

Peoples Financial
SERVICES CORP.



ANNUAL
REPORT **2019**

In *Memoriam*



OTTO P. ROBINSON, JR., ESQ.

1938 – 2019

*Former Penn Security Bank & Trust Company
and Pensco Financial Services Corporation*

*President, CEO
and General Legal Counsel*

1972 - 2006

Board Member

1967 - 2010



Craig W. Best
President & CEO

William E. Aubrey II
Chairman of the Board

DEAR SHAREHOLDERS,

Last year was a very successful year for our company. We achieved record earnings for the second consecutive year, continued to build the infrastructure necessary to support our growth initiatives, and advanced our expansion efforts into the strong growth markets of the Lehigh and the Greater Delaware Valleys. Simultaneously, we continued to modernize our branches in our legacy markets.

The year also saw a major shift in the outlook for the financial sector. In the beginning of 2019, the general consensus was positive for the banking industry. The Federal Reserve had increased rates four times in 2018 and the expectation was for two to three more increases in 2019. The economy was still extremely strong with historical lows in unemployment and the banking industry was benefiting with strong loan growth and good asset quality. Suddenly, global economic concerns and low gross domestic product (GDP) growth caused the Federal Reserve to cut interest rates three times from August 2019 through October 2019, causing the yield curve to flatten and put pressure on our margins. On December 31, 2019, China reported 41 people were identified to have contracted a new form of pneumonia. This mysterious pneumonia was later identified as a new virus called COVID-19. On March 11, 2020, the World Health Organization (WHO) declared COVID-19 a global pandemic.

2019 Financial Results

Our Company generated record earnings of \$25.7 million or \$3.48 per diluted share. This was the second consecutive year we posted record earnings. In 2019, earnings increased \$800 thousand or \$0.11 per diluted share over 2018 earnings of \$24.9 million or \$3.37 per diluted share. It should be noted that our 2019 earnings were negatively impacted by a \$4.0 million increase in our provision for loan losses in the fourth quarter. This increase primarily resulted from issues with certain small business credits originated by one bank employee. The bank carried out a detailed credit review of this portfolio and determined that certain actions were required with respect to eight credits causing the bank to charge off \$2.8 million of this portfolio during the 4th quarter.

Our record earnings were due to a \$4.2 million increase in our pre-provision net interest income. The increase in our net interest income was driven by a \$188 million increase in earning assets from \$2.1 billion in 2018 to \$2.3 billion in 2019.

The growth in assets in 2019 was driven by a \$115.0 million or 6.3% increase in loans and a \$60.2 million (21.6%) increase in investments. The increase in assets was funded by a \$96.5 million (5.1%) increase in deposits and a \$65.6 million increase in short-term borrowings. Non-interest income increased 10.7% from \$13.6 million in 2018 to \$15.1 million in 2019. The increase in non-interest expenses was driven by a \$3.0 million (10.4%) increase in salaries and benefits used to hire additional commercial lenders and credit professionals in support of our expansion strategy into the Lehigh Valley, Greater Delaware Valley and Lebanon County.

Market Expansion

We continue to invest in our market expansion strategy. In 2019, we opened the Central PA Business Center in Lebanon and hired two seasoned lenders and a portfolio manager. We also hired two lenders to work in the Doylestown market of Bucks County. We submitted an application to establish a new branch for the Doylestown market in January of 2020, and that office opened in early March. We also added our first board member from our expansion market area. In February of 2020, Sandra L. Bodnyk was appointed to our board of directors, and will be placed in the upcoming class of directors for election by our shareholders. Ms. Bodnyk is a 45 year banking professional. She retired from BB&T in 2018 as Executive Vice President and Senior Loan Administration Manager for the Mid-Atlantic Region.

In addition to new facilities in our expansion markets, we also have been renovating some of the older offices in our legacy markets. In 2018, we modernized the Montrose office and in 2019, our Hallstead Plaza and Susquehanna offices were significantly upgraded.

COVID-19 Pandemic

The most significant event of 2019 occurred on December 31st. That day China notified the WHO that they had 41 patients from the Hubei Province who had contracted a mysterious pneumonia. On January 7, 2020, this illness was identified as a new virus called Coronavirus (COVID-19). In February

2020, COVID-19 had spread to South Korea, Italy and Iran, and on February 29th the United States recorded its first death associated with COVID-19. On March 11, 2020, WHO declared COVID-19 a global pandemic. Unemployment claims for the week of March 26th totaled 3.3 million or more than 4 times the previous weekly record of 695 thousand claims recorded in 1982. As of March 30th, the U.S.A., District of Columbia and the U.S. territories all have declared a state of emergency, and and three out of every four Americans are now on mandatory lockdown.

COVID-19 has significantly impacted the way we live our lives. I want to assure all of our shareholders, customers and employees that Peoples Financial Services Corp. is prepared and ready to continue operating during this pandemic. We will continue to assist our business and consumer customers as we work through this unprecedented time in our country's history.

Peoples has had a contingency pandemic plan since 2014. We practice this plan once a year and had just completed our simulation in November 2019. Each quarter every department of the bank rotates an employee to work remotely for one day so we are always prepared to operate the bank even if we cannot make it into our facilities. As COVID-19 was spreading across Europe, we conducted another pandemic tabletop exercise on February 12, 2020, and assigned 45 key employees to start working from home. We have educated all employees on the Centers for Disease Control's best practices for preventing the spread of COVID-19 for their safety and the safety of all our customers.

As of March 31, 2020, all our facilities remain open on a limited basis except our South Scranton Office. Most transactions are directed to our drive-up windows with lobbies available by appointment.

This pandemic has negatively impacted our region's economy. Only essential businesses are allowed to operate in Pennsylvania and New York and most counties are under a shelter-in-place order. Peoples stands prepared and ready to assist our businesses and consumers during this time of crisis.

In Memoriam

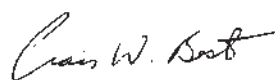
The year also brought us the sad news that former long-time CEO and Board Member, Otto P. Robinson, Jr., Esq., passed away on September 25, 2019. A memoriam is in this annual

report. Attorney Robinson was President and CEO of Penn Security Bank and Pensco Financial Services Corporation for 33 years and a member of the Board of Directors for 43 years. Graduating from Massachusetts Institute of Technology, he had a strong background in technology and through his innovation, Penn Security Bank became the first bank in the country to offer electronic banking from home in the early 1980's. As an accomplished attorney, he was also the company's legal counsel from 1972 to 2006. His early leadership and guidance provided a large portion of the foundation for which our organization was built upon.

We do not know what lies ahead for 2020. As of this writing, the pandemic has not yet peaked in the U.S. and already our country, as we know it, has changed dramatically. All schools and restaurants are closed and all professional sports and entertainment venues are cancelled and closed. Travel has all but been eliminated and all non-essential businesses are closed. All this to stop the spread of COVID-19 in an effort to not overwhelm our healthcare systems. People who live in our communities have all faced hardships in one way or another. Now we are facing this together, and together we will work through this hardship. Peoples is ready to assist our shareholders, customers, employees and community through this crisis.

As always, our Board and management are focused on preserving and enhancing shareholder value. We are doing this by making sure our customers and employees are safe while we continue providing our customers much needed financial services and helping them access newly formed governmental resources.

The Board of Directors, management and employees are dedicated to ensure our company will be here when our customers need us. Our company has strong earnings, is well capitalized and has enough liquidity to not just weather this pandemic, but to continue providing the financial services our customers depend on.



Craig W. Best
President & CEO



William E. Aubrey II
Chairman of the Board

FINANCIAL HIGHLIGHTS

PEOPLES FINANCIAL SERVICES CORP. CONSOLIDATED SELECTED FINANCIAL DATA

(Dollars in thousands, except per share data)

| Year Ended December 31 | 2019 | 2018 | 2017 | 2016 | 2015 |
|---|-------------|-------------|-------------|-------------|-------------|
| Condensed statements of financial performance: | | | | | |
| Interest income | \$93,381 | \$84,661 | \$74,242 | \$68,984 | \$63,041 |
| Interest expense | 17,868 | 13,322 | 8,698 | 7,251 | 6,037 |
| Net interest income | 75,513 | 71,339 | 65,544 | 61,733 | 57,004 |
| Provision for loan losses | 6,100 | 4,200 | 4,800 | 5,000 | 3,700 |
| Net interest income after the provision for loan losses | 69,413 | 67,139 | 60,744 | 56,733 | 53,304 |
| Noninterest income | 15,120 | 13,659 | 17,186 | 15,888 | 15,719 |
| Noninterest expense | 55,642 | 52,487 | 51,293 | 48,030 | 46,779 |
| Income before income taxes | 28,891 | 28,311 | 26,637 | 24,591 | 22,244 |
| Provision for income tax expense | 3,155 | 3,391 | 8,180 | 5,008 | 4,521 |
| Net income | \$25,736 | \$24,920 | \$18,457 | \$19,583 | \$17,723 |
| Condensed statements of financial position: | | | | | |
| Investments securities | \$338,557 | \$278,334 | \$281,822 | \$269,927 | \$297,044 |
| Net loans | 1,915,563 | 1,801,887 | 1,674,105 | 1,517,004 | 1,327,890 |
| Other assets | 221,207 | 208,772 | 214,347 | 212,511 | 194,124 |
| Total Assets | 2,475,327 | \$2,288,993 | \$2,170,274 | \$1,999,442 | \$1,819,058 |
| Deposits | \$1,971,489 | \$1,875,022 | \$1,719,018 | \$1,588,757 | \$1,455,810 |
| Short-term borrowings | 152,150 | 86,500 | 123,675 | 82,700 | 38,325 |
| Long-term debt | 32,733 | 37,906 | 49,734 | 58,134 | 60,354 |
| Other liabilities | 19,945 | 10,951 | 12,871 | 13,233 | 15,801 |
| Stockholders' equity | 299,010 | 278,614 | 264,976 | 256,618 | 248,768 |
| Total liabilities and stockholders' equity | \$2,475,327 | \$2,288,993 | \$2,170,274 | \$1,999,442 | \$1,819,058 |
| Per share data: | | | | | |
| Net income | \$3.48 | \$3.37 | \$2.50 | \$2.65 | \$2.36 |
| Cash dividends declared | 1.37 | 1.31 | 1.26 | 1.24 | 1.24 |
| Stockholders' equity | \$40.47 | \$37.66 | \$35.82 | \$34.71 | \$33.57 |
| Cash dividends as a percentage of net income | 39.37% | 38.87% | 50.40% | 46.79% | 52.54% |
| Average common shares outstanding | 7,395,429 | 7,397,797 | 7,395,837 | 7,396,716 | 7,516,451 |
| Selected ratios (based on average balances): | | | | | |
| Net income as a percentage of total assets | 1.10% | 1.12% | 0.90% | 1.02% | 1.02% |
| Net income as a percentage of stockholders' equity | 8.87 | 9.21 | 7.02 | 7.64 | 7.13 |
| Stockholders' equity as a percentage of total assets | 12.37 | 12.14 | 12.77 | 13.36 | 14.26 |
| Tier I capital as a percentage of adjusted total assets | 10.14 | 10.03 | 9.94 | 10.16 | 10.80 |
| Net interest income as a percentage of earning assets | 3.58 | 3.59 | 3.69 | 3.77 | 3.81 |
| Loans, net, as a percentage of deposits | 96.83% | 99.55% | 96.50% | 95.81% | 87.55% |
| Selected ratios (based on period end balances): | | | | | |
| Tier I capital as a percentage of risk-weighted assets | 11.90% | 11.95% | 11.85% | 12.49% | 13.52% |
| Total capital as a percentage of risk-weighted assets | 13.04 | 13.10 | 12.95 | 13.51 | 14.47 |
| Allowance for loan losses as a percentage of loans, net | 1.17 | 1.17 | 1.12 | 1.04 | 0.97 |
| Nonperforming loans as a percentage of loans, net | 0.52% | 0.53% | 0.67% | 0.90% | 0.86% |

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 21.0 percent for 2019 and 2018, and 35.0 percent for the years 2017, 2016, and 2015.

LEADERSHIP

BOARD OF DIRECTORS



William E. Aubrey II

Chairman
President & CEO
Gertrude Hawk Chocolates



Craig W. Best

President & CEO
Peoples Financial Services Corp.
Peoples Security Bank & Trust



Sandra L. Bodnyk

Retired Banking Executive



James G. Keisling

Treasurer
Northeast Architectural
Products, Inc.



Ronald G. Kukuchka

President
Ace Robbins, Inc.



Richard S. Lochen, Jr.

Certified Public Accountant
Partner | Lochen & Chase PC



Robert W. Naismith, Ph.D.

Chairman
JuJaMa, Inc.



James B. Nicholas

President
D.G. Nicholas Co.



George H. Stover, Jr.

Real Estate Appraiser



Steven L. Weinberger

President
G. Weinberger Company



Joseph T. Wright, Jr., Esq

Attorney at Law | Partner
Wright & Reihner PC

EXECUTIVE MANAGEMENT

Craig W. Best

President & CEO

Thomas P. Tulaney

Senior Executive Vice President
Chief Operating Officer

Neal D. Koplín

Senior Executive Vice President
Chief Banking Officer

Debra E. Adams

Executive Vice President
Chief Risk Officer
Corporate Secretary

John R. Anderson III

Executive Vice President
Chief Financial Officer

Joseph M. Ferretti

Executive Vice President
Northeast Market President

Susan L. Hubble

Executive Vice President
Chief Information Officer

Timothy H. Kirtley

Executive Vice President
Chief Credit Officer

Lynn M. Peters Thiel

Executive Vice President
Chief Retail Officer

PEOPLES SECURITY WEALTH MANAGEMENT GROUP

Thomas C. Cassidy

Senior Vice President
Chief Investment Officer



HALLSTEAD & SUSQUEHANNA NEWLY RENOVATED STATE-OF-THE-ART OFFICES

On September 9, 2019, our newly renovated Hallstead Plaza office located at 25109 State Route 11 opened for business. These renovations have improved our visibility and presence dramatically, allowing us to better serve our customers as well as provide an aesthetic addition to our local community.

The new branch is spacious and bright with 5,300 square feet of upgraded features including: fully-automatic handicap entry for easy access, a spacious open lobby with upgraded teller line enhanced with West Mountain Stone, and an impressive full-length stock ticker overhead. Other upgrades include tinted windows for added security, a state-of-the-art security system and private office space for our Branch Manager, Assistant Manager, Customer Service Representatives, and Wealth Consultant. Exterior improvements include an impressive wraparound canopy providing easy access to the front entrance while covering the ATM and Night Depository from the elements. Additionally, we have enhanced the traffic flow patterns, paved all points of entry, parking and drive-up areas to ensure safety precautions are in place. For added convenience, we installed a new digital LED message board featuring product information, time and temperature.

On November 30, 2019, our newly renovated Susquehanna office at 215 Erie Boulevard was completed. The 2,670 square foot facility was upgraded to include new private office space for our Branch Manager, Assistant Manager and Customer Service Representatives. The teller line now features an impressive full-length stock ticker overhead. The vestibule area was expanded to provide a fully-automatic handicap entry. Exterior improvements include a new ATM and Night Depository installed under a wraparound canopy to provide cover from the elements. We also upgraded our digital LED message board to feature time and temperature, and to share product messaging.

Craig Best, President & CEO commented, "We are fortunate to be a part of these communities and look forward to serving the needs of our customers from our new facilities".



empower

PEOPLES SECURITY BANK SUPPORTS THE EMPOWER NEPA WOMEN'S LEADERSHIP CONFERENCE

Peoples Security Bank & Trust was proud to serve as the Presenting Sponsor for the 2019 Empower NEPA Women's Leadership Conference. This annual conference featured a number of dynamic speakers highlighting topics such as leadership, self-esteem, social media, and much more. The purpose of this day-long conference is to provide women with the tools to create positive change professionally and personally.

In addition to the Presenting Sponsorship, the Bank partnered with the Greater Scranton Chamber of Commerce to develop the Peoples Security Bank Empower Scholarship. This program, funded by the Bank, allowed individuals and small businesses the opportunity to attend the conference and/or participate as a vendor in the Small Business Marketplace.

The 2019 marketplace vendor recipients were: 13 Olives, AOS Metals, FAB Travel, N3 Cleaning Services LLC, Nearme Yoga, Nibbles and Bits, On & On, Pure Suds, The Naked Angel and Township Trading Co.

"At Peoples Security Bank, we strongly believe in contributing our resources to make our community a better place to live and work," said Thomas P. Tulaney, Senior Executive Vice President. "This scholarship program perfectly fits that mission as it will help more people further enhance their professional goals through participating in the Empower conference." Congratulations to all of the sponsorship recipients!



LIVE UNITED[®]



PEOPLES SECURITY BANK SUPPORTS THE UNITED WAY OF LACKAWANNA & WAYNE COUNTIES

UNITED...WE CAN DO MORE...HELP MORE...MAKE MORE OF A DIFFERENCE IN OUR COMMUNITIES. These are words that Peoples Security Bank & Trust takes very seriously. The bank's past contributions have been instrumental in supporting vital programs and services throughout the community. Because of the generosity of the bank's employees, the United Way continues to improve lives by funding programs and creating special initiatives that get to the heart of problems and create lasting changes right here in our local communities.

At the "Celebration of Caring Awards", Peoples Security Bank and its employees were recognized with four separate awards, each with its own distinct honor and recognition. For its continued commitment to the United Way, the bank was awarded with the following:

- PILLARS OF OUR COMMUNITY AWARD, which recognizes the bank as being ranked among the top ten giving organizations and part of the foundation for the United Way campaign's success
- SPIRIT OF CARING CHAIRMAN'S AWARD, highlighting the growth in giving by the bank's employees over the previous year's campaign
- RISING STAR AWARD, honoring Peoples Security Bank employees with the recognition of the most new or increased dollars raised during the annual campaign
- PLATINUM HAND AWARD, honoring the superior commitment to the people of our communities through corporate and employee giving

Over the past twelve years, combined employee and corporate contributions have totaled over \$570,000. These contributions have been instrumental in supporting vital programs and services the United Way provides throughout our communities. The United Way works with their partner agencies to deliver programs and services that target community needs and assistance to over 60,000 individuals in NEPA, Lehigh Valley, Greater Delaware Valley, and the Broome County area. The bank is committed to helping the communities it serves.



PEOPLES SECURITY BANK TAKES PART IN THE UNITED WAY DAY OF CARING

Employees of our Emrick Boulevard office participated in the 27th Annual United Way Day of Caring. This project benefited the Friends of Johnston, which aims to protect the land and buildings at Camel Hump’s Farm. This is accomplished through conservation, the development of programming, and fund-raising events that provide revenue to sustain the farm into the future.

The United Way Day of Caring “brings together energetic volunteers to complete 60 community service projects throughout the Greater Lehigh Valley.” Companies allow their employees to take time off to volunteer, and the individuals contribute more than \$100,000 worth of volunteer hours in this single day event. Our participating employees helped Camel’s Hump Farm by planting trees and mulching the grounds, along with other community service activities.

