

PEOPLES FINANCIAL SERVICES CORP/
Form 10-K
March 15, 2006

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, 2005,

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 or Other Jurisdiction of
Incorporation or Organization)*

23-2391852

*(I.R.S. Employer
Identification Number)*

50 MAIN STREET, HALLSTEAD, PA
(Address of Principal Executive Offices)

18822
(Zip Code)

Registrant's telephone number, including area code: **(570) 879-2175**

Securities registered pursuant to Section 12(b) of the Act: **NONE**

Securities registered pursuant to Section 12(g) of the Act: **COMMON STOCK (\$2 Par Value)**

(Title Class)

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 an accelerated filer. Yes X No _____

The aggregate market value of voting stock held by non-affiliates of the registrant is **\$ 98,239,618**

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 by June 30, 2005. 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.

Number of shares outstanding as of December 31, 2005	COMMON STOCK (\$2 Par Value) <i>(Title Class)</i>	3,155,670 <i>(Outstanding Shares)</i>
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DOCUMENTS INCORPORATED BY REFERENCE

Portions of the 2006 Proxy Statement for the Registrant are incorporated by reference into Part III of this report.

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ITEM 1 BUSINESS

BRIEF HISTORY

Peoples Financial Services Corp. was incorporated under the laws of the Commonwealth of Pennsylvania on February 6, 1986, and is a one-bank holding company headquartered in Hallstead, Pennsylvania.

The Company is engaged primarily in commercial and retail banking services and in businesses related to banking services through its subsidiary, Peoples National Bank (“PNB” or the “Bank”). 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 and into 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.

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 at page 55 of this Report. The Segment Reporting information in Note 1 is incorporated by reference into this Item 1.

SUPERVISION AND REGULATION

The Company and PNB 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 and PNB.

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 Bank (“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 the 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, 2005, PFSC's ratio of Tier 1 capital to risk-weighted assets stood at 13.93% and its ratio of total capital to risk-weighted assets stood at 14.78%. 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, 2005, the Company's leverage-capital ratio was 10.10%.

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 \$100,000 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. PNB's assessment for 2005 was \$37,634. These figures can be compared to FDIC assessments in 2004 of \$40,474 and in 2003 of \$40,765. 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 2005 was \$.0136 for each \$100 of BIF deposits.

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 2002 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.

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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.

In addition, the GLB also contains provisions that expressly preempt any state law restricting the establishment of financial affiliations, primarily related to insurance. The general effect of the law is to establish a comprehensive framework to permit affiliations among commercial banks, insurance companies, securities firms and other financial service providers by revising and expanding the Bank Holding Company Act framework to permit a holding company to engage in a full range of financial activities through a new entity known as a "financial holding company." "Financial activities" is broadly defined to include not only banking, insurance and securities activities, but also merchant banking and additional activities that the Federal Reserve Board, in consultation with the Secretary of the Treasury, determines to be financial in nature, incidental to such financial activities or complementary activities that do not pose a substantial risk to the safety and soundness of depository institutions or the financial system generally.

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 new rules to the Company will 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 codifies 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.

In addition, under Regulation W:

- a bank and its subsidiaries may not purchase a low-quality asset from an affiliate;
- covered transactions and other specified transactions between a bank or its subsidiaries and an affiliate must be on terms and conditions that are consistent with safe and sound banking practices; and
- with some exceptions, each loan or extension of credit by a bank to an affiliate must be secured by collateral with a market value ranging from 100% to 130%, depending on the type of collateral, of the amount of the loan or extension of credit.

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. In addition, parts of Lackawanna, Wayne, and Bradford Counties in Pennsylvania that border Susquehanna and Wyoming Counties are also considered part of the PNB market area.

PNB purchased property in Deposit, New York, on December 12, 2002. PNB also signed a building lease agreement dated April 19, 2004, that allowed the Bank to establish a presence on Front Street in the Town of Chenango in Broome County, New York. Permission to establish branches in these locations was received and the Deposit office opened on April 18, 2005, and the Town of Chenango office opened on June 6, 2005. With the addition of these offices, the Bank will be better able to serve its present customers as well as add new customers. However, the market areas will be substantially the same.

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.

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 30,000 residents. Both counties are experiencing growth, but not robust growth. Broome County has approximately 208,000 residents and the Town of Conklin has approximately 7,000 residents. The economy of Broome County has overall been hit hard and has lost many manufacturing jobs in the past ten 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. 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 four full-time commercial lending officers. These four 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.

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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 100% 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 2005 when compared to 2003 and 2004. 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 senior 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, has the authority to approve loans up to \$500,000 following an analysis and review by loan administration and a written recommendation by the Chief Credit Officer. 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 \$500,000 must be analyzed and reviewed by loan administration 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 within specified limits, ranging from 75% for loans secured by raw land to 80% for 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 also offers a full range of deposit and personal banking services insured by the FDIC, including commercial checking and small business 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 checking account products, automated teller machines (“ATM’s”), point of sale and other electronic services such as automated clearing house (“ACH”) originations, and other personal 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 hire a joint employee to sell investment products. An agent was hired and has an office located in the Bank’s Hallstead Plaza building. 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. has 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. Advisors had no activity in 2005.

Insurance Products

In April of 2001, PNB purchased a 20% equity interest in Community Bankers Insurance Agency. This investment gives the Bank a referral avenue to provide insurance, broadening our available lines of financial services.

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, such as trust services, 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.

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.

SIGNIFICANT 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 the most sensitive of these issues, including the provision and allowance for loan losses, which are located in Note 4 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.

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 8 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, 2005, our lending limit per borrower was approximately \$5.8 million, or approximately 15% of our 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

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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.

The administrative/operations office of the Company and PNB is located at 50 Main Street, 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 \$2,535 to \$38,496 annually. The leases provide that the Bank pay property taxes, insurance, and maintenance costs. Nine of the ten offices provide drive-up banking services and eight offices have 24-hour ATM services.

ITEM 3 LEGAL PROCEEDINGS

The Company is a defendant in various lawsuits wherein various amounts are claimed. In the opinion of the Company's management, these suits are without merit and 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 Ferris, Baker Watts, Incorporated from Baltimore, Maryland, 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 90 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, 2005, there were 61,500 outstanding options to purchase the Company's common stock. See Note 9 of the Consolidated Financial Statements for more information. Book value of common stock at December 31, 2005, was \$12.55 and on December 31, 2004, it was \$13.42. As of December 31, 2005, the Company had approximately 1,038 shareholders of record. At such date, 3,155,670 shares of Common Stock were outstanding.

