
**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**
Washington, DC 20549

Form 10-Q

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

for the quarterly period ended June 30, 2019

or

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

for the transition period from

001-36388

(Commission File Number)

PEOPLES FINANCIAL SERVICES CORP.

(Exact name of registrant as specified in its charter)

Pennsylvania
(State of
incorporation)

150 North Washington Avenue, Scranton, PA
(Address of principal executive offices)

23-2391852
(IRS Employer
ID Number)

18503
(Zip code)

(570) 346-7741

(Registrant's telephone number, including area code)

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

<u>Title of each class:</u>	<u>Trading Symbol</u>	<u>Name of each exchange on which registered:</u>
Common stock, \$2.00 par value	PFIS	The Nasdaq Stock Market

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. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company," and "emerging growth company" 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: 7,399,078 at July 31, 2019.

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PEOPLES FINANCIAL SERVICES CORP.
FORM 10-Q

For the Quarter Ended June 30, 2019

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Peoples Financial Services Corp.
CONSOLIDATED BALANCE SHEET S
(Dollars in thousands, except share data)

	June 30, 2019	December 31, 2018
Assets:		
Cash and due from banks:		
Cash and due from banks	\$ 26,615	\$ 32,569
Interest-bearing deposits in other banks	3,347	47
Total cash and due from banks	29,962	32,616
Investment securities:		
Available-for-sale	261,665	269,682
Equity investments carried at fair value	283	291
Held-to-maturity: Fair value June 30, 2019, \$8,151; December 31, 2018, \$8,380	7,969	8,361
Total investment securities	269,917	278,334
Loans, net	1,858,799	1,823,266
Less: allowance for loan losses	21,930	21,379
Net loans	1,836,869	1,801,887
Loans held for sale	831	749
Premises and equipment, net	46,468	38,889
Accrued interest receivable	7,303	7,115
Goodwill	63,370	63,370
Intangible assets, net	1,921	2,296
Other assets	67,625	63,737
Total assets	\$ 2,324,266	\$ 2,288,993
Liabilities:		
Deposits:		
Noninterest-bearing	\$ 419,995	\$ 410,260
Interest-bearing	1,456,804	1,464,762
Total deposits	1,876,799	1,875,022
Short-term borrowings	82,700	86,500
Long-term debt	52,980	37,906
Accrued interest payable	1,058	1,195
Other liabilities	19,146	9,756
Total liabilities	2,032,683	2,010,379
Stockholders' equity:		
Common stock, par value \$2.00, authorized 25,000,000 shares, issued and outstanding 7,399,078 shares at June 30, 2019 and 7,399,054 shares at December 31, 2018	14,798	14,798
Capital surplus	135,384	135,310
Retained earnings	145,106	136,582
Accumulated other comprehensive loss	(3,705)	(8,076)
Total stockholders' equity	291,583	278,614
Total liabilities and stockholders' equity	\$ 2,324,266	\$ 2,288,993

See notes to unaudited consolidated financial statements

Peoples Financial Services Corp.
CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME (UNAUDITED)
(Dollars in thousands, except per share data)

June 30,	Three Months Ended		Six Months Ended	
	2019	2018	2019	2018
Interest income:				
Interest and fees on loans:				
Taxable	\$ 20,641	\$ 18,239	\$ 40,744	\$ 35,748
Tax-exempt	1,109	871	2,208	1,741
Interest and dividends on investment securities:				
Taxable	1,025	934	2,035	1,792
Tax-exempt	520	661	1,082	1,362
Dividends	22	19	41	35
Interest on interest-bearing deposits in other banks	15	42	23	82
Total interest income	23,332	20,766	46,133	40,760
Interest expense:				
Interest on deposits	3,713	1,959	7,124	3,793
Interest on short-term borrowings	595	841	1,408	1,508
Interest on long-term debt	296	315	576	621
Total interest expense	4,604	3,115	9,108	5,922
Net interest income	18,728	17,651	37,025	34,838
Provision for loan losses	350	1,050	1,400	2,100
Net interest income after provision for loan losses	18,378	16,601	35,625	32,738
Noninterest income:				
Service charges, fees and commissions	2,490	1,885	4,489	3,973
Merchant services income	457	309	655	559
Commission and fees on fiduciary activities	492	485	999	982
Wealth management income	370	332	747	743
Mortgage banking income	137	162	285	309
Life insurance investment income	192	191	378	378
Net losses (gains) on equity investment securities	(9)	8	(8)	
Net gains on sale of investment securities available-for-sale	23		23	
Net gain on sale of credit card loans		291		291
Total noninterest income	4,152	3,663	7,568	7,235
Salaries and employee benefits expense	8,037	7,390	15,632	14,345
Net occupancy and equipment expense	2,849	2,720	5,810	5,534
Amortization of intangible assets	182	220	374	450
Professional fees and outside services	525	446	856	1,069
FDIC insurance and assessments	288	297	547	583
Donations	359	343	691	656
Other expenses	2,189	2,080	4,009	3,940
Total noninterest expense	14,429	13,496	27,919	26,577
Income before income taxes	8,101	6,768	15,274	13,396
Income tax expense	957	811	1,718	1,585
Net income	7,144	5,957	13,556	11,811
Other comprehensive income (loss):				
Unrealized gain (loss) on investment securities available-for-sale	2,611	(839)	5,050	(3,215)
Reclassification adjustment for net gain on sales included in net income	(23)		(23)	
Change in derivative fair value	443		506	
Other comprehensive gain (loss)	3,031	(839)	5,533	(3,215)
Income tax expense (benefit)	637	(176)	1,162	(677)
Other comprehensive income (loss), net of income taxes	2,394	(663)	4,371	(2,538)
Comprehensive income	\$ 9,538	\$ 5,294	\$ 17,927	\$ 9,273
Per share data:				
Net income:				
Basic	\$ 0.96	\$ 0.81	\$ 1.83	\$ 1.60
Diluted	\$ 0.96	\$ 0.81	\$ 1.83	\$ 1.60
Average common shares outstanding:				
Basic	7,399,302	7,396,533	7,399,178	7,396,519
Diluted	7,399,302	7,396,533	7,399,178	7,396,519
Dividends declared	\$ 0.34	\$ 0.33	0.68	0.65

See notes to unaudited consolidated financial statements

Peoples Financial Services Corp.
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY (UNAUDITED)

(Dollars in thousands, except per share data)

	Common Stock	Capital Surplus	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total
Balance, January 1, 2019	\$ 14,798	\$ 135,310	\$ 136,582	\$ (8,076)	\$ 278,614
Net income			13,556		13,556
Other comprehensive income, net of income taxes				4,371	4,371
Dividends declared: \$0.68 per share			(5,032)		(5,032)
Stock based compensation		240			240
Share retirement: 3,830 shares	(8)	(158)			(166)
Common stock grants awarded, net of unearned compensation of \$164: 3,854 shares	8	(8)			
Balance, June 30, 2019	<u>\$ 14,798</u>	<u>\$ 135,384</u>	<u>\$ 145,106</u>	<u>\$ (3,705)</u>	<u>\$ 291,583</u>
Balance, January 1, 2018	\$ 14,793	\$ 135,043	\$ 121,353	\$ (6,213)	\$ 264,976
Net income			11,811		11,811
Other comprehensive loss, net of income taxes				(2,538)	(2,538)
Dividends declared: \$0.65 per share			(4,810)		(4,810)
Stock based compensation		105			105
Reclassification related to adoption of ASU 2016-01			2	(2)	
Common stock grants awarded, net of unearned compensation of \$113: 2,548 shares	5	(5)			
Balance, June 30, 2018	<u>\$ 14,798</u>	<u>\$ 135,143</u>	<u>\$ 128,356</u>	<u>\$ (8,753)</u>	<u>\$ 269,544</u>

See notes to unaudited consolidated financial statements

Peoples Financial Services Corp.
CONSOLIDATED STATEMENTS OF CASH FLOW S (UNAUDITED)
(Dollars in thousands, except per share data)

For the Six Months Ended June 30,	2019	2018
Cash flows from operating activities:		
Net income	\$ 13,556	\$ 11,811
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation of premises and equipment	1,227	1,140
Amortization of right-of-use lease asset	187	
Amortization of deferred loan costs	(156)	482
Amortization of intangibles	374	450
Amortization of low income housing partnerships	238	233
Provision for loan losses	1,400	2,100
Net unrealized loss on equity investment securities	8	
Net loss on sale of other real estate owned	20	19
Loans originated for sale	(5,848)	(5,932)
Proceeds from sale of loans originated for sale	5,813	6,074
Net gain on sale of loans originated for sale	(47)	(36)
Net amortization of investment securities	895	1,197
Net gain on sale of investment securities available-for-sale	(23)	
Net gain on sale of credit card loans held for sale		(291)
Life insurance investment income	(378)	(378)
Stock based compensation	240	105
Net change in:		
Accrued interest receivable	(188)	134
Other assets	(4,114)	(1,187)
Accrued interest payable	(137)	41
Other liabilities	3,022	(914)
Net cash provided by operating activities	<u>16,089</u>	<u>15,048</u>
Cash flows from investing activities:		
Proceeds from sales of investment securities available-for-sale	9,677	
Proceeds from repayments of investment securities:		
Available-for-sale	24,651	15,445
Held-to-maturity	387	485
Purchases of investment securities:		
Available-for-sale	(22,151)	(22,627)
Net purchase of restricted equity securities	(371)	(2,794)
Proceeds from sale of student loan portfolio		3,171
Net increase in lending activities	(36,380)	(68,291)
Purchases of premises and equipment	(2,541)	(1,071)
Proceeds from the sale of premises and equipment	21	340
Proceeds from sale of other real estate owned	111	200
Net cash used in investing activities	<u>(26,596)</u>	<u>(75,142)</u>
Cash flows from financing activities:		
Net increase (decrease) in deposits	1,777	(157)
Proceeds from long-term debt	16,000	
Repayment of long-term debt	(926)	(823)
Net (decrease) increase in short-term borrowings	(3,800)	63,775
Retirement of common stock	(166)	
Cash dividends paid	(5,032)	(4,810)
Net cash provided by financing activities	<u>7,853</u>	<u>57,985</u>
Net decrease in cash and cash equivalents	<u>(2,654)</u>	<u>(2,109)</u>
Cash and cash equivalents at beginning of period	<u>32,616</u>	<u>37,488</u>
Cash and cash equivalents at end of period	<u>\$ 29,962</u>	<u>\$ 35,379</u>

Peoples Financial Services Corp.
CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)
(Dollars in thousands, except per share data)

For the Six Months Ended June 30,	2019	2018
Supplemental disclosures:		
Cash paid during the period for:		
Interest	\$ 9,245	\$ 5,881
Income taxes	2,200	2,050
Noncash items:		
Transfers of loans to other real estate	\$ 172	\$ 495
Initial recognition of right-of-use assets	6,523	
Initial recognition of lease liability	6,523	

See notes to unaudited consolidated financial statements

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. Unless the context indicates otherwise, all references in this quarterly report to “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-eight full-service community banking offices located within the Lackawanna, Lebanon, Lehigh, Luzerne, Monroe, Montgomery, Northampton, Susquehanna, Wayne and Wyoming Counties of Pennsylvania and Broome County of New York. Additionally, we operate a Limited Purpose Banking Office (“LPO”) located in and serving Schuylkill County, Pennsylvania.

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 consolidated 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 consolidated operating results or financial position of the Company. The consolidated operating results and financial position of the Company for the six months ended and as of June 30, 2019, are not necessarily indicative of the results of consolidated 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, and impairment of goodwill. 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, 2018.

Recent accounting standards:

In February 2016, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“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. The ROU asset and lease liability are calculated based on the present value of future lease payments using an estimated incremental borrowing rate. The Company utilized the incremental borrowing rate of interest on a collateralized basis for the lease term as quoted by the Federal Home Loan Bank of Pittsburgh (“FHLB”).

Leases are classified as either finance or operating, with classification affecting the pattern of expense recognition in the statement of income 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 is 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 were effective for annual periods, and interim periods within those annual periods, beginning after December 15, 2018.

Peoples Financial Services Corp.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)
(Dollars in thousands, except per share data)

The new standard provides a number of optional practical expedients in transition. We have elected the "package of practical expedients," which permit us not to reassess under the new standard our prior conclusions about lease identification, lease classification and initial direct costs. We elected the "use-of-hindsight" practical expedient which allows us to use hindsight in judgments that impact the lease term. In order to establish the value of the ROU and lease liability and in accordance with the guidance, management determined the term of the leases held by carefully evaluating and assessing each lease and applying economic and other relevant factors to determine whether the Company is reasonably certain to exercise or not to exercise a renewal option within each lease. We have also elected an accounting policy not to restate comparative periods upon adoption. The Company elected to adopt this pronouncement using the optional transition method under ASU 2018-11 as of January 1, 2019 and recorded right-of-use assets and lease liabilities for operating leases of \$6,523 on its consolidated balance sheets, with no adjustment to stockholders' equity and no material impact to its consolidated statements of income and comprehensive income.