CHAMPION FOR THE CHILDREN AWARD

On October 17, 2019, The Senate of Pennsylvania and Pocono Services for Families and Children presented Peoples Security Bank & Trust Company with the “Champion for the Children Award”. Peoples Security Bank was recognized for the inestimable contributions to the welfare of society through its successful business operations and its involvement in community affairs, enhancing the quality of life for all.

Pocono Services for Families and Children provides comprehensive, supportive services and resources for young children and their families in Monroe County to promote success in school and life. The award commends our continued commitment to improving lives, strengthening our communities and providing new educational opportunities for families of Monroe County. The bank is proud to support its local communities.





PILLARS OF THE COMMUNITY AWARD

On June 10, 2019, Peoples Security Bank & Trust was presented with the prestigious “PILLARS OF THE COMMUNITY AWARD” in recognition of its commitment to community lending, revitalization and service over the previous year. The Pillars Award is Federal Home Loan Bank (FHLBank) of Pittsburgh's highest honor and is presented annually to select FHLBank members.

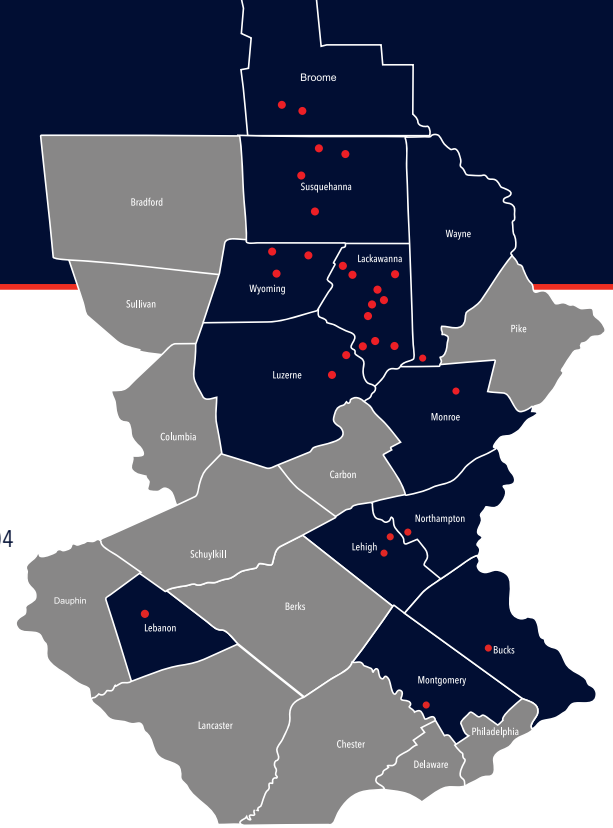
This honor is bestowed annually on a bank that has done an outstanding job of creating housing for lower income families and promoting community development throughout the region. It is presented each year by the FHLBank of Pittsburgh, a private cooperative of nearly 300 financial institutions across Delaware, Pennsylvania and West Virginia.

“Peoples Security Bank & Trust is truly honored to be recognized for this distinguished award,” said Thomas P. Tulaney, Senior Executive Vice President and Chief Operating Officer, Peoples Security Bank & Trust Company. “More importantly, we want to thank FHLBank of Pittsburgh for their proactive approach in providing innovative products and services that have directly benefited both consumers and small business owners in our market areas. In particular, these programs have provided housing for low-income senior citizens, homeownership for the first-time homebuyers, and new job creation for a number of our small business customers.”

An active member of the FHLBank cooperative, Peoples Security Bank saw the completion in 2018 of phase one of the Lehigh Coal and Navigation Building, which provided 27 apartments to low-income seniors in Jim Thorpe, PA. The project took advantage of a grant from FHLBank Pittsburgh's Affordable Housing Program.

“Peoples Security Bank & Trust Company is committed to making positive change in the communities it serves,” said Winthrop Watson, FHLBank President and CEO. “Their work in creating affordable housing, assisting small businesses, placing families in their first homes, and fighting homelessness shows just how deep that commitment is. We are proud to have Peoples Security Bank & Trust as part of our membership cooperative.”

OUR LOCATIONS



BUCKS COUNTY | PA

Doylestown

325 S Main St, Doylestown, PA 18901
(215) 348-8207

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

LEBANON COUNTY | PA

Central PA Business Center

830 Norman Dr, Lebanon, PA 17042
(717) 279-2200

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

SCHUYLKILL COUNTY | PA

Orwigsburg

Business Lending Center
705 W Market St, Suite 8
Orwigsburg, PA 17961
(570) 968-4720

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

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, 2019 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

VIRTUAL ANNUAL MEETING

Saturday, May 16, 2020, 9:00am
www.virtualshareholdermeeting.com/PFIS2020

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.

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

Piper Sandler
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 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, 2019

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:

Title of each class
Common stock, \$2.00 par value

Trading Symbol
PFIS

Name of each exchange on which registered
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 every Interactive Data File required to be submitted 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 whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, smaller reporting company, or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company" and "emerging growth company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer
Non-accelerated filer
Emerging growth company

Accelerated filer
Smaller reporting company

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

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

The aggregate market value of the registrant's common stock held by non-affiliates of the registrant on June 30, 2019 was \$332,884,519 (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, 2020 was 7,388,480.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant's definitive proxy statement to be filed in connection with solicitation of proxies for its 2020 annual meeting of shareholders, within 120 days of the end of registrant's fiscal year, are incorporated by reference into Part III of this Annual Report on Form 10-K.

Peoples Financial Services Corp.
Form 10-K
For the Year Ended December 31, 2019
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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 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.

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. and its subsidiaries. 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-eight 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, Lebanon, Lehigh, Luzerne, Monroe, Montgomery, Northampton, Susquehanna, Wayne and Wyoming Counties in Pennsylvania and Broome County in New York. In addition, parts of Bradford and Schuylkill Counties in Pennsylvania are also considered part of the market area. Approximately half of our offices are located in and around Scranton, the largest city in Lackawanna County.

Specifically, we conduct the majority of our business in our legacy market of Binghamton and the southern tier of New York and northeastern Pennsylvania. Our recent growth strategy expanded our operations into the Greater Lehigh Valley, King of Prussia and the Greater Delaware Valley of southeastern Pennsylvania, and south central Pennsylvania.

Peoples commenced a growth strategy during the fourth quarter of 2014 with the opening of a community banking office in the Lehigh County market. During 2017, the Company added two additional branch offices, one in Allentown, Lehigh County and one in Bethlehem, Northampton County to continue our strategic expansion initiative into the Greater Lehigh Valley market. This market has a greater population than the other counties served, with Bethlehem being the second largest city within Lehigh County.

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. The annual unemployment rates for 2019 were 3.3% in Montgomery County and 3.6% in Bucks County, lower than Pennsylvania’s state unemployment rate of 4.1% and the federal unemployment rate of 3.7%, according to the Bureau of Labor Statistics.

In 2019, the Company entered the south central Pennsylvania market with the establishment of a full-service branch in Lebanon County. A team of experienced lenders in this market was recruited to serve the Lancaster, Lebanon, and Harrisburg market.

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.

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 deposits to commercial enterprises and individuals. Our 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 the loans in our portfolio.

Our retail lending products include the following types of loans, among others: residential real estate; automobiles; manufactured housing; personal and home equity. 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 our 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 and wealth management fees, fees generated from commercial loan interest rate swap transactions 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, five or ten 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 mortgages partially insured by the U.S. Department of Veteran Affairs ("VA") and Federal Housing Administration ("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 residential 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, five, seven or ten 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 term 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 seven years. We offer automobile loans with loan-to-value ratios of up to 100% or more 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, 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 loans, an increased monthly loan 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 renegotiation 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 consider 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 exist or have existed on the site, or the site may be or 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, 2019, our regulatory limit on loans to one borrower was \$38.2 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; retirement plan services; 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, through a marketing and sales agreement with an industry leader in payment processing services. Services include small business checking accounts, merchant money market accounts, online banking, telephone banking, business credit cards, merchant line of credit and financial checkup.

Competition

We compete primarily with commercial banks, online financial institutions, 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 our market area.

Seasonality

Generally, our operations are not seasonal in nature.

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

A bank holding company that the FRB has determined to be well capitalized and well managed and that has well capitalized and well managed subsidiary banks may engage in certain nonbanking activities closely related to banking or managing or controlling banks, on a de novo basis, by providing notice to the FRB after commencing the activities. Such a bank holding company proposing to engage in other permissible nonbanking activities either de novo, or through the acquisition of an existing company, must provide prior notice to the FRB. For transactions that do not qualify for the post or expedited prior notice procedures, a bank holding company must file a notice for prior FRB approval.

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.

Civil money penalties can be \$2.0 million per violation and may be up to \$9.8 million for continuing violations or for the actual amount of gain or loss. 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, 2019. 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.

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. In addition to adopting information security standards, 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. Before establishing new branch offices, Peoples Bank must meet certain minimum capital stock and surplus requirements and must obtain state approval from the Department of Banking.

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 U.S. Treasury securities, to 150% 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 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. 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. Full phase-in occurred on January 1, 2019.

Accumulated other comprehensive income (AOCI) is included in a banking organization's common equity tier 1 capital. The rules, however, allowed community banks to make a one-time election not to include components of AOCI in regulatory capital and instead exclude most AOCI components from regulatory capital. Peoples Bank made that one-time election to "opt-out" of the inclusion of components of AOCI in regulatory capital.

The rules 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.

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.

Mortgage servicing assets (MSAs) and certain deferred tax assets (DTAs) are subject to stricter limitations than those applicable to other assets under the capital rules.

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, 2019, Peoples met its capital requirements with a ratio of common equity tier 1 capital to risk-weighted assets of 11.64%; its ratio of tier 1 capital to risk-weighted assets of 11.64%; its ratio of total capital to risk-weighted assets of 12.78%; and its leverage ratio of 9.91%.

A qualifying community banking organization (defined to have, among other things, total consolidated assets of less than \$10 billion) that has made an election to use the community bank leverage ratio framework will be considered to have met the minimum capital requirements, the capital ratio requirements, and any other capital or leverage requirements to which the qualifying community banking organization would be subject, if it has a leverage ratio of greater than 9 percent.

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 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. Among the provisions that 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), 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 six financial ratios. The financial ratios are: the leverage ratio; loans past due 30-89 days/gross assets; nonperforming assets/gross assets; net loan charge-offs/gross assets; net income before taxes/risk-

weighted assets; and the adjusted brokered deposit ratio. 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.

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.

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. 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. 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. Mortgage lenders are required 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, at a minimum, 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.

TILA/RESPA Integrated Disclosures (TRID)

The CFPB implemented rules combining the mortgage disclosures consumers previously received under TILA and RESPA.

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, 2019, we had 408 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 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. 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, 2019 totaled \$5.2 million. Our non-performing assets were approximately \$10.5 million on December 31, 2019. Our allowance for loan and lease losses was approximately \$22.7 million on December 31, 2019.

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, 2019, \$301.4 million or 15.5%, of our loan portfolio consisted of residential mortgage loans and \$1.0 billion or 52.2%, 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. 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. 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.

The outbreak of the recent coronavirus ("COVID-19"), or an outbreak of another highly infectious or contagious disease, could adversely affect our business activities, financial condition and results of operations.

Our business is dependent upon the willingness and ability of our customers to conduct banking and other financial transactions. The spread of a highly infectious or contagious disease, such as COVID-19, could cause severe disruptions in the U.S. economy, which could in turn disrupt the business, activities, and operations of our customers, as well as our business and operations. Moreover, since the beginning of January 2020, the coronavirus outbreak has caused significant disruption in the financial markets both globally and in the United States. The spread of COVID-19, or an outbreak of another highly infectious or contagious disease, may result in a significant decrease in business and/or cause our customers to be unable to meet existing payment or other obligations to us, particularly in the event of a spread of COVID-19 or an outbreak of an infectious disease in our market area. Although we maintain contingency plans for pandemic outbreaks, a spread of COVID-19, or an outbreak of another contagious disease, could also negatively impact the availability of key personnel necessary to conduct our business activities. Such a spread or outbreak could also negatively impact the business and operations of third-party service providers who perform critical services for us. If COVID-19, or another highly infectious or contagious disease, spreads or the response to contain COVID-19 is unsuccessful, we could experience a material adverse effect to our business, financial condition, and results of operations.

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

As of December 31, 2019, approximately 79.2% 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 economy 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 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 monetary policy, 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.

The Company may be required to transition from the use of the LIBOR interest rate index in the future.

The Company has certain loans and derivative instruments whose interest rate is indexed to the London InterBank Offered Rate (LIBOR). The United Kingdom's Financial Conduct Authority, which is responsible for regulating LIBOR, has announced that the publication of LIBOR is not guaranteed beyond 2021 and it appears highly likely that LIBOR will be discontinued or modified by 2021. At this time, no consensus exists as to what reference rate or rates or benchmarks may become acceptable alternatives to LIBOR, although the Alternative Reference Rates Committee (a group of private-market participants convened by the Federal Reserve Board and the Federal Reserve Bank of New York) has identified the Secured Overnight Financing Rate, or SOFR, as the recommend alternative to LIBOR. Uncertainty as to the adoption, market acceptance or availability of SOFR or other alternative reference rates may adversely affect the value of LIBOR-based loans in the Company's portfolio and may impact the availability and cost of hedging instruments and borrowings. The

language in the Company's LIBOR-based contracts and financial instruments has developed over time and may have various events that trigger when a successor index to LIBOR would be selected. If a trigger is satisfied, contracts and financial instruments may give the Company or the calculation agent, as applicable, discretion over the selection of the substitute index for the calculation of interest rates. The implementation of a substitute index for the calculation of interest rates under the Company's loan agreements may result in the Company incurring significant expenses in effecting the transition and may result in disputes or litigation with customers over the appropriateness or comparability to LIBOR of the substitute index, any of which could have an adverse effect on the Company's results of operations.

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

At December 31, 2019, we had approximately \$330.5 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, 2019, our available-for-sale securities had an unrealized gain, net of taxes, of \$1.4 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 accounting principles generally accepted in the United States of America ("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, 2019, 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.

Changes in U.S. or regional economic conditions could have an adverse effect on the Company's business, financial condition and results of operations.

The Company's business activities and earnings are affected by general business conditions in the United States and in the Company's local market area. These conditions include short-term and long-term interest rates, inflation, unemployment levels, consumer confidence and spending, fluctuations in both debt and equity capital markets, and the strength of the economy in the United States generally and, in particular, the Company's market area. A favorable business environment is generally characterized by, among other factors, economic growth, efficient capital markets, low inflation, low unemployment, high business and investor confidence, and strong business earnings. Unfavorable or uncertain economic and market conditions can be caused by declines in economic growth, business activity or investor or business confidence; limitations on the availability or increases in the cost of credit and capital; increases in inflation or interest rates; high unemployment; natural disasters; or a combination of these or other factors. Economic pressure on consumers and uncertainty regarding continuing economic improvement may result in changes in consumer and business spending, borrowing and savings habits. Elevated levels of unemployment, declines in the values of real estate, extended federal government shutdowns, or other events that affect household and/or corporate incomes could impair the ability of the Company's borrowers to repay their loans in accordance with their terms and reduce demand for banking products and services.

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.

We maintain a non-contributory defined benefit pension plan, which was frozen 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 28 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. Banking regulations requires us to perform due diligence, ongoing monitoring and maintain 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.

Our ability to pay dividends on or repurchase shares of our stock depends upon our receipt of dividends from Peoples Bank. Additionally, our ability to pay dividends is limited by Pennsylvania corporate law and by federal banking regulations. Under Pennsylvania law, we may not pay a dividend if, after payment, we could not pay our debts as they become due in the usual course of business or our total assets would be less than our total liabilities. 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.

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 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 FDIC, the Board of Governors of the Federal Reserve System and the Pennsylvania Department of Banking. 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 may be subject to more stringent capital and liquidity requirements in the future, which may adversely affect our net income and future growth.

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 the 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. Should our supervisory rating be lowered or our unsecured debt increase, we may be required to pay an increased assessment. More generally, should the designated reserve ratio of the FDIC Deposit Insurance Fund be raised or the fund suffer losses, we may be required to pay an increased assessment. An increase in the assessment we pay 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, 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 28 full-service community banking offices located within the Lackawanna, Lebanon, Lehigh, Luzerne, Monroe, Montgomery, Northampton, Susquehanna, Wayne and Wyoming Counties of Pennsylvania and Broome County of New York. Eight offices are leased and the balance are owned by Peoples Bank. Additionally, we operate a Limited Purpose Banking Office (“LPO”) located in and serving Schuylkill County, Pennsylvania.

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, 2020 there were approximately 3,644 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. 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.

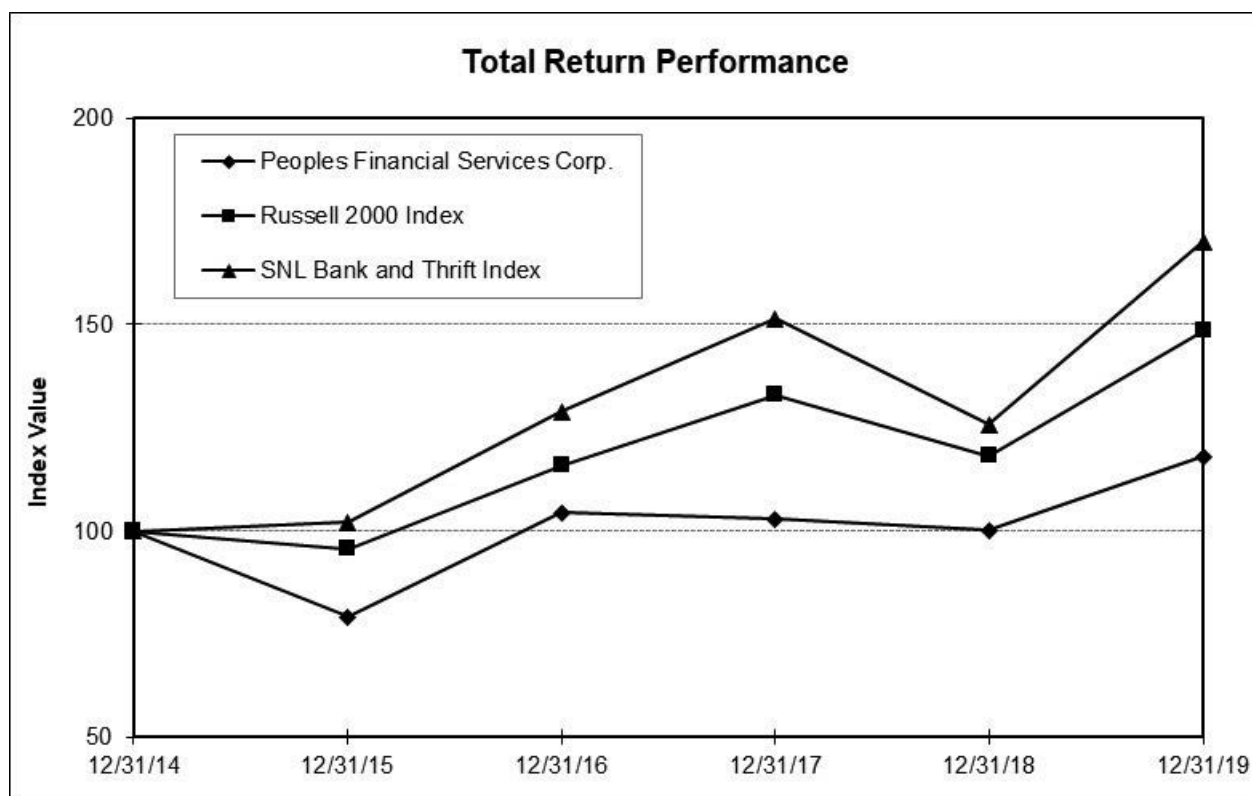
The following table presents information with respect to purchases made by or on behalf of the Company or any “affiliated purchaser,” as defined in the Exchange Act Rule 10b-18(a)(3), of the Company’s common stock during each of the three months ended December 31, 2019:

| Month Ending | Total Number of Shares Purchased | Average Price Paid Per Share | Total Number of Shares Purchased as Part of Publicly Announced Programs | Maximum Number of Shares that may yet be Purchased Under the Programs |
|---------------------|---|-------------------------------------|--|--|
| October 31, 2019 | 280 | \$ 44.87 | | 210,572 |
| November 30, 2019 | | \$ | | 210,572 |
| December 31, 2019 | | \$ | | 210,572 |

On February 1, 2019, 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. On February 28, 2020, our board of directors authorized a new common stock repurchase plan whereby we are authorized to repurchase up to 225,000 shares of our outstanding common stock through open market purchases.

