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

Form 10-Q

☒ **Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
for the quarterly period ended September 30, 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: 7,388,480 at October 31, 2019.

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PEOPLES FINANCIAL SERVICES CORP.
FORM 10-Q

For the Quarter Ended September 30, 2019

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

	September 30, 2019	December 31, 2018
Assets:		
Cash and due from banks:		
Cash and due from banks	\$ 35,908	\$ 32,569
Interest-bearing deposits in other banks	5,275	47
Total cash and due from banks	41,183	32,616
Federal funds sold	10,100	
Investment securities:		
Available-for-sale	268,823	269,682
Equity investments carried at fair value	297	291
Held-to-maturity: Fair value September 30, 2019, \$8,016; December 31, 2018, \$8,380	7,808	8,361
Total investment securities	276,928	278,334
Loans, net	1,881,090	1,823,266
Less: allowance for loan losses	22,392	21,379
Net loans	1,858,698	1,801,887
Loans held for sale	1,390	749
Premises and equipment, net	47,437	38,889
Accrued interest receivable	6,655	7,115
Goodwill	63,370	63,370
Intangible assets, net	1,738	2,296
Other assets	65,200	63,737
Total assets	<u>\$ 2,372,699</u>	<u>\$ 2,288,993</u>
Liabilities:		
Deposits:		
Noninterest-bearing	\$ 440,582	\$ 410,260
Interest-bearing	1,560,703	1,464,762
Total deposits	2,001,285	1,875,022
Short-term borrowings		86,500
Long-term debt	52,509	37,906
Accrued interest payable	1,461	1,195
Other liabilities	21,277	9,756
Total liabilities	<u>2,076,532</u>	<u>2,010,379</u>
Stockholders' equity:		
Common stock, par value \$2.00, authorized 25,000,000 shares, issued and outstanding 7,388,760 shares at September 30, 2019 and 7,399,054 shares at December 31, 2018	14,778	14,798
Capital surplus	135,106	135,310
Retained earnings	149,740	136,582
Accumulated other comprehensive loss	(3,457)	(8,076)
Total stockholders' equity	296,167	278,614
Total liabilities and stockholders' equity	<u>\$ 2,372,699</u>	<u>\$ 2,288,993</u>

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)

September 30,	Three Months Ended		Nine Months Ended	
	2019	2018	2019	2018
Interest income:				
Interest and fees on loans:				
Taxable	\$ 20,940	\$ 18,798	\$ 61,684	\$ 54,546
Tax-exempt	1,066	919	3,274	2,660
Interest and dividends on investment securities:				
Taxable	1,092	998	3,127	2,790
Tax-exempt	411	639	1,493	2,001
Dividends	19	16	60	51
Interest on interest-bearing deposits in other banks	27	49	50	131
Interest on federal funds sold	77		77	
Total interest income	<u>23,632</u>	<u>21,419</u>	<u>69,765</u>	<u>62,179</u>
Interest expense:				
Interest on deposits	3,966	2,342	11,090	6,135
Interest on short-term borrowings	83	809	1,491	2,317
Interest on long-term debt	347	315	923	936
Total interest expense	<u>4,396</u>	<u>3,466</u>	<u>13,504</u>	<u>9,388</u>
Net interest income	19,236	17,953	56,261	52,791
Provision for loan losses	700	1,050	2,100	3,150
Net interest income after provision for loan losses	<u>18,536</u>	<u>16,903</u>	<u>54,161</u>	<u>49,641</u>
Noninterest income:				
Service charges, fees and commissions	2,161	1,883	6,650	5,856
Merchant services income	182	128	837	687
Commission and fees on fiduciary activities	569	570	1,568	1,552
Wealth management income	395	305	1,142	1,048
Mortgage banking income	172	163	457	472
Life insurance investment income	189	190	567	568
Net gains on equity investment securities	14	14	6	14
Net gains on sale of investment securities available-for-sale			23	
Net gain on sale of credit card loans				291
Total noninterest income	<u>3,682</u>	<u>3,253</u>	<u>11,250</u>	<u>10,488</u>
Salaries and employee benefits expense	8,056	6,946	23,688	21,291
Net occupancy and equipment expense	2,997	2,681	8,807	8,215
Amortization of intangible assets	183	220	557	670
Professional fees and outside services	487	431	1,343	1,500
FDIC insurance and assessments	68	247	615	830
Donations	386	355	1,077	1,011
Other expenses	1,902	1,657	5,911	5,597
Total noninterest expense	<u>14,079</u>	<u>12,537</u>	<u>41,998</u>	<u>39,114</u>
Income before income taxes	8,139	7,619	23,413	21,015
Income tax expense	991	902	2,709	2,487
Net income	<u>7,148</u>	<u>6,717</u>	<u>20,704</u>	<u>18,528</u>
Other comprehensive income (loss):				
Unrealized gain (loss) on investment securities available-for-sale	161	(1,179)	5,211	(4,394)
Reclassification adjustment for net gain on sales included in net income			(23)	
Change in derivative fair value	153		659	
Other comprehensive gain (loss)	314	(1,179)	5,847	(4,394)
Income tax expense (benefit)	66	(248)	1,228	(925)
Other comprehensive income (loss), net of income taxes	<u>248</u>	<u>(931)</u>	<u>4,619</u>	<u>(3,469)</u>
Comprehensive income	<u>\$ 7,396</u>	<u>\$ 5,786</u>	<u>\$ 25,323</u>	<u>\$ 15,059</u>
Per share data:				
Net income:				
Basic	\$ 0.97	\$ 0.91	\$ 2.80	\$ 2.50
Diluted	\$ 0.97	\$ 0.91	\$ 2.80	\$ 2.50
Average common shares outstanding:				
Basic	7,394,992	7,399,054	7,397,768	7,397,373
Diluted	7,394,992	7,399,054	7,397,768	7,397,373
Dividends declared	\$ 0.34	\$ 0.33	1.02	0.98

See notes to unaudited consolidated financial statements

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

For the Nine Months Ended September 30,	2019	2018
Cash flows from operating activities:		
Net income	\$ 20,704	\$ 18,528
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation of premises and equipment	1,881	1,728
Amortization of right-of-use lease asset	293	
Amortization of deferred loan costs	(159)	729
Amortization of intangibles	557	670
Amortization of low income housing partnerships	357	349
Provision for loan losses	2,100	3,150
Net unrealized gain on equity investment securities	(6)	
Net loss (gain) on sale of other real estate owned	20	(17)
Loans originated for sale	(11,945)	(9,931)
Proceeds from sale of loans originated for sale	11,374	10,013
Net gain on sale of loans originated for sale	(70)	(74)
Net amortization of investment securities	1,279	1,718
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	(567)	(568)
Stock based compensation	397	188
Net change in:		
Accrued interest receivable	460	371
Other assets	(4,633)	516
Accrued interest payable	266	248
Other liabilities	4,998	(2,967)
Net cash provided by operating activities	<u>27,283</u>	<u>24,360</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	45,790	24,087
Held-to-maturity	547	710
Purchases of investment securities:		
Available-for-sale	(50,670)	(32,723)
Net redemption of restricted equity securities	2,992	735
Proceeds from sale of student loan portfolio		5,103
Proceeds from sale of credit card loan portfolio		2,407
Net increase in lending activities	(58,987)	(96,916)
Purchases of premises and equipment	(4,296)	(1,979)
Proceeds from the sale of premises and equipment	21	341
Proceeds from investment in life insurance		304
Proceeds from sale of other real estate owned	111	582
Net cash used in investing activities	<u>(54,815)</u>	<u>(97,349)</u>
Cash flows from financing activities:		
Net increase in deposits	126,263	108,846
Proceeds from long-term debt	16,000	
Repayment of long-term debt	(1,397)	(1,273)
Net decrease in short-term borrowings	(86,500)	(24,225)
Retirement of common stock	(621)	
Cash dividends paid	(7,546)	(7,252)
Net cash provided by financing activities	<u>46,199</u>	<u>76,096</u>
Net increase in cash and cash equivalents	18,667	3,107
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>\$ 51,283</u>	<u>\$ 40,595</u>

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

For the Nine Months Ended September 30,	2019	2018
Supplemental disclosures:		
Cash paid during the period for:		
Interest	\$ 8,842	\$ 9,140
Income taxes	3,300	2,550
Noncash items:		
Transfers of loans to other real estate	\$ 253	\$ 623
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 nine months ended and as of September 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”) 2016-02, “Leases”. From the lessees’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 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 October 2019, the FASB voted to defer the adoption date for smaller reporting companies from 2020 to 2023. The Company currently qualifies as a smaller reporting company and therefore guidance is effective for the Company in 2023. 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" which modifies the disclosure requirements on fair value measurements in Topic 820, Fair Value Measurement, based on the FASB Concepts Statement, "Conceptual Framework for Financial Reporting – Chapter 8: Notes to Financial Statements". In accordance with the Concepts Statement, this ASU removes, modifies and adds select disclosure requirements under Topic 820 after consideration of costs and benefits. ASU 2018-13 is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019 for public entities, with early adoption permitted. The adoption of this guidance on January 1, 2020 is not expected to have a material effect on the Company's consolidated financial statements.

