

PEOPLES FINANCIAL SERVICES CORP/
Form 10-K
March 16, 2009

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549
FORM 10-K

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

For the fiscal year ended December 31, 2008,

or

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

For the transition period from _____ to _____

Commission file number 0-23863

PEOPLES FINANCIAL SERVICES CORP.

(Exact name of registrant as specified in its charter)

PENNSYLVANIA

(State of incorporation)

23-2391852

(IRS Employer Identification No.)

82 FRANKLIN AVENUE, HALLSTEAD, PA

(Address of principal executive offices)

18822

(Zip code)

(570) 879-2175

(Registrant's telephone number including area code)

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

Title of each class

Name of each exchange on which registered

None

None

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

COMMON STOCK (\$2 Par Value)

(Title of Class)

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes ___ No X

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act.

Yes ___ No X

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

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

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

Smaller reporting company

___ -

X

Non-accelerated filer ___

(Do not check if smaller reporting company)

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

The aggregate market value of voting stock held by non-affiliates of the registrant is \$ 63,803,363 as of June 30, 2008

The aggregate dollar amount of the voting stock set forth equals the number of shares of the registrant's Common Stock outstanding, reduced by the amount of Common stock held by executive officers, directors, and shareholders owning in excess of 10% of the registrant's Common Stock, multiplied by the last sale price for the registrant's Common Stock at June 30, 2008. The information provided shall in no way be construed as an admission that the officer, director, or 10% shareholder in the registrant may be deemed an affiliate of the registrant or that such person is the beneficial owner of the shares reported as being held by him and any such inference is hereby disclaimed. The information provided herein is included solely for the record keeping purpose of the Securities and Exchange Commission.

COMMON STOCK

Number of shares outstanding as of December 31, 2008	(\$2 Par Value) (Title of Class)	3,131,181 (Outstanding Shares)
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DOCUMENTS INCORPORATED BY REFERENCE

Portions of the 2009 Proxy Statement for the Registrant are incorporated by reference into Part III of this report.

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PART I

ITEM 1 BUSINESS

BRIEF HISTORY

Peoples Financial Services Corp. (“PFSC” or the “Company”) was incorporated under the laws of the Commonwealth of Pennsylvania on February 6, 1986, and is a one-bank holding company head quartered in Hallstead, Pennsylvania.

The Company is engaged primarily in commercial and retail banking services and in businesses related to banking services through its subsidiaries, Peoples National Bank (“PNB” or the “Bank”), Peoples Advisors, LLC (“Advisors”) and Peoples Financial Capital Corporation. The Bank has two wholly owned subsidiaries, Peoples Financial Leasing, LLC and Peoples Investment Holdings, LLC. PNB was chartered in Hallstead, Pennsylvania in 1905 under the name of The First National Bank of Hallstead. In 1965, the Hop Bottom National Bank (chartered in 1910) merged with The First National Bank of Hallstead to form Peoples National Bank of Susquehanna County. In 2001, the Bank changed its name to Peoples National Bank. Advisors was formed in 2006 as a member-managed limited liability company for the purpose of providing investment advisory services to the general public. Peoples Financial Leasing, LLC, formed in 2007, is a subsidiary of the Bank and provides employee leasing services to the Bank. Peoples Investment Holdings, LLC, formed in 2007, is also a subsidiary of the Bank and its main activities are the maintenance and management of its intangible investments and the collection and distribution of the income from such investments or from tangible investments located outside of Delaware. Finally, Peoples Financial Capital Corporation which was also formed in 2007 is a subsidiary of the Company and its main activities are the maintenance and management of its intangible investments and the collection and distribution of the income from such investments or from tangible investments located outside of Delaware.

OPERATING SEGMENTS

The Company has one reportable operating segment, Community Banking, which consists of commercial and retail banking, and other non-reportable operating segments, as described in Note 1 of the Notes to Consolidated Financial Statements included on page 59 of this Report. The Segment Reporting information in Note 1 is incorporated by reference into this Item 1.

SUPERVISION AND REGULATION

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

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

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

The Company's banking subsidiary is a federally chartered national banking association regulated by the Office of the Comptroller of the Currency ("OCC"). The OCC may prohibit an institution over which it has supervisory authority from engaging in activities or investments that the agency believes constitute unsafe or unsound banking practices. Federal banking regulators have extensive enforcement authority over the institutions they regulate to prohibit or correct activities that violate law, regulation or a regulatory agreement or which are deemed to constitute unsafe or unsound practices.

Enforcement actions may include:

- the appointment of a conservator or receiver;
- the issuance of a cease and desist order;
- the termination of deposit insurance, the imposition of civil money penalties on the institution, its directors, officers, employees and institution affiliated parties;
- the issuance of directives to increase capital;
- the issuance of formal and informal agreements;
- the removal of or restrictions on directors, officers, employees and institution-affiliated parties; and
- the enforcement of any such mechanisms through restraining orders or any other court actions.

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

Limitations on Dividends and Other Payments

The Company's current ability to pay dividends is largely dependent upon the receipt of dividends from its banking subsidiary, PNB. Both federal and state laws impose restrictions on the ability of the Company to pay dividends. The FRB has issued a policy statement that provides that, as a general matter, insured banks and bank holding companies may pay dividends only out of prior operating earnings. Under the National Bank Act, a national bank, such as PNB, may pay dividends only out of the current year's net profits and the net profits of the last two years. In addition to these specific restrictions, bank regulatory agencies, in general, also have the ability to prohibit proposed dividends by a financial institution that would otherwise be permitted under applicable regulations if the regulatory body determines that such distribution would constitute an unsafe or unsound practice.

Permitted Non-Banking Activities

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

Subsidiary banks of a bank holding company are subject to certain quantitative and qualitative restrictions:

- on extensions of credit to the bank holding company or its subsidiaries;
- on investments in their securities; and
- on the use of their securities as collateral for loans to any borrower.

These regulations and restrictions may limit the Company's ability to obtain funds from PNB for its cash needs, including funds for the payment of dividends, interest and operating expenses. Further, subject to certain exceptions, a bank holding company and its subsidiaries are prohibited from engaging in certain tie-in arrangements in connection with any extension of credit, lease or sale of property or furnishing of services. For example, PNB may not generally require a customer to obtain other services from itself or the Company, and may not require that a customer promise not to obtain other services from a competitor as a condition to an extension of credit to the customer.

Under FRB policy, a bank holding company is expected to act as a source of financial strength to its subsidiary banks and to make capital injections into a troubled subsidiary bank, and the FRB may charge the bank holding company

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

Pennsylvania Law

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

Interstate Banking Legislation

The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 were enacted into law on September 29, 1994. The law provides that, among other things, substantially all state law barriers to the acquisition of banks by out-of-state bank holding companies were eliminated effective September 29, 1995. The law also permits interstate branching by banks effective as of June 1, 1997, subject to the ability of states to opt-out completely or to set an earlier effective date.

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

FIRREA was enacted into law in order to address the financial condition of the Federal Savings and Loan Insurance Corporation, to restructure the regulation of the thrift industry, and to enhance the supervisory and enforcement powers of the federal bank and thrift regulatory agencies. As the primary federal regulator of the Bank, the OCC is responsible for the supervision of the Bank. When dealing with capital requirements, the OCC and FDIC have the flexibility to impose supervisory agreements on institutions that fail to comply with regulatory requirements. The imposition of a capital plan, termination of deposit insurance, and removal or temporary suspension of an officer, director or other institution-affiliated person may cause enforcement actions.

There are three levels of civil penalties under FIRREA.

- The first tier provides for civil penalties of up to \$5,000 per day for any violation of law or regulation.
- The second tier provides for civil penalties of up to \$25,000 per day if more than a minimal loss or a pattern is involved.
- Finally, civil penalties of up to \$1 million per day may be assessed for knowingly or recklessly causing a substantial loss to an institution or taking action that results in a substantial pecuniary gain or other benefit.

