

PEOPLES FINANCIAL SERVICES CORP.

Form 10-Q

November 08, 2018

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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

Form 10-Q

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

for the quarterly period ended September 30, 2018

or

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

for the transition period from

001-36388

(Commission File Number)

PEOPLES FINANCIAL SERVICES CORP.

(Exact name of registrant as specified in its charter)

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

(570) 346-7741

(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit such files). Yes No

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

| | |
|-------------------------|---------------------------|
| Large accelerated filer | Accelerated filer |
| Non-accelerated filer | Smaller reporting company |
| Emerging growth company | |

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

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

APPLICABLE ONLY TO CORPORATE ISSUERS:

Indicate the number of shares outstanding of the registrant's common stock, as of the latest practicable date: 7,399,054 at October 31, 2018.

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For the Quarter Ended September 30, 2018

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Peoples Financial Services Corp.

CONSOLIDATED BALANCE SHEETS

(Dollars in thousands, except share data)

| | (Unaudited) | |
|--|--------------------|-------------------|
| | September 30, 2018 | December 31, 2017 |
| Assets: | | |
| Cash and due from banks: | | |
| Cash and due from banks | \$ 40,458 | \$ 36,336 |
| Interest-bearing deposits in other banks | 137 | 1,152 |
| Total cash and due from banks | 40,595 | 37,488 |
| Investment securities: | | |
| Available-for-sale | 274,794 | 272,502 |
| Equity investments carried at fair value | 291 | 46 |
| Held-to-maturity: Fair value September 30, 2018, \$8,435; December 31, 2017, \$9,547 | 8,551 | 9,274 |
| Total investment securities | 283,636 | 281,822 |
| Loans, net | 1,779,445 | 1,693,065 |
| Less: allowance for loan losses | 20,413 | 18,960 |
| Net loans | 1,759,032 | 1,674,105 |
| Loans held for sale | 98 | 106 |
| Premises and equipment, net | 37,467 | 37,557 |
| Accrued interest receivable | 6,565 | 6,936 |
| Goodwill | 63,370 | 63,370 |
| Intangible assets, net | 2,507 | 3,178 |
| Other assets | 64,573 | 64,469 |
| Total assets | \$ 2,257,843 | \$ 2,169,031 |
| Liabilities: | | |
| Deposits: | | |
| Noninterest-bearing | \$ 404,293 | \$ 380,729 |
| Interest-bearing | 1,423,571 | 1,338,289 |
| Total deposits | 1,827,864 | 1,719,018 |
| Short-term borrowings | 99,450 | 123,675 |
| Long-term debt | 48,461 | 49,734 |
| Accrued interest payable | 745 | 497 |
| Other liabilities | 8,352 | 11,131 |
| Total liabilities | 1,984,872 | 1,904,055 |
| Stockholders' equity: | | |
| Common stock, par value \$2.00, authorized 25,000,000 shares, issued and outstanding 7,399,054 shares at September 30, 2018 and 7,396,505 at December 31, 2017 | 14,798 | 14,793 |
| Capital surplus | 135,226 | 135,043 |

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|--|--------------|--------------|
| Retained earnings | 132,631 | 121,353 |
| Accumulated other comprehensive loss | (9,684) | (6,213) |
| Total stockholders' equity | 272,971 | 264,976 |
| Total liabilities and stockholders' equity | \$ 2,257,843 | \$ 2,169,031 |

See notes to unaudited consolidated financial statements

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Peoples Financial Services Corp.

CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME (UNAUDITED)

(Dollars in thousands, except per share data)

| September 30, | Three Months Ended | | Nine Months Ended | |
|--|--------------------|-----------|-------------------|-----------|
| | 2018 | 2017 | 2018 | 2017 |
| Interest income: | | | | |
| Interest and fees on loans: | | | | |
| Taxable | \$ 18,798 | \$ 16,535 | \$ 54,546 | \$ 48,021 |
| Tax-exempt | 919 | 813 | 2,660 | 2,334 |
| Interest and dividends on investment securities: | | | | |
| Taxable | 998 | 714 | 2,790 | 2,130 |
| Tax-exempt | 639 | 716 | 2,001 | 2,262 |
| Dividends | 16 | 13 | 51 | 37 |
| Interest on interest-bearing deposits in other banks | 49 | 40 | 131 | 107 |
| Total interest income | 21,419 | 18,831 | 62,179 | 54,891 |
| Interest expense: | | | | |
| Interest on deposits | 2,342 | 1,654 | 6,135 | 4,617 |
| Interest on short-term borrowings | 809 | 177 | 2,317 | 599 |
| Interest on long-term debt | 315 | 344 | 936 | 1,041 |
| Total interest expense | 3,466 | 2,175 | 9,388 | 6,257 |
| Net interest income | 17,953 | 16,656 | 52,791 | 48,634 |
| Provision for loan losses | 1,050 | 1,200 | 3,150 | 3,600 |
| Net interest income after provision for loan losses | 16,903 | 15,456 | 49,641 | 45,034 |
| Noninterest income: | | | | |
| Service charges, fees and commissions | 1,883 | 2,156 | 5,856 | 5,410 |
| Merchant services income | 128 | 165 | 687 | 2,358 |
| Commission and fees on fiduciary activities | 570 | 540 | 1,552 | 1,542 |
| Wealth management income | 305 | 414 | 1,048 | 1,081 |
| Mortgage banking income | 163 | 193 | 472 | 576 |
| Life insurance investment income | 190 | 193 | 568 | 577 |
| Net unrealized gain on equity investment securities | 14 | | 14 | |
| Net gain on sale of credit card loans | | | 291 | |
| Net gain on sale of merchant services business | | | | 2,278 |
| Total noninterest income | 3,253 | 3,661 | 10,488 | 13,822 |
| Noninterest expense: | | | | |
| Salaries and employee benefits expense | 6,946 | 6,550 | 21,291 | 19,851 |
| Net occupancy and equipment expense | 2,681 | 2,483 | 8,215 | 7,327 |

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| | | | | |
|---|-----------|-----------|-----------|-----------|
| Merchant services expense | 3 | 33 | 6 | 1,796 |
| Amortization of intangible assets | 220 | 259 | 670 | 785 |
| Professional fees and outside services | 431 | 472 | 1,500 | 1,757 |
| FDIC insurance and assessments | 247 | 241 | 830 | 607 |
| Donations | 355 | 323 | 1,011 | 878 |
| Other expenses | 1,654 | 2,119 | 5,591 | 5,837 |
| Total noninterest expense | 12,537 | 12,480 | 39,114 | 38,838 |
| Income before income taxes | 7,619 | 6,637 | 21,015 | 20,018 |
| Income tax expense | 902 | 1,287 | 2,487 | 4,209 |
| Net income | 6,717 | 5,350 | 18,528 | 15,809 |
| Other comprehensive (loss) income: | | | | |
| Unrealized (loss) gain on investment securities available-for-sale | (1,179) | (381) | (4,394) | 1,076 |
| Income tax (benefit) expense | (248) | (133) | (925) | 377 |
| Other comprehensive (loss) income, net of income taxes | (931) | (248) | (3,469) | 699 |
| Comprehensive income | \$ 5,786 | \$ 5,102 | \$ 15,059 | \$ 16,508 |
| Per share data: | | | | |
| Net income: | | | | |
| Basic | \$ 0.91 | \$ 0.72 | \$ 2.50 | \$ 2.14 |
| Diluted | \$ 0.91 | \$ 0.72 | \$ 2.50 | \$ 2.14 |
| Average common shares outstanding: | | | | |
| Basic | 7,399,054 | 7,396,505 | 7,397,373 | 7,395,612 |
| Diluted | 7,399,054 | 7,396,505 | 7,397,373 | 7,395,612 |
| Dividends declared | \$ 0.33 | \$ 0.32 | \$ 0.98 | \$ 0.94 |

See notes to unaudited consolidated financial statements

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Peoples Financial Services Corp.

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY (UNAUDITED)

(Dollars in thousands, except per share data)

| | Common | Capital | Retained | Accumulated Other Comprehensive Income (Loss) | Total |
|--|-----------|------------|------------|---|------------|
| | Stock | Surplus | Earnings | | |
| Balance, January 1, 2018 | \$ 14,793 | \$ 135,043 | \$ 121,353 | \$ (6,213) | \$ 264,976 |
| Stock based compensation | | 188 | | | 188 |
| Net income | | | 18,528 | | 18,528 |
| Other comprehensive loss, net of income taxes | | | | (3,469) | (3,469) |
| Dividends declared: \$0.98 per share | | | (7,252) | | (7,252) |
| Reclassification related to adoption of ASU 2016-01 | | | 2 | (2) | |
| Common stock grants awarded, net of unearned compensation of \$103: 2,548 shares | 5 | (5) | | | |
| Balance, September 30, 2018 | \$ 14,798 | \$ 135,226 | \$ 132,631 | \$ (9,684) | \$ 272,971 |
| Balance, January 1, 2017 | \$ 14,788 | \$ 134,871 | \$ 111,114 | \$ (4,155) | \$ 256,618 |
| Stock based compensation | | 122 | | | 122 |
| Net income | | | 15,809 | | 15,809 |
| Other comprehensive income, net of income taxes | | | | 699 | 699 |
| Dividends declared: \$0.94 per share | | | (6,952) | | (6,952) |
| Common stock grants awarded, net of unearned compensation of \$53: 2,362 shares | 5 | (5) | | | |
| Balance, September 30, 2017 | \$ 14,793 | \$ 134,988 | \$ 119,971 | \$ (3,456) | \$ 266,296 |

See notes to unaudited consolidated financial statements

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Peoples Financial Services Corp.

CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

(Dollars in thousands, except per share data)

| For the Nine Months Ended September 30, | 2018 | 2017 |
|---|-----------|-----------|
| Cash flows from operating activities: | | |
| Net income | \$ 18,528 | \$ 15,809 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation of premises and equipment | 1,728 | 1,401 |
| Amortization of deferred loan costs | 729 | 662 |
| Amortization of intangibles | 670 | 785 |
| Amortization of low income housing partnerships | 349 | 352 |
| Provision for loan losses | 3,150 | 3,600 |
| Net gain on sale of other real estate owned | (17) | (50) |
| Loans originated for sale | (9,931) | (16,927) |
| Proceeds from sale of loans originated for sale | 10,013 | 16,622 |
| Net gain on sale of loans originated for sale | (74) | (155) |
| Net amortization of investment securities | 1,718 | 2,130 |
| Net gain on sale of credit card loans held for sale | (291) | |
| Net gain on sale of merchant services business | | (2,278) |
| Life insurance investment income | (568) | (577) |
| Stock based compensation | 188 | 122 |
| Net change in: | | |
| Accrued interest receivable | 371 | 320 |
| Other assets | 516 | (1,780) |
| Accrued interest payable | 248 | 19 |
| Other liabilities | (2,967) | 2,665 |
| Net cash provided by operating activities | 24,360 | 22,720 |
| Cash flows from investing activities: | | |
| Proceeds from repayments of investment securities: | | |
| Available-for-sale | 24,087 | 44,489 |
| Held-to-maturity | 710 | 936 |
| Purchases of investment securities: | | |
| Available-for-sale | (32,723) | (45,254) |
| Net redemption of restricted equity securities | 735 | 710 |
| Proceeds from sale of student loan portfolio | 5,103 | |
| Proceeds from sale of credit card loan portfolio | 2,407 | |
| Net increase in lending activities | (96,916) | (101,320) |
| Purchases of premises and equipment | (1,979) | (5,514) |
| Proceeds from the sale of premises and equipment | 341 | |
| Proceeds from investment in life insurance | 304 | |
| Proceeds from the sale of merchant services business | | 2,300 |
| Proceeds from sale of other real estate owned | 582 | 487 |
| Net cash used in investing activities | (97,349) | (103,166) |

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Cash flows from financing activities:

| | | |
|--|-----------|-----------|
| Net increase in deposits | 108,846 | 99,098 |
| Repayment of long-term debt | (1,273) | (7,935) |
| Net decrease in short-term borrowings | (24,225) | (10,800) |
| Cash dividends paid | (7,252) | (6,952) |
| Net cash provided by financing activities | 76,096 | 73,411 |
| Net increase (decrease) in cash and cash equivalents | 3,107 | (7,035) |
| Cash and cash equivalents at beginning of period | 37,488 | 39,941 |
| Cash and cash equivalents at end of period | \$ 40,595 | \$ 32,906 |

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Peoples Financial Services Corp.

CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

(Dollars in thousands, except per share data)

| For the Nine Months Ended September 30, | 2018 | 2017 |
|---|----------|----------|
| Supplemental disclosures: | | |
| Cash paid during the period for: | | |
| Interest | \$ 9,140 | \$ 6,238 |
| Income taxes | 2,550 | 4,100 |
| Noncash items: | | |
| Transfers of loans to other real estate | \$ 623 | \$ 479 |

See notes to unaudited consolidated financial statements

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Peoples Financial Services Corp.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

(Dollars in thousands, except per share data)

1. Summary of significant accounting policies:

Nature of operations:

Peoples Financial Services Corp., a bank holding company incorporated under the laws of Pennsylvania, provides a full range of financial services through its wholly-owned subsidiary, Peoples Security Bank and Trust Company (“Peoples Bank”). Unless the context indicates otherwise, all references in this quarterly report to the “Peoples”, “Company”, “Bank”, “we”, “us” and “our” refer to Peoples Financial Services Corp., its subsidiaries and its and their respective predecessors. The Company services its retail and commercial customers through twenty-seven full-service community banking offices located within the Lackawanna, Lehigh, Luzerne, Monroe, Montgomery, Northampton, Susquehanna, Wayne and Wyoming Counties of Pennsylvania and Broome County of New York.

Basis of presentation:

The accompanying unaudited consolidated financial statements of the Company have been prepared in accordance with accounting principles generally accepted in the United States of America (“GAAP”) for interim financial information and with the instructions to Form 10-Q and Article 10-01 of Regulation S-X. In the opinion of management, all normal recurring adjustments necessary for a fair presentation of the financial position and results of operations for the periods presented have been included. All significant intercompany balances and transactions have been eliminated in consolidation. Prior-period amounts are reclassified when necessary to conform to the current year’s presentation. These reclassifications did not have any effect on the operating results or financial position of the Company. The operating results and financial position of the Company for the three and nine months ended and as of September 30, 2018, are not necessarily indicative of the results of operations and financial position that may be expected in the future.

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

determination of other-than-temporary impairment losses on securities, impairment of goodwill and fair value of assets acquired and liabilities assumed in business combinations. Actual results could differ from those estimates. For additional information and disclosures required under GAAP, reference is made to the Company's Annual Report on Form 10-K for the period ended December 31, 2017.

Revenue from Contracts with Customers:

The Company records revenue from contracts with customers in accordance with Accounting Standards Codification Topic 606, "Revenue from Contracts with Customers" ("Topic 606"). Under Topic 606, the Company must identify the contract with a customer, identify the performance obligations in the contract, determine the transaction price, allocate the transaction price to the performance obligations in the contract, and recognize revenue when (or as) the Company satisfies a performance obligation. Significant revenue has not been recognized in the current reporting period that results from performance obligations satisfied in previous periods.

The Company's primary sources of revenue are derived from interest and dividends earned on loans, investment securities, and other financial instruments that are not within the scope of Topic 606. The Company has evaluated the nature of its contracts with customers and determined that further disaggregation of revenue from contracts with customers into more granular categories beyond what is presented in the Consolidated Statements of Income was not necessary. The Company generally fully satisfies its performance obligations on its contracts with customers as services are rendered and the transaction prices are typically fixed; charged either on a periodic basis or based on activity. The following is a discussion of revenues within the scope of the new guidance:

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Peoples Financial Services Corp.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

(Dollars in thousands, except per share data)

Service charges, fees and commissions. Service charges, fees and commissions on deposit accounts include fees for banking services provided, overdrafts and non-sufficient funds. Revenue is generally recognized in accordance with published deposit account agreements for retail accounts or contractual agreements for commercial accounts. Our deposit services also include our ATM and debit card interchange revenue that is presented gross of the associated costs. Interchange revenue is generated by our deposit customers' usage and volume of activity. Interchange rates are not controlled by the Company, which effectively acts as processor that collects and remits payments associated with customer debit card transactions.

