



2017 ANNUAL  
REPORT



**Peoples Financial**  
SERVICES CORP.

---

# Shareholder *Letter*

photo by: K Hart Photography & Design LLC



Craig W. Best  
President & CEO

William E. Aubrey II  
Chairman of the Board

## DEAR SHAREHOLDERS,

In 2017, our nation's economy experienced a strong year as our country continued its recovery from the Great Recession. National Gross Domestic Product topped \$19 trillion, up 2.50% over 2016. Unemployment continued to decline to 4.40%. The Dow Jones Industrial average topped 25,000 for the first time in its history and inflation finished the year at 1.54%, well below the Federal Reserve's 2.00% target. The strong economy increased loan demand as the banking industry posted robust loan growth and improved credit metrics.

On December 22, 2017, the Tax Reform Bill was signed into law reducing the federal corporate tax rate from 35% to 21%. The reduced tax rate required many financial institutions, including Peoples, to write down deferred tax assets. As a result, we recorded a \$2.6 million charge in the fourth quarter of 2017, which adjusted our earnings from a projected \$21.0 million or \$2.85 per share to \$18.5 million or \$2.50 per share.

The strong economy, reduced federal tax rate and the possibility of favorable regulatory reform creates a very favorable environment for the banking industry. Banks that will thrive in this environment are those that have worked hard developing a solid growth model, strong risk management processes and an efficient operating discipline.

## *Building for the Future*

In 2017, we continued investing in our expansion into the growth markets of the Lehigh Valley and Greater Delaware Valley. In April, we added two additional commercial lending teams and opened our regional

corporate office complex in Lehigh Valley on Emrick Boulevard. This 24,000 square foot facility provides us easy access to the Easton, Bethlehem and Allentown markets while giving us great visibility and presence in the Lehigh Valley. The facility houses a full-service retail branch, a wealth management office and a corporate business center for our commercial lenders, mortgage originators and credit team in the Lehigh Valley.

In July, we opened a new full-service retail branch on West Tilghman Street in front of Wegman's Market in West Allentown. This office provides great visibility and easy access from Tilghman Street. In addition to the retail branch, the office also provides space for mortgage originators, commercial lenders and wealth management advisors.

The expansion into the Lehigh and Greater Delaware Valley's also required additional investment in our credit administration, information technology and operations departments. Since expanding into these markets, we have hired eleven additional credit professionals including a new Chief Credit Officer. We have also upgraded our core processing software and invested in a new cash management solution and additional support in our Operations Department and Call Center.

## *Wealth Management Expansion*

Our expansion into the Lehigh and Greater Delaware Valleys continues to build momentum as loans, deposits and earnings are up over last year. Unfortunately, our Wealth Management initiative is not experiencing the same success. Overall, Wealth Management revenues were up 5.9% year over year. However, many of the areas that showed so much promise at the beginning of 2017 took several steps back by the end of the year. We continue to believe a strong Wealth Management platform provides tremendous franchise value, and our efforts in 2018 will focus on personnel, structure and process.

Our expansion into the strong growth markets of the Lehigh and Greater Delaware Valley's were not the



PEOPLES FINANCIAL SERVICES CORP.



only initiatives undertaken in 2017 to strengthen our long-term performance. We also made significant investments in Information Technology and Mortgage banking.

## ***Information Technology Enhancements***

The company focused on three primary technology projects during 2017. As outside threats to data security appeared on our national news every night, the Bank's first focus was on additional hardening of security systems. The company actively engaged service providers and consultants to make investments in state-of-the-art tools to continue to improve the mitigation of security risks.

The second technology project focused on creating the ability to improve our recovery time in the event of a disaster or an incident. By upgrading equipment with redundancies and monitoring tools, the Bank narrowed its exposure to downtime.

The third project produced enhancements to our information delivery systems to both our employees and our customers. With the installation of a state-of-the-art imaging system, the Bank now uses an automated image recognition system with efficiency tools to speed the delivery of images to multiple departments and reduce the use of paper documents throughout the Bank. The company also implemented the use of a call recording system used to review the quality of service calls through the Bank's Call Center. The system provides reports to management on areas where opportunities to improve the quality of customer service are observed and additional training can be provided. Security, safety and service are the three primary points of focus in the use of technology.

## ***Mortgage and Consumer Lending Enhancement***

In January 2018, we completed installation and training on our new mortgage origination software. This software improves the automation and communication from our retail offices and mortgage originators to

our loan underwriting and operations areas. It improves our efficiency while increasing our capacity. In 2017, we increased our number of mortgage originations by 25% and increased our mortgage origination dollar volume by 38%.

We feel this momentum will continue into 2019. In the fourth quarter of 2017, we began the development of two new mortgage products that will provide a low cost mortgage solution and help protect homeowners from rising rates.

We are also encouraged about the congressional review of mortgage reform contained in Dodd Frank Banking Reform. Our hope is that a new law will provide a safe harbor for community banks that are willing to portfolio "non-qualified" mortgages. This change will allow community banks to grant mortgages to borrowers who may not fit into a "conventional" underwriting box without the fear of legal reprisal.

## ***Financial Results***

As mentioned above, the December 2017 Tax Reform Bill was signed into law reducing the federal corporate tax rate from 35% to 21%. Although Peoples will benefit from this tax reduction, we were required to write down our deferred tax asset of \$2.6 million.

Even with this fourth quarter charge, our company was able to report strong earnings of \$18.5 million in 2017 – a decrease of \$1.1 million or 5.6% from our performance in 2016. Earnings per share on a fully diluted basis were \$2.50 in the current year compared to \$2.65 in 2016. Dividends paid to shareholders were \$1.26 per share and represented a very strong dividend yield of 2.7% based on the year-end closing stock price of \$46.58. The return on average assets for the year was 0.90% and return on average equity was 7.02%.

Total assets ended the year at \$2.2 billion, an increase over year-ended 2016 of \$171 million or 8.5%. Loans totaled \$1.7 billion at year-end 2017. This was an increase of \$157 million or 10.4% from year-ended 2016. Deposits grew \$130 million in 2017 or 8.2% to \$1.7 billion. Contributing to this growth was our expansion into the Lehigh Valley. Stockholders' equity increased



# Shareholder *Letter*

\$8.4 million or 3.3% to \$265 million as the company continues to significantly exceed the well-capitalized measures of the Federal Regulators.

Asset quality remains strong. Nonperforming assets totaled \$11.6 million or 0.68% of total loans at year-end 2017 compared to \$14.2 million or 0.93% of total loans at year-end 2016. The allowance for loan losses increased to \$19.0 million or 1.12% of loans compared to \$16 million or 1.04% of loans at the end of 2016. Net charge-offs were at \$1.8 million in 2017 or 0.11% of average loans versus charge-offs of \$2.0 million or 0.14% of average loans in 2016.

For the year, net interest income after provision for loan loss totaled \$60.7 million, an increase of \$4.0 million or 7.1%. Our net interest margin (fully tax equivalent) declined eight basis points from 3.77% in 2016 to 3.69% in 2017. During 2017, we were able to offset this decrease in our net interest margin with an increase in average assets causing the increase in our net interest income.

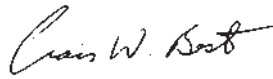
Non-interest income increased \$1.3 million or 8.2% in 2017 when compared to 2016. The sale of our merchant services business resulted in a before tax gain of \$2.3 million, while merchant services income decreased \$1.7 million or 39.4%. This decrease was offset by higher services charges and other fees of \$1.2 million.

Non-interest expenses totaled \$51.3 million in 2017, up \$3.3 million or 6.8%. Salaries and benefits increased \$4.2 million or 18.9% and occupancy expenses increased \$553 thousand, both primarily due to investments in our market expansion. These increases were partially offset by a decrease in other expenses of \$189 thousand as well as a decrease of \$1.2 million in merchant services expense due to our sale of that business line.

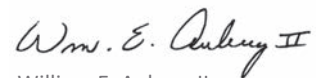
We strongly encourage you to read the financial section of this Annual Report for a more detailed analysis of our results.

On behalf of our Directors, Officers and Employees, sincere appreciation is expressed to our stockholders and customers for their continued support. The progress outlined herein is the result of the dedicated and effective effort on the part of our Board of Directors, Officers and Employees. We extend to our stockholders, customers and employees the gratitude of the Board of Directors for your support and confidence.

Sincerely yours,



Craig W. Best  
President & CEO



William E. Aubrey II  
Chairman of the Board

photo by: Michelle Scaturro



# Board of *Directors & Executive Officers*

The Board of Peoples Financial Services Corp. is a distinguished group of community leaders and professionals. Their combined abundance of business and professional expertise helps us to fulfill our company's core values that are integral to our success and growth.



photo by: K Hart Photography & Design LLC

FRONT ROW

**Ronald G. Kukuchka**  
President | Ace Robbins, Inc.

**Craig W. Best**  
President & CEO  
Peoples Financial Services Corp.  
Peoples Security Bank  
and Trust Company

**William E. Aubrey II**  
Chairman  
President & CEO  
Gertrude Hawk Chocolates  
Chief Executive Officer  
Drew's Organics

**James G. Keisling**  
Treasurer  
Northeast Architectural  
Products, Inc.

**Emily S. Perry**  
Retired Insurance  
Account Executive  
Community Volunteer

**George H. Stover, Jr.**  
Real Estate Appraiser

BACK ROW

**James B. Nicholas**  
President  
D. G. Nicholas Co.

**Richard S. Lochen, Jr.**  
Certified Public Accountant  
Partner | Lochen & Chase PC

**Robert W. Naismith, Ph.D.**  
Chairman | JuJaMa, Inc.

**Joseph T. Wright, Jr., Esq.**  
Attorney at Law | Partner  
Wright & Reihner PC

**Steven L. Weinberger**  
President  
G. Weinberger Company

**Joseph G. Cesare, M.D.**  
Retired Orthopedic Surgeon  
Former President  
Scranton Orthopedic Specialists

**Earle A. Wootton**  
Chairman & CEO  
Director Community Foundation  
of the Endless Mountains, Inc.  
President & CEO  
Mountain Resource Partners, Inc.

EXECUTIVE OFFICERS

**Craig W. Best**  
President & CEO

**Thomas P. Tulaney**  
Senior Executive  
Vice President  
Chief Operating Officer

**John R. Anderson III**  
Executive Vice President  
Chief Financial Officer

**Joseph M. Ferretti**  
Executive Vice President  
Senior Lending Officer

**Michael L. Jake**  
Executive Vice President  
Chief Risk Officer

**Debra E. Dissinger**  
Executive Vice President  
Chief Operations Officer

**Lynn M. Peters Thiel**  
Executive Vice President  
Chief Retail Officer

**Neal D. Koplín**  
Executive Vice President  
Lehigh Valley Region  
President

**Timothy H. Kirtley**  
Executive Vice President  
Chief Credit Officer

# Financial Highlights

## PEOPLES FINANCIAL SERVICES CORP. CONSOLIDATED SELECTED FINANCIAL DATA

(Dollars in thousands, except per share data)

Year Ended December 31	2017	2016	2015	2014	2013
<b>Condensed statements of financial performance:</b>					
Interest income	\$74,242	\$68,984	\$63,041	\$63,956	\$37,370
Interest expense	8,698	7,251	6,037	6,642	4,169
Net interest income	65,544	61,733	57,004	57,314	33,201
Provision for loan losses	4,800	5,000	3,700	3,524	2,361
Net interest income after the provision for loan losses	60,744	56,733	53,304	53,790	30,840
Noninterest income	17,186	15,888	15,719	15,251	11,762
Noninterest expense	51,293	48,030	46,779	45,933	36,396
Income before income taxes	26,637	24,591	22,244	23,108	6,206
Provision for income tax expense	8,180	5,008	4,521	5,459	485
Net income	\$18,457	\$19,583	\$17,723	\$17,649	\$5,721
<b>Condensed statements of financial position:</b>					
Investments securities	\$281,822	\$269,927	\$297,044	\$354,251	\$317,010
Net loans	1,674,105	1,517,004	1,327,890	1,199,556	1,167,966
Other assets	213,104	212,511	194,124	187,862	203,245
Total Assets	\$2,169,031	\$1,999,442	\$1,819,058	\$1,741,669	\$1,688,221
Deposits	\$1,719,018	\$1,588,757	\$1,455,810	\$1,425,558	\$1,379,507
Short-term borrowings	123,675	82,700	38,325	19,557	22,052
Long-term debt	49,734	58,134	60,354	33,140	36,743
Other liabilities	11,628	13,233	15,801	16,635	11,127
Stockholders' equity	264,976	256,618	248,768	246,779	238,792
Total liabilities and stockholders' equity	\$2,169,031	\$1,999,442	\$1,819,058	\$1,741,669	\$1,668,221
<b>Per share data:</b>					
Net income	\$2.50	\$2.65	\$2.36	\$2.34	\$1.21
Cash dividends declared	1.26	1.24	1.24	1.24	1.23
Stockholders' equity	\$35.82	\$34.71	\$33.57	\$32.69	\$31.62
Cash dividends as a percentage of net income	50.40%	46.79%	52.54%	53.03%	96.33%
Average common shares outstanding	7,395,837	7,396,716	7,516,451	7,548,825	4,733,059
<b>Selected ratios (based on average balances):</b>					
Net income as a percentage of total assets	0.90%	1.02%	1.02%	1.03%	0.58%
Net income as a percentage of stockholders' equity	7.02	7.64	7.13	7.29	4.01
Stockholders' equity as a percentage of total assets	12.77	13.36	14.26	14.12	14.43
Tier I capital as a percentage of adjusted total assets	9.94	10.16	10.80	10.76	10.12
Net interest income as a percentage of earning assets	3.69	3.77	3.81	3.86	3.91
Loans, net, as a percentage of deposits	96.50%	95.81%	87.55%	84.13%	87.72%
<b>Selected ratios (based on period end balances):</b>					
Tier I capital as a percentage of risk-weighted assets	11.85%	12.49%	13.52%	14.75%	13.62%
Total capital as a percentage of risk-weighted assets	12.95	13.51	14.47	15.61	14.29
Allowance for loan losses as a percentage of loans, net	1.12	1.04	0.97	0.85	0.74
Nonperforming loans as a percentage of loans, net	0.67%	0.90%	0.86%	0.85%	1.60%

**Note:** Average balances were calculated using average daily balances. Average balances for loans include nonaccrual loans. Tax-equivalent adjustments were calculated using the prevailing statutory rate of 35.0 percent.



photo by: Michelle Scaturro

Emrick Office | 2151 Emrick Blvd | Bethlehem



photo by: Casey Greenfield

Tilghman Office | 3920 W Tilghman St | Allentown

## EXPANSION IN THE LEHIGH VALLEY MARKET

During 2017, the bank reinforced its commitment to this region by opening two additional offices in the Lehigh Valley.

The Emrick Boulevard Office in Bethlehem and the Tilghman Street Office in Allentown joined the bank's first location on Airport Road in Bethlehem to bring the total number of banking offices in the Lehigh Valley to three. All three offices offer consumer and commercial banking, wealth management, financing and cash management services.

The bank's success in the Lehigh Valley is built on a long tradition of banking excellence, cultivated on the foundation and experience of serving the greater Scranton area since 1905.

Neal Koplín, Lehigh Valley Region President, is responsible for the expansion and growth in this region and oversees a team of trusted professionals who can offer expertise in all facets of banking.

Since its establishment in the Lehigh Valley, Peoples Security Bank & Trust has provided significant loan commitments to local businesses in Allentown, Bethlehem and Easton. For example, the bank has pledged \$300,000 over the next six years to Southside Vision 2020 in Bethlehem in an effort to revitalize the city's south side neighborhood. The funds will help improve housing, healthcare, green space, children's services and art initiatives in the area.

## WOMEN IN PHILANTHROPY LOAN PROGRAM

Peoples Security Bank & Trust recently partnered with the Scranton Area Community Foundation in order to create a Women in Philanthropy loan program that supports entrepreneurship by women in our communities.

The program was created to provide the funding and support necessary for women who are economically disadvantaged, or who are in transition, to achieve their goals of business ownership. Women owned businesses now have a place to obtain financing who may otherwise be turned away when they do not meet the lending criteria required by traditional lending institutions or even small business loan programs, including SBA loans. Unlike traditional lending, these micro-loans do not require a minimum credit score or collateral. By supporting these needs, we provide

women business owners the opportunity to establish a credit history so that they can qualify for traditional lending opportunities in the future.

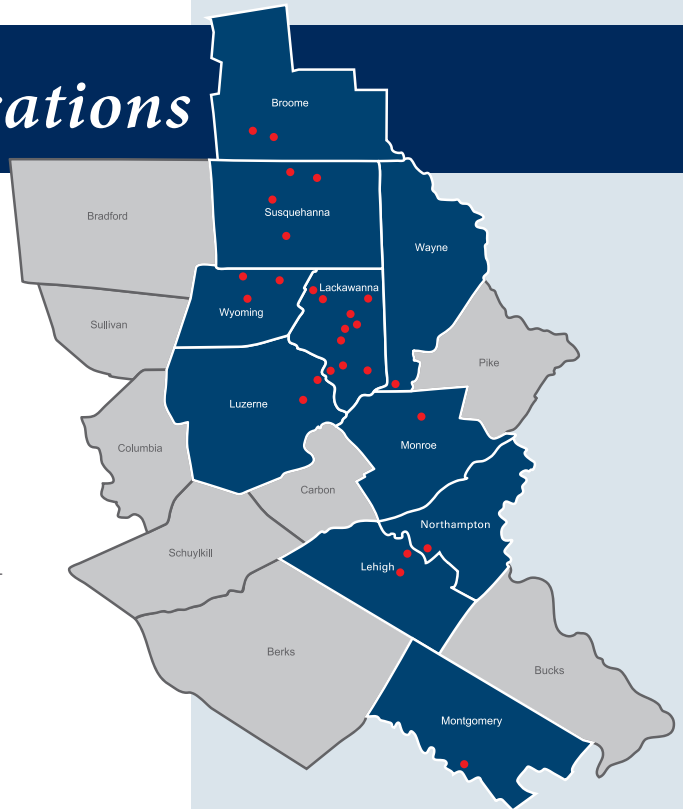
The program features favorable terms and conditions which benefit the business owner. It offers commercial loans as small as \$1,000 and as large as \$10,000 with loan terms up to 48 months.

The loan program also helps the borrowers save for their future—the interest paid (at an interest rate of 6%) is put into a savings account and returned to the borrower after the loan has been repaid. In addition to the funding aspects, the

program also provides training and education in business management and financial literacy, and one-on-one mentorship.



# Office Locations



## **BROOME COUNTY | NY**

**Binghamton West Side**  
273 Main St  
Binghamton, NY 13905  
(607) 729-3832

**Conklin**  
1026 Conklin Rd  
Conklin, NY 13748  
(607) 722-2114

## **LACKAWANNA COUNTY | PA**

**Abington**  
1100 Northern Blvd  
S Abington Twp, PA 18411  
(570) 587-4898

**Central City Scranton**  
150 N Washington Ave  
Scranton, PA 18503  
(570) 955-1700

**East Scranton**  
968 Prescott Ave  
Scranton, PA 18510  
(570) 342-9101

**Glenburn**  
494 N Gravel Pond Rd  
Clarks Summit, PA 18411  
(570) 585-5130

**Green Ridge**  
1901 Sanderson Ave  
Scranton, PA 18509  
(570) 346-4695

**Minooka**  
420 Davis St  
Scranton, PA 18505  
(570) 955-1883

**Moscow**  
141 N Main St  
Moscow, PA 18444  
(570) 842-7626

**Old Forge**  
216 S Main St  
Old Forge, PA 18518  
(570) 451-7200

**Peckville**  
540 Main St  
Peckville, PA 18452  
(570) 383-2154

**South Scranton**  
526 Cedar Ave  
Scranton, PA 18505  
(570) 343-1151

## **LEHIGH COUNTY | PA**

**Airport Rd**  
2355 City Line Rd  
Bethlehem, PA 18017  
(610) 691-1202

**Tilghman St**  
3920 W Tilghman St  
Allentown, PA 18104  
(610) 398-9680

## **LUZERNE COUNTY | PA**

**Duryea**  
304 Main St  
Duryea, PA 18642  
(570) 457-1120

**Kingston**  
435 Wyoming Ave  
Kingston, PA 18704  
(570) 288-0128

## **MONROE COUNTY | PA**

**Mount Pocono**  
1322 Pocono Blvd  
Mount Pocono, PA 18344  
(570) 839-8732

## **MONTGOMERY COUNTY | PA**

**King of Prussia**  
610 Freedom Business Center Dr  
Suite 105  
King of Prussia, PA 19406  
(610) 205-1880

## **NORTHAMPTON COUNTY | PA**

**Emrick Blvd**  
2151 Emrick Blvd  
Bethlehem, PA 18020  
(610) 317-4690

## **SUSQUEHANNA COUNTY | PA**

**Hallstead**  
25109 State Rt 11  
Hallstead, PA 18822  
(570) 879-2195

**Hop Bottom**  
126 Main St  
Hop Bottom, PA 18824  
(570) 289-4124

**Montrose**  
695 Grow Ave  
Montrose, PA 18801  
(570) 278-4100

**Susquehanna**  
215 Erie Blvd  
Susquehanna, PA 18847  
(570) 853-4901

## **WAYNE COUNTY | PA**

**Gouldsboro**  
534 Main St  
Gouldsboro, PA 18424  
(570) 842-6473

## **WYOMING COUNTY | PA**

**Meshoppen**  
8178 State Rt 6  
Meshoppen, PA 18630  
(570) 833-5171

**Nicholson**  
42-48 State St  
Nicholson, PA 18446  
(570) 942-2265

**Tunkhannock**  
83 E Tioga St  
Tunkhannock, PA 18657  
(570) 836-2135

## **Off-site ATMs**

**GEISINGER COMMONWEALTH SCHOOL OF MEDICINE**  
525 Pine Street  
Scranton, PA

**LACKAWANNA COLLEGE**  
501 Vine Street  
Scranton, PA

**MEADOW AVENUE**  
Meadow Avenue & Hemlock Street  
Scranton, PA

**RADISSON LACKAWANNA STATION HOTEL**  
700 Lackawanna Avenue  
Scranton, PA

**SAINT MARY'S VILLA NURSING HOME**  
516 Saint Mary's Villa Road  
Elmhurst Township, PA



# Corporate *Information*

## PEOPLES SECURITY BANK AND TRUST COMPANY CORPORATE HEADQUARTERS

150 North Washington Avenue  
Scranton, PA 18503  
(570) 346-7741  
(888) 868-3858  
psbt.com

## INVESTOR RELATIONS OFFICER

Marie L. Luciani  
(570) 346-7741 x2352  
(888) 868-3858 x2352

## STOCK INFORMATION

The common stock of Peoples Financial Services Corp. is listed on the NASDAQ Stock Market under the ticker symbol PFIS.

## STOCK TRANSFER AND REGISTRAR AGENT

### AMERICAN STOCK TRANSFER & TRUST COMPANY, LLC

6201 15th Avenue  
Brooklyn, NY 11219  
(718) 921-8124  
(800) 937-5449

## FORM 10-K ANNUAL REPORT

A copy of our form 10-K for the year ended December 31, 2017 is included herein. **Copies of the company's Annual Report to the Securities and Exchange Commission on Form 10-K, quarterly reports on Form 10-Q and news releases may be obtained without charge upon request to:**  
**Marie L. Luciani**  
**Investor Relations Officer**  
**150 North Washington Avenue**  
**Scranton, PA 18503**

## ANNUAL MEETING

Saturday, May 12, 2018, 9:00am  
Shadowbrook Inn and Resort  
201 Resort Lane  
Tunkhannock, PA 18657  
(570) 836-2151

## DIVIDEND CALENDAR

Dividends on Peoples Financial Services Corp. common stock are customarily payable on or about the 15th of March, June, September and December.

## DIVIDEND REINVESTMENT PLAN

American Stock Transfer & Trust Company, LLC administers a Dividend Reinvestment Plan and Stock Purchase Plan. Additional information may be obtained on American Stock Transfer & Trust Company's website: [astfinancial.com](http://astfinancial.com).

## DIRECT DEPOSIT OF DIVIDENDS

As a shareholder of Peoples Financial Services Corp., you may have your dividend payments deposited directly into a personal checking, savings, or other account. Direct deposit of your dividend eliminates the chance of your dividend check being lost or stolen and is credited to your account on the same day that the dividend is paid. To begin direct deposit of your dividend, please contact Marie L. Luciani, Investor Relations Officer, at the Corporate Headquarters address.

## INDEPENDENT AUDITORS

Baker Tilly Virchow Krause, LLP  
7535 Windsor Drive, Suite 300  
Allentown, PA 18195-1014  
(610) 336-8180

## GENERAL COUNSEL

Jerry Weinberger, Esq.  
Jerry Weinberger P.C.  
345 Wyoming Avenue  
Suite 200  
Scranton, PA 18503  
(570) 963-8880

## SEC COUNSEL

Pepper Hamilton, LLP  
3000 Two Logan Square  
Eighteenth & Arch Streets  
Philadelphia, PA 19103  
(215) 981-4000

## TRUST COUNSEL

James W. Reid, Esq.  
Oliver, Price & Rhodes  
1212 South Abington Road  
Clarks Summit, PA 18411  
(570) 585-1200

## MARKET MAKERS

*Boenning & Scattergood, Inc.*  
4 Tower Bridge  
200 Barr Harbor Drive  
Suite 300  
West Conshohocken, PA 19428  
(610) 862-5368

*Griffin Financial Group, LLC*  
440 Monticello Avenue  
Suite 1824  
Norfolk, VA 23510  
(757) 955-8444

*Keefe Bruyette & Woods (KBW)*  
The Equitable Building  
787 7th Avenue  
New York, NY 10019  
(212) 887-8996

*Sandler O'Neill + Partners, L.P.*  
1251 Avenue of the Americas  
6th Floor  
New York, NY 10020  
(800) 635-6851

## PRODUCTS AND SERVICES

Detailed information on our products and services offered by Peoples Security Bank & Trust can be obtained by visiting [psbt.com](http://psbt.com) or by calling (888) 868-3858 or (570) 346-7741.

---

---

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**  
Washington, D.C. 20549

---

**FORM 10-K**

---

(Mark One)

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

For the fiscal year ended December 31, 2017

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number: 001-36388

---

**Peoples Financial Services Corp.**

(Exact name of registrant as specified in its charter)

---

Pennsylvania  
State or other jurisdiction of  
incorporation or organization

23-2391852  
(I.R.S. Employer  
Identification No.)

150 North Washington Avenue,  
Scranton, PA 18503  
(Address of principal executive offices) (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>Name of each exchange on which registered</u>
Common stock, \$2.00 par value	The Nasdaq Stock Market

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

None

---

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes  No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes  No

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 and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§ 229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer	<input type="checkbox"/>	Accelerated filer	<input checked="" type="checkbox"/>
Non-accelerated filer	<input type="checkbox"/> (Do not check if a smaller reporting company)	Smaller reporting company	<input type="checkbox"/>
Emerging growth company	<input type="checkbox"/>		

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 Act). Yes  No

The aggregate market value of the registrant's common stock held by non-affiliates of the registrant on June 30, 2017 was approximately \$323,434,208 (based on the closing sales price of the registrant's common stock on that date).

The number of shares of the registrant's common stock outstanding as of February 28, 2018 was 7,396,505.

**DOCUMENTS INCORPORATED BY REFERENCE**

Portions of the registrant's definitive proxy statement to be filed in connection with solicitation of proxies for its 2018 annual meeting of shareholders, within 120 days of the end of registrant's fiscal year, is incorporated by reference into Part III of this Annual Report on Form 10-K.

---

---

**Peoples Financial Services Corp.**  
**Form 10K**  
**For the Year Ended December 31, 2017**  
**TABLE OF CONTENTS**

	<u>Page Number</u>
<b>PART I</b>	
Item 1. Business	1
Item 1A. Risk Factors	15
Item 1B. Unresolved Staff Comments	24
Item 2. Properties	24
Item 3. Legal Proceedings	25
Item 4. Mine Safety Disclosures	25
<b>PART II</b>	
Item 5. Market for Registrant’s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities	25
Item 6. Selected Financial Data	28
Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations	29
Item 7A. Quantitative and Qualitative Disclosures About Market Risk	65
Item 8. Financial Statements and Supplementary Data	66
Item 9. Changes in and Disagreements With Accountants on Accounting and Financial Disclosure	121
Item 9A. Controls and Procedures	121
Item 9B. Other Information	123
<b>PART III</b>	
Item 10. Directors, Executive Officers and Corporate Governance	123
Item 11. Executive Compensation	123
Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters	123
Item 13. Certain Relationships and Related Transactions, and Director Independence	123
Item 14. Principal Accounting Fees and Services	123
<b>PART IV</b>	
Item 15. Exhibits, Financial Statement Schedules	123
Item 16. Form 10-K Summary	123
<b>SIGNATURES</b>	127

### **Cautionary Note Regarding Forward-Looking Statements.**

This Annual Report on Form 10-K contains forward-looking statements within the meaning of Section 27A of the Securities Act, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, which are subject to risks and uncertainties. These statements are based on assumptions and may describe future plans, strategies and expectations of Peoples Financial Services Corp. and its direct and indirect subsidiaries. These forward-looking statements are generally identified by use of the words “believe,” “expect,” “intend,” “anticipate,” “estimate,” “project” or similar expressions. All statements in this report, other than statements of historical facts, are forward-looking statements.

The ability of Peoples Financial Services Corp. to predict results or the actual effect of future plans or strategies is inherently uncertain. Important factors that could cause actual results of Peoples Financial Services Corp. to differ materially from those in the forward-looking statements include, but are not limited to: changes in interest rates; economic conditions, particularly in the Peoples Financial Services Corp. 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 the Peoples Financial Services Corp. market area; the ability to achieve the intended benefits of, or other risks associated with, business combinations; changes in relevant accounting principles and guidelines; inability of third party service providers to perform; and the ability to prevent, detect and respond to cyberattacks. Additional factors that may affect our results are discussed in Item 1A to this Annual Report on Form 10-K titled “Risk Factors”.

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

## **Part I**

### **Item 1. Business.**

#### **General**

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. On November 30, 2013, Penseco Financial Services Corporation, a financial holding company incorporated under the laws of Pennsylvania, referred to as “Penseco,” merged with and into Peoples Financial Services Corp., with Peoples Financial Services Corp. being the surviving corporation, pursuant to an Agreement and Plan of Merger dated June 28, 2013. Such transaction is sometimes referred to in this annual report as the “Penseco merger” and such agreement as the “Penseco merger agreement.” In connection with the Penseco merger, on December 1, 2013, Penseco’s former banking subsidiary, Penn Security Bank and Trust Company, merged with and into Peoples Neighborhood Bank, and the resulting institution adopted the name, “Peoples Security Bank and Trust Company.”

Unless the context indicates otherwise, all references in this annual report to the “Peoples,” “Company,” “we,” “us” and “our” refer to Peoples Financial Services Corp., its subsidiaries and its and their respective predecessors. Peoples Security Bank and Trust Company is sometimes referred to as “Peoples Bank.”

Peoples Bank is a state-chartered bank and trust company under the jurisdiction of the Pennsylvania Department of Banking and Securities and the Federal Deposit Insurance Corporation, or “FDIC.” Peoples Bank’s twenty-seven community banking offices, all similar with respect to economic characteristics, share a majority of the following aggregation criteria: products and services; operating processes; customer bases; delivery systems; and regulatory oversight. Accordingly, they are aggregated into a single operating segment.

#### **Market Areas**

Our principal market area consists of Bucks, Lackawanna, Lehigh, Luzerne, Monroe, Montgomery, Northampton, Susquehanna, Wayne and Wyoming Counties in Pennsylvania and Broome County in New York. In addition, parts of Bradford County in Pennsylvania that borders Susquehanna and Wyoming Counties are also considered part of the market area.

Specifically, our market area is situated between:

- Binghamton, Broome County, New York, located to the north; and
- King of Prussia, Montgomery County, Pennsylvania, to the south.

Susquehanna County could best be described as a bedroom county with a high percentage of its residents commuting to work in Broome County, New York, or Lackawanna County, Pennsylvania. The southern part of Susquehanna County tends to gravitate south for both employment and shopping, while the northern part of the county goes north to Broome County, New York. The western part of Susquehanna County gravitates south and west to and through Wyoming County. Approximately half of our offices are located in and around Scranton, the largest city in Lackawanna County with most of the remaining offices located in counties that would be considered sparsely populated, as they are made up of many small towns and villages. Peoples entered into the Lehigh County market during the fourth quarter of 2014 with the opening of a community banking office. This market has a greater population than the other counties served, with Bethlehem being the second largest city within Lehigh County. During 2017, the company has added two additional branch offices, one in Allentown, Lehigh County and one in Bethlehem, Northampton County to continue our strategic expansion initiative.

In 2015, the Company entered the King of Prussia market, which includes parts of Bucks and Montgomery counties of Pennsylvania, with the establishment of a loan production office and a team of experienced lenders. During the fourth quarter of 2016, a retail branch office was established, replacing the loan production office, and staffed by personal bankers and our experienced lenders. Montgomery and Bucks counties are two of the wealthiest counties in Pennsylvania. Significant types of employment industries include pharmaceuticals, health care, electronics, computer

services, insurance, industrial machinery, retailing, schools and meat processing. Unemployment rates at December 2017 were 3.4% in Montgomery County and 3.7% in Bucks County, lower than Pennsylvania's state unemployment rate of 4.7% and the federal unemployment rate of 4.1%, according to the Bureau of Labor Statistics.

The Marcellus Shale formation located in the heart of our northern market area has provided economic benefits to the communities served and as a result to us. Natural gas producers have invested billions of dollars in Pennsylvania in lease and land acquisition, new well drilling, infrastructure development and community partnerships. The growth of our deposits, and to a lesser extent, loan portfolio, has been influenced by natural gas drilling activities.

## **Products and Services**

Our primary products are loans to small- and medium-sized businesses. Other lending products include one-to-four family residential mortgages and consumer loans. We fund our loans, primarily, by offering open time deposits to commercial enterprises and individuals. Other deposit products include certificates of deposits and various demand deposit accounts.

### *Lending Activities*

We provide a full range of retail and commercial lending products designed to meet the borrowing needs of consumers and small- and medium-sized businesses in our market areas. A significant amount of our loans are to customers located within our market area. We have no foreign loans or highly leveraged transaction loans, as defined by the Federal Reserve Board. Although we participate in loans originated by other banks, we have originated the majority of loans in our portfolio.

Our retail lending products include the following types of loans, among others: residential real estate; automobiles; manufactured housing; personal; student; home equity; and credit card. Our commercial lending products include the following types of loans, among others: commercial real estate; working capital; equipment and other commercial needs; construction; Small Business Administration; and agricultural and mineral rights. The terms offered on a loan vary depending primarily on the type of loan and credit-worthiness of the borrower.

Payment risk is a function of the economic climate in which our lending activities are conducted. Economic downturns in the economy generally or in a particular sector could cause cash flow problems for customers and make loan payments more difficult. We attempt to minimize this risk by not being exposed to loan concentrations of a single customer or a group of customers, the loss of any one or more of whom would have a materially adverse effect on its financial condition. One element of interest rate risk arises from our fixed rate loans in an environment of changing interest rates. We attempt to mitigate this risk by making adjustable rate commercial loans and by limiting repricing terms to five years or less for customers requiring fixed rate loans. Our lending activity also exposes us to risks that any collateral we take as security is not adequate. We attempt to manage collateral risk by avoiding loan concentrations to particular borrowers, by perfecting liens on collateral and by obtaining appraisals on property prior to extending loans. We attempt to mitigate our exposure to these and other types of risks by stratifying authorization requirements by loan size and complexity.

We generate interest income from our loan and securities portfolios. Other income is generated primarily from merchant transaction fees, trust fees and service charges on deposit accounts. Our primary costs are interest paid on deposits and borrowings and general operating expenses. We provide a variety of commercial and retail banking services to business, non-profits, governmental, municipal agencies and professional customers, as well as retail customers, on a personalized basis. Our primary lending products are real estate, commercial and consumer loans. We also offer ATM access, credit cards, active investment accounts, trust department services and other various lending, depository and related financial services. Our primary deposit products are savings and demand deposit accounts and certificates of deposit.

We are not dependent upon a single customer, or a few customers, the loss of one or more of which would have a material adverse effect on our operations. In the ordinary course of our business, our operations and earnings are not materially affected by seasonal changes or by compliance with Federal, state or local environmental laws or regulations.

We offer a variety of loans including commercial, residential and consumer loans as described above. The consumer portfolio includes automobile loans, educational loans and lines of credit.

We intend to continue to evaluate commercial real estate, commercial business and governmental lending opportunities, including small business lending. We continue to proactively monitor and manage existing credit relationships.

We have not engaged in sub-prime residential mortgage lending, which is defined as mortgage loans advanced to borrowers who do not qualify for market interest rates because of problems with their credit history. We focus our lending efforts within our market area.

*One-to-Four Family Residential Loans.* We offer two types of residential mortgage loans: fixed-rate loans, with terms of up to 30 years, and adjustable-rate loans, with interest rates and payments that adjust annually after an initial fixed period of one, three or five years. Interest rates and payments on our adjustable-rate loans generally are adjusted to a rate equal to a percentage above the appropriate U.S. Treasury Security Index. Our adjustable-rate single-family residential real estate loans generally have caps on increases or floors on decreases in the interest rate at any adjustment date, and a maximum adjustment limit over the life of the loan. Although we offer adjustable-rate loans with initial rates below the fully indexed rate, loans tied to the one-year constant maturity treasury are underwritten using methods approved by the Federal Home Loan Mortgage Corporation, which require borrowers to be qualified at a rate equal to 200 basis points above the discounted loan rate under certain conditions.

Borrower demand for adjustable-rate loans compared to fixed-rate loans is a function of the level of interest rates, the expectations of changes in the level of interest rates, and the difference between the interest rates and loan fees offered for fixed-rate mortgage loans as compared to the interest rates and loan fees for adjustable-rate loans, among other factors. The loan fees, interest rates and other provisions of mortgage loans are determined by us on the basis of our own pricing criteria and competitive market conditions.

Most of our residential loans are underwritten to standards established by the secondary market. We also offer VA and FHA loans via a third party lending source.

While one-to-four family residential real estate loans are normally originated with up to 30-year terms, such loans typically remain outstanding for substantially shorter periods because borrowers often prepay their loans in full either upon sale of the property pledged as security or upon refinancing the original loan. Therefore, average loan maturity is a function of, among other factors, the level of purchase and sale activity in the real estate market, prevailing interest rates and the interest rates payable on outstanding loans. We do not offer loans with negative amortization or interest only loans.

We offer home equity loans and lines of credit, typically with a maximum combined loan-to-value ratio of 80%. Home equity loans generally have fixed-rates of interest and are originated with terms of up to 15 years. Home equity lines of credit generally have variable rates and are indexed to the prime rate. Home equity lines of credit generally have draw periods with 20 year repayment periods.

We generally do not make high loan-to-value loans (defined as loans with a loan-to-value ratio in excess of 80%) without private mortgage insurance. The maximum loan-to-value ratio we generally permit is 95% with private mortgage insurance. We require all properties securing mortgage loans to be appraised by a board-approved independent appraiser. We generally require title insurance on all first mortgage loans. Borrowers must obtain hazard insurance, and flood insurance is required for loans on properties located in a flood zone.

*Commercial Real Estate Loans.* We offer commercial real estate loans secured by real estate primarily with adjustable rates. We originate a variety of commercial real estate loans generally for terms up to 25 years and payments based on an amortization schedule of up to 25 years. These loans are typically based on either the Federal Home Loan Bank borrowing rate or our own pricing criteria and adjust every three to five years. Commercial real estate loans also are originated for the acquisition and development of land, including development for residential use. Conditions of acquisition and development loans originated generally limit the number of model homes and homes built on speculation, and draws are scheduled against executed agreements of sale. Commercial real estate loans for the acquisition and development of land are typically based upon the prime rate. Commercial real estate loans for developed real estate and for real estate acquisition and development are originated generally with loan-to-value ratios up to 75%, while loans for the acquisition of land are originated with a maximum loan to value ratio of 65%.

*Commercial Loans.* We offer commercial business loans to professionals, sole proprietorships and small businesses in our market area. We offer installment loans for capital improvements, equipment acquisition and long-term working capital. These loans are typically priced at short term fixed rates or variable rates based on the prime rate. These loans are secured by business assets other than real estate, such as business equipment and inventory, and, generally, are backed by personal guarantees of the owner or owners of the business. We originate lines of credit to finance the working capital needs of businesses to be repaid by seasonal cash flows or to provide a period of time during which the business can borrow funds for planned equipment purchases.

When making commercial business loans, we consider the consolidated financial statements of the borrower and any guarantors, the borrower's payment history of both corporate and personal debt, the debt service capabilities of the borrower, the projected cash flows of the business and guarantor, the viability of the industry in which the customer operates and the value of the collateral.

*Consumer Loans.* We offer a variety of consumer loans, including lines of credit, automobile loans and loans secured by savings accounts and certificates of deposit. We also offer unsecured loans.

We offer loans secured by new and used automobiles, primarily indirectly through dealerships. These loans have fixed interest rates and generally have terms up to six years. We offer automobile loans with loan-to-value ratios of up to 100% of the purchase price of the vehicle depending upon the credit history of the borrower and other factors.

We offer consumer loans secured by savings accounts and certificates of deposit held by us based upon the deposit rates plus a margin with terms up to five years. We offer such loans up to 100% of the principal balance of the certificate of deposit or balance in the savings account. We also offer unsecured loans and lines of credit with terms up to five years. Our unsecured loans and lines of credit bear a substantially higher interest rate than our secured loans and lines of credit.

The procedures for underwriting consumer loans include an assessment of the applicant's payment history on other debts and ability to meet existing obligations and payments on the proposed loan. Although the applicant's creditworthiness is a primary consideration, the underwriting process also includes a comparison of the value of the collateral, if any, to the proposed loan amount.

We have adhered and continue to adhere to credit policies, both prior to and during the recent economic downturn, which management believes are sound. Our loan policies require verification of information provided by loan applicants as well as an assessment of their ability to repay for all loans. At no time have we made loans similar to those commonly referred to as "no doc" or "stated income" loans.

While the vast majority of the loans in our loan portfolio are secured by collateral, we have made and will continue to make loans on an unsecured basis. Unsecured commercial loans are only granted to those borrowers exhibiting historically strong cash flow and capacity with seasoned management. Unsecured consumer loans are made for relatively short terms and to borrowers with strong credit histories.

We consider requests to modify, restructure or otherwise change the terms of loans on an individual basis as circumstances and/or reasons for such changes may vary. All such changes in terms must be authorized by the appropriate approval body. Also, our credit policy prohibits the modification of loans or the extension of additional credit to borrowers who are not current on their payments. Exceptions are approved only where our position in the credit relationship is expected to be enhanced by such action.

*Adjustable-Rate Loans.* While we anticipate that adjustable-rate loans will better offset the adverse effects of an increase in interest rates as compared to fixed-rate mortgages, an increased monthly mortgage payment required of adjustable-rate loan borrowers in a rising interest rate environment could cause an increase in delinquencies and defaults. The marketability of collateral also may be adversely affected in a high interest rate environment. In addition, although adjustable-rate mortgage loans make our asset base more responsive to changes in interest rates, the extent of this interest sensitivity is limited by the annual and lifetime interest rate adjustment limits on residential mortgage loans. We attempt to negotiate floors on most adjustable rate commercial loans. The commercial adjustable rate loans generally provide a fixed rate re-negotiation at the end of the initial fixed rate period. If we and the borrower are unable to agree on a new fixed rate then the rate converts to a floating rate obligation. In addition, some commercial loans adjust to a



predetermined index plus a spread at the end of the initial fixed rate period, for a like period of time. To a lesser degree, we have entered into transactions with collars generally for periods of five years or less.

*Commercial Real Estate Loans.* Loans secured by commercial real estate generally have larger balances and involve a greater degree of risk than one-to-four family residential mortgage loans. Of primary concern in commercial real estate lending is the borrower's and any guarantor's creditworthiness and the feasibility and cash flow potential of the financed project. Additional considerations include: location, market and geographic concentrations, loan to value, strength of guarantors and quality of tenants. Payments on loans secured by income properties often depend on successful operation and management of the properties. As a result, repayment of such loans may be subject to a greater extent than residential real estate loans, to adverse conditions in the real estate market or the economy. To monitor cash flows on income properties, we require borrowers and loan guarantors, if any, to provide annual consolidated financial statements on commercial real estate loans and rent rolls where applicable. In reaching a decision on whether to make a commercial real estate loan, we consider and review a cash flow analysis of the borrower and guarantor, when applicable, and considers the net operating income of the property, the borrower's expertise, credit history and profitability and the value of the underlying property. We have generally required that the properties securing these real estate loans have debt service coverage ratios (the ratio of earnings before debt service to debt service) of at least 1.2 times. An environmental report is obtained when the possibility exists that hazardous materials may have existed on the site, or the site may have been impacted by adjoining properties that handled hazardous materials.

*Commercial Business Loans.* Unlike residential mortgage loans, which generally are made on the basis of the borrower's ability to make repayment from his or her employment or other income, and which are secured by real property, the value of which tends to be more easily ascertainable, commercial business loans are of higher risk and typically are made on the basis of the borrower's ability to make repayment from the cash flow of the borrower's business. As a result, the availability of funds for the repayment of commercial business loans may depend substantially on the success of the business itself. Further, any collateral securing such loans may depreciate over time, may be difficult to appraise and may fluctuate in value.