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

FDICIA (Federal Deposit Insurance Corporation Improvement Act of 1991)

In December 1991, Congress enacted FDICIA which substantially revised the bank regulatory and funding provisions of the Federal Deposit Insurance Act and made significant revisions to several other federal banking statutes. FDICIA provides for, among other things:

- publicly available annual financial condition and management reports for financial institutions, including audits by independent accountants;
- the establishment of uniform accounting standards by federal banking agencies;
- the establishment of a “prompt corrective action” system of regulatory supervision and intervention, based on capitalization levels, with more scrutiny and restrictions placed on depository institutions with lower levels of capital;
- additional grounds for the appointment of a conservator or receiver; and
- restrictions or prohibitions on accepting brokered deposits, except for institutions which significantly exceed minimum capital requirements.

FDICIA also provides for increased funding of the FDIC insurance funds and the implementation of risk-based premiums.

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

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

PNB is currently classified as “well capitalized.” An institution may be deemed by the regulators to be in a capitalization category that is lower than is indicated by its actual capital position if, among other things, it receives an unsatisfactory examination rating with respect to asset quality, management, earnings or liquidity.

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

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

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

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

Any institution that fails to meet these standards may be required by the agency to develop a plan acceptable to the agency, specifying the steps that the institutions will take to meet the standards. Failure to submit or implement such a plan may subject the institution to regulatory sanctions. The Company, on behalf of PNB, believes that it meets substantially all the standards that have been adopted. FDICIA also imposed new capital standards on insured depository institutions. Before establishing new branch offices, PNB must meet certain minimum capital stock and surplus requirements and must obtain OCC approval.

Risk-Based Capital Requirements

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

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

·"Tier 1", or core capital, includes common equity, perpetual preferred stock (excluding auction rate issues) and minority interest in equity accounts of consolidated subsidiaries, less goodwill and other intangibles, subject to certain exceptions.

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

Banks and bank holding companies subject to the risk-based capital guidelines are required to maintain a ratio of Tier 1 capital to risk-weighted assets of at least 4% and a ratio of total capital to risk-weighted assets of at least 8%. The appropriate regulatory authority may set higher capital requirements when particular circumstances warrant. As of December 31, 2008, PFSC's ratio of Tier 1 capital to risk-weighted assets stood at 12.26% and its ratio of total capital to risk-weighted assets stood at 13.10%. In addition to risk-based capital, banks and bank holding companies are required to maintain a minimum amount of Tier 1 capital to total assets, referred to as the leverage capital ratio, of at least 4.00%. As of December 31, 2008, the Company's leverage-capital ratio was 9.31%.

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

- limitations on its ability to pay dividends;
- the issuance by the applicable regulatory authority of a capital directive to increase capital, and in the case of depository institutions, the termination of deposit insurance by the FDIC, as well as to the measures described under FDICIA as applicable to under capitalized institutions.

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

Interest Rate Risk

In August 1995 and May 1996, the federal banking agencies adopted final regulations specifying that the agencies will include, in their evaluations of a bank's capital adequacy, an assessment of the bank's interest rate risk ("IRR") exposure. The standards for measuring the adequacy and effectiveness of a banking organization's IRR management includes a measurement of Board of Directors and senior management oversight, and a determination of whether a banking organization's procedures for comprehensive risk management are appropriate to the circumstances of the specific banking organization. PNB has internal IRR models that are used to measure and monitor IRR. In addition, an outside source also assesses IRR using its model on a quarterly basis. Additionally, the regulatory agencies have been assessing IRR on an informal basis for several years. For these reasons, the Company does not expect the IRR evaluation in the agencies' capital guidelines to result in significant changes in capital requirements for PNB.

FDIC Insurance Assessments

As a FDIC member institution, PNB's deposits are insured to a maximum of \$250,000 per depositor through the Bank Insurance Fund ("BIF") that is administered by the FDIC and each institution is required to pay semi-annual deposit insurance premium assessments to the FDIC. Prior to 1997, only thrift institutions were subject to assessments to raise funds to pay the financing corporate bonds. On September 30, 1996, as part of the Omnibus Budget Act, Congress enacted the Deposit Insurance Funds Act of 1996, which recapitalized the Savings Association Insurance Fund ("SAIF") and provided that BIF deposits would be subject to 1/5 of the assessment to which SAIF deposits are subject for FICO bond payments through 1999. Beginning in 2000, BIF deposits and SAIF deposits were subject to the same assessment for FICO bonds. The FICO assessment for PNB for 2008 was \$.0112 for each \$100 of BIF deposits.

The FDIC adopted a risk-based deposit insurance assessment system that requires all FDIC-insured institutions to pay quarterly premiums beginning in 2007. Annual premiums range from 5 and 7 basis points of deposits for well-capitalized banks with the highest examination ratings to 43 basis points for undercapitalized institutions. Through the second quarter of 2008, the Bank had been able to offset the premium with an assessment credit of \$218,000 for premiums paid prior to 1996. The FDIC assessment for PNB for 2008 was \$.05799 for each \$100 of BIF deposits. FDIC insurance and assessments increased in 2008 by \$76,000 due to the additional risk-based premiums assessed to the Company.

The Company anticipates a significant increase in the cost of federal deposit insurance from current levels of five to seven basis points. The FDIC has recently proposed to increase the assessment rate for the most highly rated institutions to between 12 and 14 basis points for the first quarter of 2009 and to between 10 and 14 basis points thereafter. Assessment rates could be further increased if an institution's FHLB advances exceed 15% of deposits. The FDIC has also established a program under which it fully guarantees all non-interest bearing transaction accounts and senior unsecured debt of a bank or its holding company. The Bank elected to opt out of the debt guarantee program but opted into the deposit guarantee program and will be assessed ten basis points for non-interest bearing transaction account balances in excess of \$250,000. This additional premium is not expected to be significant. The FDIC has further proposed to collect a special assessment of 20 basis points based on insured deposits as of June 30, 2009. This special assessment will be payable on September 30, 2009.

Community Reinvestment Act

The Community Reinvestment Act of 1977, (“CRA”) is designed to create a system for bank regulatory agencies to evaluate a depository institution’s record in meeting the credit needs of its community. Until May 1995, a depository institution was evaluated for CRA compliance based on twelve assessment factors.

The CRA regulations were completely revised as of July 1, 1995, (the revised CRA regulation) to establish new performance-based standards for use in examining for compliance.

The Bank had its last CRA compliance examination in 2008 and received a “satisfactory” rating.

Concentration

Payment risk is a function of the economic climate in which the Bank’s lending activities are conducted. Economic downturns in the economy generally or in a particular sector could cause cash flow problems for customers and make loan payments more difficult. The Bank attempts to minimize this risk by avoiding loan concentrations to a single customer or to a small group of customers whose loss would have a materially adverse effect on the financial condition of the Bank.

Monetary Policy

The earnings of a bank holding company are affected by the policies of regulatory authorities, including the FRB, in connection with the FRB’s regulation of the money supply. Various methods employed by the FRB are:

- open market operations in United States Government securities;
- changes in the discount rate on member bank borrowings; and
- changes in reserve requirements against member bank deposits.

These methods are used in varying combinations to influence overall growth and distribution of bank loans, investments, and deposits, and their use may also affect interest rates charged on loans or paid on deposits. The monetary policies of the FRB have had a significant effect on the operating results of commercial banks in the past and are expected to do so in the future.

RECENT LEGISLATION

USA Patriot Act of 2001

In October 2001, the USA Patriot Act of 2001 was enacted in response to the terrorist attacks in New York, Pennsylvania and Washington D.C., which occurred on September 11, 2001. The Patriot Act is intended to strengthen U.S. law enforcement’s and the intelligence communities’ abilities to work cohesively to combat terrorism on a variety of fronts. The potential impact of the Patriot Act on financial institutions of all kinds is significant and wide ranging. The Patriot Act contains sweeping anti-money laundering and financial transparency laws and imposes various regulations, including standards for verifying client identification at account opening, and rules to promote cooperation among financial institutions, regulators and law enforcement entities in identifying parties that may be involved in terrorism or money laundering.