In January 2017, the FASB issued ASU 2017-04, "Simplifying the Test for Goodwill Impairment," - Intangibles - Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment. The amendments in this ASU simplify how an entity is required to test goodwill for impairment by eliminating the requirement to calculate the implied fair value of goodwill to measure a goodwill impairment charge. This accounting guidance will be effective for interim and annual reporting periods beginning after December 15, 2019 (effective January 1, 2020 for the Company). Adoption of this ASU is not expected to have a material impact 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 September 30, 2019 and December 31, 2018 are as follows:

	September 30, 2019	December 31, 2018
Net unrealized gain (loss) on investment securities available-for-sale	\$ 1,937	\$ (3,251)
Income tax	407	(683)
Net of income taxes	1,530	(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	905	246
Income tax	190	52
Net of income taxes	715	194
Accumulated other comprehensive loss	<u>\$ (3,457)</u>	<u>\$ (8,076)</u>

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

3. Earnings per share:

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

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

	2019		2018	
	Basic	Diluted	Basic	Diluted
For the Three Months Ended September 30,				
Net Income	\$ 7,148	\$ 7,148	\$ 6,717	\$ 6,717
Average common shares outstanding	7,394,992	7,394,992	7,399,054	7,399,054
Earnings per share	\$ 0.97	\$ 0.97	\$ 0.91	\$ 0.91
	2019		2018	
	Basic	Diluted	Basic	Diluted
For the Nine Months Ended September 30				
Net income	\$ 20,704	\$ 20,704	\$ 18,528	\$ 18,528
Average common shares outstanding	7,397,768	7,397,768	7,397,373	7,397,373
Earnings per share	\$ 2.80	\$ 2.80	\$ 2.50	\$ 2.50

4. Investment securities:

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

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
September 30, 2019				
Available-for-sale:				
U.S. Treasury securities	\$ 23,963	\$ 120	\$ 17	\$ 24,066
U.S. Government-sponsored enterprises	92,223	107	340	91,990
State and municipals:				
Taxable	21,392	346	238	21,500
Tax-exempt	60,794	920	31	61,683
Residential Mortgage-backed securities:				
U.S. Government agencies	9,536	95	18	9,613
U.S. Government-sponsored enterprises	45,284	820	63	46,041
Commercial Mortgage-backed securities:				
U.S. Government-sponsored enterprises	13,694	236		13,930
Total	<u>\$ 266,886</u>	<u>\$ 2,644</u>	<u>\$ 707</u>	<u>\$ 268,823</u>
Held-to-maturity:				
Tax-exempt state and municipals	\$ 6,853	\$ 182		\$ 7,035
Residential Mortgage-backed securities:				
U.S. Government agencies	33			33
U.S. Government-sponsored enterprises	922	27	\$ 1	948
Total	<u>\$ 7,808</u>	<u>\$ 209</u>	<u>\$ 1</u>	<u>\$ 8,016</u>

Peoples Financial Services Corp.
NOTES TO CONSOLIDATED 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 September 30, 2019 and December 31, 2018, we had \$297 and \$291 respectively, in equity securities recorded at fair value. At September 30, 2019, the fair value of our equity portfolio exceeded the cost basis by \$20. The following is a summary of unrealized and realized gains and losses recognized in net income on equity securities during the three and nine months ended September 30, 2019 (in thousands):

Three Months Ended September 30.	2019	2018
Net gains recognized during the period on equity securities	\$ 14	\$ 14
Less: Net gains recognized during the period on equity securities sold during the period		
Unrealized gains recognized during the reporting period on equity securities still held at the reporting date	\$ 14	\$ 14

For the Nine Months Ended September 30.	2019	2018
Net gains recognized during the period on equity securities	\$ 6	\$ 14
Less: Net gains recognized during the period on equity securities sold during the period		
Unrealized gains recognized during the reporting period on equity securities still held at the reporting date	\$ 6	\$ 14

Restricted Investment In Stock

Restricted investment in stock includes FHLB with a carrying cost of \$4,428 and \$7,420 at September 30, 2019 and December 31, 2018, respectively, Atlantic Community Bankers Bank ("ACBB") stock with a carrying cost of \$42, and VISA Class B stock with a carrying cost of \$0 at September 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

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in borrowing and other banking services. The investment in FHLB stock may fluctuate, as it is based on the member bank's use of FHLB's services. The decrease in FHLB stock from December 31, 2018 is due to lower borrowings.

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 (1.6228 as of September 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 September 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 September 30, 2019, is summarized as follows:

September 30, 2019	Fair Value
Within one year	\$ 33,989
After one but within five years	121,112
After five but within ten years	11,846
After ten years	28,871
	<u>195,818</u>
Mortgage-backed and other amortizing securities	73,005
Total	\$ 268,823

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

September 30, 2019	Amortized Cost	Fair Value
Within one year		
After one but within five years		
After five but within ten years		
After ten years	\$ 6,853	\$ 7,035
	<u>6,853</u>	<u>7,035</u>
Mortgage-backed securities	955	981
Total	\$ 7,808	\$ 8,016

Securities with a carrying value of \$142,963 and \$161,647 at September 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 September 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 September 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
September 30, 2019						
U.S. Treasury securities	\$ 4,524	\$ 2	\$ 5,482	\$ 15	\$ 10,006	\$ 17
U.S. Government-sponsored enterprises	29,242	129	38,468	211	67,710	340
State and municipals:						
Taxable	8,970	238			8,970	238
Tax-exempt	6,139	29	1,101	2	7,240	31
Residential Mortgage-backed securities:						
U.S. Government agencies	423	1	4,346	17	4,769	18
U.S. Government-sponsored enterprises	3,997	12	5,502	52	9,499	64
Total	<u>\$ 53,295</u>	<u>\$ 411</u>	<u>\$ 54,899</u>	<u>\$ 297</u>	<u>\$ 108,194</u>	<u>\$ 708</u>
	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	<u>\$ 25,905</u>	<u>\$ 132</u>	<u>\$ 189,472</u>	<u>\$ 3,924</u>	<u>\$ 215,377</u>	<u>\$ 4,056</u>

The Company had 72 investment securities, consisting of 10 tax-exempt and 9 taxable state and municipal obligations, 4 U.S. Treasury securities, 25 U.S. Government-sponsored enterprise securities, and 24 mortgage-backed securities that were in unrealized loss positions at September 30, 2019. Of these securities, 2 U.S. Treasury securities, 17 U.S. Government-sponsored enterprise securities, 2 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 September 30, 2019. There was no OTTI recognized for the three or nine months ended September 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 September 30, 2019 and December 31, 2018 are summarized as follows. Net deferred loan costs were \$903 and \$744 at September 30, 2019 and December 31, 2018.

	September 30, 2019	December 31, 2018
Commercial	\$ 497,985	\$ 494,134
Real estate:		
Commercial	976,258	907,803
Residential	299,209	299,876
Consumer	107,638	121,453
Total	<u>\$ 1,881,090</u>	<u>\$ 1,823,266</u>

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

September 30, 2019	Commercial	Real estate		Consumer	Total
		Commercial	Residential		
Allowance for loan losses:					
Beginning Balance July 1, 2019	\$ 6,142	\$ 11,042	\$ 3,615	\$ 1,131	\$ 21,930
Charge-offs	(26)	(34)	(104)	(144)	(308)
Recoveries	12		11	47	70
Provisions	(205)	762	34	109	700
Ending balance	<u>\$ 5,923</u>	<u>\$ 11,770</u>	<u>\$ 3,556</u>	<u>\$ 1,143</u>	<u>\$ 22,392</u>

September 30, 2018	Commercial	Real estate		Consumer	Total
		Commercial	Residential		
Allowance for loan losses:					
Beginning Balance July 1, 2018	\$ 5,191	\$ 10,058	\$ 3,156	\$ 1,168	\$ 19,573
Charge-offs	(148)	(63)		(117)	(328)
Recoveries	12	26	13	67	118
Provisions	414	421	153	62	1,050
Ending balance	<u>\$ 5,469</u>	<u>\$ 10,442</u>	<u>\$ 3,322</u>	<u>\$ 1,180</u>	<u>\$ 20,413</u>

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September 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	(113)	(383)	(406)	(356)	(1,258)
Recoveries	22		27	122	171
Provisions	498	1,417	43	142	2,100
Ending balance	<u>\$ 5,923</u>	<u>\$ 11,770</u>	<u>\$ 3,556</u>	<u>\$ 1,143</u>	<u>\$ 22,392</u>

September 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	(150)	(1,232)	(381)	(389)	(2,152)
Recoveries	128	83	80	164	455
Provisions	(22)	2,647	512	13	3,150
Ending balance	<u>\$ 5,469</u>	<u>\$ 10,442</u>	<u>\$ 3,322</u>	<u>\$ 1,180</u>	<u>\$ 20,413</u>

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

September 30, 2019	Commercial	Real estate		Consumer	Total
		Commercial	Residential		
Allowance for loan losses:					
Ending balance	<u>\$ 5,923</u>	<u>\$ 11,770</u>	<u>\$ 3,556</u>	<u>\$ 1,143</u>	<u>\$ 22,392</u>
Ending balance: individually evaluated for impairment	394	225	196		815
Ending balance: collectively evaluated for impairment	<u>\$ 5,529</u>	<u>\$ 11,545</u>	<u>\$ 3,360</u>	<u>\$ 1,143</u>	<u>\$ 21,577</u>
Loans receivable:					
Ending balance	<u>\$ 497,985</u>	<u>\$ 976,258</u>	<u>\$ 299,209</u>	<u>\$ 107,638</u>	<u>\$ 1,881,090</u>
Ending balance: individually evaluated for impairment	4,772	3,603	2,450	262	11,087
Ending balance: collectively evaluated for impairment	<u>\$ 493,213</u>	<u>\$ 972,655</u>	<u>\$ 296,759</u>	<u>\$ 107,376</u>	<u>\$ 1,870,003</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 September 30, 2019 and December 31, 2018:

September 30, 2019	Pass	Special Mention	Substandard	Doubtful	Total
Commercial	\$ 488,395	\$ 1,971	\$ 7,619		\$ 497,985
Real estate:					
Commercial	948,854	2,644	24,760		976,258
Residential	296,565		2,644		299,209
Consumer	107,354		284		107,638
Total	<u>\$ 1,841,168</u>	<u>\$ 4,615</u>	<u>\$ 35,307</u>	<u>\$</u>	<u>\$ 1,881,090</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 September 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 complete and the certificate of occupancy has been issued for the property. The Bank considers both of these credit relationships to be well secured and both relationships were current as of September 30, 2019.