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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

	2005			2004		
	Price Range		Dividends	Price Range		Dividends
	Low	High	Declared	Low	High	Declared
First Quarter	\$ 34.00	\$ 36.25	\$.19	\$ 32.40	\$ 33.55	\$ 0.18
Second Quarter	\$ 32.50	\$ 34.00	\$ 1.19	\$ 33.00	\$ 34.50	\$ 0.18
Third Quarter	\$ 30.25	\$ 32.75	\$.19	\$ 33.05	\$ 35.50	\$ 0.18
Fourth Quarter	\$ 30.75	\$ 32.30	\$.19	\$ 34.10	\$ 36.00	\$ 0.19

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	61,500	19.80	67,728
Equity compensation plans not approved by stockholders	0	0	0
Total	61,500	19.80	67,728

* 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 2005.

MONTH	Total number of shares purchased	Average price paid per share	Total number of shares purchased as part of publicly	Maximum number of shares that may yet be purchased under the plans or programs (1)

			announced plans or programs	
October 1, 2005 - October 31, 2005	0	0	0	112,659
November 1, 2005 - November 30, 2005	0	0	0	112,659
December 1, 2005 - December 31, 2005	0	0	0	112,659
TOTAL	0	0	0	

(1) On December 27, 1995, the Board of Directors authorized the repurchase of 187,500 shares of the Company's common stock from shareholders. On July 2, 2001, the Board of Directors authorized the repurchase of an additional 5%, or 158,931 shares, of the Company's common stock outstanding. Neither repurchase program stipulated an expiration date.

ITEM 6 SELECTED FINANCIAL DATA

Consolidated Financial Highlights (In Thousands, except Per Share Data)	At and For the Years Ended December 31,				
	2005	2004	2003	2002	2001
Net Income	\$ 4,476	\$ 4,453	\$ 5,564	\$ 5,015	\$ 4,836
Return of Average Assets	1.16%	1.18%	1.54%	1.52%	1.62%
Return on Average Equity	11.37%	10.84%	14.18%	14.30%	15.15%
Shareholders' Value					
Earnings per Share, Basic	\$ 1.42	\$ 1.41	\$ 1.76	\$ 1.59	\$ 1.52
Earnings per Share, Diluted	1.41	1.40	1.75	1.59	1.52
Regular Cash Dividends	0.76	0.73	0.65	0.59	0.48
Special Cash Dividends	1.00	0.00	0.00	0.00	0.00
Book Value	12.55	13.42	12.98	12.17	10.69
Market Value	31.45	36.00	32.40	20.00	17.33
Market Value/Book Value Ratio	250.60%	268.26%	249.61%	164.38%	162.20%
Price Earnings Multiple	22.14x	25.59x	18.41x	12.57x	11.40x
Dividend Payout Ratio	53.50%	51.91%	36.96%	36.89%	31.62%
Dividend Yield	2.42%	2.03%	2.07%	3.03%	2.77%
Safety and Soundness					
Stockholders' Equity/Asset Ratio	10.13%	11.16%	11.06%	11.05%	10.70%
Allowance for Loan Loss as a Percent of Loans	0.92%	1.12%	0.89%	0.87%	0.94%
Net Charge Offs/Total Loans	0.29%	0.17%	0.06%	0.03%	0.06%
Allowance for Loan Loss/Nonaccrual Loans	206.62%	132.77%	212.70%	567.45%	383.67%
Allowance for Loan Loss/Non-performing Loans	183.74%	116.29%	192.20%	367.87%	306.28%
Balance Sheet Highlights					
Total Assets	\$ 391,198	\$ 379,375	\$ 371,289	\$ 346,842	\$ 315,347
Total Investments	108,313	113,598	116,126	105,972	100,783
Net Loans	256,870	242,075	234,274	219,437	191,913
Allowance for Loan Losses	2,375	2,739	2,093	1,935	1,816
Short-term Borrowings	17,842	14,614	7,085	13,113	21,338
Long-term Borrowings	34,770	46,034	41,952	34,744	20,000
Total Deposits	296,962	274,775	279,700	259,187	238,891
Stockholders' Equity	\$ 39,616	\$ 42,354	\$ 41,076	\$ 38,323	\$ 33,754

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 2005, 2004, and 2003. 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 ten full-service branches in the Hallstead Shopping Plaza, Hop Bottom, Montrose, Susquehanna, Nicholson, Tunkhannock, and Meshoppen, 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 and Wyoming Counties in Pennsylvania and the Southern Tier of Broome County, New York and the bordering areas of those counties. As of December 31, 2005, the Bank employed 103 full-time employees and 25 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 Bank to make estimates and assumptions. The Bank believes that its determination of the allowance for loan losses involves a higher degree of judgment and complexity than the Bank'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 Bank's borrowers, subjecting the Bank 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 Bank 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 Bank's allowance for loan losses and related matters, see "Provision for Loan Losses".

As permitted by SFAS No. 123, the Company accounts for stock-based compensation in accordance with Accounting Principals Board Opinion (APB) No. 25. Under APB No. 25, no compensation expense is recognized in the income statement related to any option granted under the Company stock option plans. The pro forma impact to net income and earnings per share that would occur if compensation expense was recognized, based on the estimated fair value of the options on the date of the grant, is disclosed in the notes to the consolidated financial statements. In December 2004, the Financial Accounting Standards Board (FASB) issued Statement No. 123(R), "Share-Based Payment." Statement No. 123(R) replaces Statement No. 123, "Accounting for Stock-Based Compensation," and supersedes 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 are required to adopt the new standard using a modified prospective method and may elect to restate prior periods using the modified retrospective method. The Bank will 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) is effective for annual reporting periods beginning after December 15, 2005. Early application of Statement No. 123(R) is encouraged, but not required. Adopting Statement No. 123(R) on January 1, 2006 using the modified prospective method, the Company estimates that total stock-based compensation expense, net of related tax effects, will increase by \$3,000 for the year-ending December 31, 2006, for unvested stock options outstanding at December 31, 2005. Any additional impact that the adoption of this statement will have on our results of operations will be determined by share-based payments granted in future periods.