*Consumer Loans.* Consumer loans may entail greater risk than do residential mortgage loans, particularly in the case of consumer loans that are unsecured or secured by assets that depreciate rapidly, such as motor vehicles. In the latter case, repossessed collateral for a defaulted consumer loan may not provide an adequate source of repayment for the outstanding loan and a small remaining deficiency often does not warrant further substantial collection efforts against the borrower. Consumer loan collections depend on the borrower's continuing financial stability, and therefore are likely to be adversely affected by various factors, including job loss, divorce, illness or personal bankruptcy. Furthermore, the application of various federal and state laws, including federal and state insolvency laws, may limit the amount that can be recovered on such loans.

*Loan Originations.* Loan originations come from a number of sources. The primary sources of loan originations are existing customers, walk-in traffic, advertising and referrals from customers. We also purchase participations in loans from local financial institutions to supplement our lending portfolio. Loan participations are subject to the same credit analysis and loan approvals as the loans we originate. We are permitted to review all of the documentation relating to any loan in which we participate. However, in a purchased participation loan, we do not service the loan and are subject to the policies and practices of the lead lender with regard to monitoring delinquencies, pursuing collections and instituting foreclosure proceedings.

*Loan Approval Procedures and Authority.* Our lending activities follow written, non-discriminatory, underwriting standards and loan origination procedures established by our board of directors and management. The board of directors has granted loan approval authority to certain officers or groups of officers up to prescribed limits, based on the officer's experience.

*Loans to One Borrower.* The maximum amount that we may lend to one borrower and the borrower's related entities generally is limited, by regulation, to 15% of the capital accounts of Peoples Bank. Capital accounts include the aggregate of capital, surplus, undivided profits, capital securities and reserve for loan losses. At December 31, 2017, our regulatory limit on loans to one borrower was \$32.8 million.

### *Deposit Activities*

Our primary source of funds is the cash flow provided by our financing activities, mainly deposit gathering. Other sources of funds are provided by investing activities, including principal and interest payments on loans and investment securities, and operating activities, primarily net income. We offer a variety of deposit accounts with a range of interest rates and terms, including, among others: money market accounts; NOW accounts; savings accounts; certificates of deposit; individual retirement accounts, and demand deposit accounts. These deposits are primarily obtained from areas surrounding our branch offices. We rely primarily on marketing, product innovation, technology, service and long-standing relationships with customers to attract and retain these deposits. Other deposit related services include: remote deposit capture; automatic clearing house transactions; cash management services; automated teller machines; point of sale transactions; safe deposit boxes; night depository services; direct deposit, and official check services.

### *Trust, Wealth Management and Brokerage Services*

Through our trust department, we offer a broad range of fiduciary and investment services. Our trust and investment services include:

- investment management
- IRA trustee services
- estate administration
- living trusts
- trustee under will
- guardianships
- life insurance trusts
- custodial services / IRA custodial services
- corporate trusts, and
- pension and profit sharing plans.

We provide a comprehensive array of wealth management products and services to individuals, small businesses and nonprofit entities. These products and services include the following, among others: investment portfolio management; estate planning; annuities; business succession planning; insurances; education funding strategies, and tax planning.

We have a third party marketing agreement with a broker-dealer that allows us to offer a full range of securities, brokerage services and annuity sales to our customers. Our investor services division is located in our headquarters building and the services are offered throughout the branch system. Through this relationship, our clients have access to a wide array of financial and wealth management strategies, including services such as professional money management, retirement and education planning, and investment products including stocks, bonds, mutual funds, annuities and insurance products.

### *Merchant Services*

We offer credit card processing and a variety of other products and services to our merchant customers, including:

- small business checking accounts

- merchant money market account
- online banking
- telephone banking
- business credit cards
- merchant line of credit
- financial checkup.

## **Competition**

We compete primarily with commercial banks, thrift institutions and credit unions, many of which are substantially larger in terms of assets and available resources. Certain of these institutions have significantly higher lending limits than we do, and may provide various services for their customers that we presently do not. In addition, we experience competition for deposits from mutual funds and security brokers, while consumer discount, mortgage and insurance companies compete for various types of loans. Credit unions, finance companies and mortgage companies enjoy certain competitive advantages over us, as they are not subject to the same regulatory restrictions and taxations as commercial banks. Principal methods of competing for bank products, permitted nonbanking services and financial activities include price, nature of product, quality of service and convenience of location.

In our market area, we expect continued competition from these financial institutions in the foreseeable future. With the continued acceptance of internet banking by our customers and consumers generally, competition for deposits has increased from institutions operating outside of our market area as well as from insurance companies.

We believe that our most significant competitive advantage originates from our business philosophy which includes offering direct access to senior management and other officers and providing friendly, informed and courteous service, local and timely decision making, flexible and reasonable operating procedures and consistently applied credit policies. In addition, our success has been, and will continue to be, a result of our emphasis on community involvement and customer relationships. With consolidation continuing in the financial industry, and particularly in our market area, community banks like us are gaining opportunities and market share as larger institutions reduce their emphasis on or exit the markets.

## **Seasonality**

Generally, our operations are not seasonal in nature. Our business activities, however, have been somewhat influenced by the recent increase in activities related to natural gas drilling in our market area.

## **Supervision and Regulation**

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

Peoples is a bank holding company within the meaning of the Bank Holding Company Act of 1956, as amended, and is subject to regulation, supervision, and examination by the Board of Governors of the Federal Reserve System, referred to as the "Federal Reserve Board" or the "FRB." We are required to file annual and quarterly reports with the FRB and to provide the FRB with such additional information as the FRB may require. The FRB also conducts examinations of Peoples.

With certain limited exceptions, we are required to obtain prior approval from the FRB before acquiring direct or indirect ownership or control of more than 5% of any voting securities or substantially all of the assets of a bank or bank holding

company, or before merging or consolidating with another bank holding company. Additionally, with certain exceptions, any person or entity proposing to acquire control through direct or indirect ownership of 25% or more of our voting securities is required to give 60 days' written notice of the acquisition to the FRB, which may prohibit the transaction, and to publish notice to the public.

Peoples Bank is regulated by the Pennsylvania Department of Banking and Securities (the "Department of Banking") and the FDIC. The Department of Banking may prohibit an institution over which it has supervisory authority from engaging in activities or investments that the agency believes constitute unsafe or unsound banking practices. Federal banking regulators have extensive enforcement authority over the institutions they regulate to prohibit or correct activities that violate law, regulation or a regulatory agreement or which are deemed to constitute unsafe or unsound practices.

Enforcement actions may include:

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

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

#### *Limitations on Dividends and Other Payments*

Our ability to pay dividends is largely dependent upon the receipt of dividends from Peoples Bank. Both federal and state laws impose restrictions on our ability and the ability of Peoples Bank to pay dividends. Under such restrictions, Peoples Bank may only declare and pay dividends out of accumulated net earnings, including accumulated net earnings acquired as a result of a merger within seven years. Further, Peoples Bank may not declare or pay any dividends unless Peoples Bank's surplus would not be reduced by the payment of the dividend below 100% of our capital stock. Pennsylvania law requires that each year Peoples Bank set aside as surplus, a sum equal to not less than 10 percent of its net earnings if surplus does not equal at least 100 percent of our capital stock. In addition to these specific restrictions, bank regulatory agencies, in general, also have the ability to prohibit proposed dividends by a financial institution that would otherwise be permitted under applicable regulations if the regulatory body determines that such distribution would constitute an unsafe or unsound practice.

#### *Permitted Non-Banking Activities*

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

Subsidiary banks of a bank holding company are subject to certain quantitative and qualitative restrictions on extensions of credit to the bank holding company or its subsidiaries, and on the use of their securities as collateral for loans to any borrower. These regulations and restrictions may limit our ability to obtain funds from Peoples Bank for our cash needs, including funds for the payment of dividends, interest and operating expenses. Further, subject to certain exceptions, a bank holding company and its subsidiaries are prohibited from engaging in certain tie-in arrangements in connection with any extension of credit, lease or sale of property or furnishing of services.

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

#### *Pennsylvania Law*

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

#### *Financial Institution Reform, Recovery, and Enforcement Act ("FIRREA")*

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

There are three levels of civil penalties under FIRREA, with the amount of the penalty varying based on the action penalized.

Criminal penalties can be \$1.1 million per violation and may be up to \$5.5 million for continuing violations or for the actual amount of gain or loss. These penalties may be combined with prison sentences of up to five years. These penalties are subject to adjustment in accordance with inflation adjustment procedures prescribed under applicable law.

#### *Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA")*

FDICIA provides for, among other things:

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

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

- "well capitalized";
- "adequately capitalized";
- "under capitalized";

- “significantly undercapitalized”; and
- “critically undercapitalized”.

Peoples Bank was “well capitalized” based on its actual capital position at December 31, 2017. However, an institution may be deemed by the regulators to be in a capitalization category that is lower than is indicated by its actual capital position if, among other things, it receives an unsatisfactory examination rating with respect to asset quality, management, earnings or liquidity.

Beginning January 1, 2015, all insured depository institutions were required to incorporate the revised regulatory capital requirements (see Supervision and Regulatory – Risk-Based Capital Requirements) into the prompt corrective action framework.

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

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

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

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

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

#### *Risk-Based Capital Requirements*

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

A banking organization's risk-based capital ratios are obtained by dividing its qualifying capital by its total risk adjusted assets. The regulators measure risk-adjusted assets, which include off-balance-sheet items, against both total qualifying capital, Common Equity Tier 1 capital, and Tier 1 capital.

- "Common Equity Tier 1 Capital" includes common equity and minority interest in equity accounts of consolidated subsidiaries, less goodwill and other intangibles, subject to certain exceptions, and retained earnings.
- "Tier 1", or core capital, includes common equity, non-cumulative preferred stock and minority interest in equity accounts of consolidated subsidiaries, less goodwill and other intangibles, subject to certain exceptions.
- "Tier 2", or supplementary capital, includes, among other things, limited life preferred stock, hybrid capital instruments, mandatory convertible securities, qualifying subordinated debt, and the allowance for loan and lease losses, subject to certain limitations and less restricted deductions. The inclusion of elements of Tier 2 capital is subject to certain other requirements and limitations of the federal banking agencies.

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:

- A minimum ratio of common equity tier 1 capital to risk-weighted assets of 4.5%.
- A minimum ratio of tier 1 capital to risk-weighted assets of 6%.
- A minimum ratio of total capital to risk-weighted assets of 8%.
- A minimum leverage ratio of 4%.

In addition, the final rules establish a common equity tier 1 capital conservation buffer of 2.5% of risk-weighted assets applicable to all banking organizations. If a banking organization fails to hold capital above the minimum capital ratios and the capital conservation buffer, it will be subject to certain restrictions on capital distributions and discretionary bonus payments. The phase-in period for the capital conservation and countercyclical capital buffers for all banking organizations began on January 1, 2016. Full phase-in occurs on January 1, 2019.

Under the proposed rules, accumulated other comprehensive income (AOCI) would have been included in a banking organization's common equity tier 1 capital. The final rules allow community banks to make a one-time election not to include these additional components of AOCI in regulatory capital and instead use the existing treatment under the general risk-based capital rules that excludes most AOCI components from regulatory capital. The opt-out election was required to be made in the first call report or FR Y-9 series report that is filed after the financial institution becomes subject to the final rule. On January 30, 2015, Peoples Board of Directors adopted a resolution to "opt-out" of the inclusion of the components of AOCI in regulatory capital.

The final rules permanently grandfather non-qualifying capital instruments (such as trust preferred securities and cumulative perpetual preferred stock) issued before May 19, 2010 for inclusion in the tier 1 capital of banking organizations with total consolidated assets less than \$15 billion as of December 31, 2009 and banking organizations that were mutual holding companies as of May 19, 2010.

Consistent with the Dodd-Frank Act, the new rules replace the ratings-based approach to securitization exposures, which is based on external credit ratings, with the simplified supervisory formula approach in order to determine the appropriate risk weights for these exposures. Alternatively, banking organizations may use the existing gross-up approach to assign securitization exposures to a risk weight category or choose to assign such exposures a 1,250 percent risk weight.

Under the new rules, mortgage servicing assets (MSAs) and certain deferred tax assets (DTAs) are subject to stricter limitations than those applicable under the current general risk-based capital rule. The new rules also increase the risk weights for past-due loans, certain commercial real estate loans, and some equity exposures, and makes selected other changes in risk weights and credit conversion factors.

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

- limitations on its ability to pay dividends;

- the issuance by the applicable regulatory authority of a capital directive to increase capital, and in the case of depository institutions, the termination of deposit insurance by the FDIC, as well as to the measures described under FDICIA as applicable to undercapitalized institutions.

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

At December 31, 2017, Peoples met its capital requirements with a ratio of common equity tier 1 capital to risk-weighted assets of 11.53%; its ratio of tier 1 capital to risk-weighted assets of 11.53%; its ratio of total capital to risk-weighted assets of 12.63%; and its leverage ratio of 9.68%.

#### *Interest Rate Risk*

Regulatory agencies include, in their evaluations of a bank's capital adequacy, an assessment of the bank's interest rate risk exposure. The standards for measuring the adequacy and effectiveness of a banking organization's interest rate risk management includes a measurement of board of directors and senior management oversight, and a determination of whether a banking organization's procedures for comprehensive risk management are appropriate to the circumstances of the specific banking organization. We utilize interest rate risk models to measure and monitor interest rate risk. In addition, we employ an independent consultant to provide a quarterly assessment of our interest rate risk. Finally, regulatory agencies, as part of the scope of their periodic examinations, evaluate our interest rate risk.

#### *Community Reinvestment Act ("CRA")*

The Community Reinvestment Act of 1977 is designed to create a system for bank regulatory agencies to evaluate a depository institution's record in meeting the credit needs of its community. The CRA regulations were completely revised as of July 1, 1995, to establish performance-based standards for use in examining for compliance. Peoples Bank had its last CRA compliance examination in 2016 and received a "satisfactory" rating.

#### *USA Patriot Act of 2001*

The Patriot Act contains anti-money laundering and financial transparency laws and imposes various regulations, including standards for verifying client identification at account opening, and rules to promote cooperation among financial institutions, regulators and law enforcement entities in identifying parties that may be involved in terrorism or money laundering.

#### *Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank)*

In 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act was signed into law. Dodd-Frank is intended to effect a fundamental restructuring of federal banking regulation. Among other things, Dodd-Frank created the Financial Stability Oversight Council to identify systemic risks in the financial system and gives federal regulators authority to take control of and liquidate financial firms. Dodd-Frank additionally created an independent federal regulator to administer federal consumer protection laws. Dodd-Frank has and is expected to continue to have a significant impact on our business operations as its provisions take effect. It is expected that, as various implementing rules and regulations continue to be released, they will increase our operating and compliance costs and could increase our interest expense. Among the provisions that affect us or are likely to affect us are the following:

*Holding Company Capital Requirements.*  Dodd-Frank requires the FRB to apply consolidated capital requirements to bank holding companies that are no less stringent than those currently applied to depository institutions. Under these standards, trust preferred securities will be excluded from Tier 1 capital unless such securities were issued prior to May 19, 2010, by a bank holding company with less than \$15 billion in assets. Dodd-Frank additionally requires that bank regulators issue countercyclical capital requirements so that the required amount of capital increases in times of economic expansion, consistent with safety and soundness.

*Deposit Insurance.*  Dodd-Frank permanently increases the maximum deposit insurance amount for banks, savings institutions and credit unions to \$250,000 per depositor. Dodd-Frank also broadens the base for FDIC insurance assessments. Further, Dodd-Frank eliminated the federal statutory prohibition against the payment of interest on business checking accounts. Assessments for institutions such as Peoples Bank (assets of less than \$10 billion), as of July 1, 2017, are based on initial assessment rates that are adjusted by combining supervisory ratings with financial ratios to determine a total assessment rate. For most institutions, assessment rates are based on weighted-average supervisory ratings of banking operation components and seven financial ratios. The financial ratios are: the leverage ratio; net income before taxes/total assets; nonperforming loans and leases/gross assets; other real estate owned/gross assets; brokered



deposits/total assets; a Loan Mix Index; and one-year asset growth rate. Net income before taxes is for the trailing 12 months and is adjusted for mergers that occurred during the measurement period. The one-year asset growth rate is adjusted for mergers and for acquisitions of failed banks. In addition, an institution's assessment rate may be lowered if the institution holds long-term unsecured debt and raised if it holds long-term unsecured debt that is issued by another depository institution.

*Corporate Governance.* Dodd-Frank requires publicly-traded companies to give stockholders a non-binding vote on executive compensation at least every three years, a non-binding vote regarding the frequency of the vote on executive compensation at least every six years, and a non-binding vote on “golden parachute” payments in connection with approvals of mergers and acquisitions unless previously voted on by stockholders. Additionally, Dodd-Frank directs the federal banking regulators to promulgate rules prohibiting excessive compensation paid to executives of depository institutions and their holding companies with assets of \$1.0 billion or more, regardless of whether the company is publicly traded. Dodd-Frank also gives the SEC authority to prohibit broker discretionary voting on elections of directors and executive compensation matters.

*Prohibition Against Charter Conversions of Troubled Institutions.* Dodd-Frank prohibits a depository institution from converting from a state to a federal charter, or vice versa, while it is the subject of a cease and desist order or other formal enforcement action or a memorandum of understanding with respect to a significant supervisory matter unless the appropriate federal banking agency gives notice of the conversion to the federal or state authority that issued the enforcement action and that agency does not object within 30 days. The notice must include a plan to address the significant supervisory matter. The converting institution must also file a copy of the conversion application with its current federal regulator, which must notify the resulting federal regulator of any ongoing supervisory or investigative proceedings that are likely to result in an enforcement action and provide access to all supervisory and investigative information relating thereto.

*Interstate Branching.* Dodd-Frank authorizes national and state banks to establish branches in other states to the same extent as a bank chartered by that state would be permitted. Previously, banks could only establish branches in other states if the host state expressly permitted out-of-state banks to establish branches in that state. Accordingly, banks are able to enter new markets more freely.

*Limits on Interstate Acquisitions and Mergers.* Dodd-Frank precludes a bank holding company from engaging in an interstate acquisition—the acquisition of a bank outside its home state—unless the bank holding company is both well capitalized and well managed. Furthermore, a bank may not engage in an interstate merger with another bank headquartered in another state unless the surviving institution will be well capitalized and well managed. The previous standard in both cases was adequately capitalized and adequately managed.

*Limits on Interchange Fees.* Dodd-Frank amended the Electronic Fund Transfer Act to, among other things, give the Federal Reserve the authority to establish rules regarding interchange fees charged for electronic debit transactions by payment card issuers having assets of \$10 billion or more and to enforce a statutory requirement that such fees be reasonable and proportional to the actual cost of a transaction to the issuer. The Federal Reserve issued its final rule, Regulation II, effective October 1, 2011. Consistent with Dodd-Frank, issuers with less than \$10 billion in assets, like us, are exempt from debit card interchange fee standards.

*Consumer Financial Protection Bureau.* Dodd-Frank created the Consumer Financial Protection Bureau (CFPB), which is granted broad rulemaking, supervisory and enforcement powers under various federal consumer financial protection laws, including the Equal Credit Opportunity Act, Truth in Lending Act, Real Estate Settlement Procedures Act, Fair Credit Reporting Act, Fair Debt Collection Act, Consumer Financial Privacy provisions of the Gramm-Leach-Bliley Act, and certain other statutes. The CFPB has examination and primary enforcement authority with respect to depository institutions with \$10 billion or more in assets. Smaller institutions are subject to rules promulgated by the CFPB, but continue to be examined and supervised by federal banking regulators for consumer compliance purposes. The CFPB has authority to prevent unfair, deceptive or abusive practices in connection with the offering of consumer financial products. Dodd-Frank authorizes the CFPB to establish certain minimum standards for the origination of residential mortgages including a determination of the borrower's ability to repay. In addition, Dodd-Frank allows borrowers to raise certain defenses to foreclosure if they receive any loan other than a “qualified mortgage” as defined by the CFPB. Dodd-Frank permits states to adopt consumer protection laws and standards that are more stringent than those adopted at the federal level and, in certain circumstances, permits state attorneys general to enforce compliance with both the state and federal laws and regulations.

*Ability to Repay and Qualified Mortgage Rule.* Pursuant to the Dodd Frank Act, the Consumer Financial Protection Bureau issued a final rule on January 10, 2013, which became effective January 10, 2014, amending Regulation Z as

implemented by the Truth in Lending Act, requiring mortgage lenders to make a reasonable and good faith determination based on verified and documented information that a consumer applying for a mortgage loan has a reasonable ability to repay the loan according to its terms. Mortgage lenders are required to determine consumers' ability to repay in one of two ways. The first alternative requires the mortgage lender to consider the following eight underwriting factors when making the credit decision:

- current or reasonably expected income or assets;
- current employment status;
- the monthly payment on the covered transaction;
- the monthly payment on any simultaneous loan;
- the monthly payment for mortgage-related obligations;
- current debt obligations, alimony, and child support;
- the monthly debt-to-income ratio or residual income; and
- credit history.

Alternatively, the mortgage lender can originate "qualified mortgages," which are entitled to a presumption that the creditor making the loan satisfied the ability-to-repay requirements. In general, a "qualified mortgage" is a mortgage loan without negative amortization, interest-only payments, balloon payments, or terms exceeding 30 years. In addition, to be a qualified mortgage, the points and fees paid by a consumer cannot exceed 3% of the total loan amount. Loans which meet these criteria will be considered qualified mortgages, and as a result generally protect lenders from fines or litigation in the event of foreclosure. Qualified mortgages that are "higher-priced" (e.g. subprime loans) garner a rebuttable presumption of compliance with the ability-to-repay rules, while qualified mortgages that are not "higher-priced" (e.g. prime loans) are given a safe harbor of compliance. The final rule, as issued, is not expected to have a material impact on our lending activities or our results of operations or financial condition.

#### *TILA/RESPA Integrated Disclosures (TRID)*

On October 3, 2015, the CFPB implemented a final rule combining the mortgage disclosures consumers previously received under TILA and RESPA. For more than 30 years, the TILA and RESPA mortgage disclosures had been administered separately by, respectively, the Federal Reserve Board and the U.S. Department of Housing and Urban Development. The final rule requires lenders to provide applicants with the new Loan Estimate and Closing Disclosure and generally applies to most closed-end consumer mortgage loans for which the creditor or mortgage broker receives an application on or after October 3, 2015.

#### *Future Legislation*

Proposed legislation is introduced in almost every legislative session that would dramatically affect the regulation of the banking industry. We cannot predict if any such legislation will be adopted nor if adopted how it would affect our business. Past history has demonstrated that new legislation or change to existing laws or regulations usually results in greater compliance burden and therefore generally increases the cost of doing business.

#### **Employees**

As of December 31, 2017, we had 388 full-time-equivalent employees. We are not parties to any collective bargaining agreements and we consider our employee relations to be good.

#### **Availability of Securities Filings**

We file annual, quarterly, and current reports, proxy statements, and other documents with the SEC under the Exchange Act. The public may read and copy any materials that we file with the SEC at the SEC's Public Reference Room at Station Place, 100 F Street, N.E., Washington, DC 20549. The public may obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. Also, the SEC maintains an Internet website that contains reports, proxy and information statements, and other information regarding issuers, including us, that file electronically with the SEC. The public can obtain any documents that we file with the SEC at <http://www.sec.gov>.

In addition, we maintain an Internet website at [www.psbt.com](http://www.psbt.com). We make available free of charge through the “Investor Relations” link on our Internet website, our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Exchange Act as soon as reasonably practicable after we electronically file such material with, or furnish it to, the SEC.

#### **Item 1A. Risk Factors.**

In addition to the other information set forth in this report, one should carefully consider the factors discussed below, which could materially affect our business, financial condition or future results. The risks described below are not the only risks that we face. Additional risks and uncertainties not currently known to us or that we currently deem to be insignificant also may materially adversely affect our business, financial condition and/or operating results.

##### **Risks Relating to Peoples and Its Business**

***We are subject to credit risk in connection with our lending activities, and our financial condition and results of operations may be negatively impacted by economic conditions and other factors that adversely affect our borrowers.***

Lending money is a significant part of the banking business and interest income on our loan portfolio is the principal component of our revenue. Our financial condition and results of operations are affected by the ability of our borrowers to repay their loans, and in a timely manner. Borrowers, however, do not always repay their loans. The risk of non-payment is assessed through our underwriting and loan review procedures based on several factors including credit risks of a particular borrower, changes in economic conditions, the duration of the loan and in the case of a collateralized loan, uncertainties as to the future value of the collateral and other factors. Despite our efforts, we do and will experience loan and lease losses, and our financial condition and results of operations will be adversely affected. Our loans which were between 30 and 89 days delinquent on December 31, 2017 totaled \$6.4 million. Our non-performing assets were approximately \$11.6 million on December 31, 2017, including \$1.0 million of loans acquired as part of the merger net of the remaining credit adjustment of \$0.9 million. Our allowance for loan and lease losses was approximately \$19.0 million on December 31, 2017.

***Our emphasis on the Eastern Pennsylvania and the Southern Tier of New York market area exposes us to a risk of loss associated with the region.***

At December 31, 2017, \$287.9 million or 17.0%, of our loan portfolio consisted of residential mortgage loans and \$786.2 million or 46.4%, of our loan portfolio consisted of commercial real estate loans. A majority of these loans are made to borrowers or secured by properties located in Eastern Pennsylvania and Broome County, New York. As a result of this concentration, a sustained downturn in the regional economy could significantly increase non-performing loans, which would hurt our net income. Future declines in real estate values in the region could also cause some of our mortgage and commercial real estate loans to be inadequately collateralized, which would expose us to a greater risk of loss if we seek to recover on defaulted loans by selling the real estate collateral.

***We make commercial and industrial, construction, and commercial real estate loans, which present greater risks than other types of loans.***

As of December 31, 2017, approximately 74.6% of our loan portfolio consisted of commercial and industrial, construction, and commercial real estate loans. These types of loans are generally viewed as having more risk of default than residential real estate loans or consumer loans. These types of loans are also typically larger than residential real estate loans and consumer loans. Because our loan portfolio contains a significant number of commercial and industrial, construction, and commercial real estate loans some of which have large balances, the deterioration of one or a few of these loans could cause a significant increase in non-performing loans. An increase in non-performing loans could result in a net loss of earnings from these loans, an increase in the provision for loan losses, and an increase in loan charge-offs, all of which could have a material adverse effect on our financial condition and results of operations.

The commercial real estate market is cyclical and poses risks of loss to us because of the concentration of commercial real estate loans in our loan portfolio, and the lack of diversity in risk associated with such a concentration. Banking regulators have been giving and continue to give commercial real estate lending greater scrutiny, and banks with larger commercial real estate loan portfolios are expected by their regulators to implement improved underwriting, internal

controls, risk management policies and portfolio stress-testing practices to manage risks associated with commercial real estate lending. Additional losses or regulatory requirements related to our commercial real estate loan concentration could materially adversely affect our business, financial condition and results of operations.

***Our allowance for loan and lease losses may not be adequate to absorb actual loan and lease losses, and we may be required to make further provisions for loan and lease losses and charge off additional loans in the future, which could materially and adversely affect our business.***

We attempt to maintain an allowance for loan and lease losses, established through a provision for loan and lease losses accounted for as an expense, which is adequate to absorb losses inherent in our loan portfolio. If our allowance for loan and lease losses is inadequate, it may have a material adverse effect on our financial condition and results of operations.

The determination of the allowance for loan and lease losses involves a high degree of subjectivity and judgment and requires us to make significant estimates of current credit risks and future trends, all of which may undergo material changes. Changes in economic conditions affecting borrowers, new information regarding existing loans, identification of additional problem loans and other factors, both within and outside of our control, may require us to increase our allowance for loan and lease losses. Increases in non-performing loans have a significant impact on our allowance for loan and lease losses. Our allowance for loan and lease losses may not be adequate to absorb actual loan and lease losses. If conditions in our regional real estate markets decline, we could experience increased delinquencies and credit losses, particularly with respect to real estate construction and land acquisition and development loans and one-to-four family residential mortgage loans. Moreover, if the current economic growth slows, the negative impact to our market areas could result in higher delinquencies and credit losses. As a result, we will continue to make provisions for loan and lease losses and to charge off additional loans in the future, which could materially adversely affect our financial conditions and results of operations.

In addition to our internal processes for determining loss allowances, bank regulatory agencies periodically review our allowance for loan and lease losses and may require us to increase the provision for loan and lease losses, to recognize further loan charge-offs, or to take other actions, based on judgments that differ from those of our management. If loan charge-offs in future periods exceed the allowance for loan and lease losses, we will need to increase our allowance for loan and lease losses. Furthermore, growth in our loan portfolio would generally lead to an increase in the provision for loan and lease losses. Provisions for loan and lease losses will result in a decrease in net income and capital, and may have a material adverse effect on our financial condition, and results of operations and cash flows.

***Changes in interest rates could adversely impact our financial condition and results of operations.***

Our ability to generate net income substantially depends upon our net interest income, which is the difference between the interest income earned on interest-earning assets, such as loans and investment securities, and the interest expense paid on interest-bearing liabilities, such as deposits and borrowings. Certain assets and liabilities react differently to changes in market interest rates. Further, interest rates on some types of assets and liabilities may fluctuate prior to changes in broader market interest rates, while rates on other types of assets may lag behind. Additionally, some assets such as adjustable-rate mortgages have features, and rate caps, which restrict changes in their interest rates.

Factors such as inflation, recession, unemployment, money supply, global disorder, terrorist activity, instability in domestic and foreign financial markets, and other factors beyond our control, may affect interest rates. Changes in market interest rates will also affect the level of voluntary prepayments on loans and the receipt of payments on mortgage-backed securities, resulting in the receipt of proceeds that may have to be reinvested at a lower rate than the loan or mortgage-backed security being prepaid. Although we pursue an asset-liability management strategy designed to manage our risk from changes in market interest rates, changes in interest rates can still have a material adverse effect on our profitability.

***Changes in interest rates could affect our investment values and impact comprehensive income and stockholders' equity.***

At December 31, 2017, we had approximately \$272.5 million of securities available-for-sale. These securities are carried at fair value on our consolidated balance sheets. Unrealized gains or losses on these securities, that is, the difference between the fair value and the amortized cost of these securities, are reflected in stockholders' equity, net of deferred

taxes. As of December 31, 2017, our available-for-sale securities had an unrealized loss, net of taxes, of \$1.0 million. The fair value of our available-for-sale securities is subject to interest rate change, which would not affect recorded earnings, but would increase or decrease comprehensive income and stockholders' equity.

***Our results of operations may be materially and adversely affected by other-than-temporary impairment charges relating to our investment portfolio.***

Numerous factors, including the lack of liquidity for re-sales of certain investment securities, the absence of reliable pricing information for investment securities, adverse changes in the business climate, adverse regulatory actions or unanticipated changes in the competitive environment, could have a negative effect on our investment portfolio in future periods. Investments are evaluated periodically to determine whether a decline in their value is other than temporary. Management utilizes criteria such as the magnitude and duration of the decline, in addition to the reasons underlying the decline, to determine whether the loss in value is other than temporary. The term "other than temporary" indicates that the prospects for a near term recovery of value are not necessarily favorable, or that there is a lack of evidence to support fair values equal to, or greater than, the carrying value of the investment.

Once a decline in value is determined to be other than temporary, the value of the security is reduced and a corresponding charge to earnings is recognized. If an impairment charge is significant enough, it could affect our ability to pay dividends, which could materially adversely affect us and our ability to pay dividends to shareholders. Significant impairment charges could also negatively impact our regulatory capital ratios and result in us not being classified as "well-capitalized" for regulatory purposes.

***The requirement to record certain assets and liabilities at fair value may adversely affect our financial results.***

We report certain assets, including available-for-sale investment securities, at fair value. Generally, for assets that are reported at fair value we use quoted market prices or valuation models that utilize market data inputs to estimate fair value. Because we record these assets at their estimated fair value, we may incur losses even if the asset in question presents minimal credit risk. The level of interest rates can impact the estimated fair value of investment securities. Disruptions in the capital markets may require us to recognize other-than-temporary impairments in future periods with respect to investment securities in our portfolio. The amount and timing of any impairment recognized will depend on the severity and duration of the decline in fair value of our investment securities and our estimation of the anticipated recovery period.

***Changes in the value of goodwill and intangible assets could reduce our earnings.***

We account for goodwill and other intangible assets in accordance with GAAP, which, in general, requires that goodwill not be amortized, but rather that it be tested for impairment at least annually at the reporting unit level using the two step approach. Testing for impairment of goodwill and intangible assets is performed annually and involves the identification of reporting units and the estimation of fair values. The estimation of fair values involves a high degree of judgment and subjectivity in the assumptions used. As of December 31, 2017, the market value of our shares exceeded the recorded book value, therefore goodwill is considered not impaired and no further testing is required. Changes in the local and national economy, the federal and state legislative and regulatory environments for financial institutions, the stock market, interest rates and other external factors (such as natural disasters or significant world events) may occur from time to time, often with great unpredictability, and may materially impact the fair value of publicly traded financial institutions and could result in an impairment charge at a future date.

***Our results of operations, financial condition or liquidity may be adversely impacted by issues arising from certain industry deficiencies in foreclosure practices, including delays and challenges in the foreclosure process.***

Over the past few years, foreclosure timelines have increased due to, among other reasons, delays associated with the significant increase in the number of foreclosure cases as a result of the economic downturn, federal and state legal and regulatory actions, including additional consumer protection initiatives related to the foreclosure process and voluntary and, in some cases, mandatory programs intended to permit or require lenders to consider loan modifications or other alternatives to foreclosure. Further increases in the foreclosure timeline may have an adverse effect on collateral values and our ability to minimize our losses.

***Difficult market conditions have adversely affected our industry.***

We are operating in a challenging economic environment, including generally uncertain national and local conditions. Additional concerns from some of the countries in the European Union and elsewhere have also strained the financial markets both abroad and domestically. Although there has been some improvement in the overall global macroeconomic conditions in 2017, financial institutions continue to be affected by conditions in the real estate market and the constrained financial markets. In recent years, declines in the housing market, increases in unemployment and under-employment have negatively impacted the credit performance of loans and resulted in significant write-downs of asset values by financial institutions. Reflecting concern over economic conditions, many lenders and institutional investors have reduced or ceased providing funding to borrowers. A worsening of economic conditions may impact our results of operations and financial condition. In particular, we may face the following risks in connection with these events:

- Loan delinquencies could increase further;
- Problem assets and foreclosures could increase further;
- Demand for our products and services could decline;
- Collateral for loans made by us, especially real estate, could decline further in value, in turn reducing a customer's borrowing power, and reducing the value of assets and collateral associated with our loans; and
- Investments in mortgage-backed securities could decline in value as a result of performance of the underlying loans or the diminution of the value of the underlying real estate collateral pressing the government sponsored agencies to honor its guarantees to principal and interest.

Our operations are concentrated in Eastern Pennsylvania and the Southern Tier of New York. As a result of this geographic concentration, our financial results may correlate to the economic conditions in our specific local market. Deterioration in economic conditions in this market area, particularly in the industries on which this geographic area depend, or a general decline in economic conditions may adversely affect the quality of our loan portfolio (including the level of non-performing assets, charge offs and provision expense) and demand for our products and services, and, accordingly, our results of operations.

***Strong competition within our market area may limit our growth and profitability.***

Competition in the banking and financial services industry is intense. We compete actively with other Pennsylvania and southern New York financial institutions, many larger than us, as well as with financial and non-financial institutions headquartered elsewhere. Commercial banks, savings banks, savings and loan associations, credit unions, and money market funds actively compete for deposits and loans. Such institutions, as well as consumer finance, insurance companies and brokerage firms, may be considered competitors with respect to one or more services they render. Many of the institutions with which we compete have substantially greater resources and lending limits and may offer certain services that we do not or cannot provide. Our profitability depends upon our ability to successfully compete in our market area.

***Increased needs for disbursement of funds on loans and deposits can affect our liquidity.***

We manage our liquidity with an objective of maintaining a balance between sources and uses of funds in such a way that the cash requirements of customers for loans and deposit withdrawals are met in the most economical manner. If we do not properly manage our liquidity, our business, financial condition, results of operations and cash flows may be materially and adversely affected.

***Our future pension plan costs and contributions could be unfavorably impacted by the factors that are used in the actuarial calculations.***

As part of the Pensco merger, we assumed Pensco's legacy non-contributory defined benefit pension plan, which was frozen by Pensco in 2008. The costs for this legacy pension plan are dependent upon a number of factors, such as the

rates of return on plan assets, discount rates, the level of interest rates used to measure the required minimum funding levels of the plans, future government regulation and required or voluntary contributions made to the plans. Without sustained growth in the pension investments over time to increase the value of our plan assets and depending upon the other factors impacting our costs as listed above, we could be required to fund the plan with higher amounts of cash than are anticipated by our actuaries. Such increased funding obligations could have a material impact on our liquidity by reducing our cash flows.

***Our holding company is dependent for liquidity on payments from Peoples Bank, which payments are subject to restrictions.***

We depend on dividends, distributions and other payments from Peoples Bank to fund dividend payments to our shareholders, if any, and to fund all payments on obligations of our holding company. Peoples Bank is subject to laws that restrict dividend payments or authorize regulatory bodies to block or reduce the flow of funds from Peoples Bank to us. Restrictions or regulatory actions of that kind could impede our access to funds that we may need to make payments on our obligations or dividend payments, if any. In addition, our right to participate in a distribution of assets upon a subsidiary's liquidation or reorganization is subject to the prior claims of the subsidiary's creditors. Holders of our common stock are entitled to receive dividends if and when declared from time to time by our board of directors in its sole discretion out of funds legally available for that purpose.

***We need to continually attract and retain qualified personnel for our operations.***

Our ability to provide high-quality customer service and to operate efficiently and profitably is dependent on our ability to attract and retain qualified individuals for key positions within the organization. We rely heavily on our executive officers and employees. The loss of certain executive officers or employees could have an adverse effect on us because, as a community bank, the executive officers and employees typically have more responsibility than would be typical at a larger financial institution with more employees. In addition, due to our size as a community bank, we have fewer management-level and other personnel who are in position to succeed to and assume the responsibilities of certain existing executive officers and employees. If we expand geographically or expand to provide non-banking services, current management may not have the necessary experience for successful operation in these new areas. There is no guarantee that management would be able to meet these new challenges or that we would be able to retain new directors or personnel with the appropriate background and expertise.

***Our financial performance may suffer if our information technology is unable to keep pace with growth or industry developments.***

Effective and competitive delivery of our products and services is increasingly dependent upon information technology resources and processes, both those provided internally as well as those provided through third party vendors. In addition to better serving customers, the effective use of technology increases efficiency and enables us to reduce costs. Our future success will depend, in part, upon our ability to address the needs of our customers by using technology to provide products and services to enhance customer convenience, as well as to create additional efficiencies in our operations. Many of our competitors have greater resources to invest in technological improvements. Additionally, as technology in the financial services industry changes and evolves, keeping pace becomes increasingly complex and expensive for us. There can be no assurance that we will be able to effectively implement new technology-driven products and services, which could reduce our ability to compete effectively.

***A failure in or a breach of our information systems or infrastructure, including as a result of cyber-attacks, could disrupt our business, damage our reputation, and could have a material adverse effect on our business, financial condition and results of operations.***

In the ordinary course of our business activities, including the ongoing maintenance of deposits, loan and other account relationships for our customers, receiving instructions and effecting transactions for those customers and other users of our products and services, we regularly collect, process, transmit and store significant amounts of confidential information regarding our customers, employees and others. In addition to confidential information regarding our customers, employees and others, we, and in some cases a third party, compile, process, transmit and store proprietary, non-public information concerning our business, operations, plans and strategies.

Information security risks have significantly increased in recent years in part because of the proliferation of new technologies, the use of the Internet and telecommunications technologies to conduct financial transactions, and the increased sophistication and activities of organized crime, hackers, terrorists and other external parties. We rely on digital technologies, computer and email systems, software, and networks to conduct secure processing, transmission and storage of confidential information. In addition, to access our products and services, our customers may use personal smart phones, tablet PCs and other mobile devices that are beyond our control systems. Our technologies, systems, networks and our customers' devices have been subject to, and are likely to continue to be the target of, cyber-attacks, computer viruses, malicious code, phishing attacks or information security breaches that could result in the unauthorized use, loss or destruction of our or our customers' or third parties' confidential information, or otherwise disrupt our or our customers' or other third parties' business operations.

In addition to cyber-attacks or other security breaches involving the theft of sensitive and confidential information, hackers recently have engaged in attacks against large financial institutions, particularly denial of service attacks, that are designed to disrupt key business services, such as customer-facing web sites. We are not able to anticipate or implement effective preventive measures against all security breaches of these types, especially because the techniques used change frequently and because attacks can originate from a wide variety of sources.

Although we use a variety of physical, procedural and technological safeguards to protect confidential information from mishandling, misuse or loss, these safeguards cannot provide assurance that mishandling, misuse or loss of the information will not occur, and that if mishandling, misuse or loss of the information did occur, those events will be promptly detected and addressed. A failure in or breach of our operational or information security systems, or those of a third-party service provider, as a result of cyber-attacks or information security breaches or otherwise could have a material adverse effect on our business, damage our reputation, increase our costs and/or cause significant losses. As information security risks and cyber threats continue to evolve, we may be required to expend substantial resources to further enhance our information security measures and/or to investigate and remediate any information security vulnerabilities.

If information security is breached, despite the controls we and our third-party vendors have instituted, information can be lost or misappropriated, resulting in financial loss or costs to us or damages to others. These costs or losses could materially exceed the amount of insurance coverage, if any, which would adversely affect our earnings. In addition, our reputation could be damaged which could result in loss of customers, greater difficulty in attracting new customers, or an adverse effect on the value of our common stock.

***Our disclosure controls and procedures and our internal control over financial reporting may not achieve their intended objectives.***

We maintain disclosure controls and procedures designed to ensure that we timely report information as specified in the rules and forms of the Securities and Exchange Commission. We also maintain a system of internal control over financial reporting. These controls may not achieve their intended objectives. Control processes that involve human diligence and compliance, such as our disclosure controls and procedures and internal control over financial reporting, are subject to lapses in judgment and breakdowns resulting from human failures. Controls can also be circumvented by collusion or improper management override. Because of such limitations, there are risks that material misstatements due to error or fraud may not be prevented or detected and that information may not be reported on a timely basis. If our controls are not effective, it could have a material adverse effect on our financial condition, results of operations, and market for our common stock, and could subject us to regulatory scrutiny.

***We are exposed to environmental liabilities with respect to real estate.***

We currently operate 27 branch offices, and own additional real estate. In addition, a significant portion of our loan portfolio is secured by real property. In the course of our business, we may foreclose, accept deeds in lieu of foreclosure, or otherwise acquire real estate, and in doing so could become subject to environmental liabilities with respect to these properties. We may become responsible to a governmental agency or third parties for property damage, personal injury, investigation and clean-up costs incurred by those parties in connection with environmental contamination, or may be required to investigate or clean-up hazardous or toxic substances, or chemical releases at a property. The costs associated with environmental investigation or remediation activities could be substantial. In addition, as the owner or former owner of a contaminated site, we may be subject to common law claims by third parties based on damages and costs resulting



from environmental contamination emanating from the property. Although we have policies and procedures to perform an environmental review before acquiring title to any real property, these may not be sufficient to detect all potential environmental hazards. If we were to become subject to significant environmental liabilities, it could materially and adversely affect us.

***The soundness of other financial services institutions may adversely affect our credit risk.***

We rely on other financial services institutions through trading, clearing, counterparty, and other relationships. We maintain limits and monitor concentration levels of our counterparties as specified in our internal policies. Our reliance on other financial services institutions exposes us to credit risk in the event of default by these institutions or counterparties. These losses could adversely affect our results of operations and financial condition.

***Our operations could be interrupted if certain external vendors on which we rely experience difficulty, terminate their services or fail to comply with applicable laws and regulations.***

We depend to a significant extent on relationships with third party service providers. Specifically, we utilize third party core banking services and receive credit card and debit card services, branch capture services, Internet banking services and services complementary to our banking products from various third party service providers. If these third party service providers experience difficulties or terminate their services and we are unable to replace them with other service providers, our operations could be interrupted. It may be difficult for us to replace some of our third party vendors, particularly vendors providing our core banking, credit card and debit card services, in a timely manner if they were unwilling or unable to provide us with these services in the future for any reason. If an interruption were to continue for a significant period of time, it could have a material adverse effect on our business, financial condition or results of operations. Even if we are able to replace them, it may be at higher cost to us, which could have a material adverse effect on our business, financial condition or results of operations. In addition, if a third party provider fails to provide the services we require, fails to meet contractual requirements, such as compliance with applicable laws and regulations, or suffers a cyber-attack or other security breach, our business could suffer economic and reputational harm that could have a material adverse effect on our business, financial condition or results of operations.

***Our use of third party vendors and our other ongoing third party business relationships are subject to increasing regulatory requirements and attention.***

We regularly use third party vendors as part of our business. We also have substantial ongoing business relationships with other third parties. These types of third party relationships are subject to increasingly demanding regulatory requirements and attention by our bank regulators. Recent regulation requires us to enhance our due diligence, ongoing monitoring and control over our third party vendors and other ongoing third party business relationships. We expect that our regulators will hold us responsible for deficiencies in our oversight and control of our third party relationships and in the performance of the parties with which we have these relationships. As a result, if our regulators conclude that we have not exercised adequate oversight and control over our third party vendors or other ongoing third party business relationships or that such third parties have not performed appropriately, we could be subject to enforcement actions, including civil money penalties or other administrative or judicial penalties or fines as well as requirements for customer remediation, any of which could have a material adverse effect on our business, financial condition or results of operations.

