease $589. In addition, long-term debt averaged $10.9 million less and reduced interest expense by $400 comparing 2012 and 2011.

The tax-equivalent yield on earning assets decreased 19 basis points to 4.71 percent in 2012 from 4.90 percent in 2011, resulting in a reduction in interest income of $2,160. Specifically, the tax-equivalent yield on the loan portfolio decreased 25 basis points to 5.25 percent in 2012 from 5.50 percent in 2011. The decline in the tax-equivalent yield on the loan portfolio was a reflection of the condition of general market rates. Loan yield reductions caused interest income to decrease $1,460, representing 67.6 percent of the entire reduction in interest income due to changes in rates.

The reduction in interest income was mitigated by a decrease of $1,026 in interest expense, which resulted from a 24 basis point decrease in the cost of funds to 0.84 percent in 2012 from 1.08 percent in 2011. We experienced significant reductions in the rates paid on all major deposit categories. Specifically, the cost of money market, NOW and savings accounts decreased 13 basis points, 9 basis points and 13 basis points comparing 2012 and

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Management s Discussion and Analysis 2012 versus 2011

(Dollars in thousands, except per share data)

2011. These decreases resulted in reductions in interest expense of $198, $74 and $163. With regard to time deposits, the average rate paid for time deposits less than $100 decreased 25 basis points while time deposits $100 or more declined 27 basis points, which together resulted in a $581 decrease in interest expense. The average rate paid on short-term borrowings declined 7 basis points, resulting in a $12 reduction in interest expense.

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 an appropriate level. The provision for loan losses equaled $924 in 2012 and $2,381 in 2011.

Noninterest Income:

Our noninterest income decreased $1,178 or 9.3 percent to $11,441 in 2012 from $12,619 in 2011. Reductions in service charges, fees, commissions and others of $790 and merchant services income of $380 were the major contributors to the reduction in noninterest income.

Noninterest Expense:

Salaries and employee benefits expense increased $170 or 1.2 percent to $14,121 in 2012 from $13,951 in 2011. Salaries and payroll taxes increased $201 or 1.8 percent, while employee benefits expense decreased $31 or 1.4 percent. The increase in the salaries and payroll taxes component was directly related to the annual merit increases.

For 2012, occupancy and equipment expense decreased $615 or 17.3 percent to $2,946 from $3,561 in 2011. Specifically, building-related costs decreased $240 or 9.2 percent while equipment-related costs decreased $375 or 39.7 percent. The decrease in equipment expense resulted from reductions in costs, including maintenance and depreciation. Lower building repairs was the primary factor causing the decrease in occupancy expense.

Other expenses increased $503 or 4.4 percent to $12,032 in 2012 from $11,529 in 2011. Increases in professional and outside services expense of $579 and bank shares tax of $846 were offset partially by reductions in merchant services expense of $424 and advertising expense of $207.

Income Taxes:

Our income tax expense increased $24 to $3,058 in 2012, from $3,034 in 2011. Tax-exempt interest revenue, as a percentage of total interest revenue, increased to 11.6 percent in 2012 from 11.2 percent in 2011. Our effective tax rate was 22.4 percent in 2012 and 2011.

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Item 7A. 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 overnight borrowing rate has been subject to a range of 0% to 0.25% since the Federal Open Market Committee (FOMC) adopted their accommodative monetary policy. The FOMC has acted to drive longer term rates to historic lows and operate as a backstop to the financial industry through direct infusions of capital by implementing their quantitative easing policies.

The projected impact of instantaneous changes in interest rates on our net interest income and economic value of equity at December 31, 2013, based on our simulation model, is summarized as follows:

	December 31, 2013			
	% Change in			
Changes in Interest Rates (basis points)	Net Interest Income		Economic Value of Equity	
	Metric	Policy	Metric	Policy
+400	5.2	N/A	0.0	N/A
+300	4.0	(30.0)	0.7	(30.0)
+200	2.5	(20.0)	0.7	(25.0)
+100	0.9	(10.0)	0.9	(15.0)
Static				
-100	(2.5)	(10.0)	(10.4)	(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 December 31, 2013, would increase slightly at 0.9 percent from model results using current interest rates. Additional disclosures about market risk are included in Part II, Item 7 of this Annual Report, under the heading Market Risk Sensitivity, and are incorporated into this Item 7A by reference.

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Item 8. Financial Statements.
REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors and Stockholders

Peoples Financial Services Corp.

