PEOPLES FINANCIAL SERVICES CORP.
Form 10-Q
August 04, 2017
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

Form 10-Q

Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

for the quarterly period ended June 30, 2017

or

Transition report pursuant to Section 13 or 15 (d) of the Securities Exchange Act of 1934

for the transition period from

001-36388

(Commission File Number)

PEOPLES FINANCIAL SERVICES CORP.

(Exact name of registrant as specified in its charter)

Pennsylvania	23-2391852

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

(570) 346-7741

(Registrant's telephone number, including area code)

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

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

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

Large accelerated filer Accelerated filer

Non-accelerated filer Smaller reporting company
Emerging growth company
If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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

APPLICABLE ONLY TO CORPORATE ISSUERS:

Indicate the number of shares outstanding of the registrant's common stock, as of the latest practicable date: 7,396,163 at July 31, 2017.

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PEOPLES FINANCIAL SERVICES CORP.

FORM 10-Q

For the Quarter Ended June 30, 2017

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CONSOLIDATED BALANCE SHEETS (UNAUDITED)

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

	June 30, 2017	December 31, 2016
Assets:		
Cash and due from banks:		
Cash and due from banks	$ 41,026	$ 39,496
Interest-bearing deposits in other banks	375	445
Total cash and due from banks	41,401	39,941
Investment securities:		
Available-for-sale	256,774	259,410
Held-to-maturity: Fair value June 30, 2017, $10,221; December 31, 2016, $10,714	9,868	10,517
Total investment securities	266,642	269,927
Loans, net	1,597,362	1,532,965
Less: allowance for loan losses	17,802	15,961
Net loans	1,579,560	1,517,004
Loans held for sale		
Premises and equipment, net	35,892	33,260
Accrued interest receivable	6,206	6,228
Goodwill	63,370	63,370
Intangible assets, net	3,685	4,211
Other assets	68,002	65,501
Total assets	$ 2,064,758	$ 1,999,442
Liabilities:		
Deposits:		
Noninterest-bearing	$ 356,435	$ 353,686
Interest-bearing	1,282,998	1,235,071
Total deposits	1,639,433	1,588,757
Short-term borrowings	91,500	82,700
Long-term debt	57,160	58,134
Accrued interest payable	431	462
Other liabilities	12,725	12,771
Total liabilities	1,801,249	1,742,824
Stockholders' equity:		
Common stock, par value $2.00, authorized 25,000,000 shares, issued and outstanding 7,396,163 shares at June 30, 2017 and 7,394,143 shares at December 31, 2016	14,792	14,788
Capital surplus	134,937	134,871
Retained earnings	116,988	111,114
Accumulated other comprehensive loss	(3,208)	(4,155)

Total stockholders’ equity	263,509	256,618
Total liabilities and stockholders’ equity	$ 2,064,758	$ 1,999,442

See notes to unaudited consolidated financial statements

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Peoples Financial Services Corp.

CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME (UNAUDITED)

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

	Three Months Ended		Six Months Ended	
June 30,	2017	2016	2017	2016
Interest income:				
Interest and fees on loans:				
Taxable	$ 15,945	$ 14,760	$ 31,486	$ 29,106
Tax-exempt	795	780	1,521	1,531
Interest and dividends on investment securities:				
Taxable	719	617	1,416	1,304
Tax-exempt	752	875	1,546	1,750
Dividends	12	11	24	21
Interest on interest-bearing deposits in other banks	38	15	67	32
Total interest income	18,261	17,058	36,060	33,744
Interest expense:				
Interest on deposits	1,529	1,322	2,963	2,605
Interest on short-term borrowings	248	89	422	166
Interest on long-term debt	349	354	697	714
Total interest expense	2,126	1,765	4,082	3,485
Net interest income	16,135	15,293	31,978	30,259
Provision for loan losses	1,200	1,200	2,400	2,400
Net interest income after provision for loan losses	14,935	14,093	29,578	27,859
Noninterest income:				
Service charges, fees and commissions	1,682	1,527	3,254	2,971
Merchant services income	1,178	1,038	2,193	1,952
Commission and fees on fiduciary activities	494	474	1,002	956
Wealth management income	348	296	667	708
Mortgage banking income	204	195	383	399
Life insurance investment income	195	202	384	395
Net gain on sale of investment securities available-for-sale		381		623
Net gain on sale of merchant services business	2,278		2,278	
Total noninterest income	6,379	4,113	10,161	8,004
Noninterest expense:				
Salaries and employee benefits expense	7,026	5,904	13,301	11,236
Net occupancy and equipment expense	2,450	2,245	4,844	4,682
Merchant services expense	1,033	748	1,763	1,380
Amortization of intangible assets	258	297	526	602
Other expenses	3,235	2,919	5,924	5,831

Total noninterest expense	14,002	12,113	26,358	23,731
Income before income taxes	7,312	6,093	13,381	12,132
Income tax expense	1,653	1,238	2,922	2,395
Net income	5,659	4,855	10,459	9,737
Other comprehensive income:				
Unrealized gain on investment securities available-for-sale	1,184	1,128	1,457	2,123
Reclassification adjustment for net gain on sales included in net income		(381)		(623)
Other comprehensive income	1,184	747	1,457	1,500
Income tax related to other comprehensive income	415	261	510	525
Other comprehensive income, net of income taxes	769	486	947	975
Comprehensive income	$ 6,428	$ 5,341	$ 11,406	$ 10,712
Per share data:				
Net income:				
Basic	$ 0.76	$ 0.66	$ 1.41	$ 1.32
Diluted	$ 0.76	$ 0.66	$ 1.41	$ 1.32
Average common shares outstanding:				
Basic	7,396,163	7,395,127	7,395,158	7,399,318
Diluted	7,396,163	7,395,127	7,395,158	7,399,318
Dividends declared	$ 0.31	$ 0.31	$ 0.62	$ 0.62

See notes to unaudited consolidated financial statements

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Peoples Financial Services Corp.

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY (UNAUDITED)

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

	Common Stock	Capital Surplus	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total
Balance, January 1, 2017	$ 14,788	$ 134,871	$ 111,114	$ (4,155)	$ 256,618
Stock based compensation		70			70
Net income			10,459		10,459
Other comprehensive income, net of income taxes				947	947
Dividends declared: $0.62 per share			(4,585)		(4,585)
Common stock grants awarded, net of unearned compensation of $81: 2,020 shares	4	(4)			
Balance, June 30, 2017	$ 14,792	$ 134,937	$ 116,988	$ (3,208)	$ 263,509
Balance, January 1, 2016	$ 14,821	$ 135,371	$ 100,701	$ (2,125)	$ 248,768
Stock based compensation		35			35
Net income			9,737		9,737
Other comprehensive income, net of income taxes				975	975
Dividends declared: $0.62 per share			(4,586)		(4,586)
Shares retired: 16,463 shares	(33)	(571)			(604)
Balance, June 30, 2016	$ 14,788	$ 134,835	$ 105,852	$ (1,150)	$ 254,325

See notes to unaudited consolidated financial statements

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Peoples Financial Services Corp.

CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

(Dollars in thousands, except per share data)

For the Six Months Ended June 30,	2017	2016
Cash flows from operating activities:		
Net income	$ 10,459	$ 9,737
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation of premises and equipment	884	788
Amortization of deferred loan costs	427	362
Amortization of intangibles	526	602
Net accretion of purchase accounting adjustments on tangible assets		
Amortization of loss on investment tax credits	235	244
Provision for loan losses	2,400	2,400
Net gain on sale of other real estate owned	(5)	(9)
Loans originated for sale	(10,411)	(10,709)
Proceeds from sale of loans originated for sale	10,520	11,108
Net gain on sale of loans originated for sale	(109)	(399)
Net amortization of investment securities	1,469	1,997
Net gain on sale of investment securities available-for-sale		(623)
Net gain on sale of merchant services business	(2,278)	
Life insurance investment income	(384)	(395)
Stock based compensation	70	35
Net change in:		
Accrued interest receivable	22	(156)
Other assets	(2,136)	(1,654)
Accrued interest payable	(31)	(107)
Other liabilities	(116)	(804)
Net cash provided by operating activities	11,542	12,417
Cash flows from investing activities:		
Proceeds from sales of investment securities available-for-sale		27,408
Proceeds from repayments of investment securities:		
Available-for-sale	21,594	23,013
Held-to-maturity	637	830
Purchases of investment securities:		
Available-for-sale	(18,958)	(16,725)
Net purchase of restricted equity securities	(703)	(1,475)
Net increase in lending activities	(65,625)	(125,528)
Investment in low income housing investment tax credits		(2,050)
Purchases of premises and equipment	(3,516)	(2,141)
Purchase of investment in life insurance		(1,500)
Proceeds from the sale of merchant services business	2,300	
Proceeds from sale of other real estate owned	272	195
Net cash used in investing activities	(63,999)	(97,973)

Cash flows from financing activities:		
Net increase in deposits	50,676	41,053
Repayment of long-term debt	(974)	(1,122)
Net increase in short-term borrowings	8,800	47,975
Retirement of common stock		(604)
Cash dividends paid	(4,585)	(4,586)
Net cash provided by financing activities	53,917	82,716
Net increase (decrease) in cash and cash equivalents	1,460	(2,840)
Cash and cash equivalents at beginning of period	39,941	32,917
Cash and cash equivalents at end of period	$ 41,401	$ 30,077

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Peoples Financial Services Corp.

CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED) (Continued)

(Dollars in thousands, except per share data)

For the Six Months Ended June 30,	2017	2016
Supplemental disclosures:		
Cash paid during the period for:		
Interest	$ 4,113	$ 3,592
Income taxes	3,100	1,800
Noncash items:		
Transfers of loans to other real estate	$ 279	$ 761

See notes to unaudited consolidated financial statements

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Peoples Financial Services Corp.

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

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

1. Summary of significant accounting policies:

Nature of operations:

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

Basis of presentation:

The accompanying unaudited consolidated financial statements of the Company have been prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP') for interim financial information and with the instructions to Form 10-Q and Article 10-01 of Regulation S-X. In the opinion of management, all normal recurring adjustments necessary for a fair presentation of the financial position and results of operations for the periods presented have been included. All significant intercompany balances and transactions have been eliminated in consolidation. Prior-period amounts are reclassified when necessary to conform to the current year's presentation. These reclassifications did not have any effect on the operating results or financial position of the Company. The operating results and financial position of the Company for the three and six months ended and as of June 30, 2017, are not necessarily indicative of the results of operations and financial position that may be expected in the future.

The preparation of consolidated financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Significant estimates that are particularly susceptible to material change in the near term relate to the determination of the allowance for loan losses, fair value of financial instruments, the valuation of real estate acquired in connection with foreclosures or in satisfaction of loans, the valuation of deferred tax assets, determination of other-than-temporary impairment losses on securities, impairment of goodwill and fair value of

assets acquired and liabilities assumed in business combinations. Actual results could differ from those estimates. For additional information and disclosures required under GAAP, reference is made to the Company’s Annual Report on Form 10-K for the year ended December 31, 2016.