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 were adopted on January 1, 2019 and did not have a material impact on the Company's consolidated financial statements.

In March 2019, the FASB issued ASU 2019-01, "Leases (Topic 842) Codification Improvements" which was issued to address lessors' concerns about determining fair value of underlying leased assets and presentation issues in the statement of cash flows for sales-type and direct financing leases. ASU 2019-01 also clarified for both lessees and lessors that transition disclosures related to Topic 250 were not required for annual periods are also not required for interim periods. ASU 2019-01 was effective for annual periods, and interim periods within those annual periods, beginning after December 15, 2019, with early adoption permitted. The Company early adopted this ASU 2019-01 effective January 1, 2019 and it did not have a material impact on the Company's consolidated financial statements.

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.

Peoples Financial Services Corp.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)
(Dollars in thousands, except per share data)

- In July 2019, the FASB agreed to issue a proposal to delay the effective date for smaller reporting companies, which the Company currently qualifies as such. If approved, the proposal could delay the effective date until 2023, though the Company may need to adopt earlier if it no longer qualifies as a smaller reporting company. 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 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.

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, benefit plan adjustments and adjustments to derivative fair values.

The components of accumulated other comprehensive loss included in stockholders' equity at June 30, 2019 and December 31, 2018 are as follows:

	June 30, 2019	December 31, 2018
Net unrealized loss on investment securities available-for-sale	\$ 1,776	\$ (3,251)
Income tax	373	(683)
Net of income taxes	1,403	(2,568)
Benefit plan adjustments	(7,218)	(7,218)
Income tax	(1,516)	(1,516)
Net of income taxes	(5,702)	(5,702)
Derivative adjustments	752	246
Income tax	158	52
Net of income taxes	594	194
Accumulated other comprehensive loss	<u>\$ (3,705)</u>	<u>\$ (8,076)</u>

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.

Peoples Financial Services Corp.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)
(Dollars in thousands, except per share data)

There were no shares considered anti-dilutive for the three and six month periods ended June 30, 2019 and 2018.

For the Three Months Ended June 30,	2019		2018	
	Basic	Diluted	Basic	Diluted
Net Income	\$ 7,144	\$ 7,144	\$ 5,957	\$ 5,957
Average common shares outstanding	7,399,302	7,399,302	7,396,533	7,396,533
Earnings per share	\$ 0.96	\$ 0.96	\$ 0.81	\$ 0.81

For the Six Months Ended June 30	2019		2018	
	Basic	Diluted	Basic	Diluted
Net income	\$ 13,556	\$ 13,556	\$ 11,811	\$ 11,811
Average common shares outstanding	7,399,178	7,399,178	7,396,519	7,396,519
Earnings per share	\$ 1.83	\$ 1.83	\$ 1.60	\$ 1.60

4. Investment securities:

The amortized cost and fair value of investment securities aggregated by investment category at June 30, 2019 and December 31, 2018 are summarized as follows:

June 30, 2019	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available-for-sale:				
U.S. Treasury securities	\$ 23,958	\$ 143	\$ 17	\$ 24,084
U.S. Government-sponsored enterprises	93,830	82	423	93,489
State and municipals:				
Taxable	12,475	367		12,842
Tax-exempt	69,454	713	32	70,135
Residential Mortgage-backed securities:				
U.S. Government agencies	10,669	135	20	10,784
U.S. Government-sponsored enterprises	40,901	776	92	41,585
Commercial Mortgage-backed securities:				
U.S. Government-sponsored enterprises	8,601	145		8,746
Total	<u>\$ 259,888</u>	<u>\$ 2,361</u>	<u>\$ 584</u>	<u>\$ 261,665</u>
Held-to-maturity:				
Tax-exempt state and municipals	\$ 6,854	\$ 151		\$ 7,005
Residential Mortgage-backed securities:				
U.S. Government agencies	36			36
U.S. Government-sponsored enterprises	1,079	32	\$ 1	1,110
Total	<u>\$ 7,969</u>	<u>\$ 183</u>	<u>\$ 1</u>	<u>\$ 8,151</u>

Peoples Financial Services Corp.
NOTES TO CONSOLIDATE D FINANCIAL STATEMENTS (UNAUDITED)
(Dollars in thousands, except per share data)

December 31, 2018	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available-for-sale:				
U.S. Treasury securities	\$ 25,948	9	\$ 365	\$ 25,592
U.S. Government-sponsored enterprises	94,999	2	2,183	92,818
State and municipals:				
Taxable	13,544	309		13,853
Tax-exempt	86,361	338	745	85,954
Residential Mortgage-backed securities:				
U.S. Government agencies	12,663	50	84	12,629
U.S. Government-sponsored enterprises	33,149	49	401	32,797
Commercial Mortgage-backed securities:				
U.S. Government-sponsored enterprises	6,269		230	6,039
Total	\$ 272,933	\$ 757	\$ 4,008	\$ 269,682
Held-to-maturity:				
Tax-exempt state and municipals	\$ 6,855	\$ 12	\$ 43	\$ 6,824
Residential Mortgage-backed securities:				
U.S. Government agencies	42			42
U.S. Government-sponsored enterprises	1,464	55	5	1,514
Total	\$ 8,361	\$ 67	\$ 48	\$ 8,380

Equity Securities

Our equity securities portfolio consists of stock of two other financial institutions. At June 30, 2019 and December 31, 2018, we had \$283 and \$291 respectively, in equity securities recorded at fair value. At June 30, 2019, the fair value of our equity portfolio exceeded the cost basis by \$6. The following is a summary of unrealized and realized gains and losses recognized in net income on equity securities during the three and six months ended June 30, 2019 (in thousands):

For the Three Months Ended June 30,	2019	2018
Net gains (losses) recognized during the period on equity securities	\$ (9)	\$ 8
Less: Net gains and (losses) recognized during the period on equity securities sold during the period		
Unrealized gains (losses) recognized during the reporting period on equity securities still held at the reporting date	\$ (9)	\$ 8

For the Six Months Ended June 30,	2019	2018
Net gains (losses) recognized during the period on equity securities	\$ (8)	\$
Less: Net gains and (losses) recognized during the period on equity securities sold during the period		
Unrealized gains (losses) recognized during the reporting period on equity securities still held at the reporting date	\$ (8)	\$

Restricted Investment In Stock

Restricted investment in stock includes FHLB with a carrying cost of \$7,791 and \$7,420 at June 30, 2019 and December 31, 2018, 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 June 30, 2019 and December 31, 2018, 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.

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The Company owns 44,982 shares of Visa Class B stock, which was necessary to participate in Visa services in support of the Company's credit card, debit card, and related payment programs (permissible activities under banking regulations) as a member institution. Following the resolution of Visa's litigation, shares of Visa's Class B stock will be converted to Visa Class A shares using a conversion factor (1.6298 as of June 30, 2019), 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 stock. 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 June 30, 2019, 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 June 30, 2019, is summarized as follows:

June 30, 2019	Fair Value
Within one year	\$ 38,102
After one but within five years	133,582
After five but within ten years	10,729
After ten years	18,137
	<u>200,550</u>
Mortgage-backed securities	61,115
Total	<u>\$ 261,665</u>

The maturity distribution of the amortized cost and fair value, of debt securities classified as held-to-maturity at June 30, 2019, is summarized as follows:

June 30, 2019	Amortized Cost	Fair Value
Within one year		
After one but within five years		
After five but within ten years		
After ten years	\$ 6,854	\$ 7,005
	<u>6,854</u>	<u>7,005</u>
Mortgage-backed securities	1,115	1,146
Total	<u>\$ 7,969</u>	<u>\$ 8,151</u>

Securities with a carrying value of \$144,991 and \$161,647 at June 30, 2019 and December 31, 2018, respectively, were pledged to secure public deposits and certain other deposits as required or permitted by law.

Securities and short-term investment activities are conducted with a diverse group of government entities, corporations and state and local municipalities. The counterparty's creditworthiness and type of collateral is evaluated on a case-by-case basis. At June 30, 2019 and December 31, 2018, 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.

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The fair value and gross unrealized losses of investment securities with unrealized losses for which an OTTI has not been recognized at June 30, 2019 and December 31, 2018, 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
June 30, 2019						
U.S. Treasury securities	\$	\$	\$ 7,993	\$ 17	\$ 7,993	\$ 17
U.S. Government-sponsored enterprises			75,292	423	75,292	423
State and municipals:						
Tax-exempt			14,499	32	14,499	32
Residential Mortgage-backed securities:						
U.S. Government agencies			5,281	20	5,281	20
U.S. Government-sponsored enterprises			10,372	93	10,372	93
Commercial Mortgage-backed securities:						
U.S. Government-sponsored enterprises					—	—
Total	\$ —	\$ —	\$ 113,437	\$ 585	\$ 113,437	\$ 585
	Less Than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
December 31, 2018						
U.S. Treasury securities	\$ 1,995	\$ 2	\$ 19,671	\$ 363	\$ 21,666	\$ 365
U.S. Government-sponsored enterprises	2,037	1	89,729	2,182	91,766	2,183
State and municipals:						
Tax-exempt	9,022	74	52,352	714	61,374	788
Residential Mortgage-backed securities:						
U.S. Government agencies			7,800	84	7,800	84
U.S. Government-sponsored enterprises	12,851	55	13,881	351	26,732	406
Commercial Mortgage-backed securities:						
U.S. Government-sponsored enterprises			6,039	230	6,039	230
Total	\$ 25,905	\$ 132	\$ 189,472	\$ 3,924	\$ 215,377	\$ 4,056

The Company had 73 investment securities, consisting of 20 tax-exempt state and municipal obligations, 3 U.S. Treasury securities, 28 U.S. Government-sponsored enterprise securities, and 22 mortgage-backed securities that were in unrealized loss positions at June 30, 2019. Of these securities, 3 U.S. Treasury securities, 28 U.S. Government-sponsored enterprise securities, 20 tax-exempt state and municipal obligations, and 20 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 June 30, 2019. There was no OTTI recognized for the three or six months ended June 30, 2019 and 2018.

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5. Loans, net and allowance for loan losses:

The major classifications of loans outstanding, net of deferred loan origination fees and costs at June 30, 2019 and December 31, 2018 are summarized as follows. Net deferred loan costs were \$901 and \$744 at June 30, 2019 and December 31, 2018.

	<u>June 30, 2019</u>	<u>December 31, 2018</u>
Commercial	\$ 513,655	\$ 494,134
Real estate:		
Commercial	935,578	907,803
Residential	298,527	299,876
Consumer	111,039	121,453
Total	<u>\$ 1,858,799</u>	<u>\$ 1,823,266</u>

The changes in the allowance for loan losses account by major classification of loan for the three and six months ended June 30, 2019 and 2018 are summarized as follows:

		<u>Real estate</u>			
<u>June 30, 2019</u>	<u>Commercial</u>	<u>Commercial</u>	<u>Residential</u>	<u>Consumer</u>	<u>Total</u>
Allowance for loan losses:					
Beginning Balance April 1, 2019	\$ 5,955	\$ 11,074	\$ 3,880	\$ 1,196	\$ 22,105
Charge-offs	(10)	(343)	(143)	(80)	(576)
Recoveries	2		12	37	51
Provisions	195	311	(134)	(22)	350
Ending balance	<u>\$ 6,142</u>	<u>\$ 11,042</u>	<u>\$ 3,615</u>	<u>\$ 1,131</u>	<u>\$ 21,930</u>

		<u>Real estate</u>			
<u>June 30, 2018</u>	<u>Commercial</u>	<u>Commercial</u>	<u>Residential</u>	<u>Consumer</u>	<u>Total</u>
Allowance for loan losses:					
Beginning Balance April 1, 2018	\$ 5,198	\$ 10,301	\$ 2,924	\$ 1,295	\$ 19,718
Charge-offs	(2)	(1,169)	(82)	(145)	(1,398)
Recoveries	59	30	57	57	203
Provisions	(64)	896	257	(39)	1,050
Ending balance	<u>\$ 5,191</u>	<u>\$ 10,058</u>	<u>\$ 3,156</u>	<u>\$ 1,168</u>	<u>\$ 19,573</u>

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June 30, 2019	Commercial	Real estate		Consumer	Total
		Commercial	Residential		
Allowance for loan losses:					
Beginning Balance January 1, 2019	\$ 5,516	\$ 10,736	\$ 3,892	1,235	21,379
Charge-offs	(87)	(349)	(302)	(212)	(950)
Recoveries	10		16	75	101
Provisions	703	655	9	33	1,400
Ending balance	<u>\$ 6,142</u>	<u>\$ 11,042</u>	<u>\$ 3,615</u>	<u>\$ 1,131</u>	<u>\$ 21,930</u>