Commission and fees on fiduciary activities. Commission and fees on fiduciary activities includes fees and commissions from investment management, administrative and advisory services primarily for individuals, and to a lesser extent, partnerships and corporations. Revenue is recognized on an accrual basis at the time the services are performed and when we have a right to invoice and are based on either the market value of the assets managed or the services provided.

Wealth management incomes. Wealth management income includes fees and commissions charged when we arrange for another party to transfer brokerage services to a customer. The fees and commissions under this agent relationship are based upon stated fee schedules based upon the type of transaction, volume, and value of the services provided.

Other noninterest income. Other noninterest income includes, among other things, merchant services income. Merchant services revenue is derived from a third party vendor that processes credit card transactions on behalf of our merchant customers. Merchant services revenue is primarily comprised of residual fee income based on the referred merchant's processing volumes and/or margin.

Recent accounting standards:

In March 2018, the FASB issued ASU 2018-05 "Income Taxes (Topic 740): Amendments to SEC Paragraphs Pursuant to SEC Staff Accounting Bulletin (SAB) No. 118." These amendments add SEC guidance to the FASB Accounting Standards Codification regarding the Tax Cuts and Jobs Act pursuant to the issuance of SAB 118. The amendments were effective upon addition to the FASB Codification. Adoption of this ASU did not have a material impact on the Company's consolidated financial statements.

In May 2014, the FASB issued ASU 2014-09, "Revenue from Contracts with Customers" ("ASU 2014-09"), which requires an entity to recognize the amount of revenue to which it expects to be entitled for the transfer of promised goods or services to customers. The ASU replaces most existing revenue recognition guidance in GAAP. The new

standard was effective for the Company on January 1, 2018. Adoption of ASU 2014-09 did not have a material impact on the Company's consolidated financial statements and related disclosures as the Company's primary sources of revenues are derived from interest and dividends earned on loans, investment securities, and other financial instruments that are not within the scope of ASU 2014-09. The Company's revenue recognition pattern for revenue streams within the scope of ASU 2014-09, including but not limited to service charges on deposit accounts and gains/losses on the sale of other real estate owned, did not change significantly from current practice. The standard permits the use of either the full retrospective or modified retrospective transition method. The Company elected to use the modified retrospective transition method which requires application of ASU 2014-09 to uncompleted contracts at the date of adoption however, periods prior to the date of adoption will not be retrospectively revised as the impact of the ASU on uncompleted contracts at the date of adoption was not material.

In February 2016, the FASB issued ASU No. 2016-02, "Leases". From the lessee's perspective, the new standard establishes a right-of-use ("ROU") model that requires a lessee to record a ROU asset and a lease liability on the balance sheet for all leases with terms longer than 12 months. Leases will be classified as either finance or operating, with classification affecting the pattern of expense recognition in the income statement for a lessee. From the lessor's perspective, the new standard requires a lessor to classify leases as either sales-type, finance or operating. A lease will be treated as a sale if it transfers all of the risks and rewards, as well as control of the underlying asset, to the lessee. If risks and rewards are conveyed without the transfer of control, the lease is treated as a financing. If the lessor doesn't convey risks and rewards or control, an operating lease results. The amendments in this ASU are effective for annual periods, and

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Peoples Financial Services Corp.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

(Dollars in thousands, except per share data)

interim periods within those annual periods, beginning after December 15, 2018. Accordingly, the Company will adopt this guidance on January 1, 2019. Once adopted, the Company will recognize ROU assets and lease liabilities for the majority of its operating lease commitments. The amounts of ROU and corresponding lease liabilities recorded upon adoption will be based primarily on the present value of unpaid future minimum lease payments as of January 1, 2019. The amounts will also be impacted by assumptions around renewals and extensions, and the interest rate used to discount those future lease obligations. As of September 30, 2018, the Company has approximately \$4,555 in minimum lease payments due under such agreements for the period January 1, 2019 and forward. While these leases represent a majority of the leases within the scope of the standard, the leases are subject to change as a result of the execution of new leases and the termination of existing leases prior to the effective date, as well as the identification of potential leases through the date of adoption.

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

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

The amendments in the ASU retain many of the disclosure requirements related to credit quality in current GAAP, updated to reflect the change from an incurred loss methodology to an expected credit loss methodology. In addition, the ASU requires that disclosure of credit quality indicators in relation to the amortized cost of financing receivables, a current requirement, be further disaggregated by year of origination. This ASU requires that credit losses on available-for-sale debt securities be presented as an allowance rather than as a write-down, and limits the amount of the allowance for credit losses to the amount by which the fair value is below amortized cost. For purchased investment securities available-for-sale with a more-than-insignificant amount of credit deterioration since origination, the ASU requires an allowance be determined in a manner similar to other investment securities available-for-sale; however, the initial allowance would be added to the purchase price, with only subsequent changes in the allowance recorded in credit loss expense, and interest income recognized at the effective rate excluding the discount embedded in the purchase price related to estimated credit losses at acquisition.

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

We are evaluating the impact of the ASU on our consolidated financial statements. In addition to our allowance for loan losses, we will also record an allowance for credit losses on debt securities instead of applying the impairment model currently utilized. The amount of the adjustments will be impacted by each portfolio's composition and credit quality at the adoption date as well as economic conditions and forecasts at that time.

In July 2018, the FASB issued ASU No. 2018-11, "Leases - Targeted Improvements" to provide entities with relief from the costs of implementing certain aspects of the new leasing standard, ASU No. 2016-02. Specifically, under the amendments in ASU 2018-11: (1) entities may elect not to recast the comparative periods presented when transitioning to the new leasing standard, and (2) lessors may elect not to separate lease and non-lease components when certain conditions are met. The amendments have the same effective date as ASU 2016-02 (January 1, 2019 for the Company).

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Peoples Financial Services Corp.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

(Dollars in thousands, except per share data)

The Company expects to elect both transition options. ASU 2018-11 is not expected to have a material impact on the Company's consolidated financial statements.

In August 2018, the FASB issued ASU 2018-13 Fair Value Measurement (Topic 820): "Disclosure Framework – Changes to the Disclosure Requirements for Fair Value Measurement" modifies the disclosure requirements on fair value measurements in Topic 820, Fair Value Measurement, based on the FASB Concepts Statement, "Conceptual Framework for Financial Reporting – Chapter 8: Notes to Financial Statements". In accordance with the Concepts Statement, this ASU removes, modifies and adds select disclosure requirements under Topic 820 after consideration of costs and benefits. ASU 2018-13 is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019 for public entities, with early adoption permitted. The adoption of this guidance on January 1, 2020 is not expected to have a material effect on the Company's consolidated financial statements.

In August 2018, the FASB issued ASU 2018-15 Intangibles – Goodwill and Other—Internal-Use Software (Subtopic 350-40): "Customer's Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement That Is a Service Contract" aligns the requirements for capitalizing implementation costs incurred in a hosting arrangement that is a service contract with the requirements for capitalizing implementation costs incurred to develop or obtain internal-use software and hosting arrangements that include an internal-use software license. ASU 2018-15 requires that a customer in a hosting arrangement that is a service contract follow the guidance in Subtopic 350-40 to determine which implementation costs to capitalize and which costs to expense, as well as requiring costs that cannot be capitalized to be expensed over the term of the hosting arrangement. ASU 2018-15 is effective for fiscal years beginning after December 15, 2019 for public entities, and interim periods within those fiscal years, beginning after December 15, 2019, with early adoption permitted. The adoption of this guidance on January 1, 2020 is not expected to have a material effect on the operating results or financial position of the Company.

Refer to Note 1 to the Company's consolidated financial statements included in the 2017 Annual Report on Form 10-K and the Quarterly Report on Form 10-Q for the periods ended March 31, 2018 and June 30, 2018 for a discussion of additional accounting guidance applicable to the Company that will be adopted in future periods and accounting guidance adopted by the Company during those periods.

2. Other comprehensive loss:

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

The components of accumulated other comprehensive loss included in stockholders' equity at September 30, 2018 and December 31, 2017 is as follows:

| | September 30, 2018 | December 31, 2017 |
|---|--------------------|-------------------|
| Net unrealized loss on investment securities available-for-sale | \$ (5,631) | \$ (1,237) |
| Income tax | (1,183) | (260) |
| Net of income taxes | (4,448) | (977) |
| Benefit plan adjustments | (6,628) | (6,628) |
| Income tax | (1,392) | (1,392) |
| Net of income taxes | (5,236) | (5,236) |
| Accumulated other comprehensive loss | \$ (9,684) | \$ (6,213) |

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Peoples Financial Services Corp.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

(Dollars in thousands, except per share data)

Other comprehensive income (loss) and related tax effects for the three and nine months ended September 30, 2018 and 2017 is as follows:

| | | |
|--|------------|----------|
| Three Months Ended September 30, | 2018 | 2017 |
| Unrealized loss on investment securities available-for-sale | \$ (1,179) | \$ (381) |
| Net gain on the sale of investment securities available-for-sale | | |
| Other comprehensive loss before taxes | (1,179) | (381) |
| Income tax | (248) | (133) |
| Other comprehensive loss | \$ (931) | \$ (248) |
| | | |
| Nine Months Ended September 30, | 2018 | 2017 |
| Unrealized (loss) gain on investment securities available-for-sale | \$ (4,394) | \$ 1,076 |
| Net gain on the sale of investment securities available-for-sale | | |
| Other comprehensive (loss) income before taxes | (4,394) | 1,076 |
| Income tax | (925) | 377 |
| Other comprehensive (loss) income | \$ (3,469) | \$ 699 |

3. Earnings per share:

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

There were no shares considered anti-dilutive for the three and nine month periods ended September 30, 2018 and 2017.

| | | | | |
|--|-----------|-----------|-----------|-----------|
| | 2018 | | 2017 | |
| For the Three Months Ended September 30, | Basic | Diluted | Basic | Diluted |
| Net Income | \$ 6,717 | \$ 6,717 | \$ 5,350 | \$ 5,350 |
| Average common shares outstanding | 7,399,054 | 7,399,054 | 7,396,505 | 7,396,505 |
| Earnings per share | \$ 0.91 | \$ 0.91 | \$ 0.72 | \$ 0.72 |
| | 2018 | | 2017 | |
| For the Nine Months Ended September 30 | Basic | Diluted | Basic | Diluted |
| Net Income | \$ 18,528 | \$ 18,528 | \$ 15,809 | \$ 15,809 |
| Average common shares outstanding | 7,397,373 | 7,397,373 | 7,395,612 | 7,395,612 |
| Earnings per share | \$ 2.50 | \$ 2.50 | \$ 2.14 | \$ 2.14 |

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Peoples Financial Services Corp.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

(Dollars in thousands, except per share data)

4. Investment securities:

The amortized cost and fair value of investment securities aggregated by investment category at September 30, 2018 and December 31, 2017 are summarized as follows:

| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|---|-------------------|------------------------------|-------------------------------|---------------|
| September 30, 2018 | | | | |
| Available-for-sale: | | | | |
| U.S. Treasury securities | \$ 25,941 | | \$ 711 | \$ 25,230 |
| U.S. Government-sponsored enterprises | 95,089 | | 3,317 | 91,772 |
| State and municipals: | | | | |
| Taxable | 13,576 | \$ 237 | | 13,813 |
| Tax-exempt | 90,535 | 495 | 1,061 | 89,969 |
| Residential Mortgage-backed securities: | | | | |
| U.S. Government agencies | 13,719 | | 134 | 13,585 |
| U.S. Government-sponsored enterprises | 35,284 | 1 | 811 | 34,474 |
| Commercial Mortgage-backed securities: | | | | |
| U.S. Government-sponsored enterprises | 6,281 | | 330 | 5,951 |
| Total | \$ 280,425 | \$ 733 | \$ 6,364 | \$ 274,794 |
| Held-to-maturity: | | | | |
| Tax-exempt state and municipals | \$ 6,856 | \$ 2 | \$ 185 | \$ 6,673 |
| Residential Mortgage-backed securities: | | | | |
| U.S. Government agencies | 45 | | | 45 |
| U.S. Government-sponsored enterprises | 1,650 | 72 | 5 | 1,717 |
| Total | \$ 8,551 | \$ 74 | \$ 190 | \$ 8,435 |
| December 31, 2017 | | | | |
| Available-for-sale: | | | | |
| U.S. Treasury securities | \$ 20,042 | | \$ 228 | \$ 19,814 |

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| | | | | |
|---|------------|----------|----------|------------|
| U.S. Government-sponsored enterprises | 95,358 | \$ 30 | 1,740 | 93,648 |
| State and municipals: | | | | |
| Taxable | 14,559 | 488 | | 15,047 |
| Tax-exempt | 103,199 | 1,136 | 502 | 103,833 |
| Residential Mortgage-backed securities: | | | | |
| U.S. Government agencies | 14,517 | 2 | 85 | 14,434 |
| U.S. Government-sponsored enterprises | 19,752 | 10 | 231 | 19,531 |
| Commercial Mortgage-backed securities: | | | | |
| U.S. Government-sponsored enterprises | 6,315 | | 120 | 6,195 |
| Total | \$ 273,742 | \$ 1,666 | \$ 2,906 | \$ 272,502 |
| Held-to-maturity: | | | | |
| Tax-exempt state and municipals | \$ 6,859 | \$ 152 | \$ 13 | \$ 6,998 |
| Residential Mortgage-backed securities: | | | | |
| U.S. Government agencies | 54 | | | 54 |
| U.S. Government-sponsored enterprises | 2,361 | 138 | 4 | 2,495 |
| Total | \$ 9,274 | \$ 290 | \$ 17 | \$ 9,547 |

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Peoples Financial Services Corp.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

(Dollars in thousands, except per share data)

Equity Securities

Our equity securities portfolio consists of stock of two other financial institutions. At September 30, 2018 and December 31, 2017, we had \$291 thousand and \$46 thousand, respectively, in equity securities recorded at fair value. Prior to January 1, 2018, equity securities were stated at fair value with unrealized gains and losses reported as a separate component of Accumulated Other Comprehensive Income (“AOCI”), net of tax. At December 31, 2017, net unrealized gains of \$3 thousand had been recognized in AOCI. On January 1, 2018, these unrealized gains, net of income tax were reclassified out of AOCI and into retained earnings with subsequent changes in fair value being recognized in net income. At September 30, 2018, the fair value of our equity portfolio exceeded the cost basis by \$14. The following is a summary of unrealized and realized gains and losses recognized in net income on equity securities during the three and nine months ended September 30, 2018 (in thousands):

| September 30, 2018 | Three months ended September 30, 2018 | Nine months ended September 30, 2018 |
|---|--|---|
| Net gains recognized during the period on equity securities | \$ 14 | \$ 14 |
| Less: Net gains and (losses) recognized during the period on equity securities sold during the period | | |
| Unrealized gains recognized during the reporting period on equity securities still held at the reporting date | \$ 14 | \$ 14 |

Restricted Investment In Stock

Restricted investment in stock includes Federal Home Loan Bank of Pittsburgh (“FHLB”) with a carrying cost of \$7,785 and \$8,520 at September 30, 2018 and December 31, 2017, respectively and Atlantic Community Bankers Bank (“ACBB”) stock with a carrying cost of \$42 and VISA Class B stock with a carry cost of \$0 at September 30, 2018 and December 31, 2017, are included in other assets in the consolidated balance sheets. FHLB and ACBB stock was issued as a requirement to facilitate participation in borrowing and other banking services. The investment in FHLB stock may fluctuate, as it is based on the member banks’ use of FHLB’s services.

Peoples Bank owns 44,982 shares of Visa Class B stock, which was necessary to participate in Visa services in support of the Bank’s credit card, debit card, and related payment programs (permissible activities under banking

regulations) as a member institution. Following the resolution of Visa’s covered litigation, shares of Visa’s Class B stock will be converted to Visa Class A shares using a conversion factor (1.6298 as of September 30, 2018), which is periodically adjusted to reflect VISA’s ongoing litigation costs. There is a very limited market for this stock, as only current owners of Class B shares are permitted to transact in Class B. Due to the lack of orderly trades and public information of such trades, Visa Class B stock has no readily determinable fair value.