Recent accounting standards:

In May 2014, the FASB issued ASU No. 2014-09, “Revenue from Contracts with Customers (Topic 606).” The updated standard is a new comprehensive revenue recognition model that requires revenue to be recognized in a manner that depicts the transfer of goods or services to a customer at an amount that reflects the consideration expected to be received in exchange for those goods or services. In August 2015, the FASB issued ASU 2015-14 which deferred the effective date of ASU 2014-09 by one year. During 2016, the FASB issued ASU Nos. 2016-10, 2016-12 and 2016-20 that provide additional guidance related to the identification of performance obligations within a contract, assessing collectability, contract costs, and other technical corrections and improvements. ASU 2014-09 will become effective for the Company for the annual period beginning after December 15, 2017 and for interim periods within the annual period. ASU 2014-09 allows for either full retrospective or modified retrospective adoption. The Company has not selected a transition method. The Company has completed an evaluation of its revenue-producing contracts and determined they are primarily agreements that are not within the scope of this standard. As a result, the Company does not expect the adoption of this standard to have a material impact to the Company’s reported revenues and interest income. The Company is continuing to evaluate the impact on other revenue and income sources.

In January 2016, the FASB issued Accounting Standards Update ("ASU") No. 2016-01, “Financial Instruments – Overall.” The guidance in this ASU among other things, (1) requires equity investments with certain exceptions, to be measured at fair value with changes in fair value recognized in net income, (2) simplifies the impairment assessment of

Peoples Financial Services Corp.

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

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

equity investments without readily determinable fair values by requiring a qualitative assessment to identify impairment, (3) eliminates the requirement for public businesses entities to disclose the methods and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost on the balance sheet, (4) requires public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes, (5) requires an entity to present separately in other comprehensive income the portion of the change in fair value of a liability resulting from a change in the instrument-specific credit risk when the entity has elected to measure the liability at fair value in accordance with the fair value option for financial instruments, (6) requires separate presentation of financial assets and financial liabilities by measurement category and form of financial asset on the balance sheet or the accompanying notes to the financial statements and (7) clarifies that an entity should evaluate the need for a valuation allowance on a deferred tax asset related to available-for-sale securities. The guidance in this ASU is effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The Company is in the process of evaluating the impact of the adoption of this guidance on the Company’s financial statements.

In February 2016, the FASB issued ASU No. 2016-02, “Leases”. From the lessee's perspective, the new standard establishes a right-of-use (“ROU”) model that requires a lessee to record a ROU asset and a lease liability on the balance sheet for all leases with terms longer than 12 months. Leases will be classified as either finance or operating, with classification affecting the pattern of expense recognition in the income statement for a lessee. From the lessor's perspective, the new standard requires a lessor to classify leases as either sales-type, finance or operating. A lease will be treated as a sale if it transfers all of the risks and rewards, as well as control of the underlying asset, to the lessee. If risks and rewards are conveyed without the transfer of control, the lease is treated as a financing. If the lessor doesn’t convey risks and rewards or control, an operating lease results. The new standard is effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Early application is permitted. A modified retrospective transition approach is required for lessees for capital and operating leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements, with certain practical expedients available. A modified retrospective transition approach is required for lessors for sales-type, direct financing, and operating leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements, with certain practical expedients available. The Company’s initial findings conclude that the new pronouncement will not have a significant impact on its consolidated financial statements as the current projected minimum lease payments under existing lease contracts subject to the new pronouncement are less than one percent of its current assets.

In June 2016, the FASB issued ASU 2016-13, Financial Instruments-Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments. This ASU will have a significant impact on the Company’s calculation and accounting for its Allowance for Loan Losses as well as credit losses related to investment securities available-for-sale. A summary of significant provisions of this ASU is as follows:

- The ASU requires that a financial asset (or a group of financial assets) measured at amortized cost basis be presented, net of a valuation allowance for credit losses, at an amount expected to be collected on the financial asset(s), and that the income statement include the measurement of credit losses for newly recognized financial assets as well as changes in expected losses on previously recognized financial assets. The provisions of this ASU require measurement of expected credit losses based on relevant information including past events, historical experience, current conditions, and reasonable and supportive forecasts that affect the collectability of the asset. The provisions of this ASU differ from current U.S. GAAP in that current U.S. GAAP generally delays recognition of the full amount of credit losses until the loss is probable of occurring.

- The amendments in the Update retain many of the disclosure requirements related to credit quality in current U.S. GAAP, updated to reflect the change from an incurred loss methodology to an expected credit loss methodology. In addition, the Update requires that disclosure of credit quality indicators in relation to the amortized cost of financing receivables, a current requirement, be further disaggregated by year of origination.

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- This ASU requires that credit losses on available-for-sale debt securities be presented as an allowance rather than as a write-down, and limits the amount of the allowance for credit losses to the amount by which the fair value is below amortized cost. For purchased investment securities available-for-sale with a more-than-insignificant amount of credit deterioration since origination, the ASU requires an allowance be determined in a manner similar to other investment securities available-for-sale; however, the initial allowance would be added to the purchase price, with only subsequent changes in the allowance recorded in credit loss expense, and interest income recognized at the effective rate excluding the discount embedded in the purchase price related to estimated credit losses at acquisition.

- This ASU will be effective for the Company for interim and annual periods beginning in the first quarter of 2020. Earlier adoption is permitted beginning in the first quarter of 2019. The Company will record the effect of implementing this ASU through a cumulative-effect adjustment through retained earnings as of the beginning of the reporting period in which Topic 326 is effective.

The Company cannot yet determine the magnitude of any such one-time cumulative adjustment or of the overall impact of the new standard on our financial condition or results of operations; however, it is anticipated that the allowance will increase upon adoption and that the increased allowance level will decrease regulatory capital and ratios.

In June 2016, the FASB issued ASU 2016-15, Statement of Cash Flows (Topic 230) –Classification of Certain Cash Receipts and Cash Payments. This Update provides clarification regarding eight specific cash flow issues with the objective of reducing diversity in practice in how certain cash receipts and cash payments are presented and classified in the statement of cash flows. For the Company, the amendments in this Update are effective beginning in the first quarter 2018. The amendments in this Update should be applied using a retroactive transition method to each period presented. The Company anticipates there will be no adjustments to the Consolidated Statements of Cash Flows, as previously reported, as a result of the clarifications provided in the Update.

In January 2017, the FASB issued ASU 2017-04, Intangibles – Goodwill and Other (Topic 350) to simplify the accounting for goodwill impairment. This guidance, among other things, removes step 2 of the goodwill impairment test thus eliminating the need to determine the fair value of individual assets and liabilities of the reporting unit. Upon adoption of this ASU, goodwill impairment will be the amount by which a reporting unit's carrying value exceeds its fair value, not to exceed the carrying amount of goodwill. This may result in more or less impairment being recognized than under current guidance. This Update will become effective for the Company's annual and interim goodwill impairment tests beginning in the first quarter of 2020.

2. Other comprehensive loss:

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

The components of accumulated other comprehensive loss included in stockholders' equity at June 30, 2017 and December 31, 2016 is as follows:

	June 30, 2017	December 31, 2016
Net unrealized gain on investment securities available-for-sale	$ 2,010	$ 553
Income tax	703	193
Net of income taxes	1,307	360
Benefit plan adjustments	(6,946)	(6,946)
Income tax	(2,431)	(2,431)
Net of income taxes	(4,515)	(4,515)
Accumulated other comprehensive loss	$ (3,208)	$ (4,155)

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

Other comprehensive income (loss) and related tax effects for the three and six months ended June 30, 2017 and 2016 is as follows:

Three Months Ended June 30,	2017	2016
Unrealized gain on investment securities available-for-sale	$ 1,184	$ 1,128
Net gain on the sale of investment securities available-for-sale(1)		(381)
Other comprehensive income gain before taxes	1,184	747
Income tax expense	415	261
Other comprehensive income	$ 769	$ 486

Six Months Ended June 30,	2017	2016
Unrealized gain on investment securities available-for-sale	$ 1,457	$ 2,123
Net gain on the sale of investment securities available-for-sale(1)		(623)
Other comprehensive income gain before taxes	1,457	1,500
Income tax expense	510	525
Other comprehensive income	$ 947	$ 975

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

3. Earnings per share:

Basic earnings per share represent income available to common stockholders divided by the weighted-average number of common shares outstanding during the period. Diluted earnings per share reflect additional common shares that would have been outstanding if dilutive potential common shares had been issued, as well as any adjustment to income that would result from the assumed issuance.

There were no shares considered anti-dilutive for the three and six month periods ended June 30, 2017 and 2016.

2017	2016

For the Three Months Ended June 30,	Basic	Diluted	Basic	Diluted
Net Income	$ 5,659	$ 5,659	$ 4,855	$ 4,855
Average common shares outstanding	7,396,163	7,396,163	7,395,127	7,395,127
Earnings per share	$ 0.76	$ 0.76	$ 0.66	$ 0.66

	2017		2016	
For the Six Months Ended June 30	Basic	Diluted	Basic	Diluted
Net Income	$ 10,459	$ 10,459	$ 9,737	$ 9,737
Average common shares outstanding	7,395,158	7,395,158	7,399,318	7,399,318
Earnings per share	$ 1.41	$ 1.41	$ 1.32	$ 1.32

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Peoples Financial Services Corp.

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

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

4. Investment securities:

The amortized cost and fair value of investment securities aggregated by investment category at June 30, 2017 and December 31, 2016 are summarized as follows:

June 30, 2017	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available-for-sale:				
U.S. Treasury securities	$ 20,047	$ 56	$ 23	$ 20,080
U.S. Government-sponsored enterprises	81,495	96	847	80,744
State and municipals:				
Taxable	14,629	667	1	15,295
Tax-exempt	102,737	2,191	59	104,869
Mortgage-backed securities:				
U.S. Government agencies	17,576	31	29	17,578
U.S. Government-sponsored enterprises	18,280	39	111	18,208
Total	$ 254,764	$ 3,080	$ 1,070	$ 256,774
Held-to-maturity:				
Tax-exempt state and municipals	$ 6,860	$ 163	$ 3	$ 7,020
Mortgage-backed securities:				
U.S. Government agencies	61			61
U.S. Government-sponsored enterprises	2,947	193		3,140
Total	$ 9,868	$ 356	$ 3	$ 10,221

December 31, 2016	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available-for-sale:				
U.S. Treasury securities	$ 7,570		$ 132	$ 7,438
U.S. Government-sponsored enterprises	82,314	$ 79	1,480	80,913
State and municipals:				

Taxable	14,698	566	39	15,225
Tax-exempt	110,931	2,309	640	112,600
Mortgage-backed securities:				
U.S. Government agencies	21,041	48	47	21,042
U.S. Government-sponsored enterprises	22,303	48	159	22,192
Total	$ 258,857	$ 3,050	$ 2,497	$ 259,410
Held-to-maturity:				
Tax-exempt state and municipals	$ 6,862	$ 72	$ 67	$ 6,867
Mortgage-backed securities:				
U.S. Government agencies	68	1		69
U.S. Government-sponsored enterprises	3,587	191		3,778
Total	$ 10,517	$ 264	$ 67	$ 10,714

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The maturity distribution of the fair value, which is the net carrying amount, of the debt securities classified as available-for-sale at June 30, 2017, is summarized as follows:

June 30, 2017	Fair Value
Within one year	$ 33,157
After one but within five years	127,433
After five but within ten years	45,799
After ten years	14,599
	220,988
Mortgage-backed securities	35,786
Total	$ 256,774

The maturity distribution of the amortized cost and fair value, of debt securities classified as held-to-maturity at June 30, 2017, is summarized as follows:

June 30, 2017	Amortized Cost	Fair Value
Within one year		
After one but within five years		
After five but within ten years		
After ten years	$ 6,860	$ 7,020
	6,860	7,020
Mortgage-backed securities	3,008	3,201
Total	$ 9,868	$ 10,221

Securities with a carrying value of $138,272 and $144,750 at June 30, 2017 and December 31, 2016, respectively, were pledged to secure public deposits and certain other deposits as required or permitted by law.