June 30, 2018	Commercial	Real estate		Consumer	Total
		Commercial	Residential		
Allowance for loan losses:					
Beginning Balance January 1, 2018	\$ 5,513	\$ 8,944	\$ 3,111	\$ 1,392	\$ 18,960
Charge-offs	(2)	(1,169)	(381)	(272)	(1,824)
Recoveries	116	57	67	97	337
Provisions	(436)	2,226	359	(49)	2,100
Ending balance	<u>\$ 5,191</u>	<u>\$ 10,058</u>	<u>\$ 3,156</u>	<u>\$ 1,168</u>	<u>\$ 19,573</u>

The allocation of the allowance for loan losses and the related loans by major classifications of loans at June 30, 2019 and December 31, 2018 is summarized as follows:

June 30, 2019	Commercial	Real estate		Consumer	Total
		Commercial	Residential		
Allowance for loan losses:					
Ending balance	<u>\$ 6,142</u>	<u>\$ 11,042</u>	<u>\$ 3,615</u>	<u>\$ 1,131</u>	<u>\$ 21,930</u>
Ending balance: individually evaluated for impairment	615	216	295		1,126
Ending balance: collectively evaluated for impairment	<u>\$ 5,527</u>	<u>\$ 10,826</u>	<u>\$ 3,320</u>	<u>\$ 1,131</u>	<u>\$ 20,804</u>
Loans receivable:					
Ending balance	<u>\$ 513,655</u>	<u>\$ 935,578</u>	<u>\$ 298,527</u>	<u>\$ 111,039</u>	<u>\$ 1,858,799</u>
Ending balance: individually evaluated for impairment	5,915	3,867	2,280	251	12,313
Ending balance: collectively evaluated for impairment	<u>\$ 507,740</u>	<u>\$ 931,711</u>	<u>\$ 296,247</u>	<u>\$ 110,788</u>	<u>\$ 1,846,486</u>

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December 31, 2018	Commercial	Real estate		Consumer	Total
		Commercial	Residential		
Allowance for loan losses:					
Ending balance	\$ 5,516	\$ 10,736	\$ 3,892	\$ 1,235	\$ 21,379
Ending balance: individually evaluated for impairment	50	403	666	60	1,179
Ending balance: collectively evaluated for impairment	\$ 5,466	\$ 10,333	\$ 3,226	\$ 1,175	\$ 20,200
Loans receivable:					
Ending balance	\$ 494,134	\$ 907,803	\$ 299,876	\$ 121,453	\$ 1,823,266
Ending balance: individually evaluated for impairment	2,237	3,121	4,071	212	9,641
Ending balance: collectively evaluated for impairment	\$ 491,897	\$ 904,682	\$ 295,805	\$ 121,241	\$ 1,813,625

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

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The following tables present the major classification of loans summarized by the aggregate pass rating and the classified ratings of special mention, substandard and doubtful within the Company's internal risk rating system at June 30, 2019 and December 31, 2018:

June 30, 2019	Pass	Special Mention	Substandard	Doubtful	Total
Commercial	\$ 504,060	\$ 2,029	\$ 7,566		\$ 513,655
Real estate:					
Commercial	905,398	3,054	27,126		935,578
Residential	296,021	351	2,155		298,527
Consumer	110,672		367		111,039
Total	<u>\$ 1,816,151</u>	<u>\$ 5,434</u>	<u>\$ 37,214</u>	<u>\$</u>	<u>\$ 1,858,799</u>

December 31, 2018	Pass	Special Mention	Substandard	Doubtful	Total
Commercial	\$ 491,531	\$ 869	\$ 1,734		\$ 494,134
Real estate:					
Commercial	886,849	8,934	12,020		907,803
Residential	295,758	357	3,761		299,876
Consumer	121,229		224		121,453
Total	<u>\$ 1,795,367</u>	<u>\$ 10,160</u>	<u>\$ 17,739</u>	<u>\$</u>	<u>\$ 1,823,266</u>

The increase in substandard loans from December 31, 2018 to June 30, 2019 is primarily associated with the reclassification of several larger commercial credits to this category. The largest relationship totals \$10.4 million and consists of commercial real estate and equipment financing for a borrowing group that has encountered some financial difficulties. The second largest reclassification consists of a \$5.3 million commercial real estate construction loan that experienced significant construction delays. The construction is now complete and the property recently received its certificate of occupancy. The Bank considers both of these credit relationships to be well secured and both relationships were current as of June 30, 2019.

Information concerning nonaccrual loans by major loan classification at June 30, 2019 and December 31, 2018 is summarized as follows:

	June 30, 2019	December 31, 2018
Commercial	\$ 4,494	\$ 776
Real estate:		
Commercial	3,044	2,663
Residential	1,464	2,580
Consumer	251	212
Total	<u>\$ 9,253</u>	<u>\$ 6,231</u>

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
June 30, 2019							
Commercial	\$ 385	\$ 136	\$ 4,502	\$ 5,023	\$ 508,632	\$ 513,655	\$ 8
Real estate:							
Commercial	1,200	54	3,192	4,446	931,132	935,578	148
Residential	1,930	427	1,649	4,006	294,521	298,527	185
Consumer	495	128	251	874	110,165	111,039	
Total	<u>\$ 4,010</u>	<u>\$ 745</u>	<u>\$ 9,594</u>	<u>\$ 14,349</u>	<u>\$ 1,844,450</u>	<u>\$ 1,858,799</u>	<u>\$ 341</u>

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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, 2018							
Commercial	\$ 973	\$ 79	\$ 776	\$ 1,828	\$ 492,306	\$ 494,134	
Real estate:							
Commercial	1,889	218	2,736	4,843	902,960	907,803	\$ 73
Residential	2,486	1,545	3,430	7,461	292,415	299,876	850
Consumer	756	292	212	1,260	120,193	121,453	
Total	<u>\$ 6,104</u>	<u>\$ 2,134</u>	<u>\$ 7,154</u>	<u>\$ 15,392</u>	<u>\$ 1,807,874</u>	<u>\$ 1,823,266</u>	<u>\$ 923</u>

The following tables summarize information concerning impaired loans as of and for the three and six months ended June 30, 2019 and June 30, 2018, and as of and for the year ended, December 31, 2018 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
June 30, 2019							
With no related allowance:							
Commercial	\$ 4,495	\$ 4,931		\$ 5,284	\$ 17	\$ 4,043	\$ 34
Real estate:							
Commercial	2,957	3,116		2,528	10	2,341	23
Residential	619	888		740	4	1,150	11
Consumer	251	261		245		214	
Total	<u>8,322</u>	<u>9,196</u>		<u>8,797</u>	<u>31</u>	<u>7,748</u>	<u>68</u>
With an allowance recorded:							
Commercial	1,420	1,432	615	1,180	5	1,012	12
Real estate:							
Commercial	910	1,380	216	1,174	5	1,166	10
Residential	1,661	1,740	295	1,848	7	1,932	18
Consumer						20	
Total	<u>3,991</u>	<u>4,552</u>	<u>1,126</u>	<u>4,202</u>	<u>17</u>	<u>4,130</u>	<u>40</u>
Total impaired loans							
Commercial	5,915	6,363	615	6,464	22	5,055	46
Real estate:							
Commercial	3,867	4,496	216	3,702	15	3,507	33
Residential	2,280	2,628	295	2,588	11	3,082	29
Consumer	251	261		245		234	
Total	<u>\$ 12,313</u>	<u>\$ 13,748</u>	<u>\$ 1,126</u>	<u>\$ 12,999</u>	<u>\$ 48</u>	<u>\$ 11,878</u>	<u>\$ 108</u>

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				For the Year Ended	
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
December 31, 2018					
With no related allowance:					
Commercial	\$ 1,562	\$ 1,900		\$ 1,318	\$ 67
Real estate:					
Commercial	1,969	2,299		2,822	28
Residential	1,970	2,658		2,193	22
Consumer	152	160		135	
Total	5,653	7,017		6,468	117
With an allowance recorded:					
Commercial	675	675	50	1,006	30
Real estate:					
Commercial	1,152	1,323	403	1,676	18
Residential	2,101	2,328	666	1,585	22
Consumer	60	60	60	21	
Total	3,988	4,386	1,179	4,288	70
Total impaired loans					
Commercial	2,237	2,575	50	2,324	97
Real estate:					
Commercial	3,121	3,622	403	4,498	46
Residential	4,071	4,986	666	3,778	44
Consumer	212	220	60	156	
Total	\$ 9,641	\$ 11,403	\$ 1,179	\$ 10,756	\$ 187

	Recorded Investment	Unpaid Principal Balance	Related Allowance	This Quarter		Year-to-Date	
				Average Recorded Investment	Interest Income	Average Recorded Investment	Interest Income
					Recognized		Recognized
June 30, 2018							
With no related allowance:							
Commercial	\$ 1,182	\$ 1,355		\$ 1,197	\$ 16	\$ 1,224	\$ 33
Real estate:							
Commercial	2,871	3,262		2,921	9	2,910	15
Residential	2,146	2,848		2,218	4	2,210	8
Consumer	60	67		106		127	
Total	6,259	7,532		6,442	29	6,471	56
With an allowance recorded:							
Commercial	1,100	1,124	\$ 146	1,117	8	1,139	16
Real estate:							
Commercial	1,755	1,876	502	2,079	4	1,853	10
Residential	1,425	1,550	378	1,458	4	1,504	8
Consumer	3	3	3	11		10	
Total	4,283	4,553	1,029	4,665	16	4,506	34
Total impaired loans							
Commercial	2,282	2,479	146	2,314	24	2,363	49
Real estate:							
Commercial	4,626	5,138	502	5,000	13	4,763	25
Residential	3,571	4,398	378	3,676	8	3,714	16
Consumer	63	70	3	117		137	
Total	\$ 10,542	\$ 12,085	\$ 1,029	\$ 11,107	\$ 45	\$ 10,977	\$ 90

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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 \$2,677 at June 30, 2019, \$2,779 at December 31, 2018 and \$3,307 at June 30, 2018.

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 troubled debt restructurings for the three months ended June 30, 2019. There was one commercial real estate loan modified as a troubled debt restructuring during the six months ended June 30, 2019 in the amount of \$340. There was one commercial real estate loan modified as a troubled debt restructuring for the three and six months ended June 30, 2018 totaling \$340. During the three and six months ended June 30, 2019, there were payment defaults on two restructured commercial real estate loans with balances totaling \$335 which were subsequently charged-off. During the three months ended June 30, 2018, there were no payment defaults on restructured loans. During the six months ended June 30, 2018, there was one payment default on a restructured residential mortgage loan with an outstanding balance of \$58.

6. Other assets:

The components of other assets at June 30, 2019, and December 31, 2018 are summarized as follows:

	June 30, 2019	December 31, 2018
Other real estate owned	\$ 408	\$ 376
Investment in low income housing partnership	7,139	7,377
Mortgage servicing rights	719	718
Bank owned life insurance	34,667	34,288
Restricted equity securities	7,833	7,462
Net deferred tax asset	3,919	5,081
Other assets	12,940	8,435
Total	<u>\$ 67,625</u>	<u>\$ 63,737</u>

7. Fair value estimates:

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

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

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 June 30, 2019 and December 31, 2018 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 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.