These restricted investments are carried at cost and evaluated for other-than-temporary impairment (“OTTI”) periodically. As of September 30, 2018, there was no OTTI associated with these investments.

The maturity distribution of the fair value, which is the net carrying amount, of the debt securities classified as available-for-sale at September 30, 2018, is summarized as follows:

| September 30, 2018 | Fair Value |
|---------------------------------|---------------|
| Within one year | \$ 34,805 |
| After one but within five years | 156,767 |
| After five but within ten years | 16,149 |
| After ten years | 13,063 |
| | 220,784 |
| Mortgage-backed securities | 54,010 |
| Total | \$ 274,794 |

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Peoples Financial Services Corp.

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(Dollars in thousands, except per share data)

The maturity distribution of the amortized cost and fair value, of debt securities classified as held-to-maturity at September 30, 2018, is summarized as follows:

| September 30, 2018 | Amortized Cost | Fair Value |
|---------------------------------|-------------------|---------------|
| Within one year | | |
| After one but within five years | | |
| After five but within ten years | | |
| After ten years | \$ 6,856 | \$ 6,673 |
| | 6,856 | 6,673 |
| Mortgage-backed securities | 1,695 | 1,762 |
| Total | \$ 8,551 | \$ 8,435 |

Securities with a carrying value of \$164,516 and \$163,936 at September 30, 2018 and December 31, 2017, respectively, were pledged to secure public deposits and certain other deposits as required or permitted by law.

Securities and short-term investment activities are conducted with a diverse group of government entities, corporations and state and local municipalities. The counterparty's creditworthiness and type of collateral is evaluated on a case-by-case basis. At September 30, 2018 and December 31, 2017, there were no significant concentrations of credit risk from any one issuer, with the exception of U.S. Government agencies and sponsored enterprises, that exceeded 10.0 percent of stockholders' equity.

The fair value and gross unrealized losses of investment securities with unrealized losses for which an OTTI has not been recognized at September 30, 2018 and December 31, 2017, aggregated by investment category and length of time that the individual securities have been in a continuous unrealized loss position, are summarized as follows:

| | Less Than 12 Months | | 12 Months or More | | Total | |
|--------------------------|---------------------|----------------------|-------------------|----------------------|---------------|----------------------|
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| September 30, 2018 | | | | | | |
| U.S. Treasury securities | \$ 8,711 | \$ 169 | \$ 16,519 | \$ 542 | \$ 25,230 | \$ 711 |

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| | | | | | | |
|--|------------|----------|------------|----------|------------|----------|
| U.S. Government-sponsored enterprises | 16,813 | 337 | 74,959 | 2,980 | 91,772 | 3,317 |
| State and municipals: | | | | | | |
| Tax-exempt Residential | 52,220 | 893 | 14,529 | 353 | 66,749 | 1,246 |
| Mortgage-backed securities: | | | | | | |
| U.S. Government agencies | 6,423 | 33 | 7,162 | 101 | 13,585 | 134 |
| U.S. Government-sponsored enterprises Commercial | 21,705 | 322 | 13,261 | 494 | 34,966 | 816 |
| Mortgage-backed securities: | | | | | | |
| U.S. Government-sponsored enterprises | | | 5,951 | 330 | 5,951 | 330 |
| Total | \$ 105,872 | \$ 1,754 | \$ 132,381 | \$ 4,800 | \$ 238,253 | \$ 6,554 |

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Peoples Financial Services Corp.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

(Dollars in thousands, except per share data)

| | Less Than 12 Months | | 12 Months or More | | Total | |
|---|---------------------|-------------------|-------------------|-------------------|------------|-------------------|
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| December 31, 2017 | | | | | | |
| U.S. Treasury securities | \$ 17,350 | \$ 170 | \$ 2,464 | \$ 58 | \$ 19,814 | \$ 228 |
| U.S. Government-sponsored enterprises | 39,096 | 445 | 51,365 | 1,295 | 90,461 | 1,740 |
| State and municipals: | | | | | | |
| Tax-exempt | 54,788 | 454 | 3,808 | 61 | 58,596 | 515 |
| Residential Mortgage-backed securities: | | | | | | |
| U.S. Government agencies | 9,484 | 39 | 3,968 | 46 | 13,452 | 85 |
| U.S. Government-sponsored enterprises | 12,537 | 103 | 6,504 | 132 | 19,041 | 235 |
| Commercial Mortgage-backed securities: | | | | | | |
| U.S. Government-sponsored enterprises | 6,195 | 120 | | | 6,195 | 120 |
| Total | \$ 139,450 | \$ 1,331 | \$ 68,109 | \$ 1,592 | \$ 207,559 | \$ 2,923 |

The Company had 209 investment securities, consisting of 118 tax-exempt state and municipal obligations, nine U.S. Treasury securities, 38 U.S. Government-sponsored enterprise securities, and 44 mortgage-backed securities that were in unrealized loss positions at September 30, 2018. Of these securities, six U.S. Treasury securities, 30 U.S. Government-sponsored enterprise securities, 23 tax-exempt state and municipal obligations, and 28 mortgage-backed securities were in a continuous unrealized loss position for twelve months or more. Management does not consider the unrealized losses on the debt securities, as a result of changes in interest rates, to be OTTI based on historical evidence that indicates the cost of these securities is recoverable within a reasonable period of time in relation to normal cyclical changes in the market rates of interest. Moreover, because there has been no material change in the credit quality of the issuers or other events or circumstances that may cause a significant adverse impact on the fair value of these securities, and management does not intend to sell these securities and it is unlikely that the Company will be required to sell these securities before recovery of their amortized cost basis, which may be maturity, the Company does not consider the unrealized losses to be OTTI at September 30, 2018. There was no OTTI recognized for the three or nine months ended September 30, 2018 and 2017.

5. Loans, net and allowance for loan losses:

The major classifications of loans outstanding, net of deferred loan origination fees and costs at September 30, 2018 and December 31, 2017 are summarized as follows. Net deferred loan costs were \$930 and \$575 at September 30, 2018 and December 31, 2017.

| | September 30, 2018 | December 31, 2017 |
|--------------|--------------------|-------------------|
| Commercial | \$ 478,128 | \$ 476,199 |
| Real estate: | | |
| Commercial | 881,071 | 786,210 |
| Residential | 297,819 | 287,935 |
| Consumer | 122,427 | 142,721 |
| Total | \$ 1,779,445 | \$ 1,693,065 |

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Peoples Financial Services Corp.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

(Dollars in thousands, except per share data)

The changes in the allowance for loan losses account by major classification of loan for the three and nine months ended September 30, 2018 and 2017 are summarized as follows:

| September 30, 2018 | Commercial | Real estate | | Consumer | Total |
|--------------------------------|------------|-------------|-------------|----------|-----------|
| | | Commercial | Residential | | |
| Allowance for loan losses: | | | | | |
| Beginning Balance July 1, 2018 | \$ 5,749 | \$ 7,506 | \$ 4,962 | \$ 1,356 | \$ 19,573 |
| Charge-offs | (148) | (63) | | (117) | (328) |
| Recoveries | 12 | 26 | 13 | 67 | 118 |
| Provisions | 289 | 536 | 164 | 61 | 1,050 |
| Ending balance | \$ 5,902 | \$ 8,005 | \$ 5,139 | \$ 1,367 | \$ 20,413 |

| September 30, 2017 | Commercial | Real estate | | Consumer | Total |
|--------------------------------|------------|-------------|-------------|----------|-----------|
| | | Commercial | Residential | | |
| Allowance for loan losses: | | | | | |
| Beginning Balance July 1, 2017 | \$ 4,426 | \$ 6,587 | \$ 5,196 | \$ 1,593 | \$ 17,802 |
| Charge-offs | (17) | | (82) | (169) | (268) |
| Recoveries | 3 | 41 | 4 | 49 | 97 |
| Provisions | 358 | 566 | 175 | 101 | 1,200 |
| Ending balance | \$ 4,770 | \$ 7,194 | \$ 5,293 | \$ 1,574 | \$ 18,831 |

| September 30, 2018 | Commercial | Real estate | | Consumer | Total |
|-----------------------------------|------------|-------------|-------------|----------|---------|
| | | Commercial | Residential | | |
| Allowance for loan losses: | | | | | |
| Beginning Balance January 1, 2018 | \$ 5,052 | \$ 7,548 | \$ 4,980 | 1,380 | 18,960 |
| Charge-offs | (150) | (1,232) | (381) | (389) | (2,152) |
| Recoveries | 128 | 83 | 80 | 164 | 455 |
| Provisions | 872 | 1,606 | 460 | 212 | 3,150 |

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| | | | | | |
|-----------------------------------|----------|----------|----------|----------|-----------|
| Ending balance | \$ 5,902 | \$ 8,005 | \$ 5,139 | \$ 1,367 | \$ 20,413 |
| | | | | | |
| September 30, 2017 | | | | | |
| Allowance for loan losses: | | | | | |
| Beginning Balance January 1, 2017 | \$ 3,799 | \$ 5,847 | \$ 4,707 | \$ 1,608 | \$ 15,961 |
| Charge-offs | (49) | (367) | (105) | (489) | (1,010) |
| Recoveries | 16 | 96 | 30 | 138 | 280 |
| Provisions | 1,004 | 1,618 | 661 | 317 | 3,600 |
| Ending balance | \$ 4,770 | \$ 7,194 | \$ 5,293 | \$ 1,574 | \$ 18,831 |

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(Dollars in thousands, except per share data)

The allocation of the allowance for loan losses and the related loans by major classifications of loans at September 30, 2018 and December 31, 2017 is summarized as follows:

| September 30, 2018 | Commercial | Real estate Commercial | Residential | Consumer | Total |
|--|------------|---------------------------|-------------|------------|--------------|
| Allowance for loan losses: | | | | | |
| Ending balance | \$ 5,902 | \$ 8,005 | \$ 5,139 | \$ 1,367 | \$ 20,413 |
| Ending balance: individually evaluated for impairment | 93 | 462 | 362 | 14 | 931 |
| Ending balance: collectively evaluated for impairment | 5,809 | 7,543 | 4,777 | 1,353 | 19,482 |
| Ending balance: loans acquired with deteriorated credit quality | \$ | \$ | \$ | \$ | \$ |
| Loans receivable: | | | | | |
| Ending balance | \$ 478,128 | \$ 881,071 | \$ 297,819 | \$ 122,427 | \$ 1,779,445 |
| Ending balance: individually evaluated for impairment | 1,996 | 4,538 | 3,651 | 156 | 10,341 |
| Ending balance: collectively evaluated for impairment | 475,833 | 875,988 | 294,141 | 122,271 | 1,768,233 |
| Ending balance: loans acquired with deteriorated credit quality | \$ 299 | \$ 545 | \$ 27 | \$ | \$ 871 |

| December 31, 2017 | Commercial | Real estate Commercial | Residential | Consumer | Total |
|--|------------|---------------------------|-------------|----------|-----------|
| Allowance for loan losses: | | | | | |
| Ending balance | \$ 5,052 | \$ 7,548 | \$ 4,980 | \$ 1,380 | \$ 18,960 |
| Ending balance: individually evaluated for impairment | 159 | 263 | 336 | 8 | 766 |
| Ending balance: collectively evaluated for impairment | 4,893 | 7,285 | 4,644 | 1,372 | 18,194 |
| Ending balance: loans acquired with deteriorated credit quality | \$ | \$ | \$ | \$ | \$ |

| | | | | | |
|--|------------|------------|------------|------------|--------------|
| Loans receivable: | | | | | |
| Ending balance | \$ 476,199 | \$ 786,210 | \$ 287,935 | \$ 142,721 | \$ 1,693,065 |
| Ending balance: individually evaluated for impairment | 2,121 | 3,644 | 3,763 | 177 | 9,705 |
| Ending balance: collectively evaluated for impairment | 473,736 | 781,921 | 284,142 | 142,544 | 1,682,343 |
| Ending balance: loans acquired with deteriorated credit quality | \$ 342 | \$ 645 | \$ 30 | \$ | \$ 1,017 |

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

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

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Peoples Financial Services Corp.

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(Dollars in thousands, except per share data)

- **Special Mention-** A loan that has potential weaknesses that deserves management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the loan or in the institution's credit position at some future date. Special Mention loans are not adversely classified since they do not expose the Company to sufficient risk to warrant adverse classification.
- **Substandard-** A loan that is inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Loans so classified must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the bank will sustain some loss if the deficiencies are not corrected.
- **Doubtful –** A loan classified as Doubtful has all the weaknesses inherent in one classified Substandard with the added characteristic that the weaknesses make the collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable.
- **Loss-** A loan classified as Loss is considered uncollectible and of such little value that its continuance as bankable loan is not warranted. This classification does not mean that the loan has absolutely no recovery or salvage value, but rather it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may be affected in the future.

The following tables present the major classification of loans summarized by the aggregate pass rating and the classified ratings of special mention, substandard and doubtful within the Company's internal risk rating system at September 30, 2018 and December 31, 2017:

| September 30, 2018 | Pass | Special Mention | Substandard | Doubtful | Total |
|--------------------|--------------|--------------------|-------------|----------|--------------|
| Commercial | \$ 473,685 | \$ 1,542 | \$ 2,901 | \$ | \$ 478,128 |
| Real estate: | | | | | |
| Commercial | 856,513 | 11,920 | 12,638 | | 881,071 |
| Residential | 292,530 | 361 | 4,928 | | 297,819 |
| Consumer | 122,210 | | 217 | | 122,427 |
| Total | \$ 1,744,938 | \$ 13,823 | \$ 20,684 | \$ | \$ 1,779,445 |

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| December 31, 2017 | Pass | Special Mention | Substandard | Doubtful | Total |
|-------------------|--------------|--------------------|-------------|----------|--------------|
| Commercial | \$ 472,185 | \$ 1,958 | \$ 2,056 | \$ | \$ 476,199 |
| Real estate: | | | | | |
| Commercial | 764,320 | 13,015 | 8,875 | | 786,210 |
| Residential | 282,484 | 18 | 5,433 | | 287,935 |
| Consumer | 142,507 | | 214 | | 142,721 |
| Total | \$ 1,661,496 | \$ 14,991 | \$ 16,578 | \$ | \$ 1,693,065 |

Information concerning nonaccrual loans by major loan classification at September 30, 2018 and December 31, 2017 is summarized as follows:

| | September 30, 2018 | December 31, 2017 |
|--------------|--------------------|-------------------|
| Commercial | \$ 808 | \$ 860 |
| Real estate: | | |
| Commercial | 4,214 | 3,821 |
| Residential | 2,565 | 2,994 |
| Consumer | 156 | 177 |
| Total | \$ 7,743 | \$ 7,852 |

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(Dollars in thousands, except per share data)

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

| | 30-59 Days Past Due | 60-89 Days Past Due | Greater than 90 Days | Total Past Due | Current | Total Loans | Loans > 90 Days and Accruing |
|--------------------|------------------------|------------------------|----------------------------|-------------------|--------------|--------------|------------------------------------|
| September 30, 2018 | | | | | | | |
| Commercial | \$ 218 | \$ | \$ 808 | \$ 1,026 | \$ 477,102 | \$ 478,128 | |
| Real estate: | | | | | | | |
| Commercial | 1,681 | 104 | 4,288 | 6,073 | 874,998 | 881,071 | 74 |
| Residential | 1,774 | 531 | 3,075 | 5,380 | 292,439 | 297,819 | \$ 510 |
| Consumer | 527 | 420 | 156 | 1,103 | 121,324 | 122,427 | |
| Total | \$ 4,200 | \$ 1,055 | \$ 8,327 | \$ 13,582 | \$ 1,765,863 | \$ 1,779,445 | \$ 584 |

The Company classifies all nonaccrual loans in the greater than 90 days category.