Securities and short-term investment activities are conducted with a diverse group of government entities, corporations and state and local municipalities. The counterparty’s creditworthiness and type of collateral is evaluated

on a case-by-case basis. At June 30, 2017 and December 31, 2016, there were no significant concentrations of credit risk from any one issuer, with the exception of U.S. Government agencies and sponsored enterprises that exceeded 10.0 percent of stockholders' equity.

The fair value and gross unrealized losses of investment securities with unrealized losses for which an other-than-temporary impairment ("OTTI") has not been recognized at June 30, 2017 and December 31, 2016, aggregated by investment category and length of time that the individual securities have been in a continuous unrealized loss position, are summarized as follows:

	Less Than 12 Months		12 Months or More		Total	
June 30, 2017	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
U.S. Treasury securities	$ 2,501	$ 23			$ 2,501	$ 23
U.S. Government-sponsored enterprises	65,845	823	$ 1,067	$ 24	66,912	847
State and municipals:						
Taxable	554	1			554	1
Tax-exempt	15,898	62			15,898	62
Mortgage-backed securities:						
U.S. Government agencies	2,848	8	3,503	21	6,351	29
U.S. Government-sponsored enterprises	11,218	50	2,327	61	13,545	111
Total	$ 98,864	$ 967	$ 6,897	$ 106	$ 105,761	$ 1,073

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	Less Than 12 Months		12 Months or More		Total	
December 31, 2016	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
U.S. Treasury securities	$ 7,438	$ 132			$ 7,438	$ 132
U.S. Government-sponsored enterprises	59,460	1,480			59,460	1,480
State and municipals:						
Taxable	1,035	39			1,035	39
Tax-exempt	55,166	707	$ 226		55,392	707
Mortgage-backed securities:						
U.S. Government agencies	5,917	27	1,496	$ 20	7,413	47
U.S. Government-sponsored enterprises	16,412	85	2,712	74	19,124	159
Total	$ 145,428	$ 2,470	$ 4,434	$ 94	$ 149,862	$ 2,564

The Company had 80 investment securities, consisting of 27 tax-exempt state and municipal obligations, one U.S. Treasury security, one taxable municipal obligation, 25 U.S. Government-sponsored enterprise securities, and 26 mortgage-backed securities that were in unrealized loss positions at June 30, 2017. Of these securities, eleven mortgage-backed securities and one U.S. Government-sponsored enterprise security were in a continuous unrealized loss position for twelve months or more. Management does not consider the unrealized losses on the debt securities, as a result of changes in interest rates, to be OTTI based on historical evidence that indicates the cost of these securities is recoverable within a reasonable period of time in relation to normal cyclical changes in the market rates of interest. Moreover, because there has been no material change in the credit quality of the issuers or other events or circumstances that may cause a significant adverse impact on the fair value of these securities, and management does not intend to sell these securities and it is unlikely that the Company will be required to sell these securities before recovery of their amortized cost basis, which may be maturity, the Company does not consider the unrealized losses to be OTTI at June 30, 2017. There was no OTTI recognized for the three or six months ended June 30, 2017 and 2016.

The Company had 163 investment securities, consisting of 107 tax-exempt state and municipal obligations, two taxable state and municipal obligations, two U.S. Treasury securities, 22 U.S. Government-sponsored enterprise securities and 30 mortgage-backed securities that were in unrealized loss positions at December 31, 2016. Of these securities, nine mortgage-backed securities, and two tax-exempt state and municipal securities were in a continuous unrealized loss position for twelve months or more.

5. Loans, net and allowance for loan losses:

The major classifications of loans outstanding, net of deferred loan origination fees and costs at June 30, 2017 and December 31, 2016 are summarized as follows. Net deferred loan costs were $542 and $579 at June 30, 2017 and December 31, 2016.

	June 30, 2017	December 31, 2016
Commercial	$ 452,180	$ 408,814
Real estate:		
Commercial	719,652	700,144
Residential	286,232	289,781
Consumer	139,298	134,226
Total	$ 1,597,362	$ 1,532,965

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The changes in the allowance for loan losses account by major classification of loan for the three and six months ended June 30, 2017 and 2016 are summarized as follows:

June 30, 2017	Commercial	Real estate Commercial	Residential	Consumer	Unallocated	Total
Allowance for loan losses:						
Beginning Balance April 1, 2017	$ 4,129	$ 6,291	$ 4,978	$ 1,571	$	$ 16,969
Charge-offs	(32)	(242)	(8)	(149)		(431)
Recoveries	6	22	4	32		64
Provisions	323	516	222	139		1,200
Ending balance	$ 4,426	$ 6,587	$ 5,196	$ 1,593	$	$ 17,802

June 30, 2016	Commercial	Real estate Commercial	Residential	Consumer	Unallocated	Total
Allowance for loan losses:						
Beginning Balance April 1, 2016	$ 3,322	$ 4,616	$ 4,359	$ 1,646	$ 215	$ 14,158
Charge-offs	(393)	(48)	(126)	(65)		(632)
Recoveries	34	14	10	15		73
Provisions	300	495	222	83	100	1,200
Ending balance	$ 3,263	$ 5,077	$ 4,465	$ 1,679	$ 315	$ 14,799

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June 30, 2017	Commercial	Real estate Commercial	Residential	Consumer	Unallocated	Total
Allowance for loan losses:						
Beginning Balance January 1, 2017	$ 3,799	$ 5,847	$ 4,707	1,608		15,961
Charge-offs	(32)	(367)	(23)	(320)		(742)
Recoveries	13	55	26	89		183
Provisions	646	1,052	486	216		2,400
Ending balance	$ 4,426	$ 6,587	$ 5,196	$ 1,593	$	$ 17,802

June 30, 2016	Commercial	Real estate Commercial	Residential	Consumer	Unallocated	Total
Allowance for loan losses:						
Beginning Balance January 1, 2016	$ 3,042	$ 4,245	$ 4,082	$ 1,583	$ 23	$ 12,975
Charge-offs	(396)	(103)	(126)	(130)		(755)
Recoveries	36	30	35	78		179
Provisions	581	905	474	148	292	2,400
Ending balance	$ 3,263	$ 5,077	$ 4,465	$ 1,679	$ 315	$ 14,799

The allocation of the allowance for loan losses and the related loans by major classifications of loans at June 30, 2017 and December 31, 2016 is summarized as follows:

June 30, 2017	Commercial	Real estate Commercial	Residential	Consumer	Unallocated	Total
Allowance for loan losses:						
Ending balance	$ 4,426	$ 6,587	$ 5,196	$ 1,593	$	$ 17,802
Ending balance: individually evaluated for impairment	322	509	461	43		1,335
Ending balance: collectively evaluated for impairment	4,104	6,078	4,735	1,550		16,467

Ending balance: loans acquired with deteriorated credit quality	$	$	$	$	$	$
Loans receivable:						
Ending balance	$ 452,180	$ 719,652	$ 286,232	$ 139,298	$	$ 1,597,362
Ending balance: individually evaluated for impairment	1,944	3,951	3,285	232		9,412
Ending balance: collectively evaluated for impairment	449,868	715,056	282,915	139,066		1,586,905
Ending balance: loans acquired with deteriorated credit quality	$ 368	$ 645	$ 32	$	$	$ 1,045

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December 31, 2016	Commercial	Real estate Commercial	Residential	Consumer	Unallocated	Total
Allowance for loan losses:						
Ending balance	$ 3,799	$ 5,847	$ 4,707	$ 1,608	$	$ 15,961
Ending balance: individually evaluated for impairment	225	1,197	520			1,942
Ending balance: collectively evaluated for impairment	3,574	4,650	4,187	1,608		14,019
Ending balance: loans acquired with deteriorated credit quality	$	$	$	$	$	$
Loans receivable:						
Ending balance	$ 408,814	$ 700,144	$ 289,781	$ 134,226	$	$ 1,532,965
Ending balance: individually evaluated for impairment	1,724	5,820	3,543	155		11,242
Ending balance: collectively evaluated for impairment	406,127	692,987	286,201	134,071		1,519,386
Ending balance: loans acquired with deteriorated credit quality	$ 963	$ 1,337	$ 37	$	$	$ 2,337

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

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

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

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

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

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

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The following tables present the major classification of loans summarized by the aggregate pass rating and the classified ratings of special mention, substandard and doubtful within the Company's internal risk rating system at June 30, 2017 and December 31, 2016:

June 30, 2017	Pass	Special Mention	Substandard	Doubtful	Total
Commercial	$ 444,700	$ 2,976	$ 4,504	$	$ 452,180
Real estate:					
Commercial	698,625	8,590	12,437		719,652
Residential	279,578	143	6,511		286,232
Consumer	139,154		144		139,298
Total	$ 1,562,057	$ 11,709	$ 23,596	$	$ 1,597,362

December 31, 2016	Pass	Special Mention	Substandard	Doubtful	Total
Commercial	$ 398,867	$ 6,222	$ 3,725	$	$ 408,814
Real estate:					
Commercial	674,914	10,392	14,838		700,144
Residential	282,737	233	6,811		289,781
Consumer	133,983		243		134,226
Total	$ 1,490,501	$ 16,847	$ 25,617	$	$ 1,532,965

Information concerning nonaccrual loans by major loan classification at June 30, 2017 and December 31, 2016 is summarized as follows:

	June 30, 2017	December 31, 2016
Commercial	$ 1,285	$ 934
Real estate:		

Commercial	4,115	7,016
Residential	2,645	3,003
Consumer	232	155
Total	$ 8,277	$ 11,108

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

June 30, 2017	30-59 Days Past Due	60-89 Days Past Due	Greater than 90 Days	Total Past Due	Current	Total Loans	Loans > 90 Days and Accruing
Commercial	$ 501	$ 105	$ 1,285	$ 1,891	$ 450,289	$ 452,180	
Real estate:							
Commercial	2,003	71	4,115	6,189	713,463	719,652	
Residential	964	474	3,212	4,650	281,582	286,232	$ 567
Consumer	964	346	500	1,810	137,488	139,298	268
Total	$ 4,432	$ 996	$ 9,112	$ 14,540	$ 1,582,822	$ 1,597,362	$ 835