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-ending December 2005, 2004, and 2003.

TABLE 1

NET INTEREST INCOME

(In Thousands)	Year-Ended December 31,		
	2005	2004	2003
Total Interest Income	\$ 20,906	\$ 19,959	\$ 19,900
Tax Equivalent Adjustment	1,174	1,175	906
Total Tax Equivalent Interest Income	22,080	21,134	20,806
Total Interest Expense	8,248	7,084	7,574
Net Interest Income (Fully Tax Equivalent Basis)	\$ 13,832	\$ 14,050	\$ 13,232

Table 2 includes the average balances, interest income and expense, and the average rates earned and paid for assets and liabilities. Yields on tax-exempt assets have not been calculated on a fully-tax-equivalent basis. 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.

Distribution of Assets, Liabilities and Stockholders' Equity
Interest Rates and Interest Differential

TABLE 2

(In Thousands)	Year-Ended December 31, 2005			Year-Ended December 31, 2004			Year-Ended December 31, 2003		
	Average Balance	Interest	Yield/ Rate	Average Balance	Interest	Yield/ Rate	Average Balance	Interest	Yield/ Rate
ASSETS									
Loans									
Real Estate	\$ 108,887	\$ 7,048	6.47%	\$ 107,956	\$ 7,045	6.53%	\$ 108,030	\$ 7,654	7.09%
Installment	17,587	1,304	7.41%	17,561	1,178	6.71%	17,862	1,252	7.01%
Commercial	104,317	7,058	6.77%	99,935	6,208	6.21%	93,781	5,907	6.30%
Tax Exempt	19,136	757	3.96%	14,937	593	3.97%	8,993	379	4.21%
Other Loans	632	53	8.39%	648	47	7.25%	627	44	7.02%
Total Loans	250,559	16,220	6.47%	241,037	15,071	6.25%	229,293	15,236	6.60%
Investment Securities (AFS)									
Taxable	72,358	3,086	4.26%	72,816	3,152	4.33%	78,890	3,250	4.12%
Non-Taxable	39,386	1,523	3.87%	41,257	1,687	4.09%	30,515	1,380	4.52%
Total Securities	111,744	4,609	4.12%	114,073	4,839	4.24%	109,405	4,630	4.23%
Fed Funds Sold	2,093	77	3.68%	3,796	49	1.29%	2,922	34	1.16%
Total Earning Assets	364,396	\$ 20,906	5.74%	358,906	\$ 19,959	5.56%	341,620	\$ 19,900	5.80%
Less: Allowance for									
Loan Losses	(2,601)			(2,398)			(2,027)		
Cash and Due from									
Banks	6,526			6,535			6,598		
Premises and									
Equipment, Net	5,565			4,644			4,331		
Other Assets									
	12,167			11,130			10,502		
Total Assets	\$ 386,053			\$ 378,817			\$ 361,024		
(In Thousands)									
LIABILITIES AND STOCKHOLDERS' EQUITY									
Deposits									
Interest Bearing									
Demand	\$ 24,207	\$ 169	0.70%	\$ 26,282	\$ 190	0.72%	\$ 24,568	\$ 217	0.88%
Regular Savings	72,597	1,258	1.73%	63,414	637	1.00%	58,926	763	1.29%
Money Market Savings	37,232	911	2.45%	39,778	559	1.41%	35,254	536	1.52%
Time	107,115	3,448	3.22%	111,431	3,392	3.04%	114,956	3,907	3.40%
Total Interest Bearing	241,151	5,786	2.40%	240,905	4,778	1.98%	233,704	5,423	2.32%
Other Borrowings									
	57,987	2,462	4.25%	53,957	2,306	4.27%	49,903	2,151	4.31%
Total Interest Bearing	299,138	8,248	2.76%	294,862	7,084	2.40%	283,607	7,574	2.67%
Liabilities									
Net Interest Spread		\$ 12,658	2.98%		\$ 12,875	3.16%		\$ 12,326	3.13%
Non-Interest Bearing									
Demand Deposits	45,574			41,315			36,607		
Accrued Expenses and									
Other Liabilities	1,959			1,554			1,572		
Stockholder's Equity	39,382			41,086			39,238		

Total Liabilities and Stockholder's Equity	\$ 386,053	\$ 378,817	\$ 361,024
Interest Income/Earning Assets		5.74 %	5.52%
Interest Expense/Earning Assets		2.26 %	1.97%
Net Interest Margin		3.47 %	3.59%
			5.83%
			2.22%
			3.61%

TABLE 3

Rate/Volume Analysis of Changes in Net Interest Income

(In Thousands)	2005 to 2004			2004 to 2003		
	Increase Decrease	Change Due to Rate	Volume	Increase Decrease	Change Due to Rate	Volume
Interest Income						
Real Estate Loans	\$ 3	\$ (57)	\$ 60	\$ (609)	\$ (604)	\$ (5)
Installment Loans	126	124	2	(74)	(54)	(20)
Commercial Loans	850	554	296	301	(73)	374
Tax Exempt Loans	164	(2)	166	214	(22)	236
Other Loans	6	7	(1)	3	2	1
Total Loans	1,149	626	523	(165)	(751)	586
Investment Securities (AFS)						
Taxable	(66)	(46)	(20)	(98)	165	(263)
Non-Taxable	(164)	(92)	(72)	307	(133)	440
Total Securities (AFS)	(230)	(138)	(92)	209	32	177
Time Deposits with Other Banks						
Fed Funds Sold	28	91	(63)	15	4	11
Total Interest Income	947	579	368	59	(715)	774
Interest Expense						
Interest Bearing Demand Deposits						
Regular Savings Deposits	(21)	(7)	(14)	(27)	(39)	12
Money Market Savings Deposits	621	462	159	(126)	(171)	45
Time Deposits	352	414	(62)	23	(41)	64
Total Interest Bearing Deposits	56	195	(139)	(515)	(408)	(107)
Other Borrowings	1,008	1,064	(56)	(645)	(659)	14
Total Interest Expense	156	(15)	171	155	(18)	173
Net Interest Spread	1,164	1,049	115	(490)	(677)	187
Net Interest Spread	\$ (217)	\$ (470)	\$ 253	\$ 549	\$ (38)	\$ 587

Interest income on total loans increased in 2005. This increase of \$1,149,000 is shown in Table 3. Higher interest rates had a positive impact on the Bank's interest income of \$579,000 in our year-to-year comparisons of loan interest income as shown in Table 3. Although loan growth had a positive impact on the bottom line of \$368,000, it was the higher rates that played the largest part in the \$947,000 increase in interest income. Table 2 shows the average balance in loans grew from \$241,037,000 in 2004 to \$250,559,000 in 2005. Investments declined from \$114,073,000 in 2004 to \$111,744,000 in 2005, and the interest income in total securities for the year shows a decrease of \$230,000 compared to 2004. The decrease in rate had a negative impact on earnings of \$138,000 as did the decline in the balance of the investment portfolio which took another \$92,000 from earnings.