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

	September 30, 2019	December 31, 2018
Commercial	\$ 3,343	\$ 776
Real estate:		
Commercial	3,246	2,663
Residential	1,548	2,580
Consumer	262	212
Total	<u>\$ 8,399</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
September 30, 2019							
Commercial	\$ 9	\$ 25	\$ 3,396	\$ 3,430	\$ 494,555	\$ 497,985	\$ 53
Real estate:							
Commercial	776	159	3,300	4,235	972,023	976,258	54
Residential	656	996	1,827	3,479	295,730	299,209	279
Consumer	435	146	262	843	106,795	107,638	
Total	<u>\$ 1,876</u>	<u>\$ 1,326</u>	<u>\$ 8,785</u>	<u>\$ 11,987</u>	<u>\$ 1,869,103</u>	<u>\$ 1,881,090</u>	<u>\$ 386</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 nine months ended September 30, 2019 and September 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
September 30, 2019							
With no related allowance:							
Commercial	\$ 3,766	\$ 4,272		\$ 4,131	\$ 18	\$ 3,974	\$ 52
Real estate:							
Commercial	2,981	3,219		2,969	8	2,501	31
Residential	1,644	1,974		1,132	6	1,273	17
Consumer	262	275		257		226	
Total	<u>8,653</u>	<u>9,740</u>		<u>8,489</u>	<u>32</u>	<u>7,974</u>	<u>100</u>
With an allowance recorded:							
Commercial	1,006	1,008	394	1,213	9	1,010	21
Real estate:							
Commercial	622	1,103	225	766		1,030	10
Residential	806	813	196	1,234	8	1,651	26
Consumer						20	
Total	<u>2,434</u>	<u>2,924</u>	<u>815</u>	<u>3,213</u>	<u>17</u>	<u>3,711</u>	<u>57</u>
Total impaired loans							
Commercial	4,772	5,280	394	5,344	27	4,984	73
Real estate:							
Commercial	3,603	4,322	225	3,735	8	3,531	41
Residential	2,450	2,787	196	2,366	14	2,924	43
Consumer	262	275		257		246	
Total	<u>\$ 11,087</u>	<u>\$ 12,664</u>	<u>\$ 815</u>	<u>\$ 11,702</u>	<u>\$ 49</u>	<u>\$ 11,685</u>	<u>\$ 157</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

				This Quarter		Year-to-Date	
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
September 30, 2018							
With no related allowance:							
Commercial	\$ 1,356	\$ 1,538		\$ 1,269	\$ 17	\$ 1,257	\$ 50
Real estate:							
Commercial	3,414	3,666		3,143	5	3,036	20
Residential	2,366	3,003		2,256	7	2,249	15
Consumer	142	149		101		131	
Total	7,278	8,356		6,769	29	6,673	85
With an allowance recorded:							
Commercial	939	1,086	\$ 93	1,020	7	1,089	23
Real estate:							
Commercial	1,669	1,774	462	1,712	8	1,807	18
Residential	1,312	1,508	362	1,369	5	1,456	13
Consumer	14	14	14	9		11	
Total	3,934	4,382	931	4,110	20	4,363	54
Total impaired loans							
Commercial	2,295	2,624	93	2,289	24	2,346	73
Real estate:							
Commercial	5,083	5,440	462	4,855	13	4,843	38
Residential	3,678	4,511	362	3,625	12	3,705	28
Consumer	156	163	14	110		142	
Total	\$ 11,212	\$ 12,738	\$ 931	\$ 10,879	\$ 49	\$ 11,036	\$ 139

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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 \$2,262 at September 30, 2019, \$2,779 at December 31, 2018 and \$3,230 at September 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 during the three or nine months ended September 30, 2019. For the three months ended September 30, 2018, there were no loans modified as troubled debt restructurings. There was one commercial real estate loan modified as a troubled debt restructuring during the nine months ended September 30, 2018 in the amount of \$340. During the three months ended September 30, 2019, there were no payment defaults on troubled debt restructurings and one commercial real estate loan paid-off totaling \$332. During the nine months ended September 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 September 30, 2018, there was one payment default on a restructured residential real estate loan with an outstanding balance of \$6. During the nine months ended September 30, 2018, there were two payment defaults on restructured residential real estate loans with a total outstanding balance of \$64.

6. Other assets:

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

	<u>September 30, 2019</u>	<u>December 31, 2018</u>
Other real estate owned	\$ 485	\$ 376
Investment in low income housing partnership	7,020	7,377
Mortgage servicing rights	730	718
Bank owned life insurance	34,853	34,288
Restricted equity securities	4,470	7,462
Net deferred tax asset	3,853	5,081
Interest rate floor	1,170	553
Interest rate swaps	6,065	108
Other assets	6,554	7,774
Total	<u>\$ 65,200</u>	<u>\$ 63,737</u>

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7. Fair value estimates:

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

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

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

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

- Level 1: Unadjusted quoted prices of identical assets or liabilities in active markets that the entity has the ability to access as of the measurement date.
- Level 2: Significant other observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data.
- Level 3: Significant unobservable inputs that reflect a reporting entity's own assumptions about the assumptions that market participants would use in pricing an asset or liability.

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

During the periods ended September 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.

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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.

Assets and liabilities measured at fair value on a recurring basis at September 30, 2019 and December 31, 2018 are summarized as follows:

	Fair Value Measurement Using			
	Amount	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
September 30, 2019				
U.S. Treasury securities	\$ 24,066	\$ 24,066		\$
U.S. Government-sponsored enterprises	91,990		\$ 91,990	
State and Municipals:				
Taxable	21,500		21,500	
Tax-exempt	61,683		61,683	
Mortgage-backed securities:				
U.S. Government agencies	9,613		9,613	
U.S. Government-sponsored enterprises	59,971		59,971	
Common equity securities	297	297		
Interest rate floor-other assets	1,170		1,170	
Interest rate swap-other assets	6,065		6,065	
Interest rate swap-other liabilities	(6,085)		(6,085)	
Total	\$ 270,270	\$ 24,363	\$ 245,907	\$

	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	\$

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Assets and liabilities measured at fair value on a nonrecurring basis at September 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)
September 30, 2019	Amount			
Impaired loans	\$ 1,619			\$ 1,619
Other real estate owned	\$ 357			\$ 357
		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)
September 30, 2019				
Impaired loans	\$ 1,619	Appraisal of collateral	Appraisal adjustments	7.6% to 97.0% (73.4)%
			Liquidation expenses	3.0% to 6.0% (5.3)%
Other real estate owned	\$ 357	Appraisal of collateral	Appraisal adjustments	20.0% to 48.8% (31.2)%
			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.

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The carrying and fair values of the Company's financial instruments at September 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)
September 30, 2019					
Financial assets:					
Cash and cash equivalents	\$ 51,283	\$ 51,283	\$ 51,283		
Investment securities:					
Available-for-sale	268,823	268,823	24,066	\$ 244,757	
Common equity securities	297	297	297		
Held-to-maturity	7,808	8,016		8,016	
Loans held for sale	1,390	1,390		1,390	
Net loans	1,858,698	1,832,080			\$ 1,832,080
Accrued interest receivable	6,655	6,655		6,655	
Mortgage servicing rights	730	1,739		1,739	
Restricted equity securities	4,470	4,470		4,470	
Interest rate floor	1,170	1,170		1,170	
Interest rate swaps	6,065	6,065		6,065	
Total	<u>\$ 2,207,389</u>	<u>\$ 2,181,988</u>			
Financial liabilities:					
Deposits	\$ 2,001,285	\$ 2,001,911		\$ 2,001,911	
Long-term debt	52,509	52,875		52,875	
Accrued interest payable	1,461	1,461		1,461	
Interest rate swaps	6,085	6,085		6,085	
Total	<u>\$ 2,061,340</u>	<u>\$ 2,062,332</u>			

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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 nine months ended September 30, salaries and employee benefits expense includes approximately \$327 and \$1,081, respectively in 2019 and \$330 and \$1,073, respectively in 2018 relating to the employee benefit plans.

	Pension Benefits	
	2019	2018
Three Months Ended September 30,		
Components of net periodic pension cost:		
Interest cost	\$ 128	\$ 233
Expected return on plan assets	(217)	(360)
Amortization of unrecognized net gain	45	73
Net periodic benefit cost	<u>\$ (44)</u>	<u>\$ (54)</u>
Nine Months Ended September 30,		
Components of net periodic pension cost:		
Interest cost	\$ 447	\$ 389
Expected return on plan assets	(759)	(600)
Amortization of unrecognized net gain	159	122
Net periodic benefit cost	<u>\$ (153)</u>	<u>\$ (89)</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 September 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.

For the nine months ended September 30, 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 \$157 and \$397 for the three and nine months ended September 30, 2019 for awards granted under the 2017 Plan. The Company recognized compensation expense of \$52 and \$95 for the three and nine months ended September 30, 2018 for awards granted under the 2017 Plan and \$31 and \$93 for awards granted under the 2008 Plan. As of September 30, 2019, the Company had \$938 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 1.4 years.

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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 September 30, 2019, the Company had 22 interest rate swaps with an aggregate notional amount of \$126,574 related to this program.

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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 September 30, 2019 and December 31, 2018.

	Notional Amount	Asset Derivatives As of September 30, 2019		Asset Derivatives As of December 31, 2018 (1)		Liability Derivatives As of September 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	\$ 1,170		\$ 553				
Total derivatives designated as hedging instruments			\$ 1,170		\$ 553				
Derivatives not designated as hedging instruments									
Interest Rate Swaps	\$ 126,574	Other Assets	\$ 6,065	Other Assets	\$ 108	Other Liabilities	\$ 6,085	Other Liabilities	\$ 138
Total derivatives not designated as hedging instruments			\$ 6,065		\$ 108		\$ 6,085		\$ 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 September 30, 2019. There was no cash flow hedge as of September 30, 2018.