## **Risks Related to Our Common Stock**

***Our ability to pay dividends or repurchase shares is subject to limitations.***

The Pensco merger agreement contemplates that, unless 80 percent of our board of directors determines otherwise, we will pay a quarterly cash dividend in an amount no less than \$0.31 per share through 2018, provided that sufficient funds are legally available, and that Peoples and Peoples Bank remain “well-capitalized” in accordance with applicable regulatory guidelines.

Our ability to pay dividends on our stock depends upon our receipt of dividends from Peoples Bank and its subsidiaries. As a state-chartered bank, Peoples Bank is subject to regulatory restrictions on the payment and amounts of dividends under the Pennsylvania Banking Code.

Further, Peoples Bank's ability to pay dividends is also subject to its profitability, financial condition, capital expenditures and other cash flow requirements. There is no assurance that Peoples Bank will be able to pay the dividends contemplated by the Pensco merger agreement or other dividends. Our failure to pay dividends could have a material adverse effect on the market price of our common stock.

***Proxy contests and shareholder litigation may adversely affect our results of operations.***

Proxy contests or shareholder litigation could cause us to use resources, both in expense and in the time and attention of our management, which could otherwise be used in operating our business. Accordingly, our results of operations may be adversely effected.

**Risks Related to Potential Future Transactions**

***Future acquisitions by us could dilute existing shareholders' ownership of Peoples and may cause us to become more susceptible to adverse economic events.***

We may issue shares of our common stock in connection with future acquisitions and other investments, which would dilute existing shareholders' ownership interests in Peoples. While there is no assurance that these transactions will occur, or that they will occur on terms favorable to us, future business acquisitions could be material to us, and the degree of success achieved in acquiring and integrating these businesses could have a material effect on the value of our common stock. In addition, these acquisitions could require us to expend substantial cash or other liquid assets or to incur debt, which could cause us to become more susceptible to economic downturns and competitive pressures.

***Our governing documents, Pennsylvania law, and current policies of our board of directors contain provisions which may reduce the likelihood of a change in control transaction that may otherwise be available and attractive to shareholders.***

Our articles of incorporation and bylaws contain certain anti-takeover provisions that may make it more difficult or expensive or may discourage a tender offer, change in control or takeover attempt that is opposed by our board of directors. In particular, the articles of incorporation and bylaws: classify our board of directors into three groups, so that shareholders elect only approximately one-third of the board each year; require our shareholders to give us advance notice to nominate candidates for election to the board of directors or to make shareholder proposals at a shareholders' meeting; and require the affirmative vote of the holders of at least 75% of our common stock to approve amendments to our bylaws or to approve certain business combinations that have not received the support of two-thirds of our board of directors. These provisions of our articles of incorporation and bylaws could discourage potential acquisition proposals and could delay or prevent a change in control, even though a majority of our shareholders may consider such proposals desirable. Such provisions could also make it more difficult for third parties to remove and replace the members of our board of directors. Moreover, these provisions could diminish the opportunities for shareholders to participate in certain tender offers, including tender offers at prices above the then-current market value of our common stock, and may also inhibit increases in the trading price of our common stock that could result from takeover attempts or speculation.

In addition, anti-takeover provisions in Pennsylvania law could make it more difficult for a third party to acquire control of us. These provisions could adversely affect the market price of our common stock and could reduce the amount that shareholders might receive if we are sold. For example, Pennsylvania law may restrict a third party's ability to obtain control of Peoples and may prevent shareholders from receiving a premium for their shares of our common stock. Pennsylvania law also provides that our shareholders are not entitled by statute to propose amendments to our articles of incorporation.

***Our ability to make opportunistic acquisitions is subject to significant risks, including the risk that regulators will not provide the requisite approvals.***

We may make opportunistic whole or partial acquisitions of other banks, branches, financial institutions, or related businesses from time to time that we expect may further our business strategy. Any possible acquisition will be subject to regulatory approval, and there can be no assurance that we will be able to obtain such approval in a timely manner or at all. Even if we obtain regulatory approval, these acquisitions could involve numerous risks, including lower than expected performance or higher than expected costs, difficulties related to integration, diversion of management's

attention from other business activities, changes in relationships with customers, and the potential loss of key employees. In addition, we may not be successful in identifying acquisition candidates, integrating acquired institutions, or preventing deposit erosion or loan quality deterioration at acquired institutions. Competition for acquisitions can be highly competitive, and we may not be able to acquire other institutions on attractive terms. There can be no assurance that we will be successful in completing or will even pursue future acquisitions, or if such transactions are completed, that we will be successful in integrating acquired businesses into operations. Our ability to grow may be limited if we choose not to pursue or are unable to successfully make acquisitions in the future.

### **Risks Related to Government Regulation**

#### ***We operate in a highly regulated environment and may be adversely affected by changes in laws and regulations.***

We are subject to extensive regulation, supervision and examination by certain state and federal agencies including the Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System and the Pennsylvania Department of Banking and Securities. Such regulation and supervision govern the activities in which we may engage and are intended primarily to ensure the safety and soundness of financial institutions. Regulatory authorities have extensive discretion in their supervisory and enforcement activities, including the imposition of restrictions on operations, the classification of assets and determination of the level of the allowance for loan losses. Any change in such regulation and oversight, whether in the form of regulatory policy, regulations, legislation or supervisory action, may have a material impact on us and our operations. There also are several federal and state statutes which regulate the obligation and liabilities of financial institutions pertaining to environmental issues. In addition to the potential for attachment of liability resulting from our own actions, we may be held liable under certain circumstances for the actions of our borrowers, or third parties, when such actions result in environmental problems on properties that collateralize loans held by us. Further, the liability has the potential to far exceed the original amount of a loan.

#### ***We will be subject to more stringent capital and liquidity requirements in the future, which may adversely affect our net income and future growth.***

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. U.S. implementation of Basel III will lead to significantly higher capital requirements and more restrictive leverage and liquidity ratios than those currently in place.

Future increases in minimum capital requirements could adversely affect our net income. Furthermore, our failure to comply with the minimum capital requirements could result in our regulators taking formal or informal actions against us which could restrict our future growth or operations.

#### ***The Dodd-Frank Act, among other things, created the Consumer Financial Protection Bureau and has resulted and will result in new regulations that are expected to increase our costs of operations.***

On July 21, 2010, the Dodd-Frank Act became law. This law continues to have a significant impact on the bank regulatory structure and the lending, deposit, investment, trading and operating activities of financial institutions and their holding companies. The Dodd-Frank Act requires various federal agencies to adopt a broad range of new implementing rules and regulations, and to prepare numerous studies and reports for Congress. The federal agencies are given significant discretion in drafting the implementing rules and regulations, and consequently, many of the details and much of the impact of the Dodd-Frank Act may not be known for many years.

The Dodd-Frank Act created a new Consumer Financial Protection Bureau with broad powers to supervise and enforce consumer protection laws. The Consumer Financial Protection Bureau has broad rule-making authority for a wide range of consumer protection laws that apply to all banks and savings institutions, including the authority to prohibit “unfair, deceptive or abusive” acts and practices. The Consumer Financial Protection Bureau has examination and enforcement authority over all banks and savings institutions with more than \$10 billion in assets. Banks with \$10 billion or less in assets, like us, will continue to be examined for compliance with the consumer laws by their primary bank regulators. Dodd-Frank permits states to adopt consumer protection laws and standards that are more stringent than those adopted at the federal level and, in certain circumstances, permits state attorneys general to enforce compliance with both the state and federal laws and regulations.

#### ***Increases in FDIC insurance premiums may adversely affect our earnings.***

Our deposits are insured by the FDIC up to legal limits and, accordingly, we are subject to FDIC deposit insurance assessments. In order to maintain a strong funding position and restore reserve ratios of the deposit insurance fund

depleted during the financial crisis, the FDIC has increased assessment rates of insured institutions. Under the Dodd-Frank Act, the FDIC must undertake several initiatives that will result in higher deposit insurance fees being paid to the FDIC. We are generally unable to control the amount of premiums that we are required to pay for FDIC insurance. Any future increases or required prepayments of FDIC insurance premiums or special assessments may adversely impact our earnings.

***Regulations relating to privacy, information security and data protection could increase our costs, affect or limit how we collect and use personal information and adversely affect our business opportunities.***

We are subject to various privacy, information security and data protection laws, including requirements concerning security breach notification, and we could be negatively impacted by these laws. For example, our business is subject to the Gramm-Leach-Bliley Act which, among other things: (i) imposes certain limitations on our ability to share nonpublic personal information about our customers with nonaffiliated third parties; (ii) requires that we provide certain disclosures to customers about our information collection, sharing and security practices and afford customers the right to “opt out” of any information sharing by us with nonaffiliated third parties (with certain exceptions) and (iii) requires we develop, implement and maintain a written comprehensive information security program containing safeguards appropriate based on our size and complexity, the nature and scope of our activities, and the sensitivity of customer information we process, as well as plans for responding to data security breaches. Various state and federal banking regulators and states have also enacted data security breach notification requirements with varying levels of individual, consumer, regulatory or law enforcement notification in certain circumstances in the event of a security breach. Moreover, legislators and regulators in the United States are increasingly adopting or revising privacy, information security and data protection laws that potentially could have a significant impact on our current and planned privacy, data protection and information security-related practices, our collection, use, sharing, retention and safeguarding of consumer or employee information, and some of our current or planned business activities. This could also increase our costs of compliance and business operations and could reduce income from certain business initiatives. This includes increased privacy-related enforcement activity at the federal level, by the Federal Trade Commission, as well as at the state level, such as with regard to mobile applications.

Compliance with current or future privacy, data protection and information security laws (including those regarding security breach notification) affecting customer or employee data to which we are subject could result in higher compliance and technology costs and could restrict our ability to provide certain products and services, which could have a material adverse effect on our business, financial conditions or results of operations. Our failure to comply with privacy, data protection and information security laws could result in potentially significant regulatory or governmental investigations or actions, litigation, fines, sanctions, increased insurance cost and damage to our reputation, which could have a material adverse effect on our business, financial condition or results of operations.

**Item 1B. Unresolved Staff Comments.**

None.

**Item 2. Properties.**

Our corporate headquarters is located at 150 N. Washington Avenue, Scranton, Pennsylvania, which houses our finance and planning, trust, commercial lending, marketing, human resources and investor services divisions, as well as our executive offices. Our operations division is located at 82 Franklin Avenue, Hallstead, Pennsylvania.

We operate 27 full-service community banking offices located within the Lackawanna, Lehigh, Luzerne, Monroe, Montgomery, Northampton, Susquehanna, Wayne and Wyoming Counties of Pennsylvania and Broome County of New York. Seven offices are leased and the balance are owned by Peoples Bank.

We lease several remote ATM locations throughout our market area. All branches and ATM locations are equipped with closed circuit television monitoring.

We consider our properties to be suitable and adequate for our current and immediate future purposes.

**Item 3. Legal Proceedings.**

There are no material pending legal proceedings, other than ordinary routine litigation incidental to our business, as to which we are a party or of which any of our property is subject.

**Item 4. Mine Safety Disclosures.**

Not applicable.

**Part II**

**Item 5. Market for Registrant’s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities.**

As of February 28, 2018, there were approximately 3,530 holders of our common stock, \$2.00 par value, including individual participants in security position listings. Our common stock trades on The Nasdaq Stock Market under the symbol “PFIS.”

Peoples has paid cash dividends since its incorporation in 1986. Our 2013 Pensco merger agreement states that, unless 80% of our board of directors determines otherwise, we will pay a quarterly cash dividend in an amount no less than \$0.31 per share through 2018, provided that sufficient funds are legally available, and that Peoples and Peoples Bank remain “well-capitalized” in accordance with applicable regulatory guidelines. The payment of future dividends must necessarily depend upon earnings, financial position, appropriate restrictions under applicable laws and other factors relevant at the time our board of directors considers any declaration of dividends. For information on dividend restrictions on the Company and Peoples Bank, refer to Part I, Item 1 “Supervision and Regulation – Limitations on Dividends and Other Payments” to this report and refer to the consolidated financial statements and notes to these statements filed at Item 8 to this report and incorporated in their entirety by reference under this Item 5.

The high and low closing sale prices and dividends per share of the Company's common stock for the four quarters of 2017 and 2016 are summarized in the following table:

	2017			2016		
	Low	High	Dividends Declared	Low	High	Dividends Declared
First Quarter	\$ 39.66	\$ 49.57	\$ 0.31	\$ 33.22	\$ 38.77	\$ 0.31
Second Quarter	39.32	45.00	0.31	35.56	40.55	0.31
Third Quarter	39.25	49.00	0.32	37.93	40.76	0.31
Fourth Quarter	\$ 44.04	\$ 51.06	\$ 0.32	\$ 39.17	\$ 50.04	\$ 0.31

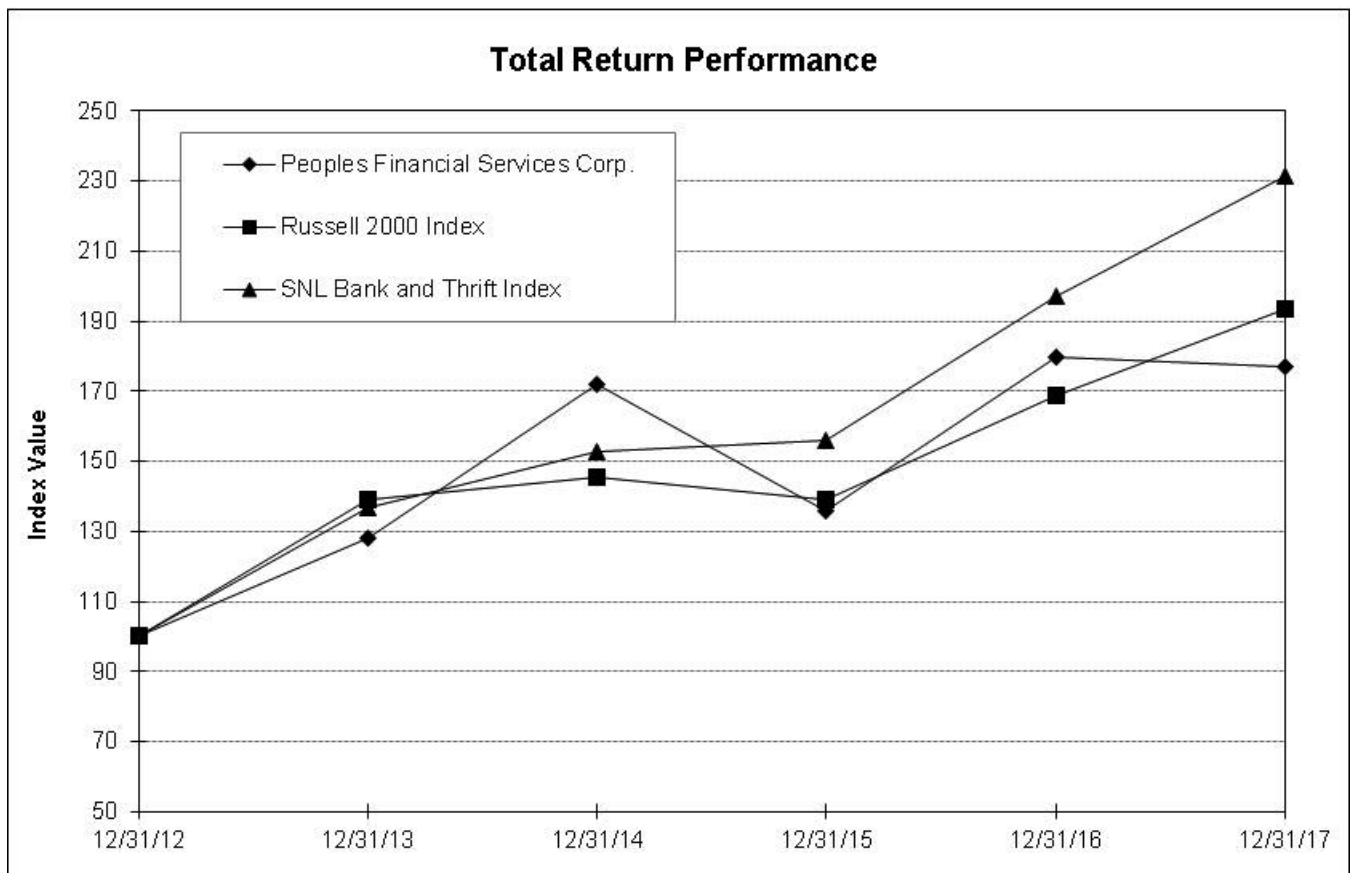
The following table presents information with respect to purchases made by or on behalf of the Company or any "affiliated purchaser," as defined in the Exchange Act Rule 10b-18(a)(3), of the Company's common stock during each of the three months ended December 31, 2017:

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
October 31, 2017		\$		225,000
November 30, 2017		\$		225,000
December 31, 2017		\$		225,000

- (1) On April 28, 2017, our board of directors reauthorized a common stock repurchase plan whereby we were authorized to repurchase up to 225,000 shares of our outstanding common stock through open market purchases.

The following graph and table show the cumulative total return on the common stock of the Company over the last five years, compared with the cumulative total return of a broad stock market index (the Russell 2000 Index or “Russell 2000”), and the SNL Bank and Thrift Index. The SNL Bank and Thrift Index replaced the index for The NASDAQ Bank Stocks that was used in previous years. The cumulative total return on the stock or the index equals the total increase in value since December 31, 2012, assuming reinvestment of all dividends paid into the stock or the index. The graph and table were prepared assuming that \$100 was invested on December 31, 2012, in the common stock and the securities included in the indexes.

**Comparison of Five-Year Cumulative Total Returns**  
Performance Graph of  
PEOPLES FINANCIAL SERVICES CORP



<i>Index</i>	<i>Period Ending</i>					
	<u>12/31/2012</u>	<u>12/31/2013</u>	<u>12/31/2014</u>	<u>12/31/2015</u>	<u>12/31/2016</u>	<u>12/31/2017</u>
Peoples Financial Services Corp.	100.00	128.05	171.95	136.05	179.64	176.89
Russell 2000 Index	100.00	138.82	145.62	139.19	168.85	193.58
SNL Bank and Thrift Index	100.00	136.92	152.85	155.94	196.86	231.49

Source: S&P Global Market Intelligence  
©2017

## Item 6. Selected Financial Data.

### Consolidated Selected Financial Data

(Dollars in thousands, except per share data)

Year Ended December 31	2017	2016	2015	2014	2013
<b>Condensed statements of financial performance:</b>					
Interest income	\$ 74,242	\$ 68,984	\$ 63,041	\$ 63,956	\$ 37,370
Interest expense	8,698	7,251	6,037	6,642	4,169
Net interest income	65,544	61,733	57,004	57,314	33,201
Provision for loan losses	4,800	5,000	3,700	3,524	2,361
Net interest income after provision for loan losses	60,744	56,733	53,304	53,790	30,840
Noninterest income	17,186	15,888	15,719	15,251	11,762
Noninterest expense	51,293	48,030	46,779	45,933	36,396
Income before income taxes	26,637	24,591	22,244	23,108	6,206
Provision for income tax expense	8,180	5,008	4,521	5,459	485
Net income	\$ 18,457	\$ 19,583	\$ 17,723	\$ 17,649	\$ 5,721
<b>Condensed statements of financial position:</b>					
Investment securities	\$ 281,822	\$ 269,927	\$ 297,044	\$ 354,251	\$ 317,010
Net loans	1,674,105	1,517,004	1,327,890	1,199,556	1,167,966
Other assets	213,104	212,511	194,124	187,862	203,245
Total assets	\$ 2,169,031	\$ 1,999,442	\$ 1,819,058	\$ 1,741,669	\$ 1,688,221
Deposits	\$ 1,719,018	\$ 1,588,757	\$ 1,455,810	\$ 1,425,558	\$ 1,379,507
Short-term borrowings	123,675	82,700	38,325	19,557	22,052
Long-term debt	49,734	58,134	60,354	33,140	36,743
Other liabilities	11,628	13,233	15,801	16,635	11,127
Stockholders' equity	264,976	256,618	248,768	246,779	238,792
Total liabilities and stockholders' equity	\$ 2,169,031	\$ 1,999,442	\$ 1,819,058	\$ 1,741,669	\$ 1,688,221
<b>Per share data:</b>					
Net income	\$ 2.50	\$ 2.65	\$ 2.36	\$ 2.34	\$ 1.21
Cash dividends declared	1.26	1.24	1.24	1.24	1.23
Stockholders' equity	\$ 35.82	\$ 34.71	\$ 33.57	\$ 32.69	\$ 31.62
Cash dividends declared as a percentage of net income	50.40 %	46.79 %	52.54 %	53.03 %	96.33 %
Average common shares outstanding	7,395,837	7,396,716	7,516,451	7,548,825	4,733,059
<b>Selected ratios (based on average balances):</b>					
Net income as a percentage of total assets	0.90 %	1.02 %	1.02 %	1.03 %	0.58 %
Net income as a percentage of stockholders' equity	7.02	7.64	7.13	7.29	4.01
Stockholders' equity as a percentage of total assets	12.77	13.36	14.26	14.12	14.43
Tier I capital as a percentage of adjusted total assets	9.94	10.16	10.80	10.76	10.12
Net interest income as a percentage of earning assets	3.69	3.77	3.81	3.86	3.91
Loans, net, as a percentage of deposits	96.50 %	95.81 %	87.55 %	84.13 %	87.72 %
<b>Selected ratios and data (based on period end balances):</b>					
Tier I capital as a percentage of risk-weighted assets	11.85 %	12.49 %	13.52 %	14.75 %	13.62 %
Total capital as a percentage of risk-weighted assets	12.95	13.51	14.47	15.61	14.29
Allowance for loan losses as a percentage of loans, net	1.12	1.04	0.97	0.85	0.74
Nonperforming loans as a percentage of loans, net	0.67 %	0.90 %	0.86 %	0.85 %	1.60 %

Note: Average balances were calculated using average daily balances. Average balances for loans include nonaccrual loans. Tax-equivalent adjustments were calculated using the prevailing statutory tax rate of 35.0% for the years 2017, 2016, 2015 and 2014 and 34.0% for the year 2013.



## **Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations.**

### **Management’s Discussion and Analysis 2017 versus 2016 (Dollars in thousands, except per share data)**

Management’s Discussion and Analysis appearing on the following pages should be read in conjunction with the Consolidated Financial Statements and Management’s Discussion and Analysis 2016 versus 2015 contained in this Annual Report on Form 10-K.

#### **Forward-Looking Discussion:**

In addition to the historical information contained in this document, the discussion presented may contain and, from time to time, may make, certain statements that constitute forward-looking statements. Words such as “expects,” “anticipates,” “believes,” “estimates” and other similar expressions or future or conditional verbs such as “will,” “should,” “would” and “could” are intended to identify such forward-looking statements. These statements are not historical facts, but instead represent the current expectations, plans or forecasts of Peoples Financial Services Corp. and its subsidiaries regarding its future operating results, financial position, asset quality, credit reserves, credit losses, capital levels, dividends, liquidity, service charges, cost savings, effective tax rate, impact of changes in fair value of financial assets and liabilities, impact of new accounting and regulatory guidance, legal proceedings and other matters relating to us and the securities that we may offer from time to time. These statements are not guarantees of future results or performance and involve certain risks, uncertainties and assumptions that are difficult to predict, change over time and are often beyond our control. Actual outcomes and results may differ materially from those expressed in, or implied by, forward-looking statements.

You should not place undue reliance on any forward-looking statement and should consider the uncertainties and risks discussed in the “Risk Factors” in Part I, Item 1A of this Annual Report, among others, and in any of our subsequent Securities and Exchange Commission (“SEC”) filings. Forward-looking statements speak only as of the date they are made, and we undertake no obligation to update any forward-looking statement to reflect the impact of circumstances or events that arise after the date the forward-looking statement was made. 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 have been reclassified to conform with the current year’s presentation.

#### **Critical Accounting Policies:**

Our consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States of America (“GAAP”). The preparation of consolidated financial statements in conformity with GAAP requires us to establish critical accounting policies and make accounting estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the consolidated financial statements, as well as the reported amounts of revenues and expenses during those reporting periods.

For a discussion of the recent Accounting Standards Updates (“ASU”) issued by the Financial Accounting Standards Board (“FASB”) refer to Note 1 entitled “Summary of significant accounting policies — Recent accounting standards,” in the Notes to Consolidated Financial Statements included in Part II, Item 8 of this Annual Report.

An accounting estimate requires assumptions about uncertain matters that could have a material effect on the consolidated financial statements if a different amount within a range of estimates were used or if estimates changed from period to period. Readers of this report should understand that estimates are made considering facts and circumstances at a point in time, and changes in those facts and circumstances could produce results that differ from when those estimates were made. Significant estimates that are particularly susceptible to material change within the near term relate to the determination of allowance for loan losses, determination of other-than-temporary impairment of investment securities, fair value of financial instruments, the valuation of real estate acquired in connection with foreclosures or satisfaction of loans, the valuation of deferred tax assets, the valuation of acquired assets and liabilities assumed in business combinations, and the impairment of goodwill. Actual amounts could differ from those estimates.

We maintain the allowance for loan losses at a level we believe adequate to absorb probable credit losses related to individually evaluated loans, as well as probable incurred losses inherent in the remainder of the loan portfolio as of the balance sheet date. The balance in the allowance for loan losses account is based on past events and current economic conditions among other things.

The allowance for loan losses account consists of an allocated element and an unallocated element. The allocated element consists of a specific portion for the impairment of loans individually evaluated and a formula portion for loss contingencies on those loans collectively evaluated. The unallocated element, if any, is used to cover inherent losses that exist as of the evaluation date, but which have not been identified as part of the allocated allowance using our impairment evaluation methodology due to limitations in the process.

We monitor the adequacy of the allocated portion of the allowance quarterly and adjust the allowance as necessary through normal operations. This ongoing evaluation reduces potential differences between estimates and actual observed losses. The determination of the level of the allowance for loan losses is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available. Accordingly, management cannot ensure that charge-offs in future periods will not exceed the allowance for loan losses or that additional increases in the allowance for loan losses will not be required, resulting in an adverse impact on operating results.

In determining the requirement to record an other-than-temporary impairment on securities owned by us, four main characteristics are considered including: (i) the length of time and the extent to which the fair value has been less than amortized cost; (ii) the financial condition and near-term prospects of the issuer; (iii) whether the market decline was affected by macroeconomic conditions and (iv) whether the Company has the intent to sell the debt security or more likely than not will be required to sell the debt security before its anticipated recovery. The assessment of whether an other-than-temporary impairment exists involves a high degree of subjectivity and judgment and is based on information available to us at a point in time.

Fair values of financial instruments, in cases where quoted market prices are not available, are based on estimates using present value or other valuation techniques which are subject to change.

Real estate acquired in connection with foreclosures or in satisfaction of loans is adjusted to fair value based upon current estimates derived through independent appraisals less cost to sell. However, proceeds realized from sales may ultimately be higher or lower than those estimates.

Deferred tax assets and liabilities are recognized for the estimated future tax effects of temporary differences by applying enacted statutory tax rates to differences between the financial statement carrying amounts and the tax bases of existing assets and liabilities. The amount of deferred tax assets is reduced, if necessary, to the amount that, based on available evidence, will more likely than not be realized. As changes in tax laws or rates are enacted, deferred tax assets and liabilities are adjusted through the provision for income taxes.

The acquired assets and liabilities assumed in business combinations are measured at fair value as of the acquisition date. In many cases, determining the fair value of the acquired assets and assumed liabilities requires the Company to estimate cash flows expected to result from those assets and liabilities and to discount those cash flows at appropriate rates of interest, which required the utilization of significant estimates and judgment in accounting for the acquisition.

Goodwill is evaluated at least annually for impairment or more frequently if conditions indicate potential impairment exist. Any impairment losses arising from such testing are reported in the income statement in the current period as a separate line item within operations.

For a further discussion of our critical accounting policies, refer to Note 1 entitled, "Summary of significant accounting policies," in the Notes to Consolidated Financial Statements to this Annual Report. Note 1 lists the significant accounting policies used by us in the development and presentation of the consolidated financial statements. This discussion and analysis, the Notes to Consolidated Financial Statements and other financial statement disclosures identify and address key variables and other qualitative and quantitative factors that are necessary for the understanding and evaluation of our financial position, results of operations and cash flows.

## Operating Environment:

The United States economy continued to show signs of expansion in 2017, as the gross domestic product (“GDP”), the value of all goods and services produced in the Nation, came in at an annual rate of 2.5 percent (estimated) in the fourth quarter. This comes on the heels of a third quarter reading of 3.2 percent in real GDP. The economy grew at 1.6 percent for all of 2016, the worst performance since 2011, after growing at a rate of 2.6 percent in 2015. The Federal Reserve Board’s Federal Open Market Committee (“FOMC”) increased the federal funds rate three times in 2017 ending the year at a range of 1.25% to 1.50%. In raising the key target range for the federal funds rate, the FOMC noted strong labor markets and below target inflation. FOMC officials expect inflation to stabilize around their 2.0 percent objective over the “medium term”. The median forecast is for a federal funds rate of 2.125 percent by year-end 2018, implying that there will be three additional rate hikes in 2018.

Inflation picked up somewhat in 2017, as the consumer price index (“CPI”) registered 2.1 percent for 2017, just eclipsing the FOMC’s benchmark of 2.0 percent. The CPI was 2.1 percent in 2016 as well. Core personal consumption expenditure price index, which ignores food and energy, averaged 1.8 percent in 2017.

On a national level, employment conditions improved in 2017. The civilian labor force increased 1.4 million, while the number of people employed increased 1.8 million in 2017. As a result, the annual unemployment rate for the U.S. fell in 2017 when compared to 2016. All sectors of employment, with the exception of the private sector, reported employment gains from the end of 2016.

National, Pennsylvania, New York and our market area’s non-seasonally-adjusted annual unemployment rates in 2017 and 2016, are summarized as follows:

	2017	2016
United States	4.4 %	4.9 %
New York (statewide)	4.6	4.8
Pennsylvania (statewide)	4.9	5.4
Broome County	5.5	5.4
Bucks County	4.2	4.6
Lackawanna County	5.1	5.7
Lehigh County	5.1	5.4
Luzerne County	5.9	6.4
Monroe County	5.9	6.3
Montgomery County	3.8	4.2
Northampton County	4.9	5.2
Susquehanna County	4.7	5.7
Wayne County	5.1	5.9
Wyoming County	5.2 %	6.2 %

Employment conditions improved for both the Commonwealth of Pennsylvania and New York State in 2017 as evidenced by a decrease in their respective unemployment rates. With respect to the markets we serve, the unemployment rate decreased in all but one of the counties in which we have branches or ATM locations. The lowest unemployment rate in 2017, for all of the counties we serve, was Montgomery County at 3.8 percent.

With respect to the banking industry, net income for all Federal Deposit Insurance Corporation (“FDIC”)-insured banks in 2017 totaled \$164.8 billion, a decrease of \$6.0 billion or 3.5 percent from 2016. Approximately 56.2 percent of all institutions reported higher net income in 2016, while only 5.4 percent reported net losses, a slight uptick from last year’s reported 4.2 percent unprofitable institutions. Loan loss provisions of \$51.1 billion in 2017 were \$3.0 billion or 6.2 percent more than banks set aside in 2016. This is the third consecutive year that loan loss provisions have been higher than the preceding year. Net interest income increased for the fourth year in a row, by \$37.7 billion or 8.2 percent. Noninterest income was \$1.8 billion or 0.7 percent above the level of 2016. Realized gains on sales of investments were \$1.7 billion or 43.8 percent less than a year ago. Total noninterest expense increased \$19.5 billion or 4.6 percent comparing 2017 and 2016. The return on average assets for 2017 was 0.97 percent compared to 1.04 percent in 2016.

The United States economy continued to improve in 2017. This could affect future interest rates which may adversely impact bank earnings as net interest margins compress from the inability of management to keep funding costs low. Continuous expense control, sound balance sheet management and lower loan loss provisions could offset some of the negative impact of the reduction in net interest margins.

### **Review of Financial Position:**

Peoples Financial Services Corp., a bank holding company incorporated under the laws of Pennsylvania, provides a full range of financial services through its wholly-owned subsidiary, Peoples Security Bank and Trust Company (“Peoples Bank”), collectively, the “Company” or “Peoples”. On November 30, 2013, Penseco Financial Services Corporation, a financial holding company incorporated under the laws of Pennsylvania (“Penseco”), merged with and into Peoples Financial Services Corp., with Peoples Financial Services Corp. being the surviving corporation (the “Merger”), pursuant to an Agreement and Plan of Merger dated June 28, 2013 (the “Merger Agreement”). In connection with the Merger, on December 1, 2013, Penseco’s former banking subsidiary, Penn Security Bank and Trust Company, merged with and into Peoples Neighborhood Bank (the “Bank Merger”), and the resulting institution adopted the name, “Peoples Security Bank and Trust Company.” The Company services its retail and commercial customers through twenty-seven full-service community banking offices located within the Lackawanna, Lehigh, Luzerne, Monroe, Montgomery, Northampton, Susquehanna, Wayne and Wyoming Counties of Pennsylvania and Broome County of New York.

Peoples Bank is a state-chartered bank and trust company under the jurisdiction of the Pennsylvania Department of Banking and Securities and the Federal Deposit Insurance Corporation. Peoples Bank’s primary product is loans to small- and medium-sized businesses. Other lending products include one-to-four family residential mortgages and consumer loans. Peoples Bank primarily funds its loans by offering open time deposits to commercial enterprises and individuals. Other deposit product offerings include certificates of deposits and various demand deposit accounts.

The Company faces competition primarily from commercial banks, thrift institutions and credit unions within its Pennsylvania and New York market, many of which are substantially larger in terms of assets and capital. In addition, mutual funds and security brokers compete for various types of deposits, and consumer, mortgage, leasing and insurance companies compete for various types of loans and leases. Principal methods of competing for banking and permitted nonbanking services include price, nature of product, quality of service and convenience of location.

The Company and Peoples Bank are subject to regulations of certain federal and state regulatory agencies and undergo periodic examinations by such agencies.

Total assets, loans and deposits were \$2.2 billion, \$1.7 billion and \$1.7 billion, respectively, at December 31, 2017. Total assets, loans and deposits grew 8.5 percent, 10.4 percent and 8.2 percent, respectively, compared to 2016 year-end balances.

The loan portfolio consisted of \$1.3 billion of business loans, including commercial and commercial real estate loans, and \$430.7 million in retail loans, including residential mortgage and consumer loans at December 31, 2017. Total investment securities were \$281.8 million at December 31, 2017, including \$272.5 million of investment securities classified as available-for sale and \$9.3 million classified as held-to-maturity. Total deposits consisted of \$380.7 million in noninterest-bearing deposits and \$1.3 billion in interest-bearing deposits at December 31, 2017.

Stockholders’ equity equaled \$265.0 million, or \$35.82 per share, at December 31, 2017, and \$256.6 million, or \$34.71 per share, at December 31, 2016. Our equity to asset ratio was 12.21 percent and 12.83 percent at those respective period ends. Dividends declared for the 2017 amounted to \$1.26 per share representing 50.4 percent of net income.

Nonperforming assets equaled \$11.6 million or 0.68 percent of loans, net and foreclosed assets at December 31, 2017, down from \$14.2 million or 0.93 percent at December 31, 2016. The allowance for loan losses equaled \$19.0 million or 1.12 percent of loans, net, at December 31, 2017, compared to \$16.0 million or 1.04 percent at year-end 2016. Loans charged-off, net of recoveries equaled \$1.8 million or 0.11 percent of average loans in 2017, compared to \$2.0 million or 0.14 percent of average loans in 2016.

## **Investment Portfolio:**

Primarily, our investment portfolio provides a source of liquidity needed to meet expected loan demand and generates a reasonable return in order to increase our profitability. Additionally, we utilize the investment portfolio to meet pledging requirements and reduce income taxes. At December 31, 2017, our portfolio consisted primarily of short-term U.S. Treasury and Government agency securities, which provide a source of liquidity and intermediate-term, tax-exempt state and municipal obligations, which mitigate our tax burden.

Our investment portfolio is subject to various risk elements that may negatively impact our liquidity and profitability. The greatest risk element affecting our portfolio is market risk or interest rate risk (“IRR”). Understanding IRR, along with other inherent risks and their potential effects, is essential in effectively managing the investment portfolio.

Market risk or IRR relates to the inverse relationship between bond prices and market yields. It is defined as the risk that increases in general market interest rates will result in market value depreciation. A marked reduction in the value of the investment portfolio could subject us to liquidity strains and reduced earnings if we are unable or unwilling to sell these investments at a loss. Moreover, the inability to liquidate these assets could require us to seek alternative funding, which may further reduce profitability and expose us to greater risk in the future. In addition, since the majority of our investment portfolio is designated as available-for-sale and carried at estimated fair value, with net unrealized gains and losses reported as a separate component of stockholders’ equity, market value depreciation could negatively impact our capital position.

During 2017 the FOMC raised the target federal funds rate three times. At their December 2017 meeting, the FOMC decided to raise the target range for the federal funds rate to 1.25% to 1.50%. The FOMC expects that, with gradual adjustments in monetary policy, economic activity will expand at a moderate pace and labor market conditions will remain strong. The Committee expects that economic conditions will evolve in a manner that will warrant gradual increases in the federal funds rate; the federal funds rate is likely to remain, for some time, below levels that are expected to prevail in the longer run. However, the actual path of the federal funds rate will depend on the economic outlook as informed by incoming data. Our investment portfolio consists primarily of fixed-rate bonds. As a result, changes in the velocity and magnitude of future FOMC actions can significantly influence the fair value of our portfolio. Specifically, the parts of the yield curve most closely related to our investments include the 2-year and 10-year U.S. Treasury securities. The yield on the 2-year U.S. Treasury note affects the values of our U.S. Treasury and Government agency securities, whereas the 10-year U.S. Treasury note influences the value of tax-exempt state and municipal obligations. The yield on the 2-year U.S. Treasury ranged from a low of 112 basis points to a high of 192 basis points during 2017 before ending the year at 1.89 percent. The yield on the 10-year U.S. Treasury ranged from a low of 205 basis points to a high of 262 basis points while ending 2017 at 2.40 percent. Since bond prices move inversely to yields, we experienced a decline in the aggregate fair value of our investment portfolio when comparing December 31, 2017 to December 31, 2016 due to higher rates at year end 2017. The net unrealized holding losses included in our available-for-sale investment portfolio were \$1.2 million at December 31, 2017 compared to a gain of \$553 thousand at December 31, 2016. We reported net unrealized holding loss, included as a separate component of stockholders’ equity of \$977 thousand, net of income taxes of \$260 thousand, at December 31, 2017, and \$360 thousand, net of income taxes of \$193 thousand, at December 31, 2016. An increase in interest rates could negatively impact the market value of our investments and our capital position. In order to monitor the potential effects a rise in interest rates could have on the value of our investments, we perform stress test modeling on the portfolio. Stress tests conducted on our portfolio at December 31, 2017, indicated that should general market rates increase by 100, 200 and 300 basis points, we would anticipate declines of 3.1 percent, 6.6 percent and 9.3 percent in the market value of our portfolio.

The carrying values of the major classifications of investment securities and their respective percentages of total investment securities for the past three years are summarized as follows:

#### Distribution of investment securities

December 31,	2017		2016		2015	
	Amount	%	Amount	%	Amount	%
U.S. Treasury securities	\$ 19,814	7.03 %	\$ 7,438	2.76 %	9,999	3.37
U.S. Government-sponsored enterprises	93,648	33.23	80,913	29.98	\$ 69,060	23.25 %
State and municipals:						
Taxable	15,047	5.34	15,225	5.64	16,545	5.57
Tax-exempt	110,692	39.28	119,462	44.25	131,789	44.36
Residential Mortgage-backed securities:						
U.S. Government agencies	14,488	5.14	21,110	7.82	31,652	10.66
U.S. Government-sponsored enterprises	21,892	7.77	25,779	9.55	37,999	12.79
Commercial Mortgage-backed securities:						
U.S. Government-sponsored enterprises	6,195	2.20				
Common equity securities	46	0.01				
Total	<u>\$ 281,822</u>	<u>100.00 %</u>	<u>\$ 269,927</u>	<u>100.00 %</u>	<u>\$ 297,044</u>	<u>100.00 %</u>

Investment securities increased \$11.9 million, to \$281.8 million at December 31, 2017, from \$269.9 million at December 31, 2016. At December 31, 2017, the investment portfolio consisted of \$272.5 million of investment securities classified as available-for-sale and \$9.3 million classified as held-to-maturity. Strong loan demand during 2017 resulted in using a portion of the investment cash flow to fund loans. Excess cash flow from investment repayments was directed back into the investment portfolio primarily during the third and fourth quarters of 2017. Security purchases totaled \$73.5 million in 2017, with purchases consisting of short-term U.S. Treasury securities, intermediate-term U.S. government sponsored enterprises securities, longer term tax-exempt securities and mortgage-backed securities. Investment purchases in 2016 amounted to \$62.0 million.

Repayments of investment securities totaled \$57.0 million in 2017 and \$54.7 million in 2016. There were no sales of investment securities during 2017. Proceeds from the sale of investment securities available-for-sale in 2016 totaled \$27.4 million with net gains recognized on the sale totaling \$623. The 2016 sales consisted of \$17.1 million of short-term U.S. Government-sponsored enterprises securities and \$10.3 million of short-term U.S. Treasury securities. We continually analyze the investment portfolio with respect to its exposure to various risk elements.

The composition of our investment portfolio changed during 2017 as a result of the aforementioned transactions. Short-term bullet U.S. Treasury and U.S. Government-sponsored enterprise securities comprised 40.3 percent of our total portfolio at year-end 2017 compared to 32.7 percent at the end of 2016. Tax-exempt municipal obligations declined as a percentage of the total portfolio to 39.3 percent at year-end 2017 from 44.3 percent at the end of 2016. The weighted average life of the investment portfolio shortened slightly to 4.2 years at December 31, 2017 from 4.4 years at year end 2016, while the effective duration of the investment portfolio increased slightly to 3.0 years at December 31, 2017 from 2.9 years at December 31, 2016.

There were no other-than-temporary impairments (“OTTI”) recognized for the years ended December 31, 2017, 2016 and 2015. For additional information related to OTTI refer to Note 4 entitled “Investment securities” in the Notes to Consolidated Financial Statements to this Annual Report.

Investment securities averaged \$272.4 million and equaled 14.6 percent of average earning assets in 2017, compared to \$271.3 million and equaled 15.7 percent of average earning assets in 2016. The tax-equivalent yield on the investment portfolio decreased five basis points to 2.84 percent in 2017 from 2.89 percent in 2016.

At December 31, 2017 and 2016, there were no securities of any individual issuer, except for U.S. Government agency mortgage-backed securities, that exceeded 10.0 percent of stockholders’ equity.

The maturity distribution based on the carrying value and weighted-average, tax-equivalent yield of the investment portfolio at December 31, 2017, is summarized as follows. The weighted-average yield, based on amortized cost, has been computed for tax-exempt state and municipals on a tax-equivalent basis using the prevailing federal statutory tax rate of 35.0 percent. The distributions are based on contractual maturity. Expected maturities may differ from contractual maturities because borrowers have the right to call or prepay obligations with or without call or prepayment penalties.

### Maturity distribution of investment securities

December 31, 2017	Within one year		After one but within five years		After five but within ten years		After ten years		Total	
	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield
U.S. Treasury securities			\$ 19,814	1.78 %	—	—			\$ 19,814	1.78 %
U.S. Government-sponsored enterprises			79,488	1.57	\$ 14,160	1.67 %			93,648	1.58
State and municipals:										
Taxable	\$ 888	3.72 %	3,016	3.73	11,143	4.25			15,047	4.12
Tax-exempt	9,987	5.06	60,616	3.29	11,520	4.54	\$ 28,569	5.20 %	110,692	4.07
Residential Mortgage-backed securities:										
U.S. Government agencies	31	0.28	10,899	1.86	3,558	1.79			14,488	1.84
U.S. Government-sponsored enterprises	51	1.17	8,543	1.96	8,483	2.55	4,815	2.55	21,892	2.32
Commercial Mortgage-backed securities:										
U.S. Government-sponsored enterprises					6,195	2.29			6,195	2.29
Total	\$ 10,957	4.92 %	\$ 182,376	2.23 %	\$ 55,059	2.98 %	\$ 33,384	4.81 %	\$ 281,776	2.78 %

### Loan Portfolio:

Economic factors and how they affect loan demand are of extreme importance to us and the overall banking industry, as lending is a primary business activity. Loans are the most significant component of earning assets and they generate the greatest amount of revenue for us. Similar to the investment portfolio, there are risks inherent in the loan portfolio that must be understood and considered in managing the lending function. These risks include IRR, credit concentrations and fluctuations in demand. Changes in economic conditions and interest rates affect these risks which influence loan demand, the composition of the loan portfolio and profitability of the lending function.