Interest income on taxable investments decreased \$66,000 from 2004 due to fewer investments and lower rates. Average taxable investments, as shown in Table 2, were \$72,358,000 in 2005 compared to \$72,816,000 in 2004. Due to the lower rates, interest income on taxable investments only dropped \$46,000. Interest income on non-taxable investments decreased \$164,000 from 2004 due to lower rates and lower volume. Average non-taxable investments

were \$39,386,000 in 2005 compared to \$41,257,000 in 2004. Interest income from federal funds sold increased \$28,000 from 2004 to 2005 because of higher interest rates, as shown in Table 3. Average federal funds sold were \$2,093,000 in 2005 compared to \$3,796,000 in 2004.

For comparison, interest income on total loans decreased in 2004 from 2003. This decrease of \$165,000 is shown in Table 3. Lower interest rates had a negative impact on the Bank's earnings of \$751,000 in our year-to-year comparisons of loan interest income as show in Table 3. Although loan growth had a positive impact on the bottom line of \$586,000, it was not enough to keep the earnings on loans even with the previous year. Table 2 shows the average balance in loans grew from \$229,293,000 in 2003 to \$241,037,000 in 2004. A similar analysis can be seen in the total securities portfolio, but ending with different results because of rate. Investments grew from \$109,405,000 in 2003 to \$114,073,000 in 2004, the interest income for the year shows an increase of \$211,000 compared to 2003. The increase in rate caused a positive impact to earnings of \$34,000 as did the growth in the investment portfolio which added \$177,000 more to earnings.

Interest income on taxable investments decreased \$97,000 from 2003 to 2004 due to fewer investments in taxable securities. Average taxable investments, as shown in Table 2, were \$72,816,000 in 2004 compared to \$78,890,000 in 2003. Due to the higher rates however, interest income on taxable investments only dropped \$97,000. Interest income on non-taxable investments increased \$308,000 from 2003 due to more volume. Average non-taxable investments were \$41,257,000 in 2004 compared to \$30,515,000 in 2003.

On the interest expense side, overall interest expense increased by \$1,164,000. Of the total increase, the largest portion is attributable to higher rates. The deposit interest costs increased \$1,064,000 over 2004 costs because of rate. Costs for other borrowed funds increased by \$156,000 over 2004 costs. The driver in this increase was the increase in borrowings. In 2004 the average balance of borrowed funds was \$53,957,000 compared to the average balance of \$57,987,000 in 2005.

For comparison, on the interest expense side, average deposits grew during 2004 by \$7,201,000 when compared to 2003 as shown in the average balance comparisons in Table 2. This added more expense for 2004, as shown in Table 3, as \$14,000 in the "Volume" column. The decrease in rates helped this side of the balance sheet with reducing interest expense by \$659,000 on deposits. The rate effect also caused a decrease of \$18,000 on borrowed funds. We did add more in other borrowings in 2004 as shown in Table 2. The average borrowings in 2003 were \$49,903,000 compared to an average of \$53,957,000 in 2004. Borrowing these funds cost the Bank an additional \$173,000 for the year as shown in Table 3.

The net interest spread decreased by \$217,000 from 2004. In the bottom line of Table 3, you can see that \$470,000 of this decrease was related to the change in rates. The Bank was able to offset part of the negative impact of the rate environment with growth which contributed an increase of \$253,000 to 2005 income.

For the final comparison, the net effect of the income and expense changes, comparing 2004 to 2003, is shown in the last row of Table 3. The Bank increased net interest income by \$549,000 from 2003 to 2004. Net interest income was reduced by \$38,000 in rate on its existing portfolio, and gained \$587,000 in additional revenue from new business.

PROVISION FOR LOAN LOSS

The provision and allowance for loan losses are based on management's ongoing assessment of the Company's credit exposure and consideration of other relevant factors. The allowance for loan losses is a valuation reserve that is available to absorb future loan charge-offs. The provision for loan losses is the amount charged to earnings on an annual basis. The factors considered in management's assessment of the reasonableness of the allowance for loan losses include prevailing and anticipated economic conditions, assigned risk ratings on loan exposures, the results of examinations and appraisals of the loan portfolio conducted by federal regulatory authorities and an independent loan review firm, the diversification and size of the loan portfolio, the level of and inherent risk in non-performing assets, and any other factors deemed relevant by management.

The provision for loan losses was \$392,000, \$1,050,000 and \$289,000 for the years 2005, 2004, and 2003, respectively. Net charge-offs for 2005 were \$756,000 compared to \$404,000 in 2004. As of December 31, 2005, the allowance for loan loss was .92% of loans and at December 31, 2004, the ratio was 1.12% of loans. After allocation of reserves to all non-accrual and special-mention loans, as well as applying a percentage of outstanding loans based on the loss history of such loans in each category, the opinion of management was that the provision for loan loss was proper and sufficient. The ratio of allowance for loan loss to non-performing loans was 183.74% at year-end 2005 compared to 116.29% at year-end 2004 and 192.20% at year-end 2003.

The following table analyzes the increase in total other income by comparing the years-ending 2005, 2004 and 2003.