Scranton, Pennsylvania

We have audited the accompanying consolidated balance sheet of Peoples Financial Services Corp. and subsidiaries (the Company) as of December 31, 2013 and the related consolidated statements of income and comprehensive income, changes in stockholders equity, and cash flows for the year ended December 31, 2013. These consolidated financial statements are the responsibility of the Company s management. Our responsibility is to express an opinion on these consolidated financial statements based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall consolidated financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Peoples Financial Services Corp. and subsidiaries as of December 31, 2013, and the results of their operations and their cash flows for the year ended December 31, 2013**,** in conformity with accounting principles generally accepted in the United States of America.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), Peoples Financial Services Corp. and subsidiaries internal control over financial reporting as of December 31, 2013, based on criteria established in *Internal Control Integrated Framework (1992)* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) and our report dated March 17, 2014 expressed an unqualified opinion thereon.

/s/ BDO USA, LLP

Harrisburg, Pennsylvania

March 17, 2014

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders

Penseco Financial Services Corporation

We have audited the accompanying consolidated balance sheets of Penseco Financial Services Corporation and subsidiary (Penseco as defined in Note 1) as of December 31, 2012, and the related consolidated statements of income, comprehensive income, stockholders equity, and cash flows for each of the two years in the period ended December 31, 2012. These financial statements are the responsibility of the Company s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Penseco Financial Services Corporation and subsidiary as of December 31, 2012, and the results of their operations and their cash flows for each of the two years in the period ended December 31, 2012, in conformity with U.S. generally accepted accounting principles.

/s/ McGrail Merkel Quinn & Associate, P.C.

Scranton, Pennsylvania

March 14, 2013

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Peoples Financial Services Corp.

CONSOLIDATED BALANCE SHEETS

(Dollars in thousands, except share data)

December 31	**2013**	**2012**
Assets:		
Cash and due from banks	$ 30,004	$ 15,581
Interest-bearing deposits in other banks	11,846	32,263
Federal funds sold	9,460	
Investment securities:		
Available-for-sale	299,715	161,391
Held-to-maturity: Fair value 2013, $17,175; 2012, $16,774	17,295	15,902
Total investment securities	317,010	177,293
Loans held for sale	1,757	
Loans, net	1,176,617	623,530
Less: allowance for loan losses	8,651	6,950
Net loans	1,167,966	616,580
Premises and equipment, net	26,119	15,137
Accrued interest receivable	5,866	2,862
Goodwill	63,370	26,398
Intangible assets	6,835	838
Other assets	47,988	31,090
Total assets	$ 1,688,221	$ 918,042
Liabilities:		
Deposits:		
Noninterest-bearing	$ 279,942	$ 151,121
Interest-bearing	1,099,565	570,827
Total deposits	1,379,507	721,948
Short-term borrowings	22,052	8,019
Long-term debt	36,743	45,397
Accrued interest payable	723	716
Other liabilities	10,404	9,516
Total liabilities	1,449,429	785,596
Stockholders equity:		
Common stock: par value $2.00, authorized 25,000,000 shares, 2013, issued 7,806,789 shares; 2012, issued 4,467,261 shares	15,614	8,935

Capital surplus	146,109	40,003
Retained earnings	84,008	83,798
Accumulated other comprehensive loss	(698)	(290)
Less: treasury stock, at cost: 2013, 253,845 shares	6,241	
Total stockholders equity	238,792	132,446
Total liabilities and stockholders equity	$ 1,688,221	$ 918,042

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Peoples Financial Services Corp.

CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME

(Dollars in thousands, except per share data)

Year Ended December 31	2013	2012	2011
Interest income:			
Interest and fees on loans:			
Taxable	$ 31,102	$ 30,852	$ 32,398
Tax-exempt	1,674	1,687	1,187
Interest and dividends on investment securities:			
Taxable	1,793	2,282	2,724
Tax-exempt	2,625	2,660	3,273
Dividends	88	63	64
Interest on interest-bearing deposits in other banks	86	47	59
Interest on federal funds sold	2		2
Total interest income	37,370	37,591	39,707
Interest expense:			
Interest on deposits	2,876	3,424	4,958
Interest on short-term borrowings	34	38	83
Interest on long-term debt	1,259	1,900	2,298
Total interest expense	4,169	5,362	7,339
Net interest income	33,201	32,229	32,368
Provision for loan losses	2,361	924	2,381
Net interest income after provision for loan losses	30,840	31,305	29,987
Noninterest income:			
Service charges, fees and commissions	4,092	3,680	4,470
Merchant services income	3,936	4,290	4,670
Commission and fees on fiduciary activities	1,735	1,481	1,563
Wealth management income	505	264	253
Mortgage banking income	363	905	585
Life insurance investment income	968	504	490
Net gain on sale of investment securities available-for-sale	163	317	666
Other-than-temporary impairment of investment securities			(78)
Total noninterest income	11,762	11,441	12,619