Derivatives in Hedging Relationships	Amount of Loss Recognized in OCI on Derivative	Amount of Gain Recognized in OCI Included Component September 30, 2019	Amount of Gain Recognized in OCI Excluded Component	Location of Gain or (Loss) Recognized from Accumulated Other Comprehensive Income into Income	Amount of Loss Reclassified from Accumulated OCI into Income	Amount of Gain Reclassified from Accumulated OCI into Income Included Component September 30, 2019	Amount of Loss Reclassified from Accumulated OCI into Income Excluded Component
	Loss Recognized in OCI on Derivative	Gain Recognized in OCI Included Component September 30, 2019	Gain Recognized in OCI Excluded Component	Location of Gain or (Loss) Recognized from Accumulated Other Comprehensive Income into Income	Loss Reclassified from Accumulated OCI into Income	Gain Reclassified from Accumulated OCI into Income Included Component September 30, 2019	Loss Reclassified from Accumulated OCI into Income Excluded Component
Derivatives in Cash Flow Hedging Relationships							
Interest Rate Floor (*)	\$ 138	\$ 186	\$ (48)	Interest Income	\$ (16)		\$ (16)
Derivatives in Hedging Relationships	Amount of Loss Recognized in OCI on Derivative	Amount of Gain Recognized in OCI Included Component September 30, 2019	Amount of Gain Recognized in OCI Excluded Component	Location of Gain or (Loss) Recognized from Accumulated Other Comprehensive Income into Income	Amount of Loss Reclassified from Accumulated OCI into Income	Amount of Gain Reclassified from Accumulated OCI into Income Included Component September 30, 2019	Amount of Loss Reclassified from Accumulated OCI into Income Excluded Component
	Loss Recognized in OCI on Derivative	Gain Recognized in OCI Included Component September 30, 2019	Gain Recognized in OCI Excluded Component	Location of Gain or (Loss) Recognized from Accumulated Other Comprehensive Income into Income	Loss Reclassified from Accumulated OCI into Income	Gain Reclassified from Accumulated OCI into Income Included Component September 30, 2019	Loss Reclassified from Accumulated OCI into Income Excluded Component
Derivatives in Cash Flow Hedging Relationships							
Interest Rate Floor (*)	\$ 611	\$ 1,013	\$ (402)	Interest Income	\$ (48)		\$ (48)

* Amounts disclosed are gross and not net of taxes.

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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 nine months ended September 30, 2019 and September 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	\$ (48)	
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	\$ (48)	
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	\$ (48)	

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 nine months ended September 30, 2019 and 2018.

	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 September 30, 2019	Nine Months Ended September 30, 2019	Three Months Ended September 30, 2018	Nine Months Ended September 30, 2018
Derivatives Not Designated as Hedging Instruments					
Interest Rate Swaps	Other non-interest income	\$ 355	\$ 9	\$ 18	\$ 103
Fee Income	Other income / (expense)	\$	\$ 1,136	\$	\$ 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 September 30, 2019 and December 31, 2018. The net amounts of derivative assets or liabilities can be reconciled to

Peoples Financial Services Corp.
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the 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 September 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	\$ 7,235	\$	\$ 7,235	\$		\$ 7,235

Offsetting of Derivative Liabilities
as of September 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	\$ 6,085	\$	\$ 6,085	\$		\$ 6,085

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.

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As of September 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 \$20. 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 \$5,120 against its obligations under these agreements as of September 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 consists of FHLB advances representing overnight borrowings. The table below outlines short-term borrowings at September 30, 2019 and December 31, 2018:

At and for the nine months ended September 30, 2019					
	Ending Balance	Average Balance	Maximum Month-End Balance	Weighted Average Rate for the nine months ended September 30, 2019	Weighted Average Rate at September 30, 2019
FHLB advances	\$ 74,036	\$ 133,725		2.69 %	%

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 September 30, 2019, the maximum borrowing capacity was \$719,470 of which \$52,509 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. However, growth in deposit balances during the third quarter of 2019 has allowed us to pay down the short-term borrowings to zero at September 30, 2019. 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 September 30, 2019 and December 31, 2018 are as follows:

Due	Interest Rate		September 30, 2019	December 31, 2018
	Fixed	Adjustable		
December 2019		3.71 %	\$ 3,000	3,000
December 2019		3.37	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		7,209	8,606
			\$ 52,509	\$ 37,906

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

2019	\$ 19,777
2020	17,963
2021	12,058
2022	2,156
2023	555
	<u>\$ 52,509</u>

None of the advances from the FHLB are convertible. At September 30, 2019, long-term debt consist of \$43,209 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 12.2% and 11.6% for the three and nine months ended September 30, 2019 compared to 11.8% for the three and nine months ended September 30, 2018. The three and nine months ended September 30, 2019 include before tax investment tax credits and other credits of \$394 and \$1,172 compared to before tax investment tax credits \$276 and \$819 for those same periods last year.

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MANAGEMENT'S DISCUSSION AND ANALYSIS
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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 October 2019, the Federal Open Market Committee ("FOMC") voted to decrease the target range for federal funds to 1.50% to 1.75%, marking the third cut in the overnight rate in the most recent monetary easing cycle, which began in July 2019 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 2.4% for the 12 months ended September 30, 2019. This is up from 2.1% for the 12 months ended June 30, 2019 and from 2.0% for the 12 months ended March 31, 2019. Gross domestic product ("GDP"), the value of all goods and services produced in the nation, came in with an initial third quarter 2019 reading of a 1.9% annualized rate, above all forecasts for the quarter which came in at a

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consensus rate of 1.6% but below the second quarter of 2019 which registered 2.0%. Strong consumer spending has continued in the third quarter of 2019 coming in at 2.9% although this is down from the second quarter of 2019 which came in at 4.6%. The weak global economy as well as trade concerns continue to weigh on overall economic growth.

Review of Financial Position:

Total assets increased \$83,706, or 4.9% annualized, to \$2,372,699 at September 30, 2019, from \$2,288,993 at December 31, 2018. Loans, net increased to \$1,881,090 at September 30, 2019, compared to \$1,823,266 at December 31, 2018, an increase of \$57,824 or 4.2% annualized. The increase in loans, net during 2019 has been funded primarily by borrowings during the first half of the year and more recently by deposit inflows. Deposits increased by \$126,263 or 9.0% annualized with the majority of growth occurring in the third quarter of 2019 due in part to seasonal inflows of public deposits. Interest-bearing deposits increased \$95,941 while noninterest-bearing deposits increased \$30,322. Total stockholders' equity increased \$17,553 or 6.3%, from \$278,614 at year-end 2018 to \$296,167 at September 30, 2019. For the nine months ended September 30, 2019, total assets averaged \$2,324,996, an increase of \$106,363 from \$2,218,633 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 \$268,823 at September 30, 2019, a slight decrease of \$859, or 0.3% from \$269,682 at December 31, 2018. The decrease was 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 and scheduled maturities and calls of agency and municipal bonds. An increase in the market value of the available-for-sale portfolio due to a decline in market rates and new purchases from investment cashflow and deposit inflows partially offset the decrease. Investment securities held-to-maturity totaled \$7,808 at September 30, 2019, a decrease of \$553 or 6.6% from \$8,361 at December 31, 2018 due to payments received on mortgage backed securities.

For the nine months ended September 30, 2019, the investment portfolio averaged \$273,083, a decrease of \$9,258 or 3.3% compared to \$282,341 for the same period last year. Average tax-exempt municipal bonds have decreased \$21,119 or 20.6% to \$81,227 for the nine months ended September 30, 2019 from \$102,346 during the comparable period of 2018. The tax-equivalent yield on the investment portfolio decreased 11 basis points to 2.49% for the nine months ended September 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 loss component of stockholders' equity. We reported net unrealized gains, included as a separate component of stockholders' equity of \$1,530, net of deferred income taxes of \$407, at September 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 third quarter of 2019 accelerated when compared to the second quarter increasing \$22,291. Loans, net increased to \$1,881,090 at September 30, 2019 from \$1,823,266 at December 31, 2018, an increase of \$57,824 or 4.2% 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 \$68,455 or 10.1% annualized, to \$976,258 at September 30, 2019 compared to \$907,803 at December 31, 2018 due to increased activity in both our core and expansion markets. Commercial and industrial loans increased \$3,851 or 1.0% annualized, to \$497,985 at September 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, offset by a number of large loan payoffs in the current period. Our growth in commercial and commercial real estate loans is due in part to the

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success in executing our strategic market expansion initiative in the Lehigh Valley, Greater Delaware Valley and most recently in the Central Pennsylvania region.

Consumer loans decreased \$13,815, or 15.2% on an annualized basis, to \$107,638 at September 30, 2019 compared to \$121,453 at December 31, 2018. The decrease in consumer loans was primarily due to payoffs outpacing dealer indirect 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 \$667, or 0.3% on an annualized basis, to \$299,209 at September 30, 2019 compared to \$299,876 at December 31, 2018. The home equity line of credit portfolio has remained flat during 2019 while the residential real estate loans decreased in part to the sale of \$1,038 of non-performing mortgage loans during the first quarter.

For the nine months ended September 30, 2019, loans, net averaged \$1,853,811, an increase of \$110,803 or 6.4% compared to \$1,743,008 for the same period of 2018. The tax-equivalent yield on the loan portfolio was 4.75% for the nine months ended September 30, 2019, a 31 basis point increase from the comparable period last year. The increase in yield is due to higher market rates and floating and adjustable rate loans repricing higher due to the FOMC's actions to increase the Federal Funds rate 100 basis points during 2018. During the third quarter of 2019, the FOMC has lowered the Federal Funds rate 50 basis points which resulted in a 4 basis point decrease when comparing the third quarter to the second quarter of 2019.

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

Unused commitments at September 30, 2019, totaled \$411,142, consisting of \$368,045 in unfunded commitments of existing loan facilities and \$43,097 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.

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Asset Quality:

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

	2019	2018
United States	3.7 %	3.9 %
New York (statewide)	4.0	4.3
Pennsylvania (statewide)	4.0	4.5
Broome County	4.6	5.2
Bucks County	3.6	3.9
Lackawanna County	4.6	4.8
Lebanon County	3.6	3.9
Lehigh County	4.2	4.8
Luzerne County	5.3	5.6
Monroe County	4.9	5.5
Montgomery County	3.3	3.6
Northampton County	4.2	4.6
Schuylkill County	5.0	5.4
Susquehanna County	4.0	4.2
Wayne County	4.4	4.9
Wyoming County	4.5 %	4.6 %

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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>September 30, 2019</u>	<u>December 31, 2018</u>
Nonaccrual loans:		
Commercial	\$ 3,343	\$ 776
Real estate:		
Commercial	3,246	2,328
Residential	1,543	2,574
Consumer	262	212
Total nonaccrual loans	<u>8,394</u>	<u>5,890</u>
Troubled debt restructured loans:		
Commercial	1,355	1,438
Real estate:		
Commercial	303	719
Residential	604	622
Total troubled debt restructured loans	<u>2,262</u>	<u>2,779</u>
Accruing loans past due 90 days or more:		
Commercial	53	
Real estate:		
Commercial	54	73
Residential	279	850
Total accruing loans past due 90 days or more	<u>386</u>	<u>923</u>
Total nonperforming loans	<u>11,042</u>	<u>9,592</u>
Foreclosed assets	485	376
Total nonperforming assets	<u>\$ 11,527</u>	<u>\$ 9,968</u>
Nonperforming loans as a percentage of loans, net	0.59 %	0.53 %
Nonperforming assets as a percentage of loans, net and foreclosed assets	0.61 %	0.55 %

We experienced a decline in our asset quality during the first nine months of 2019 as evidenced by an increase of \$1,559 in nonperforming assets. Nonperforming assets totaled \$11,527 or 0.61% of loans, net and foreclosed assets at September 30, 2019, from \$9,968 or 0.55% of loans, net and foreclosed assets at December 31, 2018. An increase in nonaccrual loans and foreclosed assets was partially offset by a decrease in restructured loans and accruing loans past due ninety days or more.