TABLE 4

NON-INTEREST INCOME

(In Thousands)	December 31,			Variance 2005		Variance 2004	
	2005	2004	2003	Amount Of Change	Percent Of Change	Amount Of Change	Percent Of Change
Customer Service Fees	\$ 1,749	\$ 1,489	\$ 1,296	\$ 260	17.46 %	\$ 193	14.89 %
Investment Division							
Commission Income	201	426	182	(225)	(52.82)%	244	134.07 %
Earnings on Investment on Life							
Insurance	263	236	202	27	11.44 %	34	16.83 %
Other Income	372	429	249	(57)	(13.29)%	180	72.29 %
Gains on Security Sales	222	296	662	(74)	(25.00)%	(366)	(55.29)%
Impairment of Securities	0	(1,144)	0	1,144	100.00 %	(1,144)	100.00 %
TOTAL Other Income	\$ 2,807	\$ 1,732	\$ 2,591	\$ 1,075	62.07 %	\$ (859)	(33.15)%

OTHER INCOME**Non-Interest Income**

Non-interest income includes items that are not related to interest rates, but rather to services rendered and activities conducted in conjunction with the operation of a commercial bank. Service charges earned on deposit accounts is the largest single item in this category and represents fees related to deposit accounts including overdraft fees, minimum balance fees, and transaction fees. In 2005, service charges and fees increased \$260,000 or 17.46% compared to an increase of \$193,000 in 2004, when compared to 2003, or 14.89%.

There was an overall increase in non-interest income of \$1,075,000 in 2005. The increase of 62.07% in 2005 is due to an other-than-temporary security impairment incurred in the fourth quarter of 2004. At the time, the Company owned four preferred equity securities issued by FNMA and FHLMC with aggregate market value depreciation of 20% or more from the Company's amortized cost basis of \$5,000,000. Management had been closely monitoring the market valuations of those preferred equity securities and determined that due to adverse financial events surrounding those agencies that the best course of action, at the time, would be to record an other-than-temporary impairment on those securities in that reporting period under guidance provided by the Financial Accounting Standards Board (FASB). Thus, an impairment charge of \$1,144,000 was recorded in non-interest income in the fourth quarter of 2004. Without that impairment charge in 2004, non-interest income would show an overall decrease of \$69,000, or 2.40%, in 2005.

For comparison, there was an overall decrease in non-interest income of \$859,000 in 2004 when compared to 2003. This decrease of 33.15% was due primarily to an other-than-temporary security impairment incurred in the fourth quarter of 2004. The Company owned four preferred equity securities issued by FNMA and FHLMC with aggregate market value depreciation of 20% or more from the Company's amortized cost basis of \$5,000,000. Management had been closely monitoring the market valuations of these preferred equity securities and adverse financial events regarding these agencies, and concluded that these securities were other-than-temporarily impaired under guidance provided by the Financial Accounting Standards Board (FASB). Thus, an impairment charge of \$1,144,000 was recorded in other income in the fourth quarter of 2004. Without the security impairment in that year, non-interest income would have shown an increase of \$285,000, or 11%.

A major component of non-interest income, which reflects an increase, is income realized on overdrafts of \$1,249,000 in 2005 compared to \$1,029,000 in 2004. The Company entered into an overdraft privilege program in June of 2004, which significantly increased the amount of overdraft fees recognized by the Company, with a full-year effect recognized in 2005. Commissions earned by the Investment Division in 2005 were \$201,000, compared to \$426,000 in 2004, a decrease of \$225,000, or 52.82%. In 2005, the Bank scaled back the underwriting of annuities by its Licensed Bank Employees. Earnings on Investment in Life Insurance were \$263,000 in 2005, compared to \$236,000 in 2004, an increase of \$27,000, or 11.44%. This was due to the purchase of an additional \$2,000,000 in Bank Owned Life Insurance (BOLI) in June of 2004 and the associated earnings on the additional BOLI for the full twelve months in 2005, as opposed to seven months of earnings in 2004 on that same BOLI policy.

As with 2005, a major component of non-interest income, which reflected a significant increase in 2004, was income realized on overdrafts of \$1,029,000 in 2004, compared to \$845,000 in 2003. In addition to the overdraft fee being increased in the fourth quarter of 2003 to \$30 from \$25, the Company entered into an overdraft privilege program in June of 2004 which significantly increased the amount of overdraft fees recognized by the Company. Commissions earned by the Investment Division in 2004 were \$426,000, compared to \$182,000 in 2003, an increase of \$244,000, or 134.07%. In 2004, the Bank added five Licensed Bank Employees to the Investment Division. These employees are licensed to sell life insurance and annuity products. Due to a high demand for these products within the Bank's operating regions, sales and related commissions increased dramatically in 2004 when compared to 2003.

Other income was \$372,000 in 2005, compared to \$429,000 in 2004, a decrease of \$57,000, or 13.29%. This was primarily due to the decrease of funds received as settlement of the net fraud claim involving certificates of deposit invested in through Entrust Group and Bentley Financial Services, Inc. to \$27,000 in 2005. Related receipts in 2004 totaled \$110,000. Lastly, in 2005, the Company had \$222,000 in realized gains through sales of available-for-sale securities compared to \$296,000 in 2004. This is a decrease of \$74,000, or 25.00%.

Other income increased by \$180,000, or 72.29%, in 2004 to \$429,000, compared to \$249,000 in 2003. The two major components of other income, which contributed to this increase, were 2004 receipts which surpassed the net fraud claim involving certificates of deposit invested in through Entrust Group and Bentley Financial Services, Inc., in the amount of \$110,000, and fees earned through the sale of mortgage loans to the Federal Home Loan Bank of Pittsburgh, which amounted to \$61,000 in 2004. Both of these events were new in 2004. Realized gains on the sale of available-for-sale securities were a component of non-interest income which showed a decrease in 2004. Realized gains in 2004 were \$296,000, a decrease of \$366,000, or 55.29%.