Financial Services Modernization Legislation

In November 1999, the Gramm-Leach-Bliley Act of 1999, or the GLB, was enacted. The GLB repeals provisions of the Glass-Steagall Act which restricted the affiliation of Federal Reserve member banks with firms “engaged principally” in specified securities activities, and which restricted officer, director or employee interlocks between a member bank and any company or person “primarily engaged” in specified securities activities.

The GLB also permits national banks to engage in expanded activities through the formation of financial subsidiaries. A national bank may have a subsidiary engaged in any activity authorized for national banks directly or any financial activity, except for insurance underwriting, insurance investments, real estate investment or development, or merchant

banking, which may only be conducted through a subsidiary of a financial holding company. Financial activities include all activities permitted under new sections of the Bank Holding Company Act or permitted by regulation.

To the extent that the GLB permits banks, securities firms and insurance companies to affiliate, the financial services industry may experience further consolidation. The GLB is intended to grant to community banks certain powers as a matter of right that larger institutions have accumulated on an ad hoc basis and which unitary savings and loan holding companies already possess. Nevertheless, the GLB may have the result of increasing the amount of competition that the Registrant faces from larger institutions and other types of companies offering financial products, many of which may have substantially more financial resources than the Registrant has.

Sarbanes-Oxley Act of 2002

On July 30, 2002, President Bush signed into law the Sarbanes-Oxley Act of 2002, or the SOA. The stated goals of the SOA are to increase corporate responsibility, to provide for enhanced penalties for accounting and auditing improprieties at publicly traded companies and to protect investors by improving the accuracy and reliability of corporate disclosures pursuant to the securities laws.

The SOA is the most far-reaching U.S. securities legislation enacted in some time. The SOA generally applies to all companies, both U.S. and non-U.S., that file or are required to file periodic reports with the Securities and Exchange Commission (the "SEC") under the Securities Exchange Act of 1934, or the Exchange Act. The legislation includes provisions, among other things, governing the services that can be provided by a public company's independent auditors and the procedures for approving such services, requiring the chief executive officer and principal accounting officer to certify certain matters relating to the company's periodic filings under the Exchange Act, requiring expedited filings of reports by insiders of their securities transactions and containing other provisions relating to insider conflicts of interest, increasing disclosure requirements relating to critical financial accounting policies and their application, increasing penalties for securities law violations, and creating a new public accounting oversight board, a regulatory body subject to SEC jurisdiction with broad powers to set auditing, quality control and ethics standards for accounting firms.

The Company does not believe that the application of these rules to the Company have a material effect on its results of operations.

Regulation W

Transactions between a bank and its "affiliates" are quantitatively and qualitatively restricted under the Federal Reserve Act. The Federal Deposit Insurance Act applies Sections 23A and 23B to insured nonmember banks in the same manner and to the same extent as if they were members of the Federal Reserve System. The Federal Reserve Board has also recently issued Regulation W, which co-defies prior regulations under Sections 23A and 23B of the Federal Reserve Act and interpretative guidance with respect to affiliate transactions. Regulation W incorporates the exemption from the affiliate transaction rules but expands the exemption to cover the purchase of any type of loan or extension of credit from an affiliate. Affiliates of a bank include, among other entities, the bank's holding company and companies that are under common control with the bank. The Company is considered to be an affiliate of the Bank. In general, subject to certain specified exemptions, a bank or its subsidiaries are limited in their ability to engage in "covered transactions" with affiliates:

- to an amount equal to 10% of the bank's capital and surplus, in the case of covered transactions with any one affiliate; and
- to an amount equal to 20% of the bank's capital and surplus, in the case of covered transactions with all affiliates.

In addition, a bank and its subsidiaries may engage in covered transactions and other specified transactions only on terms and under circumstances that are substantially the same, or at least as favorable to the bank or its subsidiary, as those prevailing at the time for comparable transactions with nonaffiliated companies. A "covered transaction" includes:

- a loan or extension of credit to an affiliate;
- a purchase of, or an investment in, securities issued by an affiliate;
- a purchase of assets from an affiliate, with some exceptions;
- the acceptance of securities issued by an affiliate as collateral for a loan or extension of credit to any party; and
- the issuance of a guarantee, acceptance or letter of credit on behalf of an affiliate.

Regulation W generally excludes all non-bank and non-savings association subsidiaries of banks from treatment as affiliates, except to the extent that the Federal Reserve Board decides to treat these subsidiaries as affiliates.

Concurrently with the adoption of Regulation W, the Federal Reserve Board has proposed a regulation which would further limit the amount of loans that could be purchased by a bank from an affiliate to not more than 100% of the bank's capital and surplus.

Legislation and Regulatory Changes

From time to time, legislation is enacted that affects the cost of doing business or limits the activities of a financial institution. We cannot predict the likelihood of any major changes or the impact those changes may have on the Company.

MARKET AREAS

The PNB market areas are in the northeastern part of Pennsylvania with the primary focus being Susquehanna and Wyoming Counties. With the addition of an office in Conklin, Broome County, New York in 2003, and offices in the Village of Deposit and Town of Chenango, both in Broome County, New York, in 2005, Broome County is part of the Bank's market area, particularly the Southern Tier that encompasses the towns of Conklin, Kirkwood, Windsor, and Deposit. The Bank's market area was expanded further in 2008 with the addition of the Glenburn Township office. This gave PNB its first physical presence in Lackawanna County, serving the northern end of the county including the Clarks Summit area. In addition, parts of Wayne and Bradford Counties in Pennsylvania that border Susquehanna and Wyoming Counties are also considered part of the PNB market area.

The PNB market area is situated between:

- the city of Binghamton, Broome County, New York, located to the north;
- the city of Scranton, Lackawanna County, Pennsylvania, to the south; and
- Wilkes-Barre, Luzerne County, Pennsylvania, to the southwest.

Susquehanna County could best be described as a bedroom county with a high percentage of its residents commuting to work in Broome County, New York, or to the Scranton, Pennsylvania, area. The southern part of Susquehanna County tends to gravitate south for both employment and shopping, while the northern part of the county goes north to Broome County, New York. The western part of Susquehanna County gravitates south and west to and through Wyoming County. Wyoming County is home to a Proctor & Gamble manufacturing facility. This is an economic stimulus to Wyoming County and the surrounding areas.

The majority of our offices are located in counties that would be considered sparsely populated, as they are made up of many small towns and villages. The latest population figures show Susquehanna County at approximately 42,000 and Wyoming County at approximately 28,000 residents. Neither county is experiencing growth. Broome County has approximately 196,000 residents and continues to experience a population decline. The economy of Broome County has lost many manufacturing jobs in the past twenty to twenty-five years. This trend continues. Fortunately, the new employment centers are in the Town of Conklin and the neighboring Town of Kirkwood. Both towns border Susquehanna County, Pennsylvania. Lackawanna County has approximately 210,000 residents. Interstate 81 runs north and south through the eastern half of Susquehanna County and has brought an influx of people from New Jersey and the Philadelphia area. These people have purchased homes and land to build homes that are used as vacation/recreation retreats and, quite often, become retirement homes.

BUSINESS

Lending Activities

PNB provides a full range of retail and commercial banking services designed to meet the borrowing and depository needs of small and medium sized businesses and consumers in its market areas. A significant amount of PNB's loans are to customers located within its service areas. PNB has no foreign loans or highly leveraged transaction loans, as defined by the FRB. A majority of the loans in PNB's portfolio have been originated by PNB. Policies adopted by the Board of Directors are the basis by which PNB conducts its lending activities. These loan policies grant individual lending officers authority to make secured and unsecured loans in specific dollar amounts. Larger loans must be approved by senior officers or by the Board of Directors. PNB's management information systems and loan review policies are designed to monitor lending to ensure adherence to PNB's loan policies.

The commercial loans offered by PNB include:

- commercial real estate loans;
- working capital;
- equipment and other commercial loans;
- construction loans;

- SBA guaranteed loans; and
- agricultural loans.