Loans on nonaccrual status increased \$2,504 to \$8,394 at September 30, 2019 from \$5,890 at December 31, 2018. The majority of the increase from year end was due to an increase of \$2,567 in commercial and industrial loans resulting from the placement of one credit relationship on nonaccrual totaling \$4,718 during the first quarter. At September 30, 2019, the value of the collateral is sufficient to support the debt of this credit. Commercial real estate loans on nonaccrual increased \$918 from yearend 2018 due to one credit relationship added in the third quarter; an agreement of sale for the property has been received. A decrease in nonaccrual residential real estate loans due to a sale of a pool of non-performing loans during the first quarter partially offset the increase in commercial real estate loans. Restructured loans decreased \$517 to \$2,262 at September 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 and the payment-in-full of one other commercial real estate loan totaling \$332 during the third quarter of 2019. Foreclosed assets increased \$109 to \$485 at September 30, 2019 from \$376 at December 31, 2018. Other real estate owned comprised seven properties at both September 30, 2019 and December 31, 2018, respectively.

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

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

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

The allowance for loan losses increased \$1,013 to \$22,392, or 1.19% of loans, net at September 30, 2019, from \$21,379, or 1.17% of loans, net at the end of 2018. For the nine months ended September 30, 2019, net charge-offs were \$1,087 or 0.08% of average loans outstanding, a \$610 decrease compared to \$1,697 or 0.13% 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 nine months ended September 30, 2019, total deposits increased \$126,263 or 9.0% annualized, to \$2,001,285 from \$1,875,022 at December 31, 2018. The growth in deposits occurred primarily in the third quarter of 2019 due to seasonal inflows of municipal deposits and growth in commercial balances. Interest-bearing deposits increased \$30,322 and noninterest-bearing deposits increased \$95,941. Interest-bearing transaction accounts, including NOW and money market accounts increased \$31,619, or 4.2% annualized, to \$781,982 at September 30, 2019, from \$750,363 at December 31, 2018, savings accounts decreased \$5,405, or 1.9% annualized to \$372,752 as of September 30, 2019 from \$378,157 at December 31, 2018 and time deposits less than \$250 increased \$14,968, or 8.0% annualized, to \$265,424 at September 30, 2019, from \$250,456 at December 31, 2018. Time deposits \$250 or more increased \$54,760, or 85.3% annualized to \$140,546 at September 30, 2019 from \$85,786 at year end 2018 due in part to growth in short-term municipal accounts.

For the nine months ended September 30, interest-bearing deposits averaged \$1,472,466 in 2019 compared to \$1,338,689 in 2018, an increase of \$133,777, or 10.0%. The cost of interest-bearing deposits was 1.01% in 2019 compared to 0.61% for the same period last year. For the first nine months, the overall cost of interest-bearing liabilities including the cost of borrowed funds, was 1.14% in 2019 and 0.81% 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.

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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 September 30, 2019, totaled \$52,509 compared to \$124,406 at December 31, 2018, a decrease of \$71,897. Deposit growth primarily during the third quarter of 2019 resulted in the paydown of overnight short-term borrowings. There were no short-term borrowings outstanding at September 30, 2019 compared to \$86,500 at December 31, 2018. Long-term debt was \$52,509 at September 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 and decreases 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 1.32% at September 30, 2019. Given the latest action by the FOMC to lower the targeted federal funds rate 50 basis points during the third quarter of 2019, 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

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loans. With respect to RSL, we are offering short term certificates of deposit in an attempt to decrease duration. The current position at September 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.

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

As the static gap report fails to address the dynamic changes in the balance sheet composition or prevailing interest rates, we utilize a simulation model to enhance our asset/liability management. This model is used to create pro forma net interest income scenarios under various interest rate shocks. Model results at September 30, 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 September 30, 2019. Our noncore funds at September 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

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because they are very interest rate sensitive and are considered to be highly volatile. At September 30, 2019, our net noncore funding dependence ratio, the difference between noncore funds and short-term investments to long-term assets, was 13.8%, while our net short-term noncore funding dependence ratio, noncore funds maturing within one-year, less short-term investments to long-term assets equaled 9.0%. 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 decreased in the near term but increased overall.

The Consolidated Statements of Cash Flows present the changes in cash and cash equivalents from operating, investing and financing activities. Cash and cash equivalents, consisting of cash on hand, cash items in the process of collection, deposit balances with other banks and federal funds sold, increased \$18,667 during the nine months ended September 30, 2019. Cash and cash equivalents increased \$3,107 for the same period last year. For the nine months ended September 30, 2019, net cash inflows of \$27,283 from operating activities and \$46,199 from financing activities were partially offset by net cash outflows of \$54,815 from investing activities. For the same period of 2018, net cash inflows of \$24,360 from operating activities and \$76,096 from financing activities were partially offset by net cash outflows of \$97,349 from investing activities.

Operating activities provided net cash of \$27,283 for the nine months ended September 30, 2019, and \$24,360 for the corresponding nine 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 \$54,815 for the nine months ended September 30, 2019, compared to using net cash of \$97,349 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 \$46,199 for the nine months ended September 30, 2019, and provided net cash of \$76,096 for the corresponding nine 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 provide additional funding. Deposits provided cash of \$126,263 for the nine months ended September 30, 2019. Comparatively, deposits increased \$108,846 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 \$86,500 in the nine months ended September 30, 2019 compared to an decrease of \$24,225 for the comparable period in 2018 as deposit growth outpaced the growth in loans. Long term borrowings increased \$14,603, net of repayments for the nine months ended September 30, 2019, compared to a decrease of \$1,273 for the same nine 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 \$296,167 or \$40.08 per share at September 30, 2019, compared to \$278,614 or \$37.66 per share at December 31, 2018. Net income of \$20,704 for the nine months ended September 30, 2019 was the primary factor leading to the improved capital position. Stockholders' equity was also affected by cash dividends declared of \$7,546, stock based compensation of \$397, and other comprehensive income of \$4,619 resulting from market value fluctuations in the investment portfolio and changes to the fair value of derivatives.

Dividends declared equaled \$1.02 per share through the nine months ended September 30, 2019 and \$0.98 per share for the same period of 2018. The dividend payout ratio was 36.4% for the nine months ended September 30, 2019 and 39.2% 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.

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In July 2013, the federal banking agencies issued final rules to implement the Basel III regulatory capital reforms and changes required by the Dodd-Frank Act. The phase-in period for community banking organizations began January 1, 2015, while larger institutions (generally those with assets of \$250 billion or more) began compliance on January 1, 2014. The final rules call for the following capital requirements: (i) a minimum ratio of common equity tier 1 capital to risk-weighted assets of 4.5%; (ii) a minimum ratio of tier 1 capital to risk-weighted assets of 6%; (iii) a minimum ratio of total capital to risk-weighted assets of 8%; and (iv) a minimum leverage ratio of 4%. In addition, the final rules establish a common equity tier 1 capital conservation buffer of 2.5% of risk-weighted assets applicable to all banking organizations. If a banking organization fails to hold capital above the minimum capital ratios and the capital conservation buffer, it will be subject to certain restrictions on capital distributions and discretionary bonus payments. The 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 September 30, 2019, the Bank's Tier 1 capital to total average assets was 10.05% 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 September 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 September 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 September 30, 2019.

Review of Financial Performance:

Net income for the three months ended September 30, 2019 equaled \$7,148 or \$0.97 per share compared to \$6,717 or \$0.91 per share for the comparable period of 2018. The increase in earnings for the current period is the product of higher net interest income of \$1,283 due to growth in our average earning assets of \$116.1 million since the year ago period, a lower provision for loan losses of \$350 and an increase in non-interest income of \$429 due primarily to revenue from commercial loan interest rate swap transactions. These increases were partially offset by higher non-interest expenses of \$1,542 related to annual merit increases and costs in support of our market expansion initiative. Return on average assets ("ROA") measures our net income in relation to total assets. Our ROA was 1.21% for the third quarter of 2019 compared to 1.19% 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 9.65% for the third quarter of 2019 compared to 9.81% for the comparable period in 2018.

Net income through the first nine months of 2019 equaled \$20,704 or \$2.80 per share compared to \$18,528 or \$2.50 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 \$3,470 due to growth of our earning assets coupled with a reduction to the provision for loan losses expense of \$1,050, partially offset by an increase in non-interest expenses of \$2,884. Our ROA and ROE were 1.19% and 9.63% through nine months in 2019 compared to 1.12% and 9.21% 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.

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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.

For the three months ended September 30, tax-equivalent net interest income increased \$1,259 to \$19,627 in 2019 from \$18,368 in 2018. The net interest spread decreased to 3.32% for the three months ended September 30, 2019 from 3.36% for the three months ended September 30, 2018 as the average rate paid on interest bearing liabilities increased 21 basis points while the earning asset yield increased 17 basis points. The tax-equivalent net interest margin increased to 3.61% for the third quarter of 2019 from 3.57% for the comparable period of 2018.

For the three months ended September 30, tax-equivalent interest income on earning assets increased \$2,189, to \$24,023 in 2019 as compared to \$21,834 in 2018. The overall yield on earning assets, on a fully tax-equivalent basis, increased 17 basis points for the three months ended September 30, 2019 to 4.42% as compared to 4.25% for the three months ended September 30, 2018. The increase in the yield on earning assets resulted from a 23 basis point increase in loan yields, 4.74% for the third quarter of 2019 compared to 4.51% for the same period last year. Loan yields increased due to higher rates on new loan originations during 2018, 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. However, the FOMC during the third quarter of 2019 has cut the federal funds rate 50 basis points which will put downward pressure on loan yields. The overall yield earned on investments decreased 23 basis points in the third quarter of 2019 to 2.39% from 2.62% for the third 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 \$12,940 lower when comparing the current and year ago quarter.