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December 31, 2016	30-59 Days Past Due	60-89 Days Past Due	Greater than 90 Days	Total Past Due	Current	Total Loans	Loans > 90 Days and Accruing
Commercial	$ 249	$ 75	$ 934	$ 1,258	$ 407,556	$ 408,814	
Real estate:							
Commercial	4,782	527	7,016	12,325	687,819	700,144	
Residential	2,100	354	3,561	6,015	283,766	289,781	$ 558
Consumer	962	259	441	1,662	132,564	134,226	286
Total	$ 8,093	$ 1,215	$ 11,952	$ 21,260	$ 1,511,705	$ 1,532,965	$ 844

The following tables summarize information concerning impaired loans as of and for the three and six months ended June 30, 2017 and June 30, 2016, and as of and for the year ended, December 31, 2016 by major loan classification:

June 30, 2017	Recorded Investment	Unpaid Principal Balance	Related Allowance	This Quarter Average Recorded Investment	Interest Income Recognized	Year-to-Date Average Recorded Investment	Interest Income Recognized
With no related allowance:							
Commercial	$ 1,580	$ 2,197		$ 1,173	$ 18	$ 1,583	$ 35
Real estate:							
Commercial	3,058	3,706		3,387	7	3,045	13
Residential	2,083	2,265		2,216	4	2,212	6
Consumer	188	188		186		176	
Total	6,909	8,356		6,962	29	7,016	54
With an allowance recorded:							
Commercial	732	732	$ 321	1,328		979	
Real estate:							
Commercial	1,538	1,538	509	1,505	3	2,601	7
Residential	1,234	1,234	461	1,139	8	1,218	14
Consumer	44	44	44	34		22	
Total	3,548	3,548	1,335	4,006	11	4,820	21
Commercial	2,312	2,929	321	2,501	18	2,562	35
Real estate:							

Commercial	4,596	5,244	509	4,892	10	5,646	20
Residential	3,317	3,499	461	3,355	12	3,430	20
Consumer	232	232	44	220		198	
Total	$ 10,457	$ 11,904	$ 1,335	$ 10,968	$ 40	$ 11,836	$ 75

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				For the Year Ended	
December 31, 2016	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
With no related allowance:					
Commercial	$ 2,404	$ 3,213		$ 1,461	$ 48
Real estate:					
Commercial	2,364	3,018		4,300	71
Residential	2,205	2,388		2,133	35
Consumer	155	155		147	
Total	7,128	8,774		8,041	154
With an allowance recorded:					
Commercial	283	283	$ 225	859	
Real estate:					
Commercial	4,793	4,793	1,197	2,366	2
Residential	1,375	1,376	520	1,185	7
Consumer				50	
Total	6,451	6,452	1,942	4,460	9
Commercial	2,687	3,496	225	2,320	48
Real estate:					
Commercial	7,157	7,811	1,197	6,666	73
Residential	3,580	3,764	520	3,318	42
Consumer	155	155		197	
Total	$ 13,579	$ 15,226	$ 1,942	$ 12,501	$ 163

				This Quarter		Year-to-Date	
June 30, 2016	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
With no related allowance:							
Commercial	$ 1,296	$ 2,378		$ 1,235	$ 14	$ 1,249	30
Real estate:							
Commercial	5,517	6,181		4,340	30	3,643	61
Residential	1,941	2,124		2,079	3	2,355	11

Consumer	157	157		123		92	
Total	8,911	10,840		7,777	47	7,339	102
With an allowance recorded:							
Commercial	615	615	$ 615	878		923	$
Real estate:							
Commercial	899	899	405	1,964		2,400	
Residential	1,279	1,279	723	1,136	2	1,295	4
Consumer	71	71	71	80		92	
Total	2,864	2,864	1,814	4,058	2	4,710	4
Commercial	1,911	2,993	615	2,113	14	2,172	30
Real estate:							
Commercial	6,416	7,080	405	6,304	30	6,043	61
Residential	3,220	3,403	723	3,215	5	3,650	15
Consumer	228	228	71	203		184	
Total	$ 11,775	$ 13,704	$ 1,814	$ 11,835	$ 49	$ 12,049	$ 106

Included in the commercial loan and commercial and residential real estate categories are troubled debt restructurings that are classified as impaired. Troubled debt restructurings totaled $2,152 at June 30, 2017, $1,909 at December 31, 2016 and $2,701 at June 30, 2016.

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

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

There was one loan modified as a troubled debt restructuring for the three months ended June 30, 2017 totaling $64. For the six months ended June 30, 2017, two loans were modified as troubled debt restructurings in the amount of $409. There were no loans modified as troubled debt restructurings for the three months ended June 30, 2016. For the six months ended June 30, 2016, there was one loan modified as a troubled debt restructuring in the amount of $75. During the three and six months ended June 30, 2017, there were no payment defaults on loans restructured within the last twelve months. During the three months ended June 30, 2016, there were no payment defaults on loans restructured within the last twelve months. During the six months ended June 30, 2016, there were two payment defaults on restructured residential real estate loans totaling $208.

6. Other assets and gain on sale of merchant services business:

The components of other assets at June 30, 2017, and December 31, 2016 are summarized as follows:

	June 30, 2017	December 31, 2016
Other real estate owned	$ 384	$ 393
Investment in residential housing program	8,077	8,312
Mortgage servicing rights	707	698
Bank owned life insurance	33,454	33,073
Restricted equity securities	7,754	7,051
Other assets	17,626	15,974
Total	$ 68,002	$ 65,501

In the second quarter of 2017, the Company entered into and executed a merchant asset sales agreement with a third party to sell and transfer the Company's merchant business. Proceeds from the sale were received on June 30, 2017 in the amount of $2,300. In connection with the sale, merchant related equipment in the amount of $22 previously included in other assets above were sold, resulting in a net gain of $2,278 to the Company which is included in noninterest income in the accompanying consolidated statements of income for the three and six months ended June 30, 2017. The sale represents the entirety of the Company's merchant services business and the Company will no longer originate any proprietary merchant service relationships. The Company did not receive an ownership interest in the unrelated purchaser of the merchant business. The $2,300 represents the entire consideration received by the Company under the merchant asset sales agreement and there is no form of contingent consideration. Separate from the merchant asset sales

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agreement, the Company entered into a marketing and sales agreement with the merchant business purchaser to share in future revenue generated from the sold merchant portfolio, and from new merchant referrals.

7. Fair value estimates:

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Off-balance sheet financial instruments:

The majority of commitments to extend credit, unused portions of lines of credit and standby letters of credit carry current market interest rates if converted to loans. Because such commitments are generally unassignable of either the Company or the borrower, they only have value to the Company and the borrower. None of the commitments are subject to undue credit risk. The estimated fair values of off-balance sheet financial instruments are based on fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the counterparties' credit standing. The fair value of off-balance sheet financial instruments was not material at June 30, 2017 and December 31, 2016.

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Assets and liabilities measured at fair value on a recurring basis at June 30, 2017 and December 31, 2016 are summarized as follows:

	Fair Value Measurement Using			
June 30, 2017	Amount	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
U.S. Treasury securities	$ 20,080	$ 20,080		$
U.S. Government-sponsored enterprises	80,744		$ 80,744	
State and Municipals:				
Taxable	15,295		15,295	
Tax-exempt	104,869		104,869	
Mortgage-backed securities:				
U.S. Government agencies	17,578		17,578	
U.S. Government-sponsored enterprises	18,208		18,208	
Total	$ 256,774	$ 20,080	$ 236,694	$

	Fair Value Measurement Using			
December 31, 2016	Amount	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
U.S. Treasury securities	$ 7,438	$ 7,438		$
U.S. Government-sponsored enterprises	80,913		$ 80,913	
State and Municipals:				
Taxable	15,225		15,225	
Tax-exempt	112,600		112,600	
Mortgage-backed securities:				
U.S. Government agencies	21,042		21,042	
U.S. Government-sponsored enterprises	22,192		22,192	
Total	$ 259,410	$ 7,438	$ 251,972	$

Assets and liabilities measured at fair value on a nonrecurring basis at June 30, 2017 and December 31, 2016 are summarized as follows:

	Fair Value Measurement Using			
June 30, 2017	Amount	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Impaired loans	$ 1,798			$ 1,798
Other real estate owned	$ 213			$ 213

	Fair Value Measurement Using			
December 31, 2016	Amount	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Impaired loans	$ 3,193			$ 3,193
Other real estate owned	$ 371			$ 371

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

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Peoples Financial Services Corp.

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

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

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

	Quantitative Information about Level 3 Fair Value Measurements			
June 30, 2017	Fair Value Estimate	Valuation Techniques	Unobservable Input	Range (Weighted Average)
Impaired loans	$ 1,798	Appraisal of collateral	Appraisal adjustments	6.3% to 97.0% (75.3)%
			Liquidation expenses	3.0% to 6.0% (4.8)%
Other real estate owned	$ 213	Appraisal of collateral	Appraisal adjustments	20.0% to 38.2% (27.5)%
			Liquidation expenses	3.0% to 6.0% (5.0)%

	Quantitative Information about Level 3 Fair Value Measurements			
December 31, 2016	Fair Value Estimate	Valuation Techniques	Unobservable Input	Range (Weighted Average)
Impaired loans	$ 3,193	Appraisal of collateral	Appraisal adjustments	18.0% to 97.0% (74.5)%
			Liquidation expenses	3.0% to 6.0% (5.3)%
Other real estate owned	$ 371	Appraisal of collateral	Appraisal adjustments	25.0% to 54.6% (43.1)%
			Liquidation expenses	3.0% to 6.0% (5.0)%

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

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

The carrying and fair values of the Company's financial instruments at June 30, 2017 and December 31, 2016 and their placement within the fair value hierarchy are as follows:

			Fair Value Hierarchy		
June 30, 2017	Carrying Value	Fair Value	Quoted Prices in Active Markets for Identical Assets (level 1)	Significant Other Observable Inputs (level 2)	Significant Unobservable Inputs (Level 3)
Financial assets:					
Cash and cash equivalents	$ 41,401	$ 41,401	$ 41,401		
Investment securities:					
Available-for-sale	256,774	256,774	20,080	$ 236,694	
Held-to-maturity	9,868	10,221		10,221	
Loans held for sale				—	
Net loans	1,579,560	1,567,146			$ 1,567,146
Accrued interest receivable	6,206	6,206		6,206	
Mortgage servicing rights	707	1,607		1,607	
Restricted equity securities	7,754	7,754		7,754	
Total	$ 1,902,270	$ 1,891,109			
Financial liabilities:					
Deposits	$ 1,639,433	$ 1,638,514		$ 1,638,514	
Short-term borrowings	91,500	91,500		91,500	
Long-term debt	57,160	58,053		58,053	
Accrued interest payable	431	431		431	
Total	$ 1,788,524	$ 1,788,498			

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			Fair Value Hierarchy		
December 31, 2016	Carrying Value	Fair Value	Quoted Prices in Active Markets for Identical Assets (level 1)	Significant Other Observable Inputs (level 2)	Significant Unobservable Inputs (Level 3)
Financial assets:					
Cash and cash equivalents	$ 39,941	$ 39,941	$ 39,941		
Investment securities:					
Available-for-sale	259,410	259,410	$ 7,438	$ 251,972	
Held-to-maturity	10,517	10,714		10,714	
Loans held for sale					
Net loans	1,517,004	1,507,936			$ 1,507,936
Accrued interest receivable	6,228	6,228		6,228	
Mortgage servicing rights	698	1,587		1,587	
Restricted equity securities	7,051	7,051		7,051	
Total	$ 1,840,849	$ 1,832,867			
Financial liabilities:					
Deposits	$ 1,588,757	$ 1,587,701		$ 1,587,701	
Short-term borrowings	82,700	82,700		82,700	
Long-term debt	58,134	58,987		58,987	
Accrued interest payable	462	462		462	
Total	$ 1,730,053	$ 1,729,850			

8. Employee benefit plans:

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

For the three and six months ended June 30, salaries and employee benefits expense includes approximately $307 and $603 in 2017 and $329 and $603 in 2016 relating to the employee benefit plans.