| | 30-59 Days Past Due | 60-89 Days Past Due | Greater than 90 Days | Total Past Due | Current | Total Loans | Loans > 90 Days and Accruing |
|-------------------|------------------------|------------------------|----------------------------|-------------------|--------------|--------------|------------------------------------|
| December 31, 2017 | | | | | | | |
| Commercial | \$ 124 | \$ 216 | \$ 860 | \$ 1,200 | \$ 474,999 | \$ 476,199 | |
| Real estate: | | | | | | | |
| Commercial | 1,722 | 194 | 3,821 | 5,737 | 780,473 | 786,210 | |
| Residential | 1,134 | 1,551 | 3,543 | 6,228 | 281,707 | 287,935 | \$ 549 |
| Consumer | 1,101 | 364 | 363 | 1,828 | 140,893 | 142,721 | 186 |
| Total | \$ 4,081 | \$ 2,325 | \$ 8,587 | \$ 14,993 | \$ 1,678,072 | \$ 1,693,065 | \$ 735 |

The following tables summarize information concerning impaired loans as of and for the three and nine months ended September 30, 2018 and September 30, 2017, and as of and for the year ended, December 31, 2017 by major loan classification:

| | Recorded Investment | Unpaid Principal Balance | Related Allowance | This Quarter Average Recorded Investment | Interest Income Recognized | Year-to-Date Average Recorded Investment | Interest Income Recognized |
|--------------------|------------------------|--------------------------------|----------------------|---|----------------------------------|---|----------------------------------|
| September 30, 2018 | | | | | | | |

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| | | | | | | | |
|-----------------------------|-----------|-----------|--------|-----------|-------|-----------|--------|
| With no related allowance: | | | | | | | |
| Commercial | \$ 1,356 | \$ 1,538 | | \$ 1,269 | \$ 17 | \$ 1,257 | \$ 50 |
| Real estate: | | | | | | | |
| Commercial | 3,414 | 3,666 | | 3,143 | 5 | 3,036 | 20 |
| Residential | 2,366 | 3,003 | | 2,256 | 7 | 2,249 | 15 |
| Consumer | 142 | 149 | | 101 | | 131 | |
| Total | 7,278 | 8,356 | | 6,769 | 29 | 6,673 | 85 |
| With an allowance recorded: | | | | | | | |
| Commercial | 939 | 1,086 | 93 | 1,020 | 7 | 1,089 | 23 |
| Real estate: | | | | | | | |
| Commercial | 1,669 | 1,774 | 462 | 1,712 | 8 | 1,807 | 18 |
| Residential | 1,312 | 1,508 | 362 | 1,369 | 5 | 1,456 | 13 |
| Consumer | 14 | 14 | 14 | 9 | | 11 | |
| Total | 3,934 | 4,382 | 931 | 4,110 | 20 | 4,363 | 54 |
| Total impaired loans | | | | | | | |
| Commercial | 2,295 | 2,624 | 93 | 2,289 | 24 | 2,346 | 73 |
| Real estate: | | | | | | | |
| Commercial | 5,083 | 5,440 | 462 | 4,855 | 13 | 4,843 | 38 |
| Residential | 3,678 | 4,511 | 362 | 3,625 | 12 | 3,705 | 28 |
| Consumer | 156 | 163 | 14 | 110 | | 142 | |
| Total | \$ 11,212 | \$ 12,738 | \$ 931 | \$ 10,879 | \$ 49 | \$ 11,036 | \$ 139 |

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Peoples Financial Services Corp.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

(Dollars in thousands, except per share data)

| December 31, 2017 | Recorded Investment | Unpaid Principal Balance | Related Allowance | For the Year Ended | |
|-----------------------------|------------------------|--------------------------------|----------------------|-----------------------------------|----------------------------------|
| | | | | Average Recorded Investment | Interest Income Recognized |
| With no related allowance: | | | | | |
| Commercial | \$ 1,279 | \$ 1,439 | | \$ 1,668 | \$ 43 |
| Real estate: | | | | | |
| Commercial | 2,888 | 3,190 | | 2,985 | 24 |
| Residential | 2,196 | 2,672 | | 2,227 | 21 |
| Consumer | 169 | 181 | | 173 | |
| Total | 6,532 | 7,482 | | 7,053 | 88 |
| With an allowance recorded: | | | | | |
| Commercial | 1,184 | 1,218 | 159 | 991 | 50 |
| Real estate: | | | | | |
| Commercial | 1,401 | 1,496 | 263 | 2,202 | 18 |
| Residential | 1,597 | 1,759 | 336 | 1,335 | 23 |
| Consumer | 8 | 8 | 8 | 20 | |
| Total | 4,190 | 4,481 | 766 | 4,548 | 91 |
| Total impaired loans | | | | | |
| Commercial | 2,463 | 2,657 | 159 | 2,659 | 93 |
| Real estate: | | | | | |
| Commercial | 4,289 | 4,686 | 263 | 5,187 | 42 |
| Residential | 3,793 | 4,431 | 336 | 3,562 | 44 |
| Consumer | 177 | 189 | 8 | 193 | |
| Total | \$ 10,722 | \$ 11,963 | \$ 766 | \$ 11,601 | \$ 179 |

| September 30, 2017 | Recorded Investment | Unpaid Principal Balance | Related Allowance | This Quarter | Year-to-Date | Interest Income Recognized | Interest Income Recognized |
|----------------------------|------------------------|--------------------------------|----------------------|-----------------------------------|-----------------------------------|----------------------------------|----------------------------------|
| | | | | Average Recorded Investment | Average Recorded Investment | | |
| With no related allowance: | | | | | | | |
| Commercial | \$ 2,310 | \$ 2,455 | | \$ 1,945 | \$ 28 | \$ 1,765 | \$ 63 |
| Real estate: | | | | | | | |
| Commercial | 2,900 | 3,192 | | 2,979 | 6 | 3,009 | 19 |

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| | | | | | | | |
|-----------------------------|-----------|-----------|----------|-----------|-------|-----------|--------|
| Residential | 2,303 | 2,727 | | 2,193 | 4 | 2,235 | 10 |
| Consumer | 171 | 183 | | 180 | | 175 | |
| Total | 7,684 | 8,557 | | 7,297 | 38 | 7,184 | 92 |
| With an allowance recorded: | | | | | | | |
| Commercial | 833 | 910 | \$ 436 | 783 | | 943 | |
| Real estate: | | | | | | | |
| Commercial | 1,807 | 2,073 | 631 | 1,673 | 6 | 2,402 | 13 |
| Residential | 1,425 | 1,663 | 616 | 1,330 | 8 | 1,270 | 22 |
| Consumer | 23 | 23 | 23 | 34 | | 23 | |
| Total | 4,088 | 4,669 | 1,706 | 3,820 | 14 | 4,638 | 35 |
| Total impaired loans | | | | | | | |
| Commercial | 3,143 | 3,365 | 436 | 2,728 | 28 | 2,708 | 63 |
| Real estate: | | | | | | | |
| Commercial | 4,707 | 5,265 | 631 | 4,652 | 12 | 5,411 | 32 |
| Residential | 3,728 | 4,390 | 616 | 3,523 | 12 | 3,505 | 32 |
| Consumer | 194 | 206 | 23 | 214 | | 198 | |
| Total | \$ 11,772 | \$ 13,226 | \$ 1,706 | \$ 11,117 | \$ 52 | \$ 11,822 | \$ 127 |

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Included in the commercial loan and commercial and residential real estate categories are troubled debt restructurings that are classified as impaired. Troubled debt restructurings totaled \$3,230 at September 30, 2018, \$3,074 at December 31, 2017 and \$3,365 at September 30, 2017.

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

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

There were no loans modified as a troubled debt restructuring for the three months ended September 30, 2018. There were four loans, representing two credit relationships, modified as a troubled debt restructurings for the three months ended September 30, 2017 totaling \$1,249. For the nine months ended September 30, 2018, there was one commercial real estate loan modified as a troubled debt restructuring totaling \$340. For the nine months ended September 30, 2017, six loans were modified as troubled debt restructurings in the amount of \$1,658. During the three months ended September 30, 2018, there was one payment default on a restructured residential real estate loan with an outstanding balance of \$6. During the nine months ended September 30, 2018, there were two payment defaults on restructured residential mortgage loans with a total outstanding amount of \$64. There were no payment defaults during the three or nine months ended September 30, 2017 on loans restructured within the last twelve months.

6. Other assets:

The components of other assets at September 30, 2018, and December 31, 2017 are summarized as follows:

| | September 30, 2018 | December 31, 2017 |
|--|--------------------|-------------------|
| Other real estate owned | \$ 342 | \$ 284 |
| Investment in low income housing partnership | 7,493 | 7,842 |
| Mortgage servicing rights | 731 | 728 |
| Bank owned life insurance | 34,100 | 33,836 |
| Restricted equity securities | 7,827 | 8,562 |
| Net deferred tax asset | 4,828 | 3,906 |
| Other assets | 9,252 | 9,311 |
| Total | \$ 64,573 | \$ 64,469 |

7. Fair value estimates:

The Company uses fair value measurements to record fair value adjustments to certain assets and liabilities and to determine fair value disclosure under GAAP. Fair value estimates are calculated without attempting to estimate the value

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of anticipated future business and the value of certain assets and liabilities that are not considered financial. Accordingly, such assets and liabilities are excluded from disclosure requirements.

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

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

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

- Level 1: Unadjusted quoted prices of identical assets or liabilities in active markets that the entity has the ability to access as of the measurement date.
- Level 2: Significant other observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data.

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

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

During the periods ended September 30, 2018 and December 31, 2017 there were no significant transfers between Level 1 and Level 2 and no transfers in or out of Level 3.

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

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

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

Interest rate swaps: The Company's interest rate swaps are reported at fair value utilizing Level 2 inputs. Values of these instruments are obtained through an independent pricing source utilizing information which may include market

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observed quotations for swaps, Libor rates, forward rates and rate volatility. Derivative contracts create exposure to interest rate movements as well as risks from the potential of non-performance of the counterparty.

Assets and liabilities measured at fair value on a recurring basis at September 30, 2018 and December 31, 2017 are summarized as follows:

| | | Fair Value Measurement Using | | |
|--|-----------|---|--|--|
| | | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| September 30, 2018 | Amount | | | |
| U.S. Treasury securities | \$ 25,230 | \$ 25,230 | | \$ |
| U.S. Government-sponsored enterprises | 91,772 | | \$ 91,772 | |
| State and Municipals: | | | | |
| Taxable | 13,813 | | 13,813 | |
| Tax-exempt | 89,969 | | 89,969 | |
| Mortgage-backed securities: | | | | |
| U.S. Government agencies | 13,585 | | 13,585 | |
| U.S. Government-sponsored enterprises | 40,425 | | 40,425 | |
| Common equity securities | 291 | 291 | | |

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| | | | | |
|--------------------------------------|------------|-----------|------------|----|
| Interest rate swap-other assets | 864 | | 864 | |
| Interest rate swap-other liabilities | (841) | | (841) | |
| Total | \$ 275,108 | \$ 25,521 | \$ 249,587 | \$ |

| December 31, 2017 | Fair Value Measurement Using | | | |
|--|------------------------------|---|--|--|
| | Amount | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| U.S. Treasury securities | \$ 19,814 | \$ 19,814 | | \$ |
| U.S. Government-sponsored enterprises | 93,648 | | \$ 93,648 | |
| State and Municipals: | | | | |
| Taxable | 15,047 | | 15,047 | |
| Tax-exempt | 103,833 | | 103,833 | |
| Mortgage-backed securities: | | | | |
| U.S. Government agencies | 14,434 | | 14,434 | |
| U.S. Government-sponsored enterprises | 25,726 | | 25,726 | |
| Common equity securities | 46 | 46 | | |
| Interest rate swap-other assets | 655 | | 655 | |
| Interest rate swap-other liabilities | (733) | | (733) | |
| Total | \$ 272,470 | \$ 19,860 | \$ 252,610 | \$ |

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Peoples Financial Services Corp.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

(Dollars in thousands, except per share data)

Assets and liabilities measured at fair value on a nonrecurring basis at September 30, 2018 and December 31, 2017 are summarized as follows:

| | | Fair Value Measurement Using | | |
|-------------------------|----------|------------------------------|------------------|--------------|
| | | Quoted Prices in | Significant | Significant |
| | | Active Markets for | Other Observable | Unobservable |
| | | Identical Assets | Inputs | Inputs |
| | Amount | (Level 1) | (Level 2) | (Level 3) |
| September 30, 2018 | | | | |
| Impaired loans | \$ 3,003 | | | \$ 3,003 |
| Other real estate owned | \$ 342 | | | \$ 342 |

| | | Fair Value Measurement Using | | |
|-------------------------|----------|------------------------------|-------------------|--------------|
| | | Quoted Prices in | Significant Other | Significant |
| | | Active Markets for | Observable | Unobservable |
| | | Identical Assets | Inputs | Inputs |
| | Amount | (Level 1) | (Level 2) | (Level 3) |
| December 31, 2017 | | | | |
| Impaired loans | \$ 3,424 | | | \$ 3,424 |
| Other real estate owned | \$ 216 | | | \$ 216 |

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

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

| | Quantitative Information about Level 3 Fair Value Measurements | | | |
|--------------------|--|----------------------|--------------------|--------------------|
| | Fair Value | | | Range |
| September 30, 2018 | Estimate | Valuation Techniques | Unobservable Input | (Weighted Average) |

| | | | | |
|-------------------------|----------|-------------------------|-----------------------|---------------------|
| Impaired loans | \$ 3,003 | Appraisal of collateral | Appraisal adjustments | 1.3% to 97.0% |
| | | | Liquidation expenses | (55.9)% |
| Other real estate owned | \$ 342 | Appraisal of collateral | Appraisal adjustments | 3.0% to 6.0% (4.9)% |
| | | | Liquidation expenses | 26.0% to 73.3% |
| | | | Appraisal adjustments | (31.8)% |
| | | | Liquidation expenses | 3.0% to 6.0% (5.0)% |

Quantitative Information about Level 3 Fair Value Measurements

| December 31, 2017 | Fair Value Estimate | Valuation Techniques | Unobservable Input | Range (Weighted Average) |
|-------------------------|---------------------|-------------------------|-----------------------|--------------------------|
| Impaired loans | \$ 3,424 | Appraisal of collateral | Appraisal adjustments | 4.0% to 97.0% |
| | | | Liquidation expenses | (67.2)% |
| Other real estate owned | \$ 216 | Appraisal of collateral | Appraisal adjustments | 3.0% to 6.0% (4.9)% |
| | | | Liquidation expenses | 25.0% to 41.3% |
| | | | Appraisal adjustments | (30.7)% |
| | | | Liquidation expenses | 3.0% to 6.0% (5.0)% |

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

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

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(Dollars in thousands, except per share data)

The carrying and fair values of the Company's financial instruments at September 30, 2018 and December 31, 2017 and their placement within the fair value hierarchy are as follows:

| | Carrying Value | Fair Value | Fair Value Hierarchy | | |
|------------------------------|----------------|--------------|--|---|---|
| | | | Quoted Prices in Active Markets for Identical Assets (level 1) | Significant Other Observable Inputs (level 2) | Significant Unobservable Inputs (Level 3) |
| September 30, 2018 | | | | | |
| Financial assets: | | | | | |
| Cash and cash equivalents | \$ 40,595 | \$ 40,595 | \$ 40,595 | | |
| Investment securities: | | | | | |
| Available-for-sale | 274,794 | 274,794 | 25,230 | \$ 249,564 | |
| Common equity securities | 291 | 291 | 291 | | |
| Held-to-maturity | 8,551 | 8,435 | | 8,435 | |
| Loans held for sale | 98 | 98 | | 98 | |
| Net loans | 1,759,032 | 1,706,913 | | | \$ 1,706,913 |
| Accrued interest receivable | 6,565 | 6,565 | | 6,565 | |
| Mortgage servicing rights | 731 | 1,645 | | 1,645 | |
| Restricted equity securities | 7,827 | 7,827 | | 7,827 | |
| Interest rate swaps | 864 | 864 | | 864 | |
| Total | \$ 2,099,348 | \$ 2,048,027 | | | |
| Financial liabilities: | | | | | |
| Deposits | \$ 1,827,864 | \$ 1,822,365 | | \$ 1,822,365 | |
| Short-term borrowings | 99,450 | 99,450 | | 99,450 | |
| Long-term debt | 48,461 | 48,487 | | 48,487 | |
| Accrued interest payable | 745 | 745 | | 745 | |
| Interest rate swaps | 841 | 841 | | 841 | |
| Total | \$ 1,977,361 | \$ 1,971,888 | | | |

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Peoples Financial Services Corp.