Total interest expense increased \$930 to \$4,396 for the three months ended September 30, 2019 from \$3,466 for the three months ended September 30, 2018. An increase in the average balance of interest bearing liabilities of \$41,800 combined with a 21 basis point increase in the cost of funds comparing the three months ended September 30, 2019 and 2018 caused the increase. Average short-term borrowings decreased \$131,599 to \$12,563 for the quarter ended September 30, 2019 compared to \$144,162 for the corresponding year ago period as growth in deposits resulted in a reduction to short-term borrowings. Average time deposits \$100 or more increased \$109,493 and money market accounts increased \$69,115. The increase in interest expense for the three months ended September 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. The benefit of lower interest bearing liability costs will lag the aforementioned action of the FOMC to cut rates during the third quarter of 2019.

For the nine months ended September 30, tax-equivalent net interest income increased \$3,498 to \$57,528 in 2019 from \$54,030 in 2018. The net interest spread decreased to 3.31% for the nine months ended September 30, 2019 from 3.38% for the nine months ended September 30, 2018. The tax-equivalent net interest margin for the nine months ended September 30 was 3.60% in 2019 compared to 3.57% in 2018.

For the nine months ended September 30, 2019, tax-equivalent interest income increased \$7,614, to \$71,032 compared to \$63,418 for the nine months ended September 30, 2018. A volume variance in interest income of \$3,562 attributable primarily to an increase in the average balance of loans coupled with a \$4,052 favorable rate variance due to an increase in the yield on loans for the nine months ended September 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 nine months ended September 30, 2019 to 4.45% as compared to 4.19% for the nine months ended September 30, 2018.

Total interest expense increased \$4,116 to \$13,504 for the nine months ended September 30, 2019 from \$9,388 for the nine months ended September 30, 2018. The average balance of interest bearing liabilities increased to \$1,590,671 for the nine months ended September 30, 2019, as compared to \$1,541,346 for the nine months ended September 30, 2018.

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An unfavorable rate variance in each of the categories of interest-bearing liabilities totaled \$4,602 and was the primary reason for the increase in interest expense. Unfavorable rate variances were greatest as it related to money market accounts, time deposits of \$100 or more, and short-term borrowings. Offsetting the rate variance was a favorable volume variance of \$486 due to lower average short-term borrowings, partially offset by higher time deposits of \$100 or more. All other deposit categories experienced a mix of volume variances that only slightly offset the decrease. The cost of funds increased to 1.14% for the nine months ended September 30, 2019 as compared to 0.81% 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 during 2018 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					
	September 30, 2019			September 30, 2018		
	Average Balance	Interest Income/Expense	Yield/Rate	Average Balance	Interest Income/Expense	Yield/Rate
Assets:						
Earning assets:						
Loans:						
Taxable	\$ 1,729,741	\$ 20,940	4.80 %	\$ 1,632,012	\$ 18,798	4.57 %
Tax-exempt	135,580	1,348	3.94	123,199	1,162	3.74
Total loans	1,865,321	22,288	4.74	1,755,211	19,960	4.51
Investments:						
Taxable	200,444	1,111	2.20	184,623	1,062	2.28
Tax-exempt	70,381	520	2.93	99,142	811	3.25
Total investments	270,825	1,631	2.39	283,765	1,873	2.62
Interest-bearing deposits	5,006	27	2.14	377	1	1.05
Federal funds sold	14,267	77	2.14			
Total earning assets	2,155,419	24,023	4.42 %	2,039,353	21,834	4.25 %
Less: allowance for loan losses	22,248			19,944		
Other assets	215,289			218,173		
Total assets	<u>\$ 2,348,460</u>	<u>\$ 24,023</u>		<u>\$ 2,237,582</u>	<u>\$ 21,834</u>	
Liabilities and Stockholders' Equity:						
Interest-bearing liabilities:						
Money market accounts	\$ 362,178	\$ 1,269	1.39 %	\$ 293,063	\$ 650	0.88 %
NOW accounts	385,903	721	0.74	382,401	580	0.60
Savings accounts	379,784	128	0.13	389,775	122	0.12
Time deposits less than \$100	138,470	514	1.47	141,251	426	1.20
Time deposits \$100 or more	254,712	1,334	2.08	145,219	564	1.54
Short-term borrowings	12,563	83	2.62	144,162	809	2.23
Long-term debt	52,731	347	2.61	48,670	315	2.57
Total interest-bearing liabilities	1,586,341	4,396	1.10	1,544,541	3,466	0.89
Noninterest-bearing deposits	445,238			405,671		
Other liabilities	22,900			15,609		
Stockholders' equity	293,981			271,761		
Total liabilities and stockholders' equity	<u>\$ 2,348,460</u>	<u>4,396</u>		<u>\$ 2,237,582</u>	<u>3,466</u>	
Net interest income/spread		<u>\$ 19,627</u>	3.32 %		<u>\$ 18,368</u>	3.36 %
Net interest margin			3.61 %			3.57 %
Tax-equivalent adjustments:						
Loans		\$ 282			\$ 243	
Investments		109			172	
Total adjustments		<u>\$ 391</u>			<u>\$ 415</u>	

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	Nine months ended					
	September 30, 2019			September 30, 2018		
	Average Balance	Interest Income/Expense	Yield/Rate	Average Balance	Interest Income/Expense	Yield/Rate
Assets:						
Earning assets:						
Loans:						
Taxable	\$ 1,713,173	\$ 61,684	4.81 %	\$ 1,619,409	\$ 54,546	4.50 %
Tax-exempt	140,638	4,144	3.94	123,599	3,367	3.64
Total loans	1,853,811	65,828	4.75	1,743,008	57,913	4.44
Investments:						
Taxable	191,856	3,187	2.22	179,995	2,967	2.20
Tax-exempt	81,227	1,890	3.11	102,346	2,533	3.31
Total investments	273,083	5,077	2.49	282,341	5,500	2.60
Interest-bearing deposits	2,877	50	2.32	441	5	1.52
Federal funds sold	4,808	77	2.14			
Total earning assets	2,134,579	71,032	4.45 %	2,025,790	63,418	4.19 %
Less: allowance for loan losses	22,087			19,755		
Other assets	212,504			212,598		
Total assets	<u>\$2,324,996</u>	<u>\$ 71,032</u>		<u>\$2,218,633</u>	<u>\$ 63,418</u>	
Liabilities and Stockholders' Equity:						
Interest-bearing liabilities:						
Money market accounts	\$ 339,771	\$ 3,358	1.32 %	\$ 290,126	\$ 1,676	0.77 %
NOW accounts	386,720	2,130	0.74	375,534	1,524	0.54
Savings accounts	382,805	371	0.13	391,613	366	0.12
Time deposits less than \$100	137,376	1,477	1.44	145,517	1,275	1.17
Time deposits \$100 or more	225,794	3,754	2.22	135,899	1,294	1.27
Short-term borrowings	74,036	1,491	2.69	153,669	2,317	2.02
Long-term debt	44,169	923	2.79	48,988	936	2.55
Total interest-bearing liabilities	1,590,671	13,504	1.14	1,541,346	9,388	0.81
Noninterest-bearing deposits	426,395			392,523		
Other liabilities	20,575			15,678		
Stockholders' equity	287,355			269,086		
Total liabilities and stockholders' equity	<u>\$2,324,996</u>	<u>13,504</u>		<u>\$2,218,633</u>	<u>9,388</u>	
Net interest income/spread		<u>\$ 57,528</u>	<u>3.31 %</u>		<u>\$ 54,030</u>	<u>3.38 %</u>
Net interest margin			<u>3.60 %</u>			<u>3.57 %</u>
Tax-equivalent adjustments:						
Loans		\$ 870			\$ 707	
Investments		397			532	
Total adjustments		<u>\$ 1,267</u>			<u>\$ 1,239</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 September 30, 2019.

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The provision for loan losses totaled \$2,100 for the nine months ended September 30, 2019 and \$3,150 for the nine months ended September 30, 2018. For the three months ended September 30, the provision for loan losses was \$700 in 2019 and \$1,050 in 2018. The decrease in the current period is due to lower than projected loan growth.

Noninterest Income:

Noninterest income for the three months ended September 30, 2019 increased \$429 or 13.2% to \$3,682 in 2019 from \$3,253 in 2018. The increase is due primarily to an increase in service charges, fees, and commissions of \$278 or 14.8% due to an increase in fee income on our commercial loan interest rate swap transactions. Merchant revenue increased \$54 from the previous period due to higher volume and an increase in rates paid by merchants. Wealth management revenue increased \$90 in the current period when compared to the prior year due to increased volume in both our brokerage and retirement plan services departments.

For the nine months ended September 30, 2019, noninterest income totaled \$11,250, an increase of \$762 or 7.3% from \$10,488 for the comparable period of 2018. Fee income generated by commercial loan interest rate swap transactions increased \$989 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 \$150 to \$837 for the nine months ended September 30, 2019 from \$687 for the same period last year due in part to higher incentive fees and increased rates. Income generated from our wealth management division increased \$94 through the first nine months of 2019 due primarily to increased activity within our retirement plan services department, while mortgage banking income decreased slightly to \$457 for the first nine months of 2019 compared to \$472 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 third quarter, noninterest expense increased \$1,542 or 12.3% to \$14,079 in 2019 from \$12,537 in 2018. For the nine months ended September 30, noninterest expense increased \$2,884 or 7.4% to \$41,998 in 2019 from \$39,114 in 2018. Personnel costs increased 16.0%, net occupancy and equipment costs increased 11.8%, and all other expense categories which include, professional fees and outside services, FDIC insurance and assessments, donations and other miscellaneous expenses increased 5.7% comparing the three months ended September 30, 2019 and 2018. During the nine months ended September 30, 2019, higher personnel costs of \$2,397 or 11.3%, and net occupancy and equipment costs of \$592 or 7.2% were the primary reasons for the increase in total non-interest expense.