Components of net periodic benefit cost are as follows:

	Pension Benefits	
Three Months Ended June 30,	2017	2016
Components of net periodic pension cost:		
Interest cost	$ 217	$ 166
Expected return on plan assets	(305)	(223)
Amortization of unrecognized net gain	65	52
Net periodic other benefit cost	$ (23)	$ (5)

	Pension Benefits	
Six Months Ended June 30,	2017	2016
Components of net periodic pension cost:		
Interest cost	$ 217	$ 333
Expected return on plan assets	(305)	(447)
Amortization of unrecognized net gain	65	104
Net periodic other benefit cost	$ (23)	$ (10)

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The 2008 long-term incentive plan ("2008 Plan") allows for eligible participants to be granted equity awards. The plan was a legacy plan of Penseco Financial Services Corporation. Under the 2008 Plan the Compensation Committee of the board of directors has broad authority with respect to awards granted under the 2008 Plan, including, without limitation, the authority to:

- Designate the individuals eligible to receive awards under the 2008 Plan.

- Determine the size, type and date of grant for individual awards, provided that awards approved by the Committee are not effective unless and until ratified by the board of directors.

- Interpret the 2008 Plan and award agreements issued with respect to individual participants.

Persons eligible to receive awards under the 2008 Plan include directors, officers, employees, consultants and other service providers of the Company and its subsidiaries, except that incentive stock option may be granted only to individuals who are employees on the date of grant.

As of June 30, 2017, there were 120,116 shares of the Company's common stock available for grant as awards pursuant to the 2008 Plan. If any outstanding awards are forfeited by the holder or canceled by the Company, the underlying shares would be available for regrant to others.

The 2008 Plan authorizes grants of stock options, stock appreciation rights, dividend equivalents, performance awards, restricted stock and restricted stock units.

In 2017, the Company awarded 2,020 shares of non-performance-based restricted stock, bringing the total of nonvested restricted stock awards to 14,382 shares, and 7,071 performance-based restricted stock units under the 2008 Plan. In 2016, the Company did not make any awards under the 2008 Plan.

The non-performance restricted stock grants made in 2017 vest equally over three years from the grant date. Grants of restricted stock made in prior periods cliff vest after five years. The performance-based restricted stock units vest three years after the grant date and include conditions based on the Company's three year cumulative diluted earnings per share and three-year average return on equity that determines the number of restricted stock units that may vest.

The Company expenses the fair value of all-share based compensation over the requisite service period commencing at grant date. The fair value of restricted stock is expensed on a straight-line basis. The Company periodically assesses the probability of achievement of the performance criteria and adjusts the amount of compensation expense accordingly. Compensation is recognized over the vesting period and adjusted for the probability of achievement of the performance criteria. The Company classifies share-based compensation for employees within "salaries and employee benefits expense" on the Consolidated Statements of Income and Comprehensive Income.

The Company recognized compensation expense of $40 for the three and six months ended June 30, 2017 and did not recognize any compensation expense for the three and six months ended June 30, 2016 for awards granted under the 2008 Plan. As of June 30, 2017, the Company had $325 of unrecognized compensation expense associated with awards. The remaining cost is expected to be recognized over a weighted average vesting period of 2.75 years.

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

The following discussion and analysis should be read in conjunction with the unaudited consolidated interim financial statements contained in Part I, Item 1 of this report, and with our audited consolidated financial statements and "Management's Discussion and Analysis of Financial Condition and Results of Operations" presented in our Annual Report on Form 10-K for the year ended December 31, 2016.

Cautionary Note Regarding Forward-Looking Statements:

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

Our ability to predict results or the actual effect of future plans or strategies is inherently uncertain. Important factors that could cause our actual results to differ materially from those in the forward-looking statements include, but are not limited to: changes in interest rates; economic conditions, particularly in our market area; legislative and regulatory changes and the ability to comply with the significant laws and regulations governing the banking and financial services business; monetary and fiscal policies of the U.S. government, including policies of the U.S. Department of Treasury and the Federal Reserve System; credit risk associated with lending activities and changes in the quality and composition of our loan and investment portfolios; demand for loan and other products; deposit flows; competition; changes in the values of real estate and other collateral securing the loan portfolio, particularly in our market area; our ability to achieve the intended benefits of, or other risks associated with, business combinations; changes in relevant accounting principles and guidelines; inability of third party service providers to perform; and our ability to prevent, detect and respond to cyberattacks. Additional factors that may affect our results are discussed in Part I, Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2016, and in reports we file with the Securities and Exchange Commission from time to time.

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

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

Critical Accounting Policies:

Disclosure of our significant accounting policies are included in Note 1 to the consolidated financial statements of the Annual Report on Form 10-K for the year ended December 31, 2016. Some of these policies are particularly sensitive requiring significant judgments, estimates and assumptions. Critical accounting policies are defined as those that are reflective of significant judgments and uncertainties, and could potentially result in materially different results under different assumptions and conditions. We believe that the most critical accounting policies upon which our financial condition and results of operation depend, and which involve the most complex subjective decisions or assessments, are included in Note 1 to the consolidated financial statements in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2016, and all amendments thereto, as filed with the Securities and Exchange Commission.

Peoples Financial Services Corp.

Management's Discussion and Analysis

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

Operating Environment:

The Federal Open Market Committee ("FOMC") increased the overnight rate 25 basis points during the first quarter of 2017 and another 25 basis points in the second quarter of 2017 as well as projected one more rate hike in 2017. In doing so, the FOMC cited improvement in labor markets and the move in recent quarters to the committee's long-term desired 2 percent level of inflation. The initial reading of second quarter 2017 gross domestic product ("GDP"), the value of all goods and services produced in the Nation, came in at an annualized rate of 2.6%, up significantly from the final reading of 0.7% in the first quarter of 2017 while the consumer price index ("CPI") decreased slightly for the 12 months ended June 30, 2017 at 1.6% from 2.4% for the 12 months ended March 31, 2017. The core personal consumption expenditure price index, which ignores food and energy, averaged 1.7% for the 12 months ended June 30, 2017.

Review of Financial Position:

Total assets increased $65,316, or 6.6% annualized, to $2,064,758 at June 30, 2017, from $1,999,442 at December 31, 2016. Loans, net increased to $1,597,362 at June 30, 2017, compared to $1,532,965 at December 31, 2016, an increase of $64,397 or 8.5% annualized. The increase in loans, net during 2017 has been funded primarily by increases in deposits and to a lesser extent short-term borrowings and investment cashflow. Investment securities decreased $3,285 or 2.4% annualized in 2017. Total deposits increased $50,676 or 6.4% as interest-bearing deposits increased $47,927 and noninterest-bearing deposits increased $2,749. Total stockholders' equity increased $6,891 or at an annual rate of 5.4%, from $256,618 at year-end 2016 to $263,509 at June 30, 2017. Compared to March 31, 2017, total assets increased $41,252 or 2.0% while loans, net increased $37,495 or 2.4% and deposits increased $23,889 or 1.5%. For the six months ended June 30, 2017, total assets averaged $2,025,301, an increase of $148,470 from $1,876,831 for the same period of 2016.

Investment Portfolio:

The majority of the investment portfolio is held as available-for-sale, which allows for greater flexibility in using the investment portfolio for liquidity purposes by allowing securities to be sold when market opportunities occur. Investment securities available-for-sale totaled $256,774 at June 30, 2017, a decrease of $2,636, or 1.0% from $259,410 at December 31, 2016. The majority of the investment cashflow from maturing bonds and principal

payments on mortgage-backed securities was re-invested back into the investment portfolio. The Company has not incrementally grown the investment portfolio due to the flattening yield curve. Investment securities held-to-maturity totaled $9,868 at June 30, 2017, a decrease of $649 or 6.2% from $10,517 at December 31, 2016 due to payments received from mortgage backed holdings.

For the six months ended June 30, 2017, the investment portfolio averaged $272,910, a decrease of $6,070 or 2.2% compared to $278,980 for the same period last year. The tax-equivalent yield on the investment portfolio decreased 3 basis points to 2.87% for the six months ended June 30, 2017, from 2.90% for the comparable period of 2016. The decrease in the yield is resulting from investment cashflows being replaced into the low rate environment. The tax-equivalent yield on the investment portfolio decreased 4 basis points to 2.85% in the second quarter of 2017 compared to 2.89% in the first quarter of 2017.

Securities available-for-sale are carried at fair value, with unrealized gains or losses net of deferred income taxes reported in the accumulated other comprehensive income (loss) component of stockholders' equity. We reported net unrealized gains, included as a separate component of stockholders' equity of $1,307, net of deferred income taxes of $703, at June 30, 2017, and $360, net of deferred income taxes of $193, at December 31, 2016.

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

Loan Portfolio:

The Company's continued investment in its Lehigh Valley and King of Prussia expansion markets led to the loan growth during the six months ended June 30, 2017. Loans, net increased to $1,597,362 at June 30, 2017 from $1,532,965 at December 31, 2016, an increase of $64,397 or 8.5% annualized. The growth reflected increases in commercial loans,

commercial real estate loans and consumer loans, partially offset by a decrease in residential real estate loans. Commercial loans increased $43,366, or 21.4% annualized, to $452,180 at June 30, 2017 compared to $408,814 at December 31, 2016. Commercial real estate loans increased $19,508 or 5.6% annualized, to $719,652 at June 30, 2017 compared to $700,144 at December 31, 2016. Consumer loans increased $5,072, or 7.6% on an annualized basis, to $139,298 at June 30, 2017 compared to $134,226 at December 31, 2016. The primary contributor to the growth in consumer loans was our indirect automobile lending portfolio which increased $6,927, due to increased consumer demand for automobiles.

Residential real estate loans decreased $3,549, or 2.4% on an annualized basis, to $286,232 at June 30, 2017 compared to $289,781 at December 31, 2016. The decrease is due to lower first lien residential mortgage loans as the majority of new originations were sold into the secondary market in lieu of being retained in our loan portfolio to mitigate interest rate risk in the current low rate environment. Growth in our home equity line of credit portfolio due to seasonal demand partially offset the decline.

For the six months ended June 30, 2017, loans, net averaged $1,556,848, an increase of $147,898 or 10.5% compared to $1,408,950 for the same period of 2016. The tax-equivalent yield on the loan portfolio was 4.38% for the six months ended June 30, 2017, an 11 basis point decrease from the comparable period last year. The tax-equivalent yield on the loan portfolio decreased to 4.36% for the second quarter of 2017 as compared to 4.40% for the first quarter of 2017 and 4.47% for the second quarter of 2016.