Noninterest expense:			
Salaries and employee benefits expense	15,983	14,121	13,951
Net occupancy and equipment expense	3,988	2,946	3,561
Merchant services expense	2,490	2,742	3,166
Amortization of intangible assets	326	267	304
Acquisition related expense	4,609		
Other expenses	9,000	9,023	8,059
Total noninterest expense	36,396	29,099	29,041
Income before income taxes	6,206	13,647	13,565
Income tax expense	485	3,058	3,034
Net income	5,721	10,589	10,531
Other comprehensive income (loss):			
Unrealized gain (loss) on investment securities available-for-sale	(3,882)	1,223	4,873
Reclassification adjustment for net gain on sales included in net income	(163)	(317)	(666)
Reclassification adjustment for other-than-temporary impairment			78
Change in pension liability	3,642	(924)	(1,497)
Other comprehensive income (loss)	(403)	(18)	2,788
Income tax expense (benefit) related to other comprehensive income (loss)	(5)	(6)	948
Other comprehensive income (loss), net of income taxes	(408)	(12)	1,840
Comprehensive income	$ 5,313	$ 10,577	$ 12,371
Per share data:			
Net income:			
Basic	$ 1.21	$ 2.37	$ 2.36
Diluted	$ 1.21	$ 2.37	$ 2.36
Average common shares outstanding:			
Basic	4,733,059	4,467,261	4,467,261
Diluted	4,733,059	4,467,714	4,467,261
Dividends declared	$ 1.23	$ 1.23	$ 1.23

See notes to consolidated financial statements

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Peoples Financial Services Corp.

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS EQUITY

(Dollars in thousands, except per share data)

For the Three Years Ended December 31, 2013	Common Stock	Capital Surplus	Retained Earnings	Accumulated Other Comprehensive Loss	Treasury Stock	Total
Balance, January 1, 2011	$ 8,935	$ 39,963	$ 73,686	$ (2,118)	$	$ 120,466
Net income			10,531			10,531
Other comprehensive income, net of income taxes				1,840		1,840
Dividends declared: $1.23 per share			(5,504)			(5,504)
Balance, December 31, 2011	8,935	39,963	78,713	(278)		127,333
Net income			10,589			10,589
Other comprehensive loss, net of income taxes				(12)		(12)
Dividends declared: $1.23 per share			(5,504)			(5,504)
Stock based compensation		40				40
Balance, December 31, 2012	8,935	40,003	83,798	(290)		132,446
Net income			5,721			5,721
Other comprehensive loss, net of income taxes				(408)		(408)
Dividends declared: $1.23 per share			(5,511)			(5,511)
Stock based compensation		25				25
Retirement of treasury stock	(28)	(384)			412	
Fair value of consideration exchanged	6,707	106,465			(6,653)	106,519
Balance, December 31, 2013	$ 15,614	$ 146,109	$ 84,008	$ (698)	$ (6,241)	$ 238,792

See notes to consolidated financial statements

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Peoples Financial Services Corp.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(Dollars in thousands, except per share data)

Year Ended December 31,	**2013**	**2012**	**2011**
Cash flows from operating activities:			
Net income	$ 5,721	$ 10,589	$ 10,531
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation of premises and equipment	924	855	1,050
Amortization of intangibles	(326)	(267)	(304)
Amortization of purchase accounting adjustments on tangible assets	(70)	(285)	(345)
Provision for loan losses	2,361	924	2,381
Net loss on sale of other real estate owned	91	5	262
Net loss on disposal of equipment	438		
Net amortization of investment securities	737	383	494
Net gain on sale of investment securities	(163)	(317)	(666)
Other-than-temporary impairment of investment securities			78
Life insurance investment income	(968)	(504)	(490)
Deferred income tax expense (benefit)	(1,143)	353	217
Stock based compensation	25	40	
Net change in:			
Loans held for sale	(421)		
Accrued interest receivable	621	390	557
Other assets	1,406	607	1,221
Accrued interest payable	(466)	(294)	(118)
Other liabilities	1,048	123	(931)
Net cash provided by operating activities	9,815	12,602	13,937
Cash flows from investing activities:			
Proceeds from sales of investment securities available-for-sale	4,573	5,821	15,318
Proceeds from repayments of investment securities:			
Available-for-sale	24,221	47,500	23,325
Held-to-maturity	5,405	7,730	19,883
Purchases of investment securities:			
Available-for-sale	(15,262)	(46,297)	(28,312)
Held-to-maturity	(6,873)		
Net increase (decrease) in lending activities	(50,746)	7,268	(19,420)
Purchases of premises and equipment	(614)	(2,897)	(739)
Proceeds from investment in life insurance	1,226		
Purchases of investment in life insurance		(1,242)	
Proceeds from sale of other real estate owned	761	1,778	1,141
Net cash received from acquisition	22,392		