Salaries and employee benefits expense, which comprise the majority of noninterest expense, totaled \$8,056 for the third quarter of 2019, an increase of \$1,110 or 16.0% when compared to the third quarter of 2018. Salaries and employee benefits expense totaled \$23,688 for the nine months ending September 30, 2019, an increase of \$2,397 or 11.3% when compared to \$21,291 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 lenders and credit professionals have been put in place to support our expansion in the Lehigh Valley and King of

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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 \$316 or 11.8% increase in net occupancy and equipment expense comparing the third quarter of 2019 at \$2,997 and 2018 at \$2,681. The nine months ended September 30, 2019 resulted in a \$592 or 7.2% increase to \$8,807 in net occupancy and equipment expense compared to \$8,215 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 third quarter, all other expense categories increased \$116 or 4.0% to \$3,026 from \$2,910 comparing 2019 to 2018. Legal and professional expenses increased \$56 due to costs related to loan workouts. For the nine months ended September 30, all other expense categories decreased \$105 or 2.6% to \$9,503 in 2019 compared to \$9,608 in 2018. Amortization expense related to intangible assets declined \$113, FDIC assessments decreased \$215, or 25.9% when comparing the nine months ended September 30, 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 \$66, or 6.5% through nine months in 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 \$991 or 12.2% of pre-tax income, and \$2,709 or 11.6% of pre-tax income for the three and nine months ended September 30, 2019, respectively. In the year ago period, we recorded income tax expense of \$902 or 11.8% of pre-tax income, and \$2,487 or 11.8% of pre-tax income for those same periods. The three and nine months ended September 30, 2019 include before tax investment tax credits and other credits totaling \$394 and \$1,172 compared to before tax investment tax credits \$276 and \$819 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 September 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

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rate scenario, 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 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 September 30, 2019, based on our simulation model, as compared to our ALCO policy limits are summarized as follows:

Changes in Interest Rates (basis points)	September 30, 2019 % Change in			
	Net Interest Income		Economic Value of Equity	
	Metric	Policy	Metric	Policy
+400	0.0	(20.0)	7.4	(40.0)
+300	0.2	(20.0)	6.6	(30.0)
+200	0.2	(10.0)	5.2	(20.0)
+100	0.1	(10.0)	4.0	(10.0)
Static				
(100)	(1.8)	(10.0)	(9.6)	(10.0)

Our simulation model creates pro forma net interest income scenarios under various interest rate shocks. Given instantaneous and parallel shifts in general market rates of plus 100 basis points, our projected net interest income for the 12 months ending September 30, 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 September 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 September 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 nine-months ended September 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 September 30, 2019.

Month Ending	Total Number of Shares Purchased	Average Price Paid Per Share	Total Number of Shares Purchased as Part of Publicly Announced Programs	Maximum Number of Shares that may yet be Purchased Under the Programs
July 31, 2019		\$		221,170
August 31, 2019	7,418	\$ 43.97		213,752
September 30, 2019	2,900	\$ 44.60		210,852

Item 3. Defaults upon Senior Securities.

None.

Peoples Financial Services Corp.

Item 4. Mine Safety Disclosures.

Not applicable.

Item 5. Other Information.

None.

Item 6. Exhibits.

Item Number	Description	Page
10.1	Consulting and Confidentiality Agreement dated August 29, 2019 between Peoples Security Bank and Trust Company and Michael L. Jake.	
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 September 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.	

SIGNATURES

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

	Peoples Financial Services Corp. (Registrant)
Date: November 7, 2019	<u>/s/ Craig W. Best</u> Craig W. Best President and Chief Executive Officer (Principal Executive Officer)
Date: November 7, 2019	<u>/s/ John R. Anderson, III</u> John R. Anderson, III Executive Vice President and Chief Financial Officer (Principal Financial Officer and Principal Accounting Officer)

CONSULTING AND CONFIDENTIALITY AGREEMENT

THIS CONSULTING AND CONFIDENTIALITY AGREEMENT ("Agreement") is made as of the latest date written below, by and between Peoples Security Bank and Trust Company, a Pennsylvania bank and trust company (the "Bank") and the undersigned consultant (the "Consultant") and, together with the Bank, the "Parties").

BACKGROUND

- A. The Parties desire the Consultant to provide certain services to the Bank. In order to perform the services, the Consultant may have access to certain confidential information of the Bank and its affiliates.
- B. The Consultant has been advised of and acknowledges the competitive value and proprietary nature of the confidential information of the Bank and its affiliates, and the damage that could result to the Bank and its affiliates if their confidential information is improperly used or disclosed.
- C. The Bank is only willing to engage the Consultant to provide services to the Bank in the event that the Consultant agrees to the terms and conditions set forth in this Agreement.

AGREEMENT

NOW THEREFORE, in consideration the mutual premises and undertakings contained herein, and other good and valuable consideration, the receipt and sufficiency of which is hereby acknowledged, the Parties, intending to be legally bound hereby, agree as follows:

1. Services. During the term of this Agreement, the Consultant shall perform the services described on Exhibit A hereto (the "Services"). The Consultant shall determine the manner, method, details and means of performing the Services, and the Parties acknowledge and agree that the Consultant may perform services for any other person or entity as long as the performance of such services does not conflict with Consultant's obligations under this Agreement or are in competition with the business of the Bank and its affiliates.
 2. Term. The term of this Agreement shall commence on September 1, 2019 and, unless sooner terminated as provided herein, shall expire on August 31, 2020. Either Party may terminate this Agreement at any time, and for any reason or no reason, by ten days' written notice to the other Party. The Consultant's obligations of confidentiality, limited use and nondisclosure shall survive the termination or expiration of this Agreement indefinitely. The consultant agrees that for a period ending two years from the date of termination or expiration of this agreement the consultant will not knowingly or actively solicit, target, sell offer or provide banking services to the Bank customers.
 3. Compensation. In full consideration for the Services to be provided hereunder, the Bank shall pay consultant \$3,000.00 per month.
 4. Independent Contractor Relationship. The Consultant shall at all times be an independent contractor and not an employee of the Bank and nothing herein shall be deemed to create an employer-employee relationship. As an independent contractor, the Consultant shall not be eligible to participate in any employee benefits the Bank may provide, such as those it provides to its employees, if any, including, but not limited to: medical, disability, workers' compensation or other insurance; vacation, personal, sick or holiday pay; or other benefits. The Consultant shall obtain his own insurance and provide proof of insurance to the Bank upon request. The Bank shall not withhold taxes or otherwise make deductions from the Consultant's compensation and the Consultant shall be issued an IRS Form 1099 in connection
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with his compensation to the extent required by law. The Consultant shall be solely responsible for any taxes incurred as a result of the compensation paid under this Agreement.

5. Definition of Confidential Information. As used in this Agreement, the term “Confidential Information” means all oral and written information, including without limitation the Bank Data (as such term is defined below), that is not generally known to the public, including, without limitation, any and all information and trade secrets relating to the operation, business, strategies, financial affairs, products, systems (computer and otherwise), technologies, sales, research and development, user data, services, vendor information, customer information (including nonpublic personal information), employee information or intellectual properties of the Bank or its affiliates or any other party with whom the Bank or its affiliates is doing business, and any and all other information concerning the Bank and its affiliates, including without limitation all information encompassed in descriptions, reports, recommendations, analyses, proposals, test data, other data, business plans or other plans, treatments, scripts, budgets, programs, outlines, specifications, ideas, concepts, models, and documents, whether or not protectable by patent, copyright or other laws, whether furnished before or after the date of this Agreement, together with any additional information derived from such information and contained in all analyses, compilations, studies or other documents or records prepared by the Consultant or its Representatives, as well as all copies and other reproductions thereof, whether in writing or stored or maintained in or by electronic, magnetic or other means, media or devices. As used in this Agreement, the term “Representatives” means, with respect to any Party, the directors, officers, shareholders, employees, affiliates and controlling persons of such Party (as applicable), and its and their respective agents, advisors and representatives (including without limitation attorneys, accountants and financial advisors).

6. Exclusions from Confidential Information. Notwithstanding anything to the contrary contained in Paragraph 5, Confidential Information does not include information which (i) was or becomes available to the public other than as a result of a disclosure by the Consultant or its Representatives; or (ii) was or becomes available to the Consultant on a non-confidential basis from a source other than the Bank or any of its Representatives, provided that such source is not bound by a confidentiality agreement with the Bank or otherwise prohibited from transmitting the information to the Consultant; or (iii) was within the Consultant’s possession prior to its being furnished by or on behalf of the Bank, provided that the source of such information was not bound by a confidentiality agreement with the Bank in respect thereof or otherwise prohibited from transmitting the information to the Consultant.