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

Unused commitments at June 30, 2017, totaled $366,936, consisting of $341,292 in unfunded commitments of existing loan facilities and $25,644 in standby letters of credit. Due to fixed maturity dates, specified conditions within these instruments, and the ultimate needs of our customers, many will expire without being drawn upon. We believe that amounts actually drawn upon can be funded in the normal course of operations and therefore, do not represent a significant liquidity risk to us. In comparison, unused commitments at December 31, 2016 totaled $324,713,

consisting of $293,662 in unfunded commitments of existing loans and $31,051 in standby letters of credit.

Asset Quality:

National, Pennsylvania, New York and market area unemployment rates at June 30, 2017 and 2016, are summarized as follows:

	2017		2016	
United States	4.5	%	4.9	%
New York (statewide)	4.6		4.9	
Pennsylvania (statewide)	5.1		5.5	
Broome County	5.6		5.6	
Bucks County	4.3		4.7	
Lackawanna County	5.4		5.9	
Lehigh County	5.3		5.4	
Luzerne County	6.3		6.6	
Monroe County	6.2		6.4	
Montgomery County	4.0		4.2	
Northampton County	5.2		5.3	
Susquehanna County	5.5		6.2	
Wayne County	6.0		6.3	
Wyoming County	5.9	%	6.8	%

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Peoples Financial Services Corp.

Management's Discussion and Analysis

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

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

We experienced improvement in our our asset quality as nonperforming assets decreased for the six months ended June 30, 2017 by $2,564 or 18.0% to $11,648 at June 30, 2017, from $14,212 at December 31, 2016. We experienced a decrease in nonaccrual and restructured loans which was partially offset by increases to accruing loans past due 90 days or more and foreclosed assets. As a percentage of loans, net and foreclosed assets, nonperforming assets equaled 0.73% at June 30, 2017 and 0.93% at December 31, 2016.

Loans on nonaccrual status decreased $2,831 to $8,277 at June 30, 2017 from $11,108 at December 31, 2016. The majority of the decrease from year end was due to a decrease of $2,901 in nonaccrual commercial real estate loans which was due to the successful work-out and collection activities related to two large credit relationships. Nonaccrual residential real estate loans decreased by $358 due to a combination of principal payments, payoffs and loans transferred to other real estate owned. Increases in nonaccrual commercial and industrial loans of $351 and consumer loans of $77 partially offset the decreases. Other real estate owned decreased $9 to $384 at June 30, 2017 from $393 at December 31, 2016, as five properties were sold during the period with five additional loans transferred to other real estate. At June 30, 2017 and December 31, 2016 there were eight properties comprising other real estate owned.

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

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

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

The allowance for loan losses increased $1,841 to $17,802 at June 30, 2017, from $15,961 at the end of 2016. For the six months ended June 30, 2017, net charge-offs were $559 or 0.07% of average loans outstanding, a $17 decrease compared to $576 or 0.08% of average loans outstanding in the same period of 2016.

Deposits:

We attract the majority of our deposits from within our ten county market area that stretches from Bucks and Montgomery Counties in southeastern Pennsylvania to Broome County in the Southern Tier of New York State through the offering of various deposit instruments including demand deposit accounts, NOW accounts, money market deposit accounts, savings accounts, and time deposits, including certificates of deposit and IRA’s. For the six months ended June 30, 2017, total deposits increased to $1,639,433 from $1,588,757 at December 31, 2016. Interest-bearing deposits increased $47,927 and noninterest-bearing deposits increased $2,749. Interest-bearing transaction accounts, including

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Management's Discussion and Analysis

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NOW and money market accounts, increased $41,386, or 15.0% annualized, to $596,714 at June 30, 2017, from $555,328 at December 31, 2016. Time deposits less than $100 decreased $5,418, or 6.7% annualized, to $158,732 at June 30, 2017, from $164,150 at December 31, 2016. Increases in savings accounts of $7,470 and time deposits $100 or more of $4,489 were recorded in the six months ended June 30, 2017.

For the six months ended June 30, 2017 interest-bearing deposits averaged $1,257,313 in 2017 compared to $1,166,966 in 2016. The cost of interest-bearing deposits was 0.48% in 2017 compared to 0.45% for the same period last year. For the first six months, the overall cost of interest-bearing liabilities including the cost of borrowed funds, was 0.59% in 2017 compared to 0.55% in 2016. The cost of interest-bearing liabilities increased 3 basis point when comparing the first and second quarters of 2017.

Borrowings:

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

Total short-term borrowings at June 30, 2017, totaled $91,500 compared to $82,700 at December 31, 2016, an increase of $8,800. Long-term debt was $57,160 at June 30, 2017, compared to $58,134 at year end 2016. The increase in short-term borrowing was a function of strong loan demand outpacing our deposit growth whereas the decline in long-term debt was a product of monthly contractual amortized payments made during the six months ended June 30, 2017.

Market Risk Sensitivity:

Market risk is the risk to our earnings or financial position resulting from adverse changes in market rates or prices, such as interest rates, foreign exchange rates or equity prices. Our exposure to market risk is primarily "IRR" associated with our lending, investing and deposit-gathering activities. During the normal course of business, we are not exposed to foreign exchange risk or commodity price risk. Our exposure to IRR can be explained as the potential for change in

our reported earnings and/or the market value of our net worth. Variations in interest rates affect earnings by changing net interest income and the level of other interest-sensitive income and operating expenses. Interest rate changes also affect the underlying economic value of our assets, liabilities and off-balance sheet items. These changes arise because the present value of future cash flows, and often the cash flows themselves, change with interest rates. The effects of the changes in these present values reflect the change in our underlying economic value and provide a basis for the expected change in future earnings related to interest rates. IRR is inherent in the role of banks as financial intermediaries. However, a bank with a high degree of IRR may experience lower earnings, impaired liquidity and capital positions, and most likely, a greater risk of insolvency. Therefore, banks must carefully evaluate IRR to promote safety and soundness in their activities.

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

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

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

Our cumulative one-year RSA/RSL ratio equaled 1.64% at June 30, 2017. Given the length of time that market rates have been at historical lows and the potential for rates to increase in the future, the focus of ALCO has been to create a positive static gap position. With regard to RSA, we predominantly offer medium- term, fixed-rate loans as well as adjustable rate loans. With respect to RSL, we offer longer term promotional certificates of deposit in an attempt to increase duration. The current position at June 30, 2017, indicates that the amount of RSA repricing within one year would exceed that of RSL, thereby causing net interest income to increase as market rates increase. However, these forward-looking statements are qualified in the aforementioned section entitled “Forward-Looking Discussion” in this Management's Discussion and Analysis.

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

As the static gap report fails to address the dynamic changes in the balance sheet composition or prevailing interest rates, we utilize a simulation model to enhance our asset/liability management. This model is used to create pro forma net interest income scenarios under various interest rate shocks. Model results at June 30, 2017, produced results similar to those indicated by the one-year static gap position. In addition, parallel and instantaneous shifts in interest rates under various interest rate shocks resulted in changes in net interest income that were well within ALCO policy limits. We will continue to monitor our IRR throughout 2017 and endeavor to employ deposit and loan pricing strategies and direct the reinvestment of loan and investment repayments in order to manage our IRR position.

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

Liquidity:

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

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

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

Historically, core deposits have been the primary source of liquidity because of their stability and lower cost, in general, than other types of funding. Providing additional sources of funds are loan and investment payments and prepayments

and the ability to sell both available for sale securities and mortgage loans held for sale. We believe liquidity is adequate to meet both present and future financial obligations and commitments on a timely basis.

We employ a number of analytical techniques in assessing the adequacy of our liquidity position. One such technique is the use of ratio analysis to determine the extent of our reliance on noncore funds to fund our investments and loans maturing after June 30, 2017. Our noncore funds at June 30, 2017, were comprised of time deposits in denominations of $100 or more and other borrowings. These funds are not considered to be a strong source of liquidity because they are very interest rate sensitive and are considered to be highly volatile. At June 30, 2017, our net noncore funding dependence ratio, the difference between noncore funds and short-term investments to long-term assets, was 14.6%, while our net short-term noncore funding dependence ratio, noncore funds maturing within one-year, less short-term investments to long-term assets equaled 7.4%. Comparatively, our overall noncore dependence ratio at year-end 2016 was 14.4% and our net short-term noncore funding dependence ratio was 6.5%, indicating that our reliance on noncore funds has increased.

The Consolidated Statements of Cash Flows present the changes in cash and cash equivalents from operating, investing and financing activities. Cash and cash equivalents, consisting of cash on hand, cash items in the process of collection, deposit balances with other banks and federal funds sold, increased $1,460 during the six months ended June 30, 2017. Cash and cash equivalents decreased $2,840 for the same period last year. For the six months ended June 30, 2017, net cash inflows of $11,542 from operating activities and $53,917 from financing activities were partially offset by net cash outflows of $63,999 from investing activities. For the same period of 2016, net cash inflows of $12,417 from operating activities and $82,716 from financing activities were more than offset by net cash outflows of $97,973 from investing activities.

Operating activities provided net cash of $11,542 for the six months ended June 30, 2017, and $12,417 for the corresponding six months of 2016. Net income, adjusted for the effects of gains and losses along with noncash transactions such as depreciation and the provision for loan losses, is the primary source of funds from operations.

Investing activities primarily include transactions related to our lending activities and investment portfolio. Investing activities used net cash of $63,999 for the six months ended June 30, 2017, compared to using $97,973 for the same period of 2016. In 2017, an increase in lending activities was the primary factor causing the net cash outflow from investing activities. In 2016, lending also led to the decrease in cash from investing activities and was only partially offset by proceeds received from investment securities.

Financing activities provided net cash of $53,917 for the six months ended June 30, 2017, and $82,716 for the corresponding six months of 2016. Deposit gathering is our predominant financing activity. Deposits increased for the six months ended June 30, 2017 and 2016. The increase in deposits totaled $50,676 in the six months ended June 30, 2017. Comparatively, deposits increased $41,053 for the same period of 2016. We continued to attract deposits from customers in new markets as well as existing customers, including municipalities and school districts. Another source of financing is our short term borrowings which increased $8,800 in the six months ended June 30, 2017 compared to an increase of $47,975 in the first six months of 2016 due to higher loan growth.

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

Capital:

Stockholders’ equity totaled $263,509 or $35.63 per share at June 30, 2017, compared to $256,618 or $34.71 per share at December 31, 2016. Net income of $10,459 for the six months ended June 30, 2017 was the primary factor leading to the improved capital position. Stockholders’ equity was also affected by cash dividends declared of $4,585, stock based compensation of $70, and other comprehensive income resulting from market value fluctuations in the investment portfolio of $947.

Dividends declared equaled $0.62 per share through six months of 2017 and 2016. The dividend payout ratio was 44.0% for the six months ended June 30, 2017 and 47.0% for the same period of 2016. The merger agreement pursuant to

which we merged with Penseco in 2013 contemplates that, unless 80 percent of our board of directors determines otherwise, we will pay a quarterly cash dividend in an amount no less than $0.31 per share through 2018, provided that sufficient funds are legally available, and that we remain "well-capitalized" in accordance with applicable regulatory guidelines. It is the intention of our board of directors to continue to pay cash dividends in the future. However, these decisions are affected by operating results, financial and economic decisions, capital and growth objectives, appropriate dividend restrictions and other relevant factors.