The following 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 cumulative total return on the stock or the index equals the total increase in value since December 31, 2014, 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, 2014, 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>12/31/2014</u> | <u>12/31/2015</u> | <u>12/31/2016</u> | <u>12/31/2017</u> | <u>12/31/2018</u> | <u>12/31/2019</u> |
| Peoples Financial Services Corp. | 100.00 | 79.12 | 104.47 | 102.87 | 100.20 | 118.04 |
| Russell 2000 Index | 100.00 | 95.59 | 115.95 | 132.94 | 118.30 | 148.49 |
| SNL Bank and Thrift Index | 100.00 | 102.02 | 128.80 | 151.45 | 125.81 | 170.04 |

Source: S& P Global Market Intelligence
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Item 6. Selected Financial Data.

Consolidated Selected Financial Data

(Dollars in thousands, except per share data)

| Year Ended December 31 | 2019 | 2018 | 2017 | 2016 | 2015 |
|---|---------------------|---------------------|---------------------|---------------------|---------------------|
| Condensed statements of financial performance: | | | | | |
| Interest income | \$ 93,381 | \$ 84,661 | \$ 74,242 | \$ 68,984 | \$ 63,041 |
| Interest expense | 17,868 | 13,322 | 8,698 | 7,251 | 6,037 |
| Net interest income | 75,513 | 71,339 | 65,544 | 61,733 | 57,004 |
| Provision for loan losses | 6,100 | 4,200 | 4,800 | 5,000 | 3,700 |
| Net interest income after provision for loan losses | 69,413 | 67,139 | 60,744 | 56,733 | 53,304 |
| Noninterest income | 15,120 | 13,659 | 17,186 | 15,888 | 15,719 |
| Noninterest expense | 55,642 | 52,487 | 51,293 | 48,030 | 46,779 |
| Income before income taxes | 28,891 | 28,311 | 26,637 | 24,591 | 22,244 |
| Provision for income tax expense | 3,155 | 3,391 | 8,180 | 5,008 | 4,521 |
| Net income | <u>\$ 25,736</u> | <u>\$ 24,920</u> | <u>\$ 18,457</u> | <u>\$ 19,583</u> | <u>\$ 17,723</u> |
| Condensed statements of financial position: | | | | | |
| Investment securities | \$ 338,557 | \$ 278,334 | \$ 281,822 | \$ 269,927 | \$ 297,044 |
| Net loans | 1,915,563 | 1,801,887 | 1,674,105 | 1,517,004 | 1,327,890 |
| Other assets | 221,207 | 208,772 | 213,104 | 212,511 | 194,124 |
| Total assets | <u>\$ 2,475,327</u> | <u>\$ 2,288,993</u> | <u>\$ 2,169,031</u> | <u>\$ 1,999,442</u> | <u>\$ 1,819,058</u> |
| Deposits | \$ 1,971,489 | \$ 1,875,022 | \$ 1,719,018 | \$ 1,588,757 | \$ 1,455,810 |
| Short-term borrowings | 152,150 | 86,500 | 123,675 | 82,700 | 38,325 |
| Long-term debt | 32,733 | 37,906 | 49,734 | 58,134 | 60,354 |
| Other liabilities | 19,945 | 10,951 | 11,628 | 13,233 | 15,801 |
| Stockholders' equity | 299,010 | 278,614 | 264,976 | 256,618 | 248,768 |
| Total liabilities and stockholders' equity | <u>\$ 2,475,327</u> | <u>\$ 2,288,993</u> | <u>\$ 2,169,031</u> | <u>\$ 1,999,442</u> | <u>\$ 1,819,058</u> |
| Per share data: | | | | | |
| Net income | \$ 3.48 | \$ 3.37 | \$ 2.50 | \$ 2.65 | \$ 2.36 |
| Cash dividends declared | 1.37 | 1.31 | 1.26 | 1.24 | 1.24 |
| Stockholders' equity | \$ 40.47 | \$ 37.66 | \$ 35.82 | \$ 34.71 | \$ 33.57 |
| Cash dividends declared as a percentage of net income | 39.37 % | 38.87 % | 50.40 % | 46.79 % | 52.54 % |
| Average common shares outstanding | 7,395,429 | 7,397,797 | 7,395,837 | 7,396,716 | 7,516,451 |
| Selected ratios (based on average balances): | | | | | |
| Net income as a percentage of total assets | 1.10 % | 1.12 % | 0.90 % | 1.02 % | 1.02 % |
| Net income as a percentage of stockholders' equity | 8.87 | 9.21 | 7.02 | 7.64 | 7.13 |
| Stockholders' equity as a percentage of total assets | 12.37 | 12.14 | 12.77 | 13.36 | 14.26 |
| Tier I capital as a percentage of adjusted total assets | 10.14 | 10.03 | 9.94 | 10.16 | 10.80 |
| Net interest income as a percentage of earning assets | 3.58 | 3.59 | 3.69 | 3.77 | 3.81 |
| Loans, net, as a percentage of deposits | 96.83 % | 99.55 % | 96.50 % | 95.81 % | 87.55 % |
| Selected ratios and data (based on period end balances): | | | | | |
| Tier I capital as a percentage of risk-weighted assets | 11.90 % | 11.95 % | 11.85 % | 12.49 % | 13.52 % |
| Total capital as a percentage of risk-weighted assets | 13.04 | 13.10 | 12.95 | 13.51 | 14.47 |
| Allowance for loan losses as a percentage of loans, net | 1.17 | 1.17 | 1.12 | 1.04 | 0.97 |
| Nonperforming loans as a percentage of loans, net | 0.52 % | 0.53 % | 0.67 % | 0.90 % | 0.86 % |

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 21.0% for 2019 and 2018, and 35.0% for the years 2017, 2016, and 2015.

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

Management’s Discussion and Analysis 2019 versus 2018 (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 2018 versus 2017 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 “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 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, 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.

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 2019, as the real gross domestic product ("GDP"), the value of all goods and services produced in the nation, grew at an annual rate of 2.1 percent (estimated) in the fourth quarter. This followed third quarter growth of 2.1 percent in real GDP. The economy grew at a solid 2.3 percent for all of 2019. GDP grew at a rate of 2.9 percent in 2018 by comparison. The Federal Reserve Board's Federal Open Market Committee ("FOMC") decreased the federal funds rate three times in 2019 ending the year at a range of 1.50 percent to 1.75 percent. In lowering the key target range for the federal funds rate, the FOMC noted that the labor market remains

strong and that economic activity has been rising at a moderate rate. Job gains have been solid and the unemployment rate has remained low. On the inflation front, it remains below the target rate of 2.0 percent and expectations for longer-term inflation remain little changed. The median forecast is for a federal funds rate of 1.3 percent by year-end 2020, implying that there will be one additional rate cut in 2020, although global events could influence the number of rate cuts.

On a national level, employment conditions improved in 2019. The civilian labor force increased 1.4 million, while the number of people employed increased 2.0 million in 2019. As a result, the annual unemployment rate for the U.S. fell in 2019 when compared to 2018. All sectors of employment, reported employment gains from the end of 2018.

National, Pennsylvania, New York and our market area's non-seasonally-adjusted annual unemployment rates in 2019 and 2018, are summarized as follows:

| | 2019 | 2018 |
|--------------------------|-------|-------|
| United States | 3.7 % | 3.9 % |
| New York (statewide) | 4.0 | 4.1 |
| Pennsylvania (statewide) | 4.1 | 4.3 |
| Broome County | 4.6 | 4.9 |
| Bucks County | 3.6 | 3.8 |
| Lackawanna County | 4.6 | 4.6 |
| Lebanon County | 3.7 | 3.8 |
| Lehigh County | 4.3 | 4.6 |
| Luzerne County | 5.4 | 5.4 |
| Monroe County | 5.1 | 5.3 |
| Montgomery County | 3.3 | 3.4 |
| Northampton County | 4.2 | 4.4 |
| Schuylkill County | 5.1 | 5.2 |
| Susquehanna County | 4.1 | 4.0 |
| Wayne County | 4.4 | 4.8 |
| Wyoming County | 4.6 % | 4.5 % |

Employment conditions improved for both the Commonwealth of Pennsylvania and New York State in 2019 as evidenced by a decrease in their respective unemployment rates. With respect to the markets we serve, the unemployment rate decreased in nine of the thirteen counties in which we have branches or ATM locations. The unemployment rate remained the same year over year in two of the remaining counties and increased nominally in the other two counties. The lowest unemployment rate in 2019, for all of the counties we serve, was Montgomery County at 3.3 percent.

With respect to the banking industry, net income for all FDIC-insured banks in 2019 totaled \$233.1 billion, a decrease of \$3.6 billion or 1.5 percent from 2018. Approximately 64.3 percent of all institutions reported higher net income in 2019, while only 3.6 percent reported net losses, up slightly from last year's reported 3.2 percent unprofitable institutions. Loan loss provisions of \$55.0 billion in 2019 were \$5.0 billion or 10.0 percent more than banks set aside in 2018. Net interest income increased for the sixth year in a row, by \$5.5 billion or 1.0 percent. Noninterest income was \$1.7 billion or 0.6 percent below the level of 2018. Realized gains on sales of investments were \$4.0 billion compared to \$328.0 million in 2018. Total noninterest expense increased \$6.6 billion or 1.4 percent comparing 2019 and 2018. The return on average assets for 2019 was 1.29 percent compared to 1.35 percent in 2018.

Currently, the global economy is experiencing what is called a "Black Swan" event with the onset of the coronavirus. On March 3, 2020, the FOMC voted unanimously to cut its overnight federal funds target range 50 basis points to 1.00 percent to 1.25 percent in an intra-meeting decision. In their statement accompanying the emergency policy action, the FOMC stated "the coronavirus poses evolving risks to economic activity." The statement also noted "the fundamentals of the U.S. economy remain strong." The expected economic impact of the coronavirus is growing and will result in disruptions to supply chains, weakness in demand and deterioration in financial conditions. If economic conditions worsen, the economy would likely face recessionary conditions resulting in the FOMC to cut rates more aggressively. Lower market rates may adversely impact bank earnings due to net interest margin compression as asset yields continue to re-price lower. Continuous expense control, sound balance sheet management and strong asset quality 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”. The Company services its retail and commercial customers through twenty-eight full-service community banking offices located within the Lackawanna, Lebanon, Lehigh, Luzerne, Monroe, Montgomery, Northampton, Susquehanna, Wayne and Wyoming Counties of Pennsylvania and Broome County of New York and one limited purpose banking office located in Schuylkill County Pennsylvania.

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 checking accounts and money market accounts to commercial enterprises and individuals. Other deposit product offerings include certificates of deposits and various non-maturity 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, including the Federal Reserve, the FDIC, and Pennsylvania Department of Banking and Securities, and undergo periodic examinations by such agencies.

Total assets, loans and deposits were \$2.5 billion, \$1.9 billion and \$2.0 billion, respectively, at December 31, 2019. Total assets, loans and deposits grew 8.1 percent, 6.3 percent and 5.1 percent, respectively, compared to 2018 year-end balances.

The loan portfolio consisted of \$1.5 billion of business loans, including commercial and commercial real estate loans, and \$403.9 million in retail loans, including residential mortgage and consumer loans at December 31, 2019. Total investment securities were \$338.6 million at December 31, 2019, including \$330.5 million of investment securities classified as available-for sale and \$7.7 million classified as held-to-maturity. Total deposits consisted of \$463.2 million in noninterest-bearing deposits and \$1.5 billion in interest-bearing deposits at December 31, 2019.

Stockholders’ equity equaled \$299.0 million, or \$40.47 per share, at December 31, 2019, and \$278.6 million, or \$37.66 per share, at December 31, 2018. Our equity to asset ratio was 12.08 percent and 12.17 percent at those respective period ends. Dividends declared for the 2019 amounted to \$1.37 per share representing 39.4 percent of net income.

Nonperforming assets equaled \$10.5 million or 0.54 percent of loans, net and foreclosed assets at December 31, 2019, an increase in balance but lower percentage when compared to \$10.0 million or 0.55 percent at December 31, 2018. The allowance for loan losses equaled \$22.7 million or 1.17 percent of loans, net, at December 31, 2019, compared to \$21.4 million or 1.17 percent at year-end 2018. Loans charged-off, net of recoveries equaled \$4.8 million or 0.26 percent of average loans in 2019, compared to \$1.8 million or 0.10 percent of average loans in 2018.

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, 2019, 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 2019 the FOMC cut the target federal funds rate three times. At their December 2019 meeting, the FOMC decided to maintain the target range for the federal funds rate at 1.50 percent to 1.75 percent. The FOMC judges the current stance of monetary policy is appropriate to support sustained expansion of economic activity, strong labor market conditions, and inflation near the Committee’s two percent target. The Committee will assess realized and expected economic conditions relative to its maximum employment objective and its two percent inflation objective to determine the timing and size of future adjustments to the target range for the federal funds rates. 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 security. 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 and taxable state and municipal obligations. The yield on the 2-year U.S. Treasury ranged from a low of 139 basis points to a high of 262 basis points during 2019 before ending the year at 1.58 percent. The yield on the 10-year U.S. Treasury ranged from a low of 147 basis points to a high of 279 basis points while ending 2019 at 1.92 percent. Since bond prices move inversely to yields, we experienced an increase in the aggregate fair value of our investment portfolio when comparing December 31, 2019 to December 31, 2018 due to lower market rates at year end 2019. The net unrealized holding gains included in our available-for-sale investment portfolio were \$1.8 million at December 31, 2019 compared to a loss of \$3.3 million at December 31, 2018. We reported net unrealized holding gain, included as a separate component of stockholders’ equity of \$1.4 million, net of income taxes of \$385 thousand, at December 31, 2019, and an unrealized holding loss of \$2.6 million, net of income taxes of \$683 thousand, at December 31, 2018. 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, 2019, indicated that should general market rates increase by 100, 200 and 300 basis points, we would anticipate declines of 3.3 percent, 7.1 percent and 11.0 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 (Dollars in thousands)

| December 31, | 2019 | | 2018 | | 2017 | |
|---|-------------------|-----------------|-------------------|-----------------|-------------------|-----------------|
| | Amount | % | Amount | % | Amount | % |
| U.S. Treasury securities | \$ 24,128 | 7.13 % | \$ 25,592 | 9.20 % | 19,814 | 7.03 |
| U.S. government-sponsored enterprises | 87,110 | 25.73 | 92,818 | 33.35 | \$ 93,648 | 33.23 % |
| State and municipals: | | | | | | |
| Taxable | 34,898 | 10.31 | 13,853 | 4.98 | 15,047 | 5.34 |
| Tax-exempt | 67,015 | 19.79 | 92,809 | 33.34 | 110,692 | 39.28 |
| Residential mortgage-backed securities: | | | | | | |
| U.S. government agencies | 8,501 | 2.51 | 12,671 | 4.55 | 14,488 | 5.14 |
| U.S. government-sponsored enterprises | 103,621 | 30.60 | 34,261 | 12.31 | 21,892 | 7.77 |
| Commercial mortgage-backed securities: | | | | | | |
| U.S. government-sponsored enterprises | 12,861 | 3.80 | 6,039 | 2.17 | 6,195 | 2.20 |
| Common equity securities | 423 | 0.13 | 291 | 0.10 | 46 | 0.01 |
| Total | <u>\$ 338,557</u> | <u>100.00 %</u> | <u>\$ 278,334</u> | <u>100.00 %</u> | <u>\$ 281,822</u> | <u>100.00 %</u> |

Investment securities increased \$60.3 million, to \$338.6 million at December 31, 2019, from \$278.3 million at December 31, 2018. At December 31, 2019, the investment portfolio consisted of \$330.5 million of investment securities classified as available-for-sale and \$7.7 million classified as held-to-maturity. Investment cash flow was directed back into the investment portfolio primarily during the third and fourth quarters of 2019. Additionally during the fourth quarter, \$55.0 of residential mortgage-backed securities were purchased with overnight borrowings to mitigate interest rate risk in a flat or down rate environment. Security purchases totaled \$124.5 million in 2019, with purchases consisting of longer term taxable and tax-exempt municipal securities and mortgage-backed securities. Investment purchases in 2018 amounted to \$32.7 million.

Repayments of investment securities totaled \$58.2 million in 2019 and \$32.0 million in 2018. During 2019, the Company sold \$9.7 million of low-yielding short-term municipal bonds resulting in a gain of \$23 thousand. The proceeds were used to reinvest back into longer duration and higher yielding bonds. There were no sales of investment securities during 2018. We continually analyze the investment portfolio with respect to its exposure to various risk elements.

The composition of our investment portfolio changed during 2019 as a result of the aforementioned transactions. Short-term bullet U.S. Treasury and U.S. government-sponsored enterprise securities comprised 32.9 percent of our total portfolio at year-end 2019 compared to 42.5 percent at the end of 2018. Tax-exempt municipal obligations declined as a percentage of the total portfolio to 19.8 percent at year-end 2019 from 33.3 percent at the end of 2018 due to the sale of \$9.7 million, maturities and bond calls. The weighted average life of the investment portfolio lengthened to 3.7 years at December 31, 2019 from 3.5 years at year end 2018, while the effective duration of the investment portfolio increased to 3.6 years at December 31, 2019 from 2.6 years at December 31, 2018.

There were no other-than-temporary impairments (“OTTI”) recognized for the years ended December 31, 2019, 2018 and 2017. For additional information related to OTTI refer to Note 3 entitled “Investment securities” in the Notes to Consolidated Financial Statements to this Annual Report.