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(Dollars in thousands, except per share data)

| | Carrying Value | Fair Value | Fair Value Hierarchy | | |
|------------------------------|-------------------|---------------|--|---|--|
| | | | Quoted Prices in Active Markets for Identical Assets (level 1) | Significant Other Observable Inputs (level 2) | Significant Unobservable Inputs (Level 3) |
| December 31, 2017 | | | | | |
| Financial assets: | | | | | |
| Cash and cash equivalents | \$ 37,488 | \$ 37,488 | \$ 37,488 | | |
| Investment securities: | | | | | |
| Available-for-sale | 272,548 | 272,548 | 19,860 | \$ 252,688 | |
| Held-to-maturity | 9,274 | 9,547 | | 9,547 | |
| Loans held for sale | 106 | 106 | | 106 | |
| Net loans | 1,674,105 | 1,645,292 | | | \$ 1,645,292 |
| Accrued interest receivable | 6,936 | 6,936 | | 6,936 | |
| Mortgage servicing rights | 728 | 1,638 | | 1,638 | |
| Restricted equity securities | 8,562 | 8,562 | | 8,562 | |
| Interest rate swaps | 655 | 655 | | 655 | |
| Total | \$ 2,010,402 | \$ 1,982,772 | | | |
| Financial liabilities: | | | | | |
| Deposits | \$ 1,719,018 | \$ 1,666,284 | | \$ 1,666,284 | |
| Short-term borrowings | 123,675 | 123,675 | | 123,675 | |
| Long-term debt | 49,734 | 50,147 | | 50,147 | |
| Accrued interest payable | 497 | 497 | | 497 | |
| Interest rate swaps | 733 | 733 | | 733 | |
| Total | \$ 1,893,657 | \$ 1,841,336 | | | |

8. Employee benefit plans:

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

For the three and nine months ended September 30, salaries and employee benefits expense includes approximately \$330 and \$1,073, respectively in 2018 and \$311 and \$982, respectively in 2017 relating to the employee benefit plans.

| Three Months Ended September 30, Components of net periodic pension cost: | Pension Benefits | |
|--|------------------|---------|
| | 2018 | 2017 |
| Interest cost | \$ 233 | \$ 217 |
| Expected return on plan assets | (360) | (305) |
| Amortization of unrecognized net gain | 73 | 65 |
| Net periodic other benefit cost | \$ (54) | \$ (23) |

| Nine Months Ended September 30, Components of net periodic pension cost: | Pension Benefits | |
|---|------------------|---------|
| | 2018 | 2017 |
| Interest cost | \$ 389 | \$ 433 |
| Expected return on plan assets | (600) | (610) |
| Amortization of unrecognized net gain | 122 | 130 |
| Net periodic other benefit cost | \$ (89) | \$ (47) |

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The Company contributed \$2,700 to the pension plan during the third quarter of 2018. This contribution lessens the unfunded portion of the pension plan and will reduce future premium costs associated with the plan. Currently, the Company pays a fixed premium cost of \$18 annually with an additional \$92 for the variable portion of the premium. This will be reduced to \$0 with the current funding status of the pension.

The 2008 long-term incentive plan (“2008 Plan”) allowed for eligible participants to be granted equity awards. The 2008 Plan was a legacy plan of Pensco Financial Services Corporation and no awards may be made under the 2008 Plan after January 15, 2018. Under the 2008 Plan the Compensation Committee of the Board of Directors had broad authority with respect to awards granted under the 2008 Plan, including, without limitation, the authority to:

- Designate the individuals eligible to receive awards under the 2008 Plan.
- Determine the size, type and date of grant for individual awards, provided that awards approved by the Committee are not effective unless and until ratified by the board of directors.
- Interpret the 2008 Plan and award agreements issued with respect to individual participants.

In May 2017, the Company’s stockholders approved the 2017 equity incentive plan (“2017 Plan”). The 2017 Plan allows for eligible participants to be granted equity awards. Under the 2017 Plan the Compensation Committee of the Board of Directors has the authority to, among other things:

- Select the persons to be granted awards under the 2017 Plan.
- Determine the type, size and term of awards.
- Determine whether such performance objectives and conditions have been met.
- Accelerate the vesting or exercisability of an award.

Persons eligible to receive awards under the 2017 Plan include directors, officers, employees, consultants and other service providers of the Company and its subsidiaries.

As of September 30, 2018, there were 86,994 shares of the Company's common stock available for grant as awards pursuant to the 2017 Plan. The 2008 Plan expired in January 2018 but will remain in effect in accordance with its terms to govern outstanding awards under that plan. If any outstanding awards under the 2017 Plan are forfeited by the holder or canceled by the Company, the underlying shares would be available for regrant to others.

The 2017 Plan authorizes grants of stock options, stock appreciation rights, cash awards, performance awards, restricted stock and restricted stock units.

In 2018, the Company awarded 2,548 shares of non-performance-based restricted stock, bringing the total of nonvested restricted stock awards to 2,890 shares, and 8,920 performance-based restricted stock units under the 2017 Plan. In 2017, the Company awarded 2,020 shares of non-performance-based restricted stock, bringing the total of nonvested restricted stock awards to 14,382 shares, and 7,071 performance-based restricted stock units under the 2008 Plan. Also in 2017, the Company awarded 342 shares of non-performance based restricted stock and 1,196 performance based restricted stock units under the 2017 Plan.

The non-performance restricted stock grants made in 2017 and 2018 vest equally over three years from the grant date. Grants of restricted stock made in prior periods cliff vest after five years. The performance-based restricted stock units vest three years after the grant date and include conditions based on the Company's three year cumulative diluted earnings per share and three-year average return on equity that determines the number of restricted stock units that may vest.

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

The Company recognized compensation expense of \$31 and \$93 for the three and nine months ended September 30, 2018 for awards granted under the 2008 Plan and \$52 and \$95 for awards granted under the 2017 Plan. The Company recognized compensation expense of \$41 and \$89 for the three and nine months ended September 30, 2017 for awards granted under the 2008 Plan and did not recognize any compensation expense for the three and nine months ended September 30, 2017 for awards granted under the 2017 Plan. As of September 30, 2018, the Company had \$609 of unrecognized compensation expense associated with restricted stock awards. The remaining cost is expected to be recognized over a weighted average vesting period of 2 years.

9. Derivatives and hedging activities

Risk Management Objective of Using Derivatives

The Company is exposed to certain risks arising from both its business operations and economic conditions. The Company principally manages its exposures to a wide variety of business and operational risks through management of its core business activities. The Company manages economic risks, including interest rate, liquidity, and credit risk, primarily by managing the amount, sources, and duration of its assets and liabilities. The Company’s existing interest rate derivatives result from a service provided to certain qualifying customers and, therefore, are not used to manage interest rate risk in the Company’s assets or liabilities. The Company manages a matched book with respect to its derivative instruments in order to minimize its net risk exposure resulting from such transactions.

Fair Values of Derivative Instruments on the Balance Sheet

The table below presents the fair value of the Company’s derivative financial instruments as well as their classification on the Consolidated Balance Sheets as of September 30, 2018 and December 31, 2017.

| Asset Derivatives As of September 30, 2018 | Asset Derivatives As of December 31, 2017 | Liability Derivatives As of September 30, 2018 | Liability Derivatives As of December 31, |
|--|--|---|---|
|--|--|---|---|

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| | Balance Sheet Location | Fair Value | Balance Sheet Location | Fair Value | Balance Sheet Location | Fair Value | Balance Sheet Location | Fair Value |
|---|---------------------------|------------|---------------------------|------------|---------------------------|------------|---------------------------|------------|
| Derivatives not designated as hedging instruments Interest Rate Products | Other Assets | \$ 864 | Other Assets | \$ 655 | Other Liabilities | \$ 841 | Other Liabilities | |
| Total derivatives not designated as hedging instruments Non-designated Hedges | | \$ 864 | | \$ 655 | | \$ 841 | | |

None of the Company's derivatives are designated in qualifying hedging relationships. Derivatives not designated as hedges are not speculative and result from a service the Company provides to certain customers, which the Company implemented during the third quarter of 2017. The Company executes interest rate swaps with commercial banking customers to facilitate their respective risk management strategies. Those interest rate swaps are simultaneously hedged by offsetting interest rate swaps that the Company executes with a third party, such that the Company minimizes its net risk exposure resulting from such transactions. As the interest rate swaps associated with this program do not meet the strict hedge accounting requirements, changes in the fair value of both the customer swaps and the offsetting swaps are

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(Dollars in thousands, except per share data)

recognized directly in earnings. As of September 30, 2018, the Company had 6 interest rate swaps with an aggregate notional amount of \$62,657 related to this program compared to 5 interest rate swaps with an aggregate notional amount of \$55,928 at December 31, 2017.

Effect of Derivative Instruments on the Income Statement

The tables below present the effect of the Company's derivative financial instruments on the Income Statement for the three and nine months ended September 30, 2018 and 2017.

| Location of Gain or (Loss) | Recognized in Income on | Amount of Gain or (Loss) Recognized | Amount of Gain or (Loss) Recognized | Amount of Gain or (Loss) Recognized | Amount of Gain or (Loss) Recognized |
|---|---------------------------|-------------------------------------|-------------------------------------|-------------------------------------|-------------------------------------|
| | | Income Three Months Ended | Income Nine Months Ended | Income Three Months Ended | Income Nine Months Ended |
| Derivatives Not Designated as Hedging Instruments | Derivative | September 30, 2018 | September 30, 2018 | September 30, 2017 | September 30, 2017 |
| Interest Rate Products | Other non-interest income | \$ 18 | \$ 103 | \$ (55) | \$ (55) |
| Credit-risk-related Contingent Features | | | | | |

The Company has agreements with certain of its derivative counterparties that contain a provision where if the Company defaults on any of its indebtedness, including default where repayment of the indebtedness has not been accelerated by the lender, then the Company could also be declared in default on its derivative obligations.

The Company also has agreements with certain of its derivative counterparties that contain a provision where if the Company fails to maintain its status as a well capitalized institution, then the counterparty could terminate the derivative positions and the Company would be required to settle its obligations under the agreements.

The Company has agreements with certain of its derivative counterparties that contain provisions that require the Company's debt to maintain an investment grade credit rating from each of the major credit rating agencies. If the Company's credit rating is reduced below investment grade then a termination event shall be deemed to have occurred and the non-affected counterparty shall have the right but not obligation to terminate all affected transactions under the agreement.

As of September 30, 2018, the termination value of derivatives in a net asset position, which includes accrued interest but excludes any adjustment for nonperformance risk, related to these agreements was \$24. As of December 31, 2017,

the termination value of derivatives in a net liability position, which includes accrued interest but excludes any adjustment for nonperformance risk, related to these agreements was \$79. The Company has minimum collateral posting thresholds with certain of its derivative counterparties, and holds collateral of \$100 against its obligations under these agreements as of September 30, 2018, compared to posted collateral of \$880 with a counterparty at December 31, 2017. If the Company had breached any of these provisions it could have been required to settle its obligations under the agreements at the termination value.

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(Dollars in thousands, except per share data)

10. Short-term borrowings

Short-term borrowings consisted of FHLB advances representing overnight borrowings at September 30, 2018 and December 31, 2017:

| | At and for the nine months ended September 30, 2018 | | | | |
|---------------|---|------------|------------|---------------------------------|-----------|
| | Ending | Average | Maximum | Weighted | Weighted |
| | Balance | Balance | Month-End | Average | Average |
| | | | Balance | Rate for | Rate at |
| | | | | the nine months ended September | 30-Sep-18 |
| | | | | 30, 2018 | |
| | | | | 2.02 | |
| FHLB advances | \$ 99,450 | \$ 153,669 | \$ 189,275 | | % 2.38 % |

| | At and for the year ended December 31, 2017 | | | | |
|---------------|---|-----------|------------|----------|-------------|
| | Ending | Average | Maximum | Weighted | Weighted |
| | Balance | Balance | Month-End | Average | Average |
| | | | Balance | Rate for | Rate at End |
| | | | | the Year | of the Year |
| | | | | 1.17 | % 1.54 % |
| FHLB advances | \$ 123,675 | \$ 76,846 | \$ 123,675 | | |

The Bank has an agreement with the FHLB which allows for borrowings up to its maximum borrowing capacity based on a percentage of qualifying collateral assets. At September 30, 2018, the Bank's maximum borrowing capacity was \$694,115 of which \$147,811 was outstanding in borrowings. At December 31, 2017, the Bank's maximum borrowing capacity was \$631,782 of which \$173,409 was outstanding in borrowings. Short-term borrowings were used to fund our loan growth during the first half of 2018 resulting in higher average balances as deposit balances remained relatively flat, however, during the three months ended September 30, 2018 deposit balances increased allowing the Bank to decrease the amount of its short-term borrowings. Short-term borrowings are lower by \$24,225 since year end 2017. Advances with the FHLB are secured under terms of a blanket collateral agreement by a pledge of FHLB stock and certain other qualifying collateral, such as investments and mortgage-backed securities and mortgage loans. Interest accrues daily on the FHLB advances based on rates of the FHLB discount notes. This rate resets each day.

11. Income taxes

As a result of the Tax Cut and Jobs Act, signed into law on December 22, 2017, the statutory tax rate for the Company was lowered to 21% from 35% effective January 1, 2018. This lowered the effective tax rate of the Company to 11.8% for the three and nine months ended September 30, 2018 from 19.4% and 21.0% for the three and nine months ended September 30, 2017.

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Peoples Financial Services Corp.

Management's Discussion and Analysis

(Dollars in thousands, except per share data)

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

The following discussion and analysis should be read in conjunction with the unaudited consolidated interim financial statements contained in Part I, Item 1 of this report, and with our audited consolidated financial statements and "Management's Discussion and Analysis of Financial Condition and Results of Operations" presented in our Annual Report on Form 10-K for the year ended December 31, 2017.

Cautionary Note Regarding Forward-Looking Statements:

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

Our ability to predict results or the actual effect of future plans or strategies is inherently uncertain. Important factors that could cause our actual results to differ materially from those in the forward-looking statements include, but are not limited to: risks associated with business combinations; changes in interest rates; economic conditions, particularly in our market area; legislative and regulatory changes and the ability to comply with the significant laws and regulations governing the banking and financial services business; monetary and fiscal policies of the U.S. government, including policies of the U.S. Department of Treasury and the Federal Reserve System; credit risk associated with lending activities and changes in the quality and composition of our loan and investment portfolios; demand for loan and other products; deposit flows; competition; changes in the values of real estate and other collateral securing the loan portfolio, particularly in our market area; changes in relevant accounting principles and guidelines; inability of third party service providers to perform; and our ability to prevent, detect and respond to cyberattacks. Additional factors that may affect our results are discussed in Part I, Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2017, and in reports we file with the Securities and Exchange Commission from time to time.

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

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

Critical Accounting Policies:

Disclosure of our significant accounting policies are included in Note 1 to the consolidated financial statements of the Annual Report on Form 10-K for the year ended December 31, 2017. Some of these policies are particularly sensitive requiring significant judgments, estimates and assumptions.

Operating Environment:

The Federal Open Market Committee ("FOMC"), increased the overnight rate 25 basis points during the third quarter of 2018, marking the third increase in 2018 and the eighth overall in this cycle of tightening by the FOMC. Projections are for one additional rate hike in December of 2018. The FOMC noted continued strengthening in labor markets, overall inflation near the committee's long-term desired 2 percent level and economic activity rising at a strong rate.

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domestic product ("GDP"), the value of all goods and services produced in the nation, came in with an initial third quarter reading of 3.5%. This beat the consensus estimate of 3.3%. Second quarter 2018 GDP came in at an annualized rate of 4.2%, marking the first reading above 4.0% since 2014 and up from the final reading of 2.0% in the first quarter of 2018. The consumer price index ("CPI") registered 2.3% for the 12 months ended September 30, 2018. This is down from 2.9% for the 12 months ended June 30, 2018 and down slightly from 2.4% for the 12 months ended March 31, 2018.