PNB's commercial real estate loans are used primarily to provide financing for retail operations, manufacturing operations, farming operations, multi-family housing units, and churches. Commercial real estate secured loans are generally written for a term of 15 years or less or amortized over a longer period with balloon payments at shorter intervals. Personal guarantees are obtained on nearly all commercial loans. Credit analysis, loan review, and an effective collections process are also used to minimize any potential losses. PNB employs five full-time commercial lending officers. These five people are augmented by branch managers who are authorized to make smaller, less complex, commercial loans.

Payment risk is a function of the economic climate in which PNB's lending activities are conducted; economic downturns in the economy generally or in a particular sector could cause cash flow problems for customers and make loan payments more difficult. PNB attempts to minimize this risk by avoiding concentrations of credit to single borrowers or borrowers in a particular industry. Interest rate risk would occur if PNB were to make loans at fixed rates in an environment in which rates were rising thereby preventing PNB from making loans at the higher prevailing rates. PNB attempts to mitigate this risk by making adjustable rate commercial loans and, when extending fixed rate commercial loans, fixing loan maturities at five years or less. Finally, collateral risk can occur if PNB's position in collateral taken as security for loan repayment is not adequately secured. PNB attempts to minimize collateral risk by avoiding loan concentrations to particular borrowers, by perfecting liens on collateral and by obtaining appraisals on property prior to extending loans.

Consumer loans offered by PNB include:

- residential real estate loans;
- automobile loans;
- manufactured housing loans;
- personal installment loans secured and unsecured for almost any purpose;
- student loans; and
- home equity loans (fixed-rate term and open ended revolving lines of credit).

PNB offers credit cards as an agent bank through another correspondent bank.

Risks applicable to consumer lending are similar to those applicable to commercial lending. PNB attempts to mitigate payment risk in consumer lending by limiting consumer lending products to a term of five years or less. To the extent that PNB extends unsecured consumer loans, there is greater collateral risk; however, credit checks and borrower history are obtained in all consumer loan transactions.

Residential mortgage products include adjustable-rate as well as conventional fixed-rate loans. Terms vary from 1, 5, and 10-year adjustable rate loans to 5, 10, 15, 20, and 30-year fully amortized fixed rate loans. Bi-weekly payment plans are also available. Personal secured and unsecured revolving lines of credit with variable interest rates and principal amounts ranging from \$1,000 to \$10,000 are offered to credit-worthy customers. The largest segment of PNB's installment loan portfolio is fixed-rate loans. Most are secured either by automobiles, motorcycles, snowmobiles, boats, other personal property, or by liens filed against real estate. These loans are generally available in terms of up to 15 years with automobile loans having maturities of up to 60 months and real estate loans having maturities up to 15 years. Loans secured by other collateral usually require a maturity of less than 60 months. Home equity products include both fixed-rate term products and also an open-end revolving line of credit with a maximum loan-to-value ratio of 80% of current appraisal. A special MGIC program now offered through the Bank, allows for loans of up to 95% of the appreciated value for qualified applicants. Credit checks, credit scoring, and debt-to-income ratios within preset parameters are used to qualify borrowers.

Mortgage loans have historically had a longer average life than commercial or consumer loans. Accordingly, payment and interest rate risks are greater in some respects with mortgage loans than with commercial or consumer lending. Deposits, which are used as the primary source to fund mortgage lending, tend to be of shorter duration than the average maturities on residential mortgage loans and are more susceptible to interest rate changes. Historical records indicate that our mortgage loans, no matter what maturity, have an average life of less than seven years. In 2003, the Bank started selling mortgages in the secondary market. Mortgages are also written with adjustable rates. Mortgage lending is also subject to economic downturns, in that increases in unemployment could adversely affect the ability of borrowers to repay mortgage loans and decreases in property values could affect the value of the real estate serving as collateral for the loan.

Loan growth remained steady in 2008 when compared to 2007 and 2006. Industry standard debt-to-income ratios and credit checks are used to qualify borrowers on all consumer loans. Managers, assistant managers, and customer service officers have retail lending authorities at each of the full-service branch office locations. PNB has centralized loan administration at its operations/administrative offices where mortgage underwriting and loan review and analysis take place.

Loan Approval

Individual loan authorities are established by PNB's Board of Directors upon recommendation by the chief credit officer. In establishing an individual's loan authority, the experience of the lender is taken into consideration, as well as the type of lending in which the individual is involved. The President of PNB, along with members of senior management (loan committee), has the authority to approve new loans over \$250,000 up to \$2,000,000 and all aggregate loans \$325,000 to \$2,500,000 following an analysis and review by credit analysts and commercial lender. The full Board of Directors reviews on a monthly basis, all loans approved by individual lenders and the officers' loan committee. All loan requests which are either complex in nature or exceed \$2,000,000 new or \$2,500,000 aggregate must be analyzed and reviewed by the loan committee and presented with a recommendation to the full Board of Directors for approval or denial.

PNB generally requires that loans secured by first mortgages or real estate have loan-to-value ratios of less than 80% for loans secured by raw land or improved property. In addition, in some instances for qualified borrowers, private mortgage insurance is available for purchase that allows loan-to-value ratios to go as high as 100%. PNB also participates in a guaranteed mortgage insurance program. This allows PNB to make loans on real estate up to 100% of the value of the property. Adjustable rate mortgage products, as well as conventional fixed-rate products, are also available at PNB.

Deposit Activities

PNB offers a full range of deposit and banking services including commercial checking products, cash management services, retirement accounts such as Individual Retirement Accounts ("IRA"), retail deposit services such as certificates of deposit, money market accounts, savings accounts, a variety of ancillary checking account products such as automated teller machines ("ATM's"), point of sale ("POS"), automated clearing house ("ACH") originations, remote deposit capture ("RDC") as well as other miscellaneous services.

These miscellaneous services would include:

- safe deposit boxes;
- night depository services;
- traveler's checks;
- merchant credit cards;
- direct deposit of payroll and other checks;
- U.S. Savings Bonds;
- official bank checks; and
- money orders.

The principal sources of funds for PNB are core deposits that include demand deposits, interest bearing transaction accounts, money market accounts, savings deposits, and certificates of deposit. These deposits are solicited from individuals, businesses, non-profit entities, and government authorities. Substantially all of PNB's deposits are from the local market areas surrounding each of its offices.

Investment Products

In 1999, PNB entered into an agreement with T.H.E. Financial Services to sell investment products. In September of 2003, T.H.E. Financial Services was acquired by Financial Network Investment Corporation (FNIC) of Torrance, California. PNB signed a contract dated September 29, 2003 with FNIC. PNB discontinued broker-dealer services with FNIC and contracted with Uvest Financial Services, Charlotte, North Carolina, effective September 6, 2005. In 2005, Peoples Financial Services Corp. formed Peoples Advisors, LLC ("Advisors") as a member-managed limited liability company under the laws of the Commonwealth of Pennsylvania, to be a wholly owned subsidiary of the Corporation, for the purpose of providing investment advisory services to the general public.

Investment Portfolio and Activities

PNB's investment portfolio has several objectives.

- A key objective is to provide a balance in PNB's asset mix of loans and investments consistent with its liability structure, and to assist in management of interest rate risk. The investments augment PNB's capital position in the risk-based capital formula, providing the necessary liquidity to meet fluctuations in credit demands of the community and also fluctuations in deposit levels.

- In addition, the portfolio provides collateral for pledging against public funds, and a reasonable allowance for control of tax liabilities.

- Finally, the investment portfolio is designed to provide income for PNB.

In view of the above objectives, the portfolio is treated conservatively by management and only securities that pass those criteria are purchased.

Competition

PNB operates in a fairly competitive environment, competing for deposits and loans with commercial banks, thrifts, credit unions, and finance and mortgage companies. Some of these competitors possess substantially greater financial resources than those available to PNB. Also, certain of these institutions have significantly higher lending limits than PNB and may provide various services for their customers that are not presently available at PNB. Financial institutions generally compete on the basis of rates and service. PNB is subject to increasing competition from credit unions, finance companies, and mortgage companies that may not be subject to the same regulatory restrictions and taxations as commercial banks.