TABLE 5

NON-INTEREST EXPENSE

(In Thousands)	December 31,			Variance 2005		Variance 2004	
	2005	2004	2003	Amount Of Change	Percent Of Change	Amount Of Change	Percent Of Change
Salaries and Benefits	\$ 4,423	\$ 4,048	\$ 3,694	\$ 375	9.26 %	\$ 354	9.58%
Occupancy Expenses	564	489	442	75	15.34 %	47	10.63%
Furniture and Equipment Expense	427	336	299	91	27.08 %	37	12.37%
FDIC Insurance and Assessments	141	140	135	1	.71 %	5	3.70%
Professional Fees and Outside Services	471	297	240	174	58.59 %	57	23.75%
Prepayment Penalty - FHLB	808	0	0	808	100.00 %	0	0.00
Computer Services and Supplies	778	617	521	161	26.09 %	96	18.43%
Taxes, Other Than Payroll and Income	324	383	311	(59)	(15.40)%	72	23.15%
Other Operating Expenses	1,676	1,780	1,592	(104)	(5.84)%	188	11.81%
Total Non-Interest Expense	\$ 9,612	\$ 8,090	\$ 7,234	\$ 1,522	18.81 %	\$ 856	11.83%

OTHER EXPENSE**Non-Interest Expense**

Total non-interest expense increased \$1,522,000 from \$8,090,000 in 2004 to \$9,612,000 in 2005. This is an increase of 18.81%.

Non-interest expense includes all other expenses associated with the Company. Salaries and related benefits is the largest expense in this category and it increased \$375,000, or 9.26%, over year-end 2004. The full-time equivalent number of employees was 114 as of December 31, 2005, compared to 104 as of December 31, 2004 due to the addition of staff in 2005 when compared to 2004. A portion of the additional staff was hired in conjunction with 2005 branch expansion. In addition to the increased staff size, normal yearly pay increases and increased health insurance costs contributed to the overall increase in salary and benefit expense. In comparison, the increase in this category from 2003 to 2004 was 9.58%, or \$354,000. New employees and annual salary increases, along with an increase for health insurance also were the reasons for the 2004 increase.

For comparison, salaries and related benefits increased \$354,000, or 9.58%, in 2004 over year-end 2003. The full-time equivalent number of employees was 104 as of December 31, 2004, compared to 97 as of December 31, 2003 due to the addition of staff in 2004 when compared to 2003. A portion of the additional staff was hired in 2004 in preparation for the 2005 branch expansion. In addition to the increased staff size, normal yearly pay increases and increased health insurance costs contributed to the overall increase in salary and benefit expense.

Occupancy expense increased 15.34%, or \$75,000, in 2005 as compared to 2004 when occupancy expense increased 10.63%, or \$47,000. The increase in 2005 can be attributed to various factors which include; increased heating costs associated with the rise in energy prices experienced during the winter months of 2005, increased depreciation expense incurred on buildings and improvements placed in service for the Deposit, New York and Town of Chenango, New York offices opened in 2005 and lastly, additional property tax and lease costs associated with those offices.

This compares to 2004 when occupancy expense increased 10.63%, or \$47,000, as compared to 2003. The increase in 2004 was attributed to increased heating costs experienced during the winter months of 2004.

Furniture and equipment expense increased in 2005 to \$427,000, or 27.08%, compared to 2004 at \$336,000 which was up from 2003 expenses of \$299,000. The increase in 2005 is associated with depreciation expense incurred on additional computer software and equipment, as well as equipment and furnishings for the new Deposit, New York and Town of Chenango, New York offices placed in service in 2005.

For comparison, furniture and equipment expense increased in 2004 to \$336,000, or 12.37%, compared to 2003 at \$299,000. The increase in 2004 was associated with depreciation expense incurred on additional computer software and equipment placed in service in 2004.

Professional fees and outside services were \$471,000 in 2005 which compares to \$297,000 in 2004 and \$240,000 in 2003. The increase in 2005 is due to increased costs incurred by the Company in relation to testing and compliance with section 404 of the Sarbanes-Oxley Act of 2002 and consulting performed in connection with the new overdraft privilege program which was implemented in June 2004, as well as various consulting and legal services incurred in 2005, which were not incurred in 2004.

For comparison, professional fees and outside services increased to \$297,000 in 2004, compared to \$240,000 in 2003. The increase in 2004 was also due to increased costs incurred by the Company in relation to testing and compliance with section 404 of the Sarbanes-Oxley Act of 2002, as well as consulting performed in connection with a new personal computer network and on-line teller system installed at the Bank's branch offices.

Other non-interest expense was negatively impacted as the result of a prepayment penalty associated with the early retirement of long-term debt at the Federal Home Loan Bank of Pittsburgh. The penalty was incurred in conjunction with the prepayment of \$10,000,000 in term borrowings and was in the amount of \$808,000. This was a one-time charge in 2005, which was not incurred in 2004, nor will it be a recurring charge in future periods.

Computer services and supplies is another component of other expenses. This category covers the expense of data processing for the Company. In 2005, the expense was \$778,000 compared to \$617,000 in 2004 and \$521,000 in 2003. The increases are due to costs associated with maintenance agreements for various computer equipment utilized in the operation of the Bank. With the introduction of an on-line teller system and internet banking services over the past two years, these costs have continued to rise.

Taxes, other than payroll and income, are another significant component of non-interest expense. In 2005, this expense decreased by \$59,000, or 15.40%, to \$324,000, compared to 2004 at \$383,000. In 2005, shares tax owed to Pennsylvania was curtailed through credits received in conjunction with educational grants made to the Community

Foundation of Susquehanna County in the amount of \$90,000.

For comparison, taxes, other than payroll and income increased in 2004, to \$383,000, compared to \$311,000 in 2003, an increase considered to be normal.

Every other non-interest expense is in the category of other. In 2005, this expense decreased \$104,000, or 5.84%, and the total for 2005 is \$1,676,000. The remaining components in this figure were: the amortization of premiums on the purchase of the Tunkhannock, Meshoppen, and Conklin branch offices at \$262,000; directors' and associate directors' fees, and employee education costs of \$297,000; stationary printing and supplies, \$216,000; postage at \$152,000; advertising at \$151,000; and ATM expenses of \$301,000. All were deemed to be in line with budget expectations.

This compares to 2004 when this expense increased \$188,000, or 11.81%, from \$1,592,000 in 2003. The biggest components in this figure again were: the amortization of premiums on the purchase of the Tunkhannock, Meshoppen, and Conklin branch offices at \$262,000; directors' and associate directors' fees, and employee education costs of \$293,000; stationary printing and supplies, \$171,000; postage at \$147,000; advertising at \$123,000; expenses associated with other real estate owned in the amount of \$166,000; and ATM expenses of \$238,000. These were also deemed to be in line with budget expectations, with the exception of expenses on other real estate owned which were dramatically increased due to the foreclosure of two large commercial loan accounts in 2003 and 2004.