Review of Financial Position:

Total assets increased \$88,812, or 5.5% annualized, to \$2,257,843 at September 30, 2018, from \$2,169,031 at December 31, 2017. Loans, net increased to \$1,779,445 at September 30, 2018, compared to \$1,693,065 at December 31, 2017, an increase of \$86,380 or 6.8% annualized. Deposits have increased \$108,846 or 8.5% annualized, to \$1,827,864 at September 30, 2018 from \$1,719,018 at December 31, 2018. The deposit growth occurred during the three months ended September 30, 2018 due to the seasonal inflow of municipal deposits and the addition of \$50,000 of callable brokered deposits. Interest-bearing deposits increased \$85,282 while noninterest-bearing deposits increased \$23,564. During the third quarter of 2018, total assets increased \$22,217 or 1.0% due primarily to loan growth of \$26,056 or 1.5%. Deposits increased \$109,003 or 6.3%. The increase in deposits led to a decrease in short-term borrowings during the quarter of \$88,000 or 47.0%. Total stockholders' equity increased \$7,995 or 4.0% annualized, from \$264,976 at year-end 2017 to \$272,971 at September 30, 2018. For the nine months ended September 30, 2018, total assets averaged \$2,218,633, an increase of \$182,750 or 9.0% from \$2,035,883 for the same period of 2017.

Investment Portfolio:

The majority of the investment portfolio is classified as available-for-sale, which allows for greater flexibility in using the investment portfolio for liquidity purposes by allowing securities to be sold when market opportunities occur. Investment securities available-for-sale totaled \$274,794 at September 30, 2018, an increase of \$2,292, or 0.8% from \$272,502 at December 31, 2017. The marginal increase was the result of re-investing the securities cash flow back into the investment portfolio and borrowing short-term to grow the investment portfolio to add liquid assets. Offsetting the purchases was the market value decline to the available-for-sale portfolio of \$4,391 due to the increase of short-term market rates and the flattening of the U.S. treasury curve. Investment securities held-to-maturity totaled \$8,551 at September 30, 2018, a decrease of \$723 or 7.8% from \$9,274 at December 31, 2017 due to payments received from mortgage backed holdings.

For the nine months ended September 30, 2018, the investment portfolio averaged \$282,341, an increase of \$12,444 or 4.6% compared to \$269,897 for the same period last year. The tax-equivalent yield on the investment portfolio decreased 25 basis points to 2.60% for the nine months ended September 30, 2018, from 2.85% for the comparable period of 2017. Yields on our tax-exempt municipal securities were computed on a taxable-equivalent basis assuming a 21% tax rate in 2018 and a 35% tax rate in 2017, reflecting the 21% statutory tax rate that became effective for us on January 1, 2018, under the Tax Cuts and Jobs Act of 2017. The change in tax rate in the current period resulted in a 26 basis point decline. Assuming a 21% tax rate in both periods, the taxable-equivalent yield would be higher by 6 basis points in the current period.

Securities available-for-sale are carried at fair value, with unrealized gains or losses net of deferred income taxes reported in the accumulated other comprehensive income (loss) component of stockholders' equity. We reported net unrealized losses, included as a separate component of stockholders' equity of \$4,448, net of deferred income taxes of \$1,183, at September 30, 2018, and of \$977, net of deferred income taxes of \$260, at December 31, 2017.

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

Loan Portfolio:

Loan growth during the nine months ended September 30, 2018 is meeting our projections. Loans, net increased to \$1,779,445 at September 30, 2018 from \$1,693,065 at December 31, 2017, an increase of \$86,380 or 6.8% annualized. The growth was primarily from commercial real estate loans and to a lesser extent from commercial and industrial loans

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and residential real estate loans. Partially offsetting the increases were reductions to consumer loans. Commercial real estate loans increased \$94,861, or 16.1% annualized, to \$881,071 at September 30, 2018 compared to \$786,210 at December 31, 2017 due to our continued success in executing the strategic market expansion initiative in the Lehigh Valley and Greater Delaware Valley. Commercial loans increased \$1,929 or 0.5% annualized, to \$478,128 at September 30, 2018 compared to \$476,199 at December 31, 2017 due to growth in loans to tax-exempt entities. Consumer loans decreased \$20,294, or 28.7% on an annualized basis, to \$122,427 at September 30, 2018 compared to \$142,721 at December 31, 2017. Contributing to the decline in consumer loans were the sale of our credit card portfolio of \$2,407 during the second quarter of 2018 and the sale of two of our student loan portfolios totaling \$5,164 occurring in the second and third quarter of 2018. Additionally, a decrease in dealer indirect auto loan originations resulting from a change in the structure of our loan pricing has led to a decline of \$11,157 to that portfolio during 2018.

Residential real estate loans increased \$9,884, or 4.6% on an annualized basis, to \$297,819 at September 30, 2018 compared to \$287,935 at December 31, 2017. The residential real estate loans increase was due to growth in our home equity line of credit portfolio due to increased demand, and an increase in first lien residential mortgages as a majority of new loan originations are being underwritten based on the Bank's guidelines and being held in portfolio.

For the nine months ended September 30, 2018, loans, net averaged \$1,743,008, an increase of \$172,740 or 11.0% compared to \$1,570,268 for the same period of 2017. The tax-equivalent yield on the loan portfolio was 4.44% for the nine months ended September 30, 2018, a 5 basis point increase from the comparable period last year. Yields on our tax-exempt loans were computed on a taxable-equivalent basis assuming a 21% tax rate in 2018 and a 35% tax rate in 2017, reflecting the 21% statutory tax rate that became effective for us on January 1, 2018, under the Tax Cuts and Jobs Act of 2017. The change in tax rate in the current period resulted in a 6 basis point decline to the current period loan yield. The tax-equivalent yield on the loan portfolio increased to 4.51% for the third quarter of 2018 as compared to 4.46% for the second quarter of 2018 and 4.42% for the third quarter of 2017 due to higher market rates and loan yields due to the FOMC's action to increase the Federal Funds rate 100 basis points over the last twelve months.

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

Unused commitments at September 30, 2018, totaled \$382,006, consisting of \$343,393 in unfunded commitments of existing loan facilities and \$38,613 in standby letters of credit. Due to fixed maturity dates, specified conditions within these instruments, and the ultimate needs of our customers, many will expire without being drawn upon. We believe that amounts actually drawn upon can be funded in the normal course of operations and therefore, do not represent a significant liquidity risk to us. In comparison, unused commitments at December 31, 2017 totaled \$404,615, consisting of \$381,228 in unfunded commitments of existing loans and \$23,387 in standby letters of credit.

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Asset Quality:

National, Pennsylvania, New York and market area unemployment rates at September 30, 2018 and 2017, are summarized as follows:

| | 2018 | | 2017 | |
|--------------------------|------|---|------|---|
| United States | 3.9 | % | 4.4 | % |
| New York (statewide) | 4.4 | | 4.8 | |
| Pennsylvania (statewide) | 4.4 | | 5.1 | |
| Broome County | 5.6 | | 5.7 | |
| Bucks County | 3.9 | | 4.4 | |
| Lackawanna County | 4.8 | | 5.4 | |
| Lehigh County | 4.8 | | 5.2 | |
| Luzerne County | 5.6 | | 6.2 | |
| Monroe County | 5.6 | | 6.0 | |
| Montgomery County | 3.6 | | 4.0 | |
| Northampton County | 4.6 | | 5.1 | |
| Susquehanna County | 4.2 | | 4.9 | |
| Wayne County | 4.9 | | 5.2 | |
| Wyoming County | 4.6 | % | 5.5 | % |

The employment conditions improved for the Nation, Pennsylvania, and New York and in all of the eleven counties representing our market areas in Pennsylvania and New York from one year ago. Unemployment rates have fallen to multi year lows.

Distribution of nonperforming assets

| | September 30, 2018 | December 31, 2017 |
|-------------------|--------------------|-------------------|
| Nonaccrual loans: | | |
| Commercial | \$ 808 | \$ 860 |

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| | | | | |
|--|-----------|---|-----------|---|
| Real estate: | | | | |
| Commercial | 3,879 | | 3,454 | |
| Residential | 2,503 | | 2,994 | |
| Consumer | 156 | | 177 | |
| Total nonaccrual loans | 7,346 | | 7,485 | |
| Troubled debt restructured loans: | | | | |
| Commercial | 1,462 | | 1,577 | |
| Real estate: | | | | |
| Commercial | 1,130 | | 836 | |
| Residential | 638 | | 661 | |
| Total troubled debt restructured loans | 3,230 | | 3,074 | |
| Accruing loans past due 90 days or more: | | | | |
| Real estate: | | | | |
| Commercial | 74 | | | |
| Residential | 510 | | 549 | |
| Consumer | | | 186 | |
| Total accruing loans past due 90 days or more | 584 | | 735 | |
| Total nonperforming loans | 11,160 | | 11,294 | |
| Foreclosed assets | 342 | | 284 | |
| Total nonperforming assets | \$ 11,502 | | \$ 11,578 | |
| Nonperforming loans as a percentage of loans, net | 0.63 | % | 0.67 | % |
| Nonperforming assets as a percentage of loans, net and foreclosed assets | 0.65 | % | 0.68 | % |

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Our asset quality remains strong as evidenced by a decrease in nonperforming assets of \$76 or 0.7% to \$11,502 or 0.65% of loans, net and foreclosed assets at September 30, 2018, from \$11,578 or 0.68% of loans, net and foreclosed assets at December 31, 2017. Decreases to nonaccrual loans, accruing loans past due ninety days or more and foreclosed assets were partially offset by an increase to restructured loans.

Accruing loans past due ninety days or more decreased \$151 to \$584 at September 30, 2018 from \$735 at December 31, 2017 due to the sale of two of our student loan portfolios during the second and third quarters. Successful collection and workout activities led to loans on nonaccrual, excluding non-accrual restructured loans, decreasing \$139 to \$7,346 at September 30, 2018 from \$7,485 at December 31, 2017. Restructured loans increased \$156 to \$3,230 at September 30, 2018 from \$3,074 at December 31, 2017 due in part to the addition of one large commercial real estate loan during the first quarter of 2018. Foreclosed assets increased \$58 to \$342 at September 30, 2018 from \$284 at December 31, 2017. Other real estate owned comprised seven properties at September 30, 2018 and eight properties at December 31, 2017.

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

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

We follow our systematic methodology in accordance with procedural discipline by applying it in the same manner regardless of whether the allowance is being determined at a high point or a low point in the economic cycle. Each quarter, credit administration identifies those loans to be individually evaluated for impairment and those loans collectively evaluated for impairment utilizing a standard criteria. We consistently use loss experience from the latest

twelve quarters in determining the historical loss factor for each pool collectively evaluated for impairment. Qualitative factors are evaluated in the same manner each quarter and are adjusted within a relevant range of values based on current conditions. For additional disclosure related to the allowance for loan losses refer to the note entitled, "Loans, net and Allowance for Loan Losses," in the Notes to Consolidated Financial Statements to this Quarterly Report.

The allowance for loan losses increased \$1,453 to \$20,413, or 1.15% of loans, net at September 30, 2018, from \$18,960, or 1.12% of loans, net at the end of 2017. For the nine months ended September 30, 2018, net charge-offs were \$1,697 or 0.10% of average loans outstanding, a \$967 increase compared to \$730 or 0.05% of average loans outstanding in the same period of 2017. The increase in the current period is due to one large commercial real estate credit totaling \$1,154 charged off during the second quarter of 2018.

Deposits:

We attract the majority of our deposits from within our eleven county market area that stretches from Montgomery County in southeastern Pennsylvania to Broome County in the Southern Tier of New York State through the offering of various deposit instruments including demand deposit accounts, NOW accounts, money market deposit accounts, savings accounts, and time deposits, including certificates of deposit and IRA's. For the nine months ended September 30, 2018, total deposits increased \$108,846 or 8.5% annualized, to \$1,827,864 from \$1,719,018 at December 31, 2017. Included in the total increase is \$50,000 of brokered callable time deposits less than \$250 added in the third quarter of 2018 to mitigate risk in a rising rate environment. Interest-bearing deposits increased \$85,282 due to seasonal inflows of our public deposits, the addition of brokered deposits and growth in our expansion markets, while noninterest-bearing deposits increased \$23,564. Interest-bearing transaction accounts, including NOW and money market accounts,

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increased \$50,731, or 10.1% annualized, to \$718,959 at September 30, 2018, from \$668,228 at December 31, 2017, savings accounts decreased \$4,337, or 1.5% annualized to \$383,490 as of September 30, 2018 from \$387,827 at December 31, 2017 and time deposits less than \$250 increased \$32,662, or 19.8% annualized, to \$253,474 at September 30, 2018, from \$220,812 at December 31, 2017. Time deposits \$250 or more increased \$6,226, or 13.5% annualized to \$67,648 at September 30, 2018 from \$61,422 at year end 2017.

For the nine months ended September 30, interest-bearing deposits averaged \$1,338,689 in 2018 compared to \$1,271,584 in 2017, an increase of \$67,105, or 5.3%. The cost of interest-bearing deposits was 0.61% in 2018 compared to 0.49% for the same period last year. For the first nine months, the overall cost of interest-bearing liabilities including the cost of borrowed funds, was 0.81% in 2018 and 0.60% in 2017. The higher costs are due primarily to higher short-term market rates, the result of the FOMC's action to increase the overnight borrowing rate 100 basis points over the last twelve months as well as the increased reliance on higher cost short-term borrowings in 2018 when compared to 2017.

Borrowings:

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

Total short-term borrowings at September 30, 2018, totaled \$99,450 compared to \$123,675 at December 31, 2017, a decrease of \$24,225. Long-term debt was \$48,461 at September 30, 2018, compared to \$49,734 at year end 2017. Lower short-term borrowings were the result of increases to our deposit balances primarily during the third quarter of 2018. During the first half of 2018 short-term borrowing balances were elevated to fund our loan growth and marginally grow the investment portfolio; the decline in long-term debt was a product of monthly contractual amortized payments made during the nine months ended September 30, 2018.

Market Risk Sensitivity:

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

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

The ALCO, comprised of members of our Board of Directors, senior management and other appropriate officers, oversees our IRR management program. Specifically, ALCO analyzes economic data and market interest rate trends, as well as competitive pressures, and utilizes computerized modeling techniques to reveal potential exposure to IRR. This allows us to monitor and attempt to control the influence these factors may have on our rate-sensitive assets (“RSA”) and

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rate-sensitive liabilities ("RSL"), and overall operating results and financial position. One such technique utilizes a static gap model that considers repricing frequencies of RSA and RSL in order to monitor IRR. Gap analysis attempts to measure our interest rate exposure by calculating the net amount of RSA and RSL that reprice within specific time intervals. A positive gap occurs when the amount of RSA repricing in a specific period is greater than the amount of RSL repricing within that same time frame and is indicated by a RSA/RSL ratio greater than 1.0. A negative gap occurs when the amount of RSL repricing is greater than the amount of RSA and is indicated by a RSA/RSL ratio of less than 1.0. A positive gap implies that earnings will be impacted favorably if interest rates rise and adversely if interest rates fall during the period. A negative gap tends to indicate that earnings will be affected inversely to interest rate changes.

Our cumulative one-year RSA/RSL ratio equaled 1.67% at September 30, 2018. Given the length of time that market rates have been at historical lows and the potential for rates to increase in the future, the focus of ALCO has been to create a positive static gap position. With regard to RSA, we predominantly offer medium-term, fixed-rate loans as well as adjustable rate loans. With respect to RSL, we offer longer term promotional certificates of deposit in an attempt to increase duration. The current position at September 30, 2018, indicates that the amount of RSA repricing within one year would exceed that of RSL, thereby causing net interest income to increase as market rates increase. However, these forward-looking statements are qualified in the aforementioned section entitled "Cautionary Note Regarding Forward-Looking Statements" in this Management's Discussion and Analysis.