In July 2013, the Board of Governors of the FRB approved the Basel III interim final rule ("Basel III") which is intended to strengthen the quality and increase the required level of regulatory capital for a more stable and resilient banking system. The changes include: (i) a new regulatory capital measure, Common Equity Tier 1 ("CET1"), which is limited to capital elements of the highest quality; (ii) a new definition and increase of tier 1 capital which is now comprised of CET1 and Additional Tier 1; (iii) changes in calculation of some risk-weighted assets and off-balance sheet exposure; and (iv) a capital conservation buffer that will limit capital distributions, stock redemptions, and certain discretionary bonus payments if the institution does not maintain capital in excess of the minimum capital requirements. These new capital rules took effect for our Bank on January 1, 2015 and reporting began with the quarter ended June 30, 2015. Under the final capital rules that became effective on January 1, 2015, there was a requirement for a CET1 capital conservation buffer of 2.5% of risk-weighted assets which is in addition to the other minimum risk-based capital standards in the rule. Institutions that do not maintain this required capital buffer will become subject to progressively more stringent limitations on the percentage of earnings that can be paid out in dividends or used for stock repurchases and on the payment of discretionary bonuses to senior executive management. The capital buffer requirement is being phased in over three years beginning in 2016.

The adequacy of capital is reviewed on an ongoing basis with reference to the size, composition and quality of resources and regulatory guidelines. We seek to maintain a level of capital sufficient to support existing assets and anticipated asset growth, maintain favorable access to capital markets, and preserve high quality credit ratings. At June 30, 2017, the Bank's Tier 1 capital to total average assets was 9.85% as compared to 9.88% at December 31, 2016. The Bank's Tier 1 capital to risk weighted asset ratio was 11.90% and the total capital to risk weighted asset ratio was 12.99% at June 30, 2017. These ratios were 12.14% and 13.16% at December 31, 2016. The Bank's common equity Tier 1 to risk weighted asset ratio was 11.90% at June 30, 2017 compared to 12.14% at December 31, 2016. The Bank was deemed to be well-capitalized under regulatory standards at June 30, 2017. Additionally, as of June 30, 2017, the Bank would meet all capital adequacy requirements under the Basel III Capital Rules on a fully phased-in basis as if all such requirements were currently in effect.

Review of Financial Performance:

Net income for the second quarter of 2017 equaled $5,659 or $0.76 per share compared to $4,855 or $0.66 per share for the second quarter of 2016. Return on average assets ("ROA") measures our net income in relation to total assets. Our ROA was 1.11% for the second quarter of 2017 and 1.03% for the same period in 2016. Return on average equity ("ROE") indicates how effectively we can generate net income on the capital invested by stockholders. Our ROE was 8.71% for the second quarter of 2017 compared to 7.72% for the second quarter of 2016. Net income through six months in 2017 equaled $10,459 or $1.41 per share compared to $9,737 or $1.32 per share for the same period of 2016. Our ROA and ROE were 1.04% and 8.13% through six months in 2017 compared to 1.04% and 7.66% for the same period of 2016. There were no gains on sale of investment securities for the six months ended June 30, 2017 while there were gains of $623 for the same period in 2016. In the second quarter of 2017, we entered into and executed a merchant asset purchase agreement with a third party to sell and transfer our merchant business. This sale resulted in a gain of $2,278. There was no comparable gain in the corresponding period of 2016. In conjunction with the sale, we also executed a marketing and sales agreement to share in the future revenue generated from the sold merchant portfolio, and from new merchant referrals. The sale represents the entirety of our merchant services business and we will no longer originate any proprietary merchant services relationships, nor did we receive an ownership interest in the unrelated purchaser of that business.

Net Interest Income:

Net interest income is the fundamental source of earnings for commercial banks. Fluctuations in the level of net interest income can have the greatest impact on net profits. Net interest income is defined as the difference between interest

revenue, interest and fees earned on interest-earning assets, and interest expense, the cost of interest-bearing liabilities supporting those assets. The primary sources of earning assets are loans and investment securities, while interest-bearing deposits, short-term and long-term borrowings comprise interest-bearing liabilities. Net interest income is impacted by:

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

· Changes in general market rates; and

· The level of nonperforming assets.

Changes in net interest income are measured by the net interest spread and net interest margin. Net interest spread, the difference between the average yield earned on earning assets and the average rate incurred on interest-bearing liabilities, illustrates the effects changing interest rates have on profitability. Net interest margin, net interest income as a percentage of earning assets, is a more comprehensive ratio, as it reflects not only the spread, but also the change in the composition of interest-earning assets and interest-bearing liabilities. Tax-exempt loans and investments carry pre-tax yields lower than their taxable counterparts. Therefore, in order to make the analysis of net interest income more comparable, tax-exempt income and yields are reported herein on a tax-equivalent basis using the prevailing federal statutory tax rate of 35.0% in 2017 and 2016.

For the three months ended June 30, tax-equivalent net interest income increased $783 to $16,967 in 2017 from $16,184 in 2016. The net interest spread decreased to 3.54% for the three months ended June 30, 2017 from 3.68% for the three months ended June 30, 2016. The tax-equivalent net interest margin decreased to 3.68% for the second quarter of 2017 from 3.81% for the comparable period of 2016. The tax-equivalent net interest margin for the first quarter of 2017 was 3.73%.

For the three months ended June 30, tax-equivalent interest income on earning assets increased $1,144, to $19,093 in 2017 as compared to $17,949 in 2016. The overall yield on earning assets, on a fully tax-equivalent basis, decreased 9 basis points for the three months ended June 30, 2017 to 4.14% as compared to 4.23% for the three months ended June 30, 2016. The decrease in the yield on earning assets resulted from decreasing loan yields. The overall yield earned on investments decreased 10 basis points for the second quarter of 2017 to 2.85% from 2.95% for the second quarter of 2016. Average investment balances were relatively unchanged when comparing the current and year ago

quarter.

Total interest expense increased $361, to $2,126 for the three months ended June 30, 2017 from $1,765 for the three months ended June 30, 2016. An unfavorable volume variance caused the increase. An increase in the average volume of interest bearing liabilities of $118,721 coupled with a 5 basis point increase in the cost of funds comparing the three months ended June 30, 2017 and 2016 caused the increase.

For the six months ended June 30, tax-equivalent net interest income increased $1,604 to $33,629 in 2017 from $32,025 in 2016. The net interest spread decreased to 3.57% for the six months ended June 30, 2017 from 3.68% for the six months ended June 30, 2016. The tax-equivalent net interest margin for the six months ended June 30 was 3.71% in 2017 compared to 3.81% in 2016. Loan accretion income in the six months ended June 30, 2017 related to loans acquired in the fourth quarter of 2013 was $94, resulting in an increase in the tax-equivalent net interest margin of 1 basis point. Comparatively, loan accretion income on these loans recognized in the first six months of 2016 was $372, resulting in an increase in the tax-equivalent net interest margin of 4 basis points. Without such interest income, the tax equivalent net interest margin for the six months ended June 30 would have been 3.70% in 2017 and 3.76% in 2016.

For the six months ended June 30, 2017, tax-equivalent interest income increased $2,201, to $37,711 as compared to $35,510 for the six months ended June 30, 2016. A volume variance in interest income of $4,149 attributable to an increase in the average balance of earning assets was partially offset by a $1,948 unfavorable rate variance due primarily to a decrease in the yield on loans. Specifically, the increase was primarily due to a $147,898 increase in average loans for the first six months of 2017 from the same period in 2016. The overall yield on earning assets, on a fully tax-equivalent basis, decreased for the six months ended June 30, 2017 to 4.16% as compared to 4.22% for the six months ended June 30, 2016. This was a result of increased market competition for new loans.

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Management's Discussion and Analysis

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

Total interest expense increased $597 to $4,082 for the six months ended June 30, 2017 from $3,485 for the six months ended June 30, 2016. A volume variance caused interest expenses to increase $252. The average volume of interest bearing liabilities increased to $1,399,812 for the six months ended June 30, 2017, as compared to $1,284,821 for the six months ended June 30, 2016. Adding to the volume variance, a rate variance of $345 resulted in the increased interest expense through six months in 2017. The cost of funds increased to 0.59% for the six months ended June 30, 2017 as compared to 0.55% for the same period in 2016.

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

	Six months ended June 2017 Average Balance	Interest Income/ Interest	Yield/ Rate	June 2016 Average Balance	Interest Income/ Interest	Yield/ Rate
Assets:						
Earning assets:						
Loans:						
Taxable	$ 1,446,959	$ 31,486	4.39 %	$ 1,301,887	$ 29,106	4.50 %
Tax-exempt	109,889	2,340	4.29	107,063	2,355	4.42
Investments:						
Taxable	159,717	1,505	1.90	151,861	1,338	1.77
Tax-exempt	113,193	2,378	4.24	127,119	2,692	4.26
Interest-bearing deposits	328	2	1.23	2,517	19	1.52
Federal funds sold						
Total earning assets	1,830,086	37,711	4.16 %	1,690,447	35,510	4.22 %
Less: allowance for loan losses	16,867			13,983		
Other assets	212,082			200,367		
Total assets	$ 2,025,301	37,711		$ 1,876,831	35,510	
Liabilities and Stockholders' Equity:						
Interest-bearing liabilities:						

Money market accounts	$ 248,067	606	0.49	%	$ 210,935	380	0.36	%
NOW accounts	326,132	682	0.42		292,795	544	0.37	
Savings accounts	401,066	253	0.13		390,453	348	0.18	
Time deposits less than $100	159,358	845	1.07		164,678	874	1.07	
Time deposits $100 or more	122,690	577	0.95		108,105	459	0.85	
Short-term borrowings	84,886	422	1.00		58,073	166	0.57	
Long-term debt	57,613	697	2.44		59,782	714	2.40	
Total interest-bearing liabilities	1,399,812	4,082	0.59		1,284,821	3,485	0.55	
Noninterest-bearing deposits	351,451				320,923			
Other liabilities	14,587				15,455			
Stockholders' equity	259,451				255,632			
Total liabilities and stockholders' equity	$ 2,025,301	4,082			$ 1,876,831	3,485		
Net interest income/spread		$ 33,629	3.57	%		$ 32,025	3.68	%
Net interest margin			3.71	%			3.81	%
Tax-equivalent adjustments:								
Loans		$ 819				$ 824		
Investments		832				942		
Total adjustments		$ 1,651				$ 1,766		

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Provision for Loan Losses:

We evaluate the adequacy of the allowance for loan losses account on a quarterly basis utilizing our systematic analysis in accordance with procedural discipline. We take into consideration certain factors such as composition of the loan portfolio, volumes of nonperforming loans, volumes of net charge-offs, prevailing economic conditions and other relevant factors when determining the adequacy of the allowance for loan losses account. We make monthly provisions to the allowance for loan losses account in order to maintain the allowance at the appropriate level indicated by our evaluations. Based on our most current evaluation, we believe that the allowance is adequate to absorb any known and inherent losses in the portfolio as of June 30, 2017.