The composition of the loan portfolio at year-end for the past five years is summarized as follows:

### Distribution of loan portfolio

December 31,	2017		2016		2015		2014		2013	
	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%
Commercial	\$ 476,199	28.12 %	\$ 408,814	26.67 %	\$ 365,767	27.28 %	\$ 319,590	26.41 %	\$ 350,680	29.80 %
Real estate:										
Commercial	786,210	46.44	700,144	45.67	567,277	42.30	493,481	40.79	413,058	35.11
Residential	287,935	17.01	289,781	18.90	306,218	22.84	322,454	26.65	322,062	27.37
Consumer	142,721	8.43	134,226	8.76	101,603	7.58	74,369	6.15	90,817	7.72
Loans, net	1,693,065	100.00 %	1,532,965	100.00 %	1,340,865	100.00 %	1,209,894	100.00 %	1,176,617	100.00 %
Less:										
allowance for loan loss	18,960		15,961		12,975		10,338		8,651	
Net loans	\$ 1,674,105		\$ 1,517,004		\$ 1,327,890		\$ 1,199,556		\$ 1,167,966	

Loans, net increased \$160.1 million or 10.4 percent in 2017 to \$1.7 billion at December 31, 2017. Business loans, including commercial loans and commercial real estate loans, were \$1.3 billion or 74.6 percent of loans, net at December 31, 2017, and \$1.1 billion or 72.3 percent at year-end 2016. Residential mortgages and consumer loans totaled \$430.7 million or 25.4 percent of loans, net at year-end 2017 and \$424.0 million or 27.7 percent at year-end 2016. Loan growth remained strong throughout 2017. Loans, net grew at an annual rate of 10.4 percent in 2017. The increase in loans in 2017 was primarily attributable to the continued growth fostered by our entrance into the Lehigh Valley market during the fourth quarter of 2014 by establishing a community banking office with a dedicated team of commercial and

retail lenders. Our company has expanded our presence in the greater Lehigh Valley with the addition of two community banking offices, complemented with additional lending teams to continue the growth. Additional growth was attained through our entrance into the King of Prussia market initially by establishing a loan production office and then by opening a retail branch in the fourth quarter of 2016. The remainder of such growth was generated from improved demand for business lending in existing markets. Based on the customer service oriented philosophy of our organization along with the commitment of these employees, we expect to be as well received in this new market as we are in our existing markets.

Loans averaged \$1.6 billion in 2017, compared to \$1.5 billion in 2016. Taxable loans averaged \$1.5 billion, while tax-exempt loans averaged \$112.6 million in 2017. Due to improving loan demand, the loan portfolio continues to play a prominent role in our earning asset mix. As a percentage of earning assets, average loans equaled 85.4 percent in 2017, an increase from 84.2 percent in 2016.

The tax-equivalent yield on our loan portfolio decreased 4 basis points to 4.39 percent in 2017 from 4.43 percent in 2016 as repayments of higher yielding loans were replaced with new originations at lower yields. In 2017, we increased our prime lending rate three times in response to the FOMC raising its targeted federal funds rate. Our prime rate ended the year at 4.50%. The higher prime rate helped mitigate the loan yield compression. Amortization of the credit marks and interest rate fair value marks of the acquired portfolio reduced loan interest income by \$81 thousand in 2017. Comparatively, loan accretion included in loan interest income in 2016 totaled \$649 thousand which increased the tax-equivalent net interest margin by 4 basis points. The effect of the increases in the prime rate on stabilizing our loan portfolio's yield can be evidenced by evaluating quarterly loan yields, which ranged from 4.36 percent in the second quarter to 4.42 percent in the third quarter. The yield on the loan portfolio may continue to stabilize as repayments on loans are replaced with new originations at current market rates. However, increased competition will continue to prompt more aggressive pricing for fixed rate intermediate term loans, thus mitigating higher yields.

The maturity distribution and sensitivity information of the loan portfolio by major classification at December 31, 2017, is summarized as follows:

#### **Maturity distribution and interest sensitivity of loan portfolio**

<b>December 31, 2017</b>	<b>Within one year</b>	<b>After one but within five years</b>	<b>After five years</b>	<b>Total</b>
<b>Maturity schedule:</b>				
Commercial	\$ 152,833	\$ 163,437	\$ 159,929	\$ 476,199
<b>Real estate:</b>				
Commercial	149,232	401,478	235,500	786,210
Residential	65,794	151,681	70,460	287,935
Consumer	56,981	77,318	8,422	142,721
<b>Total</b>	<b>\$ 424,840</b>	<b>\$ 793,914</b>	<b>\$ 474,311</b>	<b>\$ 1,693,065</b>
<b>Predetermined interest rates</b>				
Predetermined interest rates	\$ 164,693	\$ 344,888	\$ 158,514	\$ 668,095
<b>Floating or adjustable interest rates</b>				
Floating or adjustable interest rates	260,147	449,026	315,797	1,024,970
<b>Total</b>	<b>\$ 424,840</b>	<b>\$ 793,914</b>	<b>\$ 474,311</b>	<b>\$ 1,693,065</b>

As previously mentioned, there are numerous risks inherent in the loan portfolio. We manage the portfolio by employing sound credit policies and utilizing various modeling techniques in order to limit the effects of such risks. In addition, we utilize private mortgage insurance ("PMI") and guaranteed Small Business Administration and Federal Home Loan Bank of Pittsburgh ("FHLB-Pgh") loan programs to mitigate credit risk in the loan portfolio.

In an attempt to limit IRR and liquidity strains, we continually examine the maturity distribution and interest rate sensitivity of the loan portfolio. For 2017, market interest rates began to increase from historically low levels. Given the potential for rates to rise in the future, we continued to place emphasis on originating short term fixed-rate and adjustable-rate loans. Fixed-rate loans represented 39.5 percent of the loan portfolio at December 31, 2017, compared to floating or adjustable-rate loans at 61.5 percent. Approximately 45.9 percent of the loan portfolio is expected to reprice within the next 12 months.



Additionally, our secondary market mortgage banking program provides us with an additional source of liquidity and a means to limit our exposure to IRR. Through this program, we are able to competitively price conforming one-to-four family residential mortgage loans without taking on IRR which would result from retaining these long-term, low fixed-rate loans on our books. The loans originated are subsequently sold in the secondary market, with the sales price locked in at the time of commitment, thereby greatly reducing our exposure to IRR.

Loan concentrations are considered to exist when the total amount of loans to any one borrower, or a multiple number of borrowers engaged in similar business activities or having similar characteristics, exceeds 25.0 percent of capital outstanding in any one category. We provide deposit and loan products and other financial services to individual and corporate customers in our current market area. There are no significant concentrations of credit risk from any individual counterparty or groups of counterparties, except for geographic concentrations.

#### **Off- Balance Sheet Arrangements:**

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, and may involve, to varying degrees, elements of credit risk and IRR in excess of the amount recognized in the consolidated financial statements.

Credit risk is the principal risk associated with these instruments. Our involvement and exposure to credit loss in the event that the instruments are fully drawn upon and the customer defaults is represented by the contractual amounts of these instruments. In order to control credit risk associated with entering into commitments and issuing letters of credit, we employ the same credit quality and collateral policies in making commitments that we use in other lending activities. We evaluate each customer's creditworthiness on a case-by-case basis, and if deemed necessary, obtain collateral. The amount and nature of the collateral obtained is based on our credit evaluation.

The contractual amounts of off-balance sheet commitments at year-end for the past three years are summarized as follows:

#### **Distribution of off-balance sheet commitments**

<b>December 31</b>	<b>2017</b>	<b>2016</b>	<b>2015</b>
Commitments to extend credit	\$ 324,984	\$ 235,878	\$ 257,011
Unused portions of lines of credit	56,244	57,784	52,794
Commercial letters of credit	23,387	31,051	20,017
Total	<u>\$ 404,615</u>	<u>\$ 324,713</u>	<u>\$ 329,822</u>

We record a valuation allowance for off-balance sheet credit losses, if deemed necessary, separately as a liability. The valuation allowance amounted to \$61 and \$58 at December 31, 2017 and 2016. We do not anticipate that losses, if any, that may occur as a result of funding off-balance sheet commitments, would have a material adverse effect on our operating results or financial position.

#### **Contractual Obligations and Commitments:**

In the ordinary course of operations, we enter into various financial obligations, including contractual obligations that may require future cash payments. As a financial services provider, we routinely enter into commitments to extend credit, including loan commitments, standby and commercial letters of credit. Such commitments are subject to the same credit policies and approval process accorded to loans made by the Bank. See Note 5 of the consolidated financial statements for additional information.

The following table summarizes our contractual obligations and other commitments to make future payments as of December 31, 2017. Payments for deposits and borrowings do not include interest. Payments related to leases are based on actual payments specified in the underlying contracts. Commitments to extend credit and standby letters of credit are

presented at contractual amounts; however, since many of these commitments are expected to expire unused or only partially used based upon our historical experience, the total amounts of these commitments do not necessarily reflect future cash requirements.

<i>(In Thousands)</i>	December 31, 2017				
	Total	One Year or Less	Over One Year Through Three Years	Over Three Years Through Five Years	Over Five Years
<b>Contractual Obligations:</b>					
Time Deposits	\$ 282,234	\$ 171,043	\$ 62,480	\$ 31,065	\$ 17,646
Short-term borrowings	123,675	123,675			
FHLB Advances	49,734	11,828	33,137	4,214	555
Operating Leases	3,259	494	954	845	966
<b>Total</b>	<b>\$ 458,902</b>	<b>\$ 307,040</b>	<b>\$ 96,571</b>	<b>\$ 36,124</b>	<b>\$ 19,167</b>
<b>Other commitments:</b>					
Commitments to extend credit	\$ 381,228	\$ 324,984	\$ 4,165	\$ 2,813	\$ 49,266
Standby letters of credit	23,387	23,387			
<b>Total</b>	<b>\$ 404,615</b>	<b>\$ 348,371</b>	<b>\$ 4,165</b>	<b>\$ 2,813</b>	<b>\$ 49,266</b>

#### **Asset Quality:**

We are committed to developing and maintaining sound, quality assets through our credit risk management policies and procedures. Credit risk is the risk to earnings or capital which arises from a borrower's failure to meet the terms of their loan obligations. We manage credit risk by diversifying the loan portfolio and applying policies and procedures designed to foster sound lending practices. These policies include certain standards that assist lenders in making judgments regarding the character, capacity, cash flow, capital structure and collateral of the borrower.

With regard to managing our exposure to credit risk in light of general devaluations in real estate values, we have established maximum loan-to-value ratios for commercial mortgage loans not to exceed 80.0 percent of the appraised value. With regard to residential mortgages, customers with loan-to-value ratios in excess of 80.0 percent are generally required to obtain Private Mortgage Insurance (PMI). PMI is used to protect us from loss in the event loan-to-value ratios exceed 80.0 percent and the customer defaults on the loan. Appraisals are performed by an independent appraiser engaged by us, not the customer, who is either state certified or state licensed depending upon collateral type and loan amount.

With respect to lending procedures, lenders and our credit underwriters must determine the borrower's ability to repay their loans based on prevailing and expected market conditions prior to requesting approval for the loan. The Board of Directors establishes and reviews, at least annually, the lending authority for certain Senior Officers, loan underwriters and branch personnel. Credit approvals beyond the scope of these individual authority levels are forwarded to a Loan Committee. This Committee, comprised of certain members of senior management, review credits to monitor the quality of the loan portfolio through careful analysis of credit applications, adherence to credit policies and the examination of outstanding loans and delinquencies. These procedures assist in the early detection and timely follow-up of problem loans.

Credit risk is also managed by monthly internal reviews of individual credit relationships in our loan portfolio by credit administration and the asset quality committee. These reviews aid us in identifying deteriorating financial conditions of borrowers and allows us the opportunity to assist customers in remedying these situations.

Nonperforming assets consist of nonperforming loans and foreclosed assets. Nonperforming loans include nonaccrual loans, troubled debt restructured loans and accruing loans past due 90 days or more. For a discussion of our policy regarding nonperforming assets and the recognition of interest income on impaired loans, refer to the notes entitled,

“Summary of significant accounting policies — Nonperforming assets,” and “Loans, net and allowance for loan losses” in the Notes to Consolidated Financial Statements to this Annual Report which are incorporated in this item by reference.

Information concerning nonperforming assets for the past five years is summarized as follows. The table includes credits classified for regulatory purposes and all material credits that cause us to have serious doubts as to the borrower’s ability to comply with present loan repayment terms.

### Distribution of nonperforming assets

December 31	2017	2016	2015	2014	2013
Nonaccrual loans:					
Commercial	\$ 860	\$ 934	\$ 1,632	\$ 1,322	\$ 2,035
Real estate:					
Commercial	3,454	7,016	1,680	1,275	9,172
Residential	2,994	2,961	4,424	3,047	3,569
Consumer	177	155	148	122	90
Total nonaccrual loans	<u>7,485</u>	<u>11,066</u>	<u>7,884</u>	<u>5,766</u>	<u>14,866</u>
Troubled debt restructured loans:					
Commercial	1,577	1,150			2,487
Real estate:					
Commercial	836	141	2,325	2,457	
Residential	661	618	536	476	
Consumer					
Total troubled debt restructured loans	<u>3,074</u>	<u>1,909</u>	<u>2,861</u>	<u>2,933</u>	<u>2,487</u>
Accruing loans past due 90 days or more:					
Commercial					6
Real estate:					
Commercial				136	200
Residential	548	558	525	1,062	678
Consumer	186	286	238	425	571
Total accruing loans past due 90 days or more	<u>734</u>	<u>844</u>	<u>763</u>	<u>1,623</u>	<u>1,455</u>
Total nonperforming loans	<u>11,293</u>	<u>13,819</u>	<u>11,508</u>	<u>10,322</u>	<u>18,808</u>
Foreclosed assets	284	393	957	561	648
Total nonperforming assets	<u>\$ 11,577</u>	<u>\$ 14,212</u>	<u>\$ 12,465</u>	<u>\$ 10,883</u>	<u>\$ 19,456</u>
Nonperforming loans as a percentage of loans, net	0.67 %	0.90 %	0.86 %	0.85 %	1.60 %
Nonperforming assets as a percentage of loans, net and foreclosed assets	0.68 %	0.93 %	0.93 %	0.90 %	1.65 %

We experienced improvements in our asset quality as evidenced by a decrease in nonperforming assets of \$2.6 million or 18.5 percent to \$11.6 million or 0.68 percent of loans, net of unearned income, and foreclosed assets at December 31, 2017, from \$14.2 million or 0.93 percent of loans, net of unearned income, and foreclosed assets at the end of 2016. The decrease resulted from a \$3.6 million decrease in nonaccrual loans and a decrease in foreclosed assets of \$0.1 million offset by an increase of \$1.1 million in troubled debt restructured loans. For a further discussion of assets classified as nonperforming assets and potential problem loans, refer to the note entitled, “Loans, net and the allowance for loan losses,” in the Notes to Consolidated Financial Statements to this Annual Report.

We maintain the allowance for loan losses at a level we believe adequate to absorb probable credit losses related to individually evaluated loans, as well as probable incurred losses inherent in the remainder of the loan portfolio as of the balance sheet date. The balance in the allowance for loan losses account is based on past events and current economic conditions. We employ the FFIEC Interagency Policy Statement, as amended, 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 FASB Accounting Standards Codification (“ASC”) 310 for loans specifically identified to be individually evaluated for impairment and the requirements of FASB ASC 450, 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, our credit administration department identifies those loans to be individually evaluated for impairment and those to be 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 to assure directional consistency of the allowance for loan loss account. Regulators, in reviewing the loan portfolio as part of the scope of a regulatory examination, may require us to increase our allowance for loan losses or take other actions that would require increases to our allowance for loan losses.

For a further discussion of our accounting policies for determining the amount of the allowance and a description of the systematic analysis and procedural discipline applied, refer to the note entitled, "Summary of significant accounting policies — Allowance for loan losses," in the Notes to Consolidated Financial Statements to this Annual Report.

A reconciliation of the allowance for loan losses and an illustration of charge-offs and recoveries by major loan category for the past five years are summarized as follows:

#### Reconciliation of allowance for loan losses

December 31	2017	2016	2015	2014	2013
Allowance for loan losses at beginning of period	\$ 15,961	\$ 12,975	\$ 10,338	\$ 8,651	\$ 6,950
Loans charged-off:					
Commercial	173	776	246	601	5
Real estate:					
Commercial	706	858	325	500	15
Residential	533	339	523	804	508
Consumer	737	495	333	386	313
Total	2,149	2,468	1,427	2,291	841
Loans recovered:					
Commercial	20	86	77	9	1
Real estate:					
Commercial	124	122	144	292	20
Residential	44	69	26	38	111
Consumer	160	177	117	115	49
Total	348	454	364	454	181
Net loans charged-off	1,801	2,014	1,063	1,837	660
Provision for loan losses	4,800	5,000	3,700	3,524	2,361
Allowance for loan losses at end of period	\$ 18,960	\$ 15,961	\$ 12,975	\$ 10,338	\$ 8,651
Ratios:					
Net loans charged-off as a percentage of average loans outstanding	0.11 %	0.14 %	0.08 %	0.15 %	0.10 %
Allowance for loan losses as a percentage of period end loans	1.12 %	1.04 %	0.97 %	0.85 %	0.74 %

The allowance for loan losses increased \$3.0 million to \$19.0 million at December 31, 2017, from \$16.0 million at the end of 2016. The increase resulted from a provision for loan losses of \$4.8 million less net loans charged-off of \$1.8 million. The allowance for loan losses, as a percentage of loans, net of unearned income, was 1.12 percent at the end of 2017, compared to 1.04 percent at the end of 2016. For a further discussion of the credit quality adjustment for loans acquired in the 2013 Pensco merger, refer to the Notes to the Consolidated Financial Statements to this Annual Report.

Past due loans not satisfied through repossession, foreclosure or related actions are evaluated individually to determine if all or part of the outstanding balance should be charged against the allowance for loan losses account. Any subsequent recoveries are credited to the allowance account. Net loans charged-off decreased \$231 to \$1,801 in 2017 from \$2,014 in 2016. Net charge-offs, as a percentage of average loans outstanding, equaled 0.11 percent in 2017 and 0.14 percent in 2016.

## Allocation of the allowance for loan losses

The allocation of the allowance for loan losses for the past five years is summarized as follows:

December 31	2017		2016		2015		2014		2013	
	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%
Allocated allowance:										
Specific:										
Commercial	\$ 159	0.15 %	\$ 225	0.18 %	\$ 759	0.16 %	\$ 1,240	0.33 %	\$ 1,500	0.61 %
Real Estate:										
Commercial	263	0.25	1,197	0.47	233	0.40	912	0.53	300	1.01
Residential	336	0.22	520	0.23	1,138	0.37	769	0.34	224	0.32
Consumer	8	0.01			117	0.01	38	0.01		0.01
Total specific	766	0.63	1,942	0.88	2,247	0.94	2,959	1.21	2,024	1.95
Formula:										
Commercial	4,893	27.98	3,574	26.49	2,283	27.12	1,081	26.08	508	29.19
Real Estate:										
Commercial	7,285	46.19	4,650	45.21	4,012	41.90	2,125	40.26	2,094	34.10
Residential	4,644	16.78	4,187	18.67	2,944	22.47	2,921	26.31	2,911	27.05
Consumer	1,372	8.42	1,608	8.75	1,466	7.57	1,252	6.14	1,114	7.71
Total formula	18,194	99.37	14,019	99.12	10,705	99.06	7,379	98.79	6,627	98.05
Total allocated allowance	18,960	100.00 %	15,961	100.00 %	12,952	100.00 %	10,338	100.00 %	8,651	100.00 %
Unallocated allowance					23					
Total	<u>\$ 18,960</u>		<u>\$ 15,961</u>		<u>\$ 12,975</u>		<u>\$ 10,338</u>		<u>\$ 8,651</u>	

The allocated element of the allowance for loan losses account increased \$2,999 to \$18,960 at December 31, 2017, compared to \$15,961 at December 31, 2016. The specific portion of the allowance for loan losses decreased while the formula portions of the allowance for loan losses increased from the end of 2016. The specific portion of the allowance for impairment of loans individually evaluated under FASB ASC 310 decreased \$1,176 to \$766 at December 31, 2017, from \$1,942 at December 31, 2016. However, the formula portion of the allowance for loans collectively evaluated for impairment under FASB ASC 450, increased \$4,175 to \$18,194 at December 31, 2017, from \$14,019 at December 31, 2016. The decrease in the specific portion of the allowance was a result of a decrease in the amount of impaired loans designated with a related allowance. The increase in the formula portion was due to a significant increase in volume, as the overall loss factor remained relatively unchanged.

There was no unallocated element of the total allowance for loan losses at December 31, 2017. As is inherent with all estimates, the allowance for loan losses methodology is subject to a certain level of imprecision as it provides reasonable, but not absolute, assurance that the allowance will be able to absorb probable losses, in their entirety, as of the financial statement date. Factors, among others, including judgments made in identifying those loans considered impaired, appraisals of collateral values and measurements of certain qualitative factors, all cause this imprecision and support the establishment of the unallocated element.

The coverage ratio, the allowance for loan losses account, as a percentage of nonperforming loans, is an industry ratio used to test the ability of the allowance account to absorb potential losses arising from nonperforming loans. The coverage ratio was 167.9 percent at December 31, 2017 and 115.5 percent at December 31, 2016. We believe that our allowance was adequate to absorb probable credit losses at December 31, 2017.

## Deposits:

Our deposit base is the primary source of funds to support our operations. We offer a variety of deposit products to meet the needs of our individual and commercial customers. Total deposits grew \$130.3 million or 8.2 percent to \$1.7 billion at the end of 2017. Noninterest-bearing deposits grew \$27.0 million or 7.6% while interest-bearing deposits increased

\$103.3 million or 8.4% in 2017. Noninterest-bearing deposits represented 22.1 percent of total deposits while interest-bearing deposits accounted for 77.9 percent of total deposits at December 31, 2017. Comparatively, noninterest-bearing deposits and interest-bearing deposits represented 22.3 percent and 77.7 percent of total deposits at year end 2016. With regard to noninterest-bearing deposits, personal checking accounts increased \$9.6 million or 5.4 percent, while commercial checking accounts increased \$17.4 million or 10.0 percent. The increase in noninterest-bearing deposits is essential in attempting to keep our overall cost of funds low given the pressure on our net interest margin from the increase in short-term markets during 2017 due to the FOMC increasing the targeted federal funds rate.

With regard to interest-bearing deposits, interest-bearing transaction accounts, which include money market accounts and NOW accounts, and savings accounts, increased \$106.7 million in 2017. Commercial interest-bearing transaction accounts increased \$65.8 million, while personal interest-bearing transaction accounts increased \$47.1 million. Savings accounts decreased \$6.2 million during 2017 due primarily to depositors shifting funds into higher yielding deposit accounts. The strong growth in the commercial account types was due to continuing our strategic initiative to grow our public fund deposits and our continued penetration in our expansion markets. Total time deposits decreased \$3.4 million to \$282.3 million at December 31, 2017 from \$285.7 million at December 31, 2016. The decrease was primarily due to price sensitive depositors being attracted to premium rates being offered by our competitors.

The average amount of, and the rate paid on, the major classifications of deposits for the past three years are summarized as follows:

### Deposit distribution

Year ended December 31	2017		2016		2015	
	Average Balance	Average Rate	Average Balance	Average Rate	Average Balance	Average Rate
Interest-bearing:						
Money market accounts	\$ 262,292	0.55 %	\$ 219,265	0.39 %	\$ 197,129	0.32 %
NOW accounts	345,383	0.45	305,156	0.40	273,792	0.37
Savings accounts	398,104	0.13	391,631	0.18	396,606	0.20
Time deposits	282,617	1.05	273,691	0.98	262,860	0.96
Total interest-bearing	1,288,396	0.50 %	1,189,743	0.46 %	1,130,387	0.44 %
Noninterest-bearing	361,386		330,295		303,647	
Total deposits	\$ 1,649,782		\$ 1,520,038		\$ 1,434,034	

Total deposits averaged \$1.6 billion in 2017 and \$1.5 billion in 2016, increasing \$129.7 million or 8.5 percent comparing 2017 to 2016. Average noninterest-bearing deposits increased \$31.1 million, while average interest-bearing accounts grew \$98.6 million. Average interest-bearing transaction deposits, including money market and NOW, and savings accounts, increased \$89.7 million while average total time deposits increased \$8.9 million when comparing 2017 and 2016.

Our cost of interest-bearing deposits increased 4 basis points to 0.50 percent in 2017 from 0.46 percent in 2016. Specifically, the cost of interest-bearing transaction and savings accounts increased 5 basis points to 0.35 percent while the cost of time deposits increased 7 basis points to 1.05 percent comparing 2017 and 2016. The increases to the cost of interest-bearing transaction deposits and to the cost of time deposits was due to the introduction of premium rate deposit specials at our branch office in Kingston and our new branch offices in the Lehigh Valley in 2017. Additionally, the FOMC actions to increase the targeted federal funds rate three times in 2017, has resulted in higher deposit rates.

Volatile deposits, time deposits \$100 or more, averaged \$125.2 million in 2017, an increase of \$13.8 million or 12.4 percent from \$111.4 million in 2016. Our average cost of these funds increased 14 basis points to 1.01 percent in 2017, from 0.87 percent in 2016. This type of funding is susceptible to withdrawal by the depositor as they are particularly price sensitive and are therefore not considered to be a strong source of liquidity.

Maturities of time deposits \$100 or more, which entirely consist of certificates of deposits, for the past three years are summarized as follows:

**Maturity distribution of time deposits \$100 or more**

<u>December 31</u>	<u>2017</u>	<u>2016</u>	<u>2015</u>
Within three months	\$ 26,009	\$ 25,503	\$ 14,851
After three months but within six months	24,569	25,356	24,437
After six months but within twelve months	49,852	45,385	37,898
After twelve months	56,461	55,733	49,669
Total	<u>\$ 156,891</u>	<u>\$ 151,977</u>	<u>\$ 126,855</u>

We recorded a core deposit intangible related to a value ascribed to demand, interest checking, money market and saving accounts as well as a fair value adjustment for time deposits assumed in applying the purchase accounting guidance for the 2013 Pensco merger. For a further discussion of the fair value adjustments related to deposits assumed in the merger, refer to the Notes to the Consolidated Financial Statements to this Annual Report.

In addition to deposit gathering, we have in place a secondary source of liquidity to fund operations through exercising existing credit arrangements with the FHLB-Pgh. We relied on this type of funding more extensively in 2017 than in 2016 due to the strong loan growth experienced during the year. For a further discussion of our borrowings and their terms, refer to the notes entitled, “Short-term borrowings” and “Long-term debt,” in the Notes to Consolidated Financial Statements included in Part II, Item 8 of this Annual Report.

**Market Risk Sensitivity:**

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 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 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. 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. 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.

The FOMC has raised rates from historically low levels by increasing the federal funds target rate 25 basis points in December 2016, March 2017, June 2017 and December 2017. The timing and the magnitude of future monetary policy actions that will impact the current interest rate environment are uncertain. Given these conditions, IRR and the ability to effectively manage it, are extremely critical to both bank management and regulators. The FFIEC through its advisory guidance reiterates the importance of effective corporate governance, policies and procedures, risk measuring and monitoring systems, stress testing and internal controls related to the IRR exposure of depository institutions. According to the advisory, the bank regulators believe that the current financial market and economic conditions present significant risk management challenges to all financial institutions. Although the bank regulators recognize that some degree of IRR is inherent in banking, they expect institutions to have sound risk management practices in place to measure, monitor and control IRR exposure. The advisory states that the adequacy and effectiveness of an institution’s IRR management process and the level of IRR exposure are critical factors in the bank regulators’ evaluation of an institution’s sensitivity to changes in interest rates and capital adequacy. Material weaknesses in risk management processes or high levels of IRR exposure relative to capital will require corrective action. We believe our risk management practices with regard to IRR were suitable and adequate given the level of IRR exposure at December 31, 2017.

The Asset/Liability Committee (“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 several 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”), rate sensitive liabilities (“RSL”) and overall operating results and financial position.

With respect to evaluating our exposure to IRR on earnings, we utilize a gap analysis model that considers repricing frequencies of RSA and RSL. 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 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 interest rate sensitivity gap position, illustrating RSA and RSL at their related carrying values, is summarized as follows. The distributions in the table are based on a combination of maturities, call provisions, repricing frequencies and prepayment patterns. Adjustable-rate assets and liabilities are distributed based on the repricing frequency of the instrument. Mortgage instruments are distributed in accordance with estimated cash flows, assuming there is no change in the current interest rate environment.

### Interest rate sensitivity

<b>December 31, 2017</b>	<b>Due within three months</b>	<b>Due after three months but within twelve months</b>	<b>Due after one year but within five years</b>	<b>Due after five years</b>	<b>Total</b>
<b>Rate-sensitive assets:</b>					
Interest-bearing deposits in other banks	\$ 1,152				\$ 1,152
Investment securities	11,042	\$ 23,208	\$ 203,789	\$ 43,783	281,822
Loans, net	493,910	283,379	711,905	203,871	1,693,065
Loans held for sale				106	106
Total rate-sensitive assets	<u>\$ 506,104</u>	<u>\$ 306,587</u>	<u>\$ 915,694</u>	<u>\$ 247,760</u>	<u>\$ 1,976,145</u>
<b>Rate-sensitive liabilities:</b>					
Money market accounts	\$ 278,494				\$ 278,494
NOW accounts	165,425		\$ 224,309		389,734
Savings accounts			387,827		387,827
Time deposits less than \$100	23,379	\$ 47,234	48,086	\$ 6,644	125,343
Time deposits \$100 or more	26,009	74,421	45,459	11,002	156,891
Short-term borrowings	123,675				123,675
Long-term debt	9,787	11,373	28,198	376	49,734
Total rate-sensitive liabilities	<u>\$ 626,769</u>	<u>\$ 133,028</u>	<u>\$ 733,879</u>	<u>\$ 18,022</u>	<u>\$ 1,511,698</u>
<b>Rate-sensitivity gap:</b>					
Period	\$ (120,665)	\$ 173,559	\$ 181,815	\$ 229,738	
Cumulative	\$ (120,665)	\$ 52,894	\$ 234,709	\$ 464,447	
<b>RSA/RSL ratio:</b>					
Period	0.81	2.30	1.25	13.75	
Cumulative	0.81	1.07	1.16	1.31	1.31

At December 31, 2017 and 2016, we had cumulative one-year RSA/RSL ratios of 1.07 and 1.28. As previously mentioned, this indicated that if interest rates increase, our earnings would likely be favorably impacted. Given current improvement in economic conditions and the recent action of the FOMC to raise short-term rates and their consideration to continue to raise short-term rates in the 2018, the focus of ALCO has been to maintain the positive gap position in order to safeguard future earnings from the potential risk of rising interest rates. During 2017 ALCO took steps to reduce the magnitude of our positive gap position and guard against rates unchanged through the origination of five year fixed rate loans and purchase of intermediate-term investment securities. ALCO will continue to focus efforts on strategies in 2018 in an attempt to maintain a positive gap position between RSA and RSL. However, these forward-looking



statements are qualified in the aforementioned section entitled “Forward-Looking Discussion” in this Management’s Discussion and Analysis.

The change in our cumulative one-year ratio from the previous year-end resulted from a \$136.8 million or 22.0 percent increase in RSL coupled with a \$17.4 million or 2.2 percent increase in RSA maturing or repricing within one year. The increase in RSL resulted primarily from a \$75.4 million increase in interest-bearing transaction accounts and an increase in short-term borrowings of \$41.0 million. The majority of the growth in money market and NOW accounts resulted from an increase in the deposit balances of local school districts and commercial customers. Due to the somewhat cyclical nature associated with these deposits, we classified money market and NOW accounts in the “due within twelve months” category.

With respect to the increase in RSA maturing or repricing within a twelve month time horizon, loans, net increased \$43.4 million while investment securities decreased \$27.0 million. Short-term interest rates increased faster than longer-term rates during 2017 causing the yield curve to flatten. In an effort to mitigate IRR in the investment portfolio and provide a source of liquidity, we chose to invest in fixed-rate, short-term and intermediate-term U.S. Government-sponsored agency securities and, to a lesser extent, longer-term municipal securities. The increase in loans, net of unearned income, resulted from an increase in commercial lending, which primarily involves loans with adjustable-rate terms that reprice in the near term.

Static gap analysis, although a credible 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 and variations occur daily as we adjust our rate sensitivity throughout the year. Finally, assumptions must be made in constructing such a table. For example, the conservative nature of our Asset/Liability Management Policy assigns personal NOW accounts to the “Due after three months but within twelve months” repricing interval. In reality, these accounts may reprice less frequently and in different magnitudes than changes in general market interest rate levels.

We utilize a simulation model to address the failure of the static gap model to address the dynamic changes in the balance sheet composition or prevailing interest rates and to enhance our asset/liability management. This 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 December 31, 2017, would increase slightly at 0.6 percent from model results using current interest rates.

We will continue to monitor our IRR position in 2018 and employ deposit and loan pricing strategies and direct the reinvestment of loan and investment payments and prepayments in order to maintain a favorable 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 our asset/liability management program.

### **Liquidity:**

Liquidity management is essential to our continuing operations as it gives us the ability to meet our financial obligations as they come due, as well as to take advantage of new business opportunities as they arise. Our 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.

Our liquidity position is impacted by several factors which include, among others, loan origination volumes, loan and investment maturity structure and cash flows, demand for core deposits and certificate of deposit maturity structure and retention. We manage these liquidity risks daily, thus enabling us to effectively monitor fluctuations in our position and to adapt our position according to market influence and balance sheet trends. We also forecast future liquidity needs and develop strategies to ensure adequate liquidity at all times.

Historically, core deposits have been our 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. As a final source of liquidity, we have available borrowing arrangements with various financial intermediaries, including the FHLB-Pgh. At December 31, 2017, our maximum borrowing capacity with the FHLB-Pgh was \$631.8 million of which \$173.4 million was outstanding in borrowings. We believe our liquidity is adequate to meet both present and future financial obligations and commitments on a timely basis.

We maintain a Contingency Funding Plan to address liquidity in the event of a funding crisis. Examples of some of the causes of a liquidity crisis include, among others, natural disasters, war, events causing reputational harm and severe and prolonged asset quality problems. The Plan recognizes the need to provide alternative funding sources in times of crisis that go beyond our core deposit base. As a result, we have created a funding program that ensures the availability of various alternative wholesale funding sources that can be used whenever appropriate. Identified alternative funding sources include:

- FHLB-Pgh liquidity contingency line of credit;
- Federal Reserve Bank discount window;
- Internet certificates of deposit;
- Brokered deposits;
- Institutional Deposit Corporation deposits;
- Repurchase agreements; and
- Federal funds purchased.

We have increased our borrowing capacity at the Federal Reserve by establishing a Borrower-in-Custody of Collateral arrangement that enables us to pledge certain loans, not being used as collateral at the FHLB-Pgh, as collateral for borrowings at the Federal Reserve. At December 31, 2017 our borrowing capacity at the Federal Reserve related to this program was \$205.9 million and there were no amounts outstanding.

Based on our liquidity position at December 31, 2017, we do not anticipate the need to utilize any of these sources in the near term.

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 illustrate our reliance on noncore funds to fund our investments and loans maturing after 2017. At December 31, 2017, our noncore funds consisted of time deposits in denominations of \$100 or more, repurchase agreements, short-term borrowings and long-term debt. Large denomination time deposits are particularly not considered to be a strong source of liquidity since they are very interest rate sensitive and are considered to be highly volatile. At December 31, 2017, our net noncore funding dependence ratio, the difference between noncore funds and short-term investments to long-term assets, was 16.1 percent. Our net short-term noncore funding dependence ratio, noncore funds maturing within one year, less short-term investments to long-term assets equaled 11.1 percent. Comparatively, our ratios equaled 14.4 percent and 6.5 percent at the end of 2016, which indicated an increase in our reliance on noncore funds. Moreover, our Basic Liquidity Surplus ratio, defined as liquid assets less short-term

potentially volatile liabilities as a percentage of total assets, declined to 3.7 percent at December 31, 2017, from 4.2 percent at December 31, 2016. We believe that by supplying adequate volumes of short-term investments and implementing competitive pricing strategies on deposits, we can ensure adequate liquidity to support future growth.

The Consolidated Statements of Cash Flows present the change in cash and cash equivalents from operating, investing and financing activities. Cash and cash equivalents consist of cash on hand, cash items in the process of collection, noninterest-bearing and interest-bearing deposits with other banks and federal funds sold. Cash and cash equivalents decreased \$2.5 million for the year ended December 31, 2017. For the year ended December 31, 2016, cash and cash equivalents increased \$7.0 million. During 2017, cash provided by operating and financing activities was partially offset by cash used in investing activities.

Operating activities provided net cash of \$28.6 million in 2017 and \$28.1 million in 2016. Net income, adjusted for the effects of noncash expenses such as depreciation, amortization and accretion of tangible and intangible assets and investment securities, and the provision for loan losses, is the primary source of funds from operations.

Net cash provided by financing activities equaled \$153.5 million in 2017. Net cash provided by financing activities was \$165.3 million in 2016. Deposit gathering, which is our predominant financing activity, increased in both 2017 and 2016. Deposit gathering provided a net cash inflow in 2017 of \$130.3 million and \$132.9 million in 2016. Short-term borrowings increased \$41.0 million in 2017 while a net increase in short-term borrowings of \$44.4 million led to the net cash provided by financing activities in 2016. Deposit gathering in 2017 was partially offset by \$8.4 million repayments of long-term debt as well as cash dividends paid of \$9.3 million. In 2016, deposit gathering was partially offset by a \$2.2 million repayment of long-term debt and cash dividends paid of \$9.2 million.

Our primary investing activities involve transactions related to our investment and loan portfolios. Net cash used in investing activities totaled \$184.6 million in 2017. Net cash used in investing activities was \$186.4 million in 2016. Net cash used in lending activities was \$163.2 million in 2017, a decrease from \$195.4 million in 2016. Activities related to our investment portfolio used net cash of \$16.4 million in 2017 and provided net cash of \$20.1 million in 2016.

We anticipate our liquidity position to be stable in 2018. Based on our expansion in the Lehigh Valley market and expansion into King of Prussia, we are expecting loan demand to continue to be strong throughout 2018. We expect to fund such demand through deposit gathering, payments and prepayments on loans and investments and advances from the FHLB. Additionally, we anticipate a slowdown in deposit receipts from royalties related to the natural gas drilling industry. Moreover, if economic conditions were to weaken it may result in increased interest in bank deposits, as consumers continue to save rather than spend. However, we cannot predict the economic climate or the savings habits of consumers. Should economic conditions continue to improve, deposit gathering may be negatively impacted as depositors seek alternative investments in the market. Regardless of economic conditions and stock market fluctuations, we believe that through constant monitoring and adherence to our liquidity plan, we will have the means to provide adequate cash to fund our normal operations in 2018.

#### **Capital Adequacy:**

We believe a strong capital position is essential to our continued growth and profitability. We strive to maintain a relatively high level of capital to provide our depositors and stockholders with a margin of safety. In addition, a strong capital base allows us to take advantage of profitable opportunities, support future growth and provide protection against any unforeseen losses.

Our ALCO continually reviews our capital position. As part of its review, the ALCO considers: (i) the current and expected capital requirements, including the maintenance of capital ratios in excess of minimum regulatory guidelines; (ii) potential changes in the market value of our securities due to interest rates changes and effect on capital; (iii) projected organic and inorganic asset growth; (iv) the anticipated level of net earnings and capital position, taking into account the projected asset/liability position and exposure to changes in interest rates; (v) significant deteriorations in asset quality; and (vi) the source and timing of additional funds to fulfill future capital requirements.

Based on the recent regulatory emphasis placed on banks to assure capital adequacy, our Board of Directors annually reviews and approves a Capital Plan. Among other specific objectives, this comprehensive plan: (i) attempts to ensure that we and Peoples Bank remain well capitalized under the regulatory framework for prompt corrective action;

(ii) evaluates our capital adequacy exposure through a comprehensive risk assessment; (iii) incorporates periodic stress testing in accordance with the Federal Reserve Board's Supervisory Capital Assessment Program ("SCAP"); (iv) establishes event triggers and action plans to ensure capital adequacy; and (v) identifies realistic and readily available alternative sources for augmenting capital if higher capital levels are required.

Bank regulatory agencies consider capital to be a significant factor in ensuring the safety of a depositor's accounts. These agencies have adopted minimum capital adequacy requirements that include mandatory and discretionary supervisory actions for noncompliance. Our and Peoples Bank's risk-based capital ratios are strong and have consistently exceeded the minimum regulatory capital ratios required for adequately capitalized institutions. Our ratio of Tier 1 capital to risk-weighted assets and off-balance sheet items was 11.9 percent at December 31, 2017, and 12.5 percent at December 31, 2016. Our Total capital ratio was 13.0 percent at December 31, 2017 and 13.5 percent at December 31, 2016. In addition, a new ratio effective January 1, 2015, requires the Company and Peoples Bank maintain a minimum common equity Tier 1 capital to risk-weighted assets of 4.5 percent. Our and Peoples Bank's common equity Tier I capital to risk-weighted assets ratios were 11.9 percent and 11.5 percent at December 31, 2017 and 12.5 percent and 12.1 percent at December 31, 2016. Our Leverage ratio, which equaled 9.9 percent at December 31, 2017 and 10.2 percent at December 31, 2016, exceeded the minimum of 4.0 percent for capital adequacy purposes. Peoples Bank reported Tier 1 capital, Total capital and Leverage ratios of 11.5 percent, 12.6 percent and 9.7 percent at December 31, 2017, and 12.1 percent, 13.2 percent and 9.9 percent at December 31, 2016. Based on the most recent notification from the FDIC, Peoples Bank was categorized as well capitalized at December 31, 2017 and 2016. There are no conditions or events since this notification that we believe have changed Peoples Bank's category. For a further discussion of these risk-based capital standards and supervisory actions for noncompliance, refer to the note entitled, "Regulatory matters," in the Notes to Consolidated Financial Statements to this Annual Report.

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 such as ours began January 1, 2015. For a further discussion of the incorporation of the revised regulatory requirements into the prompt corrective action framework, refer to the section entitled, "Supervision and Regulatory - Regulatory Capital Changes," in Part I of this Annual Report.

Stockholders' equity was \$265.0 million or \$35.82 per share at December 31, 2017, and \$256.6 million or \$34.71 per share at December 31, 2016. Stockholders' equity grew \$8.4 million in 2017 as net income was partially offset by an increase in accumulated other comprehensive loss and dividends.

We declared dividends of \$1.26 per share in 2017 and \$1.24 per share in both 2016 and 2015. The dividend payout ratio, dividends declared as a percent of net income, equaled 50.4 percent in 2017, 46.8 percent in 2016 and 52.5 percent in 2015. Our board of directors intends to continue paying cash dividends in the future. The Pensco merger agreement contemplates that, unless 80 percent of our board of directors determines otherwise, we will pay a quarterly cash dividend in an amount no less than \$0.31 per share through 2018, provided that sufficient funds are legally available, and that Peoples and Peoples Bank remain "well-capitalized" in accordance with applicable regulatory guidelines. Our ability to declare and pay dividends in the future, however, is based on our operating results, financial and economic conditions, capital and growth objectives, appropriate dividend restrictions and other relevant factors. We rely on dividends received from our subsidiary, Peoples Bank, for payment of dividends to stockholders. Peoples Bank's ability to pay dividends is subject to federal and state regulations. For a further discussion on our ability to declare and pay dividends in the future and dividend restrictions, refer to the note entitled, "Regulatory matters," in the Notes to Consolidated Financial Statements included in Part II, Item 8 of this Annual Report.

On January 31, 2014, our board of directors adopted a common stock repurchase plan whereby we were authorized to repurchase up to 370,000 shares of our outstanding common stock through open market purchases. This plan was reauthorized and effectively continued during 2016, resulting in our repurchase and retirement of 16,463 shares for \$604 thousand during the year. On April 28, 2017, our board of directors again effectively continued the plan by authorizing the repurchase of up to 225,000 shares of our outstanding common stock through open market purchases. There were no additional purchases of our outstanding common stock during 2017.

## **Review of Financial Performance:**

Net income was \$18.5 million or \$2.50 per share in 2017 and \$19.6 million or \$2.65 per share in 2016. The results for 2017 include a \$2.3 million net gain on the sale of our merchant services business and a \$2.6 million one time charge to the federal income tax provision related to the revaluation of our net deferred tax asset, while the 2016 results include net gains of \$0.6 million on the sale of investment securities. Return on average assets (“ROAA”) and return on average equity (“ROAE”) were 0.90 percent and 7.02 percent for the year ended December 31, 2017. ROAA was 1.02 percent and ROAE was 7.64 percent for the year ended December 31, 2016.

Tax-equivalent net interest income was \$68.9 million in 2017 and \$65.2 million in 2016. Our net interest margin equaled 3.69 percent in 2017 and 3.77 percent in 2016. Noninterest income totaled \$17.2 million in 2017 and \$15.9 million in 2016. Noninterest expense was \$51.3 million for the year ended December 31, 2017 compared to \$48.0 million for the year ended December 31, 2016. Our productivity is measured by the operating efficiency ratio, defined as noninterest expense less amortization of intangible assets divided by the total of tax-equivalent net interest income and noninterest income. Our operating efficiency ratio was 58.4 percent in 2017.

## **Net Interest Income:**

Net interest income is the fundamental source of earnings for commercial banks. Moreover, 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 and 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 interest rates; and
- The level of nonperforming assets.

Changes in net interest income are measured by the net interest spread and net interest margin. Net interest spread, the difference between the average yield earned on earning assets and the average rate incurred on interest-bearing liabilities, illustrates the effects changing interest rates have on profitability. Net interest margin, net interest income as a percentage of average 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 pretax 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 in this analysis on a tax-equivalent basis using the prevailing federal statutory tax rate.

Similar to all banks, we consider the maintenance of an adequate net interest margin to be of primary concern. The current economic environment has been very challenging for the banking industry. In addition to market rates and competition, nonperforming asset levels are of particular concern for the banking industry and may place additional pressure on net interest margins. Nonperforming assets may stabilize or decrease given the improvements in the economy, particularly the labor markets. No assurance can be given as to how general market conditions will change or how such changes will affect net interest income. Therefore, we believe through prudent deposit and loan pricing practices, careful investing, and constant monitoring of nonperforming assets, our net interest margin will remain strong.