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

As the static gap report fails to address the dynamic changes in the balance sheet composition or prevailing interest rates, we utilize a simulation model to enhance our asset/liability management. This model is used to create pro forma net interest income scenarios under various interest rate shocks. Model results at September 30, 2018, produced results similar to those indicated by the one-year static gap position. In addition, parallel and instantaneous shifts in interest rates under various interest rate shocks resulted in changes in net interest income that were well within ALCO policy limits during the first year of simulation. We will continue to monitor our IRR throughout 2018 and endeavor to employ deposit and loan pricing strategies and direct the reinvestment of loan and investment repayments in order to manage our IRR position.

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

Liquidity:

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

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

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

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

We employ a number of analytical techniques in assessing the adequacy of our liquidity position. One such technique is the use of ratio analysis to determine the extent of our reliance on noncore funds to fund our investments and loans maturing after September 30, 2018. Our noncore funds at September 30, 2018, were comprised of time deposits in denominations of \$100 or more and other borrowings. These funds are not considered to be a strong source of liquidity because they are very interest rate sensitive and are considered to be highly volatile. At September 30, 2018, our net noncore funding dependence ratio, the difference between noncore funds and short-term investments to long-term assets, was 15.7%, while our net short-term noncore funding dependence ratio, noncore funds maturing within one-year, less short-term investments to long-term assets equaled 6.6%. Comparatively, our overall noncore dependence ratio at year-end 2017 was 16.1% and our net short-term noncore funding dependence ratio was 11.1%, indicating that our reliance on noncore funds has decreased.

The Consolidated Statements of Cash Flows present the changes in cash and cash equivalents from operating, investing and financing activities. Cash and cash equivalents, consisting of cash on hand, cash items in the process of collection, deposit balances with other banks and federal funds sold, increased \$3,107 during the nine months ended September 30, 2018. Cash and cash equivalents decreased \$7,035 for the same period last year. For the nine months ended September 30, 2018, net cash inflows of \$24,360 from operating activities and \$76,096 from financing activities were partially offset by net cash outflows of \$97,349 from investing activities. For the same period of 2017, net cash inflows of \$22,720 from operating activities and \$73,411 from financing activities were more than offset by net cash outflows of \$103,166 from investing activities.

Operating activities provided net cash of \$24,360 for the nine months ended September 30, 2018, and \$22,720 for the corresponding nine months of 2017. Net income, adjusted for the effects of gains and losses along with noncash transactions such as depreciation and the provision for loan losses, is the primary source of funds from operations.

Investing activities primarily include transactions related to our lending activities and investment portfolio. Investing activities used net cash of \$97,349 for the nine months ended September 30, 2018, compared to using net cash \$103,166 for the same period of 2017. In 2018 and 2017, an increase in lending activities was the primary factor causing the net cash outflow from investing activities.

Financing activities provided net cash of \$76,096 for the nine months ended September 30, 2018, and provided net cash of \$73,411 for the corresponding nine months of 2017. Deposit gathering is our predominant financing activity. In the event that loan growth should exceed the growth in deposits, short-term borrowings fill in the gap in funding. Deposits provided cash of \$108,846 for the nine months ended September 30, 2018. Comparatively, deposits increased \$99,098 for the same period of 2017. We continue to seek deposits from new markets and customers as well as existing customers, including municipalities and school districts. Short term borrowings decreased \$24,225 in the nine months ended September 30, 2018 compared to a decrease of \$10,800 for the comparable period in 2017.

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

Capital:

Stockholders' equity totaled \$272,971 or \$36.89 per share at September 30, 2018, compared to \$264,976 or \$35.82 per share at December 31, 2017. Net income of \$18,528 for the nine months ended September 30, 2018 was the primary factor leading to the improved capital position. Stockholders' equity was also affected by cash dividends declared of

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\$7,252, stock based compensation of \$188, and other comprehensive loss resulting from market value fluctuations in the investment portfolio of \$3,469.

Dividends declared equaled \$0.98 per share through the nine months ended September 30, 2018 and \$0.94 per share for the same period of 2017. The dividend payout ratio was 39.2% for the nine months ended September 30, 2018 and 43.9% for the same period of 2017. The merger agreement pursuant to which we merged with Pensco in 2013 contemplates that, unless 80 percent of our board of directors determines otherwise, we will pay a quarterly cash dividend in an amount no less than \$0.31 per share through 2018, provided that sufficient funds are legally available, and that Peoples and Peoples Bank remain "Well-capitalized" in accordance with applicable regulatory guidelines. It is the intention of the Board of Directors to continue to pay cash dividends in the future. However, these decisions are affected by operating results, financial and economic decisions, capital and growth objectives, appropriate dividend restrictions and other relevant factors.

In July 2013, the federal banking agencies issued final rules to implement the Basel III regulatory capital reforms and changes required by the Dodd-Frank Act. The phase-in period for community banking organizations began January 1, 2015, while larger institutions (generally those with assets of \$250 billion or more) began compliance on January 1, 2014. The final rules call for the following capital requirements: (i) a minimum ratio of common equity tier 1 capital to risk-weighted assets of 4.5%; (ii) a minimum ratio of tier 1 capital to risk-weighted assets of 6%; (iii) a minimum ratio of total capital to risk-weighted assets of 8%; and (iv) a minimum leverage ratio of 4%. In addition, the final rules establish a common equity tier 1 capital conservation buffer of 2.5% of risk-weighted assets applicable to all banking organizations. If a banking organization fails to hold capital above the minimum capital ratios and the capital conservation buffer, it will be subject to certain restrictions on capital distributions and discretionary bonus payments. The phase-in period for the capital conservation buffer for all banking organizations began on January 1, 2016. Full phase-in occurs on January 1, 2019.

The adequacy of capital is reviewed on an ongoing basis with reference to the size, composition and quality of resources and regulatory guidelines. We seek to maintain a level of capital sufficient to support existing assets and anticipated asset growth, maintain favorable access to capital markets, and preserve high quality credit ratings. At September 30, 2018, the Bank's Tier 1 capital to total average assets was 9.71% as compared to 9.68% at December 31, 2017. The Bank's Tier 1 capital to risk weighted asset ratio was 11.68% and the total capital to risk weighted asset ratio was 12.82% at September 30, 2018. These ratios were 11.53% and 12.63% at December 31, 2017. The Bank's common equity Tier 1 to risk weighted asset ratio was 11.68% at September 30, 2018 compared to 11.53% at December 31, 2017. The Bank was deemed to be well-capitalized under regulatory standards at September 30, 2018. Additionally, as of September 30, 2018, the Bank would meet all capital adequacy requirements under the Basel III Capital Rules on a fully phased-in basis as if all such requirements were currently in effect.

Review of Financial Performance:

Net income for the third quarter of 2018 equaled \$6,717 or \$0.91 per share compared to \$5,350 or \$0.72 per share for the third quarter of 2017. The increase in earnings for the current period is the product of higher net interest income due to growth in our average earning assets of \$178.4 million since the year ago period driven primarily from growth in average loan balances of \$158.5 million and a reduction in income taxes due to the Tax Cuts and Jobs Act of 2017, which reduced the corporate tax rate to 21% effective January 1, 2018. These increases were partially offset by lower noninterest income and slightly higher non-interest expenses related to our market expansion initiative. In the third quarter of 2017 we entered into an interest rate swap transaction to retain a large credit relationship. Net fee income related to the swap was \$496 in the year ago period. Return on average assets (“ROA”) measures our net income in relation to total assets. Our ROA was 1.19% for the third quarter of 2018 compared to 1.03% for the same period of 2017. Return on average equity (“ROE”) indicates how effectively we can generate net income on the capital invested by stockholders. Our ROE was 9.81% for the third quarter of 2018 compared to 8.00% for the comparable period in 2017.

Net income through nine months in 2018 equaled \$18,528 or \$2.50 per share compared to \$15,809 or \$2.14 per share for the same period of 2017. In 2018, we entered into a credit card account purchase agreement with a third party to sell our credit card portfolio. This sale resulted in a pre-tax gain of \$291. In 2017, we entered into and executed a merchant asset purchase agreement with a third party to sell and transfer our merchant business. This sale resulted in a pre-tax

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gain of \$2,278. Our ROA and ROE were 1.12% and 9.21% through nine months in 2018 compared to 1.04% and 8.09% for the same period of 2017.

Net Interest Income:

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

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

Changes in net interest income are measured by the net interest spread and net interest margin. Net interest spread, the difference between the average yield earned on earning assets and the average rate incurred on interest-bearing liabilities, illustrates the effects changing interest rates have on profitability. Net interest margin, net interest income as a percentage of earning assets, is a more comprehensive ratio, as it reflects not only the spread, but also the change in the composition of interest-earning assets and interest-bearing liabilities. Tax-exempt loans and investments carry pre-tax yields lower than their taxable counterparts. Therefore, in order to make the analysis of net interest income more comparable, tax-exempt income and yields are reported herein on a tax-equivalent basis using the prevailing federal statutory tax rate of 21.0% in 2018 and 35.0% in 2017.

For the three months ended September 30, tax-equivalent net interest income increased \$889 to \$18,368 in 2018 from \$17,479 in 2017. The net interest spread decreased to 3.36% for the three months ended September 30, 2018 from 3.58% for the three months ended September 30, 2017. The tax-equivalent net interest margin decreased to 3.57% for

the third quarter of 2018 from 3.73% for the comparable period of 2017. Nine basis points of that decrease is attributable to the lowering of the statutory federal tax rate to 21% in 2018 compared to 35% in the year ago period. The tax-equivalent net interest margin for the second quarter of 2018 was 3.58%.

For the three months ended September 30, tax-equivalent interest income on earning assets increased \$2,180, to \$21,834 in 2018 as compared to \$19,654 in 2017. The overall yield on earning assets, on a fully tax-equivalent basis, increased 6 basis points for the three months ended September 30, 2018 to 4.25% as compared to 4.19% for the three months ended September 30, 2017. The increase in the yield on earning assets resulted from a 9 basis point increase in loan yields, 4.51% for the third quarter of 2018 compared to 4.42% for the same period last year. Loan yields increased as the Federal Open Market Committee ("FOMC") has increased the effective federal funds rate 75 basis points in 2017 and another 75 basis points in 2018. The overall yield earned on investments decreased 19 basis points for the third quarter of 2018 to 2.62% from 2.81% for the third quarter of 2017. Had the investment yields been calculated at the 2017 35% statutory federal tax rate, the tax-equivalent yield on the investment portfolio would have been 2.86%, a 5 basis point improvement from the year ago period as maturing investment balances were replaced by higher yielding investments. Average investment balances were \$19,796 higher when comparing the current and year ago quarter.

Total interest expense increased \$1,291, to \$3,466 for the three months ended September 30, 2018 from \$2,175 for the three months ended September 30, 2017. An increase in the average balance of interest bearing liabilities of \$134,526 combined with a 28 basis point increase in the cost of funds comparing the three months ended September 30, 2018 and 2017 caused the increase. Average short-term borrowings increased \$90,078 to \$144,162 for the quarter ended September 30, 2018 compared to \$54,084 for the corresponding year ago period as short-term borrowing were used to fund a portion of the loan demand. The increase in interest expense for the three and nine months ended September 30, 2018 was primarily due to higher deposit and borrowing costs which were impacted directly by the actions of the FOMC to increase the targeted federal funds rate.

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For the nine months ended September 30, tax-equivalent net interest income increased \$2,921 to \$54,030 in 2018 from \$51,109 in 2017. The net interest spread decreased to 3.38% for the nine months ended September 30, 2018 from 3.57% for the nine months ended September 30, 2017. The tax-equivalent net interest margin for the nine months ended September 30 was 3.57% in 2018 compared to 3.71% in 2017. Eight basis points of that decrease is attributable to the lowering of the statutory federal tax rate to 21% in 2018 compared to 35% in the year ago period.

For the nine months ended September 30, 2018, tax-equivalent interest income increased \$6,052, to \$63,418 compared to \$57,366 for the nine months ended September 30, 2017. This was due to a volume variance in interest income of \$5,977 attributable to an increase in the average balance of earning assets coupled with a \$75 favorable rate variance due primarily to an increase in the yield on loans for the nine months ended September 30, 2018 from the same period in 2017. The overall yield on earning assets, on a fully tax-equivalent basis, increased for the nine months ended September 30, 2018 to 4.19% as compared to 4.17% for the nine months ended September 30, 2017.

Total interest expense increased \$3,131 to \$9,388 for the nine months ended September 30, 2018 from \$6,257 for the nine months ended September 30, 2017. The average balance of interest bearing liabilities increased to \$1,541,346 for the nine months ended September 30, 2018, as compared to \$1,403,250 for the nine months ended September 30, 2017. A volume variance in short-term borrowings caused interest expense to increase \$997. Adding to the volume variance, a rate variance of \$2,134 resulted in the increased interest expense through nine months in 2018. The cost of funds increased to 0.81% for the nine months ended September 30, 2018 as compared to 0.60% for the same period in 2017, the result of higher short-term market rates resulting from the FOMC's actions of raising the targeted federal funds rate.

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The average balances of assets and liabilities, corresponding interest income and expense and resulting average yields or rates paid are summarized as follows. Averages for earning assets include nonaccrual loans. Investment averages include available-for-sale securities at amortized cost. Income on investment securities and loans is adjusted to a tax equivalent basis using the prevailing federal statutory tax rate of 21% in 2018 and 35% in 2017.

| | Three months ended September 30, 2018 | | | September 30, 2017 | | |
|--|--|-----------------------------|----------------|--------------------|-----------------------------|----------------|
| | Average Balance | Interest Income/ Expense | Yield/ Rate | Average Balance | Interest Income/ Expense | Yield/ Rate |
| Assets: | | | | | | |
| Earning assets: | | | | | | |
| Loans: | | | | | | |
| Taxable | \$ 1,632,012 | \$ 18,798 | 4.57 % | \$ 1,482,215 | \$ 16,535 | 4.43 % |
| Tax-exempt | 123,199 | 1,162 | 3.74 | 114,455 | 1,250 | 4.33 |
| Total loans | 1,755,211 | 19,960 | 4.51 | 1,596,670 | 17,785 | 4.42 |
| Investments: | | | | | | |
| Taxable | 184,623 | 1,062 | 2.28 | 157,104 | 766 | 1.93 |
| Tax-exempt | 99,142 | 811 | 3.25 | 106,865 | 1,102 | 4.09 |
| Total investments | 283,765 | 1,873 | 2.62 | 263,969 | 1,868 | 2.81 |
| Interest-bearing deposits | 377 | 1 | 1.05 | 272 | 1 | 1.46 |
| Federal funds sold | | | | | | |
| Total earning assets | 2,039,353 | 21,834 | 4.25 % | 1,860,911 | 19,654 | 4.19 % |
| Less: allowance for loan losses | 19,944 | | | 18,180 | | |
| Other assets | 218,173 | | | 213,953 | | |
| Total assets | \$ 2,237,582 | \$ 21,834 | | \$ 2,056,684 | \$ 19,654 | |
| Liabilities and Stockholders' Equity: | | | | | | |
| Interest-bearing liabilities: | | | | | | |
| Money market accounts | \$ 293,063 | \$ 650 | 0.88 % | \$ 273,482 | \$ 397 | 0.58 % |
| NOW accounts | 382,401 | 580 | 0.60 | 342,516 | 375 | 0.43 |
| Savings accounts | 389,775 | 122 | 0.12 | 399,639 | 127 | 0.13 |
| Time deposits less than \$100 | 141,251 | 426 | 1.20 | 156,012 | 420 | 1.07 |
| | 145,219 | 564 | 1.54 | 128,012 | 335 | 1.04 |

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| | | | | | | | |
|--|--------------|-----------|--------|--------------|-----------|--------|--|
| Time deposits \$100 or more | | | | | | | |
| Short-term borrowings | 144,162 | 809 | 2.23 | 54,084 | 177 | 1.30 | |
| Long-term debt | 48,670 | 315 | 2.57 | 56,270 | 344 | 2.43 | |
| Total interest-bearing liabilities | 1,544,541 | 3,466 | 0.89 | 1,410,015 | 2,175 | 0.61 | |
| Noninterest-bearing deposits | 405,671 | | | 366,610 | | | |
| Other liabilities | 15,609 | | | 14,820 | | | |
| Stockholders' equity | 271,761 | | | 265,239 | | | |
| Total liabilities and stockholders' equity | \$ 2,237,582 | 3,466 | | \$ 2,056,684 | 2,175 | | |
| Net interest income/spread | | \$ 18,368 | 3.36 % | | \$ 17,479 | 3.58 % | |
| Net interest margin | | | 3.57 % | | | 3.73 % | |
| Tax-equivalent adjustments: | | | | | | | |
| Loans | | \$ 243 | | | \$ 437 | | |
| Investments | | 172 | | | 386 | | |
| Total adjustments | | \$ 415 | | | \$ 823 | | |