PNB will seek to remain competitive with interest rates that it charges on its loans and offers on deposits. It also believes that its success has been, and will continue to be, due to its emphasis on community involvement, customer services, and relationships. With consolidation continuing in the financial industry, and particularly in PNB's markets, smaller profitable banks are gaining opportunities where larger institutions exit markets that are only marginally profitable for them.

The financial services industry in the Company's service area is extremely competitive. The Company's competitors within its service area include banks and bank holding companies with substantially greater resources. Many competitors have substantially higher legal lending limits.

In addition, savings banks, savings and loan associations, credit unions, money market and other mutual funds, mortgage companies, leasing companies, finance companies, and other financial services companies offer products and services similar to those offered by the Company and PNB, on competitive terms.

Although the Company has not done so, many bank holding companies have elected to become financial holding companies under the Gramm-Leach-Bliley Act, which gives them a broader range of products with which we must compete. Although the long-range effects of this development cannot be predicted, most probably it will further narrow the differences and intensify competition among commercial banks, investment banks, insurance firms and other financial services companies.

SEASONALITY

Management does not feel that the deposits or the business of PNB in general are seasonal in nature. The deposits may, however, vary with local and national economic conditions but should not have a material effect on planning and policy making.

CRITICAL ACCOUNTING POLICIES

Disclosure of the Company's significant accounting policies is included in Note 1 to the Consolidated Financial Statements. Some of these policies are particularly sensitive requiring significant judgments, estimates and assumptions to be made by management. Additional information is contained in Management's Discussion and Analysis for these issues, including the provision and allowance for loan losses, which are located in Note 3 to the Consolidated Financial Statements; the valuation of real estate acquired in connection with foreclosures or in satisfaction of loans; determination of other-than-temporary impairment losses on securities, which is located in Note 2 to the Consolidated Financial Statements; the valuation of deferred tax assets, which is located in Note 9 to the consolidated financial statements; and the potential impairment of restricted stock, which is located in Note 2 to the consolidated financial statements.

Significant estimates are made by management in determining the allowance for loan losses. Consideration is given to a variety of factors in establishing this estimate. In estimating the allowance for loan losses, management considers current economic conditions, diversification of the loan portfolio, delinquency statistics, results of internal loan review, financial and managerial strengths of borrowers, adequacy of collateral, if collateral dependent, or present

value of future cash flows and other relevant factors. In estimating the valuation of real estate acquired in connection with foreclosure or in satisfaction of loans, management considers current economic conditions and appraised values of collateral, if collateral dependent. When determining if there is other-than-temporary impairment losses on securities, management considers (1) the length of time and the extent to which the fair value has been less than costs (2) the financial condition and near-term prospects of the issuer, and (3) the intent and ability of the Company to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value.

INTERNET ADDRESS DISCLOSURES

PNB's Annual Report on Form 10-K, Quarterly Reports on Form 10-Q and Current Reports on Form 8-K and amendments to those reports can be found via a link to the SEC Web page through our Website located at www.peoplesnatbank.com. This website is available free of charge.

PNB has posted its Code of Ethics for the chief executive officer, chief operation and financial officer, and controller. This policy can be found at our Website located at www.peoplesnatbank.com. Copies are also available upon request and free of charge for Shareholders without Web access.

STATISTICAL DISCLOSURES

The following statistical disclosures are included in Management's Discussion and Analysis, Item 7 hereof, and are incorporated by reference in this Item 1:

- Interest Rate Sensitivity Analysis;
- Interest Income and Expense, Volume and Rate Analysis;
- Investment Portfolio;
- Loan Maturity and Interest Rate Sensitivity;
- Loan Portfolio;
- Allocation of Allowance for Loan Losses;
- Deposits; and
- Short-term Borrowings.

ITEM 1A RISK FACTORS

Changes in interest rates could reduce our income, cash flows and asset values.

Our income and cash flows and the value of our assets depend to a great extent on the difference between the interest rates we earn on interest-earning assets, such as loans and investment securities, and the interest rates we pay on interest-bearing liabilities such as deposits and borrowings. These rates are highly sensitive to many factors which are beyond our control, including general economic conditions and policies of various governmental and regulatory agencies and, in particular, the Board of Governors of the Federal Reserve System. Changes in monetary policy, including changes in interest rates, will influence not only the interest we receive on our loans and investment securities and the amount of interest we pay on deposits and borrowings, but will also affect our ability to originate loans and obtain deposits and the value of our investment portfolio. If the rate of interest we pay on our deposits and other borrowings increases more than the rate of interest we earn on our loans and other investments, our net interest income, and therefore our earnings, could be adversely affected. Our earnings also could be adversely affected if the rates on our loans and other investments fall more quickly than those on our deposits and other borrowings.

Economic conditions either nationally or locally in areas in which our operations are concentrated may adversely affect our business.

Deterioration in local, regional, national or global economic conditions could cause us to experience a reduction in deposits and new loans, an increase in the number of borrowers who default on their loans and a reduction in the value of the collateral securing their loans, all of which could adversely affect our performance and financial condition. Unlike larger banks that are more geographically diversified, we provide banking and financial services locally. Therefore, we are particularly vulnerable to adverse local economic conditions.

Our financial condition and results of operations would be adversely affected if our allowance for loan losses is not sufficient to absorb actual losses or if we are required to increase our allowance.

Despite our underwriting criteria, we may experience loan delinquencies and losses. In order to absorb losses associated with nonperforming loans, we maintain an allowance for loan losses based on, among other things, historical experience, an evaluation of economic conditions, and regular reviews of delinquencies and loan portfolio quality. Determination of the allowance inherently involves a high degree of subjectivity and requires us to make

significant estimates of current credit risks and future trends, all of which may undergo material changes. At any time, there are likely to be loans in our portfolio that will result in losses but that have not been identified as non-performing or potential problem credits. We cannot be sure that we will be able to identify deteriorating credits before they become nonperforming assets or that we will be able to limit losses on those loans that are identified. We may be required to increase our allowance for loan losses for any of several reasons. Regulators, in reviewing our loan portfolio as part of a regulatory examination, may request that we increase our allowance for loan losses. Changes in economic conditions affects borrowers, new information regarding existing loans, identification of additional problem loans and other factors, both within and outside of our control, may require an increase in our allowance. In addition, if charge-offs in future periods exceed our allowance for loan losses, we will need additional increases in our allowance for loan losses. Any increase in our allowance for loan losses will result in a decrease in our net income and, possibly, our capital, and may materially affect our results of operations in the period in which the allowance is increased.

Competition may decrease our growth or profits.

We face substantial competition in all phases of our operations from a variety of different competitors, including commercial banks, credit unions, consumer finance companies, insurance companies and money market funds. There is very strong competition among financial services providers in our principal service area. Our competitors may have greater resources, higher lending limits or larger branch systems than we do. Accordingly, they may be able to offer a broader range of products and services as well as better pricing for those products and services than we can. In addition, some of the financial services organizations with which we compete are not subject to the same degree of regulation as is imposed on federally insured financial institutions. As a result, those non-bank competitors may be able to access funding and provide various services more easily or at less cost than we can, adversely affecting our ability to compete effectively.

We may be adversely affected by government regulation.

The banking industry is heavily regulated. Banking regulations are primarily intended to protect the federal deposit insurance funds and depositors, not shareholders. Changes in the laws, regulations, and regulatory practices affecting the banking industry may increase our cost of doing business or otherwise adversely affect us and create competitive advantages for others. Regulations affecting banks and financial services companies undergo continuous change, and we cannot predict the ultimate effect of these changes, which could have a material adverse effect on our profitability or financial condition.

We rely on our management and other key personnel, and the loss of any of them may adversely affect our operations. We are, and will continue to be, dependent upon the services of our management team. The unexpected loss of services of any key management personnel could have an adverse effect on our business and financial condition because of their skills, knowledge of our market, years of industry experience and the difficulty of promptly finding qualified replacement personnel.

Environmental liability associated with lending activities could result in losses.