Investment securities averaged \$279.4 million and equaled 13.0 percent of average earning assets in 2019, compared to \$281.7 million and 13.8 percent of average earning assets in 2018. The tax-equivalent yield on the investment portfolio decreased thirteen basis points to 2.47 percent in 2019 from 2.60 percent in 2018. The decrease in the tax-equivalent yield is due primarily to cash flow from maturing and called bonds being reinvested into lower market rates.

At December 31, 2019 and 2018, 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, 2019, 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 21.0 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 (Dollars in thousands)

| December 31, 2019 | 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 | \$ 5,498 | 1.62 % | \$ 18,630 | 1.98 % | | | | | \$ 24,128 | 1.90 % |
| U.S. government-sponsored enterprises | 23,098 | 1.47 | 60,726 | 1.68 | | | \$ 3,286 | 2.24 % | 87,110 | 1.65 |
| State and municipals: | | | | | | | | | | |
| Taxable | 3,589 | 3.70 | 4,163 | 4.46 | \$ 15,054 | 2.65 % | 12,092 | 2.42 | 34,898 | 2.88 |
| Tax-exempt | 8,987 | 2.38 | 24,758 | 2.15 | 5,212 | 3.88 | 28,058 | 3.52 | 67,015 | 2.88 |
| Residential mortgage-backed securities: | | | | | | | | | | |
| U.S. government agencies | 1,463 | 1.71 | 2,307 | 1.88 | 231 | 2.02 | 4,500 | 3.53 | 8,501 | — |
| U.S. government-sponsored enterprises | 148 | 1.58 | 4,791 | 2.16 | 12,301 | 2.78 | 86,381 | 2.80 | 103,621 | — |
| Commercial mortgage-backed securities: | | | | | | | | | | |
| U.S. government-sponsored enterprises | | | 6,272 | 2.28 | 6,589 | 2.64 | | | 12,861 | 2.46 |
| Total | \$ 42,783 | 1.87 % | \$ 121,647 | 1.97 % | \$ 39,387 | 2.84 % | \$ 134,317 | 2.92 % | \$ 338,134 | 2.44 % |

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 (Dollars in thousands)

| December 31, | 2019 | | 2018 | | 2017 | | 2016 | | 2015 | |
|-------------------------------|--------------|----------|--------------|----------|--------------|----------|--------------|----------|--------------|----------|
| | Amount | % | Amount | % | Amount | % | Amount | % | Amount | % |
| Commercial | \$ 522,957 | 26.98 % | \$ 494,134 | 27.10 % | \$ 476,199 | 28.12 % | \$ 408,814 | 26.67 % | \$ 365,767 | 27.28 % |
| Real estate: | | | | | | | | | | |
| Commercial | 1,011,423 | 52.18 | 907,803 | 49.79 | 786,210 | 46.44 | 700,144 | 45.67 | 567,277 | 42.30 |
| Residential | 301,378 | 15.55 | 299,876 | 16.45 | 287,935 | 17.01 | 289,781 | 18.90 | 306,218 | 22.84 |
| Consumer | 102,482 | 5.29 | 121,453 | 6.66 | 142,721 | 8.43 | 134,226 | 8.76 | 101,603 | 7.58 |
| Total loans | 1,938,240 | 100.00 % | 1,823,266 | 100.00 % | 1,693,065 | 100.00 % | 1,532,965 | 100.00 % | 1,340,865 | 100.00 % |
| Less: allowance for loan loss | 22,677 | | 21,379 | | 18,960 | | 15,961 | | 12,975 | |
| Net loans | \$ 1,915,563 | | \$ 1,801,887 | | \$ 1,674,105 | | \$ 1,517,004 | | \$ 1,327,890 | |

Total loans increased \$115.0 million or 6.3 percent in 2019 to \$1.9 billion at December 31, 2019. Business loans, including commercial loans and commercial real estate loans, were \$1.5 billion or 79.2 percent of total loans at December 31, 2019, and \$1.4 billion or 76.9 percent at year-end 2018. Residential mortgages and consumer loans totaled \$403.9 million or 20.8 percent of total loans at year-end 2019 and \$421.3 million or 23.1 percent at year-end 2018. Loan growth remained strong throughout 2019. Total loans grew at an annual rate of 6.3 percent in 2019 which includes \$18.2 million of run-off in our indirect automobile portfolio due to pricing changes. The majority of the increase in loans in 2019 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. We have expanded our presence in the greater Lehigh Valley with the addition of two community banking offices, the most recent during the third quarter of 2017, 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 continue to be well received in these new markets as we are in our existing markets.

Loans averaged \$1.9 billion in 2019, compared to \$1.8 billion in 2018. Taxable loans averaged \$1.7 billion, while tax-exempt loans averaged \$139.0 million in 2019. Due to improving loan demand, the loan portfolio continues to play the prominent role in our earning asset mix. As a percentage of earning assets, average loans equaled 86.6 percent in 2019, an increase from 86.1 percent in 2018.

The tax-equivalent yield on our loan portfolio increased 20 basis points to 4.71 percent in 2019 from 4.51 percent in 2018 due to higher yields on new loan originations during the first half of 2019 and the repricing higher of floating and adjustable rate loans due to the increase in market rates during 2018. In 2019, we decreased our prime lending rate three times in response to the FOMC cutting its targeted federal funds rate. Our prime rate ended the year at 4.75%. The lower prime rate has resulted in lower loan yields commencing in the first quarter of 2019 which can be evidenced by evaluating quarterly loan yields, which ranged from 4.72 percent in the third quarter to 4.62 percent in the fourth quarter. The yield on the loan portfolio may continue to be under pressure as repayments on loans are replaced with new originations at current market rates, floating and adjustable rate loans continue to reprice lower, and competition continues to prompt more aggressive pricing for high quality fixed rate intermediate term loans thus providing downward momentum in loan yields.

The maturity distribution and sensitivity information of the loan portfolio by major classification at December 31, 2019, is summarized as follows:

Maturity distribution and interest sensitivity of loan portfolio (Dollars in thousands)

| December 31, 2019 | Within one year | After one but within five years | After five years | Total |
|---------------------------------------|--------------------|------------------------------------|---------------------|--------------|
| Maturity schedule: | | | | |
| Commercial | \$ 181,071 | \$ 183,794 | \$ 158,092 | \$ 522,957 |
| Real estate: | | | | |
| Commercial | 196,945 | 552,236 | 262,242 | 1,011,423 |
| Residential | 74,162 | 160,066 | 67,150 | 301,378 |
| Consumer | 46,861 | 54,576 | 1,045 | 102,482 |
| Total | \$ 499,039 | \$ 950,672 | \$ 488,529 | \$ 1,938,240 |
| Predetermined interest rates | \$ 200,571 | \$ 456,589 | \$ 164,895 | \$ 822,055 |
| Floating or adjustable interest rates | 298,468 | 494,083 | 323,634 | 1,116,185 |
| Total | \$ 499,039 | \$ 950,672 | \$ 488,529 | \$ 1,938,240 |

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. Market interest rates fell during the final six months of 2019 as the FOMC cut the targeted federal funds rate three times. Given our IRR to flat or falling rates, we placed emphasis on originating longer-term fixed-rate and adjustable-rate loans with interest rate floors. Fixed-rate loans represented 42.4 percent of the loan portfolio at December 31, 2019, compared to floating or adjustable-rate loans at 57.6 percent. Approximately 43.4 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 in our market area.

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 (Dollars in thousands)

| December 31 | 2019 | 2018 | 2017 |
|------------------------------------|------------|------------|------------|
| Commitments to extend credit | \$ 290,517 | \$ 294,122 | \$ 324,984 |
| Unused portions of lines of credit | 52,168 | 51,790 | 56,244 |
| Commercial letters of credit | 45,018 | 33,275 | 23,387 |
| Total | \$ 387,703 | \$ 379,187 | \$ 404,615 |

We record a valuation allowance for off-balance sheet credit losses, if deemed necessary, separately as a liability. The valuation allowance amounted to \$45 thousand and \$56 thousand at December 31, 2019 and 2018. 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, 2019. 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>(Dollars in thousands)</i> | December 31, 2019 | | | | |
|---------------------------------|-------------------|-------------------|-----------------------------------|-------------------------------------|------------------|
| | Total | One Year or Less | Over One Year Through Three Years | Over Three Years Through Five Years | Over Five Years |
| Contractual Obligations: | | | | | |
| Time Deposits | \$ 369,519 | \$ 264,824 | \$ 64,173 | \$ 33,834 | \$ 6,688 |
| Short-term borrowings | 152,150 | 152,150 | | | |
| FHLB advances | 32,733 | 17,963 | 14,215 | 555 | |
| Operating leases | 8,227 | 597 | 1,174 | 943 | 5,513 |
| Total | \$ 562,629 | \$ 435,534 | \$ 79,562 | \$ 35,332 | \$ 12,201 |
| Other commitments: | | | | | |
| Commitments to extend credit | \$ 342,685 | \$ 289,266 | \$ 1,251 | | \$ 52,168 |
| Standby letters of credit | 45,018 | 45,018 | | | |
| Total | \$ 387,703 | \$ 334,284 | \$ 1,251 | \$ | \$ 52,168 |

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 Bank's 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 (Dollars in thousands)

| December 31 | 2019 | 2018 | 2017 | 2016 | 2015 |
|--|------------------|-----------------|------------------|------------------|------------------|
| Nonaccrual loans: | | | | | |
| Commercial | \$ 3,336 | \$ 776 | \$ 860 | \$ 934 | \$ 1,632 |
| Real estate: | | | | | |
| Commercial | 2,765 | 2,328 | 3,454 | 7,016 | 1,680 |
| Residential | 1,144 | 2,574 | 2,994 | 2,961 | 4,424 |
| Consumer | 261 | 212 | 177 | 155 | 148 |
| Total nonaccrual loans | 7,506 | 5,890 | 7,485 | 11,066 | 7,884 |
| Troubled debt restructured loans: | | | | | |
| Commercial | 1,302 | 1,438 | 1,577 | 1,150 | |
| Real estate: | | | | | |
| Commercial | 283 | 719 | 836 | 141 | 2,325 |
| Residential | 608 | 622 | 661 | 618 | 536 |
| Total troubled debt restructured loans | 2,193 | 2,779 | 3,074 | 1,909 | 2,861 |
| Accruing loans past due 90 days or more: | | | | | |
| Real estate: | | | | | |
| Commercial | | 73 | | | |
| Residential | 378 | 850 | 548 | 558 | 525 |
| Consumer | | | 186 | 286 | 238 |
| Total accruing loans past due 90 days or more | 378 | 923 | 734 | 844 | 763 |
| Total nonperforming loans | 10,077 | 9,592 | 11,293 | 13,819 | 11,508 |
| Foreclosed assets | | | | | |
| Total nonperforming assets | \$ 10,527 | \$ 9,968 | \$ 11,577 | \$ 14,212 | \$ 12,465 |
| Nonperforming loans as a percentage of loans, net | 0.52 % | 0.53 % | 0.67 % | 0.90 % | 0.86 % |
| Nonperforming assets as a percentage of loans, net and foreclosed assets | 0.54 % | 0.55 % | 0.68 % | 0.93 % | 0.93 % |

Our nonperforming assets increased \$559 thousand or 5.6 percent at December 31, 2019 when compared to the end of 2018, however, we experienced improvement in our asset quality ratios as evidenced by a decrease in nonperforming assets as a percentage of loans, net and foreclosed assets to 0.54 percent from 0.55 percent, and nonperforming loans as a percentage of loans, net to 0.52 percent from 0.53 percent. The increase in balances resulted from a \$1.6 million increase in nonaccrual loans due to the addition of one large commercial relationship and an increase in foreclosed assets of \$0.1 million. A decrease of \$0.6 million in troubled debt restructured loans due to the charge-off of \$0.3 million of commercial real estate loans coupled with principal payments received on outstanding loans and a decrease of \$0.6 million of accruing loans past due ninety days partially offset the increases. 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 including charge-offs and recoveries by major loan category for the past five years are summarized as follows:

Reconciliation of allowance for loan losses (Dollars in thousands)

| December 31 | 2019 | 2018 | 2017 | 2016 | 2015 |
|--|------------------|------------------|------------------|------------------|------------------|
| Allowance for loan losses at beginning of period | \$ 21,379 | \$ 18,960 | \$ 15,961 | \$ 12,975 | \$ 10,338 |
| Loans charged-off: | | | | | |
| Commercial | 3,314 | 154 | 173 | 776 | 246 |
| Real estate: | | | | | |
| Commercial | 817 | 1,250 | 706 | 858 | 325 |
| Residential | 477 | 405 | 533 | 339 | 523 |
| Consumer | 459 | 545 | 737 | 495 | 333 |
| Total | <u>5,067</u> | <u>2,354</u> | <u>2,149</u> | <u>2,468</u> | <u>1,427</u> |
| Loans recovered: | | | | | |
| Commercial | 69 | 137 | 20 | 86 | 77 |
| Real estate: | | | | | |
| Commercial | 1 | 136 | 124 | 122 | 144 |
| Residential | 29 | 98 | 44 | 69 | 26 |
| Consumer | 166 | 202 | 160 | 177 | 117 |
| Total | <u>265</u> | <u>573</u> | <u>348</u> | <u>454</u> | <u>364</u> |
| Net loans charged-off | <u>4,802</u> | <u>1,781</u> | <u>1,801</u> | <u>2,014</u> | <u>1,063</u> |
| Provision for loan losses | <u>6,100</u> | <u>4,200</u> | <u>4,800</u> | <u>5,000</u> | <u>3,700</u> |
| Allowance for loan losses at end of period | <u>\$ 22,677</u> | <u>\$ 21,379</u> | <u>\$ 18,960</u> | <u>\$ 15,961</u> | <u>\$ 12,975</u> |
| Ratios: | | | | | |
| Net loans charged-off as a percentage of average loans outstanding | 0.26 % | 0.10 % | 0.11 % | 0.14 % | 0.08 % |
| Allowance for loan losses as a percentage of period end loans | 1.17 % | 1.17 % | 1.12 % | 1.04 % | 0.97 % |

The allowance for loan losses increased \$1.3 million to \$22.7 million at December 31, 2019, from \$21.4 million at the end of 2018. The increase resulted from a provision for loan losses of \$6.1 million less net loans charged-off of \$4.8 million. The charge-offs for fiscal 2019 primarily occurred in the fourth quarter. We charged-off \$3.3 million of commercial loans in 2019 substantially all of which were in the fourth quarter. Included in this amount was \$2.3 million related to certain small business lines of credit in our Greater Delaware Valley market and \$1.0 million of other commercial loan relationships.

In March 2020, we identified certain issues with a group of small business lines of credit, all of which had been originated by one of our lenders. All of these lines of credit were subject to credit review at origination and were considered satisfactory at such time. As a number of these lines of credit entered our annual renewal process, we identified changes in the credit quality of the borrowers which warranted action. We commenced a full review of this lender’s portfolio, as well as a review of other loans in our portfolio with similar characteristics. As a result of our review, we determined a number of the small business lines of credit originated by the particular lender to be impaired and collection doubtful at December 31, 2019. As such, we have charged-off \$2.3 million of these loans and established a specific reserve of \$0.3 million on one other line of credit retrospectively to December 31, 2019. All remaining small business commercial lines of credit for this lender were downgraded to special mention. We believe that all of the other loans in our portfolio with similar characteristics that were subject to our review were properly reflected in our allowance methodology at December 31, 2019.

There was one large commercial real estate credit charged-off in the second quarter of 2018 totaling \$1.1 million. The allowance for loan losses, as a percentage of loans, net of unearned income, was 1.17 percent at the end of 2019 and 2018, respectively.

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 \$3.0 million to \$4.8 million in 2019 from \$1.8 million in 2018. Net charge-offs, as a percentage of average loans outstanding, equaled 0.26 percent in 2019 and 0.10 percent in 2018.

Allocation of the allowance for loan losses (Dollars in thousands)

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

| December 31 | 2019 | | 2018 | | 2017 | | 2016 | | 2015 | |
|---------------------------|------------------|-----------------|------------------|-----------------|------------------|-----------------|------------------|-----------------|------------------|-----------------|
| | Amount | % | Amount | % | Amount | % | Amount | % | Amount | % |
| Allocated allowance: | | | | | | | | | | |
| Specific: | | | | | | | | | | |
| Commercial | \$ 363 | 0.24 % | \$ 50 | 0.12 % | \$ 159 | 0.15 % | \$ 225 | 0.18 % | \$ 759 | 0.16 % |
| Real Estate: | | | | | | | | | | |
| Commercial | 279 | 0.16 | 403 | 0.17 | 263 | 0.25 | 1,197 | 0.47 | 233 | 0.40 |
| Residential | 135 | 0.11 | 666 | 0.23 | 336 | 0.22 | 520 | 0.23 | 1,138 | 0.37 |
| Consumer | | | 60 | 0.01 | 8 | 0.01 | | | 117 | 0.01 |
| Total specific | <u>777</u> | <u>0.51</u> | <u>1,179</u> | <u>0.53</u> | <u>766</u> | <u>0.63</u> | <u>1,942</u> | <u>0.88</u> | <u>2,247</u> | <u>0.94</u> |
| Formula: | | | | | | | | | | |
| Commercial | 6,525 | 26.74 | 5,466 | 26.98 | 4,893 | 27.98 | 3,574 | 26.49 | 2,283 | 27.12 |
| Real Estate: | | | | | | | | | | |
| Commercial | 11,217 | 52.03 | 10,333 | 49.62 | 7,285 | 46.19 | 4,650 | 45.21 | 4,012 | 41.90 |
| Residential | 3,091 | 15.44 | 3,226 | 16.22 | 4,644 | 16.78 | 4,187 | 18.67 | 2,944 | 22.47 |
| Consumer | 1,067 | 5.28 | 1,175 | 6.65 | 1,372 | 8.42 | 1,608 | 8.75 | 1,466 | 7.57 |
| Total formula | <u>21,900</u> | <u>99.49</u> | <u>20,200</u> | <u>99.47</u> | <u>18,194</u> | <u>99.37</u> | <u>14,019</u> | <u>99.12</u> | <u>10,705</u> | <u>99.06</u> |
| Total allocated allowance | <u>22,677</u> | <u>100.00 %</u> | <u>21,379</u> | <u>100.00 %</u> | <u>18,960</u> | <u>100.00 %</u> | <u>15,961</u> | <u>100.00 %</u> | <u>12,952</u> | <u>100.00 %</u> |
| Unallocated allowance | | | | | | | | | 23 | |
| Total | <u>\$ 22,677</u> | | <u>\$ 21,379</u> | | <u>\$ 18,960</u> | | <u>\$ 15,961</u> | | <u>\$ 12,975</u> | |

The allocated element of the allowance for loan losses account increased \$1.3 million to \$22.7 million at December 31, 2019, compared to \$21.4 million at December 31, 2018. The specific portion of the allowance for impairment of loans individually evaluated under FASB ASC 310 decreased \$402 thousand to \$777 thousand at December 31, 2019, from \$1.2 million at December 31, 2018 and the formula portion of the allowance for loans collectively evaluated for impairment under FASB ASC 450, increased \$1.7 million to \$21.9 million at December 31, 2019, from \$20.2 million at December 31, 2018. The decrease in the specific portion of the allowance was a result of a decrease in measured impairment for collateral dependent loans. The increase in the formula portion was primarily the result of a significant increase in volume and an increase in the historical loss factor for commercial loans, due to the increase in charge-offs during 2019.