We analyze interest income and interest expense by segregating rate and volume components of earning assets and interest-bearing liabilities. The impact changes in the interest rates earned and paid on assets and liabilities, along with changes in the volumes of earning assets and interest-bearing liabilities, have on net interest income are summarized as follows. The net change or mix component, attributable to the combined impact of rate and volume changes within earning assets and interest-bearing liabilities’ categories, has been allocated proportionately to the change due to rate and the change due to volume.

## Net interest income changes due to rate and volume

	2017 vs 2016 Increase (decrease) attributable to			2016 vs 2015 Increase (decrease) attributable to		
	Total	Rate	Volume	Total	Rate	Volume
Interest income:						
Loans:						
Taxable	\$ 5,044	\$ (651)	\$ 5,695	\$ 5,898	\$ (1,769)	\$ 7,667
Tax-exempt	203	(59)	262	1,046	(370)	1,416
Investments:						
Taxable	566	304	262	(678)	244	(922)
Tax-exempt	(677)	(127)	(550)	81	(570)	651
Interest-bearing deposits	(44)	(23)	(21)		60	(60)
Federal funds sold				(10)	(10)	
Total interest income	<u>5,092</u>	<u>(556)</u>	<u>5,648</u>	<u>6,337</u>	<u>(2,415)</u>	<u>8,752</u>
Interest expense:						
Money market accounts	580	390	190	215	137	78
NOW accounts	341	172	169	205	83	122
Savings accounts	(190)	(201)	11	(107)	(97)	(10)
Time deposits less than \$100	(5)	47	(52)	(127)	(20)	(107)
Time deposits \$100 or more	294	165	129	290	112	178
Short-term borrowings	499	437	62	349	39	310
Long-term debt	(72)	19	(91)	389	(261)	650
Total interest expense	<u>1,447</u>	<u>1,029</u>	<u>418</u>	<u>1,214</u>	<u>(7)</u>	<u>1,221</u>
Net interest income	<u>\$ 3,645</u>	<u>\$ (1,585)</u>	<u>\$ 5,230</u>	<u>\$ 5,123</u>	<u>\$ (2,408)</u>	<u>\$ 7,531</u>

For the year ended December 31, tax-equivalent net interest income was \$68.9 million in 2017 and \$65.2 million in 2016. There was a positive volume variance that was partially offset by a negative rate variance. The growth in average earning assets exceeded that of interest-bearing liabilities, and resulted in additional tax-equivalent net interest income of \$5.2 million. A rate variance resulted in a decrease in net interest income of \$1.6 million.

Average earning assets increased \$135.9 million to \$1,864.9 million in 2017 from \$1,729.0 million in 2016 and accounted for a \$5,648 increase in interest income. Average loans, net increased \$135.6 million, which caused interest income to increase \$5,957. Average taxable investments increased \$14.3 million comparing 2017 and 2016, which resulted in increased interest income of \$262 while average tax-exempt investments decreased \$13.2 million, which resulted in a decrease to interest income of \$550.

Average interest-bearing liabilities rose \$104.2 million to \$1,420.6 million in 2017 from \$1,316.4 million in 2016 resulting in a net increase in interest expense of \$418. Large denomination time deposits averaged \$13.8 million more in 2017 and caused interest expense to increase \$129. A decrease of \$4.9 million in average time deposits less than \$100 reduced interest expense by \$52. In addition, interest-bearing transaction accounts, including money market, NOW and savings accounts grew \$89.7 million, which in aggregate caused a \$370 increase in interest expense. Short-term borrowings averaged \$9.3 million more and increased interest expense \$62 while long-term debt averaged \$3.7 million less and decreased interest expense by \$91 comparing 2017 and 2016.

An unfavorable rate variance occurred, as the tax-equivalent yield on earning assets decreased three basis points while there was a six basis point increase in the cost of funds. As a result, tax-equivalent net interest income decreased \$1,585 comparing 2017 and 2016. The tax-equivalent yield on earning assets was 4.16 percent in 2017 compared to 4.19 percent in 2016 resulting in a reduction in interest income of \$556. While the tax-equivalent yield on the investment portfolio decreased five basis points to 2.84 percent in 2017 from 2.89 percent in 2016, interest income increased \$177 due to changes in the mix of investments. The tax-equivalent yield on the loan portfolio decreased four basis points to 4.39 percent in 2017 from 4.43 percent in 2016 and resulted in a reduction in interest income of \$710.

Unfavorable rate variances were experienced in earning asset yields as well as the cost of funds. We experienced increases in the rates paid on all major categories of interest-bearing liabilities with the exception of savings accounts.

Specifically, the cost of money market and NOW accounts increased 16 basis points and 5 basis points comparing 2017 and 2016. These increases resulted in an increase in interest expense of \$562. The cost of savings accounts decreased five basis points, which resulted in a decrease of \$201 in interest expense. With regard to time deposits, the average rate paid for time deposits less than \$100 increased three basis points while time deposits \$100 or more increased 14 basis points, which together resulted in a \$212 increase in interest expense. The average rate paid on short-term borrowings increased 57 basis points in 2017 when compared to 2016, causing a \$437 increase in interest expense. Interest expense increased \$19 from a four basis point increase in the average rate paid on long-term debt.

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 35.0 percent.

## Summary of net interest income

	2017			2016		
	Average Balance	Interest Income/Expense	Average Interest Rate	Average Balance	Interest Income/Expense	Average Interest Rate
Assets:						
Earning assets:						
Loans:						
Taxable	\$ 1,479,387	\$ 64,946	4.39 %	\$ 1,349,797	\$ 59,902	4.44 %
Tax-exempt	112,594	4,866	4.32	106,544	4,663	4.38
Investments:						
Taxable	161,643	3,130	1.94	147,329	2,564	1.74
Tax-exempt	110,788	4,612	4.16	123,942	5,289	4.27
Interest-bearing deposits	500	5	1.00	1,432	49	3.42
Federal funds sold						
Total earning assets	1,864,912	77,559	4.16 %	1,729,044	72,467	4.19 %
Less: allowance for loan losses	17,673			14,781		
Other assets	212,845			204,222		
Total assets	<u>\$ 2,060,084</u>			<u>\$ 1,918,485</u>		
Liabilities and Stockholders' Equity:						
Interest-bearing liabilities:						
Money market accounts	\$ 262,292	1,434	0.55 %	\$ 219,265	854	0.39 %
NOW accounts	345,383	1,549	0.45	305,156	1,208	0.40
Savings accounts	398,104	503	0.13	391,631	693	0.18
Time deposits less than \$100	157,397	1,698	1.08	162,286	1,703	1.05
Time deposits \$100 or more	125,220	1,265	1.01	111,405	971	0.87
Short-term borrowings	76,846	901	1.17	67,553	402	0.60
Long-term debt	55,342	1,348	2.44	59,066	1,420	2.40
Total interest-bearing liabilities	1,420,584	8,698	0.61 %	1,316,362	7,251	0.55 %
Noninterest-bearing deposits	361,386			330,295		
Other liabilities	15,064			15,469		
Stockholders' equity	263,050			256,359		
Total liabilities and stockholders' equity	<u>\$ 2,060,084</u>			<u>\$ 1,918,485</u>		
Net interest income/spread		<u>\$ 68,861</u>	3.55 %		<u>\$ 65,216</u>	3.64 %
Net interest margin			3.69 %			3.77 %
Tax-equivalent adjustments:						
Loans		\$ 1,703			\$ 1,632	
Investments		1,614			1,851	
Total adjustments		<u>\$ 3,317</u>			<u>\$ 3,483</u>	

Note: Average balances were calculated using average daily balances. Interest income on loans includes fees of \$1,469 in 2017, \$1,085 in 2016 and \$1,177 in 2015.



	2015		
	Average Balance	Interest Income/ Expense	Average Interest Rate
Assets:			
Earning assets:			
Loans:			
Taxable	\$ 1,180,610	\$ 54,004	4.57 %
Tax-exempt	74,956	3,617	4.83
Investments:			
Taxable	201,663	3,242	1.61
Tax-exempt	109,575	5,208	4.75
Interest-bearing deposits	6,049	49	0.81
Federal funds sold	3,915	10	0.26
Total earning assets	<u>1,576,768</u>	<u>66,130</u>	4.19 %
Less: allowance for loan losses	11,392		
Other assets	179,173		
Total assets	<u>\$ 1,744,549</u>		
Liabilities and Stockholders' Equity:			
Interest-bearing liabilities:			
Money market accounts	\$ 197,129	639	0.32 %
NOW accounts	273,792	1,003	0.37
Savings accounts	396,606	800	0.20
Time deposits less than \$100	172,830	1,830	1.06
Time deposits \$100 or more	90,030	681	0.76
Short-term borrowings	13,480	53	0.39
Long-term debt	33,644	1,031	3.06
Total interest-bearing liabilities	<u>1,177,511</u>	<u>6,037</u>	0.51 %
Noninterest-bearing deposits	303,647		
Other liabilities	14,695		
Stockholders' equity	248,696		
Total liabilities and stockholders' equity	<u>\$ 1,744,549</u>		
Net interest income/spread		<u>\$ 60,093</u>	3.68 %
Net interest margin			3.81 %
Tax-equivalent adjustments:			
Loans		\$ 1,266	
Investments		1,823	
Total adjustments		<u>\$ 3,089</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, volume 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 an appropriate level. The provision for loan losses equaled \$4,800 in 2017 and \$5,000 in 2016. A lower provision for loan losses is the product of improving asset quality throughout 2017. Consumer loans experienced an increase in the qualitative factors for asset quality while commercial loans experienced an increase in the qualitative factor for concentration levels. Based on our most recent evaluation at December 31, 2017, we believe that the allowance was adequate to absorb any known or potential losses in our portfolio.

## Noninterest Income:

Our noninterest income increased \$1,298 or 8.2 percent to \$17.2 million in 2017 from \$15.9 million in 2016. We realized a \$2.3 million net gain on the sale of our merchant services business in 2017 while the 2016 results include net gains of \$0.6 million on the sale of investment securities. Revenue received from service charges, fees and commissions increased \$1,228 or 20.1 percent comparing 2017 and 2016, due in part to fees generated on interest rate swap transactions which we began entering into during the third quarter of 2017. Swap transactions resulted in the recognition of net fee income of \$749 thousand. These interest rate swaps allowed the bank to retain large commercial credit relationships. Commissions and fees on fiduciary activities increased \$81 or 4.1 percent comparing 2017 and 2016 due to an increase in executor fees. Wealth management income increased \$113 or 8.7 percent comparing 2017 to 2016 as the plan to accelerate growth continued throughout 2017. Offsetting the increase were lower revenues received from merchant services of \$1,656 due to the sale of our merchant services business in the second quarter of 2017. Mortgage banking income decreased \$101 or 11.4 percent in 2017 compared to 2016 due to the leveling off of volumes which were driven by the increase in market rates. Income from investment in life insurance decreased \$22 or 2.8 percent to \$769 in 2017 from \$791 in 2016.

## Noninterest Expense:

In general, our noninterest expense is categorized into three main groups, including employee-related expense, occupancy and equipment expense 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 marketing, other taxes, stationery and supplies, contractual services, insurance, including FDIC assessment and loan collection costs. Several of these costs and expenses are variable while the remainder is fixed. We utilize budgets and other related strategies in an effort to control the variable expenses.

The major components of noninterest expense for the past three years are summarized as follows:

### Noninterest expense

<u>Year ended December 31</u>	<u>2017</u>	<u>2016</u>	<u>2015</u>
<b>Salaries and employee benefits expense:</b>			
Salaries and payroll taxes	\$ 22,271	\$ 18,655	\$ 18,116
Employee benefits	4,399	3,779	3,417
Salaries and employee benefits expense	<u>26,670</u>	<u>22,434</u>	<u>21,533</u>
<b>Occupancy and equipment expenses:</b>			
Occupancy expense	5,632	5,284	5,551
Equipment expense	4,343	4,138	3,553
Occupancy and equipment expenses	<u>9,975</u>	<u>9,422</u>	<u>9,104</u>
<b>Other expenses:</b>			
Merchant transaction expense	1,808	2,993	2,643
FDIC insurance and assessments	826	1,101	997
Professional fees and outside services	2,277	2,128	2,211
Other taxes	691	767	973
Stationery and supplies	749	736	744
Advertising	942	972	736
Amortization of intangible assets	1,034	1,186	1,195
Donations	1,188	1,006	740
Other	5,133	5,285	5,903
Other expenses	<u>14,648</u>	<u>16,174</u>	<u>16,142</u>
Total noninterest expense	<u>\$ 51,293</u>	<u>\$ 48,030</u>	<u>\$ 46,779</u>

Noninterest expense was \$51.3 million for the year ended December 31, 2017 compared to \$48.0 million for the year ended December 31, 2016.

Salaries and employee benefits expense constitute the majority of our noninterest expenses accounting for 52.0 percent of the total noninterest expense. Salaries and employee benefits expense increased \$4,236 or 18.9 percent to \$26.7 million in 2017 from \$22.4 million in 2016. Salaries and payroll taxes increased \$3,616 or 19.4 percent, while employee benefits expense increased \$620 or 16.4 percent. Severances paid out in the first half of 2016 along with the addition of salaries and benefit costs associated with our further expansion in the Lehigh Valley with the opening of two new community banking offices during 2017 and a full year at our King of Prussia branch office provided the majority of the increase.

Occupancy and equipment expense increased \$553 or 5.9 percent to \$10.0 million in 2017 from \$9.4 million in 2016. Specifically, building-related costs increased \$348 or 6.6 percent while equipment-related costs increased \$205 or 5.0 percent. The increases in occupancy and equipment-related expenses were driven by costs associated with the opening of our new community banking offices on Tilghman Street in West Allentown, PA and Emrick Boulevard in Bethlehem, PA.

Other expenses, which consist of merchant transaction expense, FDIC insurance and assessments, professional fees and outside services, other taxes, stationary and supplies, advertising, amortization of intangible assets and all other expenses were \$14.6 million in 2017 and \$16.2 million in 2016. Merchant transaction expenses decreased \$1,185 or 40.0 percent to \$1,808 due to the sale of our merchant business in the second quarter of 2017. All other expenses, including FDIC insurance and assessments, professional fees and outside services, other taxes, stationery and supplies, advertising and amortization of intangible assets and other expenses totaled \$12,840 in 2017, a decrease of \$341 or 2.6 percent, compared to \$13,181 in 2016.

#### **Income Taxes:**

Our income tax expense was \$8.2 million in 2017 and \$5.0 million in 2016. On December 22, 2017, President Donald Trump signed into law H.R. 1, also known as the Tax Cuts and Jobs Act, which among other things reduced the federal corporate income tax rate to 21% effective January 1, 2018. As a result, and in accordance with accounting principles generally accepted in the United States of America ("GAAP"), we concluded that deferred tax assets, net had to be revalued. Our deferred tax assets, net represents expected corporate tax benefits anticipated to be realized in the future. The reduction in the federal corporate income tax rate reduces these anticipated future benefits. The revaluation of the our deferred tax assets, net at December 31, 2017 resulted in a reduction of these net assets and a corresponding increase in income tax expense of \$2.6 million or \$0.35 per share, which was recorded in the fourth quarter of 2017. The remainder of the increase resulted from higher before tax income in 2017 compared to 2016. We utilize loans and investments of tax-exempt organizations to mitigate our tax burden, as interest revenue from these sources is not taxable by the federal government. Without regard to the one-time deferred tax adjustment, our effective tax rate increased slightly to 20.9 percent in 2017, compared to 20.4 percent in 2016.

The effective tax rate in 2017 and 2016 was also influenced by the recognition of investment tax credits related to our limited partnership investments in elderly and low- to moderate-income residential housing programs which allow us to mitigate our tax burden. By utilizing these credits, we reduced our income tax expense by \$1.1 million in both 2017 and 2016. We anticipate investment tax credits from these investments to be \$1.1 million in 2018 as well. Over the next seven years, we will recognize aggregate tax credits from our investments in these projects of \$6.7 million.

**Management’s Discussion and Analysis 2016 versus 2015  
(Dollars in thousands, except per share data)**

**Operating Environment:**

The United States economy slowed in 2016, as the gross domestic product (“GDP”), the value of all goods and services produced in the Nation, came in at an annual rate of 1.9 percent in the fourth quarter, compared to 3.5 percent in the third quarter. The economy grew at 1.6 percent for all of 2016, the worst performance since 2011, after growing at a rate of 2.6 percent in 2015. Again in 2016, the Federal Reserve Board’s Federal Open Market Committee (“FOMC”) remained on hold for the majority of the year, keeping the target federal funds rate at a range of .25% to .50%. At their December 2016 meeting, the FOMC raised interest rates for the first time in 2016, when they voted to set the new target federal funds rate at a range of .50% to .75%, a 25 basis point increase. The FOMC stated at this meeting that they expected economic conditions to continue to improve and targeted 3 additional rate hikes in 2017.

Inflation picked up somewhat in 2016, as the consumer price index (“CPI”) registered 2.1 percent for 2016, just eclipsing the FOMC’s benchmark of 2.0 percent. The CPI was 0.7 percent in 2015. Moreover, the core personal consumption expenditure price index, which ignores food and energy, averaged 2.2 percent in 2016.

On a national level, employment conditions improved in 2016. The civilian labor force increased 1.7 million, while the number of people employed increased 2.1 million in 2016. As a result, the annual unemployment rate for the U.S. fell in 2016 when compared to 2015. All sectors of employment, with the exception of manufacturing, reported employment gains from the end of 2015.

National, Pennsylvania, New York and our market area’s non-seasonally-adjusted annual unemployment rates in 2016 and 2015, are summarized as follows:

	<u>2016</u>	<u>2015</u>
United States	4.9 %	5.3 %
New York	4.9	5.3
Pennsylvania	5.4	5.1
Broome County	5.4	6.0
Bucks County	4.6	4.5
Lackawanna County	5.7	5.6
Lehigh County	5.5	5.3
Luzerne County	6.4	6.2
Monroe County	6.3	6.4
Montgomery County	4.2	4.0
Northampton County	5.4	—
Susquehanna County	5.5	5.4
Wayne County	5.8	5.5
Wyoming County	6.2 %	5.9 %

Employment conditions deteriorated for the Commonwealth of Pennsylvania in 2016 as evidenced by an increase in the unemployment rate to 5.4 percent in 2016 from 5.1 percent in 2015. Conversely, the unemployment rate for New York State dropped to 4.9 percent in 2016, from 5.3 percent in 2015. With respect to the markets we serve, the unemployment rate increased in eight of the counties in which we have branches or ATM locations, remained the same in one and decreased in one. The lowest unemployment rate in 2016, for all of the counties we serve, was Montgomery County at 4.2 percent. The slight downturn in employment figures in a majority of our markets could have a negative impact on loan performance.

With respect to the banking industry, net income for all Federal Deposit Insurance Corporation (“FDIC”)-insured banks in 2016 totaled \$171.7 billion, an increase of \$7.8 billion or 4.8 percent from 2015. Approximately 65.2 percent of all institutions reported higher net income in 2016, while only 4.2 percent reported net losses. This is the lowest annual proportion of unprofitable institutions for the industry since 2004. Loan loss provisions of \$47.8 billion in 2016 were \$10.7 billion or 28.8 percent more than banks set aside in 2015. This is the second consecutive year that loan loss provisions have been higher than the preceding year, and the total allocation for 2015 was the largest amount since 2012.

Net interest income increased for the third year in a row, by \$29.8 billion or 6.9 percent. Noninterest income was \$0.8 billion or 0.3 percent below the level of 2015, as servicing fee income decreased by \$0.8 billion or 7.4 percent. Realized gains on sales of loans were \$1.9 billion or 14.0 percent higher than a year ago. Total noninterest expense decreased \$5.1 billion or 1.2 percent comparing 2016 and 2015. The average return on average assets for 2016 was 1.04 percent, unchanged from 2015.

The United States economy continued to improve in 2016. An improving economy could affect future interest rates which may adversely impact bank earnings as net interest margins compress from the inability of management to keep fund costs low. Continuous expense control, sound balance sheet management and lower loan loss provisions could offset some of the negative impact of the reduction in net interest margins.

### **Review of Financial Position:**

Total assets, loans and deposits were \$2.0 billion, \$1.5 billion and \$1.6 billion, respectively, at December 31, 2016. Total assets, loans and deposits grew 9.9 percent, 14.3 percent and 9.1 percent, respectively, compared to 2015 year-end balances.

The loan portfolio consisted of \$1.1 billion of business loans, including commercial and commercial real estate loans, and \$424.0 million in retail loans, including residential mortgage and consumer loans at December 31, 2016. Total investment securities were \$269.9 million at December 31, 2016, including \$259.4 million of investment securities classified as available-for sale and \$10.5 million classified as held-to-maturity. Total deposits consisted of \$353.7 million in noninterest-bearing deposits and \$1.2 billion in interest-bearing deposits at December 31, 2016

Stockholders' equity equaled \$256.6 million, or \$34.71 per share, at December 31, 2016, and \$248.8 million, or \$33.57 per share, at December 31, 2015. Our equity to asset ratio was 12.83 percent and 13.68 percent at those respective period ends. Dividends declared for 2016 amounted to \$1.24 per share representing 46.8 percent of net income.

Nonperforming assets equaled \$14.2 million or 0.93 percent of loans, net and foreclosed assets at December 31, 2016, up from \$12.5 million or 0.93 percent at December 31, 2015. The allowance for loan losses equaled \$16.0 million or 1.04 percent of loans, net, at December 31, 2016, compared to \$13.0 million or 0.97 percent at year-end 2015. Loans charged-off, net of recoveries equaled \$2.0 million or 0.14 percent of average loans in 2016, compared to \$1.1 million or 0.08 percent of average loans in 2015.

### **Investment Portfolio:**

Primarily, our investment portfolio provides a source of liquidity needed to meet expected loan demand and generates a reasonable return in order to increase our profitability. Additionally, we utilize the investment portfolio to meet pledging requirements and reduce income taxes. At December 31, 2016, our portfolio consisted primarily of short-term U.S. Treasury and Government agency securities, which provide a source of liquidity and intermediate-term, tax-exempt state and municipal obligations, which mitigate our tax burden.

Investment securities decreased \$27.1 million, to \$269.9 million at December 31, 2016, from \$297.0 million at December 31, 2015. At December 31, 2016, the investment portfolio consisted of \$259.4 million of investment securities classified as available-for-sale and \$10.5 million classified as held-to-maturity. Strong loan demand during the first three quarters of 2016 resulted in using a portion of the investment cash flow to fund loans. Excess cash flow from investment payments and repayments was directed back into the investment portfolio in the fourth quarter of 2016. Security purchases totaled \$62.0 million in 2016, with the majority of the purchases consisting of short-term U.S. Treasury securities and intermediate-term U.S. government sponsored enterprises securities. Investment purchases in 2015 amounted to \$90.4 million.

Repayments of investment securities totaled \$54.7 million in 2016 and \$60.8 million in 2015. We received proceeds of \$27.4 million from the sale of investment securities in 2016 and \$82.0 million in 2015. Net gains recognized on the sale of investment securities available-for-sale totaled \$623 in 2016 and \$1,189 in 2015. The 2016 sales consisted of \$17.1 million of short-term U.S. Government-sponsored enterprises securities and \$10.3 million of short-term U.S. Treasury securities. We continually analyze the investment portfolio with respect to its exposure to various risk elements.

Investment securities averaged \$271.3 million and equaled 15.7 percent of average earning assets in 2016, compared to \$311.2 million and equaled 19.7 percent of average earning assets in 2015. The tax-equivalent yield on the investment portfolio increased eighteen basis points to 2.89 percent in 2016 from 2.71 percent in 2015.

### **Loan Portfolio:**

Loans, net increased \$192.1 million or 14.3 percent in 2016 to \$1.5 billion at December 31, 2016. Business loans, including commercial loans and commercial real estate loans, were \$1.1 billion or 72.3 percent of loans, net at December 31, 2016, and \$933.0 million or 69.6 percent at year-end 2015. Residential mortgages and consumer loans totaled \$424.0 million or 27.7 percent of loans, net at year-end 2016 and \$407.8 million or 30.4 percent at year-end 2015. Loan growth remained strong throughout 2016. Loans, net grew at an annual rate of 14.3 percent in 2016. More than half of the increase in loans in 2016 was attributable to the continued growth fostered by our entrance into the Lehigh Valley market during the fourth quarter of 2014 by establishing a community banking office with a dedicated team of commercial and retail lenders. Additional growth was attained through our entrance into the King of Prussia market initially by establishing a loan production office and then by opening a retail branch in the fourth quarter of 2016. The remainder of such growth was generated from improved demand for business lending in existing markets. Based on the customer service oriented philosophy of our organization along with the commitment of these employees, we expect to be as well received in this new market as we are in our existing markets.

Loans averaged \$1.5 billion in 2016, compared to \$1.3 billion in 2015. Taxable loans averaged \$1.4 billion, while tax-exempt loans averaged \$107.0 million in 2016. Due to improving loan demand, the loan portfolio continues to play a prominent role in our earning asset mix. As a percentage of earning assets, average loans equaled 84.2 percent in 2016, an increase from 79.6 percent in 2015.

### **Asset Quality:**

We experienced a slight decrease in our asset quality as evidenced by an increase in nonperforming assets of \$1.7 million or 14.0 percent to \$14.2 million or 0.93 percent of loans, net of unearned income, and foreclosed assets at December 31, 2016, from \$12.5 million or 0.93 percent of loans, net of unearned income, and foreclosed assets at the end of 2015. The increase resulted from a \$3.2 million increase in nonaccrual loans, offset by a \$564 decrease in foreclosed assets and by a decrease of \$952 in troubled debt restructured loans. For a further discussion of assets classified as nonperforming assets and potential problem loans, refer to the note entitled, "Loans, net and the allowance for loan losses," in the Notes to Consolidated Financial Statements to this Annual Report.

We maintain the allowance for loan losses at a level we believe adequate to absorb probable credit losses related to individually evaluated loans, as well as probable incurred losses inherent in the remainder of the loan portfolio as of the balance sheet date. The balance in the allowance for loan losses account is based on past events and current economic conditions. We employ the FFIEC Interagency Policy Statement, as amended, 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 FASB Accounting Standards Codification ("ASC") 310 for loans specifically identified to be individually evaluated for impairment and the requirements of FASB ASC 450, for large groups of smaller-balance homogeneous loans to be collectively evaluated for impairment.

The allowance for loan losses increased \$3.0 million to \$16.0 million at December 31, 2016, from \$13.0 million at the end of 2015. The increase resulted from a provision for loan losses of \$5.0 million exceeding net loans charged-off of \$2.0 million. The allowance for loan losses, as a percentage of loans, net of unearned income, was 1.04 percent at the end of 2016, compared to 0.97 percent at the end of 2015.

Past due loans not satisfied through repossession, foreclosure or related actions are evaluated individually to determine if all or part of the outstanding balance should be charged against the allowance for loan losses account. Any subsequent recoveries are credited to the allowance account. Net loans charged-off increased \$951 to \$2,014 in 2016 from \$1,063 in 2015. Net charge-offs, as a percentage of average loans outstanding, equaled 0.14 percent in 2016 and 0.08 percent in 2015.

The allocated element of the allowance for loan losses account increased \$3,009 to \$15,961 at December 31, 2016, compared to \$12,952 at December 31, 2015. The specific portion of the allowance for loan losses decreased while the formula portions of the allowance for loan losses increased from the end of 2015. The specific portion of the allowance for impairment of loans individually evaluated under FASB ASC 310 decreased \$305 to \$1,942 at December 31, 2016, from \$2,247 at December 31, 2015. However, the formula portion of the allowance for loans collectively evaluated for impairment under FASB ASC 450, increased \$3,314 to \$14,019 at December 31, 2016, from \$10,705 at December 31, 2015. The decrease in the specific portion of the allowance was a result of a decrease in the calculated allowance on loans considered impaired despite an increase in the amount of impaired loans designated with a related allowance. The increase in the formula portion was due to higher loan volume and the relatively unchanged overall loss factor.

There was no unallocated element of the total allowance for loan losses at December 31, 2016. As is inherent with all estimates, the allowance for loan losses methodology is subject to a certain level of imprecision as it provides reasonable, but not absolute, assurance that the allowance will be able to absorb probable losses, in their entirety, as of the financial statement date. Factors, among others, including judgments made in identifying those loans considered impaired, appraisals of collateral values and measurements of certain qualitative factors, all cause this imprecision and support the establishment of the unallocated element.

The coverage ratio, the allowance for loan losses account, as a percentage of nonperforming loans, is an industry ratio used to test the ability of the allowance account to absorb potential losses arising from nonperforming loans. The coverage ratio was 115.5 percent at December 31, 2016 and 112.8 percent at December 31, 2015. We believe that our allowance was adequate to absorb probable credit losses at December 31, 2016.

#### **Deposits:**

Our deposit base is the primary source of funds to support our operations. We offer a variety of deposit products to meet the needs of our individual and commercial customers. Total deposits grew \$132.9 million or 9.1 percent to \$1.6 billion at the end of 2016. Noninterest-bearing deposits grew \$32.7 million or 10.2% while interest-bearing deposits increased \$100.2 million or 8.8% in 2016. Noninterest-bearing deposits represented 22.3 percent of total deposits while interest-bearing deposits accounted for 77.7 percent of total deposits at December 31, 2016. Comparatively, noninterest-bearing deposits and interest-bearing deposits represented 22.0 percent and 78.0 percent of total deposits at year end 2015. With regard to noninterest-bearing deposits, personal checking accounts increased \$9.6 million or 5.6 percent, while commercial checking accounts increased \$23.1 million or 15.3 percent. The increase in noninterest-bearing deposits is essential in attempting to keep our overall cost of funds low given the pressure on our net interest margin from the continuation of the low interest rate environment.

With regard to interest-bearing deposits, interest-bearing transaction accounts, which include money market accounts, NOW accounts, and savings accounts, increased \$86.5 million in 2016. Commercial interest-bearing transaction accounts increased \$70.4 million, while personal interest-bearing transaction accounts increased \$16.1 million. The increase in personal accounts was primarily due to increases in NOW and money market accounts of \$7.9 million and savings accounts of \$8.2 million. The strong growth in the commercial account types was due to our strategic initiative to grow our public fund deposits. Total time deposits increased \$13.7 million to \$285.7 million at December 31, 2016 from \$272.0 million at December 31, 2015. The increase was primarily due to a promotional premium rate offered on a time deposit with a maturity slightly over one year.

Total deposits averaged \$1.5 billion in 2016 and \$1.4 billion in 2015, increasing \$86.0 million or 6.0 percent comparing 2016 to 2015. Average noninterest-bearing deposits increased \$26.7 million, while average interest-bearing accounts grew \$59.3 million. Average interest-bearing transaction deposits, including money market, NOW and savings accounts, increased \$48.5 million while average total time deposits increased \$10.8 million when comparing 2016 and 2015.

Our cost of interest-bearing deposits increased 2 basis points to 0.46 percent in 2016 from 0.44 percent in 2015. Specifically, the cost of interest-bearing transaction accounts increased 2 basis points to 0.30 percent while the cost of time deposits increased 2 basis points to 0.98 percent comparing 2016 and 2015. The increases to the cost of interest-bearing transaction deposits and to the cost of time deposits was due to the introduction of premium rate deposit specials at our new branch office in Kingston and our branch office in the Lehigh Valley in 2016.

Volatile deposits, time deposits \$100 or more, averaged \$111.0 million in 2016, an increase of \$21.0 million or 23.7 percent from \$90.0 million in 2015. Our average cost of these funds increased 11 basis points to 0.87 percent in 2016, from 0.76 percent in 2015. This type of funding is susceptible to withdrawal by the depositor as they are particularly price sensitive and are therefore not considered to be a strong source of liquidity.

### **Market Risk Sensitivity:**

With respect to evaluating our exposure to IRR on earnings, we utilize a gap analysis model that considers repricing frequencies of RSA and RSL. 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 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.

At December 31, 2016 and 2015, we had cumulative one-year RSA/RSL ratios of 1.28 and 1.43. As previously mentioned, this indicated that if interest rates increase, our earnings would likely be favorably impacted. Given current improvement in economic conditions and the recent action of the FOMC to raise short-term rates 25 basis points and their consideration to continue to raise short-term rates in the 2017, the focus of ALCO has been to maintain the positive gap position in order to safeguard future earnings from the potential risk of rising interest rates. During 2016 ALCO took steps to reduce the magnitude of our positive gap position and guard against rates unchanged through the origination of five year fixed rate loans and purchase of intermediate-term investment securities. ALCO will continue to focus efforts on strategies in 2017 in an attempt to maintain a positive gap position between RSA and RSL. However, these forward-looking statements are qualified in the aforementioned section entitled "Forward-Looking Discussion" in this Management's Discussion and Analysis.

The change in our cumulative one-year ratio from the previous year-end resulted from a \$137.0 million or 28.2 percent increase in RSL coupled with a \$98.4 million or 14.1 percent increase in RSA maturing or repricing within one year. The increase in RSL resulted primarily from a \$92.6 million increase in interest-bearing transaction accounts and an increase in short-term borrowings of \$44.4 million. The majority of the growth in money market and NOW accounts resulted from an increase in the deposit balances of local school districts and certain commercial customers. Due to the somewhat cyclical nature associated with these deposits, we classified money market and NOW accounts in the "due within twelve months" category.

With respect to the increase in RSA maturing or repricing within a twelve month time horizon, loans, net increased \$102.3 million while investment securities remained relatively constant. Although short-term interest rates began to increase during 2016, long-term interest rates fell causing a flattening in the yield curve. In an effort to mitigate IRR in the investment portfolio and provide a source of liquidity, we chose to invest in fixed-rate, short-term U.S. Government-sponsored agency securities. The increase in loans, net of unearned income, resulted from an increase in commercial lending, which primarily involves loans with adjustable-rate terms that reprice in the near term.

### **Liquidity:**

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 illustrate our reliance on noncore funds to fund our investments and loans maturing after 2016. At December 31, 2016, our noncore funds consisted of time deposits in denominations of \$100 or more, repurchase agreements, short-term borrowings and long-term debt. Large denomination time deposits are particularly not considered to be a strong source of liquidity since they are very interest rate sensitive and are considered to be highly volatile. At December 31, 2016, our net noncore funding dependence ratio, the difference between noncore funds and short-term investments to long-term assets, was 14.4 percent. Our net short-term noncore funding dependence ratio, noncore funds maturing within one year, less short-term investments to long-term assets equaled 6.5 percent. Comparatively, our ratios equaled 11.3 percent and 4.1 percent at the end of 2015, which indicated an increase in our reliance on noncore funds. Moreover, our Basic Liquidity Surplus ratio, defined as liquid assets less short-term potentially volatile liabilities as a percentage of total assets, improved to 4.2 percent at December 31, 2016, from 1.6



percent at December 31, 2015. We believe that by supplying adequate volumes of short-term investments and implementing competitive pricing strategies on deposits, we can ensure adequate liquidity to support future growth.

The Consolidated Statements of Cash Flows present the change in cash and cash equivalents from operating, investing and financing activities. Cash and cash equivalents consist of cash on hand, cash items in the process of collection, noninterest-bearing and interest-bearing deposits with other banks and federal funds sold. Cash and cash equivalents increased \$7.0 million for the year ended December 31, 2016. For the year ended December 31, 2015, cash and cash equivalents increased \$1.5 million. During 2016, cash provided by operating and financing activities was partially offset by cash used in investing activities.

Operating activities provided net cash of \$28.1 million in 2016 and \$29.2 million in 2015. Net income, adjusted for the effects of noncash expenses such as depreciation, amortization and accretion of tangible and intangible assets and investment securities, and the provision for loan losses, is the primary source of funds from operations.

Net cash provided by financing activities equaled \$165.3 million in 2016. Net cash provided by financing activities was \$61.7 million in 2015. Deposit gathering, which is our predominant financing activity, increased in both 2016 and 2015. Deposit gathering provided a net cash inflow in 2016 of \$132.9 million and \$30.3 million in 2015. Short-term borrowings increased \$44.4 million in 2016 while proceeds from long-term debt of \$30.0 million and a net increase in short-term borrowings of \$18.8 million lead to the net cash provided by financing activities in 2015. Deposit gathering in 2016 was partially offset by \$2.2 million repayments of long-term debt as well as cash dividends paid of \$9.2 million. In 2015, deposit gathering was partially offset by a \$5.2 million decrease for the retirement of common stock, a \$2.7 million repayment of long-term debt and cash dividends paid of \$9.3 million.

Our primary investing activities involve transactions related to our investment and loan portfolios. Net cash used in investing activities totaled \$186.4 million in 2016. Net cash used in investing activities was \$89.4 million in 2015. Net cash used in lending activities was \$195.4 million in 2016, an increase from \$133.1 million in 2015. Activities related to our investment portfolio provided net cash of \$20.1 million in 2016 and \$52.4 million in 2015.

#### **Capital Adequacy:**

Bank regulatory agencies consider capital to be a significant factor in ensuring the safety of a depositor's accounts. These agencies have adopted minimum capital adequacy requirements that include mandatory and discretionary supervisory actions for noncompliance. Our and Peoples Bank's risk-based capital ratios are strong and have consistently exceeded the minimum regulatory capital ratios required for adequately capitalized institutions. Our ratio of Tier 1 capital to risk-weighted assets and off-balance sheet items was 12.5 percent at December 31, 2016, and 13.5 percent at December 31, 2015. Our Total capital ratio was 13.5 percent at December 31, 2016 and 14.5 percent at December 31, 2015. In addition, a new ratio effective January 1, 2015, requires the Company and Peoples Bank maintain a minimum common equity Tier 1 capital to risk-weighted assets of 4.5 percent. Our and Peoples Bank's common equity Tier 1 capital to risk-weighted assets ratios were 12.5 percent and 12.1 percent at December 31, 2016 and 13.5 percent and 13.1 percent at December 31, 2015. Our Leverage ratio, which equaled 10.2 percent at December 31, 2016 and 10.8 percent at December 31, 2015, exceeded the minimum of 4.0 percent for capital adequacy purposes. Peoples Bank reported Tier 1 capital, Total capital and Leverage ratios of 12.1 percent, 13.2 percent and 9.9 percent at December 31, 2016, and 13.1 percent, 14.1 percent and 10.5 percent at December 31, 2015. Based on the most recent notification from the FDIC, Peoples Bank was categorized as well capitalized at December 31, 2016 and 2015. There are no conditions or events since this notification that we believe have changed Peoples Bank's category. For a further discussion of these risk-based capital standards and supervisory actions for noncompliance, refer to the note entitled, "Regulatory matters," in the Notes to Consolidated Financial Statements to this Annual Report.

Stockholders' equity was \$256.6 million or \$34.71 per share at December 31, 2016, and \$248.8 million or \$33.57 per share at December 31, 2015. Stockholders' equity grew \$7.8 million in 2016 as net income was partially offset by an increase in accumulated other comprehensive loss, dividends and the retirement of common shares.

## **Review of Financial Performance:**

Net income was \$19.6 million or \$2.65 per share in 2016 and \$17.7 million or \$2.36 per share in 2015. The results for 2016 include net gains on sale of investment securities of \$0.6 million compared to \$1.2 million during 2015. Return on average assets (“ROAA”) and return on average equity (“ROAE”) were 1.02 percent and 7.64 percent for the year ended December 31, 2016. ROAA was 1.02 percent and ROAE was 7.13 percent for the year ended December 31, 2015.

Tax-equivalent net interest income was \$65.2 million in 2016 and \$60.1 million in 2015. Our net interest margin equaled 3.77 percent in 2016 and 3.81 percent in 2015. Noninterest income totaled \$15.9 million in 2016 and \$15.7 million in 2015. Noninterest expense was \$48.0 million for the year ended December 31, 2016 compared to \$46.8 million for the year ended December 31, 2015. Our productivity is measured by the operating efficiency ratio, defined as noninterest expense less amortization of intangible assets divided by the total of tax-equivalent net interest income and noninterest income. Our operating efficiency ratio was 57.8 percent in 2016.

## **Net Interest Income:**

For the year ended December 31, tax-equivalent net interest income was \$65.2 million in 2016 and \$60.1 million in 2015. There was a positive volume variance that was partially offset by a negative rate variance. The growth in average earning assets exceeded that of interest-bearing liabilities, and resulted in additional tax-equivalent net interest income of \$7.5 million. A rate variance resulted in a decrease in net interest income of \$2.4 million.

Average earning assets increased \$152.3 million to \$1,729.0 million in 2016 from \$1,576.8 million in 2015 and accounted for an \$8,752 increase in interest income. Average loans, net increased \$200.8 million, which caused interest income to increase \$9,083. Average taxable investments decreased \$54.3 million comparing 2016 and 2015, which resulted in decreased interest income of \$922 while average tax-exempt investments increased \$14.4 million, which resulted in an increase to interest income of \$651.

Average interest-bearing liabilities rose \$138.9 million to \$1,316.4 million in 2016 from \$1,177.5 million in 2015 resulting in a net increase in interest expense of \$1,221. Large denomination time deposits averaged \$21.4 million more in 2016 and caused interest expense to increase \$178. A decrease of \$10.5 million in average time deposits less than \$100 reduced interest expense by \$107. In addition, interest-bearing transaction accounts, including money market, NOW and savings accounts grew \$48.5 million, which in aggregate caused a \$190 increase in interest expense. Short-term borrowings averaged \$54.1 million more and increased interest expense \$310 and long-term debt averaged \$25.4 million more and increased interest expense by \$650 comparing 2016 and 2015.

An unfavorable rate variance occurred, as there was no change in the tax-equivalent yield on earning assets while there was a slight increase in the cost of funds. As a result, tax-equivalent net interest income decreased \$7,531 comparing 2016 and 2015. The tax-equivalent yield on earning assets remained level at 4.19 percent in 2016 resulting in a reduction in interest income of \$2,415. While the tax-equivalent yield on the investment portfolio increased 18 basis points to 2.89 percent in 2016 from 2.71 percent in 2015, interest income decreased \$326 due to changes in the mix of investments. The tax-equivalent yield on the loan portfolio decreased 16 basis points to 4.43 percent in 2016 from 4.59 percent in 2015 and resulted in a reduction in interest income of \$2,139. The impact that lower reinvestment rates had on the tax-equivalent yield on the loan portfolio was partially mitigated by the recognition of loan fair value accretion resulting in an increase in the tax-equivalent net interest margin of 4 basis points in 2016.

The unfavorable rate variance caused by changes in the earning asset yields was slightly offset by a decrease of \$7 in interest expense, which primarily resulted from a favorable mix of lower cost funding. We experienced increases in the rates paid on all major categories of interest-bearing liabilities with the exception of savings accounts, time deposits of less than \$100 and long-term debt. Specifically, the cost of money market and NOW accounts increased 7 basis points and 3 basis points comparing 2016 and 2015. These increases resulted in an increase in interest expense of \$220. The cost of savings accounts decreased 2 basis points which resulted in a decrease of \$97 in interest expense. With regard to time deposits, the average rate paid for time deposits less than \$100 decreased 1 basis point while time deposits \$100 or more increased 11 basis points, which together resulted in a \$92 increase in interest expense. The average rate paid on short-term borrowings increased 21 basis points in 2016 when compared to 2015, causing a \$39 increase in interest expense. Interest expense was reduced \$261 from a 66 basis point decline in the average rate paid on long-term debt.

**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, volume 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 an appropriate level. The provision for loan losses equaled \$5,000 in 2016 and \$3,700 in 2015. The primary cause for the increase in the provision was an increase in the volume of loans originated. Commercial and consumer loans experienced an increase in the qualitative factor related to asset quality, while commercial real estate experienced an increase in the qualitative factor related to concentrations. Partially offsetting these increases were decreases in the qualitative factors for residential real estate related to asset quality and loan balances. Based on our most recent evaluation at December 31, 2016, we believe that the allowance was adequate to absorb any known or potential losses in our portfolio.

**Noninterest Income:**

Our noninterest income increased \$169 or 1.1 percent to \$15.9 million in 2016 from \$15.7 million in 2015. Net gains on sale of investment securities were \$623 in 2016 compared to \$1,189 in 2015 an increase of \$566 or 47.6 percent as we took advantage of fewer opportunities to sell U.S. Treasury securities at a gain as market yields increased in 2016. Revenue received from merchant services increased \$344 or 8.9 percent to \$4,199 in 2016 from \$3,855 in 2015 due to an increase in the number of merchants serviced whom transact higher volumes. Wealth management income increased \$453 or 53.6 percent comparing 2016 to 2015 as the plan to accelerate growth, which began in 2015, was in effect for the entirety of 2016. Mortgage banking income increased \$13 or 1.5 percent in 2016 compared to 2015 due to the leveling off of volumes which were again driven by the increase in market rates. Revenue received from service charges, fees and commissions decreased \$129 or 2.1 percent comparing 2016 and 2015 due to lower overdraft and deposit fees. Commissions and fees on fiduciary activities increased \$30 or 1.5 percent comparing 2016 and 2015 due to an increase in executor fees. Income from investment in life insurance increased \$24 or 3.1 percent to \$791 in 2016 from \$767 in 2015 due to additional life insurance contracts purchased in the first quarter of 2016.

**Noninterest Expense:**

Noninterest expense was \$48.0 million for the year ended December 31, 2016 compared to \$46.8 million for the year ended December 31, 2015.

Salaries and employee benefits expense constitute the majority of our noninterest expenses accounting for 46.7 percent of the total noninterest expense. Salaries and employee benefits expense increased \$901 or 4.2 percent to \$22.4 million in 2016 from \$21.5 million in 2015. Salaries and payroll taxes increased \$539 or 3.0 percent, while employee benefits expense increased \$362 or 10.6 percent. Severances paid out in the first half of 2016 along with the addition of salaries and benefit costs associated with our expansion into Kingston, Lehigh Valley, and King of Prussia provided the majority of the increase.