In the course of our business, we may foreclose on and take title to properties securing our loans. If hazardous substances were discovered on any of these properties, we could be liable to governmental entities or third parties for the costs of remediation of the hazard, as well as for personal injury and property damage. Many environmental laws can impose liability regardless of whether we knew of, or were responsible for, the contamination. In addition, if we arrange for the disposal of hazardous or toxic substances at another site, we may be liable for the costs of cleaning up and removing those substances from the site even if we neither own nor operate the disposal site. Environmental laws may require us to incur substantial expenses and may materially limit use of properties we acquire through foreclosure, reduce their value or limit our ability to sell them in the event of a default on the loans they secure. In addition, future laws or more stringent interpretations or enforcement policies with respect to existing laws may increase our exposure to environmental liability.

Failure to implement new technologies in our operations may adversely affect our growth or profits.

The market for financial services, including banking services and consumer finance services, is increasingly affected by advances in technology, including developments in telecommunications, data processing, computers, automation, Internet-based banking and telebanking. Our ability to compete successfully in our markets may depend on the extent to which we are able to exploit such technological changes. However, we can provide no assurance that we will be able to properly or timely anticipate or implement such technologies or properly train our staff to use such technologies. Any failure to adapt to new technologies could adversely affect our business, financial condition or operating results.

An investment in our common stock is not an insured deposit.

Our common stock is not a bank deposit and, therefore, is not insured against loss by the Federal Deposit Insurance Corporation, commonly referred to as the FDIC, or any other deposit insurance fund or by any other public or private

entity. Investment in our common stock is subject to the same market forces that affect the price of common stock in any company.

Our legal lending limits are relatively low and restrict our ability to compete for larger customers.

At December 31, 2008, our lending limit per borrower was approximately \$6,100,000 or approximately 15% of our unimpaired capital. Accordingly, the size of loans that we can offer to potential borrowers (without participation by other lenders) is less than the size of loans that many of our competitors with larger capitalization are able to offer. Our legal lending limit also impacts the efficiency of our lending operation because it tends to lower our average loan size, which means we have to generate a higher number of transactions to achieve the same portfolio volume. We may engage in loan participations with other banks for loans in excess of our legal lending limits. However, there can be no assurance that such participations will be available at all or on terms which are favorable to us and our customers.

Market conditions may adversely affect our fee based investment business.

The Company receives fee based revenues from commissions from the sale of securities and investment advisory fees. In the event of decreased stock market activity, the volume of trading facilitated by Uvest Financial Services will in all likelihood decrease resulting in decreased commission revenue on purchases and sales of securities. In addition, investment advisory fees, which are generally based on a percentage of the total value of an investment portfolio, will decrease in the event of decreases in the values of the investment portfolios, for example, as a result of overall market declines.

ITEM 1B UNRESOLVED STAFF COMMENTS

NONE.

ITEM 2 PROPERTIES

PNB has four full-service banking offices in Susquehanna County that are located in:

- Borough of Susquehanna Depot;
- Hallstead Plaza, Great Bend Township;
- Borough of Hop Bottom; and
- Montrose, Bridgewater Township.

PNB's presence in Wyoming County, Pennsylvania had been limited to a de novo branch in Nicholson, which opened in 1992, until the purchase of the two Mellon bank offices in 1997. The Wyoming County locations are:

- Borough of Nicholson;
- Meshoppen Township; and
- Tunkhannock Borough.

PNB has entered into Lackawanna in 2008 with a de novo branch in Glenburn. The Lackawanna County location is:

- Glenburn Township.

The administrative/operations office of the Company and PNB is located at 82 Franklin Avenue, Hallstead, Pennsylvania. The following departments are located at that office:

- commercial, mortgage and consumer lending operations;
- executive offices;
- marketing department;
- human resources department;
- deposit account support services;
- data processing services; and
- corporate accounting.

PNB began expanding its branch locations into New York in 2002. The latest updates on these expansions are:

- The Bank had an office located in the Price Chopper Super Market in Norwich, Chenango County, New York. This office was purchased from Mohawk Community Bank, Amsterdam, New York, in March of 2002. A decision was made to close this office effective March 31, 2003, because of its distance from Hallstead, high lease payments, and lack of growth opportunity for our Bank in that area.

- Subsequently, real estate was purchased in Conklin, New York, approximately 10 miles from Hallstead. Regulators approved permission to establish an office at that site and the official opening date was March 17, 2003. The office is located at 1026 Conklin Road and is approximately ten miles from the Administrative Office of PNB.

- Also, on December 12, 2002, property was purchased at 108 Second Street, Town of Sanford, Village of Deposit, Broome County, New York. Regulatory approval was received to establish this second New York State office, and the official opening date of this office, which is located approximately 25 miles from the Administrative Office, was April 18, 2005.

- The application was approved for the third New York State office located on Front Street in the Town of Chenango, Broome County. This office, which was officially opened on June 6, 2005, is approximately 20 miles from the Administrative Office.

All offices are owned in fee title by PNB with the exception of the Hallstead Plaza, Meshoppen and Town of Chenango offices. The Hallstead Plaza and Meshoppen offices are subject to ground leases; and the Front Street office is subject to a building lease. Each lease is either long-term expiring in September 2028 or includes renewal options. Current lease payments range from \$3,296 to \$38,496 annually. The leases provide that the Bank pay property taxes, insurance, and maintenance costs. Eleven of the twelve offices provide drive-up banking services and ten offices have 24-hour ATM services.

ITEM 3 LEGAL PROCEEDINGS

The Company is subject to lawsuits and claims arising out of its business. In the opinion of the Company's management, after review and consultation with counsel, any proceedings that may arise should not result in judgments, which, in the aggregate, would have a material adverse effect on the Company's consolidated financial statements.

ITEM 4 SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

NONE.

PART II

ITEM 5 MARKET FOR REGISTRANT'S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS

The Company's Common Stock is not listed on an exchange or quoted on the National Association of Securities Dealers, Inc. Automated Quotation system (NASDAQ). The Company's common stock is traded sporadically in the over-the-counter market and, accordingly, there is no established public trading market at this time. The Company's stock is listed on the OTC Bulletin Board under the symbol PFIS. The cusip number is 711040-10-5. The investment firms of Boenning & Scattergood, Inc. from West Conshohocken, Pennsylvania, and Ryan Beck from Livingston, New Jersey, make a limited market in the Company's common stock. The Company, and previously the Bank, have continuously paid dividends for more than 100 years and it is the intention to pay dividends in the future. However, future dividends must necessarily depend upon earnings, financial condition, appropriate legal restrictions, and other factors at the time that the Board of Directors considers dividend payments. As of December 31, 2008, there were 33,549 outstanding options to purchase the Company's common stock. See Note 8 of the Consolidated Financial Statements for more information. Book value of common stock at December 31, 2008, was \$12.69 and on December 31, 2007, it was \$13.62. As of December 31, 2008, the Company had approximately 1,093 shareholders of record. At such date, 3,131,181 shares of Common Stock were outstanding.

The following table reflects high and low bid prices for shares of the Company's Common Stock to the extent such information is available, and the dividends declared with respect thereto during the preceding two years.

COMPANY STOCK

	2008			2007		
	Price Range Low	Price Range High	Dividends Declared	Price Range Low	Price Range High	Dividends Declared
First Quarter	\$ 22.00	\$ 26.30	\$.19	\$ 25.50	\$ 28.00	\$.19
Second Quarter	\$ 22.50	\$ 25.05	\$.19	\$ 26.05	\$ 30.50	\$.19
Third Quarter	\$ 22.35	\$ 25.50	\$.19	\$ 27.60	\$ 30.00	\$.19
Fourth Quarter	\$ 18.05	\$ 24.00	\$.19	\$ 26.30	\$ 30.00	\$.19

The following table discloses the number of outstanding options, warrants and rights granted by the Company to participants in equity compensation plans, as well as the number of securities remaining available for future issuance under these plans. The table provides this information separately for equity compensation plans that have and have not been approved by security holders.