There was no unallocated element of the total allowance for loan losses at December 31, 2019. 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 225.0 percent at December 31, 2019 and 222.9 percent at December 31, 2018. We believe that our allowance was adequate to absorb probable credit losses at December 31, 2019.

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 \$96.5 million or 5.1 percent to \$2.0 billion at the end of 2019. Total deposits include \$23.0 million of brokered certificates of deposit. Noninterest-bearing deposits grew \$53.0 million or 12.9% while interest-bearing deposits increased \$43.5 million or 3.0% in 2019. Noninterest-bearing deposits represented 23.5 percent of total deposits while interest-bearing deposits accounted for 76.5 percent of total deposits at December 31, 2019. Comparatively, noninterest-bearing deposits and interest-bearing deposits represented 21.9 percent and 78.1 percent of total deposits at year end 2018. With regard to noninterest-bearing deposits, personal checking accounts increased \$10.4 million or 5.1 percent, while commercial checking accounts increased \$42.7 million or 20.5 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 market rates.

With regard to interest-bearing deposits, interest-bearing transaction accounts, which include money market accounts and NOW accounts, and savings accounts, increased \$10.2 million in 2019. Commercial interest-bearing transaction accounts decreased \$3.4 million, while personal interest-bearing transaction accounts increased \$21.5 million. Savings accounts decreased \$7.9 million during 2019 as price sensitive depositors shifted balances to more attractive premium rates being offered on time deposits by us and our competitors. The strong growth in our non-maturity deposits was due to continuing our strategic initiative to grow our public fund deposits and our continued penetration in our expansion markets. Total time deposits increased \$33.3 million to \$369.5 million at December 31, 2019 from \$336.2 million at December 31, 2018. The increase was primarily due to rate conscious consumer and commercial depositors seeking higher yields.

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 (Dollars in thousands)

| Year ended December 31 | 2019 | | 2018 | | 2017 | |
|------------------------|---------------------|--------------|---------------------|--------------|---------------------|--------------|
| | Average Balance | Average Rate | Average Balance | Average Rate | Average Balance | Average Rate |
| Interest-bearing: | | | | | | |
| Money market accounts | \$ 349,668 | 1.31 % | \$ 296,331 | 0.86 % | \$ 262,292 | 0.55 % |
| NOW accounts | 394,494 | 0.75 | 388,334 | 0.60 | 345,383 | 0.45 |
| Savings accounts | 380,175 | 0.13 | 389,557 | 0.13 | 398,104 | 0.13 |
| Time deposits | 367,666 | 1.90 | 291,499 | 1.36 | 282,617 | 1.05 |
| Total interest-bearing | 1,492,003 | 1.01 % | 1,365,721 | 0.68 % | 1,288,396 | 0.50 % |
| Noninterest-bearing | 434,676 | | 395,287 | | 361,386 | |
| Total deposits | <u>\$ 1,926,679</u> | | <u>\$ 1,761,008</u> | | <u>\$ 1,649,782</u> | |

Total deposits averaged \$1.9 billion in 2019 and \$1.8 billion in 2018, increasing \$165.7 million or 9.4 percent comparing 2019 to 2018. Average noninterest-bearing deposits increased \$39.4 million, while average interest-bearing accounts grew \$126.3 million. Average interest-bearing transaction deposits, including money market and NOW, and savings accounts, increased \$50.1 million while average total time deposits increased \$76.2 million when comparing 2019 and 2018.

Our cost of interest-bearing deposits increased 33 basis points to 1.01 percent in 2019 from 0.68 percent in 2018. Specifically, the cost of money market accounts increased 45 basis points to 1.31 percent from 0.86 percent and NOW accounts increased 15 basis points while the cost of time deposits increased 54 basis points to 1.90 percent comparing 2019 and 2018. The increases to the cost of interest-bearing transaction deposits and time deposits was the result of the increase in short-term market rates resulting from the FOMC's action to raise the targeted federal funds rate four times during 2018 and the continued elevated short term market rates as the yield curve remains flat despite the FOMC's

action in the second half of 2019 to cut the federal funds rate three times. In response to the FOMC's actions in 2019, we have decreased rates on time deposits and engaged in an initiative to reduce premium rates being paid to retain our core deposit relationships both in our legacy market and expansion markets in order to reduce our overall deposit costs.

Volatile deposits, time deposits \$100 or more, averaged \$230.6 million in 2019, an increase of \$83.5 million or 56.8 percent from \$147.1 million in 2018. Our average cost of these funds increased 63 basis points to 2.16 percent in 2019, from 1.53 percent in 2018. 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 thousand or more, which entirely consist of certificates of deposits, for the past three years are summarized as follows:

Maturity distribution of time deposits \$100 thousand or more (Dollars in thousands)

| December 31 | 2019 | 2018 | 2017 |
|---|------------|------------|------------|
| Within three months | \$ 72,825 | \$ 27,659 | \$ 26,009 |
| After three months but within six months | 80,707 | 21,546 | 24,569 |
| After six months but within twelve months | 46,582 | 48,904 | 49,852 |
| After twelve months | 56,144 | 124,933 | 56,461 |
| Total | \$ 256,258 | \$ 223,042 | \$ 156,891 |

In addition to deposit gathering, we have a secondary source of liquidity through existing credit arrangements with the FHLB-Pgh. During the first six months of 2019 we relied on this type of funding due to seasonal outflows of municipal deposits. As deposit balances surged during the third quarter of 2019 due to increases in commercial and municipal accounts, short-term borrowings with the FHLB were paid down to zero. At year end 2019, strong loan growth and growth of the investment portfolio resulted in utilization of the credit facility. 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 cut the federal funds target rate 75 basis points during 2019 to a targeted range of 1.50 to 1.75 percent after raising the target rate 100 basis points during 2018 from historically low levels. 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, 2019.

The Asset/Liability Committee ("ALCO"), comprised of members of our bank's 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 (Dollars in thousands)

| December 31, 2019 | Due within three months | Due after three months but within twelve months | Due after one year but within five years | Due after five years | Total |
|--|----------------------------|--|---|-------------------------|---------------------|
| Rate-sensitive assets: | | | | | |
| Interest-bearing deposits in other banks | \$ 4,210 | | | | \$ 4,210 |
| Investment securities | 20,461 | \$ 60,474 | \$ 172,748 | \$ 84,874 | 338,557 |
| Total loans | 532,439 | 309,668 | 884,644 | 211,489 | 1,938,240 |
| Loans held for sale | 986 | | | | 986 |
| Total rate-sensitive assets | <u>\$ 558,096</u> | <u>\$ 370,142</u> | <u>\$ 1,057,392</u> | <u>\$ 296,363</u> | <u>\$ 2,281,993</u> |
| Rate-sensitive liabilities: | | | | | |
| Money market accounts | \$ 365,463 | | | | \$ 365,463 |
| NOW accounts | 152,043 | | \$ 250,956 | | 402,999 |
| Savings accounts | | | 370,270 | | 370,270 |
| Time deposits less than \$100 thousand | 16,769 | \$ 41,995 | 48,945 | \$ 5,552 | 113,261 |
| Time deposits \$100 thousand or more | 72,825 | 127,289 | 54,077 | 2,067 | 256,258 |
| Short-term borrowings | 145,850 | 6,300 | | | 152,150 |
| Long-term debt | 496 | 17,524 | 14,713 | | 32,733 |
| Total rate-sensitive liabilities | <u>\$ 753,446</u> | <u>\$ 193,108</u> | <u>\$ 738,961</u> | <u>\$ 7,619</u> | <u>\$ 1,693,134</u> |
| Rate-sensitivity gap: | | | | | |
| Period | \$ (195,350) | \$ 177,034 | \$ 318,431 | \$ 288,744 | |
| Cumulative | \$ (195,350) | \$ (18,316) | \$ 300,115 | \$ 588,859 | |
| RSA/RSL ratio: | | | | | |
| Period | 0.74 | 1.92 | 1.43 | 38.90 | |
| Cumulative | 0.74 | 0.98 | 1.18 | 1.35 | 1.35 |

At December 31, 2019, we had cumulative one-year RSA/RSL ratio of 0.98, a slightly negative gap, but manageable position. At December 31, 2018, we had cumulative one-year RSA/RSL of 1.07, a positive gap. As previously mentioned, a negative gap indicated that if interest rates increase, our earnings would likely be adversely impacted.

Given the current economic conditions and the action of the FOMC to cut short-term rates during the second half of 2019 and the uncertainty of future actions to either cut or raise short-term rates in 2020, the focus of ALCO has been to maintain a well-balanced IRR position in order to safeguard future earnings from potential risk to falling interest rates. During 2019 ALCO took steps to reduce the magnitude of our positive gap position and guard against rates unchanged or down through the origination of five year fixed rate loans and the investment in longer term, fixed rate municipal securities and longer duration U.S. government-sponsored mortgage-backed securities. ALCO will continue to focus efforts on strategies in 2020 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 \$168.5 million or 21.7 percent increase in RSL coupled with a \$91.9 million or 11.0 percent increase in RSA maturing or repricing within one year. The increase in RSL resulted primarily from a \$102.0 million increase in time deposits \$100 thousand or more and an increase in short-term borrowings of \$65.6 million. The majority of the increase in the time deposit balances is due to rate sensitive customers seeking higher rates with terms less than twelve months. The increase in short-term borrowings was due to purchasing \$55.0 million of mortgage-backed securities with short-term funding during the fourth quarter of 2019.

With respect to the increase in RSA maturing or repricing within a twelve month time horizon, loans, net increased \$64.3 million while investment securities increased \$22.5 million. The increase in total 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. The increase in investment securities was due to higher prepayment estimates as a result of the FOMC’s action to cut the targeted federal funds rate during 2019 and the flat yield curve.

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, 2020, would decrease at 0.9 percent from model results using current interest rates.

We will continue to monitor our IRR position in 2020 and employ deposit and loan pricing strategies and direct the reinvestment of loan and investment payments and prepayments in order to maintain our target 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, 2019, our maximum borrowing capacity with the FHLB-Pgh was \$723.6 million of which \$184.9 million was outstanding in borrowings and \$185.7 million outstanding in the form of irrevocable standby letters of credit. 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 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, 2019 our borrowing capacity at the Federal Reserve related to this program was \$191.0 million and there were no amounts outstanding.

Based on our liquidity position at December 31, 2019, 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 2019. At December 31, 2019, our noncore funds consisted of time deposits in denominations of \$100 thousand or more, 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, 2019, our net noncore funding dependence ratio, the difference between noncore funds and short-term investments to long-term assets, was 17.8 percent. Our net short-term noncore funding dependence ratio, noncore funds

maturing within one year, less short-term investments to long-term assets equaled 14.4 percent. Comparatively, our ratios equaled 15.0 percent and 6.3 percent at the end of 2018, which indicated an increase in our reliance on noncore funds in 2019. Moreover, our basic liquidity surplus ratio, defined as liquid assets less short-term potentially volatile liabilities as a percentage of total assets, increased to 5.7 percent at December 31, 2019, from 4.1 percent at December 31, 2018. 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 \$1.5 million for the year ended December 31, 2019. For the year ended December 31, 2018, cash and cash equivalents decreased \$4.9 million. During 2019, cash provided by operating and financing activities were more than offset by cash used in investing activities.

Operating activities provided net cash of \$37.1 million in 2019 and \$32.6 million in 2018. 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 \$146.2 million in 2019. Net cash provided by financing activities was \$97.3 million in 2018. Deposit gathering, which is our predominant financing activity, increased in both 2019 and 2018. Deposit gathering provided a net cash inflow in 2019 of \$96.5 million and \$156.0 million in 2018. Short-term borrowings increased net cash by \$65.6 million in 2019 while a net decrease in short-term borrowings of \$37.2 million reduced net cash provided by financing activities in 2018. Deposit gathering in 2019 was also partially offset by a \$5.2 million net decrease in long-term debt as well as cash dividends paid of \$10.1 million. In 2018, deposit gathering was partially offset by \$11.8 million repayments of long-term debt and cash dividends paid of \$9.7 million.

Our primary investing activities involve transactions related to our investment and loan portfolios. Net cash used in investing activities totaled \$184.7 million in 2019. Net cash used in investing activities was \$134.8 million in 2018. Net cash used in lending activities was \$120.0 million in 2019, a decrease from \$141.3 million in 2018. Activities related to our investment portfolio used net cash of \$66.3 million in 2019 and \$0.7 million in 2018.

We anticipate maintaining a relatively stable liquidity position in 2020. Our continued growth in the expanding Lehigh Valley and King of Prussia markets coupled with our maturing Lebanon County office and expected expansion into Bucks County is expected to produce strong loan demand throughout 2020. We expect to fund such demand through deposit gathering initiatives, payments and prepayments on loans and investments and advances from the FHLB. Moreover, if economic conditions were to weaken it may result in increased interest in bank deposits, as consumers seek safety for their balances. 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 2020.

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 and 12.0 percent at December 31, 2019 and 2018, respectively. Our Total capital ratio was 13.0 percent and 13.1 percent at December 31, 2019 and 2018, respectively. Our and Peoples Bank's common equity Tier I capital to risk-weighted assets ratios were 11.9 percent and 11.6 percent at December 31, 2019 and 2018, respectively. Our Leverage ratio, which equaled 10.1 percent at December 31, 2019 and 10.0 percent at December 31, 2018, exceeded the minimum of 4.0 percent for capital adequacy purposes. Peoples Bank reported Tier 1 capital, Total capital and Leverage ratios of 11.6 percent, 12.8 percent and 9.9 percent at December 31, 2019, and 11.6 percent, 12.8 percent and 9.8 percent at December 31, 2018. Based on the most recent notification from the FDIC, Peoples Bank was categorized as well capitalized at December 31, 2019. 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 \$299.0 million or \$40.47 per share at December 31, 2019, and \$278.6 million or \$37.66 per share at December 31, 2018. Stockholders' equity grew \$20.4 million in 2019 as net income and a decrease in accumulated other comprehensive loss partially offset the payment of dividends.

We declared dividends of \$1.37 per share in 2019, \$1.31 per share in 2018, and \$1.26 per share in 2017. The dividend payout ratio, dividends declared as a percent of net income, equaled 39.4 percent in 2019, 38.9 percent in 2018 and 50.4 percent in 2017. Our board of directors intends to continue paying cash dividends in the future. Our ability to declare and pay dividends in the future 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.

Since 2014, our Board of Directors has adopted various common stock repurchase plans whereby we were authorized to repurchase shares of our outstanding common stock through open market purchases. During 2019 we repurchased and retired 14,428 shares for \$634 thousand under the then current plan. There were no purchases of our outstanding common stock during 2018 or 2017.

Review of Financial Performance:

Net income was \$25.7 million or \$3.48 per share in 2019 and \$24.9 million or \$3.37 per share in 2018. The increase in earnings in 2019 is the result of higher net interest income of \$4.2 million due to growth of our earning assets and higher noninterest income of \$1.5 million which were partially offset by an increase of \$1.9 million in the provision for loan losses and higher noninterest expenses of \$3.2 million. The results for 2018 include a \$0.3 million net gain on the sale of our credit card portfolio. Return on average assets ("ROAA") and return on average equity ("ROAE") were 1.10 percent and 8.87 percent for the year ended December 31, 2019. ROAA was 1.12 percent and ROAE was 9.21 percent for the year ended December 31, 2018.

Tax-equivalent net interest income, a non-GAAP measure, was \$77.2 million in 2019 and \$73.0 million in 2018. Our net interest margin equaled 3.58 percent in 2019 and 3.59 percent in 2018. Noninterest income totaled \$15.1 million in 2019 and \$13.7 million in 2018. Noninterest expense was \$56.0 million for the year ended December 31, 2019 compared to

\$52.5 million for the year ended December 31, 2018. Our productivity is measured by the operating efficiency ratio, a non-GAAP measure, 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 59.6 percent in 2019 and 59.8 percent in 2018.

Non-GAAP Financial Measures (Dollars in thousands)

The following are non-GAAP financial measures which provide useful insight to the reader of the consolidated financial statements but should be supplemental to GAAP used to prepare Peoples' financial statements and should not be read in isolation or relied upon as a substitute for GAAP measures. In addition, Peoples' non-GAAP measures may not be comparable to non-GAAP measures of other companies. The tax rate used to calculate the fully-taxable equivalent (FTE) adjustment was 21% for 2019 and 2018, and 35% for 2017.