FEDERAL INCOME TAXES

The provision for income taxes was \$985,000 in 2005, compared to \$1,014,000 in 2004 and \$1,830,000 in 2003. The effective tax rate, which is the ratio of income tax expense to income before taxes, was 18% in 2005, 19% in 2004, and 25% in 2003. The tax rate for all periods was substantially less than the federal statutory rate of 34% primarily due to tax-exempt securities and tax-exempt loan income. The effective tax rate declined in 2005 and 2004 from 2003 due to lower pre-tax income and higher tax exempt income. Please refer to Note 9 of the Notes to Consolidated Financial Statements included as part of this report for further analysis of federal income tax expense for 2005.

QUARTERLY RESULTS

Table 6 shows the quarterly results of operations for the Company for 2005. Interest Income increased in all four quarters of 2005. This was due to the Federal Reserve Bank's rate increases which were implemented in 25 basis point increments and the resulting 25 basis point increase to the Prime Rate. These increases occurred at each meeting of the Federal Reserve's Open Market Committee (FOMC) throughout 2005. By December 31, 2005, the overnight funds rate had increased eight times to 4.25% from 2.25% at the end of 2004 and the Prime Rate had increased to 7.25% from 5.25% at the end of 2004. Many of the Bank's loans are tied directly to Prime and this, along with an overall 6.11% increase in loan balances, accounts for the increase in interest income.

Interest expense has also increased in all four quarters of 2005 due to the reasons outlined in the previous paragraph. Many deposit accounts are tied to indexes which reflect closely the short-end of the yield curve (Fed Funds) and therefore, as rates go up in 25 basis point increments, so does the resulting interest expense. As with loans, the 7.94% increase in interest-bearing deposits also played a key role in the increased interest expense in 2005.

Table 6 also shows that less gains were taken in sales of available-for-sale securities in 2005 when compared to 2004. This was due in part to increasing yields in the bond markets which increased with Federal Reserve rate increases. When this happens, yields within the Bank's portfolio become less attractive and the marketability or market value of bonds in that portfolio decrease. The result is that the Bank has fewer securities that can be sold at a gain.

Other income increased steadily throughout 2005. The Bank implemented an overdraft privilege program in June of 2004. With this program, the Bank saw its overdraft fees increase in the latter half of 2004 and throughout 2005, the first full year on the program.

Other expenses fluctuated throughout 2005. Significant increases were incurred for professional services contracted for by the Bank in relation to testing and compliance with Section 404 of the Sarbanes Oxley Act of 2002, increased occupancy expenses experienced due to increased winter heating costs in 2005 and documented increases within salary and benefits as well as depreciation expense, both the result of the addition of two new offices in 2005. The largest fluctuation however, was due to the penalty incurred on the early retirement of FHLB debt. This occurred in

the third quarter of 2005.

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Earnings per common share remained stable throughout 2005. The decrease in the third quarter was the result of the prepayment penalty paid to the FHLB Pittsburgh in relation to the early retirement of \$10,000,000 of long-term debt.

TABLE 6

Quarterly Results of Operations

(In Thousands, Except for Per Share Data)

	Quarter Ended 2005							
	31-Mar		30-Jun		30-Sep		31-Dec	
Interest Income	\$	5,007	\$	5,151	\$	5,284	\$	5,464
Interest Expense		(1,875)		(1,997)		(2,178)		(2,198)
Net Interest Income		3,132		3,154		3,106		3,266
Provision for Loan Loss		0		0		0		(392)
Securities Gains/Losses		25		109		53		35
Other Income		612		624		658		691
Other Expense		(2,168)		(2,384)		(3,045)		(2,015)
Income Before taxes		1,601		1,503		772		1,585
Income Taxes		(327)		(315)		(52)		(291)
Net Income	\$	1,274	\$	1,188	\$	720	\$	1,294
Basic Earnings per share	\$	0.40	\$	0.38	\$	0.23	\$	0.41
Diluted Earnings per share	\$	0.40	\$	0.38	\$	0.22	\$	0.41

	Quarter Ended 2004							
	31-Mar		30-Jun		30-Sep		31-Dec	
Interest Income	\$	4,973	\$	4,926	\$	5,017	\$	5,043
Interest Expense		(1,762)		(1,758)		(1,785)		(1,779)
Net Interest Income		3,211		3,168		3,232		3,264
Provision for Loan Loss		(159)		(741)		(150)		0
Securities Gains/Losses		55		21		105		115
Impairment of Security		0		0		0		(1,144)
Other Income		562		603		668		747
Other Expense		(1,974)		(2,037)		(2,042)		(2,037)
Income Before taxes		1,695		1,014		1,813		945
Income Taxes		(398)		(123)		(394)		(99)
Net Income	\$	1,297	\$	891	\$	1,419	\$	846
Basic Earnings per share	\$	0.41	\$	0.28	\$	0.45	\$	0.27
Diluted Earnings per share	\$	0.41	\$	0.28	\$	0.44	\$	0.27

RETURN ON AVERAGE ASSETS AND AVERAGE EQUITY

Return on average assets (ROA) measures the Company's net income in relation to its total average assets. The Company's ROA for 2005 was 1.16%, compared to 1.18% in 2004.

Return on average equity (ROE) indicates how effectively the Company can generate net income on the capital invested by its stockholders. ROE is calculated by dividing net income by average stockholders' equity. For purposes of calculating ROE, average stockholders' equity includes the effect of unrealized gains (losses), net of income taxes, on securities available for sale, reflected as accumulated other comprehensive income. Reference should be made to Note 3 in the Notes to Consolidated Financial Statements for an analysis of securities available for sale. The Company's ROE for 2005 was 11.37%, compared to 10.84% for 2004.