Occupancy and equipment expense increased \$318 or 3.5 percent to \$9.4 million in 2016 from \$9.1 million in 2015. Specifically, building-related costs decreased \$267 or 4.8 percent while equipment-related costs increased \$585 or 16.5 percent. The increase in equipment-related expenses was driven by costs associated with the opening of our community banking office in Kingston, Pennsylvania as well as the expansion into King of Prussia.

Other expenses, which consist of merchant transaction expense, FDIC insurance and assessments, professional fees and outside services, other taxes, stationary and supplies, advertising, amortization of intangible assets and all other expenses were \$16.2 million in 2016 and \$16.1 million in 2015. Merchant transaction expenses increased \$350 or 13.2 percent to \$2,993 in 2016 compared to \$2,643 in 2015 due to an increase in the volume of transactions processed and the number of merchant accounts serviced. This is in direct correlation to the increase in income generated from merchant services. All other expenses, including FDIC insurance and assessments, professional fees and outside services, other taxes, stationery and supplies, advertising and amortization of intangible assets and other expenses totaled \$13,181 in 2016, a decrease of \$318 or 2.4 percent, compared to \$13,499 in 2015.

**Income Taxes:**

Our income tax expense was \$5.0 million in 2016 and \$4.5 million in 2015. The increase resulted from higher before tax income in 2016 compared to 2015. We utilize loans and investments of tax-exempt organizations to mitigate our tax burden, as interest revenue from these sources is not taxable by the federal government. Our effective tax rate increased slightly to 20.4 percent in 2016, compared to 20.3 percent in 2015.

The effective tax rate in 2016 and 2015 was also influenced by the recognition of investment tax credits related to our limited partnership investments in elderly and low- to moderate-income residential housing programs which allow us to mitigate our tax burden. By utilizing these credits, we reduced our income tax expense by \$1.1 million in both 2016 and 2015. We anticipate investment tax credits from these investments of \$1.1 million in 2017. Over the next eight years, we will recognize aggregate tax credits from our investments in these projects of \$7.8 million.

## Item 7A. 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 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.

During 2017, the Federal Reserve Board’s Federal Open Market Committee (“FOMC”) continued to gradually increase the target federal funds rate. The FOMC continues to expect that, with gradual adjustments in the stance of monetary policy, economic activity will expand at a moderate pace and labor market conditions will remain strong. At their December 2017 meeting, the FOMC raised interest rates for the third time in 2017 voting to set the new target federal funds rate at a range of 1.25% to 1.50%, a 25 basis point increase. The FOMC stated it expects that economic conditions will evolve in a manner that will warrant gradual increases in the federal funds rate; the federal funds rate is likely to remain, for some time, below levels that are expected to prevail in the longer run. However, the actual path of the federal funds rate will depend on the economic outlook as informed by incoming data.

The projected impact of instantaneous changes in interest rates on our net interest income and economic value of equity at December 31, 2017, based on our simulation model, is summarized as follows:

Changes in Interest Rates (basis points)	December 31, 2017			
	% Change in			
	Net Interest Income		Economic Value of Equity	
	Metric	Policy	Metric	Policy
+400	0.9	(20.0)	1.4	(40.0)
+300	0.9	(20.0)	1.3	(30.0)
+200	0.8	(10.0)	0.8	(20.0)
+100	0.6	(10.0)	1.5	(10.0)
Static				
(100)	(4.9)	(10.0)	(9.3)	(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 December 31, 2017, would increase slightly at 0.6 percent from model results using current interest rates. Additional disclosures about market risk are included in Part II, Item 7 of this Annual Report, under the heading “Market Risk Sensitivity,” and are incorporated into this Item 7A by reference.

Item 8. Financial Statements.

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Stockholders and Board of Directors

Peoples Financial Services Corp. and Subsidiaries

Opinions on the Financial Statements and Internal Control over Financial Reporting

We have audited the accompanying consolidated balance sheet of Peoples Financial Services Corp. and Subsidiaries (the "Company") as of December 31, 2017, and the related consolidated statements of income and comprehensive income, changes in stockholders' equity, and cash flows, for the year then ended, and the related notes (collectively referred to as the "consolidated financial statements"). We also have audited the Company's internal control over financial reporting as of December 31, 2017, based on criteria established in Internal Control – Integrated Framework: (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO").

In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of the Company as of December 31, 2017, and the results of its operations and its cash flows for the year then ended, in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2017, based on criteria established in Internal Control – Integrated Framework: (2013) issued by COSO.

Basis for Opinion

The Company's management is responsible for these consolidated financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management's Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the Company's consolidated financial statements and an opinion on the Company's internal control over financial reporting based on our audit. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) ("PCAOB") and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audit in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement, whether due to error or fraud and whether effective internal control over financial reporting was maintained in all material respects.

Our audit of the consolidated financial statements included performing procedures to assess the risks of material misstatement of the consolidated financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the consolidated financial statements. Our audit also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

#### Definition and Limitations of Internal Control Over Financial Reporting

A company's internal control over financial reporting is a process designed 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. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

/s/ Baker Tilly Virchow Krause, LLP

Wilkes-Barre, Pennsylvania

We have served as the Company's auditor since 2017.

March 14, 2018

Board of Directors and Stockholders  
Peoples Financial Services Corp.  
Scranton, Pennsylvania

We have audited the accompanying consolidated balance sheet of Peoples Financial Services Corp. and subsidiaries as of December 31, 2016 and the related consolidated statements of income and comprehensive income, changes in stockholders' equity, and cash flows for each of the two years in the period ended December 31, 2016. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Peoples Financial Services Corp. and subsidiaries as of December 31, 2016, and the results of their operations and their cash flows for each of the two years in the period ended December 31, 2016, in conformity with accounting principles generally accepted in the United States of America.

/s/ BDO USA, LLP  
Harrisburg, Pennsylvania  
March 16, 2017



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

December 31	2017	2016
<b>Assets:</b>		
Cash and due from banks:		
Cash and due from banks	\$ 36,336	\$ 39,496
Interest-bearing deposits in other banks	1,152	445
Total cash and due from banks	37,488	39,941
Investment securities:		
Available-for-sale	272,548	259,410
Held-to-maturity: Fair value December 31, 2017, \$9,547; December 31, 2016, \$10,714	9,274	10,517
Total investment securities	281,822	269,927
Loans, net	1,693,065	1,532,965
Less: allowance for loan losses	18,960	15,961
Net loans	1,674,105	1,517,004
Loans held for sale	106	
Premises and equipment, net	37,557	33,260
Accrued interest receivable	6,936	6,228
Goodwill	63,370	63,370
Intangible assets, net	3,178	4,211
Other assets	64,469	65,501
Total assets	<u>\$ 2,169,031</u>	<u>\$ 1,999,442</u>
<b>Liabilities:</b>		
Deposits:		
Noninterest-bearing	\$ 380,729	\$ 353,686
Interest-bearing	1,338,289	1,235,071
Total deposits	1,719,018	1,588,757
Short-term borrowings	123,675	82,700
Long-term debt	49,734	58,134
Accrued interest payable	497	462
Other liabilities	11,131	12,771
Total liabilities	<u>1,904,055</u>	<u>1,742,824</u>
<b>Stockholders' equity:</b>		
Common stock, par value \$2.00, authorized 25,000,000 shares, issued and outstanding 7,396,505 shares at December 31, 2017 and 7,394,143 shares at December 31, 2016	14,793	14,788
Capital surplus	135,043	134,871
Retained earnings	121,353	111,114
Accumulated other comprehensive loss	(6,213)	(4,155)
Total stockholders' equity	264,976	256,618
Total liabilities and stockholders' equity	<u>\$ 2,169,031</u>	<u>\$ 1,999,442</u>

See notes to consolidated financial statements.

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

<b>Year Ended December 31</b>	<b>2017</b>	<b>2016</b>	<b>2015</b>
<b>Interest income:</b>			
Interest and fees on loans:			
Taxable	\$ 64,946	\$ 59,902	\$ 54,004
Tax-exempt	3,163	3,031	2,351
Interest and dividends on investment securities:			
Taxable	2,949	2,515	3,207
Tax-exempt	2,999	3,438	3,385
Dividends	52	48	35
Interest on interest-bearing deposits in other banks	133	50	49
Interest on federal funds sold			10
Total interest income	<u>74,242</u>	<u>68,984</u>	<u>63,041</u>
<b>Interest expense:</b>			
Interest on deposits	6,450	5,429	4,953
Interest on short-term borrowings	900	402	53
Interest on long-term debt	1,348	1,420	1,031
Total interest expense	<u>8,698</u>	<u>7,251</u>	<u>6,037</u>
Net interest income	65,544	61,733	57,004
Provision for loan losses	4,800	5,000	3,700
Net interest income after provision for loan losses	<u>60,744</u>	<u>56,733</u>	<u>53,304</u>
<b>Noninterest income:</b>			
Service charges, fees and commissions	7,344	6,116	6,245
Merchant services income	2,543	4,199	3,855
Commission and fees on fiduciary activities	2,057	1,976	1,946
Wealth management income	1,411	1,298	845
Mortgage banking income	784	885	872
Life insurance investment income	769	791	767
Net gain on sale of investment securities available-for-sale		623	1,189
Net gain on sale of merchant services business	2,278		
Total noninterest income	<u>17,186</u>	<u>15,888</u>	<u>15,719</u>
<b>Noninterest expense:</b>			
Salaries and employee benefits expense	26,670	22,434	21,533
Net occupancy and equipment expense	9,975	9,422	9,104
Merchant services expense	1,808	2,993	2,643
Amortization of intangible assets	1,034	1,186	1,195
Professional fees and outside services	2,277	2,128	2,211
Donations	1,188	1,006	740
Other expenses	8,341	8,861	9,353
Total noninterest expense	<u>51,293</u>	<u>48,030</u>	<u>46,779</u>
Income before income taxes	26,637	24,591	22,244
Income tax expense	8,180	5,008	4,521
Net income	<u>18,457</u>	<u>19,583</u>	<u>17,723</u>
<b>Other comprehensive loss:</b>			
Unrealized loss on investment securities available-for-sale	(1,790)	(3,417)	(510)
Reclassification adjustment for net gain on sales included in net income		(623)	(1,189)
Change in benefit plan liabilities	318	917	(296)
Other comprehensive loss	(1,472)	(3,123)	(1,995)
Income tax	(515)	(1,093)	(699)
Other comprehensive loss, net of income taxes	<u>(957)</u>	<u>(2,030)</u>	<u>(1,296)</u>
Comprehensive income	<u>\$ 17,500</u>	<u>\$ 17,553</u>	<u>\$ 16,427</u>
<b>Per share data:</b>			
Net income:			
Basic	\$ 2.50	\$ 2.65	\$ 2.36
Diluted	\$ 2.50	\$ 2.65	\$ 2.36
Average common shares outstanding:			
Basic	7,395,837	7,396,716	7,516,451
Diluted	7,395,837	7,396,716	7,516,451
Dividends declared	\$ 1.26	\$ 1.24	\$ 1.24

See notes to consolidated financial statements

**Peoples Financial Services Corp.**

**CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY**

(Dollars in thousands, except per share data)

For the Three Years Ended December 31, 2017	Common Stock	Capital Surplus	Retained Earnings	Accumulated Other Comprehensive Treasury		Total
				Loss	Stock	
<b>Balance, January 1, 2015</b>	\$ 15,097	\$ 140,214	\$ 92,297	\$ (829)	\$	\$ 246,779
Net income			17,723			17,723
Other comprehensive loss, net of income taxes				(1,296)		(1,296)
Dividends declared: \$1.24 per share			(9,319)			(9,319)
Stock based compensation		69				69
Share retirement: 137,752 shares	(276)	(4,912)				(5,188)
<b>Balance, December 31, 2015</b>	14,821	135,371	100,701	(2,125)		248,768
Net income			19,583			19,583
Other comprehensive loss, net of income taxes				(2,030)		(2,030)
Dividends declared: \$1.24 per share			(9,170)			(9,170)
Stock based compensation		71				71
Share retirement: 16,463 shares	(33)	(571)				(604)
<b>Balance, December 31, 2016</b>	14,788	134,871	111,114	(4,155)		256,618
Net income			18,457			18,457
Other comprehensive loss, net of income taxes				(957)		(957)
Reclassification related to adoption of ASU 2018-02			1,101	(1,101)		
Dividends declared: \$1.26 per share			(9,319)			(9,319)
Stock based compensation		177				177
Common stock grants awarded, net of unearned compensation of \$32: 2,362 shares	5	(5)				
<b>Balance, December 31, 2017</b>	<u>\$ 14,793</u>	<u>\$ 135,043</u>	<u>\$ 121,353</u>	<u>\$ (6,213)</u>	<u>\$</u>	<u>\$ 264,976</u>

See notes to consolidated financial statements

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

Year Ended December 31,	2017	2016	2015
<b>Cash flows from operating activities:</b>			
Net income	\$ 18,457	\$ 19,583	\$ 17,723
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation of premises and equipment	1,950	1,661	1,595
Amortization of deferred loan costs	907	786	603
Amortization of intangibles	1,034	1,186	1,195
Amortization of low income housing partnerships	470	477	635
Provision for loan losses	4,800	5,000	3,700
Net (gain) loss on sale of other real estate owned	(11)	137	(132)
Net loss on disposal of equipment			87
Loans originated for sale	(21,036)	(26,708)	(25,246)
Proceeds from sale of loans originated for sale	21,149	27,593	29,604
Net gain on sale of loans originated for sale	(219)	(885)	(872)
Net amortization of investment securities	2,764	3,635	4,278
Net gain on sale of investment securities available-for-sale		(623)	(1,189)
Net gain on sale of merchant services business	(2,278)		
Life insurance investment income	(769)	(791)	(767)
Deferred income tax expense (benefit)	1,665	(1,442)	(841)
Stock based compensation	177	71	69
Net change in:			
Accrued interest receivable	(708)	(432)	(216)
Other assets	2,023	1,373	(213)
Accrued interest payable	35	(98)	(14)
Other liabilities	(1,817)	(2,470)	(820)
Net cash provided by operating activities	28,593	28,053	29,179
<b>Cash flows from investing activities:</b>			
Proceeds from sales of investment securities available-for-sale		27,408	81,983
Proceeds from repayments of investment securities:			
Available-for-sale	55,800	53,128	58,318
Held-to-maturity	1,222	1,561	2,520
Purchases of investment securities:			
Available-for-sale	(73,471)	(62,022)	(90,402)
Net purchase of restricted equity securities	(1,511)	(1,648)	(1,716)
Net increase in lending activities	(163,236)	(195,408)	(133,146)
Investment in low income housing partnerships		(2,045)	(3,050)
Purchases of premises and equipment	(6,247)	(6,764)	(4,420)
Proceeds from the sale of premises and equipment			14
Purchase of investment in life insurance		(1,500)	
Proceeds from the sale of merchant services business	2,300		
Proceeds from sale of other real estate owned	580	933	484
Net cash used in investing activities	(184,563)	(186,357)	(89,415)
<b>Cash flows from financing activities:</b>			
Net increase in deposits	130,261	132,947	30,252
Proceeds from long-term debt			30,000
Repayment of long-term debt	(8,400)	(2,220)	(2,786)
Net increase in short-term borrowings	40,975	44,375	18,768
Retirement of common stock		(604)	(5,188)
Cash dividends paid	(9,319)	(9,170)	(9,319)
Net cash provided by financing activities	153,517	165,328	61,727
Net (decrease) increase in cash and cash equivalents	(2,453)	7,024	1,491
Cash and cash equivalents at beginning of period	39,941	32,917	31,426
Cash and cash equivalents at end of period	\$ 37,488	\$ 39,941	\$ 32,917

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

Year Ended December 31,	2017	2016	2015
<b>Supplemental disclosures:</b>			
Cash paid during the period for:			
Interest	\$ 8,663	\$ 7,349	\$ 6,788
Income taxes	5,900	5,900	4,200
Noncash items:			
Transfers of loans to other real estate	\$ 460	\$ 757	\$ 869

See notes to consolidated financial statements

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

**1. Summary of significant accounting policies:**

**Nature of operations:**

Peoples Financial Services Corp., a bank holding company incorporated under the laws of Pennsylvania, provides a full range of financial services through its wholly-owned subsidiary, Peoples Security Bank and Trust Company (“Peoples Bank”), collectively, the “Company” or “Peoples”. On November 30, 2013, Pensco Financial Services Corporation, a financial holding company incorporated under the laws of Pennsylvania (“Pensco”), merged with and into Peoples Financial Services Corp., with Peoples Financial Services Corp. being the surviving corporation (the “Merger”), pursuant to an Agreement and Plan of Merger dated June 28, 2013 (the “Merger Agreement”). In connection with the Merger, on December 1, 2013, Pensco’s former banking subsidiary, Penn Security Bank and Trust Company, merged with and into Peoples Neighborhood Bank (the “Bank Merger”), and the resulting institution adopted the name Peoples Security Bank and Trust Company. The Company services its retail and commercial customers through twenty-seven full-service community banking offices located within Bucks, Lackawanna, Lehigh, Luzerne, Monroe, Montgomery, Northampton, Susquehanna, Wayne and Wyoming Counties of Pennsylvania and Broome County of New York.

Peoples Bank is a state-chartered bank and trust company under the jurisdiction of the Pennsylvania Department of Banking and Securities and the Federal Deposit Insurance Corporation. Peoples Bank’s primary product is loans to small- and medium-sized businesses. Other lending products include one-to-four family residential mortgages and consumer loans. Peoples Bank primarily funds its loans by offering deposits to commercial enterprises and individuals. Deposit product offerings include checking accounts, savings accounts, money market accounts and certificates of deposits.

The Company faces competition primarily from commercial banks, thrift institutions and credit unions within its market, many of which are substantially larger in terms of assets and capital. In addition, mutual funds and security brokers compete for various types of deposits, and consumer, mortgage, leasing and insurance companies compete for various types of loans and leases. Principal methods of competing for banking and permitted nonbanking services include price, nature of product, quality of service and convenience of location.

The Company and Peoples Bank are subject to regulations of certain federal and state regulatory agencies and undergo periodic examinations.

**Basis of presentation:**

Under the acquisition method of accounting, in a business combination effected through an exchange of equity interests, consideration of the facts and circumstances surrounding a business combination that generally involve the relative ownership and control of the entity by each of the parties subsequent to the merger must be made in determining the acquirer for financial reporting purposes. Based on a review of these factors, the aforementioned merger between the Company and Pensco was accounted for as a reverse acquisition whereby Pensco was treated as the acquirer for accounting and reporting purposes.

The consolidated financial statements of the Company have been prepared in conformity with accounting principles generally accepted in The United States of America (“GAAP”), Regulation S-X and reporting practices applied in the banking industry. All significant intercompany balances and transactions have been eliminated in consolidation. The Company also presents herein condensed parent company only financial information regarding Peoples Financial Services Corp. (“Parent Company”). Prior period amounts are reclassified when necessary to conform with the current year’s presentation. Such reclassifications had no effect on financial position or results of operations.

The Company has evaluated events and transactions occurring subsequent to the balance sheet date of December 31, 2017, for items that should potentially be recognized or disclosed in these consolidated financial statements. The evaluation was conducted through the date these consolidated financial statements were issued.

**Estimates:**

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.

**Investment securities:**

Investments securities are classified and accounted for as either held-to-maturity, available-for-sale, or trading account securities based on management's intent at the time of acquisition. Management is required to reassess the appropriateness of such classifications at each reporting date. The Company classifies debt securities as held-to maturity when management has the positive intent and ability to hold such securities to maturity. Held-to-maturity securities are stated at cost, adjusted for amortization of premium and accretion of discount. Investment securities are designated as available-for-sale when they are to be held for indefinite periods of time as management intends to use such securities to implement asset/liability strategies or to sell them in response to changes in interest rates, prepayment risk, liquidity requirements, or other circumstances identified by management. Available-for-sale securities are reported at fair value, with unrealized gains and losses, net of income taxes, excluded from earnings and reported in a separate component of stockholders' equity. All marketable equity securities are accounted for at fair value. Estimated fair values for investment securities are based on quoted market prices from a national pricing service. Realized gains and losses are computed using the specific identification method and are included in noninterest income. Premiums are amortized and discounts are accreted using the interest method over the contractual lives of investment securities. Investment securities that are bought and held principally for the purpose of selling them in the near term, in order to generate profits from market appreciation, are classified as trading account securities. Trading account securities are carried at market value. Interest on trading account securities is included in interest income. Profits or losses on trading account securities are included in noninterest income. Transfers of securities between categories are recorded at fair value at the date of the transfer, with the accounting treatment of unrealized gains or losses determined by the category into which the security is transferred.

Management evaluates each investment security to determine if a decline in fair value below its amortized cost is an other-than-temporary impairment ("OTTI") at least quarterly, and more frequently when economic or market concerns warrant an evaluation. Factors considered in determining whether an other-than-temporary impairment was incurred include: (i) the length of time and the extent to which the fair value has been less than amortized cost; (ii) the financial condition and near-term prospects of the issuer; (iii) whether a decline in fair value is attributable to adverse conditions specifically related to the security or specific conditions in an industry or geographic area; (iv) the credit-worthiness of the issuer of the security; (v) whether dividend or interest payments have been reduced or have not been made; (vi) an adverse change in the remaining expected cash flows from the security such that the Company will not recover the amortized cost of the security; (vii) whether management intends to sell the security; and (viii) if it is more likely than not that management will be required to sell the security before recovery. If a decline is judged to be other-than-temporary, the individual security is written-down to fair value with the credit related component of the write-down included in earnings and the non-credit related component included in other comprehensive income or loss. The assessment of whether an other-than-temporary impairment exists involves a high degree of subjectivity and judgment and is based on information available to management at a point in time.

**Loans held for sale:**

Loans held for sale consist of one-to-four family residential mortgages originated and intended for sale in the secondary market. The loans are carried in aggregate at the lower of cost or estimated market value, based upon current delivery prices in the secondary mortgage market. Net unrealized losses are recognized through a valuation allowance by corresponding charges to income. Gains or losses on the sale of these loans are recognized in noninterest income at the time of sale using the specific identification method. Loan origination fees, net of certain direct loan origination costs, are included in net gains or losses upon the sale of the related mortgage loan. All loans are sold without recourse.

**Loans, net:**

Loans that management has the intent and ability to hold for the foreseeable future or until maturity or payoff are stated at their outstanding unpaid principal balances, net of deferred fees or costs. Interest income is accrued on the principal amount outstanding. Loan origination fees, net of certain direct origination costs, are deferred and recognized over the contractual life of the related loan as an adjustment to yield using the effective interest method. Premiums and discounts on purchased loans are amortized as adjustments to interest income using the effective interest method. Delinquency fees are recognized in income at the time when they are paid by customer.

Transfers of financial assets, which include loan participation sales, are accounted for as sales, when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when: (i) the assets have been isolated from the Company; (ii) the transferee obtains the right, free of conditions that constrain it from taking advantage of that right, to pledge or exchange the transferred assets and (iii) the Company does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity.

The loan portfolio is segmented into commercial and retail loans. Commercial loans consist of commercial, commercial real estate, municipal and other related tax free loans. Retail loans consist of residential real estate and other consumer loans.

The Company makes commercial loans for real estate development and other business purposes required by the customer base. The Company's credit policies establish advance rates against the different forms of collateral that can be pledged against various commercial loans. Typically, the majority of loans will be underwritten to a percentage of their underlying collateral values such as real estate values, equipment, eligible accounts receivable and inventory. Individual loan advance rates may be higher or lower depending upon the financial strength of the borrower and/or term of the loan. Generally, assets financed through commercial loans are used for the operations of the business. Repayment for these types of loans generally comes from the cash flow of the business or the ongoing conversion of assets. Commercial real estate loans include construction, mini-perm, or longer term loans financing commercial properties. Repayment of these loans are generally dependent upon either the ongoing business cash flow from an owner occupied property or the lease/rental income or sale of a non-owner occupied property. Commercial real estate loans typically require a loan to value of not greater than 80% and vary in terms. Commercial and commercial real estate loans generally have higher credit risk compared to residential mortgage loans and consumer loans, as they typically involve larger loan balances concentrated with single borrowers or groups of borrowers. In addition, the payment expectations on loans secured by income-producing properties typically depend on the successful operations of the related business and thus may be subject to a greater extent to adverse conditions in the real estate market and in the general economy.

Loans secured by commercial real estate generally have larger balances and involve a greater degree of risk than one-to-four family residential mortgage loans. Of primary concern in commercial real estate lending is the borrower's and any guarantor's creditworthiness and the feasibility and cash flow potential of the financed project. Additional considerations include: location, market and geographic concentration risks, loan to value, strength of guarantors and quality of tenants. Payments on loans secured by income properties often depend on successful operation and management of the properties. As a result, repayment of such loans may be subject to a higher level of risk than residential real estate loans, which could be caused by unfavorable conditions in the real estate market or the economy. To effectively monitor loans on income properties, the Company requires borrowers and loan guarantors, if any, to provide annual financial statements on commercial real estate loans and rent rolls where applicable. In reaching a decision on whether to make a



commercial real estate loan, the Company considers and reviews a cash flow analysis of the borrower and guarantor, when applicable. In addition, the Company evaluates business cash flows, if applicable, net operating income of the property, the borrower's expertise, credit history and the value of the underlying property. The Company has generally required that the properties securing these real estate loans have debt service coverage ratios, which is net cash flow before debt service to debt service, of at least 1.2 times. An environmental report is obtained when the possibility exists that hazardous materials may have existed on the site, or the site may have been impacted by adjoining properties that handled hazardous materials.

Commercial loans are generally made on the basis of a business entity or individual borrower's ability to make repayment from business cash flows or individual borrowers' employment and other income. Commercial business loans tend to have a slightly higher risk than commercial real estate loans because collateral usually consists of business assets versus real estate. Further, any collateral securing such loans may depreciate over time and could be difficult to appraise and liquidate. As a result, repayment of commercial business loans may depend substantially on the success of the business itself.

Residential mortgages, including home equity loans, are secured by the borrower's residential real estate in either a first or second lien position. Residential mortgages have varying loan rates depending on the financial condition of the borrower, loan to value ratio and term. Residential mortgages may have amortizations up to 30 years.

Consumer loans include installment loans, car loans, and overdraft lines of credit. These loans are both secured and unsecured. Consumer loans may entail greater risk than do residential mortgage loans, particularly in the case of consumer loans that are unsecured. Repossessed collateral for a defaulted consumer loan may not provide an adequate source of repayment for the outstanding loan and a small remaining deficiency often does not warrant further substantial collection efforts against the borrower. Consumer loan collections depend on the borrower's continuing financial stability, and therefore are likely to be adversely affected by various factors, including job loss, divorce, illness or personal bankruptcy. Furthermore, the application of various federal and state laws, including federal and state insolvency laws, may limit the amount that can be recovered on such loans.

#### **Off-balance sheet financial instruments:**

In the ordinary course of business, the Company has entered into off-balance sheet financial instruments consisting of commitments to extend credit, unused portions of lines of credit and standby letters of credit. These financial instruments are recorded in the consolidated financial statements when they are funded. Fees on commercial letters of credit and on unused available lines of credit are recorded as interest and fees on loans and are included in interest income when paid. The Company records an allowance for off-balance sheet credit losses, if deemed necessary, separately as a liability.

#### **Nonperforming assets:**

Nonperforming assets consist of nonperforming loans and other real estate owned. Nonperforming loans include nonaccrual loans, troubled debt restructured loans and accruing loans past due 90 days or more. Past due status is based on contractual terms of the loan. Generally, a loan is classified as nonaccrual when it is determined that the collection of all or a portion of interest or principal is doubtful or when a default of interest or principal has existed for 90 days or more, unless the loan is well secured and in the process of collection. When a loan is placed on nonaccrual, interest accruals discontinue and uncollected accrued interest is reversed against income in the current period. Interest collections after a loan has been placed on nonaccrual status are credited to a suspense account until either the loan is returned to performing status or charged-off. The interest accumulated in the suspense account is credited to income over the remaining life of the loan using the effective yield method if the nonaccrual loan is returned to performing status. However, if the nonaccrual loan is charged-off, the accumulated interest is applied as a reduction to principal at the time the loan is charged-off. A nonaccrual loan is returned to performing status when the loan is current as to principal and interest and has performed according to the contractual terms for a minimum of six months.

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 can 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.

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 loans 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 effected in the future.

Other real estate owned is comprised of properties acquired through foreclosure proceedings or in-substance foreclosures. A loan is classified as in-substance foreclosure when the Company has taken possession of the collateral regardless of whether formal foreclosure proceedings take place. Other real estate owned is included in other assets and recorded at fair value less cost to sell at the time of acquisition, establishing a new cost basis. Any excess of the loan balance over the recorded value is charged to the allowance for loan losses. Subsequent declines in the recorded values

of the properties prior to their disposal and costs to maintain the assets are included in other expenses. Any gain or loss realized upon disposal of other real estate owned is included in noninterest expense.

**Allowance for loan losses:**

The allowance for loan losses represents management's estimate of losses inherent in the loan portfolio as of the balance sheet date. The allowance for loan losses account is maintained through a provision for loan losses charged to earnings. Loans, or portions of loans, determined to be confirmed losses are charged against the allowance account and subsequent recoveries, if any, are credited to the account. A loss is considered confirmed when information available at the financial statement date indicates the loan, or a portion thereof, is uncollectible. Nonaccrual, troubled debt restructured and loans deemed impaired at the time of acquisition are reviewed monthly to determine if carrying value reductions are warranted or if these classifications should be changed. Consumer loans are considered losses and charged-off when they are 120 days past due.

Management evaluates the adequacy of the allowance for loan losses account quarterly. This assessment is based on past charge-off experience, known and inherent risks in the portfolio, adverse situations that may affect the borrower's ability to repay, the estimated value of underlying collateral, composition of the loan portfolio, current economic conditions and other relevant factors. This evaluation is inherently subjective as it requires material estimates that may be susceptible to significant revision as more information becomes available. Regulators, in reviewing the loan portfolio as part of the scope of a regulatory examination, may require the Company to increase its allowance for loan losses or take other actions that would require the Company to increase its allowance for loan losses.

The allowance for loan losses is maintained at a level believed to be adequate to absorb probable credit losses related to specifically identified loans, as well as probable incurred losses inherent in the remainder of the loan portfolio as of the balance sheet date. The allowance for loan losses consists of an allocated element and an unallocated element. The allocated element consists of a specific allowance for impaired loans individually evaluated under Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") 310, "Receivables," and a formula portion for loss contingencies on those loans collectively evaluated under FASB ASC 450, "Contingencies."

A loan is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect all amounts due according to the contractual terms of the loan agreement. All amounts due according to the contractual terms means that both the contractual interest and principal payments of a loan will be collected as scheduled in the loan agreement. Factors considered by management in determining impairment include payment status, ability to pay and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed. The Company recognizes interest income on impaired loans, including the recording of cash receipts, for nonaccrual, restructured loans or accruing loans depending on the status of the impaired loan. Loans considered impaired under FASB ASC 310 are measured for impairment 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. If 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, is less than the recorded investment in the loan, a specific allowance for the loan will be established.

The formula portion of the allowance for loan losses relates to large pools of smaller-balance homogeneous loans and those identified loans considered not individually impaired having similar characteristics as these loan pools. Loss contingencies for each of the major loan pools are determined by applying a total loss factor to the current balance outstanding for each individual pool. The total loss factor is comprised of a historical loss factor using a loss migration method plus qualitative factors, which adjusts the historical loss factor for changes in trends, conditions and other relevant factors that may affect repayment of the loans in these pools as of the evaluation date. Loss migration involves determining the percentage of each pool that is expected to ultimately result in loss based on historical loss experience.

Historical loss factors are based on the ratio of net loans charged-off to loans, net, for each of the major groups of loans evaluated and measured for impairment under FASB ASC 450. The historical loss factor for each pool is a weighted average of the Company's historical net charge-off ratio for the most recent rolling twelve quarters. Management adjusts these historical loss factors by qualitative factors that represents a number of environmental risks that may cause estimated credit losses associated with the current portfolio to differ from historical loss experience. These environmental risks include: (i) changes in lending policies and procedures including underwriting standards and collection, charge-off and recovery practices; (ii) changes in the composition and volume of the portfolio; (iii) changes in national, local and industry conditions, including the effects of such changes on the value of underlying collateral for collateral-dependent loans; (iv) changes in the volume and severity of classified loans, including past due, nonaccrual, troubled debt restructures and other loan modifications; (v) changes in the levels of, and trends in, charge-offs and recoveries; (vi) the existence and effect of any concentrations of credit and changes in the level of such concentrations; (vii) changes in the experience, ability and depth of lending management and other relevant staff; (viii) changes in the quality of the loan review system and the degree of oversight by the board of directors; and (ix) the effect of external factors such as competition and legal and regulatory requirements on the level of estimated credit losses in the current loan portfolio. Each environmental risk factor is assigned a value to reflect improving, stable or declining conditions based on management's best judgment using relevant information available at the time of the evaluation. Adjustments to the factors are supported through documentation of changes in conditions in a narrative accompanying the allowance for loan loss calculation.

The unallocated element is used to cover inherent losses that exist as of the evaluation date, but which have not been identified as part of the allocated allowance using the above impairment evaluation methodology due to limitations in the process. One such limitation is the imprecision of accurately estimating the impact current economic conditions will have on historical loss rates. Variations in the magnitude of impact may cause estimated credit losses associated with the current portfolio to differ from historical loss experience, resulting in an allowance that is higher or lower than the anticipated level. Management establishes the unallocated element of the allowance by considering a number of environmental risks similar to the ones used for determining the qualitative factors. Management continually monitors trends in historical and qualitative factors, including trends in the volume, composition and credit quality of the portfolio. The reasonableness of the unallocated element is evaluated through monitoring trends in its level to determine if changes from period to period are directionally consistent with changes in the loan portfolio.

Management believes the level of the allowance for loan losses was adequate to absorb probable credit losses inherent in the loan portfolio as of December 31, 2017.

**Premises and equipment, net:**

Land is stated at cost. Premises, equipment and leasehold improvements are stated at cost less accumulated depreciation and amortization. The cost of routine maintenance and repairs is expensed as incurred. The cost of major replacements, renewals and betterments is capitalized. When assets are retired or otherwise disposed of, the cost and related accumulated depreciation and amortization are eliminated and any resulting gain or loss is reflected in noninterest income. Depreciation and amortization are computed principally using the straight-line method based on the following estimated useful lives of the related assets, or in the case of leasehold improvements, to the expected terms of the leases, if shorter:

Premises and leasehold improvements	7 – 40 years
Furniture, fixtures and equipment	3 – 10 years

**Business combinations, goodwill and other intangible assets, net:**

The Company accounts for its acquisitions using the purchase accounting method. Purchase accounting requires the total purchase price to be allocated to the estimated fair values of assets acquired and liabilities assumed, including certain intangible assets that must be recognized. Typically, this allocation results in the purchase price exceeding the fair value of net assets acquired, which is recorded as goodwill. Core deposit intangibles are a measure of the value of checking, money market and savings deposits acquired in business combinations accounted for under the purchase method. Core

deposit intangibles and other identified intangibles with finite useful lives are amortized using the sum of the year's digits over their estimated useful lives of up to ten years.

Loans that the Company acquires in connection with acquisitions are recorded at fair value with no carryover of the related allowance for credit losses. Fair value of the loans involves estimating the amount and timing of principal and interest cash flows expected to be collected on the loans and discounting those cash flows at a market rate of interest. The excess of cash flows expected at acquisition over the estimated fair value is referred to as the accretable discount and is recognized into interest income over the remaining life of the loan. The difference between contractually required payments at acquisition and the cash flows expected to be collected at acquisition is referred to as the nonaccretable discount. The nonaccretable discount includes estimated future credit losses expected to be incurred over the life of the loan. Subsequent decreases to the expected cash flows will require the Company to evaluate the need for an additional allowance for credit losses. Subsequent improvement in expected cash flows will result in the reversal of a corresponding amount of the nonaccretable discount which the Company will then reclassify as accretable discount that will be recognized into interest income over the remaining life of the loan. Acquired loans that met the criteria for nonaccrual of interest prior to the acquisition may be considered performing upon acquisition, regardless of whether the customer is contractually delinquent. As such, the Company may no longer consider the loan to be nonaccrual or nonperforming and may accrue interest on these loans, including the impact of any accretable discount. In addition, charge-offs on such loans would be first applied to the nonaccretable difference portion of the fair value adjustment.

Goodwill and other intangible assets are tested for impairment annually or when circumstances arise indicating impairment may have occurred. In making this assessment that impairment has occurred, management considers a number of factors including, but not limited to, operating results, business plans, economic projections, anticipated future cash flows, and current market data. There are inherent uncertainties related to these factors and management's judgment in applying them to the analysis of impairment. Changes in economic and operating conditions, as well as other factors, could result in impairment in future periods. Any impairment losses arising from such testing would be reported in the Consolidated Statements of Income and Comprehensive Income as a separate line item within operations. There were no impairment losses recognized as a result of periodic impairment testing in each of the three-years ended December 31, 2017.

#### **Mortgage servicing rights:**

Mortgage servicing rights are recognized as a separate asset when acquired through sales of loan originations. The Company determines a mortgage servicing right by allocating the total costs incurred between the loan sold and the servicing right, based on their relative fair values at the date of the sale. Mortgage servicing rights are included in other assets and are amortized into noninterest income in proportion to, and over the period of, the estimated future net servicing income of the underlying mortgage loans. In addition, mortgage servicing rights are evaluated for impairment at each reporting date based on the fair value of those rights. For purposes of measuring impairment, the rights are stratified by loan type, term and interest rate. The amount of impairment recognized, through a valuation allowance, is the amount by which the mortgage servicing rights for a stratum exceed their fair value.

#### **Restricted equity securities:**

As a member of the Federal Home Loan Bank of Pittsburgh ("FHLB"), the Company is required to purchase and hold stock in the FHLB to satisfy membership and borrowing requirements. This stock is restricted in that it can only be redeemed by the FHLB or to another member institution, and all redemptions of FHLB stock must be at par. As a result of these restrictions, FHLB stock is unlike other investment securities as there is no trading market for FHLB stock and the transfer price is determined by FHLB membership rules and not by market participants. The carrying value of restricted stock is included in other assets.

#### **Bank owned life insurance:**

The Company invests in bank owned life insurance ("BOLI") as a source of funding for employee benefit expenses. BOLI involves the purchasing of life insurance by Peoples Bank on certain of its employees. The Company is the owner

and beneficiary of the policies. This life insurance investment is carried at the cash surrender value of the underlying policies and is included in other assets. Income from increases in cash surrender value of the policies is included in noninterest income.

#### **Pension and post-retirement benefit plans:**

The Company sponsors various pension plans covering substantially all employees. The Company also provides post-retirement benefit plans other than pensions, consisting principally of life insurance benefits, to eligible retirees. The liabilities and annual income or expense of the Company's pension and other post-retirement benefit plans are determined using methodologies that involve several actuarial assumptions, the most significant of which are the discount rate and the long-term rate of asset return, based on the market-related value of assets. The fair values of plan assets are determined based on prevailing market prices or estimated fair value for investments with no available quoted prices.

#### **Statements of Cash Flows:**

The Consolidated Statements of Cash Flows are presented using the indirect method. For purposes of cash flow, cash and cash equivalents include cash on hand, cash items in the process of collection, noninterest-bearing and interest-bearing deposits in other banks and federal funds sold.

#### **Fair value of financial instruments:**

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.

The following methods and assumptions were used by the Company to construct the summary table in Note 12 containing the fair values and related carrying amounts of financial instruments:

**Cash and cash equivalents:** The carrying values of cash and cash equivalents as reported on the balance sheet approximate fair value.

**Investment securities:** The fair values of 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 and quoted market prices.

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

**Net loans:** For adjustable-rate loans that reprice frequently and with no significant credit risk, fair values are based on carrying values. The fair values of other nonimpaired loans are estimated using discounted cash flow analysis, using interest rates currently offered in the market for loans with similar terms to borrowers of similar credit risk. Fair values for impaired loans are estimated using discounted cash flow analysis determined by the loan review function or underlying collateral values, where applicable.

In conjunction with the Merger, the loans purchased were recorded at their acquisition date fair value. In order to record the loans at fair value, management made three different types of fair value adjustments. A market rate adjustment was made to adjust for the movement in market interest rates, irrespective of credit adjustments, compared to the stated rates of the acquired loans. A credit adjustment was made on pools of homogeneous loans representing the changes in credit quality of the underlying borrowers from the loan inception to the acquisition date. The credit adjustment on distressed loans represents the portion of the loan balance that has been deemed uncollectible based on the management's expectations of future cash flows for each respective loan.

**Mortgage servicing rights:** To determine the fair value, the Company estimates the present value of future cash flows incorporating assumptions such as cost of servicing, discount rates, prepayment speeds and default rates.

**Accrued interest receivable:** The carrying value of accrued interest receivable as reported on the balance sheet approximates fair value.

**Restricted equity securities:** The carrying values of restricted equity securities approximate fair value, due to the lack of marketability for these securities.

**Other Assets:** Other assets include the Company's investment in Visa Class B stock. The Company's ownership includes shares acquired at no cost related to the Company's prior ownership in Visa's network while Visa operated as a cooperative. The Company holds 44,982 shares of Visa Class B stock which, following resolution of Visa litigation, will be converted to Visa Class A shares (the conversion rate as of December 31, 2017 is 1.6483 shares of Class A stock for each share of Class B stock) for a total of 74,142 shares of Visa Class A stock.

While only current owners of Class B shares are allowed to purchase other Class B shares, there have been several transactions between Class B shareholders. The Company estimates the value of our Class B shares to be \$2.2 million as of December 31, 2017.

**Deposits:** The fair values of noninterest-bearing deposits and savings, NOW and money market accounts are the amounts payable on demand at the reporting date. The fair value estimates do not include the benefit that results from such low-cost funding provided by the deposit liabilities compared to the cost of borrowing funds in the market. The

carrying values of adjustable-rate, fixed-term time deposits approximate their fair values at the reporting date. For fixed-rate time deposits, the present value of future cash flows is used to estimate fair values. The discount rates used are the current rates offered for time deposits with similar maturities.

**Short-term borrowings:** The carrying values of short-term borrowings approximate fair value.

**Long-term debt:** The fair value of fixed-rate long-term debt is based on the present value of future cash flows. The discount rate used is the current rate offered for long-term debt with the same maturity.

**Accrued interest payable:** The carrying value of accrued interest payable as reported on the balance sheet approximates fair value.

**Interest rate swaps:** 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.

**Off-balance sheet financial instruments:**

The majority of commitments to extend credit, unused portions of lines of credit and standby letters of credit carry current market interest rates if converted to loans. Because such commitments are generally unassignable of either the Company or the borrower, they only have value to the Company and the borrower. None of the commitments are subject to undue credit risk. The estimated fair values of off-balance sheet financial instruments are based on fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the counterparties' credit standing. The fair value of off-balance sheet financial instruments was not material at December 31, 2017 and December 31, 2016.

**Advertising:**

The Company follows the policy of charging marketing and advertising costs to expense as incurred. Advertising expense for the years ended December 31, 2017, 2016 and 2015 was \$942, \$972 and \$736, respectively.

**Income taxes:**

The Company accounts for income taxes in accordance with the income tax accounting guidance set forth in FASB ASC Topic 740, "Income Taxes". ASC Topic 740 sets out a consistent framework to determine the appropriate level of tax reserves to maintain for uncertain tax positions.

Deferred income taxes are provided on the balance sheet method whereby deferred tax assets are recognized for deductible temporary differences and deferred tax liabilities are recognized for taxable temporary differences. Temporary differences are the differences between the reported amounts of assets and liabilities and their tax basis. Deferred tax assets are reduced by a valuation allowance when, in the opinion of management, it is more likely than not that some portion of the deferred tax assets will not be realized. Deferred tax assets and liabilities are adjusted for the effects of changes in tax laws and rates on the effective date. A tax position is recognized as a benefit only if it is more likely than not that the tax position would be sustained in a tax examination, with a tax examination being presumed to occur. The amount recognized is the largest amount of tax benefit that has a likelihood of being realized on examination of more than 50 percent. For tax positions not meeting the more likely than not threshold, no tax benefit is recorded. Under the more likely than not threshold guidelines, the Company believes no significant uncertain tax positions exist, either individually or in the aggregate, that would give rise to the non-recognition of an existing tax benefit. The Company had no material unrecognized tax benefits or accrued interest and penalties for any year in the three-year period ended December 31, 2017.



On December 22, 2017, President Donald Trump signed into law H.R. 1, also known as the Tax Cuts and Jobs Act, which among other things reduced the federal corporate income tax rate to 21% effective January 1, 2018. As a result, and in accordance with GAAP, the Company concluded that its net deferred tax assets had to be revalued. The Company's net deferred tax assets represents expected corporate tax benefits anticipated to be realized in the future. The reduction in the federal corporate income tax rate reduces these anticipated future benefits. The revaluation of the Company's net deferred tax assets at December 31, 2017 resulted in a reduction of these net assets and a corresponding increase in income tax expense of \$2.6 million or \$0.35 per share, which was recorded in the fourth quarter of 2017.

As applicable, the Company recognizes accrued interest and penalties assessed as a result of a taxing authority examination through income tax expense. The Company files consolidated income tax returns in the United States of America and various states' jurisdictions. With limited exception, the Company is no longer subject to federal and state income tax examinations by taxing authorities for years before 2014.