The following table reconciles the non-GAAP financial measures of FTE net interest income for the years ended 2019, 2018 and 2017:

| Year ended December 31 | 2019 | 2018 | 2017 |
|--|-----------|-----------|-----------|
| Interest income (GAAP) | \$ 93,381 | \$ 84,661 | \$ 74,242 |
| Adjustment to FTE | 1,644 | 1,672 | 3,317 |
| Interest income adjusted to FTE (non-GAAP) | 95,025 | 86,333 | 77,559 |
| Interest expense | 17,868 | 13,322 | 8,698 |
| Net interest income adjusted to FTE (non-GAAP) | \$ 77,157 | \$ 73,011 | \$ 68,861 |

The efficiency ratio is noninterest expenses, less amortization of intangible assets, as a percentage of FTE net interest income plus noninterest income less gains on equity securities and gains on sale of assets. The following table reconciles the non-GAAP financial measures of the efficiency ratio to GAAP for the years ended 2019, 2018, and 2017:

| Year ended December 31 | 2019 | 2018 | 2017 |
|--|-----------|-----------|-----------|
| Efficiency ratio (non-GAAP): | | | |
| Noninterest expense (GAAP) | \$ 55,642 | \$ 52,487 | \$ 51,293 |
| Less: amortization of intangible assets expense | 730 | 881 | 1,034 |
| Noninterest expense adjusted for amortization of assets expense (non-GAAP) | 54,912 | 51,606 | 50,259 |
| Net interest income (GAAP) | 75,513 | 71,339 | 65,544 |
| Plus: taxable equivalent adjustment | 1,644 | 1,672 | 3,317 |
| Noninterest income (GAAP) | 15,120 | 13,659 | 17,186 |
| Less: net gains on equity securities | 132 | 14 | |
| Less: net gains on sale of assets | 23 | 291 | 2,278 |
| Net interest income (FTE) plus noninterest income (non-GAAP) | \$ 92,122 | \$ 86,365 | \$ 83,769 |
| Efficiency ratio (non-GAAP) | 59.6 % | 59.8 % | 60.0 % |

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 worsen given the uncertainty of the national and global economies, 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 (Dollars in thousands)

| | 2019 vs 2018 Increase (decrease) attributable to | | | 2018 vs 2017 Increase (decrease) attributable to | | |
|--------------------------------|--|-----------------|-----------------|--|-------------------|-----------------|
| | Total | Rate | Volume | Total | Rate | Volume |
| Interest income: | | | | | | |
| Loans: | | | | | | |
| Taxable | \$ 8,136 | \$ 3,469 | \$ 4,667 | \$ 9,406 | \$ 2,735 | \$ 6,671 |
| Tax-exempt | 813 | 320 | 493 | (225) | (770) | 545 |
| Investments: | | | | | | |
| Taxable | 505 | 22 | 483 | 884 | 502 | 382 |
| Tax-exempt | (941) | (202) | (739) | (1,294) | (929) | (365) |
| Interest-bearing deposits | 57 | 1 | 56 | 3 | 3 | |
| Federal funds sold | 122 | | 122 | | | |
| Total interest income | <u>8,692</u> | <u>3,610</u> | <u>5,082</u> | <u>8,774</u> | <u>1,541</u> | <u>7,233</u> |
| Interest expense: | | | | | | |
| Money market accounts | 2,028 | 1,507 | 521 | 1,121 | 915 | 206 |
| NOW accounts | 609 | 571 | 38 | 783 | 573 | 210 |
| Savings accounts | 9 | 21 | (12) | (16) | (5) | (11) |
| Time deposits less than \$100 | 276 | 368 | (92) | 21 | 167 | (146) |
| Time deposits \$100 or more | 2,727 | 1,143 | 1,584 | 988 | 738 | 250 |
| Short-term borrowings | (1,096) | 617 | (1,713) | 1,837 | 921 | 916 |
| Long-term debt | (7) | 71 | (78) | (110) | 71 | (181) |
| Total interest expense | <u>4,546</u> | <u>4,298</u> | <u>248</u> | <u>4,624</u> | <u>3,380</u> | <u>1,244</u> |
| Net interest income - non-GAAP | <u>\$ 4,146</u> | <u>\$ (688)</u> | <u>\$ 4,834</u> | <u>\$ 4,150</u> | <u>\$ (1,839)</u> | <u>\$ 5,989</u> |

Tax-equivalent net interest income, a non-GAAP measure, was \$77.2 million in 2019 and \$73.0 million in 2018. 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, a non-GAAP measure, of \$4.8 million. A rate variance resulted in a decrease in net interest income of \$0.7 million.

Average earning assets increased \$119.2 million to \$2,154.5 million in 2019 from \$2,035.3 million in 2018 and accounted for a \$5.1 million increase in interest income. Average loans, net increased \$112.4 million, which caused interest income to increase \$5.2 million. Average taxable investments increased \$21.6 million comparing 2019 and 2018, which resulted in increased interest income of \$483 thousand while average tax-exempt investments decreased \$23.8 million, which resulted in a decrease to interest income of \$739 thousand.

Average interest-bearing liabilities rose \$52.5 million to \$1,600.2 million in 2019 from \$1,547.7 million in 2018 resulting in a net increase in interest expense of \$248 thousand. Large denomination time deposits averaged \$83.6 million more in 2019 and caused interest expense to increase \$1.6 million. A decrease of \$7.4 million in average time deposits less than \$100 thousand reduced interest expense by \$92 thousand. In addition, interest-bearing transaction accounts, including money market, NOW and savings accounts grew \$50.1 million, which in aggregate caused a \$547 thousand increase in interest expense. Short-term borrowings averaged \$70.9 million less and decreased interest expense \$1.7 million while long-term debt averaged \$2.9 million less and decreased interest expense by \$78 thousand comparing 2019 and 2018.

An unfavorable rate variance occurred, as the tax-equivalent yield on earning assets increased 17 basis points while there was a 26 basis point increase in the cost of funds. As a result, tax-equivalent net interest income decreased \$688 thousand comparing 2019 and 2018. The tax-equivalent yield on earning assets was 4.41 percent in 2019 compared to 4.24 percent in 2018 resulting in an increase in interest income of \$3.6 million. With the tax-equivalent yield on the investment portfolio decreasing 13 basis points to 2.47 percent in 2019 from 2.60 percent in 2018, interest income decreased \$180 thousand. The tax-equivalent yield on the loan portfolio increased 20 basis points to 4.71 percent in 2019 from 4.51 percent in 2018 and resulted in an increase to interest income of \$3.8 million.

An unfavorable rate variance was experienced in 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 45 basis points and 15 basis points comparing 2019 and 2018. These increases resulted in an increase in interest expense of \$2.1 million. The cost of savings accounts remained level at 13 basis points and had no significant change in interest expense. With regard to time deposits, the average rate paid for time deposits less than \$100 thousand increased 27 basis points while time deposits \$100 thousand or more increased 63 basis points, which together resulted in a \$1.5 million increase in interest expense. The average rate paid on short-term borrowings increased 56 basis points in 2019 when compared to 2018, causing a \$617 thousand increase in interest expense. Interest expense increased \$71 thousand from a 15 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, a non-GAAP measure, using the prevailing federal statutory tax rate of 21.0 percent in 2019 and 2018, and 35.0 percent in 2017.

Summary of net interest income (Dollars in thousands)

| | 2019 | | | 2018 | | |
|--|---------------------|-------------------------|-----------------------|---------------------|-------------------------|-----------------------|
| | Average Balance | Interest Income/Expense | Average Interest Rate | Average Balance | Interest Income/Expense | Average Interest Rate |
| Assets: | | | | | | |
| Earning assets: | | | | | | |
| Loans: | | | | | | |
| Taxable | \$ 1,726,582 | \$ 82,488 | 4.78 % | \$ 1,627,062 | \$ 74,352 | 4.57 % |
| Tax-exempt | 138,975 | 5,454 | 3.92 | 126,088 | 4,641 | 3.68 |
| Investments: | | | | | | |
| Taxable | 201,743 | 4,519 | 2.24 | 180,182 | 4,014 | 2.23 |
| Tax-exempt | 77,693 | 2,377 | 3.06 | 101,475 | 3,318 | 3.27 |
| Interest-bearing deposits | 3,493 | 65 | 1.86 | 478 | 8 | 1.67 |
| Federal funds sold | 6,023 | 122 | 2.03 | | | |
| Total interest earning assets | 2,154,509 | 95,025 | 4.41 % | 2,035,285 | 86,333 | 4.24 % |
| Less: allowance for loan losses | 22,145 | | | 20,013 | | |
| Other assets | 212,989 | | | 213,617 | | |
| Total assets | <u>\$ 2,345,353</u> | | | <u>\$ 2,228,889</u> | | |
| Liabilities and Stockholders' Equity: | | | | | | |
| Interest-bearing liabilities: | | | | | | |
| Money market accounts | \$ 349,668 | 4,583 | 1.31 % | \$ 296,331 | 2,555 | 0.86 % |
| NOW accounts | 394,494 | 2,941 | 0.75 | 388,334 | 2,332 | 0.60 |
| Savings accounts | 380,175 | 496 | 0.13 | 389,557 | 487 | 0.13 |
| Time deposits less than \$100 | 137,059 | 1,995 | 1.46 | 144,445 | 1,719 | 1.19 |
| Time deposits \$100 or more | 230,607 | 4,980 | 2.16 | 147,054 | 2,253 | 1.53 |
| Short-term borrowings | 62,941 | 1,642 | 2.61 | 133,834 | 2,738 | 2.05 |
| Long-term debt | 45,253 | 1,231 | 2.72 | 48,189 | 1,238 | 2.57 |
| Total interest-bearing liabilities | 1,600,197 | 17,868 | 1.12 % | 1,547,744 | 13,322 | 0.86 % |
| Noninterest-bearing deposits | 434,676 | | | 395,287 | | |
| Other liabilities | 20,290 | | | 15,202 | | |
| Stockholders' equity | 290,190 | | | 270,656 | | |
| Total liabilities and stockholders' equity | <u>\$ 2,345,353</u> | | | <u>\$ 2,228,889</u> | | |
| Net interest income/spread (non-GAAP) | | <u>\$ 77,157</u> | 3.29 % | | <u>\$ 73,011</u> | 3.38 % |
| Net interest margin | | | 3.58 % | | | 3.59 % |
| Tax-equivalent adjustments: | | | | | | |
| Loans | | \$ 1,145 | | | \$ 975 | |
| Investments | | 499 | | | 697 | |
| Total adjustments | | <u>\$ 1,644</u> | | | <u>\$ 1,672</u> | |

Note: Average balances were calculated using average daily balances. Interest income on loans includes fees of \$1,622 in 2019, \$1,528 in 2018 and \$1,469 in 2017.

| <i>(Dollars in thousands)</i> | 2017 | | |
|--|---------------------|-----------------------------|-----------------------------|
| | Average Balance | Interest Income/ Expense | Average Interest Rate |
| Assets: | | | |
| Earning assets: | | | |
| Loans: | | | |
| Taxable | \$ 1,479,387 | \$ 64,946 | 4.39 % |
| Tax-exempt | 112,594 | 4,866 | 4.32 |
| Investments: | | | |
| Taxable | 161,643 | 3,130 | 1.94 |
| Tax-exempt | 110,788 | 4,612 | 4.16 |
| Interest-bearing deposits | 500 | 5 | 1.00 |
| Federal funds sold | | | |
| Total interest earning assets | <u>1,864,912</u> | <u>77,559</u> | 4.16 % |
| Less: allowance for loan losses | 17,673 | | |
| Other assets | 212,845 | | |
| Total assets | <u>\$ 2,060,084</u> | | |
| Liabilities and Stockholders' Equity: | | | |
| Interest-bearing liabilities: | | | |
| Money market accounts | \$ 262,292 | 1,434 | 0.55 % |
| NOW accounts | 345,383 | 1,549 | 0.45 |
| Savings accounts | 398,104 | 503 | 0.13 |
| Time deposits less than \$100 | 157,397 | 1,698 | 1.08 |
| Time deposits \$100 or more | 125,220 | 1,265 | 1.01 |
| Short-term borrowings | 76,846 | 901 | 1.17 |
| Long-term debt | 55,342 | 1,348 | 2.44 |
| Total interest-bearing liabilities | <u>1,420,584</u> | <u>8,698</u> | 0.61 % |
| Noninterest-bearing deposits | 361,386 | | |
| Other liabilities | 15,064 | | |
| Stockholders' equity | 263,050 | | |
| Total liabilities and stockholders' equity | <u>\$ 2,060,084</u> | | |
| Net interest income/spread | | <u>\$ 68,861</u> | 3.55 % |
| Net interest margin (non-GAAP) | | | 3.69 % |
| Tax-equivalent adjustments: | | | |
| Loans | | \$ 1,703 | |
| Investments | | 1,614 | |
| Total adjustments | | <u>\$ 3,317</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 \$6.1 million in 2019 and \$4.2 million in 2018. The higher provision for loan losses in 2019 was a direct result of significant loan growth and an increase in charge-offs, which created an increase in our calculated allowance. As previously discussed, the increase in charge-offs in 2019 was primarily related to commercial loans and specifically to small business lines of credit originated in our Greater Delaware Valley market. Based on our most recent evaluation at December 31, 2019, we believe that the allowance was adequate to absorb any known or potential losses in our portfolio.

Noninterest Income:

Our noninterest income increased \$1.5 million or 10.7 percent to \$15.1 million in 2019 from \$13.7 million in 2018. The increase in 2019 was driven primarily by higher service charges, fees, and commissions which includes an increase in fee income of \$1.7 million generated from the higher number and increased volume of commercial loan interest rate swap transactions originated in 2019 versus 2018. Excluding the swap revenue, service charges, fees, and commissions decreased \$339 thousand or 4.5 percent comparing 2019 and 2018, due in part to death benefit proceeds on a bank owned life insurance (BOLI) policy totaling \$368 thousand in 2018 with no comparable amount in 2019, and a lower dividend on our FHLB-Pgh stock of \$96 thousand due to lower borrowing volume in 2019. We realized a \$23 thousand net gain on the sale of debt securities in 2019 while the 2018 results include a \$291 thousand net gain on the sale of our credit card portfolio. Merchant services revenue increased \$164 thousand or 20.3 percent in 2019 when compared to 2018 due to higher pricing. Commissions and fees on fiduciary activities increased \$51 thousand or 2.5 percent comparing 2019 and 2018 due to market appreciation and increased business. Wealth management income increased \$77 thousand or 5.3 percent comparing 2019 to 2018 due to increased growth. Mortgage banking income decreased \$27 thousand or 4.3 percent in 2019 compared to 2018 as the volume of saleable loans originated declined.

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 (Dollars in thousands)

| <u>Year ended December 31</u> | <u>2019</u> | <u>2018</u> | <u>2017</u> |
|---|------------------|------------------|------------------|
| Salaries and employee benefits expense: | | | |
| Salaries and payroll taxes | \$ 25,930 | \$ 23,557 | \$ 22,271 |
| Employee benefits | 5,444 | 4,850 | 4,399 |
| Salaries and employee benefits expense | <u>31,374</u> | <u>28,407</u> | <u>26,670</u> |
| Occupancy and equipment expenses: | | | |
| Occupancy expense | 5,994 | 6,236 | 5,632 |
| Equipment expense | 5,917 | 4,661 | 4,343 |
| Occupancy and equipment expenses | <u>11,911</u> | <u>10,897</u> | <u>9,975</u> |
| Other expenses: | | | |
| Merchant transaction expense | 3 | 9 | 1,808 |
| FDIC insurance and assessments | 651 | 1,093 | 826 |
| Professional fees and outside services | 1,758 | 2,414 | 2,277 |
| Other taxes | 968 | 619 | 691 |
| Stationery and supplies | 753 | 773 | 749 |
| Advertising | 873 | 720 | 942 |
| Amortization of intangible assets | 730 | 881 | 1,034 |
| Donations | 1,441 | 1,339 | 1,188 |
| Other | 5,180 | 5,335 | 5,133 |
| Other expenses | <u>12,357</u> | <u>13,183</u> | <u>14,648</u> |
| Total noninterest expense | <u>\$ 55,642</u> | <u>\$ 52,487</u> | <u>\$ 51,293</u> |

Salaries and employee benefits expense constitute the majority of our noninterest expenses accounting for 56.4 percent of the total noninterest expense. Salaries and employee benefits expense increased \$3.0 million or 10.4 percent to \$31.4 million in 2019 from \$28.4 million in 2018. Salaries and payroll taxes increased \$2.4 million or 10.1 percent, while

employee benefits expense increased \$594 thousand or 12.2 percent. Annual performance-based salary adjustments as well as costs associated with our expansion into south central Pennsylvania and the addition of seasoned lending and support personnel in the region provided the majority of the increase.

Occupancy and equipment expense increased \$1.0 million or 9.3 percent to \$11.9 million in 2019 from \$10.9 million in 2018. Specifically, equipment-related costs increased \$1.3 million or 26.9 percent while building-related costs decreased \$242 thousand or 3.9 percent. The increase in equipment-related expenses was driven by costs associated with expansion into the south central Pennsylvania market area and higher depreciation expenses due to the revitalization of two of our branches.

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 \$12.4 million in 2019 and \$13.2 million in 2018. FDIC insurance and assessments was lower by \$442 thousand or 40.4 percent as the bank received a FDIC small bank assessment credit of \$358 thousand recognized in the second half of 2019. All other expenses, including professional fees and outside services, other taxes, stationery and supplies, advertising, amortization of intangible assets and other expenses totaled \$12.4 million in 2019, a decrease of \$820 thousand or 6.2 percent, compared to \$13.2 million in 2018.

Income Taxes:

Our income tax expense was \$3.2 million in 2019 and \$3.4 million in 2018. 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. As a result, our effective tax rate was 10.9 percent in 2019 and 12.0 percent in 2018.

The effective tax rate in 2019 and 2018 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 2019 and 2018. We anticipate investment tax credits from these investments to be \$1.1 million again in 2020. Over the next five years, we will recognize aggregate tax credits from our investments in these projects of \$4.5 million.

Management’s Discussion and Analysis 2018 versus 2017
(Dollars in thousands, except per share data)

Operating Environment:

The United States economy continued to show signs of expansion in 2018, as GDP, the value of all goods and services produced in the nation, grew at an annual rate of 2.6 percent (estimated) in the fourth quarter. This followed a third quarter increase of 3.4 percent in real GDP. The economy grew at a solid 2.9 percent for all of 2018. GDP grew at a rate of 2.2 percent in 2017 by comparison. The FOMC increased the federal funds rate four times in 2018 ending the year at a range of 2.25 percent to 2.50 percent. In raising the key target range for the federal funds rate, the FOMC noted that risks to the economic outlook appeared roughly balanced but that the FOMC would continue to monitor global economic and financial developments and assess their implications for the economic outlook. The median forecast was for a federal funds rate of 2.9 percent by year-end 2019, implying that there would have been two additional rate hikes in 2019.

Inflation slowed somewhat in 2018, as the CPI increased 1.9 percent for 2018, just under the FOMC’s benchmark of 2.0 percent for the first time since August 2017. The CPI increased 2.1 percent in 2017. Core personal consumption expenditure price index, which ignores food and energy, increased 2.2 percent in 2018.

On a national level, employment conditions improved in 2018. The civilian labor force increased 2.6 million, while the number of people employed increased 2.9 million in 2018. As a result, the annual unemployment rate for the U.S. fell in 2018 when compared to 2017. All sectors of employment, reported employment gains from the end of 2017.

National, Pennsylvania, New York and our market area’s non-seasonally-adjusted annual unemployment rates in 2018 and 2017, are summarized as follows:

| | <u>2018</u> | <u>2017</u> |
|--------------------|-------------|-------------|
| United States | 3.9 % | 4.4 % |
| New York | 4.2 | 4.6 |
| Pennsylvania | 4.3 | 4.9 |
| Broome County | 5.1 | 5.5 |
| Bucks County | 3.7 | 4.2 |
| Lackawanna County | 4.5 | 5.1 |
| Lehigh County | 4.6 | 5.1 |
| Luzerne County | 5.4 | 5.9 |
| Monroe County | 5.4 | 5.9 |
| Montgomery County | 3.4 | 3.8 |
| Northampton County | 4.4 | 4.9 |
| Schuylkill County | 5.3 | 5.9 |
| Susquehanna County | 4.0 | 4.7 |
| Wayne County | 4.7 | 5.1 |
| Wyoming County | 4.4 % | 5.2 % |

Employment conditions improved for both the Commonwealth of Pennsylvania and New York State in 2018 as evidenced by a decrease in their respective unemployment rates. With respect to the markets we serve, the unemployment rate decreased in all of the counties in which we have branches or ATM locations. The lowest unemployment rate in 2018, for all of the counties we serve, was Montgomery County at 3.4 percent.