Net cash provided by (used in) investing activities	(14,917)	19,661	11,196
Cash flows from financing activities:			
Net increase in deposits	28,949	1,390	29,348
Repayment of long-term debt	(11,166)	(12,823)	(10,615)
Net decrease in short-term borrowings	(3,704)	(1,962)	(18,101)
Cash dividends paid	(5,511)	(5,504)	(5,504)
Net cash provided by (used in) financing activities	8,568	(18,899)	(4,872)
Net increase in cash and cash equivalents	3,466	13,364	20,261
Cash and cash equivalents at beginning of year	47,844	34,480	14,219
Cash and cash equivalents at end of year	$ 51,310	$ 47,844	$ 34,480

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Peoples Financial Services Corp.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(Dollars in thousands, except per share data)

Year Ended December 31,	2013	2012	2011
Supplemental disclosures:			
Cash paid during the period for:			
Interest	$ 4,635	$ 5,656	$ 7,457
Income taxes	2,700	2,260	2,315
Noncash items:			
Transfers of loans to other real estate	$ 273	$ 867	$ 1,647
Acquisition:			
Assets acquired excluding cash:			
Investment securities available-for-sale	$ 156,435	$	$
Restricted equity securities	997		
Loans, net	504,002		
Accrued interest receivable	3,625		
Premises and equipment	11,737		
Core deposit and other intangible assets	6,323		
Other assets	18,647		
	$ 701,766	$	$
Liabilities assumed:			
Deposits	$ 628,304	$	$
Short-term borrowings	17,737		
Long-term debt	2,516		
Accrued interest payable	473		
Other liabilities	5,976		
	$ 655,006	$	$

See notes to consolidated financial statements

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Peoples Financial Services Corp.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Dollars in thousands, except per share data)

1. Summary of significant accounting policies:

Nature of operations:

Peoples Financial Services Corp., a bank holding company incorporated under the laws of Pennsylvania, provides a full range of financial services through its wholly-owned subsidiary, Peoples Security Bank and Trust Company (Peoples Bank), including its subsidiaries, Peoples Advisors, LLC and Penseco Realty, Inc. (collectively, the Company or Peoples). On November 30, 2013, Penseco Financial Services Corporation, a financial holding company incorporated under the laws of Pennsylvania (Penseco), merged with and into Peoples Financial Services Corp., with Peoples Financial Services Corp. being the surviving corporation (the Merger), pursuant to an Agreement and Plan of Merger dated June 28, 2013 (the Merger Agreement). In connection with the Merger, on December 1, 2013, Penseco s former banking subsidiary, Penn Security Bank and Trust Company, merged with and into Peoples Neighborhood Bank (the Bank Merger), and the resulting institution adopted the name Peoples Security Bank and Trust Company. The Company services its retail and commercial customers through twenty-six full-service community banking offices located within the Lackawanna, Luzerne, Monroe, Susquehanna, Wayne and Wyoming Counties of Northeastern Pennsylvania and Broome County of New York.

Peoples Bank is a state-chartered bank and trust company under the jurisdiction of the Pennsylvania Department of Banking and Securities and the Federal Deposit Insurance Corporation. Peoples Bank s primary product is loans to small- and medium-sized businesses. Other lending products include one-to-four family residential mortgages and consumer loans. Peoples Bank primarily funds its loans by offering open time deposits to commercial enterprises and individuals. Other deposit product offerings include certificates of deposits and various demand deposit accounts.

Peoples Advisors, LLC, a member-managed limited liability company, provides investment advisory services through a third party to individuals and small businesses. Penseco Realty, Inc. holds and manages real estate assets on behalf of Peoples Bank.