7. Use of Confidential Information.

a. The Consultant agrees to keep any Confidential Information confidential and not to disclose any Confidential Information, or use any Confidential Information for any purpose other than to the extent necessary for the performance of the Services. Accordingly, the Consultant agrees to treat the Confidential Information which he receives as he would his own confidential information and to take all reasonable precautions to prevent the unauthorized disclosure to any third party of any Confidential Information.

b. The Consultant shall be responsible for any improper use of the Confidential Information by his Representatives and agrees, at his own expense, to take all reasonable measures, including but not limited to court proceedings, to restrain his Representatives from unauthorized disclosure or use of the Confidential Information. Prior to providing any Representative with access to Confidential Information the Consultant shall (i) take reasonable steps to verify that the relevant Representative is capable of maintaining the privacy, confidentiality and security of the Confidential Information; and (ii) require the third party to maintain adequate safeguards for Confidential Information.

c. In addition, the Consultant shall comply with all applicable federal, state and local laws, rules, regulations and ordinances governing or relating to privacy rights in connection with his performance of any services for the Bank, including, without limitation, the Gramm-Leach-Bliley Act, as amended (“GLB”). The Consultant shall implement such physical and other security measures as shall be necessary to (i) ensure the security and confidentiality of the “nonpublic personal information” of the current or former “customers” and “consumers” (as those terms are defined in GLB) of the Bank (collectively: the “Bank Data”) which the Consultant holds, (ii) protect against any threats or hazards to the security and integrity of such Bank Data, and (iii) protect against any unauthorized access to or use of such Bank Data.

d. Absent the Bank’s prior written consent (which may be withheld in the Bank’s sole discretion) or as otherwise directed by the Bank or as required for the performance of the Services, Bank Data shall not be (i) used, disclosed, monitored, analyzed, individualized, anonymized, aggregated, stored, copied or otherwise provided to third parties by the Consultant or his Representatives, or (ii) sold, assigned, or leased by the Consultant or his Representatives, or (iii) commercially exploited in any form (including any individualized, anonymized or aggregated form) by or on behalf of the Consultant or his Representatives.

e. The Consultant shall at all times comply with all privacy, safety, security and data retention policies and procedures provided or communicated by the Bank which policies and procedures which may be amended from time to time. Upon request, the Consultant will provide evidence reasonably satisfactory to allow the Bank to confirm that the Consultant has satisfied its obligations as required under this paragraph.

f. The Consultant shall promptly notify the Bank in writing if the Consultant cannot comply with his obligations under this Section 7. If this is the case, the Bank and the Consultant shall use their best efforts to remedy the situation. The Bank may, in its sole discretion and without penalty of any kind to the Bank, suspend the transfer or disclosure of Bank Data to the Consultant or access to Bank Data by the Consultant, terminate any further processing of Bank Data by the Consultant, and terminate the Agreement, if doing so is necessary to comply with applicable privacy and security laws or is required or requested by a regulator or other governmental body.

g. Any determination regarding the applicability of privacy and security laws to any actual or threatened breach or compromise of the security, confidentiality, or integrity of Bank Data and/or of Confidential Information (collectively: an “Information Security Incident”) and the scope of the obligations pursuant to such laws shall be within the sole discretion of the Bank, and the Consultant shall comply with any such determination.

h. In the event of an Information Security Incident, the Consultant will fully cooperate with the Bank to secure Bank Data. The Consultant shall notify the Bank in writing within not more than forty eight (48) hours following discovery of any Information Security Incident, which notice shall include a detailed description of the circumstances of the disclosure and the parties involved. Consultant shall reimburse the Bank for the cost of notification of all affected parties as well as reimbursement of any remedy to correct and mitigate the effect of any such Information Security Incident, including at least one year of credit monitoring services to any affected party whose personal or confidential data may have been compromised.

i. The content of any filings, communications, notices, press releases or reports related to any Information Security Incident must be approved by the Bank prior to any publication or communication thereof. The Consultant agrees that the Bank retains the sole authority and discretion to contact and involve law enforcement agencies in connection with an Information Security

Incident when the decision whether to involve such agencies is discretionary (that is, when no legal obligation, statutory or otherwise, requires one of the parties to contact law enforcement). If the Bank elects to contact law enforcement agencies regarding an Information Security Incident, the Consultant agrees to cooperate fully with such law enforcement agencies and any decision made by the Bank regarding the scope and goals of any investigation undertaken by such agencies.

j. The Consultant will not transfer Bank Data across a country border or to an offshore location.

k. The Consultant hereby acknowledges that he is aware, and that he will advise any of his Representatives who receive Confidential Information, that the United States securities laws prohibit any person who has received from an issuer material, nonpublic information from purchasing or selling securities of such issuer (and options, warrants and rights relating thereto) or from communicating such information to any other person under circumstances in which it is reasonably foreseeable that such person (including, without limitation, any of the Consultant's Representatives) is likely to purchase or sell such securities.

8. Access to Information Systems. No access to Bank provided systems

9. Network Security. The Consultant shall only connect to the Bank Systems through approved network connections ("Approved Connections"). The Consultant shall use an Approved Connection only in accordance with all applicable security and other policies and procedures which the Bank implements and may change from time to time that are provided or communicated to the Consultant by the Bank. The Consultant shall use his best efforts to prevent all security breaches through the Approved Connections, implement stringent security procedures (including, but not limited to, the ones set forth herein and in the Bank's policies), and act immediately to address any non-approved methods of connection, security breach, or exposure to hacking attempts. The right to connect to Bank Systems from external locations may be revoked at any time. Minimum network security shall include:

a. The Consultant will allow only those of his Representatives approved in advance by the Bank ("Authorized Personnel") to access the Bank Systems. The Consultant shall be solely responsible for ensuring that Authorized Personnel are not security risks, and upon the Bank's request, the Consultant will provide the Bank with any information reasonably necessary for the Bank to evaluate security issues relating to any Authorized Personnel.

b. The Consultant shall promptly notify the Bank contact communicated to the Consultant, whenever any Authorized Personnel: leaves the Consultant's employ, such Authorized Personnel's service relationship with the Consultant ends or such Authorized Personnel's service relationship with the Consultant no longer requires access to the Bank Systems. Additionally, the Consultant shall immediately shut down all access to the Bank Systems for any Authorized Personnel no longer engaged by Consultant on providing Services.

c. Authorized Personnel accessing the Bank Systems externally shall at a minimum do so through password protected systems, shall change passwords on a regular basis (and no less frequently than every 30 days), and shall never access the Bank Systems from a shared or public computer, device or network.

10. No License or Transfer. The Confidential Information shall at all times remain the property of the Bank. No license of any trade secrets, copyrights, patents or other rights is granted by this Agreement or by any disclosure of Confidential Information.

11. Destruction/Return of Confidential Information. Upon the Bank's request, all Confidential Information (including all copies, extracts or other reproductions in whole or in part thereof), whether in writing or stored or maintained in or by electronic, magnetic or other means, media or devices, shall be returned or destroyed, so that no copy of the Confidential Information remains or can be accessed or restored in any way. In the event Confidential Information is destroyed, the Consultant shall certify such destruction to the Bank.

12. Compelled Disclosure. Notwithstanding anything to the contrary set forth herein, in the event that a Consultant or its Representatives are requested or become legally compelled (by oral questions, interrogatories, request for information or documents, subpoena, civil investigative demand or similar process) to disclose any of the Confidential Information or take any other action prohibited hereby, the Bank will be provided with prompt written notice so that the Bank may seek a protective order or other appropriate remedy and/or waive compliance with the provisions of this Confidentiality Agreement. In the event that such protective order or other remedy is not sought or obtained or that the compliance with the provisions of this Confidentiality Agreement is waived, the Consultant agrees that it will furnish only that portion of the Confidential Information which, in the reasonable opinion of its counsel, the Consultant is compelled to disclose without standing liable for contempt or suffering other censure or penalty. The Consultant further agrees that it will exercise its best efforts to obtain reliable assurance that confidential treatment will be accorded to that portion of the Confidential Information which subject to the compelled disclosure.

13. Audit. Consultant agrees that the Bank shall have the right, from time to time, upon written notice to the Consultant, to conduct an investigation and audit of the Consultant's policies, procedures, books, records and accounts to verify compliance with the provisions of this Agreement, including without limitation, provisions relating to confidentiality, privacy and security. The Consultant agrees to cooperate fully with such investigation, the method of which shall be at the sole discretion of the Bank. Without limiting any other remedies at law or at equity, the Bank may, at the Bank's sole discretion, terminate this Agreement or suspend or remove any Consultant Representatives.

14. Injunctive Relief. The Parties acknowledge and agree that, in the event of any breach of this Agreement, the Bank might be irreparably harmed and unable to be made whole by monetary damages. It is accordingly agreed that the Bank, in addition to any other remedy to which it may be entitled in law or equity, will be entitled to seek an injunction to remedy breaches of this Agreement and/or to compel specific performance of this Agreement.

15. No Conflicting Obligations. The Consultant represents that he is not a party to any agreement, and does not have any obligations, that conflict with his obligations under this Agreement.

16. Miscellaneous. This Agreement shall be governed by, and construed and interpreted in accordance with, the laws of the Commonwealth of Pennsylvania, without respect to its rules on the conflict of laws. The Consultant may not assign this Agreement, or any of his rights or obligations hereunder, without the prior written consent of the Bank. This Agreement shall be binding upon the respective successors and permitted assigns of the Parties and shall inure to the benefit of and be enforceable by the Parties and their respective successors and permitted assigns. In the event that any term of this Agreement is held to be invalid, illegal, or unenforceable, such invalidity, illegality, or unenforceability shall not affect any other portion of this Agreement, and there shall be deemed substituted therefor such term as will most fully realize the intent of the Parties as expressed in this Agreement to the fullest extent permitted by applicable law, the Parties hereby declaring their intent that this Agreement be construed in such fashion as to maintain its existence, validity and enforceability to the greatest extent possible. This Agreement constitutes the entire understanding and agreement of the Parties respecting the subject matter hereof and supersedes any and all prior agreements or arrangements, written or oral, between the Parties relating

thereto. This Agreement may not be amended or supplemented in any way except by a written document signed by the Party against whom such amendment or supplement is sought to be enforced. The failure on the part of either Party to enforce, or any delay in enforcing, any right, power or remedy that such Party may have under this Agreement shall not constitute a waiver of any such right, power or remedy, or release the other Party from any obligations under this Agreement, except by a written document signed by the Party against whom such waiver or release is sought to be enforced. This Agreement may be executed by the Parties in separate counterparts, and delivered by facsimile or other electronic means, each of which when so executed and delivered shall be an original, but all such counterparts shall together constitute one and the same instrument.

[Signature page follows.]

IN WITNESS WHEREOF, the Parties have executed this Agreement under their respective hands as of the day and year written.

BANK:

Peoples Security Bank and Trust Company

By: /s/ Thomas P. Tulaney, Sr.
(Signature)

Name: Thomas P. Tulaney, Sr.

Title: SEVP & Chief Operating Officer

Date: 8/29/19

CONSULTANT:

/s/ Michael L. Jake
(Signature)

Name: Michael L. Jake

Date: 8-29-19

Exhibit A

Services

The consultant agrees to act as an advisor to current bank officers and employees while also assisting the bank in various areas where the consultant has established knowledge and expertise. He further agrees to be available on a periodic basis.

CERTIFICATION

I, Craig W. Best, certify that:

1. I have reviewed this quarterly report on Form 10-Q for the period ended September 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: November 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 September 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: November 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 September 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: November 7, 2019

/s/ John R. Anderson, III

Executive Vice President and Chief Financial Officer
(Principal Financial Officer)
Date: November 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.