Peoples Financial Services Corp.
NOTES TO CONSOLIDATE D FINANCIAL STATEMENTS (UNAUDITED)
(Dollars in thousands, except per share data)

Assets and liabilities measured at fair value on a recurring basis at June 30, 2019 and December 31, 2018 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)
June 30, 2019	Amount			
U.S. Treasury securities	\$ 24,084	\$ 24,084		\$
U.S. Government-sponsored enterprises	93,489		\$ 93,489	
State and Municipals:				
Taxable	12,842		12,842	
Tax-exempt	70,135		70,135	
Mortgage-backed securities:				
U.S. Government agencies	10,784		10,784	
U.S. Government-sponsored enterprises	50,331		50,331	
Common equity securities	283	283		
Interest rate floor-other assets	1,025		1,025	
Interest rate swap-other assets	3,807		3,807	
Interest rate swap-other liabilities	(4,182)		(4,182)	
Total	\$ 262,598	\$ 24,367	\$ 238,231	\$

		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)
December 31, 2018	Amount			
U.S. Treasury securities	\$ 25,592	\$ 25,592		\$
U.S. Government-sponsored enterprises	92,818		\$ 92,818	
State and Municipals:				
Taxable	13,853		13,853	
Tax-exempt	85,954		85,954	
Mortgage-backed securities:				
U.S. Government agencies	12,629		12,629	
U.S. Government-sponsored enterprises	38,836		38,836	
Common equity securities	291	291		
Interest rate floor-other assets	553		553	
Interest rate swap-other assets	108		108	
Interest rate swap-other liabilities	(138)		(138)	
Total	\$ 270,496	\$ 25,883	\$ 244,613	\$

Assets and liabilities measured at fair value on a nonrecurring basis at June 30, 2019 and December 31, 2018 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)
June 30, 2019	Amount			
Impaired loans	\$ 2,865			\$ 2,865
Other real estate owned	\$ 250			\$ 250

Peoples Financial Services Corp.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)
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		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)
December 31, 2018	Amount			
Impaired loans	\$ 2,809			\$ 2,809
Other real estate owned	\$ 234			\$ 234

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 Estimate	Valuation Techniques	Unobservable Input	Range (Weighted Average)
June 30, 2019				
Impaired loans	\$ 2,865	Appraisal of collateral	Appraisal adjustments	7.6% to 97.0% (56.7)%
			Liquidation expenses	3.0% to 6.0% (5.4)%
Other real estate owned	\$ 250	Appraisal of collateral	Appraisal adjustments	20.0% to 43.3% (32.0)%
			Liquidation expenses	3.0% to 6.0% (5.0)%

Quantitative Information about Level 3 Fair Value Measurements				
	Fair Value Estimate	Valuation Techniques	Unobservable Input	Range (Weighted Average)
December 31, 2018				
Impaired loans	\$ 2,809	Appraisal of collateral	Appraisal adjustments	7.1% to 97.0% (61.8)%
			Liquidation expenses	3.0% to 6.0% (4.4)%
Other real estate owned	\$ 234	Appraisal of collateral	Appraisal adjustments	26.0% to 73.3% (38.9)%
			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.

Peoples Financial Services Corp.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)
(Dollars in thousands, except per share data)

The carrying and fair values of the Company's financial instruments at June 30, 2019 and December 31, 2018 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)
June 30, 2019					
Financial assets:					
Cash and cash equivalents	\$ 29,962	\$ 29,962	\$ 29,962		
Investment securities:					
Available-for-sale	261,665	261,665	24,084	\$ 237,581	
Common equity securities	283	283	283		
Held-to-maturity	7,969	8,151		8,151	
Net loans	1,836,869	1,830,139			\$ 1,830,139
Accrued interest receivable	7,303	7,303		7,303	
Mortgage servicing rights	719	1,712		1,712	
Restricted equity securities	7,833	7,833		7,833	
Interest rate floor	1,025	1,025		1,025	
Interest rate swaps	3,807	3,807		3,807	
Total	<u>\$ 2,157,435</u>	<u>\$ 2,151,880</u>			
Financial liabilities:					
Deposits	\$ 1,876,799	\$ 1,862,246		\$ 1,862,246	
Short-term borrowings	82,700	82,700		82,700	
Long-term debt	52,980	53,338		53,338	
Accrued interest payable	1,058	1,058		1,058	
Interest rate swaps	4,182	4,182		4,182	
Total	<u>\$ 2,017,719</u>	<u>\$ 2,003,524</u>			

Peoples Financial Services Corp.
NOTES TO CONSOLIDATE D FINANCIAL STATEMENTS (UNAUDITED)
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	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, 2018					
Financial assets:					
Cash and cash equivalents	\$ 32,616	\$ 32,616	\$ 32,616		
Investment securities:					
Available-for-sale	269,682	269,682	25,952	\$ 244,090	
Common equity securities	291	291	291		
Held-to-maturity	8,361	8,380		8,380	
Loans held for sale	749	749		749	
Net loans	1,801,887	1,762,449			\$ 1,762,449
Accrued interest receivable	7,115	7,115		7,115	
Mortgage servicing rights	718	1,710		1,710	
Restricted equity securities	7,462	7,462		7,462	
Interest rate floor	553	553		553	
Interest rate swaps	108	108		108	
Total	<u>\$ 2,129,542</u>	<u>\$ 2,091,115</u>			
Financial liabilities:					
Deposits	\$ 1,875,022	\$ 1,874,520		\$ 1,874,520	
Short-term borrowings	86,500	86,500		86,500	
Long-term debt	37,906	38,071		38,071	
Accrued interest payable	1,195	1,195		1,195	
Interest rate swaps	138	138		138	
Total	<u>\$ 2,000,761</u>	<u>\$ 2,000,424</u>			

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 six months ended June 30, salaries and employee benefits expense includes approximately \$415 and \$755, respectively in 2019 and \$403 and \$743, respectively in 2018 relating to the employee benefit plans.

	Pension Benefits	
	2019	2018
Three Months Ended June 30,		
Components of net periodic pension cost:		
Interest cost	\$ 192	\$ 156
Expected return on plan assets	(325)	(240)
Amortization of unrecognized net gain	68	49
Net periodic benefit cost	<u>\$ (65)</u>	<u>\$ (35)</u>
Six Months Ended June 30,		
Components of net periodic pension cost:		
Interest cost	\$ 320	\$ 156
Expected return on plan assets	(542)	(240)
Amortization of unrecognized net gain	113	49
Net periodic benefit cost	<u>\$ (109)</u>	<u>\$ (35)</u>

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The Company contributed \$2,700 to the pension plan during the third quarter of 2018. This contribution reduced the unfunded portion of the pension plan and also reduced future premium costs associated with the plan. Previously, the Company paid a fixed premium cost of \$18 annually with an additional \$92 for the variable portion of the premium. This was 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. No awards may be made under the 2008 Plan after January 15, 2018.

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 June 30, 2019, there were 61,346 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 the first six months of 2019 and 2018, the Company granted awards of restricted stock and restricted stock units under the 2017 Plan, with an aggregate of 17,345 shares and 11,468 shares underlying such awards, respectively.

The non-performance restricted stock grants made in 2019 and 2018 vest equally over three years from the grant date. The performance-based restricted stock units vest three years after the grant date and include conditions based on the Company's three year cumulative diluted earnings per share and three-year average return on equity that determines the number of restricted stock units that may vest.

The Company expenses the fair value of all-share based compensation over the requisite service period commencing at grant date. The fair value of restricted stock is expensed on a straight-line basis. The Company periodically assesses the probability of achievement of the performance criteria and adjusts the amount of compensation expense accordingly. Compensation is recognized over the vesting period. 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 \$240 and \$157 for the three and six months ended June 30, 2019 for awards granted under the 2017 Plan. The Company recognized compensation expense of \$37 and \$43 for the three and six months ended June 30, 2018 for awards granted under the 2017 Plan and \$31 and \$62 for awards granted under the 2008 Plan. As of June 30, 2019, the Company had \$1,071 of unrecognized compensation expense associated with restricted stock awards. The remaining cost is expected to be recognized over a weighted average vesting period of just under 1.7 years.

Peoples Financial Services Corp.
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9. Derivatives and hedging activities

Risk Management Objective of Using Derivatives

The Company is exposed to certain risk 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 and the use of derivative financial instruments. Specifically, the Company enters into derivative financial instruments to manage exposures that arise from business activities that result in the receipt or payment of future known and uncertain cash amounts, the value of which are determined by interest rates. The Company's derivative financial instruments are used to manage differences in the amount, timing, and duration of the Company's known or expected cash receipts principally related to the Company's assets.

Cash Flow Hedges of Interest Rate Risk

The Company's objectives in using interest rate derivatives are to add stability to interest income and to manage its exposure to interest rate movements. To accomplish this objective, the Company primarily uses interest rate floors as part of its interest rate risk management strategy. Interest rate floors designated as cash flow hedges involve the receipt of variable-rate amounts from a counterparty if interest rates fall below the strike rate on the contract in exchange for an up-front premium.

For derivatives designated and that qualify as cash flow hedges of interest rate risk, the gain or loss on the derivative is recorded in Accumulated Other Comprehensive Loss and subsequently reclassified into interest income in the same period(s) during which the hedged transaction affects earnings. Gains and losses on the derivative representing hedge components excluded from the assessment of effectiveness are recognized over the life of the hedge on a systematic and rational basis. The earnings recognition of excluded components is presented in interest income. Amounts reported in accumulated other comprehensive loss related to derivatives will be reclassified to interest income as interest payments are received on the Company's variable-rate assets. During 2019, the Company estimates that an additional \$64 will be reclassified as a reduction to interest income.

Non-designated Hedges

Derivatives not designated as hedges are not speculative and result from a service the Company provides to certain customers. 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 recognized directly in earnings. As of June 30, 2019, the Company had 22 interest rate swaps with an aggregate notional amount of \$123,351 related to this program.

Peoples Financial Services Corp.
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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 June 30, 2019 and December 31, 2018.

	Notional Amount	Asset Derivatives As of June 30, 2019		Asset Derivatives As of December 31, 2018 (1)		Liability Derivatives As of June 30, 2019		Liability Derivatives As of December 31, 2018 (2)	
		Balance Sheet Location	Fair Value	Balance Sheet Location	Fair Value	Balance Sheet Location	Fair Value	Balance Sheet Location	Fair Value
Derivatives designated as hedging instruments									
Interest Rate Floor	\$ 25,000	Other Assets	\$ 1,025		\$ 553				
Total derivatives designated as hedging instruments			\$ 1,025		\$ 553				
Derivatives not designated as hedging instruments									
Interest Rate Swaps	\$ 123,351	Other Assets	\$ 3,807	Other Assets	\$ 108	Other Liabilities	\$ 4,182	Other Liabilities	\$ 138
Total derivatives not designated as hedging instruments			\$ 3,807		\$ 108		\$ 4,182		\$ 138

- (1) Assets amount does not include accrued interest receivable of \$13
(2) Liabilities amount does not include accrued interest payable of \$13

Effect of Fair Value and Cash Flow Hedge Accounting on Accumulated Other Comprehensive Loss

The table below presents the effect of fair value and cash flow hedge accounting on Accumulated Other Comprehensive Loss as of June 30, 2019. There was no cash flow hedge as of June 30, 2018.

Derivatives in Hedging Relationships	Amount of Loss Recognized in	Amount of Gain Recognized in	Amount of Gain Recognized in	Location of Gain or (Loss) Recognized from Accumulated Other Comprehensive Income into Income	Amount of Loss Reclassified	Amount of Gain Reclassified from Accumulated	Amount of Loss Reclassified from Accumulated
	OCI on Derivative	OCI Included Component June 30, 2019	OCI Excluded Component		from Accumulated OCI into Income	OCI into Income Included Component June 30, 2019	OCI into Income Excluded Component
Derivatives in Cash Flow Hedging Relationships							
Interest Rate Floor (*)	\$ 427	\$ 532	\$ (105)	Interest Income	\$ (16)		\$ (16)
Derivatives in Hedging Relationships	Amount of Loss Recognized in	Amount of Gain Recognized in	Amount of Gain Recognized in	Location of Gain or (Loss) Recognized from Accumulated Other Comprehensive Income into Income	Amount of Loss Reclassified	Amount of Gain Reclassified from Accumulated	Amount of Loss Reclassified from Accumulated
	OCI on Derivative	OCI Included Component June 30, 2019	OCI Excluded Component		from Accumulated OCI into Income	OCI into Income Included Component June 30, 2019	OCI into Income Excluded Component
Derivatives in Cash Flow Hedging Relationships							
Interest Rate Floor (*)	\$ 474	\$ 827	\$ (353)	Interest Income	\$ (31)		\$ (31)

* Amounts disclosed are gross and not net of taxes.

Peoples Financial Services Corp.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)
(Dollars in thousands, except per share data)

Effect of Fair Value and Cash Flow Hedge Accounting on the Consolidated Statements of Income and Comprehensive Income

The table below presents the effect of the Company's derivative financial instruments on the Consolidated Statements of Income and Comprehensive Income for the three and six months ended June 30, 2019 and June 30, 2018.

	Location and Amount of Gain or (Loss) Recognized in Income on Fair Value and Cash Flow Hedging Relationships	
	2019 Interest Income	2018 Interest Income
Total amounts of income and expense line items presented in the statements of income and comprehensive income in which the effects of fair value or cash flow hedges are recorded	\$ (31)	
The effects of fair value and cash flow hedging:		
Gain or (loss) on cash flow hedging relationships		
Interest contracts		
Amount of gain or (loss) reclassified from accumulated other comprehensive income into income	\$ (31)	
Amount of gain or (loss) reclassified from accumulated other comprehensive income into income - included component		
Amount of gain or (loss) reclassified from accumulated other comprehensive income into income - excluded component	\$ (31)	

Effect of Derivative Instruments on the Consolidated Statements of Income and Comprehensive Income

The tables below present the effect of the Company's derivative financial instruments on the Consolidated Statements of Income and Comprehensive Income for the three and six months ended June 30, 2019 and 2018.