#### **Other comprehensive income (loss):**

The components of other comprehensive income (loss) and their related tax effects are reported in the Consolidated Statements of Income and Comprehensive Income. The accumulated other comprehensive loss included in the Consolidated Balance Sheets relates to net unrealized gains and losses on investment securities available-for-sale and the unfunded benefit plan amounts which include prior service costs and unrealized net losses.

#### **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. Potential common shares that may be issued by the Company relate solely to outstanding stock options, and are determined using the treasury stock method.

<b>For the Year Ended December 31</b>	<b>2017</b>		<b>2016</b>		<b>2015</b>	
	<b>Basic</b>	<b>Diluted</b>	<b>Basic</b>	<b>Diluted</b>	<b>Basic</b>	<b>Diluted</b>
Net Income	\$ 18,457	\$ 18,457	\$ 19,583	\$ 19,583	\$ 17,723	\$ 17,723
Average common shares outstanding	7,395,837	7,395,837	7,396,716	7,396,716	7,516,451	7,516,451
Earnings per share	\$ 2.50	\$ 2.50	\$ 2.65	\$ 2.65	\$ 2.36	\$ 2.36

#### **Stock-based compensation:**

The Company recognizes all share-based payments to employees in the consolidated statement of operations based on their fair values. The fair value of such equity instruments is recognized as an expense in the consolidated financial statements as services are performed. The Company has granted stock awards to employees at a price equal to the fair value of the shares at the date of grant. The fair value of restricted stock is equivalent to the fair value on the date of grant and is amortized over the vesting period.

#### **Recent accounting standards:**

In May 2014, the FASB issued Accounting Standards Update ("ASU") No. 2014-09, "Revenue from Contracts with Customers (Topic 606)." The updated standard is a new comprehensive revenue recognition model that requires revenue to be recognized in a manner that depicts the transfer of goods or services to a customer at an amount that reflects the consideration expected to be received in exchange for those goods or services. In August 2015, the FASB issued ASU 2015-14 which deferred the effective date of ASU 2014-09 by one year. During 2016, the FASB issued ASU Nos. 2016-10, 2016-12 and 2016-20 that provide additional guidance related to the identification of performance obligations within a contract, assessing collectability, contract costs, and other technical corrections and improvements. ASU 2014-09 is effective for the Company on January 1, 2018. ASU 2014-09 allows for either full retrospective or modified retrospective

adoption. The Company used the modified retrospective method. The Company has completed an evaluation of its revenue-producing contracts and determined that most of the components of noninterest income fall under the scope of this ASU. The Company evaluated the effect of this ASU on those income streams and concluded the accounting treatment would be similar to current practice. As such, no cumulative adjustment is needed. Disclosures related to these revenue streams are expected to be enhanced in 2018.

In November 2015, the FASB issued ASU 2015-17 which eliminates the guidance in Topic 740, "Income Taxes: Balance Sheet Classification of Deferred Taxes." This requires an entity to separate deferred tax liabilities and assets between current and noncurrent in a classified balance sheet. The amendments require that all deferred tax liabilities and assets of the same tax jurisdiction or a tax filing group, as well as any related valuation allowance, be offset and presented as a single noncurrent amount in a classified balance sheet. Prior GAAP required that in a classified balance sheet, deferred tax liabilities and assets be separated into a current and noncurrent amount on the basis of the classification of the related asset or liability. If deferred tax liabilities and assets did not relate to a specific asset or liability, such as a carryforward, they were classified according to the expected reversal date of the temporary difference.

ASU 2015-17 was effective for the Company in 2017. The adoption of ASU 2015-17 did not have a material effect on the financial position or the operating results of the Company.

In January 2016, the FASB issued ASU No. 2016-01, "Financial Instruments – Overall." The guidance in this ASU among other things, (1) requires equity investments with certain exceptions, to be measured at fair value with changes in fair value recognized in net income, (2) simplifies the impairment assessment of equity investments without readily determinable fair values by requiring a qualitative assessment to identify impairment, (3) eliminates the requirement for public businesses entities to disclose the methods and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost on the balance sheet, (4) requires public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes, (5) requires an entity to present separately in other comprehensive income the portion of the change in fair value of a liability resulting from a change in the instrument-specific credit risk when the entity has elected to measure the liability at fair value in accordance with the fair value option for financial instruments, (6) requires separate presentation of financial assets and financial liabilities by measurement category and form of financial asset on the balance sheet or the accompanying notes to the financial statements and (7) clarifies that an entity should evaluate the need for a valuation allowance on a deferred tax asset related to available-for-sale securities. The guidance in this ASU is effective for the Company on January 1, 2018. Management has evaluated the effect that this guidance will have and concluded that the impact on the consolidated financial statements will not be material upon adoption on January 1, 2018.

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

The new standard is effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Early application is permitted. A modified retrospective transition approach is required for lessees for capital and operating leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements, with certain practical expedients available. A modified retrospective transition approach is required for lessors for sales-type, direct financing, and operating leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements, with certain practical expedients available. The Company's initial findings conclude that the new pronouncement will not have a significant impact on its consolidated financial statements as the current projected minimum lease payments under existing lease contracts subject to the new pronouncement are less than one percent of its current assets.

In March 2016, the FASB issued ASU No. 2016-09, Compensation – Stock Compensation. This ASU changes several aspects of accounting for share-based payment transactions, and includes some changes that apply only to nonpublic companies. This ASU includes amendments that currently apply, or may apply in the future, to the Company related to the following: (1) accounting for the difference between the deduction for tax purposes and the amount of compensation cost recognized for financial reporting purposes; (2) classification of excess tax benefits on the statement of cash flows; (3) accounting for forfeitures; (4) accounting for awards partially settled in cash in excess of the employer’s minimum statutory tax withholding requirements; and (5) classification of employee taxes paid on the statement of cash flows when an employer withholds shares for tax-withholding purposes. The amendments in this ASU were effective for the Company for annual and interim periods beginning in the first quarter 2017. The ASU provides separate transition provisions for each of the amendments. Initial adoption of this ASU in 2017 did not have a significant impact on the Company.

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

- The ASU requires that a financial asset (or a group of financial assets) measured at amortized cost basis be presented, net of a valuation allowance for credit losses, at an amount expected to be collected on the financial asset(s), and that the income statement include the measurement of credit losses for newly recognized financial assets as well as changes in expected losses on previously recognized financial assets. The provisions of this ASU require measurement of expected credit losses based on relevant information including past events, historical experience, current conditions, and reasonable and supportive forecasts that affect the collectability of the asset. The provisions of this ASU differ from current GAAP in that current GAAP generally delays recognition of the full amount of credit losses until the loss is probable of occurring.
- The amendments in the ASU retain many of the disclosure requirements related to credit quality in current GAAP, updated to reflect the change from an incurred loss methodology to an expected credit loss methodology. In addition, the ASU requires that disclosure of credit quality indicators in relation to the amortized cost of financing receivables, a current requirement, be further disaggregated by year of origination.
- This ASU requires that credit losses on available-for-sale debt securities be presented as an allowance rather than as a write-down, and limits the amount of the allowance for credit losses to the amount by which the fair value is below amortized cost. For purchased investment securities available-for-sale with a more-than-insignificant amount of credit deterioration since origination, the ASU requires an allowance be determined in a manner similar to other investment securities available-for-sale; however, the initial allowance would be added to the purchase price, with only subsequent changes in the allowance recorded in credit loss expense, and interest income recognized at the effective rate excluding the discount embedded in the purchase price related to estimated credit losses at acquisition.
- This ASU will be effective for the Company for interim and annual periods beginning in the first quarter of 2020. Earlier adoption is permitted beginning in the first quarter of 2019. The Company will record the effect of implementing this ASU through a cumulative-effect adjustment through retained earnings as of the beginning of the reporting period in which Topic 326 is effective.

The Company cannot yet determine the magnitude of any such one-time cumulative adjustment or of the overall impact of the new standard on our financial condition or results of operations; however, it is anticipated that the allowance will increase upon adoption and that the increased allowance level will decrease regulatory capital and ratios.

In June 2016, the FASB issued ASU 2016-15, Statement of Cash Flows (Topic 230) –Classification of Certain Cash Receipts and Cash Payments. This ASU provides clarification regarding eight specific cash flow issues with the objective of reducing diversity in practice in how certain cash receipts and cash payments are presented and classified in the statement

of cash flows. For the Company, the amendments in this ASU are effective beginning in the first quarter 2018. The amendments in this ASU should be applied using a retroactive transition method to each period presented. The Company anticipates there will be no adjustments to the Consolidated Statements of Cash Flows, as previously reported, as a result of the clarifications provided in the Update.

In January 2017, the FASB issued ASU 2017-04, Intangibles – Goodwill and Other (Topic 350) to simplify the accounting for goodwill impairment. This guidance, among other things, removes step 2 of the goodwill impairment test thus eliminating the need to determine the fair value of individual assets and liabilities of the reporting unit. Upon adoption of this ASU, goodwill impairment will be the amount by which a reporting unit's carrying value exceeds its fair value, not to exceed the carrying amount of goodwill. This may result in more or less impairment being recognized than under current guidance. This ASU will become effective for the Company's annual and interim goodwill impairment tests beginning in the first quarter of 2020.

In March 2017, the FASB issued ASU No. 2017-07, Compensation – Retirement Benefits (Topic 715). ASU 2017-07 requires the service cost component of net periodic pension and post-retirement benefit cost to be reported separately in the consolidated statements of income from the other components. Additionally, the amendments in the ASU require presentation of the service cost component in the consolidated statements of income in the same line item as other employee compensation costs and presentation of the other components in a different line item from the service cost component. The amendments in this ASU are required to be applied retrospectively for the presentation of the service cost component and the other components of net periodic pension cost and net periodic post-retirement benefit cost in the income statement and prospectively, on or after the effective date, for the capitalization of the service cost component of net periodic pension cost and net periodic post-retirement benefit in assets with a practical expedient allowed for prior comparative period presentation permitted. ASU 2017-07 is effective for the Company on January 1, 2018. Management has evaluated the effect that this guidance will have and concluded that the impact on the consolidated financial statements and related disclosures will not be material upon adoption on January 1, 2018.

In March 2017, the FASB issued ASU 2017-08, Receivables – Nonrefundable Fees and Other Costs (Subtopic 310-20). This Update will shorten the amortization period for certain callable debt securities held at a premium. Under current U.S. GAAP, entities generally amortize the premium over the contractual life of the instrument. This Update requires the premium be amortized to the earliest call date. Discounts will continue to be amortized to maturity. The Company expects to adopt the amendments in this Update through a cumulative-effect adjustment directly to retained earnings in 2018, and does not expect the amount of the adjustment to be significant.

In August 2017, the Financial Accounting Standards Board issued ASU 2017-12, "Derivatives and Hedging: Targeted Improvements to Accounting for Hedging Activities". The purpose of this updated guidance is to better align a company's financial reporting for hedging activities with the economic objectives of those activities. ASU 2017-12 is effective for public business entities for fiscal years beginning after December 15, 2018, with early adoption, including adoption in an interim period, permitted. The Company plans to adopt ASU 2017-12 on January 1, 2019. ASU 2017-12 requires a modified retrospective transition method in which the Company will recognize the cumulative effect of the change on the opening balance of each affected component of equity in the statement of financial position as of the date of adoption. While the Company continues to assess all potential impacts of the standard, we currently expect adoption to have an immaterial impact on our consolidated financial statements, as exposure to derivatives contracts is only offered under special circumstances. The Company will continue to assess the financial statement impact as adoption draws closer and/or exposure to derivatives contracts grows to a level deemed to be material.

In February 2018, FASB issued ASU 2018-02, Income Statement – Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Loss (AOCL). Because the Tax Change and Jobs Act was signed on December 22, 2017, the accounting for the change in tax rates and effect on deferred tax assets and liabilities must be reflected in the 2017 financial statements as an adjustment to income tax expense, even though a portion of the tax effects were initially recognized directly in other comprehensive income. This adjustment would leave a stranded balance in AOCI that would not reflect the appropriate tax rate. Under this ASU, entities are allowed, but not required, to reclassify from AOCI to retained earnings the stranded tax effects resulting from the new federal corporate income tax rate. The ASU is effective for all entities for annual reporting periods beginning after December 15, 2018.

Early adoption would be permitted for interim or annual financial statements that have not been issued or made available for issuance. Early adoption will allow entities to align the timing of the stranded tax reclassification in their 2017 financial statements. The Company early adopted the ASU retrospectively and reclassified \$1.1 million from AOCL to retained earnings in the consolidated statement of changes in stockholders' equity.

**2. Cash and due from banks:**

The Federal Reserve Act, as amended, imposes reserve requirements on all depository institutions. The Company's required reserve balances were \$22,651 and \$23,800 at December 31, 2017 and 2016, respectively.

### 3. Investment securities:

The amortized cost and fair value of investment securities aggregated by investment category at December 31, 2017 and 2016 are summarized as follows:

December 31, 2017	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available-for-sale:				
U.S. Treasury securities	\$ 20,042	\$	\$ 228	\$ 19,814
U.S. Government-sponsored enterprises	95,358	30	1,740	93,648
State and municipals:				
Taxable	14,559	488		15,047
Tax-exempt	103,199	1,136	502	103,833
Residential Mortgage-backed securities:				
U.S. Government agencies	14,517	2	85	14,434
U.S. Government-sponsored enterprises	19,752	10	231	19,531
Commercial Mortgage-backed securities:				
U.S. Government-sponsored enterprises	6,315		120	6,195
Common equity securities	43	3		46
Total	\$ 273,785	\$ 1,669	\$ 2,906	\$ 272,548
Held-to-maturity:				
Tax-exempt state and municipals	\$ 6,859	\$ 152	\$ 13	\$ 6,998
Residential Mortgage-backed securities:				
U.S. Government agencies	54			54
U.S. Government-sponsored enterprises	2,361	138	4	2,495
Total	\$ 9,274	\$ 290	\$ 17	\$ 9,547
December 31, 2016	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available-for-sale:				
U.S. Treasury securities	\$ 7,570		\$ 132	\$ 7,438
U.S. Government-sponsored enterprises	82,314	\$ 79	1,480	80,913
State and municipals:				
Taxable	14,698	566	39	15,225
Tax-exempt	110,931	2,309	640	112,600
Residential Mortgage-backed securities:				
U.S. Government agencies	21,041	48	47	21,042
U.S. Government-sponsored enterprises	22,303	48	159	22,192
Total	\$ 258,857	\$ 3,050	\$ 2,497	\$ 259,410
Held-to-maturity:				
Tax-exempt state and municipals	\$ 6,862	\$ 72	\$ 67	\$ 6,867
Residential Mortgage-backed securities:				
U.S. Government agencies	68	1		69
U.S. Government-sponsored enterprises	3,587	191		3,778
Total	\$ 10,517	\$ 264	\$ 67	\$ 10,714

The Company had net unrealized losses on available-for-sale securities of \$977, net of deferred income taxes of \$260 at December 31, 2017, and net unrealized gains of \$360, net of deferred income taxes of \$193, at December 31, 2016. There were no investment securities sales in 2017, proceeds from the sale of investment securities available-for-sale amounted to \$27,408 in 2016 and \$81,983 in 2015. There were no realized gains or losses on investment securities in 2017. Gross realized gains totaled \$623 in 2016 and \$1,189 in 2015. There were no gross losses in 2016 or 2015.

The maturity distribution of the fair value, which is the net carrying amount, of the debt securities classified as available-for-sale at December 31, 2017, is summarized as follows:

<b>December 31, 2017</b>	<b>Fair Value</b>
Within one year	\$ 12,238
After one but within five years	168,657
After five but within ten years	35,278
After ten years	16,169
	<u>232,342</u>
Mortgage-backed securities	40,160
Total	<u>\$ 272,502</u>

Expected maturities will differ from contractual maturities because borrowers have the right to call or prepay obligations with or without call or prepayment penalties.

The maturity distribution of the amortized cost and fair value, of debt securities classified as held-to-maturity at December 31, 2017, is summarized as follows:

<b>December 31, 2017</b>	<b>Amortized Cost</b>	<b>Fair Value</b>
Within one year		
After one but within five years		
After five but within ten years		
After ten years	\$ 6,859	\$ 6,998
	<u>6,859</u>	<u>6,998</u>
Mortgage-backed securities	2,415	2,549
Total	<u>\$ 9,274</u>	<u>\$ 9,547</u>

Securities with a carrying value of \$163,936 and \$144,750 at December 31, 2017 and 2016, 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 December 31, 2017 and 2016, there were no significant concentrations of credit risk from any one issuer, with the exception of U.S. Government agencies and sponsored enterprises that exceeded 10.0 percent of stockholders' equity.

The fair value and gross unrealized losses of investment securities with unrealized losses for which an OTTI has not been recognized at December 31, 2017 and 2016, 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
<b>December 31, 2017</b>						
U.S. Treasury securities	\$ 17,350	\$ 170	\$ 2,464	\$ 58	\$ 19,814	\$ 228
U.S. Government-sponsored enterprises	39,096	445	51,365	1,295	90,461	1,740
State and municipals:						
Taxable						
Tax-exempt	54,788	454	3,808	61	58,596	515
Residential Mortgage-backed securities:						
U.S. Government agencies	9,484	39	3,968	46	13,452	85
U.S. Government-sponsored enterprises	12,537	103	6,504	132	19,041	235
Commercial Mortgage-backed securities:						
U.S. Government-sponsored enterprises	6,195	120			6,195	120
Total	<u>\$ 139,450</u>	<u>\$ 1,331</u>	<u>\$ 68,109</u>	<u>\$ 1,592</u>	<u>\$ 207,559</u>	<u>\$ 2,923</u>

	Less Than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
<b>December 31, 2016</b>						
U.S. Treasury securities	\$ 7,438	\$ 132			\$ 7,438	\$ 132
U.S. Government-sponsored enterprises	59,460	1,480			59,460	1,480
State and municipals:						
Taxable	1,035	39			1,035	39
Tax-exempt	55,166	707	\$ 226		55,392	707
Residential Mortgage-backed securities:						
U.S. Government agencies	5,917	27	1,496	\$ 20	7,413	47
U.S. Government-sponsored enterprises	16,412	85	2,712	74	19,124	159
Total	<u>\$ 145,428</u>	<u>\$ 2,470</u>	<u>\$ 4,434</u>	<u>\$ 94</u>	<u>\$ 149,862</u>	<u>\$ 2,564</u>

The Company had 186 investment securities, consisting of 103 tax-exempt state and municipal obligations, seven U.S. Treasury securities, one taxable state and municipal obligation, 35 U.S. Government-sponsored enterprise securities and 40 mortgage-backed securities that were in unrealized loss positions at December 31, 2017. Of these securities, one U.S. Treasury security, twenty U.S. Government-sponsored enterprise securities, seventeen mortgage-backed securities and seven tax-exempt state and municipal 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 December 31, 2017.

There was no OTTI recognized for each of the years in the three-year period ended December 31, 2017.



#### 4. Loans, net and allowance for loan losses:

The major classifications of loans outstanding, net of deferred loan origination fees and costs at December 31, 2017 and 2016 are summarized as follows. Net deferred loan costs included in loan balances were \$575 and \$579 in 2017 and 2016, respectively.

	<u>December 31, 2017</u>	<u>December 31, 2016</u>
Commercial	\$ 476,199	\$ 408,814
Real estate:		
Commercial	786,210	700,144
Residential	287,935	289,781
Consumer	142,721	134,226
Total	<u>\$ 1,693,065</u>	<u>\$ 1,532,965</u>

Loans outstanding to directors, executive officers, principal stockholders or to their affiliates totaled \$15,169 and \$15,614 at December 31, 2017 and 2016, respectively. Advances and repayments during 2017 totaled \$1,133 and \$1,578 respectively. There were no related party loans that were classified as nonaccrual, past due, or restructured at December 31, 2017 and 2016. During 2017, the Company made donations of \$1.1 million to a community foundation of which one of the Company's directors is Chairman and CEO. The community foundation is a charitable organization approved by the Pennsylvania Department of Community and Economic Development under the Educational Improvement Tax Credit (EITC) program, which permits the Company to receive tax credits toward Pennsylvania state taxes while its donations are used to improve local education. During 2016, the Company made donations of \$0.9 million to the community foundation.

Deposits from related parties held by Peoples Bank amounted to \$10.0 million at December 31, 2017 and \$9.3 million at December 31, 2016.

At December 31, 2017, the majority of the Company's loans were at least partially secured by real estate in the eastern Pennsylvania and southern tier New York counties that make up the market serviced by Peoples Security Bank & Trust Company. Therefore, a primary concentration of credit risk is directly related to the real estate market in these regions. Changes in the general economy, local economy or in the real estate market could affect the ultimate collectability of this portion of the loan portfolio. Management does not believe there are any other significant concentrations of credit risk that could affect the loan portfolio.

The changes in the allowance for loan losses account by major classification of loan for the year ended December 31, 2017, 2016, and 2015 were as follows:

December 31, 2017	Commercial	Real estate		Consumer	Unallocated	Total
		Commercial	Residential			
Allowance for loan losses:						
Beginning balance	\$ 3,799	\$ 5,847	\$ 4,707	\$ 1,608	\$ —	\$ 15,961
Charge-offs	(173)	(706)	(533)	(737)		(2,149)
Recoveries	20	124	44	160		348
Provisions	1,406	2,283	762	349	—	4,800
Ending balance	\$ 5,052	\$ 7,548	\$ 4,980	\$ 1,380	\$	\$ 18,960
Ending balance: individually evaluated for impairment	159	263	336	8		766
Ending balance: collectively evaluated for impairment	4,893	7,285	4,644	1,372		18,194
Ending balance: loans acquired with deteriorated credit quality	\$	\$	\$		\$	\$ —
Loans receivable:						
Ending balance	\$ 476,199	\$ 786,210	\$ 287,935	\$ 142,721	\$	\$ 1,693,065
Ending balance: individually evaluated for impairment	2,121	3,644	3,763	177		9,705
Ending balance: collectively evaluated for impairment	473,736	781,921	284,142	142,544		1,682,343
Ending balance: loans acquired with deteriorated credit quality	\$ 342	\$ 645	\$ 30	\$	\$	\$ 1,017

December 31, 2016	Commercial	Real estate		Consumer	Unallocated	Total
		Commercial	Residential			
Allowance for loan losses:						
Beginning balance	\$ 3,042	\$ 4,245	\$ 4,082	\$ 1,583	\$ 23	\$ 12,975
Charge-offs	(776)	(858)	(339)	(495)		(2,468)
Recoveries	86	122	69	177		454
Provisions	1,447	2,338	895	343	(23)	5,000
Ending balance	\$ 3,799	\$ 5,847	\$ 4,707	\$ 1,608	\$	\$ 15,961
Ending balance: individually evaluated for impairment	225	1,197	520			1,942
Ending balance: collectively evaluated for impairment	3,574	4,650	4,187	1,608		14,019
Ending balance: loans acquired with deteriorated credit quality	\$	\$	\$		\$	\$ —
Loans receivable:						
Ending balance	\$ 408,814	\$ 700,144	\$ 289,781	\$ 134,226	\$	\$ 1,532,965
Ending balance: individually evaluated for impairment	1,724	5,820	3,543	155		11,242
Ending balance: collectively evaluated for impairment	406,127	692,987	286,201	134,071		1,519,386
Ending balance: loans acquired with deteriorated credit quality	\$ 963	\$ 1,337	\$ 37		\$	\$ 2,337

December 31, 2015	Real estate					Total
	Commercial	Commercial	Residential	Consumer	Unallocated	
Allowance for loan losses:						
Beginning balance	\$ 2,321	\$ 3,037	\$ 3,690	\$ 1,290	\$	\$ 10,338
Charge-offs	(246)	(325)	(523)	(333)		(1,427)
Recoveries	77	144	26	117		364
Provisions	890	1,389	889	509	23	3,700
Ending balance	\$ 3,042	\$ 4,245	\$ 4,082	\$ 1,583	\$ 23	\$ 12,975
Ending balance: individually evaluated for impairment	759	126	1,138	117		2,140
Ending balance: collectively evaluated for impairment	2,283	4,012	2,944	1,466	23	10,728
Ending balance: loans acquired with deteriorated credit quality	\$	\$ 107	\$	\$	\$	\$ 107
Loans receivable:						
Ending balance	\$ 365,767	\$ 567,277	\$ 306,218	\$ 101,603	\$	\$ 1,340,865
Ending balance: individually evaluated for impairment	1,196	4,006	4,917	148		10,267
Ending balance: collectively evaluated for impairment	363,620	561,903	301,252	101,455		1,328,230
Ending balance: loans acquired with deteriorated credit quality	\$ 951	\$ 1,368	\$ 49	\$	\$	\$ 2,368

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 December 31, 2017 and 2016:

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

December 31, 2016	Pass	Special Mention	Substandard	Doubtful	Total
Commercial	\$ 398,867	\$ 6,222	\$ 3,725	\$	\$ 408,814
Real estate:					
Commercial	674,914	10,392	14,838		700,144
Residential	282,737	233	6,811		289,781
Consumer	133,983		243		134,226
Total	\$ 1,490,501	\$ 16,847	\$ 25,617	\$	\$ 1,532,965

Information concerning nonaccrual loans by major loan classification at December 31, 2017 and 2016 is summarized as follows:

	<u>December 31, 2017</u>	<u>December 31, 2016</u>
Commercial	\$ 860	\$ 934
Real estate:		
Commercial	3,821	7,016
Residential	2,994	3,003
Consumer	177	155
Total	<u>\$ 7,852</u>	<u>\$ 11,108</u>

The major classification of loans by past due status at December 31, 2017 and 2016 are summarized as follows:

<u>December 31, 2017</u>	<u>30-59 Days Past Due</u>	<u>60-89 Days Past Due</u>	<u>Greater than 90 Days</u>	<u>Total Past Due</u>	<u>Current</u>	<u>Total Loans</u>	<u>Loans &gt; 90 Days and Accruing</u>
Commercial	\$ 124	\$ 216	\$ 860	\$ 1,200	\$ 474,999	\$ 476,199	
Real estate:							
Commercial	1,722	194	3,821	5,737	780,473	786,210	
Residential	1,134	1,551	3,543	6,228	281,707	287,935	\$ 549
Consumer	1,101	364	363	1,828	140,893	142,721	186
Total	<u>\$ 4,081</u>	<u>\$ 2,325</u>	<u>\$ 8,587</u>	<u>\$ 14,993</u>	<u>\$ 1,678,072</u>	<u>\$ 1,693,065</u>	<u>\$ 735</u>
<u>December 31, 2016</u>	<u>30-59 Days Past Due</u>	<u>60-89 Days Past Due</u>	<u>Greater than 90 Days</u>	<u>Total Past Due</u>	<u>Current</u>	<u>Total Loans</u>	<u>Loans &gt; 90 Days and Accruing</u>
Commercial	\$ 249	\$ 75	\$ 934	\$ 1,258	\$ 407,556	\$ 408,814	
Real estate:							
Commercial	4,782	527	7,016	12,325	687,819	700,144	
Residential	2,100	354	3,561	6,015	283,766	289,781	\$ 558
Consumer	962	259	441	1,662	132,564	134,226	286
Total	<u>\$ 8,093</u>	<u>\$ 1,215</u>	<u>\$ 11,952</u>	<u>\$ 21,260</u>	<u>\$ 1,511,705</u>	<u>\$ 1,532,965</u>	<u>\$ 844</u>

The following tables summarize information concerning impaired loans as of and for the years ended December 31, 2017, 2016 and 2015 by major loan classification:

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

December 31, 2016	Recorded Investment	Unpaid Principal Balance	Related Allowance	For the Year Ended	
				Average Recorded Investment	Interest Income Recognized
With no related allowance:					
Commercial	\$ 2,404	\$ 3,213		\$ 1,461	\$ 48
Real estate:					
Commercial	2,364	3,018		4,300	71
Residential	2,205	2,388		2,133	35
Consumer	155	155		147	
Total	7,128	8,774		8,041	154
With an allowance recorded:					
Commercial	283	283	225	859	
Real estate:					
Commercial	4,793	4,793	1,197	2,366	2
Residential	1,375	1,376	520	1,185	7
Consumer				50	
Total	6,451	6,452	1,942	4,460	9
Commercial	2,687	3,496	225	2,320	48
Real estate:					
Commercial	7,157	7,811	1,197	6,666	73
Residential	3,580	3,764	520	3,318	42
Consumer	155	155		197	
Total	\$ 13,579	\$ 15,226	\$ 1,942	\$ 12,501	\$ 163

December 31, 2015	Recorded Investment	Unpaid Principal Balance	Related Allowance	For the Year Ended	
				Average Recorded Investment	Interest Income Recognized
With no related allowance:					
Commercial	\$ 1,352	\$ 2,720		\$ 1,848	\$ 87
Real estate:					
Commercial	2,731	3,408		2,394	95
Residential	3,048	3,231		2,664	4
Consumer	31	31		17	
Total	<u>7,162</u>	<u>9,390</u>		<u>6,923</u>	<u>186</u>
With an allowance recorded:					
Commercial	795	795	\$ 759	1,680	40
Real estate:					
Commercial	2,643	2,643	233	4,155	86
Residential	1,918	1,918	1,138	1,776	30
Consumer	117	117	117	126	
Total	<u>5,473</u>	<u>5,473</u>	<u>2,247</u>	<u>7,737</u>	<u>156</u>
Commercial	2,147	3,515	759	3,528	127
Real estate:					
Commercial	5,374	6,051	233	6,549	181
Residential	4,966	5,149	1,138	4,440	34
Consumer	148	148	117	143	
Total	<u>\$ 12,635</u>	<u>\$ 14,863</u>	<u>\$ 2,247</u>	<u>\$ 14,660</u>	<u>\$ 342</u>

There were no amounts of interest income recognized using the cash-basis method on impaired loans for the years ended December 31, 2017, 2016 and 2015.

As a part of the Merger, an adjustment was made to reflect the elimination of the allowance for loan losses related to the Peoples Neighborhood Bank loan portfolio, as required by purchase accounting standards. As a result, the acquired loan portfolio was evaluated based on risk characteristics and other credit and market criteria to determine a credit quality adjustment to the fair value of the loans acquired. The acquired loan balance was reduced by the aggregate amount of the credit quality adjustment in determining the fair value of the loans. The credit quality adjustment does not account for acquired loans deemed to be impaired in accordance with Accounting Standard Codification 310-30-30, previously known as Statement of Position (SOP) 03-3, "Accounting for Certain Loans Acquired in a Transfer." These impaired loans are accounted for in the credit adjustment on distressed loans, which represents the portion of the loan balance that has been deemed uncollectible based on the management's expectations of future cash flows for each respective loan. Based on management's evaluation of the acquired loan portfolio, 29 loans were deemed impaired resulting in a credit adjustment on distressed loans of \$6,892. As of December 31, 2017, there were a total of nine loans remaining with a credit adjustment of \$1,430. Management performed an evaluation of expected future cash flows, including the anticipated cash flow from the sale of collateral, and compared that to the carrying amount of the impaired loans. Based on these evaluations, the Company has determined that no additional reserve was required against the acquired impaired loans at December 31, 2017.

The changes in the accretible yield of acquired loans accounted for under ASC310-30 for the years ended December 31, 2017, 2016 and 2015, were as follows:

Year ended December 31	2017	2016	2015
Beginning Balance, January 1	\$ 185	\$	\$ 60
Reclassification from Nonaccretable		554	
Accretion	(185)	(369)	(60)
Charge-offs			
Payments			
Ending Balance, December 31	<u>\$ —</u>	<u>\$ 185</u>	<u>\$ —</u>

Included in the commercial loan, commercial real estate and residential real estate categories are troubled debt restructurings that were classified as impaired. Trouble debt restructurings totaled \$3,074, \$1,909 and \$2,861 at December 31, 2017, 2016 and 2015, respectively.

There were six loans modified in 2017, three loans modified in 2016 and nine loans modified in 2015 that resulted in troubled debt restructurings. The following tables summarize the loans whose terms have been modified resulting in troubled debt restructurings during the year ended December 31, 2017 and 2016.

December 31, 2017	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment	Recorded Investment
Commercial	2	\$ 885	\$ 885	\$ 864
Commercial real estate	3	721	721	700
Residential mortgage	1	64	64	64
Total	<u>6</u>	<u>\$ 1,670</u>	<u>\$ 1,670</u>	<u>\$ 1,628</u>

December 31, 2016	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment	Recorded Investment
Commercial	1	\$ 1,500	\$ 1,150	\$ 1,150
Commercial real estate				
Residential mortgage	2	216	216	207
Total	<u>3</u>	<u>\$ 1,716</u>	<u>\$ 1,366</u>	<u>\$ 1,357</u>

There were no payment defaults within 12 months of its modification on loans considered troubled debt restructurings for the year ended December 31, 2017, one payment default for the year ended December 31, 2016 totaling \$43 and two payment defaults for the year ended December 31, 2015 totaling \$166.

The amount of residential loans in the formal process of foreclosure totaled \$1,684 at December 31, 2017 and \$1,529 at December 31, 2016.

##### 5. Off-balance sheet financial instruments:

The Company is a party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit, unused portions of lines of credit and standby letters of credit. Those instruments involve, to varying degrees, elements of credit risk in excess of the amount recognized in the consolidated balance sheets.

The Company's exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit, unused portions of lines of credit and standby letters of credit is represented by the contractual amounts of those instruments. The Company follows the same credit policies in making commitments and conditional obligations as it does for on-balance sheet instruments. The Company records a valuation allowance for off-

balance sheet credit losses, if deemed necessary, separately as a liability. An allowance of \$61 and \$58 was recorded as of December 31, 2017 and 2016, respectively.

The contractual amounts of off-balance sheet commitments at December 31, 2017 and 2016 are summarized as follows:

<u>December 31</u>	<u>2017</u>	<u>2016</u>
Commitments to extend credit	\$ 324,984	\$ 235,878
Unused portions of lines of credit	56,244	57,784
Standby letters of credit	23,387	31,051
	<u>\$ 404,615</u>	<u>\$ 324,713</u>

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. The Company evaluates each customer's credit worthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Company upon extension of credit, is based on management's credit evaluation. Collateral held varies but may include personal or commercial real estate, accounts receivable, inventory and equipment.

Unused portions of lines of credit, including home equity and overdraft protection agreements, are commitments for possible future extensions of credit to existing customers. Unused portions of home equity lines are collateralized and generally have fixed expiration dates. Overdraft protection agreements are uncollateralized and usually do not carry specific maturity dates. Unused portions of lines of credit ultimately may not be drawn upon to the total extent to which the Company is committed.

Standby letters of credit are conditional commitments issued by the Company to guarantee the performance of a customer to a third party. Generally, all standby letters of credit expire within twelve months. The credit risk involved in issuing standby letters of credit is essentially the same as that involved in extending other loan commitments. The Company requires collateral supporting these standby letters of credit as deemed necessary. Collateral supporting standby letters of credit amounted to \$14,049 at December 31, 2017 and \$27,072 at December 31, 2016. The carrying value of the liability for the Company's obligations under guarantees for standby letters of credit was not material at December 31, 2017 and 2016.

## **6. Premises and equipment, net:**

Premises and equipment at December 31, 2017 and 2016 are summarized as follows:

<u>December 31</u>	<u>2017</u>	<u>2016</u>
Land	\$ 5,875	\$ 5,535
Premises and leasehold improvements	42,472	38,604
Furniture, fixtures and equipment	13,249	11,247
	61,596	55,386
Less: accumulated depreciation	24,039	22,126
	<u>\$ 37,557</u>	<u>\$ 33,260</u>

Depreciation and amortization included to noninterest expense amounted to \$1,950, \$1,661, and \$1,595 in 2017, 2016 and 2015, respectively.



Pursuant to the terms of non-cancelable lease agreements in effect at December 31, 2017, pertaining to banking premises and equipment, future minimum annual rent commitments under various operating leases are summarized as follows:

2018	\$ 494
2019	476
2020	478
2021	437
2022	408
Thereafter	966
	<u>\$ 3,259</u>

The leases contain options to extend for periods from one to ten years. The cost of such options is not included in the annual rental commitments. Rent expense for the years ended December 31, 2017, 2016 and 2015 amounted to \$407, \$416 and \$397, respectively.

#### **7. Intangible assets, net:**

The gross carrying amount of core deposit intangible assets totaled \$8,146 at December 31, 2017 and 2016. The gross carrying amount of trade name intangible assets totaled \$203 at December 31, 2017 and 2016. The gross carrying amount of the intangible asset related to the acquisition of an asset management and retirement plan services company acquired in 2015 totaled \$1,091 at December 31, 2017 and 2016. The accumulated amortization on core deposit intangible assets was \$5,810 and \$4,958 at December 31, 2017 and 2016, respectively. The accumulated amortization on trade name intangible assets was \$128 and \$102 at December 31, 2017 and 2016, respectively. The accumulated amortization on the asset management and retirement plan services intangible asset was \$324 and \$169 at December 31, 2017 and 2016, respectively. Amortization expense amounted to \$1,034, \$1,186 and \$1,195 in 2017, 2016 and 2015, respectively.

The estimated amortization expense on intangible assets in years subsequent to December 31, 2017, is as follows:

2018	\$ 882
2019	730
2020	606
2021	491
2022	363
Thereafter	106

## 8. Other assets:

The major components of other assets at December 31, 2017 and 2016 are summarized as follows:

	December 31, 2017	December 31, 2016
Other real estate owned	\$ 284	\$ 393
Investment in low income housing partnership	7,842	8,312
Mortgage servicing rights	728	698
Bank owned life insurance	33,836	33,073
Restricted equity securities	8,562	7,051
Net deferred tax asset	3,906	5,571
Other assets	9,311	10,403
Total	<u>\$ 64,469</u>	<u>\$ 65,501</u>

The Company originates one-to-four family residential mortgage loans for sale in the secondary market with servicing rights retained. Mortgage loans serviced for others are not included in the accompanying Consolidated Balance Sheets. The unpaid principal balances of mortgage loans serviced for others were \$174,017 at December 31, 2017 and \$171,034 at December 31, 2016.

## 9. Deposits:

The major components of interest-bearing and noninterest-bearing deposits at December 31, 2017 and 2016 are summarized as follows:

December 31	2017	2016
Interest-bearing deposits:		
Money market accounts	\$ 278,494	\$ 224,414
Now accounts	389,734	330,914
Savings accounts	387,827	394,033
Time deposits less than \$250	220,812	233,513
Time deposits \$250 or more	61,422	52,197
Total interest-bearing deposits	1,338,289	1,235,071
Noninterest-bearing deposits	380,729	353,686
Total deposits	<u>\$ 1,719,018</u>	<u>\$ 1,588,757</u>

The aggregate amounts of maturities for all time deposits at December 31, 2017, are summarized as follows:

2018	\$ 171,043
2019	36,854
2020	25,626
2021	18,952
2022	12,113
Thereafter	17,646
	<u>\$ 282,234</u>

The aggregate amount of deposits reclassified as loans was \$298 at December 31, 2017, and \$194 at December 31, 2016. Management evaluates transaction accounts that are overdrawn for collectability as part of its evaluation for credit losses.

## 10. Short-term borrowings:

Short-term borrowings consisted of FHLB advances representing overnight or less than 30-day borrowings at December 31, 2017 and 2016:

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

	At and for the year ended December 31, 2016				
	Ending Balance	Average Balance	Maximum Month-End Balance	Weighted Average Rate for the Year	Weighted Average Rate at End of the Year
FHLB advances	\$ 82,700	\$ 67,553	\$ 86,300	0.60	0.74 %

Peoples Bank has an agreement with the FHLB which allows for borrowings up to its maximum borrowing capacity based on a percentage of qualifying collateral assets. At December 31, 2017, Peoples Bank's maximum borrowing capacity was \$631,782 of which \$173,409 was outstanding in borrowings. Advances with the FHLB are secured under terms of a blanket collateral agreement by a pledge of FHLB stock and certain other qualifying collateral, such as investments and mortgage-backed securities and mortgage loans. Interest accrues daily on the FHLB advances based on rates of the FHLB discount notes. This rate resets each day.

## 11. Long-term debt:

Long-term debt consisting of advances from the FHLB at December 31, 2017 and 2016 are as follows:

Due	Interest Rate		2017	2016
	Fixed	Adjustable		
February 2017	4.99 %		\$	77
September 2017	2.36			6,500
April 2018	3.83		40	156
December 2018	1.27		10,000	10,000
December 2019		3.04 %	3,000	3,000
December 2019		2.82	6,300	6,300
December 2019	1.62		10,000	10,000
June 2020	1.74		5,000	5,000
December 2020	1.84		5,000	5,000
March 2023	4.69		10,394	12,101
			<u>\$ 49,734</u>	<u>\$ 58,134</u>

Maturities of long-term debt, by contractual maturity, in years subsequent to December 31, 2017 are as follows:

2018	\$ 11,828
2019	21,174
2020	11,963
2021	2,058
2022	2,156
Thereafter	555
	<u>\$ 49,734</u>

None of the advances from the FHLB are convertible. At December 31, 2017, long-term debt consist of \$40,434 at fixed rates and \$9,300 at adjustable rates which reset quarterly based on three-month Libor plus 1.21% to plus 1.57%.

## 12. Fair value of financial instruments:

Assets and liabilities measured at fair value on a recurring basis at December 31, 2017 and 2016 are summarized as follows:

December 31, 2017	Amount	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)
U.S. Treasury securities	\$ 19,814	\$ 19,814		\$
U.S. Government-sponsored enterprises	93,648		\$ 93,648	
State and Municipals:				
Taxable	15,047		15,047	
Tax-exempt	103,833		103,833	
Mortgage-backed securities:				
U.S. Government agencies	14,434		14,434	
U.S. Government-sponsored enterprises	25,726		25,726	
Common equity securities	46	46		
Interest rate swap-other assets	655		655	
Interest rate swap-other liabilities	(733)		(733)	
Total	<u>\$ 272,470</u>	<u>\$ 19,860</u>	<u>\$ 252,610</u>	<u>\$</u>

December 31, 2016	Amount	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)
U.S. Treasury securities	\$ 7,438	\$ 7,438		\$
U.S. Government-sponsored enterprises	80,913		\$ 80,913	
State and Municipals:				
Taxable	15,225		15,225	
Tax-exempt	112,600		112,600	
Mortgage-backed securities:				
U.S. Government agencies	21,042		21,042	
U.S. Government-sponsored enterprises	22,192		22,192	
Total	<u>\$ 259,410</u>	<u>\$ 7,438</u>	<u>\$ 251,972</u>	<u>\$</u>

Assets and liabilities measured at fair value on a nonrecurring basis at December 31, 2017 and 2016 are summarized as follows:

December 31, 2017	Amount	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)
Impaired loans	\$ 3,424			\$ 3,424
Other real estate owned	\$ 216			\$ 216

	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)
<b>December 31, 2016</b>				
Impaired loans	\$ 3,193			\$ 3,193
Other real estate owned	\$ 371			\$ 371

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)
<b>December 31, 2017</b>				
Impaired loans	\$ 3,424	Appraisal of collateral	Appraisal adjustments Liquidation expenses	4.0% to 97.0% (67.2)% 3.0% to 6.0% (4.9)%
Other real estate owned	\$ 216	Appraisal of collateral	Appraisal adjustments Liquidation expenses	25.0% to 41.3% (30.7)% 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)
<b>December 31, 2016</b>				
Impaired loans	\$ 3,193	Appraisal of collateral	Appraisal adjustments Liquidation expenses	18.0% to 97.0% (74.5)% 3.0% to 6.0% (5.3)%
Other real estate owned	\$ 371	Appraisal of collateral	Appraisal adjustments Liquidation expenses	25.0% to 54.6% (43.1)% 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.

The carrying and fair values of the Company's financial instruments at December 31, 2017 and 2016 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)
<b>December 31, 2017</b>					
Financial assets:					
Cash and cash equivalents	\$ 37,488	\$ 37,488	\$ 37,488		
Investment securities:					
Available-for-sale	272,548	272,548	19,860	\$ 252,688	
Held-to-maturity	9,274	9,547		9,547	
Loans held for sale	106	106		106	
Net loans	1,674,105	1,645,292			\$ 1,645,292
Accrued interest receivable	6,936	6,936		6,936	
Mortgage servicing rights	728	1,638		1,638	
Restricted equity securities	8,562	8,562		8,562	
Other assets		2,249			2,249
Interest rate swaps	655	655		655	
Total	<u>\$ 2,010,402</u>	<u>\$ 1,985,021</u>			
Financial liabilities:					
Deposits	\$ 1,719,018	\$ 1,666,284		\$ 1,666,284	
Short-term borrowings	123,675	123,675		123,675	
Long-term debt	49,734	50,147		50,147	
Accrued interest payable	497	497		497	
Interest rate swaps	733	733		733	
Total	<u>\$ 1,893,657</u>	<u>\$ 1,841,336</u>			
<b>December 31, 2016</b>					
Financial assets:					
Cash and cash equivalents	\$ 39,941	\$ 39,941	\$ 39,941		
Investment securities:					
Available-for-sale	259,410	259,410	7,438	\$ 251,972	
Held-to-maturity	10,517	10,714		10,714	
Loans held for sale					
Net loans	1,517,004	1,507,936			\$ 1,507,936
Accrued interest receivable	6,228	6,228		6,228	
Mortgage servicing rights	698	1,587		1,587	
Restricted equity securities	7,051	7,051		7,051	
Total	<u>\$ 1,840,849</u>	<u>\$ 1,832,867</u>			
Financial liabilities:					
Deposits	\$ 1,588,757	\$ 1,587,701		\$ 1,587,701	
Short-term borrowings	82,700	82,700		82,700	
Long-term debt	58,134	58,987		58,987	
Accrued interest payable	462	462		462	
Total	<u>\$ 1,730,053</u>	<u>\$ 1,729,850</u>			

### 13. Derivatives and hedging activities

#### Risk Management Objective of Using Derivatives

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

#### Fair Values of Derivative Instruments on the Balance Sheet

The table below presents the fair value of the Company's derivative financial instruments as well as their classification on the Balance Sheet as of December 31, 2017.