For the three and six months ended June 30, 2017 and 2016, the provision for loan losses totaled $1,200 and $2,400. Improving asset quality meant that no increase in the provision for the quarter and year-to-date periods ended June 30, 2017 was necessary.

Noninterest Income:

Noninterest income for the second quarter increased $2,266 or 55.1% to $6,379 in 2017 from $4,113 in 2016. For the six months ended June 30, 2017, noninterest income totaled $10,161, an increase of $2,157 or 27.0% from $8,004 for the comparable period of 2016. Service charges, fees and commissions increased $283, or 9.5% to $3,254 through six months in 2017 from $2,971 for the same period in 2016. Merchant services income increased $241 to $2,193 for the six months ended June 30, 2017 from $1,952 for the same period last year as a product of the increased volume of merchant activity. Income generated from commissions and fees on fiduciary activities increased $46 to $1,002 for the six months ended June 30, 2017 in comparison to $956 for the same period in 2016 due to additional executor fees generated in 2017. Income generated from our wealth management division decreased $41, or 5.8% to $667 through the first six months of 2017 in comparison to $708 over that same period in 2016 due to a reduction in the amount of brokerage fee income generated in 2017. Mortgage banking income decreased $16 to $383 through six months in 2017 compared to $399 for the comparable period in 2016 as the volume of loans originated for sale declined. Life insurance investment income decreased $11 to $384 for the six months ended June 30, 2017 from $395 for the same period in 2016. There were no gains from the sale of investment securities available-for-sale for the six months ended June 30, 2017 compared to $623 for the same period in 2016. As previously mentioned, the six months ended June 30, 2017 included a gain from the sale of our merchant business in the amount of $2,278. The year ago six month period ending June 30, 2016 did not have a comparable transaction.

For the three months ended June 30, increases in service charges, fees and commissions, income from merchant services, commissions and fees on fiduciary activities, wealth management, and mortgage banking income were partially offset by declines in life insurance income. There were no net gains on sale of investment securities available-for-sale for the quarter ended June 30, 2017. Net gains on sale of investment securities available-for-sale were $381 during the corresponding quarter of 2016. Additionally, the entire gain of $2,278 related to the merchant business sale was recognized within the second quarter of 2017.

Noninterest Expenses:

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

For the second quarter, noninterest expense increased $1,889 or 15.6% to $14,002 in 2017 from $12,113 in 2016. For the six months ended June 30, noninterest expense increased $2,627 or 11.1% to $26,358 in 2017 from $23,731 in 2016.

Personnel costs increased 18.4%, net occupancy and equipment costs increased 3.5%, merchant services expense increased 27.8% and other expenses increased by 1.6% comparing year-to-date 2017 and 2016.

Salaries and employee benefits expense, which comprise the majority of noninterest expense, totaled $7,026 for the second quarter of 2017, an increase of $1,122 or 19.0% when compared to the second quarter of 2016. Salaries and employee benefits expense totaled $13,301 for the six months ending June 30, 2017, an increase of $2,065 or 18.4% when compared to the same period of 2016. Costs related to our build out of our expansion plan contributed to the increase. Additional resources have been put in place to support our expansion and to continue our momentum in the Lehigh Valley and King of Prussia markets.

We experienced a $205 or 9.1% increase in net occupancy and equipment expense comparing the second quarter of 2017 at $2,450 and 2016 at $2,245. We experienced a $162 or 3.5% increase in net occupancy and equipment expense comparing $4,844 for the six months ended June 30, 2017 and $4,682 for the same period in 2016. Expenditures for occupancy and equipment related projects picked up during the first half of 2017 when compared to the same period in 2016. In general, as we expand and increase our presence in new markets, the costs associated with the maintenance and upkeep of new infrastructure within those markets increases.

Merchant services expense increased $285 or 38.1% to $1,033 for the three months ended June 30, 2017 from $748 for the same period in 2016. Merchant services expense increased $383 or 27.8% to $1,763 for the six months ended June 30, 2017 from $1,380 for the same period in 2016. The increase is due to higher volumes and correlates directly to the increase in merchant services income for the six months ended June 30, 2017. Additionally, the increased expense in the second quarter of 2017 includes costs related to the sale of the merchant business.

For the second quarter, other expenses increased $316 or 10.8% to $3,235 from $2,919 comparing 2017 to 2016. For the three months ended June 30, 2017, consulting and advisory expenses were higher by $153 due primarily to expenses related to the sale of the merchant business. Accounting and auditing expenses were higher during the current quarter by $124. For the six months ended June 30, other expenses increased $93 or 1.6% to $5,924 in 2017 compared to $5,831 in 2016. One time auditing fees amounted to $61 in the first half of 2017 as we transitioned to a new external accounting firm. Additionally, a $20 increase in shares tax expenditures to the state of Pennsylvania has been incurred through the six months ended June 30, 2017 when compared to the same period in 2016 due to our growth.

Income Taxes:

We recorded income tax expense of $1,653 or 22.6% of pre-tax income, and $1,238 or 20.3% of pre-tax income for the three months ended June 30, 2017 and 2016. We recorded income tax expense of $2,922 or 21.8% of pre-tax income for the six months ended June 30, 2017 and $2,395 or 19.7% of pre-tax income for the comparable period in 2016. The six months ended June 30, 2017 includes investment tax credits of $464 compared to $578 for that same period last year. Additionally, a higher proportion of tax-exempt interest income to before tax income was recognized during the year ago period.

Peoples Financial Services Corp.

Item 3. Quantitative and Qualitative Disclosures about Market Risk.

Market risk is the risk to our earnings and/or financial position resulting from adverse changes in market rates or prices, such as interest rates, foreign exchange rates or equity prices. Our exposure to market risk is primarily interest rate risk ("IRR"), which arises from our lending, investing and deposit gathering activities. Our market risk sensitive instruments consist of non-derivative financial instruments, none of which are entered into for trading purposes. During the normal course of business, we are not exposed to foreign exchange risk or commodity price risk. Our exposure to IRR can be explained as the potential for change in reported earnings and/or the market value of net worth. Variations in interest rates affect the underlying economic value of assets, liabilities and off-balance sheet items. These changes arise because the present value of future cash flows, and often the cash flows themselves, change with interest rates. The effects of the changes in these present values reflect the change in our underlying economic value, and provide a basis for the expected change in future earnings related to interest rates. Interest rate changes affect earnings by changing net interest income and the level of other interest-sensitive income and operating expenses. IRR is inherent in the role of banks as financial intermediaries.

A bank with a high degree of IRR may experience lower earnings, impaired liquidity and capital positions, and most likely, a greater risk of insolvency. Therefore, banks must carefully evaluate IRR to promote safety and soundness in their activities.

The projected impacts of instantaneous changes in interest rates on our net interest income and economic value of equity at June 30, 2017, based on our simulation model, as compared to our ALCO policy limits are summarized as follows:

	June 30, 2017			
	% Change in			
Changes in Interest Rates (basis points)	Net Interest Income		Economic Value of Equity	
	Metric	Policy	Metric	Policy
+400	3.5	(20.0)	7.2	(40.0)
+300	3.0	(20.0)	6.2	(30.0)
+200	2.2	(10.0)	4.6	(20.0)
+100	1.3	(10.0)	3.5	(10.0)
Static				
(100)	(5.5)	(10.0)	(10.7)	(10.0)

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 June 30, 2017, would increase 1.3 percent from model results using current interest rates. Additional disclosures about market risk are included in Part I, Item 2 of this quarterly report and Part II, Item 7 of our Annual Report on Form 10-K for the year ended December 31, 2016, under the heading "Market Risk Sensitivity," and are incorporated into this Item 3 by reference. There were no material changes in our market risk from December 31, 2016.

Item 4. Controls and Procedures.

(a) Evaluation of disclosure controls and procedures.

At June 30, 2017, the end of the period covered by this Quarterly Report on Form 10-Q, our principal executive officer ("PEO") and principal financial officer ("PFO") evaluated the effectiveness of the Company's disclosure controls and procedures as defined in Rule 13a-15(e) under the Exchange Act. Based upon that evaluation, the PEO and PFO concluded that the disclosure controls and procedures, at June 30, 2017, were effective to provide reasonable assurance that information required to be disclosed in the Company's reports filed under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and to provide reasonable assurance that information required to be disclosed in such reports is accumulated and communicated to the PEO and PFO to allow timely decisions regarding required disclosure.

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Peoples Financial Services Corp.

(b) Changes in internal control.

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

PART II—OTHER INFORMATION

Item 1. Legal Proceedings.

The nature of the Company's business generates a certain amount of litigation involving matters arising out of the ordinary course of business. In the opinion of management, there were no legal proceedings that had or might have a material effect on the consolidated results of operations, liquidity, or the financial position of the Company during the period ended June 30, 2017 and through the date of this quarterly report on Form 10-Q and no such legal proceedings known to be contemplated by governmental authorities.

Item 1A. Risk Factors.

There have been no material changes from the risk factors previously disclosed in the Company's Annual Report on Form 10-K for the year ended December 31, 2016.

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

None.

Item 3. Defaults upon Senior Securities.

None.

Item 4. Mine Safety Disclosures.

Not applicable.

Item 5. Other Information.

None.

Item 6. Exhibits.

10.1	Supplemental Executive Retirement Plan Agreement, dated April 24, 2017, by and among Peoples Security Bank and Trust Company, Peoples Financial Services Corp. and Neal D. Koplin (incorporated by reference to Exhibit 10.1 to registrant's current report on Form 8-K, filed with the Commission on April 25, 2017.)
10.2	Peoples Financial Services Corp. 2017 Equity Incentive Plan (incorporated by reference to Exhibit 10.1 to registrant's current report on Form 8-K, filed with the Commission on May 23, 2017.)
31.1	Principal Executive Officer certification pursuant to Rule 13a-14(a)/15d-14(a).
31.2	Principal Financial Officer certification pursuant to Rule 13a-14(a)/15d-14(a).
32	Principal Executive Officer and Principal Financial Officer certifications pursuant to Section 1350.
101+	Interactive Data File

+ As provided in Rule 406T of Regulation S-T, this information is filed for purposes of Sections 11 and 12 of the Securities Act of 1933 and Section 18 of the Securities Exchange Act of 1934.

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Peoples Financial Services Corp.

SIGNATURES

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

	Peoples Financial Services Corp. (Registrant)
Date: August 4, 2017	/s/ Craig W. Best Craig W. Best President and Chief Executive Officer (Principal Executive Officer)
Date: August 4, 2017	/s/ John R. Anderson, III John R. Anderson, III Interim Principal Financial and Accounting Officer (Interim Principal Financial Officer and Principal Accounting Officer)

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Peoples Financial Services Corp.

EXHIBIT INDEX

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101	The following materials from Peoples Financial Services Corp. Quarterly Report on Form 10 Q for the period ended June 30, 2017, formatted in XBRL: (i) the Consolidated Balance Sheets, (ii) the Consolidated Statements of Income and Comprehensive Income, (iii) the Consolidated Statements of Changes in Stockholders’ Equity, (iv) the Consolidated Statements of Cash Flows and (v) the Notes to the unaudited Consolidated Financial Statements.	