Derivatives Not Designated as Hedging Instruments	Location of Gain or (Loss) Recognized in Income on Derivative	Amount of Loss Recognized in Income	Amount of Loss Recognized in Income	Amount of Gain Recognized in Income	Amount of Gain Recognized in Income
		Three Months Ended June 30, 2019	Six Months Ended June 30, 2019	Three Months Ended June 30, 2018	Six Months Ended June 30, 2018
Interest Rate Swaps	Other non-interest income	\$ (236)	\$ (346)	\$ 19	\$ 85
Fee Income	Other income / (expense)	\$ 744	\$ 1,136	\$ 53	\$ 53

Offsetting Derivatives

The table below presents a gross presentation, the effects of offsetting, and a net presentation of the Company's derivatives as of June 30, 2019 and December 31, 2018. The net amounts of derivative assets or liabilities can be reconciled to the

Peoples Financial Services Corp.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)
(Dollars in thousands, except per share data)

tabular disclosure of fair value. The tabular disclosure of fair value provides the location that derivative assets and liabilities are presented on the Consolidated Balance Sheets.

Offsetting of Derivative Assets
as of June 30, 2019

	Gross Amounts of Recognized Assets	Gross Amounts Offset in the Balance Sheet	Net Amounts of Assets presented in the Balance Sheet	Gross Amounts Not Offset in the Balance Sheet		
				Financial Instruments	Cash Collateral Received	Net Amount
Derivatives	\$ 4,833	\$	\$ 4,833	\$		\$ 4,833

Offsetting of Derivative Liabilities
as of June 30, 2019

	Gross Amounts of Recognized Assets	Gross Amounts Offset in the Balance Sheet	Net Amounts of Assets presented in the Balance Sheet	Gross Amounts Not Offset in the Balance Sheet		
				Financial Instruments	Cash Collateral Received	Net Amount
Derivatives	\$ 4,183	\$	\$ 4,183	\$		\$ 4,183

Offsetting of Derivative Assets
as of December 31, 2018

	Gross Amounts of Recognized Assets	Gross Amounts Offset in the Balance Sheet	Net Amounts of Assets presented in the Balance Sheet	Gross Amounts Not Offset in the Balance Sheet		
				Financial Instruments	Cash Collateral Received	Net Amount
Derivatives	\$ 661	\$	\$ 661	\$		\$ 661

Offsetting of Derivative Liabilities
as of December 31, 2018

	Gross Amounts of Recognized Assets	Gross Amounts Offset in the Balance Sheet	Net Amounts of Assets presented in the Balance Sheet	Gross Amounts Not Offset in the Balance Sheet		
				Financial Instruments	Cash Collateral Received	Net Amount
Derivatives	\$ 138	\$	\$ 138	\$		\$ 138

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.

Peoples Financial Services Corp.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)
(Dollars in thousands, except per share data)

As of June 30, 2019, 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 \$376. As of December 31, 2018, 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 \$29. The Company has minimum collateral posting thresholds with certain of its derivative counterparties, and has posted collateral of \$3,310 against its obligations under these agreements as of June 30, 2019, compared to having no posted collateral with a counterparty at December 31, 2018. 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.

10. Borrowings

Short-term borrowings consisted of FHLB advances representing overnight borrowings at June 30, 2019 and December 31, 2018:

At and for the six months ended June 30, 2019					
	Ending Balance	Average Balance	Maximum Month-End Balance	Weighted Average Rate for the six months ended June 30, 2019	Weighted Average Rate at June 30, 2019
FHLB advances	\$ 82,700	\$ 105,212	\$ 133,725	2.70 %	2.46 %

At and for the year ended December 31, 2018					
	Ending Balance	Average Balance	Maximum Month-End Balance	Weighted Average Rate for the Year	Weighted Average Rate at End of the Year
FHLB advances	\$ 86,500	\$ 133,834	\$ 189,275	2.05 %	2.62 %

The Company 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 June 30, 2019, the maximum borrowing capacity was \$706,808 of which \$135,680 was outstanding in borrowings. At December 31, 2018, the maximum borrowing capacity was \$700,169 of which \$124,406 was outstanding in borrowings. Short-term borrowings were used to fund our loan growth during the first six months of 2019 as deposit balances were relatively unchanged from year end. Short-term borrowings were lower by \$3,800 from year end 2018 in part to us locking in \$16,000 of new long term borrowings at lower fixed rates under the FHLB's 'Community Lending Program'. 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. The short-term borrowing rate resets each day.

Long-term debt consisting of advances from the FHLB at June 30, 2019 and December 31, 2018 are as follows:

Due	Interest Rate		June 30, 2019	December 31, 2018
	Fixed	Adjustable		
December 2019		4.09 %	\$ 3,000	3,000
December 2019		3.63	6,300	6,300
December 2019	1.62 %		10,000	10,000
June 2020	1.74		5,000	5,000
June 2020	2.22		6,000	
December 2020	1.84		5,000	5,000
June 2021	1.99		10,000	
March 2023	4.69		7,680	8,606
			\$ 52,980	\$ 37,906

Peoples Financial Services Corp.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)
(Dollars in thousands, except per share data)

Maturities of long-term debt, by contractual maturity, for the remainder of 2019 and subsequent years are as follows:

2019	\$ 20,248
2020	17,963
2021	12,058
2022	2,156
2023	555
	<u>\$ 52,980</u>

None of the advances from the FHLB are convertible. At June 30, 2019, long-term debt consist of \$43,680 at fixed rates and \$9,300 at adjustable rates which reset quarterly based on three-month LIBOR plus 1.21% to plus 1.57%. New long-term advances totaling \$16,000 were entered into with the FHLB during the second quarter of 2019. The advances were qualified under the FHLB's 'Community Lending Program' which offers rates lower than their stated rates when the advances are used for community development.

11. Income taxes

The effective tax rate of the Company was 11.8% and 11.2% for the three and six months ended June 30, 2019 compared to 12.0% and 11.8% for the three and six months ended June 30, 2018. The three and six months ended June 30, 2019 include before tax investment tax credits and other credits of \$390 and \$778 compared to before tax investment tax credits \$273 and \$543 for those same periods last year.

**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, 2018.

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 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, 2018, and in reports we file with the Securities and Exchange Commission from time to time.

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

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

Critical Accounting Policies:

Disclosure of our significant accounting policies is included in Note 1 to the consolidated financial statements of the Annual Report on Form 10-K for the year ended December 31, 2018. Some of these policies are particularly sensitive requiring significant judgments, estimates and assumptions.

Operating Environment:

In July 2019, the Federal Open Market Committee ("FOMC") voted to decrease the target range for federal funds to 2.00% to 2.25% after maintaining the target range for federal funds at 2.25% to 2.50% since their last 25 basis point rate increase in December 2018. Overall inflation remains near the committee's long-term desired 2 percent level for items other than food and energy. The consumer price index ("CPI") registered 2.1% for the 12 months ended June 30, 2019. This is up from 2.0% for the 12 months ended March 31, 2019 and from 1.9% for the 12 months ended December 31, 2018. Gross domestic product ("GDP"), the value of all goods and services produced in the nation, came in with an initial second quarter reading of a 2.1% annualized rate, above all forecasts for the quarter which came in at a consensus rate of 2.0% but well below the first quarter of 2019 which registered 3.2%. The latest reading of GDP has led to

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speculation that the weakening growth in much of the world's economy may be spilling over into the United States. Consumer activity has been strong but manufacturing has slowed and housing remains weak.

Review of Financial Position:

Total assets increased \$35,273, or 3.1% annualized, to \$2,324,266 at June 30, 2019, from \$2,288,993 at December 31, 2018. Loans, net increased to \$1,858,799 at June 30, 2019, compared to \$1,823,266 at December 31, 2018, an increase of \$35,533 or 3.9% annualized. The increase in loans, net during 2019 has been funded primarily by borrowings and to a lesser extent investment cash flow. Deposits increased slightly by \$1,777 or 0.2% annualized during the first half of 2019. Interest-bearing deposits decreased \$7,958 while noninterest-bearing deposits increased \$9,735. Total stockholders' equity increased \$12,969 or 4.7%, from \$278,614 at year-end 2018 to \$291,583 at June 30, 2019. For the six months ended June 30, 2019, total assets averaged \$2,313,053, an increase of \$105,654 from \$2,207,399 for the same period of 2018.

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 \$261,665 at June 30, 2019, a decrease of \$8,017, or 3.0% from \$269,682 at December 31, 2018. The decrease was primarily due to the sale of \$9,654 of short-term, low yielding municipal securities with the proceeds used to paydown borrowings and reinvest into higher yielding, longer term securities. An increase in the market value of the available-for-sale portfolio due to a decline in market rates partially offset the decrease. Investment securities held-to-maturity totaled \$7,969 at June 30, 2019, a decrease of \$392 or 4.7% from \$8,361 at December 31, 2018 due to payments received on mortgage backed securities.

For the six months ended June 30, 2019, the investment portfolio averaged \$274,230, a decrease of \$6,671 or 2.4% compared to \$280,901 for the same period last year. The tax-equivalent yield on the investment portfolio decreased 7 basis points to 2.53% for the six months ended June 30, 2019, from 2.60% for the comparable period of 2018. The decrease in yield is due to lower reinvestment rates for cash flow from matured and called higher yielding municipal bonds.

Securities available-for-sale are carried at fair value, with unrealized gains or losses net of deferred income taxes reported in the accumulated other comprehensive income (loss) component of stockholders' equity. We reported net unrealized gains, included as a separate component of stockholders' equity of \$1,403, net of deferred income taxes of \$373, at June 30, 2019, and net unrealized losses of \$2,568, net of deferred income taxes of \$683, at December 31, 2018.

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 second quarter of 2019 slowed when compared to the first quarter increasing \$9,197. Loans, net increased to \$1,858,799 at June 30, 2019 from \$1,823,266 at December 31, 2018, an increase of \$35,533 or 3.9% annualized. The growth was primarily from commercial real estate loans and to a lesser extent from commercial and industrial loans. Partially offsetting the increases were reductions to consumer loans, primarily dealer indirect auto loans, and a slight decline to the residential real estate portfolio. Commercial real estate loans increased \$27,775 or 6.2% annualized, to \$935,578 at June 30, 2019 compared to \$907,803 at December 31, 2018 due to growth primarily in our expansion markets. Commercial and industrial loans increased \$19,521 or 8.0% annualized, to \$513,655 at June 30, 2019 compared to \$494,134 at December 31, 2018 due to growth in loans to small businesses, as we focus on developing total banking relationships with this market segment. Our growth in commercial and commercial real estate loans is due in part to our continued success in executing the strategic market expansion initiative in the Lehigh Valley and Greater Delaware Valley. Our newest branch in Lebanon County in Central Pennsylvania further extends this strategy.

Consumer loans decreased \$10,414, or 17.3% on an annualized basis, to \$111,039 at June 30, 2019 compared to \$121,453 at December 31, 2018. The decrease in consumer loans was primarily due to payoffs outpacing dealer indirect

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auto loan origination volumes. Lower origination volumes have resulted from the Bank's change to the structure of its loan pricing which began during 2018.

Residential real estate loans decreased \$1,349, or 0.9% on an annualized basis, to \$298,527 at June 30, 2019 compared to \$299,876 at December 31, 2018. The residential real estate loans decrease was due to principal reductions in our home equity line of credit portfolio and a slight 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. The residential mortgage portfolio increased during the first half of 2019 despite the sale of \$1,038 of non-performing mortgage loans during the first quarter.

For the six months ended June 30, 2019, loans, net averaged \$1,847,960, an increase of \$117,291 or 6.8% compared to \$1,730,669 for the same period of 2018. The tax-equivalent yield on the loan portfolio was 4.75% for the six months ended June 30, 2019, a 33 basis point increase from the comparable period last year. The increase in yield is due to higher market rates and loan yields resulting from the FOMC's actions to increase the Federal Funds rate 100 basis points during 2018, coupled with adjustable rate loans repricing at higher rates.

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

Unused commitments at June 30, 2019, totaled \$401,630, consisting of \$367,230 in unfunded commitments of existing loan facilities and \$34,400 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, 2018 totaled \$379,187, consisting of \$345,912 in unfunded commitments of existing loans and \$33,275 in standby letters of credit.