With respect to the banking industry, net income for all FDIC-insured banks in 2018 totaled \$236.7 billion, an increase of \$53.6 billion or 29.3 percent from 2017. Approximately 79.7 percent of all institutions reported higher net income in 2018, while only 3.2 percent reported net losses, down from 2017’s reported 5.4 percent unprofitable institutions. Loan loss provisions of \$50.0 billion in 2018 were \$1.1 billion or 2.2 percent less than banks set aside in 2017. Net interest income increased for the fifth year in a row, by \$42.2 billion or 8.5 percent. Noninterest income was \$10.9 billion or 4.3 percent above the level of 2017. Realized gains on sales of investments were \$328.0 million or 84.6 percent less than in 2017. Total noninterest expense increased \$16.8 billion or 3.8 percent comparing 2018 and 2017. The return on average assets for 2018 was 1.35 percent compared to 0.97 percent in 2017.

Review of Financial Position:

Total assets, loans and deposits were \$2.3 billion, \$1.8 billion and \$1.9 billion, respectively, at December 31, 2018. Total assets, loans and deposits grew 5.5 percent, 7.7 percent and 9.1 percent, respectively, compared to 2017 year-end balances.

The loan portfolio consisted of \$1.4 billion of business loans, including commercial and commercial real estate loans, and \$421.3 million in retail loans, including residential mortgage and consumer loans at December 31, 2018. Total investment securities were \$278.3 million at December 31, 2018, including \$269.7 million of investment securities classified as available-for sale and \$8.4 million classified as held-to-maturity. Total deposits consisted of \$410.3 million in noninterest-bearing deposits and \$1.5 billion in interest-bearing deposits at December 31, 2018.

Stockholders' equity equaled \$278.6 million, or \$37.66 per share, at December 31, 2018, and \$265.0 million, or \$35.82 per share, at December 31, 2017. Our equity to asset ratio was 12.18 percent and 12.22 percent at those respective year ends. Dividends declared for the 2018 amounted to \$1.31 per share representing 38.9 percent of net income.

Nonperforming assets equaled \$10.0 million or 0.55 percent of loans, net and foreclosed assets at December 31, 2018, down from \$11.6 million or 0.68 percent at December 31, 2017. The allowance for loan losses equaled \$21.4 million or 1.17 percent of loans, net, at December 31, 2018, compared to \$19.0 million or 1.12 percent at year-end 2017. Loans charged-off, net of recoveries equaled \$1.8 million or 0.10 percent of average loans in 2018, compared to \$1.8 million or 0.11 percent of average loans in 2017.

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, 2018, 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 \$3.5 million, to \$278.3 million at December 31, 2018, from \$281.8 million at December 31, 2017. At December 31, 2018, the investment portfolio consisted of \$269.7 million of investment securities classified as available-for-sale and \$8.4 million classified as held-to-maturity. Strong loan demand during 2018 resulted in using a portion of the investment cash flow to fund higher yielding loans. Excess cash flow from investment repayments was directed back into the investment portfolio primarily during the second and third quarters of 2018. Security purchases totaled \$33.0 million in 2018, with purchases consisting of short-term U.S. Treasury securities, longer term tax-exempt securities and mortgage-backed securities. Investment purchases in 2017 amounted to \$73.5 million.

Repayments of investment securities totaled \$32.0 million in 2018 and \$57.0 million in 2017. There were no sales of investment securities during 2018 or 2017.

Investment securities averaged \$281.7 million and equaled 13.8 percent of average earning assets in 2018, compared to \$272.4 million and equaled 14.6 percent of average earning assets in 2017. The tax-equivalent yield on the investment portfolio decreased twenty-four basis points to 2.60 percent in 2018 from 2.84 percent in 2017. The decrease in the tax-equivalent yield was due primarily to the reduction in the statutory federal corporate tax rate in 2018 to 21% from 35% in 2017.

Loan Portfolio:

Loans, net increased \$130.2 million or 7.7 percent in 2018 to \$1.8 billion at December 31, 2018. Business loans, including commercial loans and commercial real estate loans, were \$1.4 billion or 76.9 percent of loans, net at December 31, 2018, and \$1.3 billion or 74.6 percent at year-end 2017. Residential mortgages and consumer loans totaled \$421.3 million or 23.1 percent of loans, net at year-end 2018 and \$430.7 million or 25.4 percent at year-end 2017. Loan growth remained strong throughout 2018. Loans, net grew at an annual rate of 7.7 percent in 2018 despite the sale of our

\$2.4 million credit card loan portfolio and a portion of our student loan portfolio totaling \$5.3 million. The increase in loans in 2018 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, the most recent during the third quarter of 2017, 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 continue to be well received in these new markets as we are in our existing markets.

Loans averaged \$1.8 billion in 2018, compared to \$1.6 billion in 2017. Taxable loans averaged \$1.6 billion, while tax-exempt loans averaged \$126.1 million in 2018. Due to improving loan demand, the loan portfolio continued to play the prominent role in our earning asset mix. As a percentage of earning assets, average loans equaled 86.1 percent in 2018, an increase from 85.4 percent in 2017.

Asset Quality:

We experienced improvement in our asset quality as evidenced by a decrease in nonperforming assets of \$1.6 million or 13.9 percent to \$10.0 million or 0.55 percent of loans, net of unearned income, and foreclosed assets at December 31, 2018, from \$11.6 million or 0.68 percent of loans, net of unearned income, and foreclosed assets at the end of 2017. The decrease resulted from a \$1.6 million decrease in nonaccrual loans and a decrease in trouble debt restructured loans of \$0.3 million offset by an increase of \$0.2 million in accruing loans past due 90 days or more and a small increase in foreclosed assets of \$0.1 million. 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 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 \$2.4 million to \$21.4 million at December 31, 2018, from \$19.0 million at the end of 2017. The increase resulted from a provision for loan losses of \$4.2 million less net loans charged-off of \$1.8 million. There was one large commercial real estate credit charged-off in the second quarter of 2018 totaling \$1.1 million. The allowance for loan losses, as a percentage of loans, net of unearned income, was 1.17 percent at the end of 2018, compared to 1.12 percent at the end of 2017.

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 \$20 thousand to \$1,781 thousand in 2018 from \$1,801 thousand in 2017. Net charge-offs, as a percentage of average loans outstanding, equaled 0.10 percent in 2018 and 0.11 percent in 2017.

The allocated element of the allowance for loan losses account increased \$2.4 million to \$21.4 million at December 31, 2018, compared to \$19.0 million at December 31, 2017. The specific portion of the allowance for impairment of loans individually evaluated under FASB ASC 310 increased \$413 thousand to \$1.2 million at December 31, 2018, from \$0.8 million at December 31, 2017 and the formula portion of the allowance for loans collectively evaluated for impairment under FASB ASC 450, increased \$2.0 million to \$20.2 million at December 31, 2018, from \$18.2 million at December 31, 2017. The increase in the specific portion of the allowance was a result of an increase in loans with collateral impairment. 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, 2018. 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 222.9 percent at December 31, 2018 and 167.9 percent at December 31, 2017. We believe that our allowance was adequate to absorb probable credit losses at December 31, 2018.

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 \$156.0 million or 9.1 percent to \$1.9 billion at the end of 2018. The growth in deposits included the addition of \$50.0 million in callable brokered certificates of deposit. Noninterest-bearing deposits grew \$29.5 million or 7.8% while interest-bearing deposits increased \$126.5 million or 9.5% in 2018. Noninterest-bearing deposits represented 21.9 percent of total deposits while interest-bearing deposits accounted for 78.1 percent of total deposits at December 31, 2018. Comparatively, noninterest-bearing deposits and interest-bearing deposits represented 22.1 percent and 77.9 percent of total deposits at year end 2017. With regard to noninterest-bearing deposits, personal checking accounts increased \$13.2 million or 7.0 percent, while commercial checking accounts increased \$16.3 million or 8.5 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 market rates due to the FOMC increasing the targeted federal funds rate four times during 2018.

With regard to interest-bearing deposits, interest-bearing transaction accounts, which include money market accounts and NOW accounts, and savings accounts, increased \$72.5 million in 2018. Commercial interest-bearing transaction accounts increased \$71.5 million, while personal interest-bearing transaction accounts increased \$10.6 million. Savings accounts decreased \$9.7 million during 2018 as price sensitive depositors shifted balances to more attractive premium rates being offered by our competitors. The strong growth in the commercial account types was due to continuing our strategic initiative to grow our public fund deposits, our continued penetration in our expansion markets and an increase in IOLTA accounts at year end. Total time deposits increased \$54.0 million to \$336.3 million at December 31, 2018 from \$282.3 million at December 31, 2017. The increase was primarily due to the addition of \$50.0 million of callable brokered certificates of deposit.

Total deposits averaged \$1.8 billion in 2018 and \$1.6 billion in 2017, increasing \$111.2 million or 6.7 percent comparing 2018 to 2017. Average noninterest-bearing deposits increased \$33.9 million, while average interest-bearing accounts grew \$77.3 million. Average interest-bearing transaction deposits, including money market and NOW, and savings accounts, increased \$68.4 million while average total time deposits increased \$8.9 million when comparing 2018 and 2017.

Our cost of interest-bearing deposits increased 18 basis points to 0.68 percent in 2018 from 0.50 percent in 2017. Specifically, the cost of interest-bearing transaction and savings accounts increased 15 basis points to 0.50 percent while the cost of time deposits increased 31 basis points to 1.36 percent comparing 2018 and 2017. The increases to the cost of interest-bearing transaction deposits and to the cost of time deposits was the result of the increase in short-term market rates resulting from the FOMC's action to raise the targeted federal funds rate four times during 2018 ending at a range of 2.25 percent to 2.50 percent. We increased rates to retain our core deposit relationships in reaction to premium rates being offered by our competitors. Additionally and to a lesser extent, the increase in costs was due to the introduction of premium rate deposit specials at our newest branch office in Kingston and our new branch offices in the Lehigh Valley.

Volatile deposits, time deposits \$100 thousand or more, averaged \$147.1 million in 2018, an increase of \$21.8 million or 17.4 percent from \$125.2 million in 2017. Our average cost of these funds increased 52 basis points to 1.53 percent in 2018, from 1.01 percent in 2017. 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, 2018 and 2017, we had cumulative one-year RSA/RSL ratios of 1.07. As previously mentioned, this indicated that if interest rates increased, our earnings would likely be favorably impacted. Given the economic conditions and the actions of the FOMC to raise short-term rates and their consideration to raise short-term rates in 2019, the focus of ALCO had been to maintain the positive gap position in order to safeguard future earnings from the potential risk of rising interest rates. During 2018 ALCO took steps to reduce the magnitude of our positive gap position and guard against rates unchanged or down through the origination of five year fixed rate loans and purchase of an interest rate floor.

The change in our cumulative one-year ratio from the previous year-end resulted from a \$18.2 million or 2.4 percent increase in RSL coupled with a \$23.6 million or 2.9 percent increase in RSA maturing or repricing within one year. The increase in RSL resulted primarily from a \$71.9 million increase in interest-bearing transaction accounts offset by a \$16.5 million decrease in time deposits and \$37.2 million decrease in short-term borrowings. 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 \$0.6 million while investment securities increased \$24.1 million. Short-term interest rates increased faster than longer-term rates during 2018 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. Treasury securities and U.S. Government-sponsored mortgage-backed 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.

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. At December 31, 2018, our noncore funds consisted of time deposits in denominations of \$100 thousand 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, 2018, our net noncore funding dependence ratio, the difference between noncore funds and short-term investments to long-term assets, was 15.0 percent. Our net short-term noncore funding dependence ratio, noncore funds maturing within one year, less short-term investments to long-term assets equaled 6.3 percent. Comparatively, our ratios equaled 16.1 percent and 11.1 percent at the end of 2017, which indicated a decrease 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, increased to 4.1 percent at December 31, 2018, from 3.7 percent at December 31, 2017. 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 \$4.9 million for the year ended December 31, 2018. For the year ended December 31, 2017, cash and cash

equivalents decreased \$2.5 million. During 2018, cash provided by operating and financing activities were more than offset by cash used in investing activities.

Operating activities provided net cash of \$32.6 million in 2018 and \$28.6 million in 2017. 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 \$97.3 million in 2018. Net cash provided by financing activities was \$153.5 million in 2017. Deposit gathering, which is our predominant financing activity, increased in both 2018 and 2017. Deposit gathering provided a net cash inflow in 2018 of \$156.0 million and \$130.3 million in 2017. Short-term borrowings decreased net cash by \$37.2 million in 2018 while a net increase in short-term borrowings of \$41.0 million contributed to the net cash provided by financing activities in 2017. Deposit gathering in 2018 was also partially offset by \$11.8 million repayments of long-term debt as well as cash dividends paid of \$9.7 million. In 2017, deposit gathering was partially offset by a \$8.4 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 \$134.8 million in 2018. Net cash used in investing activities was \$184.6 million in 2017. Net cash used in lending activities was \$141.3 million in 2018, a decrease from \$163.2 million in 2017. Activities related to our investment portfolio used net cash of \$0.7 million in 2018 and \$16.4 million in 2017.

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 12.0 percent at December 31, 2018, and 11.9 percent at December 31, 2017. Our Total capital ratio was 13.1 percent at December 31, 2018 and 13.0 percent at December 31, 2017. Our and Peoples Bank's common equity Tier I capital to risk-weighted assets ratios were 12.0 percent and 11.6 percent at December 31, 2018 and 11.9 percent and 11.5 percent at December 31, 2017. Our Leverage ratio, which equaled 10.0 percent at December 31, 2018 and 9.9 percent at December 31, 2017, exceeded the minimum of 4.0 percent for capital adequacy purposes. Peoples Bank reported Tier 1 capital, Total capital and Leverage ratios of 11.6 percent, 12.8 percent and 9.8 percent at December 31, 2018, and 11.5 percent, 12.6 percent and 9.7 percent at December 31, 2017. Based on the most recent notification from the FDIC, Peoples Bank was categorized as well capitalized at December 31, 2018. 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 \$278.6 million or \$37.66 per share at December 31, 2018, and \$265.0 million or \$35.82 per share at December 31, 2017. Stockholders' equity grew \$13.6 million in 2018 as net income was partially offset by an increase in accumulated other comprehensive loss and the payment of dividends.

Review of Financial Performance:

Net income was \$24.9 million or \$3.37 per share in 2018 and \$18.5 million or \$2.50 per share in 2017. The increase in earnings in 2018 was the result of higher net interest income of \$5.8 million due to growth of our earning assets coupled with a \$4.8 million reduction in income taxes due to the lower corporate tax rate. The results for 2017 included 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. Return on average assets ("ROAA") and return on average equity ("ROAE") were 1.12 percent and 9.21 percent for the year ended December 31, 2018. ROAA was 0.90 percent and ROAE was 7.02 percent for the year ended December 31, 2017.

Tax-equivalent net interest income, a non-GAAP measure, was \$73.0 million in 2018 and \$68.9 million in 2017. Our net interest margin equaled 3.59 percent in 2018 and 3.69 percent in 2017. Noninterest income totaled \$13.7 million in 2018

and \$17.2 million in 2017. Noninterest expense was \$52.5 million for the year ended December 31, 2018 compared to \$51.3 million for the year ended December 31, 2017. Our productivity is measured by the operating efficiency ratio, a non-GAAP measure, defined as noninterest expense less amortization of intangible assets divided by the total of tax-equivalent net interest income, a non-GAAP measure, and noninterest income less gains on equity securities and gains on sale of assets. Our operating efficiency ratio, a non-GAAP measure, was 59.8 percent in 2018 and 60.0 percent in 2017.

Net Interest Income:

Tax-equivalent net interest income, a non-GAAP measure, was \$73.0 million in 2018 and \$68.9 million in 2017. 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 \$6.0 million. A rate variance resulted in a decrease in net interest income of \$1.8 million.

Average earning assets increased \$170.4 million to \$2,035.3 million in 2018 from \$1,864.9 million in 2017 and accounted for a \$7.2 million increase in interest income. Average loans, net increased \$161.2 million, which caused interest income to increase \$7.2 million. Average taxable investments increased \$18.5 million comparing 2018 and 2017, which resulted in increased interest income of \$382 thousand while average tax-exempt investments decreased \$9.3 million, which resulted in a decrease to interest income of \$365.

Average interest-bearing liabilities rose \$127.2 million to \$1,547.7 million in 2018 from \$1,420.6 million in 2017 resulting in a net increase in interest expense of \$1.2 million. Large denomination time deposits averaged \$21.8 million more in 2018 and caused interest expense to increase \$250 thousand. A decrease of \$13.0 million in average time deposits less than \$100 thousand reduced interest expense by \$146 thousand. In addition, interest-bearing transaction accounts, including money market, NOW and savings accounts grew \$68.4 million, which in aggregate caused a \$405 thousand increase in interest expense. Short-term borrowings averaged \$57.0 million more and increased interest expense \$916 thousand while long-term debt averaged \$7.2 million less and decreased interest expense by \$181 thousand comparing 2018 and 2017.

An unfavorable rate variance occurred, as the tax-equivalent yield on earning assets increased eight basis points while there was a 25 basis point increase in the cost of funds. As a result, tax-equivalent net interest income decreased \$1.8 million comparing 2018 and 2017. The tax-equivalent yield on earning assets was 4.24 percent in 2018 compared to 4.16 percent in 2017 resulting in an increase in interest income of \$1.5 million. With the tax-equivalent yield on the investment portfolio decreasing 24 basis points to 2.60 percent in 2018 from 2.84 percent in 2017, interest income decreased \$427 thousand. The tax-equivalent yield on the loan portfolio increased 12 basis points to 4.51 percent in 2018 from 4.39 percent in 2017 and resulted in an increase interest income of \$2.0 million.

An unfavorable rate variance was experienced in 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 31 basis points and 15 basis points comparing 2018 and 2017. These increases resulted in an increase in interest expense of \$1.5 million. The cost of savings accounts remained level at 13 basis points and had no significant change in interest expense. With regard to time deposits, the average rate paid for time deposits less than \$100 thousand increased 11 basis points while time deposits \$100 thousand or more increased 52 basis points, which together resulted in a \$905 thousand increase in interest expense. The average rate paid on short-term borrowings increased 88 basis points in 2018 when compared to 2017, causing a \$921 thousand increase in interest expense. Interest expense increased \$71 thousand from a 13 basis point increase 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 \$4.2 million in 2018 and \$4.8 million in 2017. A lower provision for loan losses was

the product of improving asset quality throughout 2018 in the historical loss factors used in the calculation. Based on our most recent evaluation at December 31, 2018, we believe that the allowance was adequate to absorb any known or potential losses in our portfolio.