FINANCIAL CONDITION

The Company's financial condition can be evaluated in terms of trends in its sources and uses of funds. The following table illustrates how the Company has managed its sources and uses of funds that are directly affected by outside economic factors, such as interest rate fluctuations:

TABLE 7

Sources, Uses of Funds

(In Thousands)

Funding Uses	2005			2004			Average Balance
	Average Balance	Increase (Decrease) Amount	(Decrease) Percent	Average Balance	Increase (Decrease) Amount	(Decrease) Percent	
Real Estate Loans	\$ 108,887	\$ 931	0.86 %	\$ 107,956	\$ (74)	(0.07)%	\$ 108,030
Consumer Loans	17,587	26	0.15 %	17,561	(301)	(1.69)%	17,862
Commercial Loans	104,317	4,382	4.38 %	99,935	6,154	6.56 %	93,781
Tax Exempt Loans	19,136	4,199	28.11 %	14,937	5,944	66.10 %	8,993
Other Loans	632	(16)	(2.47)%	648	21	3.35 %	627
Total Loans	250,559			241,037			229,293
Less Allowance for Loan Loss	(2,601)			(2,398)			(2,027)
Total Loans with Loan Loss	247,958	9,319	3.91 %	238,639	11,373	5.00 %	227,266
Taxable Securities (Include CDS)	72,358	(458)	(0.63)%	72,816	(6,074)	(7.70)%	78,890
Non-Taxable Securities	39,386	(1,871)	(4.53)%	41,257	10,742	35.20 %	30,515
Total Securities	111,744	(2,329)	(2.04)%	114,073	4,668	4.27 %	109,405
Fed Funds Sold	2,093	(1,703)	(44.86)%	3,796	874	29.91 %	2,922
Total Uses	\$ 361,795	\$ 5,287	1.48 %	\$ 356,508	\$ 16,915	4.98 %	\$ 339,593

Funding Sources	2005			2004			2003 Average Balance
	Average Balance	Increase (Decrease) Amount	(Decrease) Balance Percent	Average Balance	Increase (Decrease) Amount	(Decrease) Percent	
Interest Bearing Demand Deposits	\$ 24,207	\$ (2,075)	(7.90)%	\$ 26,282	\$ 1,714	6.98 %	\$ 24,568
Regular Savings Deposits	72,597	9,183	14.48 %	63,414	4,488	7.62 %	58,926
Money Market Savings Deposits	37,232	(2,546)	(6.40)%	39,778	4,524	12.83 %	35,254
Time Deposits	107,115	(4,316)	(3.87)%	111,431	(3,525)	(3.07)%	114,956
Total Interest Bearing Deposits	241,151	246	0.10 %	240,905	7,201	3.08 %	233,704
Other Borrowing	57,987	4,030	7.47 %	53,957	4,054	8.12 %	49,903
Short-Term Funds Borrowed	12,047			9,809			8,750
Long-Term Funds Borrowed	45,940			44,148			41,153

Total Funds			
Borrowed	57,987	53,957	49,903
Total Deposits and			
Funds Borrowed	299,138	294,862	283,607
Other Sources, net	62,657	61,646	55,986
Total Sources	\$ 361,795	\$ 356,508	\$ 339,593

Total assets increased 3.12% to \$391,198,000 in the year-ending December 31, 2005. The increase in total assets is attributable to increases in the loan portfolio. Of this loan growth, the most significant increase was in commercial loans which grew by \$12,413,000, or 10.38%. Much of the loan growth was fueled by the overall growth in deposits which increased by \$22,187,000, or 8.07%. The growth in deposits was somewhat offset on the liability side by the decrease in long-term borrowings of \$11,264,000, or 24.47%. In 2004, total assets increased 2.1% to \$379,375,000.

Investments at year-end 2005 totaled \$108,313,000, compared to \$113,598,000 on December 31, 2004, a decrease of \$5,285,000, or 4.65%.

Short-term borrowings increased to \$17,842,000 at year-end 2005, compared to \$14,614,000 the previous year.

Loan Portfolio Types

In 2005, loans to commercial borrowers helped fuel the growth in net loans. Residential mortgage loans increased only slightly with lower interest rates and mortgage finance companies making growth in this part of our loan portfolio tougher.

TABLE 8

Loan Portfolio

(In Thousands)

	Dec 2005	Dec 2004	Dec 2003	Dec 2002	Dec 2001
Commercial	\$ 132,054	\$ 119,641	\$ 112,617	\$ 95,113	\$ 73,422
Residential Real Estate Mortgage	109,034	106,454	105,949	107,756	101,934
Consumer	17,780	18,375	17,525	18,385	18,414
Total Loans	258,868	244,470	236,091	221,254	193,770
Deferred Loans	377	344	276	118	(41)
Total Loans, net of Deferred	259,245	244,814	236,367	221,372	193,729
Allowance for Loan Loss	(2,375)	(2,739)	(2,093)	(1,935)	(1,816)
Net Loans	\$ 256,870	\$ 242,075	\$ 234,274	\$ 219,437	\$ 191,913

Loans continued to increase in 2005, ending the year with \$256,870,000 in net loans compared to \$242,075,000 at year-end 2004, an increase of 6.11%. Commercial loans grew 10.38% to close the year at \$132,054,000, compared to \$119,641,000 at year-end 2004.

Mortgages were up 2.3% to \$109,034,000, compared to \$106,454,000 on December 31, 2004, an increase of \$2,580,000. Although our mortgage portfolio grew modestly in 2005, there was an additional \$2,180,000 sold to the FHLB of Pittsburgh. The Bank will continue to sell mortgages on the secondary market in order to attract and retain mortgage loans by offering more competitive rates and terms.

The continued growth in commercial lending was due, in part, to a concerted effort on our part to continue to increase our exposure to this business segment.

Loan Maturities

Table 9 shows the breakdown in maturity and type of our loan portfolio, net of non-accrual loans.

The Bank has 15.93% of its loans maturing within the next year. Of those maturing within one year, the majority are commercial loans with the remainder split between mortgages and consumer loans. In the one-to-five year maturity range, the Bank has 22.63% of its loan portfolio maturing. The over-five-year maturity group makes up 61.44% of the portfolio.

For comparison, at December 31, 2004, the Bank had 15.54% of its loans maturing within one year. Of those maturing within one year, the majority again were commercial loans with the remainder split between mortgages and consumer loans. In the one-to-five year maturity range, the Bank had 24.22% of its portfolio. The over-five-year maturity group made up 60.24% of the portfolio, which again reflected the Bank's significant investment in mortgages. Mortgages were 42% of the total loan portfolio.

TABLE 9
(In Thousands)

One Year Or Less	Over One Year Within Five Years	Over Five Years	Total
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