Asset Quality:

National, Pennsylvania, New York and market area unemployment rates at June 30, 2019 and 2018, are summarized as follows:

	2019	2018
United States	3.8 %	4.0 %
New York (statewide)	4.1	4.5
Pennsylvania (statewide)	3.9	4.5
Broome County	4.7	5.5
Bucks County	3.4	3.9
Lackawanna County	4.3	4.7
Lebanon County	3.4	3.9
Lehigh County	4.1	4.8
Luzerne County	5.1	5.6
Monroe County	4.8	5.6
Montgomery County	3.1	3.6
Northampton County	4.0	4.6
Schuylkill County	4.8	5.4
Susquehanna County	4.2	4.4
Wayne County	4.7	5.3
Wyoming County	4.5 %	4.8 %

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The employment conditions improved for the nation, Pennsylvania, and New York and in all of the thirteen 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

	<u>June 30, 2019</u>	<u>December 31, 2018</u>
Nonaccrual loans:		
Commercial	\$ 4,494	\$ 776
Real estate:		
Commercial	3,044	2,328
Residential	1,460	2,574
Consumer	251	212
Total nonaccrual loans	<u>9,249</u>	<u>5,890</u>
Troubled debt restructured loans:		
Commercial	1,391	1,438
Real estate:		
Commercial	675	719
Residential	611	622
Total troubled debt restructured loans	<u>2,677</u>	<u>2,779</u>
Accruing loans past due 90 days or more:		
Commercial	8	
Real estate:		
Commercial	148	73
Residential	185	850
Total accruing loans past due 90 days or more	<u>341</u>	<u>923</u>
Total nonperforming loans	<u>12,267</u>	<u>9,592</u>
Foreclosed assets	408	376
Total nonperforming assets	<u>\$ 12,675</u>	<u>\$ 9,968</u>
Nonperforming loans as a percentage of loans, net	0.66 %	0.53 %
Nonperforming assets as a percentage of loans, net and foreclosed assets	0.68 %	0.55 %

We experienced a decline in our asset quality during the first six months of 2019 as evidenced by an increase of \$2,707 in nonperforming assets. Nonperforming assets totaled \$12,675 or 0.68% of loans, net and foreclosed assets at June 30, 2019, from \$9,968 or 0.55% of loans, net and foreclosed assets at December 31, 2018. An increase in nonaccrual loans and slight increase in foreclosed assets was partially offset by a decrease in restructured loans and loans past due ninety days or more.

Loans on nonaccrual status increased \$3,359 to \$9,249 at June 30, 2019 from \$5,890 at December 31, 2018. The majority of the increase from year end was due to an increase of \$3,718 in commercial and industrial loans resulting from the placement of one large credit relationship on nonaccrual totaling \$4,718 during the first quarter. At June 30, 2019, the value of the collateral is sufficient to support the debt of this credit. A decrease in nonaccrual residential real estate loans due to a sale of a pool of nonperforming loans during the first quarter partially offset the increase in commercial real estate loans. Restructured loans decreased \$102 to \$2,677 at June 30, 2019 from \$2,779 at December 31, 2018 due in part to a default and subsequent charge off of two commercial real estate loans during the second quarter partially offset by the addition of one commercial real estate loan totaling \$340 during the second quarter of 2019. Foreclosed assets increased \$32 to \$408 at June 30, 2019 from \$376 at December 31, 2018. Other real estate owned comprised six properties at June 30, 2019 and seven properties at December 31, 2018, respectively.

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.

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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 \$551 to \$21,930, or 1.18% of loans, net at June 30, 2019, from \$21,379, or 1.17% of loans, net at the end of 2018. For the six months ended June 30, 2019, net charge-offs were \$849 or 0.09% of average loans outstanding, a \$638 decrease compared to \$1,487 or 0.17% of average loans outstanding in the same period of 2018. The decrease in the current period is due to the charge off of one large commercial real estate loan during the year ago period totaling \$1,154.

Deposits:

We attract the majority of our deposits from within our market area that stretches from Montgomery County in southeastern Pennsylvania to Broome County in the Southern Tier of New York State to Lebanon County in Central Pennsylvania through the offering of various deposit instruments including demand deposit accounts, NOW accounts, money market deposit accounts, savings accounts, and time deposits, including certificates of deposit and IRA's. For the six months ended June 30, 2019, total deposits increased \$1,777 or 0.2% annualized, to \$1,876,799 from \$1,875,022 at December 31, 2018. Interest-bearing deposits decreased \$7,958 due to seasonal outflows of public deposits, while noninterest-bearing deposits increased \$9,735. Interest-bearing transaction accounts, including NOW and money market accounts, experienced the majority of the municipal deposit outflow decreasing \$37,516, or 10.1% annualized, to \$712,847 at June 30, 2019, from \$750,363 at December 31, 2018, savings accounts increased \$1,675, or 0.9% annualized to \$379,832 as of June 30, 2019 from \$378,157 at December 31, 2018 and time deposits less than \$250 increased \$8,185, or 6.6% annualized, to \$258,641 at June 30, 2019, from \$250,456 at December 31, 2018. Time deposits \$250 or more increased \$19,697, or 46.3% annualized to \$105,483 at June 30, 2019 from \$85,786 at year end 2018 due in part to growth in commercial and municipal accounts.

For the six months ended June 30, interest-bearing deposits averaged \$1,447,773 in 2019 compared to \$1,325,523 in 2018, an increase of \$122,250, or 9.2%. The cost of interest-bearing deposits was 0.99% in 2019 compared to 0.58% for the same period last year. For the first six months, the overall cost of interest-bearing liabilities including the cost of borrowed funds, was 1.15% in 2019 and 0.78% in 2018. 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 during 2018.

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.

Overall, total borrowings at June 30, 2019, totaled \$135,680 compared to \$124,406 at December 31, 2018, an increase of \$11,274. The additional borrowings from yearend was used to fund loan growth, as deposit balances had a small

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increase from year end. Total short-term borrowings at June 30, 2019, totaled \$82,700 compared to \$86,500 at December 31, 2018, a decrease of \$3,800. Long-term debt was \$52,980 at June 30, 2019, compared to \$37,906 at year end 2018. The increase to long-term borrowings was the result of terming out and fixing \$16,000 of the variable rate short-term borrowings at lower rates under the FHLB's 'Community Lending Program' during the second quarter of 2019.

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 our board of directors and senior management, that involves a comprehensive risk management process in order to effectively identify, measure, monitor and control risk. Should bank regulatory agencies identify a material weakness in our risk management process or high exposure relative to our capital, bank regulatory agencies may take action to remedy these shortcomings. Moreover, the level of IRR exposure and the quality of our risk management process is a determining factor when evaluating capital adequacy.

The ALCO, comprised of members of our board of directors, senior management and other appropriate officers, oversees our IRR management program. Specifically, ALCO analyzes economic data and market interest rate trends, as well as competitive pressures, and utilizes computerized modeling techniques to reveal potential exposure to IRR. This allows us to monitor and attempt to control the influence these factors may have on our rate-sensitive assets ("RSA") and rate-sensitive liabilities ("RSL"), and overall operating results and financial position. One such technique utilizes a static gap model that considers repricing frequencies of RSA and RSL in order to monitor IRR. Gap analysis attempts to measure our interest rate exposure by calculating the net amount of RSA and RSL that reprice within specific time intervals. A positive gap occurs when the amount of RSA repricing in a specific period is greater than the amount of RSL repricing within that same time frame and is indicated by a RSA/RSL ratio greater than 1.0. A negative gap occurs when the amount of RSL repricing is greater than the amount of RSA and is indicated by a RSA/RSL ratio of less than 1.0. A positive gap implies that earnings will be impacted favorably if interest rates rise and adversely if interest rates fall during the period. A negative gap tends to indicate that earnings will be affected inversely to interest rate changes.

Our cumulative one-year RSA/RSL ratio equaled 1.29% at June 30, 2019. Given the latest action by the FOMC to lower the targeted federal funds rate 25 basis points, after increasing rates 100 basis points during 2018, and the potential for rates to decrease in the future. The focus of ALCO has been to create a balanced 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 are offering short term certificates of deposit in an attempt to decrease duration. The current position at June 30, 2019, indicates that the amount of RSA repricing within one year would exceed that of RSL, thereby causing net interest income to decrease as market rates decrease. 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.

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

As the static gap report fails to address the dynamic changes in the balance sheet composition or prevailing interest rates, we utilize a simulation model to enhance our asset/liability management. This model is used to create pro forma net interest income scenarios under various interest rate shocks. Model results at June 30, 2019, 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 2019 and endeavor to employ deposit and loan pricing strategies and direct the reinvestment of loan and investment repayments in order to manage our IRR position.

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

Liquidity:

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

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

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

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

We employ a number of analytical techniques in assessing the adequacy of our liquidity position. One such technique is the use of ratio analysis to determine the extent of our reliance on noncore funds to fund our investments and loans maturing after June 30, 2019. Our noncore funds at June 30, 2019, were comprised of time deposits in denominations of \$100 or more and other borrowings. These funds are not considered to be a strong source of liquidity because they are very interest rate sensitive and are considered to be highly volatile. At June 30, 2019, our net noncore funding dependence ratio, the difference between noncore funds and short-term investments to long-term assets, was 16.5%, while our net short-term noncore funding dependence ratio, noncore funds maturing within one-year, less short-term investments to long-term assets equaled 11.4%. Comparatively, our overall noncore dependence ratio at year-end 2018 was 15.0% and our net short-term noncore funding dependence ratio was 6.3%, indicating that our reliance on noncore funds has increased overall.

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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, decreased \$2,654 during the six months ended June 30, 2019. Cash and cash equivalents decreased \$2,109 for the same period last year. For the six months ended June 30, 2019, net cash inflows of \$16,089 from operating activities and \$7,853 from financing activities were more than offset by net cash outflows of \$26,596 from investing activities. For the same period of 2018, net cash inflows of \$15,048 from operating activities and \$57,985 from financing activities were more than offset by net cash outflows of \$75,142 from investing activities.

Operating activities provided net cash of \$16,089 for the six months ended June 30, 2019, and \$15,048 for the corresponding six months of 2018. 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 \$26,596 for the six months ended June 30, 2019, compared to using net cash of \$75,142 for the same period of 2018. In 2019 and 2018, an increase in lending activities was the primary factor causing the net cash outflow from investing activities.

Financing activities provided net cash of \$7,853 for the six months ended June 30, 2019, and provided net cash of \$57,985 for the corresponding six months of 2018. Deposit gathering is our predominant financing activity. In the event that loan growth should exceed the growth in deposits, short-term and long-term borrowings fill in the gap in funding. Deposits used cash of \$1,777 for the six months ended June 30, 2019. Comparatively, deposits decreased \$157 for the same period of 2018. We continue to seek deposits from new markets and customers as well as existing customers, including municipalities and school districts. Short term borrowings decreased \$3,800 in the six months ended June 30, 2019 compared to an increase of \$63,775 for the comparable period in 2018. Long term borrowings increased \$15,074, net of repayments for the six months ended June 30, 2019, compared to a decrease of \$823 for the same six months in 2018. With favorable borrowing rates we locked \$16,000 in longer term funding at the FHLB.

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 \$291,583 or \$39.41 per share at June 30, 2019, compared to \$278,614 or \$37.66 per share at December 31, 2018. Net income of \$13,556 for the six months ended June 30, 2019 was the primary factor leading to the improved capital position. Stockholders' equity was also affected by cash dividends declared of \$5,032, stock based compensation of \$166, and other comprehensive income of \$4,371 resulting from market value fluctuations in the investment portfolio and changes to the fair value of derivatives.

Dividends declared equaled \$0.68 per share through the six months ended June 30, 2019 and \$0.65 per share for the same period of 2018. The dividend payout ratio was 37.2% for the six months ended June 30, 2019 and 40.6% for the same period of 2018. It is the intention of our board of directors to continue to pay cash dividends in the future. However, these decisions are affected by operating results, financial and economic decisions, capital and growth objectives, appropriate dividend restrictions and other relevant factors.

In July 2013, the 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

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conservation buffer, it will be subject to certain restrictions on capital distributions and discretionary bonus payments. The capital conservation buffer for all banking organizations was phased in beginning on January 1, 2016, and was fully phased in 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 June 30, 2019, the Bank's Tier 1 capital to total average assets was 9.98% as compared to 9.78% at December 31, 2018. The Bank's Tier 1 capital to risk weighted asset ratio was 11.85% and the total capital to risk weighted asset ratio was 13.00% at June 30, 2019. These ratios were 11.64% and 12.80% at December 31, 2018. The Bank's common equity Tier 1 to risk weighted asset ratio was 11.85% at June 30, 2019 compared to 11.64% at December 31, 2018. The Bank met all capital adequacy requirements and was deemed to be well-capitalized under regulatory standards at June 30, 2019.