	Asset Derivatives As of December 31, 2017		Asset Derivatives As of December 31, 2016		Liability Derivatives As of December 31, 2017		Liability Derivatives As of December 31, 2016	
	Balance Sheet		Balance Sheet		Balance Sheet		Balance Sheet	
	Location	Fair Value	Location	Fair Value	Location	Fair Value	Location	Fair Value
Derivatives <b>not</b> designated as hedging instruments								
Interest Rate Products	Other Assets	\$ 655	Other Assets	\$	Other Liabilities	\$ 733	Other Liabilities	\$
Total derivatives <b>not</b> designated as hedging instruments		<u>\$ 655</u>		<u>\$</u>		<u>\$ 733</u>		<u>\$</u>

#### Non-designated Hedges

None of the Company's derivatives are designated in qualifying hedging relationships. Derivatives not designated as hedges are not speculative and result from a service the Company provides to certain customers, which the Company implemented during the third quarter of 2017. The Company executes interest rate swaps with commercial banking customers to facilitate their respective risk management strategies. Those interest rate swaps are simultaneously hedged by offsetting interest rate swaps that the Company executes with a third party, such that the Company minimizes its net risk exposure resulting from such transactions. As the interest rate swaps associated with this program do not meet the strict hedge accounting requirements, changes in the fair value of both the customer swaps and the offsetting swaps are recognized directly in earnings. As of December 31, 2017, the Company had 5 interest rate swaps with an aggregate notional amount of \$55,928 related to this program.

#### Effect of Derivative Instruments on the Income Statement

The tables below present the effect of the Company's derivative financial instruments on the Consolidated Statements of Income and Comprehensive Income for the years ended December 31, 2017 and 2016.

Derivatives Not Designated as Hedging Instruments	Location of Gain or (Loss) Recognized in Income on Derivative	Amount of Gain or (Loss) Recognized in	Amount of Gain or (Loss) Recognized in
		Income on Derivative Twelve Months Ended December 31, 2017	Income on Derivative Twelve Months Ended December 31, 2016
Interest Rate Products	Other non-interest income	\$ (79)	\$
Total		<u>\$ (79)</u>	<u>\$</u>



### **Credit-risk-related Contingent Features**

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

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

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

As of December 31, 2017 the termination value of derivatives in a net liability position, which includes accrued interest but excludes any adjustment for nonperformance risk, related to these agreements was \$79. The Company has minimum collateral posting thresholds with certain of its derivative counterparties, and has posted collateral of \$880 against its obligations under these agreements. The Company was in compliance with the terms of the above noted agreements at December 31, 2017.

### **14. Stock plans:**

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

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

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

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

Persons eligible to receive awards under the 2008 Plan and 2017 Plan include directors, officers, employees, consultants and other service providers of the Company and its subsidiaries.

As of December 31, 2017, there were 120,116 shares of the Company’s common stock available for grant as awards pursuant to the 2008 Plan and there were 98,462 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 2008 Plan authorizes grants of stock options, stock appreciation rights, dividend equivalents, performance awards, restricted stock and restricted stock units. The 2017 Plan authorizes grants of stock options, stock appreciation rights, cash awards, performance awards, restricted stock and restricted stock units. In 2017, the Company awarded 2,020 shares of non-performance-based restricted stock, bringing the total of nonvested restricted stock awards to 14,382 shares, and 7,071 performance-based restricted stock units under the 2008 Plan. Also in 2017, the Company awarded 342 shares of non-performance based restricted stock and 1,196 performance based restricted stock units under the 2017 Plan. A total of 10,542 restricted stock awards granted under the 2008 Plan vested in 2017. In 2016, the Company did not make any awards under the 2008 Plan.

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

The activity related to restricted stock for each of the years ended December 31, 2017, 2016 and 2015 was as follows:

<b>Year Ended December 31</b>	<b>2017</b>	<b>2016</b>	<b>2015</b>
Nonvested, January 1	12,362	14,309	14,309
Granted shares	2,362		
Vested shares	10,542	1,947	
Forfeited shares			
Nonvested, December 31	<u>4,182</u>	<u>12,362</u>	<u>14,309</u>

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

The Company recognized \$156 for awards granted under the 2008 Plan, and \$21 for awards granted under the 2017 Plan. The Company recognized \$71 and \$69 of compensation expense for the years ended December 31, 2016, and 2015, respectively for awards granted under the 2008 Plan. As of December 31, 2017, the Company had \$287 of unrecognized compensation expense associated with restricted stock awards. The remaining cost is expected to be recognized over a weighted average vesting period of 2 years.

#### **15. Employee benefit plans:**

The Company sponsors a separate Employee Stock Ownership Plan (“ESOP”) and Retirement Profit Sharing 401(k) Plan. The Company also maintains Supplemental Executive Retirement Plans (“SERP”), and an Employees’ Pension Plan, which is currently frozen.

Under the ESOP, amounts voted by the Company’s Board of Directors are paid into the ESOP and each employee is credited with a share in proportion to their annual compensation. All contributions to the ESOP are invested in or will be invested primarily in Company stock. Distribution of a participant’s ESOP account occurs upon retirement, death or termination in accordance with the plan provisions.

Under the Retirement Profit Sharing Plan, amounts approved by the Board of Directors have been paid into a fund and each employee was credited with a share in proportion to their annual compensation. Upon retirement, death or termination, each employee is paid the total amount of their credits in the fund in one of a number of optional ways in accordance with the plan provisions. Eligible employees may elect deferrals of up to the maximum amounts permitted by law.

The Company contributed \$185, \$156 and \$144 to the ESOP in 2017, 2016 and 2015. In addition, the Company contribution of \$923, \$786 and \$778 to the Retirement Profit Sharing Plan in 2017, 2016 and 2015, was comprised of a safe harbor contribution of \$509, \$446 and \$430 and a discretionary match of \$414, \$340 and \$348.

Peoples Bank established a SERP Plan to replace 401(k) plan benefits lost due to compensation limits imposed on qualified plans by Federal tax law. The annual benefit is a maximum of 6% of the executive compensation in excess of Federal limits. The total liability associated with this plan was \$96 and \$76 at December 31, 2017 and 2016, respectively. The expense associated with the plan was \$20, \$13 and \$15 for 2017, 2016 and 2015 respectively.

The Company has SERPs for the benefit of certain officers of the Company. At December 31, 2017 and 2016, other liabilities include \$1,594 and \$1,416 accrued under the Plans. Compensation expense includes approximately \$314, \$254, and \$157 relating to these SERPs for the years ended December 31, 2017, 2016 and 2015, respectively.

Under the Employees' Pension Plan, currently under curtailment, amounts computed on an actuarial basis were being paid by the Company into a trust fund. The plan provided for fixed benefits payable for life upon retirement at the age of 65, based on length of service and compensation levels as defined in the plan. As of June 22, 2008 no further benefits are being accrued in this plan. Plan assets of the trust fund are invested and administered by the Trust Department of Peoples Bank.

Information related to the Employees' Pension Plan is as follows:

December 31	Pension Benefits	
	2017	2016
Change in benefit obligation:		
Benefit obligation, beginning	\$ 16,703	\$ 17,380
Interest cost	650	665
Change in experience gain	(13)	(322)
Change in actuarial assumptions loss (gain)	395	(256)
Benefits paid	(800)	(764)
Benefit obligation, ending	16,935	16,703
Change in plan assets:		
Fair value of plan assets, beginning	12,644	12,331
Actual return on plan assets	1,420	1,023
Employer contributions		54
Benefits paid	(800)	(764)
Fair value of plan assets, ending	13,264	12,644
Funded status at end of year	\$ (3,671)	\$ (4,059)

The Society of Actuaries released new mortality tables in 2017 and 2016 which the Company utilized in its pension plan remeasurements at December 31, 2017 and 2016. The change in mortality assumption resulted in an increase to the benefit obligation of \$395 in 2017 and a decrease of \$256 in 2016.

Amounts recognized in the consolidated balance sheets are as follows:

December 31	Pension Benefits	
	2017	2016
Liabilities	\$ 3,671	\$ 4,059
Amounts recognized in the accumulated other comprehensive loss consist of:		
Net actuarial loss (gain)	(6,628)	(6,946)
Deferred taxes	1,392	2,431
Net amount recognized	\$ (5,236)	\$ (4,515)

The accumulated benefit obligation for the defined benefit pension plan was \$16,935 and \$16,703 at December 31, 2017 and 2016, respectively.

Components of net periodic pension income and other amounts recognized in other comprehensive income are as follows:

Years Ended December 31,	Pension Benefits		
	2017	2016	2015
Net periodic pension income:			
Interest cost	\$ 650	\$ 665	\$ 696
Expected return on plan assets	(915)	(893)	(931)
Amortization of unrecognized net loss	195	209	198
Net periodic pension income:	(70)	(19)	(37)
Other changes in plan assets and benefit obligations recognized in other comprehensive income (loss):			
Net loss (gain)	318	917	296
Deferred tax	(67)	(321)	(104)
Total recognized in other comprehensive income	251	596	192
Total recognized in net period pension cost and other comprehensive income	\$ 181	\$ 577	\$ 155

The estimated net loss for the defined benefit pension plan that will be amortized from accumulated other comprehensive loss into net periodic benefit cost over the next fiscal year is \$190.

Weighted-average assumptions used to determine benefit obligations and related expenses were as follows:

December 31,	Pension Benefits		
	2017	2016	2015
Discount rate:			
Obligation	4.00 %	4.00 %	4.00 %
Expense	3.75	4.00	4.00
Expected long-term return on plan assets	7.50 %	7.50 %	7.50 %

The expected long-term return on plan assets was determined using average historical returns of the Company's plan assets.

The Company's pension plan weighted-average asset allocations at December 31, 2017 and 2016, by asset category are as follows:

December 31,	2017	2016
Asset Category:		
Cash and cash equivalents	4.1 %	4.2 %
Equity securities	57.4	58.0
Corporate bonds	27.6	26.2
U.S. Government securities	10.9	11.6
	100.0 %	100.0 %

Fair value measurement of pension plan assets at December 31, 2017 and 2016 is as follows:

December 31, 2017	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Observable Inputs (Level 3)
Cash	\$ 539	\$ 539		\$
Equity securities:				
U.S. large cap	7,269	7,269		
International	350	350		
Fixed income securities:				
U.S. Treasuries	198		\$ 198	
U.S. Government agencies	1,247		1,247	
Corporate bonds	3,661		3,661	
Total	\$ 13,264	\$ 8,158	\$ 5,106	\$

December 31, 2016	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Observable Inputs (Level 3)
Cash	\$ 529	\$ 529		\$
Equity securities:				
U.S. large cap	7,046	7,046		
International	282	282		
Fixed income securities:				
U.S. Treasuries	498		\$ 498	
U.S. Government agencies	977		977	
Corporate bonds	3,312		3,312	
Total	\$ 12,644	\$ 7,857	\$ 4,787	\$

The Company investment policies and strategies with respect to the pension plan include: (i) the Trust and Investment Division's equity philosophy is Large-Cap Core with a value bias. We invest in individual high-grade common stocks that are selected from our approved list; (ii) diversification is maintained by having no more than 20% in any industry sector and no individual equity representing more than 10% of the portfolio; and (iii) the fixed income style is conservative but also responsive to the various needs of our individual clients. Fixed income securities consist of U.S. Government Agencies or corporate bonds rated "A" or better. The Company targets the following allocation percentages: (i) cash equivalents 10%; (ii) fixed income 40%; and (iii) equities 50%.

There is no Company stock included in equity securities at December 31, 2017 or 2016. The Company has not determined the amount of the expected contribution to the Employees' Pension Plan for 2018.

The following benefit payments are expected to be paid in the next five years and in the aggregate for the five years thereafter:

	<b>Pension Benefits</b>
2018	\$ 835
2019	832
2020	846
2021	847
2022	885
Thereafter	4,869

#### 16. Income taxes:

The current and deferred amounts of the provision for income taxes expense (benefit) for each of the years ended December 31, 2017, 2016 and 2015 are summarized as follows:

<b>Year Ended December 31</b>	<b>2017</b>	<b>2016</b>	<b>2015</b>
Current	\$ 6,515	\$ 6,450	\$ 5,362
Deferred	1,665	(1,442)	(841)
Total	<u>\$ 8,180</u>	<u>\$ 5,008</u>	<u>\$ 4,521</u>

The components of the net deferred tax asset at December 31, 2017 and 2016 are summarized as follows:

<b>December 31</b>	<b>2017</b>	<b>2016</b>
<b>Deferred tax assets:</b>		
Allowance for loan losses	\$ 3,981	\$ 5,586
Defined benefit plan	1,392	2,431
Deferred compensation	499	705
Capital loss carry forward		211
Investment securities available-for-sale	260	
Other	370	706
Total	<u>6,502</u>	<u>9,639</u>
<b>Deferred tax liabilities:</b>		
Premises and equipment, net	815	981
Merger related accounting	1,243	2,165
Investment securities available-for-sale		197
Other	538	725
Total	<u>2,596</u>	<u>4,068</u>
Net deferred tax asset	<u>\$ 3,906</u>	<u>\$ 5,571</u>

Management believes that future taxable income will be sufficient to utilize deferred tax assets. Core earnings of the Company have remained strong and will continue to support the recognition of the deferred tax asset based on future growth projections.

A reconciliation between the amount of the effective income tax expense and the income tax expense that would have been provided at the federal statutory rate of 35.0 percent for the years ended December 31, 2017, 2016 and 2015 is summarized as follows:

<u>Year Ended December 31</u>	<u>2017</u>	<u>2016</u>	<u>2015</u>
Federal income tax at statutory rate	\$ 9,323	\$ 8,607	\$ 7,785
Effect of federal income tax rate changes (Note 1)	2,623		
Tax exempt interest	(2,157)	(2,264)	(2,008)
Life insurance investment income	(269)	(277)	(268)
Residential housing program tax credits	(1,095)	(1,128)	(1,115)
Other, net	(245)	70	127
Total	<u>\$ 8,180</u>	<u>\$ 5,008</u>	<u>\$ 4,521</u>

## 17. Parent Company financial statements:

### CONDENSED BALANCE SHEETS

<u>December 31</u>	<u>2017</u>	<u>2016</u>
Assets:		
Cash and cash equivalents	\$ 3,932	\$ 3,948
Investment securities available-for-sale	46	
Investment in bank subsidiary	259,147	250,869
Due from subsidiaries	1,900	1,903
Total assets	<u>\$ 265,025</u>	<u>\$ 256,720</u>
Liabilities and Stockholders' Equity:		
Other liabilities	\$ 49	\$ 102
Stockholders' equity	264,976	256,618
Total liabilities and stockholders' equity	<u>\$ 265,025</u>	<u>\$ 256,720</u>

### CONDENSED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME

<u>Year Ended December 31</u>	<u>2017</u>	<u>2016</u>	<u>2015</u>
Income:			
Dividends from subsidiaries	\$ 9,319	\$ 9,170	\$ 9,319
Other income	52	46	40
Total income	<u>9,371</u>	<u>9,216</u>	<u>9,359</u>
Expense:			
Other expenses	205	259	243
Total expenses	<u>205</u>	<u>259</u>	<u>243</u>
Income before taxes and undistributed income	9,166	8,957	9,116
Income tax benefit	(54)	(75)	(70)
Income before undistributed income of subsidiaries	9,220	9,032	9,186
Equity in undistributed net income (loss) of subsidiaries	9,237	10,551	8,537
Net income	<u>\$ 18,457</u>	<u>\$ 19,583</u>	<u>\$ 17,723</u>
Comprehensive Income	<u>\$ 17,500</u>	<u>\$ 17,553</u>	<u>\$ 16,427</u>

## CONDENSED STATEMENTS OF CASH FLOWS

Year Ended December 31	2017	2016	2015
Cash flows from operating activities:			
Net income	\$ 18,457	\$ 19,583	\$ 17,723
Adjustments:			
Net realized gains on sales of securities			
Undistributed net income of subsidiaries	(9,237)	(10,551)	(8,537)
(Decrease) increase in other assets	(3)	577	5,257
Decrease in other liabilities	(53)	(77)	(69)
Stock based compensation	177	71	69
Net cash provided by operating activities	9,341	9,603	14,443
Cash flows from investing activities:			
Purchase of available-for-sale securities	(43)		
Net cash provided by investing activities	(43)		
Cash flows from financing activities:			
Redemption of common stock		(604)	(5,188)
Reissuance of treasury stock	5		
Cash dividends paid	(9,319)	(9,170)	(9,319)
Net cash used in financing activities	(9,314)	(9,774)	(14,507)
Decrease in cash	(16)	(171)	(64)
Cash at beginning of year	3,948	4,119	4,183
Cash at end of year	\$ 3,932	\$ 3,948	\$ 4,119

### 18. Regulatory matters:

Dividends are paid by the Parent Company from its assets, which are mainly provided by dividends from Peoples Bank. Under the Pennsylvania Business Corporation Law of 1988, as amended, the Company may not pay a dividend if, after payment, either the Company could not pay its debts as they become due in the usual course of business, or the Company's total assets would be less than its total liabilities. The determination of total assets and liabilities may be based upon: (i) financial statements prepared on the basis of GAAP; (ii) financial statements that are prepared on the basis of other accounting practices and principles that are reasonable under the circumstances; or (iii) a fair valuation or other method that is reasonable under the circumstances. In addition, the Federal Reserve Board has the power to prohibit dividends by bank holding companies if their actions constitute unsafe or unsound practices. The Federal Reserve Board has issued a policy statement on the payment of cash dividends by bank holding companies, which expresses the Federal Reserve Board's view that a bank holding company should pay cash dividends only to the extent that the company's net income for the past year is sufficient to cover both the cash dividends and a rate of earnings retention that is consistent with the company's capital needs, asset quality and overall financial condition. The Federal Reserve Board also indicated that it would be inappropriate for a bank holding company experiencing serious financial problems to borrow funds to pay dividends. Under the prompt corrective action regulations, the Federal Reserve Board may prohibit a bank holding company from paying any dividends if the holding company's bank subsidiary is classified as "undercapitalized."

In addition, under the Pennsylvania Banking Code of 1965, as amended, Peoples Bank may only declare and pay dividends out of accumulated net earnings, including accumulated net earnings acquired as a result of a merger within seven years. Further, Peoples Bank may not declare or pay any dividend unless Peoples Bank's surplus would not be reduced by the payment of the dividend below 100 percent of our capital stock. Pennsylvania law requires that each year Peoples Bank set aside as surplus, a sum equal to not less than 10 percent of its net earnings if surplus does not equal at least 100 percent of our capital stock. Under federal law and FDIC regulations, an insured bank may not pay dividends if



doing so would make it undercapitalized within the meaning of the prompt corrective action law or if in default of its deposit insurance fund assessment.

Although subject to the aforementioned regulatory restrictions, the Company's consolidated retained earnings at December 31, 2017 and 2016 were not restricted under any borrowing agreement as to payment of dividends or reacquisition of common stock.

The Company has paid cash dividends since its formation as a bank holding company in 1986. It is the present intention of the Board of Directors to continue this dividend payment policy, however, further dividends must necessarily depend upon earnings, financial condition, appropriate legal restrictions and other factors relevant at the time the Board of Directors considers payment of dividends. The Pensco merger agreement contemplates that, unless 80 percent of our Board of Directors determines otherwise, the Company will pay a quarterly cash dividend in an amount no less than \$0.31 per share through 2018, provided that sufficient funds are legally available, and that the Company and Peoples Bank remain "well-capitalized" in accordance with applicable regulatory guidelines.

The amount of funds available for transfer from Peoples Bank to the Company in the form of loans and other extensions of credit is also limited. Under Federal regulation, transfers to any one affiliate are limited to 10.0 percent of capital and surplus. At December 31, 2017, the maximum amount available for transfer from Peoples Bank to the Company in the form of loans amounted to \$21,968. At December 31, 2017 and 2016, there were no loans outstanding, nor were any advances made during 2017 and 2016.

The Company and Peoples Bank are subject to certain regulatory capital requirements administered by the federal banking agencies, which are defined in Section 38 of the Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA"). Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Company's and Peoples Bank's consolidated financial statements. In the event an institution is deemed to be undercapitalized by such standards, FDICIA prescribes an increasing amount of regulatory intervention, including the required institution of a capital restoration plan and restrictions on the growth of assets, branches or lines of business. Further restrictions are applied to the significantly or critically undercapitalized institutions including restrictions on interest payable on accounts, dismissal of management and appointment of a receiver. For well capitalized institutions, FDICIA provides authority for regulatory intervention when the institution is deemed to be engaging in unsafe and unsound practices or receives a less than satisfactory examination report rating. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company and Peoples Bank must meet specific capital guidelines that involve quantitative measures of their assets, liabilities and certain off-balance sheet items as calculated under regulatory accounting practices. The capital amounts and classifications are also subject to qualitative judgments by the regulators about components, risk weightings and other factors. Prompt corrective action provisions are not applicable to bank holding companies.

New risk-based capital rules became effective January 1, 2015 requiring that banks and holding companies maintain a "capital conservation buffer" of 250 basis points in excess of the "minimum capital ratio." The minimum capital ratio is equal to the prompt corrective action adequately capitalized threshold ratio. The capital conservation buffer will be phased in over four years beginning on January 1, 2016, with a maximum buffer of 0.625% of risk weighted assets for 2016, 1.25% for 2017, 1.875% for 2018, and 2.5% for 2019 and thereafter. Failure to maintain the required capital conservation buffer will result in limitations on capital distributions and on discretionary bonuses to executive officers.

Peoples Bank met the capital requirement for the "well capitalized" category under the regulatory framework for prompt corrective action at December 31, 2017. To be categorized as well capitalized, Peoples Bank must maintain certain minimum Tier I risk-based, total risk-based and Tier I Leverage ratios as set forth in the following tables. The Tier I Leverage ratio is defined as Tier I capital to total average assets less intangible assets. Regulators may assign Peoples Bank to a lower capitalization category based on factors other than capital.

The Company and Peoples Bank's actual capital ratios at December 31, 2017 and 2016, and the minimum ratios required for capital adequacy purposes and to be well capitalized under the prompt corrective action provisions are as follows:

December 31, 2017	Actual		Minimum For Capital Adequacy Purposes		Minimum to be Well Capitalized under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
Common equity						
Tier 1 capital to risk-weighted assets:						
Consolidated	\$ 205,222	11.85 %	\$ 77,930	4.50 %		
Peoples Bank	199,450	11.53	77,843	4.50	\$ 112,440	6.50 %
Tier 1 capital to risk-weighted assets:						
Consolidated	205,222	11.85	103,906	6.00		
Peoples Bank	199,450	11.53	103,791	6.00	138,388	8.00
Total capital to risk-weighted assets:						
Consolidated	224,182	12.95	138,542	8.00		
Peoples Bank	218,410	12.63	138,388	8.00	172,985	10.00
Tier 1 capital to average assets:						
Consolidated	205,222	9.94	82,564	4.00		
Peoples Bank	199,450	9.68 %	82,406	4.00 %	103,008	5.00 %

December 31, 2016	Actual		Minimum For Capital Adequacy Purposes		Minimum to be Well Capitalized under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
Common equity						
Tier 1 capital to risk-weighted assets:						
Consolidated	\$ 194,877	12.49 %	\$ 70,205	4.50 %		
Peoples Bank	189,128	12.14	70,120	4.50	\$ 101,284	6.50 %
Tier 1 capital to risk-weighted assets:						
Consolidated	194,877	12.49	93,607	6.00		
Peoples Bank	189,128	12.14	93,493	6.00	124,657	8.00
Total capital to risk-weighted assets:						
Consolidated	210,838	13.51	124,810	8.00		
Peoples Bank	205,089	13.16	124,657	8.00	155,822	10.00
Tier 1 capital to average assets:						
Consolidated	194,877	10.16	76,760	4.00		
Peoples Bank	189,128	9.88 %	76,602	4.00 %	95,753	5.00 %

## 19. Contingencies:

Neither the Company nor any of its property is subject to any material legal proceedings. Management, after consultation with legal counsel, does not anticipate that the ultimate liability, if any, arising out of pending and threatened lawsuits will have a material effect on the operating results or financial position of the Company.

## 20. Comprehensive Loss:

The components of accumulated other comprehensive loss included in stockholders' equity at December 31, 2017 and 2016 are as follows:

	December 31, 2017	December 31, 2016
Net unrealized (loss) gain on investment securities available-for-sale	\$ (1,237)	\$ 553
Income tax	(260)	193
Net of income taxes	(977)	360
Benefit plan adjustments	(6,628)	(6,946)
Income tax	(1,392)	(2,431)
Net of income taxes	(5,236)	(4,515)
Accumulated other comprehensive loss	\$ (6,213)	\$ (4,155)

Other comprehensive loss and related tax effects for the years ended December 31, 2017, 2016 and 2015 are as follows:

Year Ended December 31,	2017	2016	2015
Unrealized loss on investment securities available-for-sale	\$ (1,790)	\$ (3,417)	\$ (510)
Net gain on the sale of investment securities available-for-sale(1)	—	(623)	(1,189)
Benefit plans:			
Amortization of actuarial loss (gain)(2)	195	208	198
Actuarial gain (loss)	123	709	(494)
Net change in benefit plan liabilities	318	917	(296)
Other comprehensive loss before taxes	(1,472)	(3,123)	(1,995)
Income tax	(515)	(1,093)	(699)
Other comprehensive loss	\$ (957)	\$ (2,030)	\$ (1,296)

- (1) Represents amounts reclassified out of accumulated comprehensive loss and included in gains on sale of investment securities on the consolidated statements of income.
- (2) Represents amounts reclassified out of accumulated comprehensive loss and included in the computation of net periodic pension expense. Refer to Note 15 included in these consolidated financial statements.

## 21. Summary of quarterly financial information (unaudited):

Quarter Ended	2017			
	March 31	June 30	Sept. 30	Dec. 31
Interest income	\$ 17,799	\$ 18,261	\$ 18,831	\$ 19,351
Interest expense	1,956	2,126	2,175	2,441
Net interest income	15,843	16,135	16,656	16,910
Provision for loan losses	1,200	1,200	1,200	1,200
Net interest income after provision for loan losses	14,643	14,935	15,456	15,710
Noninterest income	3,782	6,379	3,661	3,364
Noninterest expense	12,356	14,002	12,480	12,455
Income before income taxes	6,069	7,312	6,637	6,619
Income tax expense	1,269	1,653	1,287	3,971
Net income	\$ 4,800	\$ 5,659	\$ 5,350	\$ 2,648
Per share data:				
Net income	\$ 0.65	\$ 0.77	\$ 0.72	\$ 0.36
Cash dividends declared	\$ 0.31	\$ 0.31	\$ 0.32	\$ 0.32
Average common shares outstanding	7,394,143	7,396,163	7,396,505	7,396,505
Quarter Ended	2016			
	March 31	June 30	Sept. 30	Dec. 31
Interest income	\$ 16,686	\$ 17,058	\$ 17,525	\$ 17,715
Interest expense	1,720	1,765	1,825	1,941
Net interest income	14,966	15,293	15,700	15,774
Provision for loan losses	1,200	1,200	1,200	1,400
Net interest income after provision for loan losses	13,766	14,093	14,500	14,374
Noninterest income	3,891	4,113	4,025	3,859
Noninterest expense	11,618	12,113	12,017	12,282
Income before income taxes	6,039	6,093	6,508	5,951
Income tax expense	1,157	1,238	1,390	1,223
Net income	\$ 4,882	\$ 4,855	\$ 5,118	\$ 4,728
Per share data:				
Net income	\$ 0.66	\$ 0.66	\$ 0.69	\$ 0.64
Cash dividends declared	\$ 0.31	\$ 0.31	\$ 0.31	\$ 0.31
Average common shares outstanding	7,403,510	7,395,127	7,394,143	7,394,143

**Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure.**  
None.

**Item 9A. Controls and Procedures.**

**Evaluation of Disclosure Controls and Internal Controls**

At December 31, 2017, the end of the period covered by this Annual Report on Form 10-K, the Chief Executive Officer (“CEO”) and Interim Principal Financial and Accounting Officer (“IPFAO”) 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 IPFAO concluded that the disclosure controls and procedures, at December 31, 2017, 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 IPFAO to allow timely decisions regarding required disclosure.

**MANAGEMENT’S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING**

We are responsible for the preparation and fair presentation of the accompanying consolidated balance sheets of Peoples Financial Services Corp. and subsidiaries (the “Company”) as of December 31, 2017 and 2016, and the related consolidated statements of income and comprehensive income, changes in stockholders’ equity and cash flows for each of the years in the three-year period ended December 31, 2017, in accordance with accounting principles generally accepted in the United States. This responsibility includes: establishing, implementing and maintaining adequate internal controls relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable under the circumstances. We are also responsible for compliance with the laws and regulations relating to safety and soundness that are designated by the Federal Deposit Insurance Corporation, Board of Governors of the Federal Reserve System and the Pennsylvania Department of Banking and Securities.

Our internal controls are designed to provide reasonable assurance that assets are safeguarded and transactions are initiated, executed, recorded and reported in accordance with our intentions and authorizations and to comply with applicable laws and regulations. The internal control system includes an organizational structure that provides appropriate delegation of authority and segregation of duties, established policies and procedures and comprehensive internal audit and loan review programs. To enhance the reliability of internal controls, we recruit and train highly qualified personnel and maintain sound risk management practices. The internal control system is maintained through a monitoring process that includes a program of internal audits.

Under Section 404 of the Sarbanes-Oxley Act of 2002, we are required to assess the effectiveness of our internal control over financial reporting at the end of each fiscal year and report, based on that assessment, whether the Company’s internal control over financial reporting is effective. Our assessment includes controls over initiating, recording, processing and reconciling account balances, classes of transactions and disclosure and related assertions included in the financial statements. Our assessment also includes controls related to the initiation and processing of non-routine and non-systematic transactions, to the selection and application of appropriate accounting policies and to the prevention, identification and detection of fraud.

There are inherent limitations in any internal control system, including the possibility of human error and the circumvention or overriding of controls. Accordingly, even effective internal controls can provide only reasonable assurance with respect to financial statement preparation.

Furthermore, due to changes in conditions, the effectiveness of internal controls may vary over time. Our internal auditor reviews, evaluates and makes recommendations on policies and procedures, which serves as an integral, but independent, component of our internal control.

Our financial reporting and internal controls are under the general oversight of our board of directors, acting through its audit committee. The audit committee is composed entirely of independent directors. The independent registered public accounting firm and the internal auditor have direct and unrestricted access to the audit committee at all times. The audit committee meets periodically with us, the internal auditor and the independent registered public accounting firm to determine that each is fulfilling its responsibilities and to support actions to identify, measure and control risks and augment internal controls.

Our management, including our CEO and IPFAO, is responsible for establishing and maintaining adequate internal control over financial reporting for the Company. Our management, including our CEO and IPFAO, assessed the effectiveness of our internal controls over financial reporting as of December 31, 2017 using the criteria established in *Internal Control-Integrated Framework* (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission. These criteria are in the areas of control environment, risk assessment, control activities, information and communication, and monitoring. Our management's assessment included extensive documenting, evaluating and testing the design and operating effectiveness of our internal control over financial reporting.

Based on its assessment, management believes that our internal control over financial reporting was effective as of December 31, 2017.

Baker Tilly Virchow Krause, LLP, the Company's independent registered public accounting firm that audited our consolidated financial statements as of and for the year ended December 31, 2017 has issued an audit report on the Company's internal control over financial reporting as of December 31, 2017. That report is included in Item 8 of this Annual Report on Form 10-K.

/s/ Craig W. Best

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

/s/ John R. Anderson III

John R. Anderson III  
Senior Vice President  
(Interim Principal Financial Officer and  
Principal Accounting Officer)

March 14, 2018

**Changes in Internal Control Over Financial Reporting**

There were no changes in our internal control over financial reporting that occurred during the fiscal quarter ended December 31, 2017, that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

**Item 9B. Other Information.**

None.

**PART III****Item 10. Directors, Executive Officers and Corporate Governance.**

We incorporate the information required by this Item 10 by reference to the definitive proxy statement for our 2018 annual meeting of shareholders, to be filed with the Securities and Exchange Commission.

**Item 11. Executive Compensation.**

We incorporate the information required by this Item 11 by reference to the definitive proxy statement for our 2018 annual meeting of shareholders, to be filed with the Securities and Exchange Commission.

**Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters.**

We incorporate the information required by this Item 12 by reference to the definitive proxy statement for our 2018 annual meeting of shareholders, to be filed with the Securities and Exchange Commission.

**Item 13. Certain Relationships and Related Transactions, and Director Independence.**

We incorporate the information required by this Item 13 by reference to the definitive proxy statement for our 2018 annual meeting of shareholders, to be filed with the Securities and Exchange Commission.

**Item 14. Principal Accounting Fees and Services.**

We incorporate the information required by this Item 14 by reference to the definitive proxy statement for our 2018 annual meeting of shareholders, to be filed with the Securities and Exchange Commission.

**PART IV****Item 15. Exhibits, Financial Statement Schedules.**

All consolidated financial statements and financial statement schedules required to be filed by Form 10-K or by Regulation S-X that are applicable to us have been presented in the consolidated financial statements and notes thereto in Part II, Item 8, or elsewhere in this annual report, where appropriate. The listing of exhibits is set forth on the Exhibit Index beginning on page E-1 and is incorporated in this Item 15 by reference.

**Item 16. Form 10-K Summary.**

We have elected to omit the optional summary of information included in this Form 10-K.

## EXHIBIT INDEX

Exhibit No.	Description of Exhibit
2.1	Agreement and Plan of Merger between Peoples Financial Services Corp. and Pensco Financial Services Corporation dated as of June 28, 2013 (incorporated by reference to Annex A to registrant's prospectus, dated October 10, 2013, filed on October 10, 2013 pursuant to Rule 424(b) under the Securities Act in connection with registrant's registration statement on Form S-4 originally filed August 13, 2013, as amended (File No. 333-190587)) Registrant agrees to furnish copies of Schedules to the Securities and Exchange Commission upon request.
2.2	Amendment No. 1 to Agreement and Plan of Merger between Peoples Financial Services Corp. and Pensco Financial Services Corporation dated as of September 17, 2013 (incorporated by reference to Annex A to registrant's prospectus, dated October 10, 2013, filed on October 10, 2013 pursuant to Rule 424(b) under the Securities Act in connection with registrant's registration statement on Form S-4 originally filed August 13, 2013, as amended (File No. 333-190587))
3.1	Peoples Financial Services Corp. Articles of Incorporation, as amended (incorporated by reference to Exhibit 3.1 to the registrant's Form 10-K filed with the Commission on March 17, 2014).
3.2	Amended and Restated Bylaws of Peoples Financial Services Corp. (incorporated by reference to Exhibit 3.1 to the registrant's Form 8-K filed with the Commission on December 2, 2013)
4.1	The Registrant will furnish to the SEC upon request copies of the instruments defining the rights of the Federal Home Loan Bank of Pittsburgh with respect to the Registrant's long-term debt.
10.1	Peoples Financial Services Corp. Long-Term Incentive Plan, formerly known as the Pensco Financial Services Corporation 2008 Long Term Incentive Plan (incorporated by reference to Exhibit 10.1 of registrant's registration statement on Form S-8 (File No. 333-216321) filed with the SEC on February 28, 2017)*
10.2	Form of Restricted Stock or Restricted Stock Unit Award Agreement (incorporated by reference to Exhibit 10.2 to Pensco's registration statement on Form S-8 (File No. 333-166886) filed with the SEC on May 17, 2010)*
10.3	Form of Stock Option and/or Appreciation Right Award Agreement (incorporated by reference to Exhibit 10.3 to Pensco's registration statement on Form S-8 (File No. 333-166886) filed with the SEC on May 17, 2010)*
10.4	Form of Performance Award Agreement (incorporated by reference to Exhibit 10.4 to Pensco's registration statement on Form S-8 (File No. 333-166886) filed with the SEC on May 17, 2010)*
10.5	Peoples Security Bank and Trust Company Employee Stock Ownership Plan, amended and restated as of January 1, 2015 (incorporated by reference to Exhibit 10.1 to registrant's quarterly report on Form 10-Q filed with the SEC on May 5, 2017)*
10.6	Peoples Neighborhood Bank's Executive Cash Bonus Plan (incorporated by reference to Exhibit 10.15 to Amendment No. 1 to registrant's registration statement on Form S-4 (File No. 333-190587) filed with the SEC on September 20, 2013)*
10.7	Penn Security Bank & Trust Company Executive Deferred Compensation Plan (incorporated by reference to Exhibit 10.6 to the Pensco's annual report on Form 10-K filed with the SEC on March 14, 2011)*
10.8	Employment Agreement, dated January 3, 2011, among Pensco Financial Services Corporation, Penn Security Bank & Trust, and Craig W. Best (incorporated by reference to Exhibit 10.1 of Pensco's current report on Form 8-K filed with the SEC on January 7, 2011)*
10.9	First Amendment to Employment Agreement dated December 31, 2015, by and among Peoples Financial Services Corp., Peoples Security Bank and Trust Company and Craig W. Best (incorporated by reference to Exhibit 10.1 of Pensco's current report on Form 8-K filed with the SEC on January 6, 2016)*
10.10	Amended and Restated Deferred Compensation Plan #2, dated April 22, 2014, by and between Peoples Security Bank and Trust Company and Craig W. Best (incorporated by reference to Exhibit 10.1 to the registrant's Form 8-K filed with the Commission on April 28, 2014)*
10.11	First Amendment to Amended and Restated Deferred Compensation Plan #2, dated August 29, 2015, by and between Peoples Security Bank and Trust Company and Craig Best (incorporated by reference to Exhibit 10.1 to the registrant's Form 8-K filed with the Commission on September 3, 2015)*



<b>Exhibit No.</b>	<b>Description of Exhibit</b>
10.12	Penn Security Bank & Trust Company Excess Benefit Plan, amended and restated December 31, 2008 (incorporated by reference to Exhibit 10.9 to the Pensco's annual report on Form 10-K filed with the SEC on March 14, 2011)*
10.13	Termination Agreement with Debra E. Dissinger (incorporated by reference to Exhibit 10.4 to the registrant's Form 10-25G filed with the Commission on March 4, 1998)*
10.14	Supplemental Executive Retirement Plan with Debra E. Dissinger (incorporated by reference to Exhibit 10.6 to the registrant's Form 10-K filed with the Commission on March 15, 2005)*
10.15	Amendment to Supplemental Executive Retirement Plan with Debra E. Dissinger (incorporated by reference to Exhibit 10.9 to the registrant's Form 10-K filed with the Commission on March 15, 2006)*
10.16	Employment Agreement dated as of December 1, 2013, by and among Peoples, Peoples Bank and Joseph M. Ferretti (incorporated by reference to Exhibit 10.2 to the registrant's current report on Form 8-K filed with the SEC on December 2, 2013)*
10.17	Supplemental Executive Retirement Plan Agreement, dated April 22, 2014, by and among Peoples Security Bank and Trust Company, Peoples Financial Services Corp. and Joseph M. Ferretti (incorporated by reference to Exhibit 10.2 to the registrant's Form 8-K filed with the Commission on April 28, 2014)*
10.18	Employment Agreement, dated May 30, 2012, among Pensco Financial Services Corporation, Penn Security Bank and Trust Company, and Thomas P. Tulaney (incorporated by reference to Exhibit 10.1 of the Registrant's quarterly report on Form 10-Q filed with the SEC on August 9, 2012)*
10.19	Supplemental Executive Retirement Plan Agreement, dated May 31, 2012, by and among Penn Security Bank and Trust Company, Pensco Financial Services Corporation, and Thomas P. Tulaney (incorporated by reference to Exhibit 10.2 to the Registrant's quarterly report on Form 10-Q filed with the SEC on August 9, 2012)*
10.20	Employment Agreement, dated as of August 27, 2014, by and between Peoples Bank and Neal D. Koplín (incorporated by reference to Exhibit 10.32 to the registrant's Form 10-K filed with the Commission on March 16, 2015)*
10.21	Supplemental Executive Retirement Plan Agreement, dated April 24, 2017, by and among Peoples Security Bank and Trust Company, Peoples Financial Services Corp. and Neal D. Koplín (incorporated by reference to Exhibit 10.1 to registrant's current report on Form 8-K filed with the Commission on April 25, 2017.)*
10.22	Employment Agreement dated as of February 4, 2015 between Peoples Security Bank and Trust Company and Bradley S. Grubb (incorporated by reference to Exhibit 10.1 to the Registrant's quarterly report on Form 10-Q filed with the SEC on May 8, 2015)*
10.23	Form of Supplemental Director Retirement Plan Agreement for Non-employee Directors (incorporated by reference to Exhibit 10.7 to the registrant's Form 10-K filed with the Commission on March 15, 2005) *
10.24	Form of Amendment to Supplemental Director Retirement Plan Agreement for Non-employee Directors (incorporated by reference to Exhibit 10.10 to the registrant's Form 10-K filed with the Commission on March 15, 2006)*
10.25	Life Insurance Plan for all Non-employee Directors (incorporated by reference to Exhibit 10.21 to the registrant's Form 10-K filed with the Commission on March 15, 2012)*
10.26	Supplemental Executive Retirement Plan Agreement, effective February 1, 2016, by and among Peoples Security Bank and Trust Company, Peoples Financial Services Corp. and Michael L. Jake (incorporated by reference to Exhibit 10.1 to the registrant's quarterly report on Form 10-Q filed with the Commission on August 5, 2016)*
10.27	Employment Agreement dated as of September 30, 2016 between Peoples Security Bank and Trust Company and Timothy H. Kirtley (incorporated by reference to Exhibit 10.1 to the registrant's quarterly report on Form 10-Q filed with the Commission on November 7, 2016)*
10.28	First Amendment to Employment Agreement dated as of December 5, 2017, by and between Peoples Security Bank and Trust Company and Timothy H. Kirtley*

<b>Exhibit No.</b>	<b>Description of Exhibit</b>
21.1	List of Subsidiaries (incorporated by reference to Exhibit 21.1 to the registrant's annual report on Form 10-K filed with the Commission on March 11, 2016)
23.1	Consent of Baker Tilly Virchow Krause, LLP
23.2	Consent of BDO USA, LLP
24.1	Power of Attorney (Included as part of signature page)
31.1	Rule 13a-14(a)/15d-14(a) Certification of the Principal Executive Officer of Registrant
31.2	Rule 13a-14(a)/15d-14(a) Certification of the Principal Financial Officer of Registrant
32.1	Section 1350 Certifications of the Principal Executive Officer and Principal Financial Officer of Registrant
101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Schema
101.CAL	XBRL Taxonomy Extension Calculation Linkbase
101.DEF	XBRL Taxonomy Extension Definition Linkbase
101.LAB	XBRL Taxonomy Extension Label Linkbase
101.PRE	XBRL Taxonomy Extension Presentation Linkbase
*	- Management contract or compensatory plan or arrangement

## SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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.

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

By: /s/ John R. Anderson III  
John R. Anderson III  
Senior Vice President  
(Interim Principal Financial Officer and  
Principal Accounting Officer)

## POWER OF ATTORNEY

KNOW ALL PERSONS BY THESE PRESENTS, that each person whose signature appears below constitutes and appoints each of Craig W. Best and John R. Anderson III as his or her attorney-in-fact, with the full power of substitution, for him or her in any and all capacities, to sign any amendments to this report, and to file the same, with exhibits thereto and other documents in connection therewith, with the Securities and Exchange Commission, hereby ratifying and confirming all that said attorney-in-fact, or his substitute or substitutes, may do or cause to be done by virtue hereof.

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

<i>Name</i>	<i>Title</i>	<i>Date</i>
<u>/s/ William E. Aubrey II</u> William E. Aubrey II	Director and Chairman of the Board	March 14, 2018
<u>/s/ Craig W. Best</u> Craig W. Best	Director, President and Chief Executive Officer (Principal Executive Officer)	March 14, 2018
<u>/s/ John R. Anderson III</u> John R. Anderson III	Senior Vice President (Interim Principal Financial Officer and Principal Accounting Officer)	March 14, 2018
<u>/s/ Joseph G. Cesare</u> Joseph G. Cesare	Director	March 14, 2018

<i>Name</i>	<i>Title</i>	<i>Date</i>
<u>/s/ James G. Keisling</u> James G. Keisling	Director	March 14, 2018
<u>/s/ Ronald G. Kukuchka</u> Ronald G. Kukuchka	Director	March 14, 2018
<u>/s/ Richard S. Lochen, Jr.</u> Richard S. Lochen, Jr.	Director	March 14, 2018
<u>/s/ Robert Naismith</u> Robert Naismith	Director	March 14, 2018
<u>/s/ James B. Nicholas</u> James B. Nicholas	Director	March 14, 2018
<u>/s/ Emily Perry</u> Emily Perry	Director	March 14, 2018
<u>/s/ George H. Stover, Jr.</u> George H. Stover, Jr.	Director	March 14, 2018
<u>/s/ Steven L. Weinberger</u> Steven L. Weinberger	Director	March 14, 2018
<u>/s/ Earle A. Wootton</u> Earle A. Wootton	Director	March 14, 2018
<u>/s/ Joseph T. Wright, Jr.</u> Joseph T. Wright, Jr.	Director	March 14, 2018

PEOPLES FINANCIAL SERVICES CORP.  
150 North Washington Avenue | Scranton | PA | 18503  
**psbt.com** | 888 868 3858