	(a)	(b)	(c)
	Number of securities to be issued upon exercise of outstanding options, warrants and rights	Weighted-average exercise price of outstanding options, warrants and rights	Number of securities remaining available for future issuance under equity compensation plans {excluding securities reflected in column (a) }*
Equity compensation plans approved by stockholders	33,549	\$ 21.78	65,751
Equity compensation plans not approved by stockholders	0	0	0
Total	33,549	\$ 21.78	65,751

* Securities for future issuance are reserved and issued at the discretion of the Board of Directors on an annual basis.

The following table discloses the purchases made by the Company of shares of its common stock in the fourth quarter of 2008.

MONTH	Total number of shares purchased	Average price paid per share	Total number of shares purchased as part of publicly announced plans or programs	Maximum number of shares that may yet be purchased under the plans or programs (1)
October 1, 2008 – October 31, 2008	0	\$ 0	0	65,751
November 1, 2008 – November 30, 2008	0	\$ 0	0	65,751
December 1, 2008 – December 31, 2008	0	\$ 0	0	65,751
Total	0	\$ 0	0	

(1) On July 2, 2001, the Board of Directors authorized the repurchase of 158,931 shares of the Corporation's common stock outstanding from shareholders.

The performance graph formerly included in the Company's Proxy Statement can now be found in the Company's Annual Report to its shareholders.

ITEM 6 SELECTED FINANCIAL DATA

Consolidated Financial Highlights

(Dollars In Thousands, except Per Share Data)

	At and For the Years Ended December 31,				
	2008	2007	2006	2005	2004
Net Income	\$ 3,039	\$ 4,871	\$ 4,129	\$ 4,476	\$ 4,453
Return of Average Assets	0.68%	1.17%	1.03%	1.16%	1.18%
Return on Average Equity	7.53%	11.85%	10.55%	11.37%	10.84%
Shareholders' Value					
Earnings per Share, Basic	\$ 0.97	\$ 1.55	\$ 1.31	\$ 1.42	\$ 1.41
Earnings per Share, Diluted	0.97	1.55	1.31	1.41	1.40
Regular Cash Dividends	0.76	0.76	0.76	0.76	0.73
Special Cash Dividends	0.00	0.00	0.00	1.00	0.00
Book Value	12.69	13.64	13.16	12.55	13.42
Market Value at End of the Year	18.05	26.30	26.00	31.45	36.00
Market Value/Book Value Ratio	142.24%	192.82%	197.57%	250.60%	268.26%
Price Earnings Multiple	18.61X	16.97X	19.85X	22.14X	25.59X
Dividend Payout Ratio	78.35%	48.92%	57.93%	53.50%	51.91%
Dividend Yield	4.21%	2.89%	2.94%	2.42%	2.03%
Safety and Soundness					
Stockholders' Equity/Asset Ratio	8.41%	9.85%	9.91%	10.13%	11.16%
Allowance for Loan Loss as a Percent of Loans	0.95%	0.84%	0.66%	0.92%	1.12%
Net Charge Offs/Total Loans	0.05%	(0.13%)	0.33%	0.29%	0.17%
Allowance for Loan Loss/Nonaccrual Loans	498.67%	620.51%	402.70%	206.62%	132.77%
Allowance for Loan Loss/Non-performing Loans	58.68%	620.51%	248.89%	183.74%	116.29%
Balance Sheet Highlights					
Total Assets	\$ 472,376	\$ 434,434	\$ 416,268	\$ 391,198	\$ 379,375
Total Investments	110,247	112,746	110,302	108,313	113,598
Net Loans	313,606	288,601	269,383	256,870	242,075
Allowance for Loan Losses	3,002	2,451	1,792	2,375	2,739
Short-term Borrowings	18,432	22,848	12,574	17,842	14,614
Long-term Borrowings	39,691	38,534	36,525	34,770	46,034
Total Deposits	371,268	327,430	323,613	296,962	274,775
Stockholders' Equity	39,720	42,805	41,240	39,616	42,354

ITEM 7 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

This consolidated review and analysis of Peoples Financial Services Corp. (the Company) is intended to assist the reader in evaluating the Company's performance for the years ending December 31 2008, 2007, and 2006. The information should be read in conjunction with the consolidated financial statements and the accompanying notes to those statements.

Peoples Financial Services Corp. (the Company) is the one-bank holding company of Peoples National Bank (the Bank), which is wholly owned by the Company. The Company and the Bank derive their primary income from the operation of a commercial bank, including earning interest on loans and investment securities. The Bank incurs interest expense in relation to deposits and other borrowings. The Bank operates eleven full-service branches in the Hallstead Shopping Plaza, Hop Bottom, Montrose, Susquehanna, Nicholson, Tunkhannock, Meshoppen, and Glenburn Pennsylvania and Conklin, Village of Deposit and Town of Chenango, Broome County, New York. The Bank has on-site automated teller machines at all offices except Hop Bottom and Meshoppen. The administrative offices and operations offices are located in Hallstead, Pennsylvania. Principal market areas are Susquehanna, Wyoming Counties and northern Lackawanna County in Pennsylvania and the Southern Tier of Broome County, New York and the bordering areas of those counties. As of December 31, 2008, the Bank employed 113 full-time employees and 26 part-time employees.

Forward Looking Statements

When used in this discussion, the words "believes", "anticipates", "contemplated", "expects", or similar expressions are intended to identify forward looking statements. Such statements are subject to certain risks and uncertainties that could cause actual results to differ materially from those projected. Those risks and uncertainties include changes in interest rates, the ability to control costs and expenses, and general economic conditions. The Company undertakes no obligation to publicly release the results of any revisions to those forward looking statements that may be made to reflect events or circumstances after this date or to reflect the occurrence of unanticipated events.

Critical Accounting Policies

Note 1 to the Company's consolidated financial statements lists significant accounting policies used in the development and presentation of its financial statements. This discussion and analysis, the significant accounting policies, and other financial statement disclosures identify and address key variables and other qualitative and quantitative factors that are necessary for an understanding and evaluation of the Company and its results of operations.

The consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States, which require the Company to make estimates and assumptions. The Company believes that its determination of the allowance for loan losses involves a higher degree of judgment and complexity than the Company's other significant accounting policies. Further, these estimates can be materially impacted by changes in market conditions or the actual or perceived financial condition of the Company's borrowers, subjecting the Company to significant volatility of earnings.

The allowance for loan losses is established through the provision for loan losses, which is a charge against earnings. Provisions for loan losses are made to reserve for estimated probable losses on loans. The allowance for loan losses is a significant estimate and is regularly evaluated by the Company for adequacy by taking into consideration factors such as changes in the nature and volume of the loan portfolio, trends in actual and forecasted credit quality, including delinquency, charge-off and bankruptcy rates, and current economic conditions that may affect a borrower's ability to pay. The use of different estimates of assumptions could produce a different provision for loan losses. For additional discussion concerning the Company's allowance for loan losses and related matters, see "Provision for Loan Losses".

The Company considers current economic conditions and the appraised value of any underlying collateral when determining the estimated value of foreclosed properties. In determining the necessity of recording an other-than-temporary impairment on securities owned by the Company, three main characteristics are considered; the length of time and extent to which a security has been "under water", the financial condition and current outlook of the issuer and finally, the intent and ability of the Company to hold the security until such a time in which there is a full recovery in fair value.

In estimating other-than-temporary impairment losses on securities, the Company considers 1) the length of time and extent to which the fair value has been less than cost 2) the financial condition of the issuer and 3) the intent and ability of the Company to hold the security to allow for a recovery to fair value. The Company believes that the unrealized losses, at December 31, 2008 and 2007 represent temporary impairment of the securities.

The deferred income taxes reflect temporary differences in the recognition of the revenue and expenses for tax reporting and financial statement purposes, principally because certain items are recognized in different periods for financial reporting and tax return purposes. Although realization is not assured, the Company believes it is more likely than not that all deferred tax assets will be realized.

Restricted stock which represents required investment in the common stock of correspondent banks is carried at cost and as of December 31, 2008 and 2007, consists of the common stock of Federal Home Loan Bank of Pittsburgh. In December 2008, the FHLB of Pittsburgh notified member banks that it was suspending dividend payments and the repurchase of capital stock.