Review of Financial Performance:

Net income for the second quarter of 2019 equaled \$7,144 or \$0.96 per share compared to \$5,957 or \$0.81 per share for the second quarter of 2018. The increase in earnings for the current period is the product of higher net interest income of \$1,077 due to growth in our average earning assets of \$102.3 million since the year ago period, a lower provision for loan losses of \$700 and an increase in non-interest income of \$489 due primarily to revenue from commercial loan interest rate swap transactions. These increases were partially offset by higher non-interest expenses of \$933 related to our market expansion initiative. In the second quarter of 2018, we entered into a credit card account purchase agreement with a third party to sell our credit card portfolio. The sale resulted in a pre-tax gain of \$291. Return on average assets ("ROA") measures our net income in relation to total assets. Our ROA was 1.24% for the second quarter of 2019 compared to 1.08% for the same period of 2018. Return on average equity ("ROE") indicates how effectively we can generate net income on the capital invested by stockholders. Our ROE was 9.98% for the second quarter of 2019 compared to 8.90% for the comparable period in 2018.

Net income through six months in 2019 equaled \$13,556 or \$1.83 per share compared to \$11,811 or \$1.60 per share for the same period of 2018. The increase in earnings in the current period is the result of higher net interest income of \$2,187 due to our earning asset growth coupled with a reduction to the provision for loan losses expense of \$700, partially offset by an increase in non-interest expenses of \$1,342. Our ROA and ROE were 1.18% and 9.63% through six months in 2019 compared to 1.08% and 8.90% for the same period of 2018.

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 2019 and 2018.

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MANAGEMENT'S DISCUSSION AND ANALYSIS
(Dollars in thousands, except per share data)

For the three months ended June 30, tax-equivalent net interest income increased \$1,105 to \$19,162 in 2019 from \$18,057 in 2018. The net interest spread decreased to 3.32% for the three months ended June 30, 2019 from 3.39% for the three months ended June 30, 2018 as the average rate paid on interest bearing liabilities increased 36 basis points while the earning asset yield increased 29 basis points. The tax-equivalent net interest margin increased to 3.62% for the second quarter of 2019 from 3.58% for the comparable period of 2018. The tax-equivalent net interest margin for the fourth quarter of 2018 was 3.63%.

For the three months ended June 30, tax-equivalent interest income on earning assets increased \$2,594, to \$23,766 in 2019 as compared to \$21,172 in 2018. The overall yield on earning assets, on a fully tax-equivalent basis, increased 29 basis points for the three months ended June 30, 2019 to 4.49% as compared to 4.20% for the three months ended June 30, 2018. The increase in the yield on earning assets resulted from a 32 basis point increase in loan yields, 4.78% for the second quarter of 2019 compared to 4.46% for the same period last year. Loan yields increased due to higher rates on new loan originations, coupled with adjustable rate loans repricing into a higher rate environment due to the Federal Open Market Committee ("FOMC") actions to increase the effective federal funds rate 100 basis points in 2018. The overall yield earned on investments decreased 9 basis points in the second quarter of 2019 to 2.51% from 2.60% for the second quarter of 2018 as investment cashflow from high yielding matured and pre-refunded municipal bonds are being deployed into lower yielding bonds. Average investment balances were \$10,406 lower when comparing the current and year ago quarter.

Total interest expense increased \$1,489, to \$4,604 for the three months ended June 30, 2019 from \$3,115 for the three months ended June 30, 2018. An increase in the average balance of interest bearing liabilities of \$40,637 combined with a 36 basis point increase in the cost of funds comparing the three months ended June 30, 2019 and 2018 caused the increase. Average short-term borrowings decreased \$74,804 to \$88,792 for the quarter ended June 30, 2019 compared to \$163,596 for the corresponding year ago period as growth in deposits resulted in a reduction to short-term borrowings. The increase in interest expense for the three months ended June 30, 2019 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 100 basis points during 2018, ending at a range of 2.25% to 2.50%.

For the six months ended June 30, tax-equivalent net interest income increased \$2,239 to \$37,900 in 2019 from \$35,661 in 2018. The net interest spread decreased to 3.31% for the six months ended June 30, 2019 from 3.39% for the six months ended June 30, 2018. The tax-equivalent net interest margin for the six months ended June 30 was 3.60% in 2019 compared to 3.57% in 2018.

For the six months ended June 30, 2019, tax-equivalent interest income increased \$5,425, to \$47,008 compared to \$41,583 for the six months ended June 30, 2018. A volume variance in interest income of \$2,468 attributable to an increase in the average balance of earning assets coupled with a \$2,957 favorable rate variance due to an increase in the yield on loans for the six months ended June 30, 2019 from the same period in 2018 caused the increase. The overall yield on earning assets, on a fully tax-equivalent basis, increased for the six months ended June 30, 2019 to 4.46% as compared to 4.17% for the six months ended June 30, 2018.

Total interest expense increased \$3,186 to \$9,108 for the six months ended June 30, 2019 from \$5,922 for the six months ended June 30, 2018. The average balance of interest bearing liabilities increased to \$1,592,872 for the six months ended June 30, 2019, as compared to \$1,538,115 for the six months ended June 30, 2018. A volume variance in time deposits of \$100 or more, money market accounts and NOW accounts caused interest expense to increase \$898. Adding to the volume variance, a rate variance of \$2,320 in time deposits of \$100 or more, money market accounts and NOW accounts resulted in the increased interest expense through six months in 2019. All other deposit categories experienced a mix of rate and volume variances that only slightly offset these increases. The cost of funds increased to 1.15% for the six months ended June 30, 2019 as compared to 0.78% for the same period in 2018, the result of higher short-term market rates resulting from the FOMC's actions of raising the targeted federal funds rate and increased market demand for premium deposit rates.

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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%.

	Three months ended					
	June 30, 2019			June 30, 2018		
	Average Balance	Interest Income/Expense	Yield/Rate	Average Balance	Interest Income/Expense	Yield/Rate
Assets:						
Earning assets:						
Loans:						
Taxable	\$ 1,707,730	\$ 20,641	4.85 %	\$ 1,616,729	\$ 18,239	4.52 %
Tax-exempt	142,310	1,404	3.96	122,876	1,103	3.60
Total loans	1,850,040	22,045	4.78	1,739,605	19,342	4.46
Investments:						
Taxable	189,265	1,045	2.21	178,957	991	2.22
Tax-exempt	82,565	659	3.20	103,279	837	3.25
Total investments	271,830	1,704	2.51	282,236	1,828	2.60
Interest-bearing deposits	2,554	17	2.67	342	2	2.35
Federal funds sold						
Total earning assets	2,124,424	23,766	4.49 %	2,022,183	21,172	4.20 %
Less: allowance for loan losses	22,341			20,094		
Other assets	212,924			216,013		
Total assets	\$ 2,315,007	\$ 23,766		\$ 2,218,102	\$ 21,172	
Liabilities and Stockholders' Equity:						
Interest-bearing liabilities:						
Money market accounts	\$ 325,555	\$ 1,058	1.30 %	\$ 290,194	\$ 557	0.77 %
NOW accounts	383,276	702	0.73	367,456	475	0.52
Savings accounts	385,995	124	0.13	395,750	123	0.12
Time deposits less than \$100	137,613	498	1.45	146,940	426	1.16
Time deposits \$100 or more	217,226	1,331	2.46	126,696	378	1.20
Short-term borrowings	88,792	595	2.69	163,596	841	2.06
Long-term debt	41,948	296	2.83	49,136	315	2.57
Total interest-bearing liabilities	1,580,405	4,604	1.17	1,539,768	3,115	0.81
Noninterest-bearing deposits	426,791			394,461		
Other liabilities	20,773			15,376		
Stockholders' equity	287,038			268,497		
Total liabilities and stockholders' equity	\$ 2,315,007	4,604		\$ 2,218,102	3,115	
Net interest income/spread		\$ 19,162	3.32 %		\$ 18,057	3.39 %
Net interest margin			3.62 %			3.58 %
Tax-equivalent adjustments:						
Loans		\$ 295			\$ 232	
Investments		139			176	
Total adjustments		\$ 434			\$ 408	

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(Dollars in thousands, except per share data)

	Six months ended					
	June 30, 2019			June 30, 2018		
	Average Balance	Interest Income/Expense	Yield/Rate	Average Balance	Interest Income/Expense	Yield/Rate
Assets:						
Earning assets:						
Loans:						
Taxable	\$ 1,704,750	\$ 40,744	4.82 %	\$ 1,606,666	\$ 35,748	4.49 %
Tax-exempt	143,210	2,795	3.94	124,003	2,204	3.58
Total loans	1,847,960	43,539	4.75	1,730,669	37,952	4.42
Investments:						
Taxable	187,490	2,076	2.23	175,316	1,903	2.19
Tax-exempt	86,740	1,370	3.19	105,585	1,724	3.29
Total investments	274,230	3,446	2.53	280,901	3,627	2.60
Interest-bearing deposits	1,796	23	2.58	506	4	1.59
Federal funds sold						
Total earning assets	2,123,986	47,008	4.46 %	2,012,076	41,583	4.17 %
Less: allowance for loan losses	22,005			19,659		
Other assets	211,072			214,982		
Total assets	<u>\$2,313,053</u>	<u>\$ 47,008</u>		<u>\$2,207,399</u>	<u>\$ 41,583</u>	
Liabilities and Stockholders' Equity:						
Interest-bearing liabilities:						
Money market accounts	\$ 328,382	\$ 2,089	1.28 %	\$ 287,156	\$ 1,026	0.72 %
NOW accounts	387,135	1,409	0.73	368,590	944	0.52
Savings accounts	384,341	243	0.13	393,471	244	0.13
Time deposits less than \$100	136,820	963	1.42	149,831	849	1.14
Time deposits \$100 or more	211,095	2,420	2.31	126,475	730	1.16
Short-term borrowings	105,282	1,408	2.70	163,282	1,508	1.86
Long-term debt	39,817	576	2.92	49,310	621	2.54
Total interest-bearing liabilities	1,592,872	9,108	1.15	1,538,115	5,922	0.78
Noninterest-bearing deposits	416,817			385,840		
Other liabilities	19,383			15,712		
Stockholders' equity	283,981			267,732		
Total liabilities and stockholders' equity	<u>\$2,313,053</u>	<u>9,108</u>		<u>\$2,207,399</u>	<u>5,922</u>	
Net interest income/spread		<u>\$ 37,900</u>	3.31 %		<u>\$ 35,661</u>	3.39 %
Net interest margin			3.60 %			3.57 %
Tax-equivalent adjustments:						
Loans		\$ 587			\$ 463	
Investments		288			362	
Total adjustments		<u>\$ 875</u>			<u>\$ 825</u>	

Provision for Loan Losses:

We evaluate the adequacy of the allowance for loan losses account on a quarterly basis utilizing our systematic analysis in accordance with procedural discipline. We take into consideration certain factors such as composition of the loan portfolio, volumes of nonperforming loans, volumes of net charge-offs, prevailing economic conditions and other relevant factors when determining the adequacy of the allowance for loan losses account. We make monthly provisions to the allowance for loan losses account in order to maintain the allowance at the appropriate level indicated by our evaluations. Based on our most current evaluation, we believe that the allowance is adequate to absorb any known and inherent losses in the portfolio as of June 30, 2019.

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The provision for loan losses totaled \$1,400 for the six months ended June 30, 2019 and \$2,100 for the six months ended June 30, 2018. For the three months ended June 30, the provision for loan losses was \$350 in 2019 and \$1,050 in 2018. The decrease in the current period is due to smaller loan growth and stable credit quality.

Noninterest Income:

Noninterest income for the second quarter increased \$489 or 13.3% to \$4,152 in 2019 from \$3,663 in 2018. The increase is due primarily to an increase in service charges, fees, and commissions of \$605 or 32.1% due to an increase in commercial loan interest rate swap transaction revenue of \$437 and a recovery of \$216 on a purchased impaired commercial credit, the balance of which had previously been charged-off to a specific credit mark set-up at time of acquisition under purchase accounting. Merchant revenue increased \$148 from the previous period due to higher incentive fees. In the second quarter of 2018, we completed the sale of our credit card portfolio and recognized a gain of \$291. There is no comparable gain in the corresponding period of 2019.

For the six months ended June 30, 2019, noninterest income totaled \$7,568, an increase of \$333 or 4.6% from \$7,235 for the comparable period of 2018. Fee income generated by commercial loan interest rate swap transactions increased \$651 in the current period due to higher volume. Included in service charges, fees and commissions in the current period is a recovery of \$216 on a purchased impaired commercial credit, the balance of which had previously been charged-off to a specific credit mark set-up at time of acquisition under purchase accounting. In the year ago period, service charges, fees and commissions included an accrual for death benefit proceeds on a bank owned life insurance (BOLI) policy totaling \$365, with no comparable amount in the current period. Additionally in the year ago period, we recognized a gain on the sale of our credit card portfolio of \$291. Merchant services income increased \$96 to \$655 for the six months ended June 30, 2019 from \$559 for the same period last year due in part to higher incentive fees. Income generated from commissions and fees on fiduciary activities increased slightly to \$999 for the six months ended June 30, 2019 compared to \$982 for the same period in 2018 due to higher market valuations. Income generated from our wealth management division increased slightly through the first six months of 2019, while mortgage banking income decreased modestly to \$285 for the first six months of 2019 compared to \$309 for the comparable period in 2018.