Peoples Advisors, LLC and Penseco Realty, Inc. did not meet the quantitative thresholds for required segment disclosure in conformity with accounting principles generally accepted in the United States of America (GAAP). Peoples Bank s twenty-six community banking offices, all similar with respect to economic characteristics, share a majority of the following aggregation criteria: (i) products and services; (ii) operating processes; (iii) customer bases; (iv) delivery systems; and (v) regulatory oversight. Accordingly, they were aggregated into a single operating segment.

The Company faces competition primarily from commercial banks, thrift institutions and credit unions within the Northeastern Pennsylvania market, many of which are substantially larger in terms of assets and capital. In addition, mutual funds and security brokers compete for various types of deposits, and consumer, mortgage, leasing and insurance companies compete for various types of loans and leases. Principal methods of competing for banking and permitted nonbanking services include price, nature of product, quality of service and convenience of location.

The Company and Peoples Bank are subject to regulations of certain federal and state regulatory agencies and undergo periodic examinations.

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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 (continued):

Basis of presentation:

Under the acquisition method of accounting, in a business combination effected through an exchange of equity interests, consideration of the facts and circumstances surrounding a business combination that generally involve the relative ownership and control of the entity by each of the parties subsequent to the merger must be made in determining the acquirer for financial reporting purposes. Based on a review of these factors, the aforementioned merger between the Company and Penseco was accounted for as a reverse acquisition whereby Penseco was treated as the acquirer for accounting and reporting purposes. As a result, the historical financial information included in the Company s consolidated financial statements and related notes as reported in this Form 10-K is that of Penseco.

The consolidated financial statements of the Company have been prepared in conformity with GAAP, Regulation S-X and reporting practices applied in the banking industry. All significant intercompany balances and transactions have been eliminated in consolidation. The Company also presents herein condensed parent company only financial information regarding Peoples Financial Services Corp. (Parent Company). Prior period amounts are reclassified when necessary to conform with the current year s presentation. Such reclassifications had no effect on financial position or results of operations.

The Company has evaluated events and transactions occurring subsequent to the balance sheet date of December 31, 2013, for items that should potentially be recognized or disclosed in these consolidated financial statements. The evaluation was conducted through the date these consolidated financial statements were issued.

Estimates:

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.

Investment securities:

Investments securities are classified and accounted for as either held-to-maturity, available-for-sale, or trading account securities based on management s intent at the time of acquisition. Management is required to reassess the appropriateness of such classifications at each reporting date. The Company classifies debt securities as held-to maturity when management has the positive intent and ability to hold such securities to maturity. Held-to-maturity securities are stated at cost, adjusted for amortization of premium and accretion of discount. Investment securities are designated as available-for-sale when they are to be held for indefinite periods of time as management intends to use such securities to implement asset/liability strategies or to sell them in response to changes in interest rates, prepayment risk, liquidity requirements, or other circumstances identified by management. Available-for-sale securities are reported at fair value, with unrealized gains and losses, net of income taxes, excluded from earnings and reported in a separate component of stockholders   equity. All marketable equity securities are accounted for at fair value. Estimated fair values for investment securities are

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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 (continued):

Investment securities (continued):

based on quoted market prices from a national electronic pricing service. Realized gains and losses are computed using the specific identification method and are included in noninterest income. Premiums are amortized and discounts are accreted using the interest method over the contractual lives of investment securities. Investment securities that are bought and held principally for the purpose of selling them in the near term, in order to generate profits from market appreciation, are classified as trading account securities. Trading account securities are carried at market value. Interest on trading account securities is included in interest income. Profits or losses on trading account securities are included in noninterest income. Transfers of securities between categories are recorded at fair value at the date of the transfer, with the accounting treatment of unrealized gains or losses determined by the category into which the security is transferred.

Management evaluates each investment security to determine if a decline in fair value below its amortized cost is an other-than-temporary impairment at least quarterly, and more frequently when economic or market concerns warrant an evaluation. Factors considered in determining whether an other-than-temporary impairment was incurred include: (i) the length of time and the extent to which the fair value has been less than amortized cost; (ii) the financial condition and near-term prospects of the issuer; (iii) whether a decline in fair value is attributable to adverse conditions specifically related to the security or specific conditions in an industry or geographic area; (iv) the credit-worthiness of the issuer of the security; (v) whether dividend or interest payments have been reduced or have not been made; (vi) an adverse change in the remaining expected cash flows from the security such that the Company will not recover the amortized cost of the security; (vii) whether management intends to sell the security; and (viii) if it is more likely than not that m