Management evaluates the restricted stock for impairment in accordance with Statement of Position (SOP)01-6, Accounting by Certain Entities (Including Entities With Trade Receivables) That Lend to or Finance the Activities of Others. Management's determination of whether these investments are impaired is based on their assessment of the ultimate recoverability of their cost rather than by recognizing temporary decline in value. The determination of whether a decline affects the ultimate recoverability of their cost is influenced by criteria such as (1) the significance of the decline in net assets of the FHLB as compared to the capital stock amount for the FHLB and length of time this situation has persisted, (2) commitments by the FHLB to make payments required by law or regulation and the level of such payments in relation to the operating performance of the FHLB, and (3) the impact of legislative and regulatory changes on institutions and, accordingly, on the customer base of the FHLB. Management believes no impairment charge is necessary related to the restricted stock as of December 31, 2008.

Prior to January 1, 2006 and as previously permitted by SFAS No. 123, the Company accounted for stock-based compensation in accordance with Accounting Principles Board Opinion (APB) No. 25. Under APB No. 25, no compensation expense was recognized in the income statement related to any option granted under the Company stock option plans. In December 2004, the Financial Accounting Standards Board (FASB) issued Statement No. 123(R), "Share-Based Payment." Statement No. 123(R) replaced Statement No. 123, "Accounting for Stock-Based Compensation," and superseded APB Opinion No. 25, "Accounting for Stock Issued to Employees." Statement No. 123(R) requires compensation costs related to share-based payment transactions to be recognized in the financial statements over the period that an employee provides service in exchange for the award. Public companies were required to adopt the new standard using a modified prospective method and were given the option of restating prior periods using the modified retrospective method. The Bank did not elect to use the modified retrospective method. Under the modified prospective method, companies are required to record compensation cost for new and modified awards over the related vesting period of such awards prospectively and record compensation cost prospectively for the unvested portion, at the date of adoption, of previously issued and outstanding awards over the remaining vesting period of such awards. No change to prior periods presented is permitted under the modified prospective method. Statement No. 123(R) became effective for annual reporting periods beginning after December 15, 2005. Adopting Statement No. 123(R) on January 1, 2006 using the modified prospective method, the Company incurred total stock-based compensation expense, net of related tax effects, in the amount of \$1,000, \$3,000, and \$3,000 for the years ended December 31, 2008, 2007, and 2006 respectively.

RESULTS OF OPERATIONS

Net Interest Income

Net interest income is the main source of the Company's income. It is the difference between interest earned on assets and interest paid on liabilities. The discussion of net interest income should be read in conjunction with Table 2: "Distribution of Assets, Liabilities and Stockholders' Equity; Interest Rates and Interest Differential", and Table 3: "Rate/Volume Analysis of Changes in Net Interest Income."

The following table shows the net interest income on a fully-tax-equivalent basis for each of the three years ended December 2008, 2007, and 2006.

TABLE 1

Net Interest Income (In Thousands)

	Year-Ended December 31,		
	2008	2007	2006
Total Interest Income	\$ 25,479	\$ 24,611	\$ 22,698
Tax Exempt Loans	518	486	439
Non-Taxable Securities	892	885	764
Total Tax Equivalent Adjustment	1,410	1,371	1,203
Total Tax Equivalent Interest Income	26,889	25,982	23,901
Total Interest Expense	9,154	11,105	10,797
Net Interest Income (Fully Tax Equivalent Basis)	\$ 17,735	\$ 14,877	\$ 13,104

Table 2 includes the average balances, interest income and expense, and the average rates earned and paid for assets and liabilities. For yield calculation purposes, non-accruing loans are included in average loan balances. Table 3 analyzes the components contributing to the changes in net interest income and indicates the impact in either changes

in rate or changes in volume.

TABLE 2

Distribution of Assets, Liabilities and Stockholders' Equity
Interest Rates and Interest Differential
(Dollars In Thousands)

	Year Ended December 31, 2008			Year Ended December 31, 2007			Year Ended December 31, 2006		
	Average Balance	Interest	Yield/ Rate	Average Balance	Interest	Yield/ Rate	Average Balance	Interest	Yield/ Rate
ASSETS									
Loans									
Real Estate	\$ 117,635	\$ 7,602	6.46%	\$ 115,490	\$ 7,615	6.59%	\$ 110,972	\$ 7,136	6.43%
Installment	16,815	1,303	7.75%	17,143	1,442	8.41%	17,210	1,417	8.23%
Commercial	140,903	9,917	7.04%	123,854	9,424	7.61%	118,904	8,532	7.18%
Tax Exempt	22,913	1,005	6.65%	21,165	943	6.75%	20,051	853	6.45%
Other Loans	469	44	9.38%	467	57	12.21%	473	58	12.26%
Total Loans	298,735	19,871	6.83%	278,119	19,481	7.18%	267,610	17,996	6.89%
Investment									
Securities (AFS)									
Taxable	67,897	3,771	5.55%	65,438	3,351	5.12%	65,202	3,032	4.65%
Non-Taxable	42,859	1,731	6.12%	44,192	1,717	5.89%	39,435	1,484	5.70%
Total Securities	110,756	5,502	5.77%	109,630	5,068	5.43%	104,637	4,516	5.05%
Time Deposits With									
Other Banks	1,186	26	2.19%	315	18	5.71%	932	53	5.69%
Fed Funds Sold	6,817	80	1.17%	723	44	6.09%	2,467	133	5.39%
Total Earning									
Assets	417,494	25,479	6.44%	388,787	24,611	6.68%	375,646	22,698	6.36%
Less: Allowance for									
Loan Losses	(2,599)			(2,025)			(2,344)		
Cash and Due from									
Banks	6,851			6,639			6,768		
Premises and									
Equipment, Net	6,227			5,712			7,816		
Other Assets	19,741			17,690			12,899		
Total Assets	\$ 447,714			\$ 416,803			\$ 400,785		
LIABILITIES AND STOCKHOLDERS' EQUITY									
Deposits									
Interest Bearing									
Demand	\$ 28,871	284	0.98%	\$ 25,341	290	1.14%	\$ 25,462	262	1.03%
Regular Savings	94,019	1,219	1.30%	106,969	3,311	3.10%	95,360	3,135	3.29%
Money									
Market Savings	33,858	600	1.77%	35,355	1,089	3.08%	37,747	1,446	3.83%
Time	132,313	4,923	3.72%	102,643	4,329	4.22%	102,195	3,905	3.82%
Total Interest									
Bearing Deposits	289,061	7,026	2.43%	270,308	9,019	3.34%	260,764	8,748	3.35%
Other Borrowings	58,368	2,128	3.65%	50,183	2,086	4.16%	48,878	2,049	4.19%

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Total Interest Bearing Liabilities	347,429	9,154	2.63%	320,491	11,105	3.46%	309,642	10,797	3.49%
Net Interest Spread		\$ 16,325	3.81%		\$ 13,506	3.22%		\$ 11,901	2.88%
Non-Interest Bearing									
Demand Deposits	56,778			52,613			49,888		
Accrued Expenses and Other Liabilities	3,173			2,604			2,135		
Stockholders' Equity	40,334			41,095			39,120		
Total Liabilities and Stockholders' Equity	\$ 447,714			\$ 416,803			\$ 400,785		
Interest Income/Earning Assets			6.44 %			6.68%			6.36%
Interest Expense/Earning Assets			2.19 %			2.86%			2.87%
Net Interest Margin			4.25 %			3.82%			3.49%

TABLE 3

Rate/Volume Analysis of Changes in Net Interest Income
(In Thousands)

	2008 to 2007			2007 to 2006		
	Increase (Decrease)	Change Due to Rate	Volume	Increase (Decrease)	Change Due to Rate	Volume
Interest Income						
Real Estate Loans	\$ (13)	\$ (152)	\$ 139	\$ 479	\$ 181	\$ 298
Installment Loans	(139)	(114)	(25)	25	31	(6)
Commercial Loans	493	(707)	1,200	892	515	377
Tax Exempt Loans	62	(15)	77	90	15	75
Other Loans	(13)	(13)	0	(1)		