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| | Nine months ended September 30, 2018 | | | | September 30, 2017 | | |
|--|---|-----------------------------|----------------|--------------|--------------------|-----------------------------|----------------|
| | Average Balance | Interest Income/ Expense | Yield/ Rate | | Average Balance | Interest Income/ Expense | Yield/ Rate |
| Assets: | | | | | | | |
| Earning assets: | | | | | | | |
| Loans: | | | | | | | |
| Taxable | \$ 1,619,409 | \$ 54,546 | 4.50 % | \$ 1,458,840 | \$ 48,021 | 4.40 % | |
| Tax-exempt | 123,599 | 3,367 | 3.64 | 111,428 | 3,591 | 4.31 | |
| Total loans | 1,743,008 | 57,913 | 4.44 | 1,570,268 | 51,612 | 4.39 | |
| Investments: | | | | | | | |
| Taxable | 179,995 | 2,967 | 2.20 | 158,837 | 2,271 | 1.91 | |
| Tax-exempt | 102,346 | 2,533 | 3.31 | 111,060 | 3,480 | 4.19 | |
| Total investments | 282,341 | 5,500 | 2.60 | 269,897 | 5,751 | 2.85 | |
| Interest-bearing deposits | 441 | 5 | 1.52 | 309 | 3 | 1.30 | |
| Federal funds sold | | | | | | | |
| Total earning assets | 2,025,790 | 63,418 | 4.19 % | 1,840,474 | 57,366 | 4.17 % | |
| Less: allowance for loan losses | 19,755 | | | 17,309 | | | |
| Other assets | 212,598 | | | 212,718 | | | |
| Total assets | \$ 2,218,633 | \$ 63,418 | | \$ 2,035,883 | \$ 57,366 | | |
| Liabilities and Stockholders' Equity: | | | | | | | |
| Interest-bearing liabilities: | | | | | | | |
| Money market accounts | \$ 290,126 | \$ 1,676 | 0.77 % | \$ 256,632 | \$ 1,003 | 0.52 % | |
| NOW accounts | 375,534 | 1,524 | 0.54 | 331,653 | 1,057 | 0.43 | |
| Savings accounts | 391,613 | 366 | 0.12 | 400,585 | 380 | 0.13 | |
| Time deposits less than \$100 | 145,517 | 1,275 | 1.17 | 158,230 | 1,265 | 1.07 | |
| Time deposits \$100 or more | 135,899 | 1,294 | 1.27 | 124,484 | 912 | 0.98 | |
| Short-term borrowings | 153,669 | 2,317 | 2.02 | 74,506 | 599 | 1.07 | |
| Long-term debt | 48,988 | 936 | 2.55 | 57,160 | 1,041 | 2.43 | |
| Total interest-bearing liabilities | 1,541,346 | 9,388 | 0.81 | 1,403,250 | 6,257 | 0.60 | |

| | | | | | | |
|--|--------------|-----------|--------|--------------|-----------|--------|
| Noninterest-bearing deposits | 392,523 | | | 356,560 | | |
| Other liabilities | 15,678 | | | 14,666 | | |
| Stockholders' equity | 269,086 | | | 261,407 | | |
| Total liabilities and stockholders' equity | \$ 2,218,633 | 9,388 | | \$ 2,035,883 | 6,257 | |
| Net interest income/spread | | \$ 54,030 | 3.38 % | | \$ 51,109 | 3.57 % |
| Net interest margin | | | 3.57 % | | | 3.71 % |
| Tax-equivalent adjustments: | | | | | | |
| Loans | | \$ 707 | | | \$ 1,257 | |
| Investments | | 532 | | | 1,218 | |
| Total adjustments | | \$ 1,239 | | | \$ 2,475 | |

Provision for Loan Losses:

We evaluate the adequacy of the allowance for loan losses account on a quarterly basis utilizing our systematic analysis in accordance with procedural discipline. We take into consideration certain factors such as composition of the loan portfolio, volumes of nonperforming loans, volumes of net charge-offs, prevailing economic conditions and other relevant factors when determining the adequacy of the allowance for loan losses account. We make monthly provisions to the allowance for loan losses account in order to maintain the allowance at the appropriate level indicated by our

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evaluations. Based on our most current evaluation, we believe that the allowance is adequate to absorb any known and inherent losses in the portfolio as of September 30, 2018.

The provision for loan losses totaled \$3,150 for the nine months ended September 30, 2018 and \$3,600 for the nine months ended September 30, 2017. For the three months ended September 30, the provision for loan losses was \$1,050 in 2018 and \$1,200 in 2017.

Noninterest Income:

Noninterest income for the third quarter decreased \$408 or 11.1% to \$3,253 in 2018 from \$3,661 in 2017. Service charges, fees and commissions decreased \$273 to \$1,883 in 2018 from \$2,156 in 2017. In the third quarter of 2017 we entered into an interest rate swap transaction to retain a large credit relationship. Net fee income related to the swap, included in service charges, fees, commissions, was \$496 in the year ago period compared to \$18 of swap related income in the current period. Wealth management revenue decreased \$109 to \$305 during the three months ended September 30, 2018 from \$414 in the year ago period.

For the nine months ended September 30, 2018, noninterest income totaled \$10,488, a decrease of \$3,334 or 24.1% from \$13,822 for the comparable period of 2017. Service charges, fees and commissions increased \$446 or 8.2% to \$5,856 through nine months in 2018 from \$5,410 for the same period in 2017. Included in service charges, fees and commissions in the current period are death benefit proceeds on a bank owned life insurance (BOLI) policy totaling \$365, with no comparable amount in the year ago period. Additionally, we received a higher dividend from the FHLB of \$192 due to an increase in rate and higher volume of stock. Offsetting the increases was lower revenue recognized from swap transactions in the current period of \$340 versus the year ago period. Merchant services income decreased \$1,671 to \$687 for the nine months ended September 30, 2018 from \$2,358 for the same period last year due to the sale of our merchant services business during the second quarter of 2017. Additionally, a gain of \$2,278 related to the merchant business sale was recognized in 2017; a gain of \$291 from the sale of our credit card portfolio was recognized in 2018. Income generated from commissions and fees on fiduciary activities increased \$10 to \$1,552 for the nine months ended September 30, 2018 in comparison to \$1,542 for the same period in 2017 due to increased asset values in 2018. Income generated from our wealth management division decreased \$33 to \$1,048 through the first nine months of 2018 in comparison to \$1,081 over that same period in 2017 due to a decrease in the volume of transactions in 2018 compared to the year ago period. Mortgage banking income decreased \$104 to \$472 for through nine months of 2018 compared to \$576 for the comparable period in 2017 as the volume of loans originated for sale declined. Life insurance investment income was slightly lower by \$9 to \$568 for the nine months ended September 30, 2018 from \$577 for the same period in 2017.

Noninterest Expenses:

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

For the third quarter, noninterest expense increased \$57 or 0.5% to \$12,537 in 2018 from \$12,480 in 2017. For the nine months ended September 30, noninterest expense increased \$276 or 0.7% to \$39,114 in 2018 from \$38,838 in 2017. Personnel costs increased 7.3%, net occupancy and equipment costs increased 12.1%, merchant services expense decreased 99.7% due to the sale of our merchant service business in the second quarter of 2017 and all other expense categories which include, professional fees and outside services, FDIC insurance and assessments, donations and other miscellaneous expenses decreased by 1.6% comparing year-to-date 2018 and 2017.

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Salaries and employee benefits expense, which comprise the majority of noninterest expense, totaled \$6,946 for the third quarter of 2018, an increase of \$396 or 6.1% when compared to \$6,550 for the third quarter of 2017. Salaries and employee benefits expense totaled \$21,291 for the nine months ending September 30, 2018, an increase of \$1,440 or 7.3% when compared to \$19,851 for the same period of 2017. Costs related to the build out of our market expansion coupled with annual merit increases contributed to the increase. Additional professionals have been added to support our expansion and to continue our momentum in the Lehigh Valley and King of Prussia markets. Our newest office located on Tilghman Street in West Allentown opened in July of 2017.

We experienced a \$198 or 8.0% increase in net occupancy and equipment expense comparing the third quarter of 2018 at \$2,681 and 2017 at \$2,483. The nine months ended September 30, 2018 resulted in a \$888 or 12.1% increase to \$8,215 in net occupancy and equipment expense compared to \$7,327 for the same period in 2017. Additional expenses related to our market expansion into the greater Lehigh Valley was the primary reason for the increases. In general, as we expand and increase our presence in new markets, the depreciation expenses and technology costs associated with the maintenance and operations of new infrastructure within those markets increases.

Merchant services expense for the three months ended September 30, 2018 was \$3, a decrease of \$30 from the \$33 of expense for the same period in 2017. For the nine months ended September 30, the decrease in merchant services expense was \$1,790 comparing \$6 in 2018 and \$1,796 in 2017. The decreases are the result of selling our merchant services business during the second quarter of 2017.

For the third quarter, all other expense categories decreased \$468 or 14.8% to \$2,687 from \$3,155 comparing 2018 to 2017. For the three months ended September 30, 2018, corporate taxes were lower due to a reversal in the current period of a \$130 charge expensed during the second quarter of 2018. Advertising expense was lower in the current period due to fewer new account acquisition mailings. For the nine months ended September 30, all other expense categories decreased \$147 or 1.6% to \$8,932 in 2018 compared to \$9,079 in 2017. Advertising expense decreased by \$175 due to fewer promotional mailings. Shares tax expense decreased \$256 in 2018 when compared to 2017 resulting from higher tax credits under the Commonwealth of Pennsylvania's Educational Improvement Tax Credit Program (EITC). FDIC assessments increased \$223, or 36.7% when comparing the nine month period ending September 30, 2018 to the same period in 2017, the result of an increase in average assets at the bank level when comparing 2018 to 2017 coupled with a 17.3% increase in the multiplier used to calculate the assessment. Donations increased \$133, or 15.1% in the nine months ended September 30, 2018 when compared to the same period in 2017 as the Bank has increased its support to charitable and civic organizations.

Income Taxes:

We recorded income tax expense of \$902 or 11.8% of pre-tax income, and \$1,287 or 19.4% of pre-tax income for the three months ended September 30, 2018 and 2017. We recorded income tax expense of \$2,487 or 11.8% of pre-tax income, and \$4,209 or 21.0% of pre-tax income for the nine months ended September 30, 2018 and 2017. Both the nine months ended September 30, 2018 and 2017 include before tax investment tax credits of \$819. The decrease in the statutory tax rate to 21% in 2018 from 35% in 2017 resulted in the significant reduction in the effective tax rate between the two reporting periods.

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Item 3. Quantitative and Qualitative Disclosures about Market Risk.

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

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

The projected impacts of instantaneous changes in interest rates on our net interest income and economic value of equity at September 30, 2018, based on our simulation model, as compared to our ALCO policy limits are summarized as follows:

| Changes in Interest Rates (basis points) | September 30, 2018 | | | |
|--|------------------------------------|--------|--------------------------|--------|
| | % Change in Net Interest Income | | Economic Value of Equity | |
| | Metric | Policy | Metric | Policy |
| +400 | 0.8 | (20.0) | 1.7 | (40.0) |
| +300 | 0.8 | (20.0) | 1.7 | (30.0) |
| +200 | 0.7 | (10.0) | 1.2 | (20.0) |
| +100 | 0.5 | (10.0) | 1.5 | (10.0) |
| Static | | | | |
| (100) | (3.5) | (10.0) | (6.6) | (10.0) |

Our simulation model creates pro forma net interest income scenarios under various interest rate shocks. Given instantaneous and parallel shifts in general market rates of plus 100 basis points, our projected net interest income for the 12 months ending September 30, 2019, would increase slightly at 0.5 percent from model results using current interest rates. Additional disclosures about market risk are included in Part II, Item 7 of our Annual Report on Form 10-K for the year ended December 31, 2017, and in Part I, Item 2 of this quarterly report, in each case under the heading “Market Risk Sensitivity,” and are incorporated into this Item 3 by reference. There were no material changes in our market risk from December 31, 2017.

Item 4. Controls and Procedures.

(a) Evaluation of disclosure controls and procedures.

At September 30, 2018, the end of the period covered by this Quarterly Report on Form 10-Q, the principal executive officer (“PEO”) and principal financial officer (“PFO”) evaluated the effectiveness of the Company’s disclosure controls and procedures as defined in Rule 13a-15(e) under the Exchange Act. Based upon that evaluation, the PEO and PFO concluded that the disclosure controls and procedures, at September 30, 2018, were effective to provide reasonable

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assurance that information required to be disclosed in the Company's reports filed under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and to provide reasonable assurance that information required to be disclosed in such reports is accumulated and communicated to the PEO and PFO to allow timely decisions regarding required disclosure.

(b) Changes in internal control.

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

PART II—OTHER INFORMATION

Item 1. Legal Proceedings.

The nature of the Company's business generates a certain amount of litigation involving matters arising out of the ordinary course of business. In the opinion of management, there were no legal proceedings that had or might have a material effect on the consolidated results of operations, liquidity, or the financial position of the Company during the nine-months ended September 30, 2018 and through the date of this quarterly report on Form 10-Q.

Item 1A. Risk Factors.

There have been no material changes from the risk factors previously disclosed in the Company's Annual Report on Form 10-K for the year ended December 31, 2017.

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

On May 1, 2017, we announced a stock repurchase program providing for the purchase of up to 225,000 shares of our outstanding common stock. The timing, price and volume of repurchases under the program will be based on market conditions, relevant securities laws and other factors.

There were no purchases made by or on behalf of the Company or any “affiliated purchaser,” as defined in the Exchange Act Rule 10b-18(a)(3), of the Company’s common stock during each of the months for the quarter ended September 30, 2018.

| Month Ending | Total Number of Shares Purchased | Average Price Paid Per Share | Total Number of Shares Purchased as Part of Publicly Announced Programs | Maximum Number of Shares that may yet be Purchased Under the Programs |
|--------------------|-------------------------------------|---------------------------------|---|---|
| July 31, 2018 | | \$ | | 225,000 |
| August 31, 2018 | | \$ | | 225,000 |
| September 30, 2018 | | \$ | | 225,000 |

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Item 3. Defaults upon Senior Securities.

None.

Item 4. Mine Safety Disclosures.

Not applicable.

Item 5. Other Information.

None.

Item 6. Exhibits.

| Item Number | Description | Page |
|-------------|--|------|
| 31.1 | <u>PEO Certification Pursuant to Rule 13a-14 (a) /15d-14 (a).</u> | 51 |
| 31.2 | <u>PFO Certification Pursuant to Rule 13a-14 (a) /15d-14 (a).</u> | 52 |
| 32 | <u>PEO and PFO Certifications Pursuant to Section 1350.</u> | 53 |
| 101 | The following materials from Peoples Financial Services Corp. Quarterly Report on Form 10-Q for the period ended September 30, 2018, formatted in XBRL: (i) the Consolidated Balance Sheets, (ii) the Consolidated Statements of Income and Comprehensive Income, (iii) the Consolidated Statements of Changes in Stockholders' Equity, (iv) the Consolidated Statements of Cash Flows and (v) the Notes to the Consolidated Financial Statements. | |

SIGNATURES

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

Peoples Financial Services Corp.
(Registrant)

Date: November 8, 2018 /s/ Craig W. Best
Craig W. Best
President and Chief Executive Officer
(Principal Executive Officer)

Date: November 8, 2018 /s/ John R. Anderson, III
John R. Anderson, III
Executive Vice President and Chief Financial Officer
(Principal Financial Officer and Principal Accounting Officer)