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 second quarter, noninterest expense increased \$933 or 6.9% to \$14,429 in 2019 from \$13,496 in 2018. For the six months ended June 30, noninterest expense increased \$1,342 or 5.0% to \$27,919 in 2019 from \$26,577 in 2018. Personnel costs increased 8.8%, net occupancy and equipment costs increased 4.7%, and all other expense categories which include, professional fees and outside services, FDIC insurance and assessments, donations and other miscellaneous expenses increased 6.2% comparing the three months ended June 30, 2019 and 2018. During the six months ended June 30, 2019, higher personnel costs of \$1,287 or 9.0% was the primary reason for the increase in total non-interest expense.

Salaries and employee benefits expense, which comprise the majority of noninterest expense, totaled \$8,037 for the second quarter of 2019, an increase of \$647 or 8.8% when compared to the second quarter of 2018. Salaries and employee benefits expense totaled \$15,632 for the six months ending June 30, 2019, an increase of \$1,287 or 9.0% when compared to \$14,345 for the same period of 2018. Annual merit increases and additional resources related to our continued strategic market expansion initiative contributed to the increase. Additional staffing in the form of commercial

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lenders and credit professionals have been put in place to support our expansion and to continue our momentum in the Lehigh Valley and King of Prussia markets. Additionally, during the second quarter of 2019 we opened our newest branch office located on Norman Drive in Lebanon, Pennsylvania.

We experienced a \$129 or 4.7% increase in net occupancy and equipment expense comparing the second quarter of 2019 at \$2,849 and 2018 at \$2,720. The six months ended June 30, 2019 resulted in a \$276 or 5.0% increase to \$5,810 in net occupancy and equipment expense compared to \$5,534 for the same period in 2018. Additional depreciation expense related to the transformation of two of our legacy branch offices, investment in our global information technology systems, and investment into our newest markets was the primary reason for the increase. In general, as we expand and increase our presence in new markets, depreciation expenses and technology costs associated with the implementation and maintenance of new infrastructure within those markets increases.

For the second quarter, all other expense categories increased \$157 or 4.6% to \$3,543 from \$3,386 comparing 2019 to 2018. Legal and professional expenses increased \$79 due to costs related to loan workouts. Loan processing fees related to new loan originations increased \$75, and \$55 of other assets were written-off during the current quarter. For the six months ended June 30, all other expense categories decreased \$221 or 3.3% to \$6,477 in 2019 compared to \$6,698 in 2018. Amortization expense related to intangible assets declined \$76; FDIC assessments decreased \$36, or 6.2% when comparing the first half of 2019 to the same period in 2018. Professional fees and outside services were lower due to insurance proceeds in the amount of \$181 received as settlement to legal costs previously incurred. Donations increased \$35, or 5.3% in the first half of 2019 when compared to the same period in 2018 as support for civic organizations and charitable entities grows as we enter new markets.

Income Taxes:

We recorded income tax expense of \$957 or 11.8% of pre-tax income, and \$1,718 or 11.2% of pre-tax income for the three and six months ended June 30, 2019, respectively. In the year ago period, we recorded income tax expense of \$811 or 12.0% of pre-tax income, and \$1,585 or 11.8% of pre-tax income for those same periods. The three and six months ended June 30, 2019 include before tax investment tax credits and other credits totaling \$390 and \$778 compared to before tax investment tax credits \$273 and \$543 for those same periods last year.

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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 (“IRR”), which arises from our lending, investing and deposit gathering activities. Our market risk sensitive instruments consist of derivative and 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.

Interest rate risk is the risk of loss to future earnings due to changes in interest rates. The Asset Liability Committee (“ALCO”) is responsible for establishing policy guidelines on liquidity and acceptable exposure to interest rate risk. Generally quarterly, the ALCO reports on the status of liquidity and interest rate risk matters to the Company’s board of directors. The objective of the ALCO is to manage assets and funding sources to produce results that are consistent with the Company’s liquidity, capital adequacy, growth, risk and profitability goals and are within policy limits.

The Company utilizes the pricing and structure of loans and deposits, the size and duration of the investment securities portfolio, the size and duration of the wholesale funding portfolio, and off-balance sheet interest rate contracts to manage interest rate risk. The off-balance sheet interest rate contracts may include interest rate swaps, caps and floors. These interest rate contracts involve, to varying degrees, credit risk and interest rate risk. Credit risk is the possibility that a loss may occur if a counterparty to a transaction fails to perform according to terms of the contract. The notional amount of the interest rate contracts is the amount upon which interest and other payments are based. The notional amount is not exchanged, and therefore, should not be taken as a measure of credit risk. See Note 9 to the Unaudited Consolidated Financial Statements for additional information.

The ALCO uses income simulation to measure interest rate risk inherent in the Company’s on-balance sheet and off-balance sheet financial instruments at a given point in time by showing the effect of interest rate shifts on net interest income over a 24-month horizon and a 60-month horizon. The simulations assume that the size and general composition of the Company’s balance sheet remain static over the simulation horizons, with the exception of certain deposit mix shifts from low-cost time deposits to higher-cost time deposits in selected interest rate scenarios. Additionally, the simulations take into account the specific repricing, maturity, call options, and prepayment characteristics of differing financial instruments that may vary under different interest rate scenarios. The characteristics of financial instrument classes are reviewed typically quarterly by the ALCO to ensure their accuracy and consistency.

The ALCO reviews simulation results to determine whether the Company’s exposure to a decline in net interest income remains within established tolerance levels over the simulation horizons and to develop appropriate strategies to manage this exposure. As of June 30, 2019 and December 31, 2018, net interest income simulations indicated that exposure to changing interest rates over the simulation horizons remained within tolerance levels established by the Company. All changes are measured in comparison to the projected net interest income that would result from an “unchanged” rate scenario where both interest rates and the composition of the Company’s balance sheet remain stable for a 60-month period. In addition to measuring the change in net interest income as compared to an unchanged interest rate scenario,

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the ALCO also measures the trend of both net interest income and net interest margin over a 60-month horizon to ensure the stability and adequacy of this source of earnings in different interest rate scenarios.

The ALCO regularly reviews a wide variety of interest rate shift scenario results to evaluate interest rate risk exposure, including scenarios showing the effect of steepening or flattening changes in the yield curve of up to 500 basis points as well as parallel changes in interest rates of up to 400 basis points. Because income simulations assume that the Company's balance sheet will remain static over the simulation horizon, the results do not reflect adjustments in strategy that the ALCO could implement in response to rate shifts.

The projected impacts of instantaneous changes in interest rates on our net interest income and economic value of equity at June 30, 2019, based on our simulation model, as compared to our ALCO policy limits are summarized as follows:

Changes in Interest Rates (basis points)	June 30, 2019 % Change in			
	Net Interest Income		Economic Value of Equity	
	Metric	Policy	Metric	Policy
+400	(1.1)	(20.0)	3.0	(40.0)
+300	(0.6)	(20.0)	3.2	(30.0)
+200	(0.3)	(10.0)	3.0	(20.0)
+100	0.0	(10.0)	2.6	(10.0)
Static				
(100)	(1.7)	(10.0)	(7.7)	(10.0)

Our simulation model creates pro forma net interest income scenarios under various interest rate shocks. Given instantaneous and parallel shifts in general market rates of plus 100 basis points, our projected net interest income for the 12 months ending June 30, 2020, would be relatively unchanged 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, 2018, 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, 2018.

The Alternative Reference Rates Committee ("ARRC") has proposed that the Secured Overnight Funding Rate ("SOFR") replace USD-LIBOR. ARRC has proposed that the transition to SOFR from USD-LIBOR will take place by the end of 2021. The Company has material contracts that are indexed to USD-LIBOR. Industry organizations are currently working on the transition plan. The Company is currently monitoring this activity and evaluating the risks involved.

Item 4. Controls and Procedures.

(a) Evaluation of disclosure controls and procedures.

At June 30, 2019, the end of the period covered by this Quarterly Report on Form 10-Q, the Chief Executive Officer ("CEO") and Chief Financial Officer ("CFO") 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 CEO and CFO concluded that the disclosure controls and procedures, at June 30, 2019, were effective to provide reasonable assurance that information required to be disclosed in the Company's reports filed under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and to provide reasonable assurance that information required to be disclosed in such reports is accumulated and communicated to the CEO and CFO to allow timely decisions regarding required disclosure.

Peoples Financial Services Corp.**(b) Changes in internal control.**

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

PART II—OTHER INFORMATION**Item 1. Legal Proceedings.**

The nature of the Company's business generates a certain amount of litigation involving matters arising out of the ordinary course of business. In the opinion of management, there were no legal proceedings that had or might have a material effect on the consolidated results of operations, liquidity, or the financial position of the Company during the six-months ended June 30, 2019 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, 2018.

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

On February 1, 2019, our board of directors reauthorized a common stock repurchase plan whereby we are authorized to repurchase up to 225,000 shares of our outstanding common stock through open market purchases.

The following purchases were 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 June 30, 2019.

<u>Month Ending</u>	<u>Total Number of Shares Purchased</u>	<u>Average Price Paid Per Share</u>	<u>Total Number of Shares Purchased as Part of Publicly Announced Programs</u>	<u>Maximum Number of Shares that may yet be Purchased Under the Programs</u>
April 30, 2019		\$		225,000
May 31, 2019	1,559	\$ 43.62		223,441
June 30, 2019	2,271	\$ 42.93		221,170

Item 3. Defaults upon Senior Securities.

None.

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Item 4. Mine Safety Disclosures.

Not applicable.

Item 5. Other Information .

None.

Item 6. Exhibits .

Item Number	Description	Page
31.1	CEO Certification Pursuant to Rule 13a-14 (a) /15d-14 (a).	52
31.2	CFO Certification Pursuant to Rule 13a-14 (a) /15d-14 (a).	53
32	CEO and CFO Certifications Pursuant to Section 1350.	54
101	The following materials from Peoples Financial Services Corp. Quarterly Report on Form 10-Q for the period ended June 30, 2019, 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.	

SIGNATURE S

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

Peoples Financial Services Corp.
(Registrant)

Date: August 7, 2019

/s/ Craig W. Best
Craig W. Best
President and Chief Executive Officer
(Principal Executive Officer)

Date: August 7, 2019

/s/ John R. Anderson, III
John R. Anderson, III
Executive Vice President and Chief Financial Officer
(Principal Financial Officer and Principal Accounting Officer)

CERTIFICATION

I, Craig W. Best, certify that:

1. I have reviewed this quarterly report on Form 10-Q for the period ended June 30, 2019, of Peoples Financial Services Corp.;
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13A-15(f) and 15d-15(f)) for the registrant and have:
 - a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;
 - b) designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - c) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - d) disclosed in the quarterly report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting.
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's Board of Directors (or persons performing the equivalent functions):
 - a) all significant deficiencies and material weaknesses in the design or operation of internal controls over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

/s/ Craig W. Best

President and Chief Executive Officer
(Principal Executive Officer)

Date: August 7, 2019

CERTIFICATION

I, John R. Anderson, III, certify that:

1. I have reviewed this quarterly report on Form 10-Q for the period ended June 30, 2019, of Peoples Financial Services Corp.;
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13A-15(f) and 15d-15(f)) for the registrant and have:
 - a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;
 - b) designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - c) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - d) disclosed in the quarterly report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting.
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's Board of Directors (or persons performing the equivalent functions):
 - a) all significant deficiencies and material weaknesses in the design or operation of internal controls over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

/s/ John R. Anderson, III

Executive Vice President and Chief Financial Officer
(Principal Financial Officer)

Date: August 7, 2019

SECTION 1350 CERTIFICATIONS

In connection with the Quarterly Report on Form 10-Q of Peoples Financial Services Corp. (the “Company”) for the period ended June 30, 2019, as filed with the Securities and Exchange Commission (the “Report”), I, Craig W. Best, President and Chief Executive Officer, of the Company, certify, pursuant to 18 U.S.C. Section 1350, as added by Section 906 of the Sarbanes-Oxley Act of 2002, that:

1. The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
2. To my knowledge, the information contained in the Report fairly represents, in all material respects, the financial condition and results of operations of the Company as of and for the period covered by the Report.

/s/ Craig W. Best

President and Chief Executive Officer

(Principal Executive Officer)

Date: August 7, 2019

/s/ John R. Anderson, III

Executive Vice President and Chief Financial Officer

(Principal Financial Officer)

Date: August 7, 2019

A signed copy of this written statement required by Section 906 of the Sarbanes-Oxley Act of 2002 has been provided to the Company and will be retained by the Company and furnished to the Securities and Exchange Commission or its staff upon request.