Noninterest Income:

Our noninterest income decreased \$3.5 million or 20.5 percent to \$13.7 million in 2018 from \$17.2 million in 2017. We realized a \$291 thousand net gain on the sale of our credit card portfolio in 2018 while the 2017 results include a \$2.3 million net gain on the sale of our merchant services business. Revenue received from service charges, fees and commissions increased \$334 thousand or 4.6 percent comparing 2018 and 2017, due in part to death benefit proceeds on a bank owned life insurance (BOLI) policy totaling \$368 thousand, a higher dividend on our FHLB-Pgh stock of \$277 thousand due to an increase in rate and higher volume, and increased interchange revenue from debit card transactions of \$158 thousand, partially offset by lower revenue related to swap transactions of \$610 thousand as the number and amount of transactions in 2018 was lower than during 2017. Merchant services revenue decreased \$1.7 million in 2018 when compared to 2017 due to the sale of the business during the second quarter of 2017. Commissions and fees on fiduciary activities decreased \$21 thousand or 1.0 percent comparing 2018 and 2017 due to a decrease in executor fees. Wealth management income increased \$36 thousand or 2.6 percent comparing 2018 to 2017 due to growth. Mortgage banking income decreased \$157 thousand or 20.0 percent in 2018 compared to 2017 as the volume of loans originated for sale declined. Income from investment in life insurance decreased \$12 thousand or 1.6 percent to \$757 thousand in 2018 from \$769 thousand in 2017.

Noninterest Expense:

Noninterest expense was \$52.5 million for the year ended December 31, 2018 compared to \$51.3 million for the year ended December 31, 2017.

Salaries and employee benefits expense constitute the majority of our noninterest expenses accounting for 54.1 percent of the total noninterest expense. Salaries and employee benefits expense increased \$1.7 million or 6.5 percent to \$28.4 million in 2018 from \$26.7 million in 2017. Salaries and payroll taxes increased \$1.3 million or 5.8 percent, while employee benefits expense increased \$451 thousand or 10.3 percent. Annual performance-based salary adjustments as well as costs associated with our further expansion in the Lehigh Valley during 2018, including a full operational year at our newest branch office on Tilghman Street in West Allentown and the addition of seasoned lending and support personnel in the region provided the majority of the increase.

Occupancy and equipment expense increased \$922 thousand or 9.2 percent to \$10.9 million in 2018 from \$10.0 million in 2017. Specifically, building-related costs increased \$604 thousand or 10.7 percent while equipment-related costs increased \$318 thousand or 7.3 percent. The increases in occupancy and equipment-related expenses were driven by costs associated with a full operational year at our new community banking office on Tilghman Street in West Allentown, PA. In general, as we expand and increase our market area, occupancy related expenses, including technology costs associated with the maintenance and operations of new infrastructure within these markets increases.

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 \$13.2 million in 2018 and \$14.6 million in 2017. Merchant transaction expenses decreased \$1.8 million to \$9 thousand in 2018 compared to \$1.8 million in 2017 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, amortization of intangible assets and other expenses totaled \$13.2 million in 2018, an increase of \$334 thousand or 2.6 percent, compared to \$12.8 million in 2017.

Income Taxes:

Our income tax expense was \$3.4 million in 2018 and \$8.2 million in 2017. The Tax Cuts and Jobs Act reduced the federal corporate income tax rate to 21% effective January 1, 2018. As a result, and in accordance with 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 reduced 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. This one-time charge was not replicated in 2018 and the decrease in income tax expense for 2018 was the direct result of the lowering of the statutory tax rate from 35% in prior years to 21% for 2018. Further, 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 decreased to 12.0 percent in 2018, compared to 20.9 percent in 2017.

The effective tax rate in 2018 and 2017 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 2018 and 2017.

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

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

During the third quarter of 2019, FOMC started decreasing the target federal funds rate, eventually cutting the rate by a total of 75 basis points to set the new target range of 1.50 percent to 1.75 percent at year end. The FOMC judges the current stance of monetary policy is appropriate to support sustained expansion of economic activity, and will continue to monitor the implications of incoming data for economic outlook, including global developments and muted inflation pressures, as it assesses the appropriate path of the target range for the federal funds rate. The FOMC noted determination of the timing and size of future adjustments to the target range for the federal funds rate will be its assessment of the realized and expected economic conditions relative to its maximum employment and inflation objectives.

The projected impact of instantaneous changes in interest rates on our net interest income and economic value of equity at December 31, 2019, based on our simulation model, is summarized as follows:

| Changes in Interest Rates (basis points) | December 31, 2019 | | | |
|--|---------------------|--------|--------------------------|--------|
| | % Change in | | | |
| | Net Interest Income | | Economic Value of Equity | |
| | Metric | Policy | Metric | Policy |
| +400 | (4.4) | (20.0) | (4.7) | (40.0) |
| +300 | (3.0) | (20.0) | (2.6) | (30.0) |
| +200 | (1.9) | (10.0) | (0.9) | (20.0) |
| +100 | (0.9) | (10.0) | 1.2 | (10.0) |
| Static | | | | |
| (100) | (1.7) | (10.0) | (8.0) | (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, 2019, would decrease at 0.9 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.

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

Item 8. Financial Statements.

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Stockholders and Board of Directors of
Peoples Financial Services Corp. and Subsidiaries

Opinions on the Financial Statements and Internal Control over Financial Reporting

We have audited the accompanying consolidated balance sheets of Peoples Financial Services Corp. and Subsidiaries (the "Company") as of December 31, 2019 and 2018, and the related consolidated statements of income and comprehensive income, changes in stockholders' equity, and cash flows, for each of the three years in the period ended December 31, 2019, 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, 2019, 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, 2019 and 2018, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2019, 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, 2019, based on criteria established in *Internal Control – Integrated Framework: (2013)* issued by COSO.

Basis for Opinions

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 audits. 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 audits 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 audits 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 audits 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 audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

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

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

Wilkes-Barre, Pennsylvania
March 16, 2020

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

| December 31 | 2019 | 2018 |
|--|---------------------|---------------------|
| Assets: | | |
| Cash and due from banks: | | |
| Cash and due from banks | \$ 26,943 | \$ 32,569 |
| Interest-bearing deposits in other banks | 4,210 | 47 |
| Total cash and due from banks | 31,153 | 32,616 |
| Investment securities: | | |
| Available-for-sale | 330,478 | 269,682 |
| Equity investments carried at fair value | 423 | 291 |
| Held-to-maturity: Fair value December 31, 2019, \$7,889; December 31, 2018, \$8,380 | 7,656 | 8,361 |
| Total investment securities | 338,557 | 278,334 |
| Loans | 1,938,240 | 1,823,266 |
| Less: allowance for loan losses | 22,677 | 21,379 |
| Net loans | 1,915,563 | 1,801,887 |
| Loans held for sale | 986 | 749 |
| Premises and equipment, net | 47,932 | 38,889 |
| Accrued interest receivable | 6,981 | 7,115 |
| Goodwill | 63,370 | 63,370 |
| Intangible assets, net | 1,565 | 2,296 |
| Other assets | 69,220 | 63,737 |
| Total assets | <u>\$ 2,475,327</u> | <u>\$ 2,288,993</u> |
| Liabilities: | | |
| Deposits: | | |
| Noninterest-bearing | \$ 463,238 | \$ 410,260 |
| Interest-bearing | 1,508,251 | 1,464,762 |
| Total deposits | 1,971,489 | 1,875,022 |
| Short-term borrowings | 152,150 | 86,500 |
| Long-term debt | 32,733 | 37,906 |
| Accrued interest payable | 1,277 | 1,195 |
| Other liabilities | 18,668 | 9,756 |
| Total liabilities | <u>2,176,317</u> | <u>2,010,379</u> |
| Stockholders' equity: | | |
| Common stock, par value \$2.00, authorized 25,000,000 shares, issued and outstanding 7,388,480 shares at December 31, 2019 and 7,399,054 shares at December 31, 2018 | 14,777 | 14,798 |
| Capital surplus | 135,251 | 135,310 |
| Retained earnings | 152,187 | 136,582 |
| Accumulated other comprehensive loss | (3,205) | (8,076) |
| Total stockholders' equity | 299,010 | 278,614 |
| Total liabilities and stockholders' equity | <u>\$ 2,475,327</u> | <u>\$ 2,288,993</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)

| Year Ended December 31 | 2019 | 2018 | 2017 |
|--|------------------|------------------|------------------|
| Interest income: | | | |
| Interest and fees on loans: | | | |
| Taxable | \$ 82,488 | \$ 74,352 | \$ 64,946 |
| Tax-exempt | 4,309 | 3,666 | 3,163 |
| Interest and dividends on investment securities: | | | |
| Taxable | 4,435 | 3,799 | 2,949 |
| Tax-exempt | 1,878 | 2,621 | 2,999 |
| Dividends | 84 | 72 | 52 |
| Interest on interest-bearing deposits in other banks | 65 | 151 | 133 |
| Interest on federal funds sold | 122 | | |
| Total interest income | <u>93,381</u> | <u>84,661</u> | <u>74,242</u> |
| Interest expense: | | | |
| Interest on deposits | 14,995 | 9,346 | 6,450 |
| Interest on short-term borrowings | 1,642 | 2,738 | 900 |
| Interest on long-term debt | 1,231 | 1,238 | 1,348 |
| Total interest expense | <u>17,868</u> | <u>13,322</u> | <u>8,698</u> |
| Net interest income | 75,513 | 71,339 | 65,544 |
| Provision for loan losses | 6,100 | 4,200 | 4,800 |
| Net interest income after provision for loan losses | <u>69,413</u> | <u>67,139</u> | <u>60,744</u> |
| Noninterest income: | | | |
| Service charges, fees and commissions | 9,026 | 7,678 | 7,344 |
| Merchant services income | 973 | 809 | 2,543 |
| Commission and fees on fiduciary activities | 2,087 | 2,036 | 2,057 |
| Wealth management income | 1,524 | 1,447 | 1,411 |
| Mortgage banking income | 600 | 627 | 784 |
| Bank owned life insurance income | 755 | 757 | 769 |
| Net gains on equity investment securities | 132 | 14 | |
| Net gains on sale of investment securities available-for-sale | 23 | | |
| Net gain on sale of credit card loans | | 291 | |
| Net gain on sale of merchant services business | | | 2,278 |
| Total noninterest income | <u>15,120</u> | <u>13,659</u> | <u>17,186</u> |
| Salaries and employee benefits expense | 31,374 | 28,407 | 26,670 |
| Net occupancy and equipment expense | 11,911 | 10,897 | 9,975 |
| Amortization of intangible assets | 730 | 881 | 1,034 |
| Professional fees and outside services | 1,758 | 2,414 | 2,277 |
| FDIC insurance and assessments | 651 | 1,093 | 826 |
| Donations | 1,441 | 1,339 | 1,188 |
| Other expenses | 7,777 | 7,456 | 9,323 |
| Total noninterest expense | <u>55,642</u> | <u>52,487</u> | <u>51,293</u> |
| Income before income taxes | 28,891 | 28,311 | 26,637 |
| Income tax expense | 3,155 | 3,391 | 8,180 |
| Net income | <u>25,736</u> | <u>24,920</u> | <u>18,457</u> |
| Other comprehensive income (loss): | | | |
| Unrealized gain (loss) on investment securities available-for-sale | 5,109 | (2,014) | (1,790) |
| Reclassification adjustment for net gain on sales included in net income | (23) | | |
| Change in benefit plan liabilities | 639 | (591) | 318 |
| Change in derivative fair value | 441 | 246 | |
| Other comprehensive gain (loss) | 6,166 | (2,359) | (1,472) |
| Income tax expense (benefit) | 1,295 | (496) | (515) |
| Other comprehensive income (loss), net of income taxes | <u>4,871</u> | <u>(1,863)</u> | <u>(957)</u> |
| Comprehensive income | <u>\$ 30,607</u> | <u>\$ 23,648</u> | <u>\$ 17,500</u> |
| Per share data: | | | |
| Net income: | | | |
| Basic | \$ 3.48 | \$ 3.37 | \$ 2.50 |
| Diluted | \$ 3.48 | \$ 3.37 | \$ 2.50 |
| Average common shares outstanding: | | | |
| Basic | 7,395,429 | 7,397,797 | 7,395,837 |
| Diluted | 7,395,429 | 7,397,797 | 7,395,837 |
| Dividends declared | \$ 1.37 | \$ 1.31 | \$ 1.26 |

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, 2019 | Common Stock | Capital Surplus | Retained Earnings | Accumulated Other Comprehensive Loss | Treasury Stock | Total |
|--|-------------------------|----------------------------|------------------------------|---|---------------------------|-------------------|
| Balance, January 1, 2017 | \$ 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) | | | | |
| Balance, December 31, 2017 | <u>14,793</u> | <u>135,043</u> | <u>121,353</u> | <u>(6,213)</u> | <u>\$</u> | <u>264,976</u> |
| Net income | | | 24,920 | | | 24,920 |
| Other comprehensive loss, net of income taxes | | | | (1,861) | | (1,861) |
| Reclassification related to adoption of ASU 2016-01 | | | 2 | (2) | | |
| Dividends declared: \$1.31 per share | | | (9,693) | | | (9,693) |
| Stock based compensation | | 272 | | | | 272 |
| Common stock grants awarded, net of unearned compensation of \$92: 2,548 shares | 5 | (5) | | | | |
| Balance, December 31, 2018 | <u>14,798</u> | <u>135,310</u> | <u>136,582</u> | <u>(8,076)</u> | <u>\$</u> | <u>278,614</u> |
| Net income | | | 25,736 | | | 25,736 |
| Other comprehensive income, net of income taxes | | | | 4,871 | | 4,871 |
| Dividends declared: \$1.37 per share | | | (10,131) | | | (10,131) |
| Stock based compensation | | 554 | | | | 554 |
| Common stock grants awarded, net of unearned compensation of \$147: 3,854 shares | 8 | (8) | | | | |
| Share retirement: 14,428 shares | (29) | (605) | | | | (634) |
| Balance, December 31, 2019 | <u>\$ 14,777</u> | <u>\$ 135,251</u> | <u>\$ 152,187</u> | <u>\$ (3,205)</u> | <u>\$</u> | <u>\$ 299,010</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, | 2019 | 2018 | 2017 |
|---|------------------|------------------|------------------|
| Cash flows from operating activities: | | | |
| Net income | \$ 25,736 | \$ 24,920 | \$ 18,457 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | | |
| Depreciation of premises and equipment | 3,083 | 2,333 | 1,950 |
| Amortization of right-of-use lease asset | 398 | | |
| Amortization of deferred loan costs | (164) | 525 | 907 |
| Amortization of intangibles | 730 | 881 | 1,034 |
| Amortization of low income housing partnerships | 476 | 465 | 470 |
| Provision for loan losses | 6,100 | 4,200 | 4,800 |
| Net unrealized gain on equity investment securities | (132) | (14) | |
| Net loss (gain) on sale of other real estate owned | 9 | (21) | (11) |
| Gain on life insurance proceeds | | (368) | |
| Loans originated for sale | (15,901) | (13,194) | (21,036) |
| Proceeds from sale of loans originated for sale | 15,753 | 12,650 | 21,149 |
| Net gain on sale of loans originated for sale | (89) | (99) | (219) |
| Net amortization of investment securities | 1,668 | 2,206 | 2,764 |
| Net gain on sale of investment securities available-for-sale | (23) | | |
| Net gain on sale of credit card loans held for sale | | (291) | |
| Net gain on sale of merchant services business | | | (2,278) |
| Bank owned life insurance income | (755) | (757) | (769) |
| Deferred income tax expense (benefit) | 394 | (681) | 1,665 |
| Stock based compensation | 554 | 272 | 177 |
| Net change in: | | | |
| Accrued interest receivable | 134 | (179) | (708) |
| Other assets | (3,363) | 816 | 2,023 |
| Accrued interest payable | 82 | 698 | 35 |
| Other liabilities | 2,389 | (1,736) | (1,817) |
| Net cash provided by operating activities | <u>37,079</u> | <u>32,626</u> | <u>28,593</u> |
| Cash flows from investing activities: | | | |
| Proceeds from sales of investment securities available-for-sale | 9,677 | | |
| Proceeds from repayments of investment securities: | | | |
| Available-for-sale | 57,477 | 31,093 | 55,800 |
| Held-to-maturity | 697 | 898 | 1,222 |
| Purchases of investment securities: | | | |
| Available-for-sale | (124,501) | (32,709) | (73,471) |
| Net (purchase) redemption of restricted equity securities | (2,739) | 1,100 | (1,511) |
| Proceeds from sale of student loan portfolio | | 5,103 | |
| Proceeds from sale of credit card loan portfolio | | 2,698 | |
| Net increase in lending activities | (119,998) | (141,277) | (163,236) |
| Purchases of premises and equipment | (5,603) | (4,069) | (6,247) |
| Proceeds from the sale of premises and equipment | | 404 | |
| Proceeds from bank owned life insurance | | 672 | |
| Proceeds from the sale of merchant services business | | | 2,300 |
| Proceeds from sale of other real estate owned | 269 | 1,281 | 580 |
| Net cash used in investing activities | <u>(184,721)</u> | <u>(134,806)</u> | <u>(184,563)</u> |
| Cash flows from financing activities: | | | |
| Net increase in deposits | 96,467 | 156,004 | 130,261 |
| Proceeds from long-term debt | 16,000 | | |
| Repayment of long-term debt | (21,173) | (11,828) | (8,400) |
| Net increase (decrease) in short-term borrowings | 65,650 | (37,175) | 40,975 |
| Retirement of common stock | (634) | | |
| Cash dividends paid | (10,131) | (9,693) | (9,319) |
| Net cash provided by financing activities | <u>146,179</u> | <u>97,308</u> | <u>153,517</u> |
| Net decrease in cash and cash equivalents | | | |
| | (1,463) | (4,872) | (2,453) |
| Cash and cash equivalents at beginning of period | 32,616 | 37,488 | 39,941 |
| Cash and cash equivalents at end of period | <u>\$ 31,153</u> | <u>\$ 32,616</u> | <u>\$ 37,488</u> |

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

| Year Ended December 31, | 2019 | 2018 | 2017 |
|--|-----------|-----------|----------|
| Supplemental disclosures: | | | |
| Cash paid during the period for: | | | |
| Interest | \$ 17,786 | \$ 12,624 | \$ 8,663 |
| Income taxes | 4,550 | 2,650 | 5,900 |
| Noncash items: | | | |
| Transfers of loans to other real estate | \$ 421 | \$ 1,432 | \$ 460 |
| Initial recognition of right-of-use assets | 6,523 | | |
| Initial recognition of lease liability | 6,523 | | |

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”. The Company services its retail and commercial customers through twenty-eight full-service community banking offices located within Bucks, Lackawanna, Lebanon, Lehigh, Luzerne, Monroe, Montgomery, Northampton, Susquehanna, Wayne and Wyoming Counties of Pennsylvania and Broome County of New York and one limited purpose banking office located in Schuylkill County, Pennsylvania.

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:

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, 2019, 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:

Investment securities are classified and accounted for as either held-to-maturity or available-for-sale 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 with unrealized gains and losses reported in earnings. 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 on callable debt securities are amortized to the earliest call date from the maturity date. Premiums on non-callable securities are amortized and discounts are accreted using the interest method over the expected life of the security. 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. 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 with 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 and a formula portion for loss contingencies on those loans collectively evaluated.

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 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. 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, 2019.

Revenue from Contracts with Customers:

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

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

- *Service charges, fees and commissions.* Service charges, fees and commissions on deposit accounts include fees for banking services provided, overdrafts and non-sufficient funds. Revenue is generally recognized in accordance with published deposit account agreements for retail accounts or contractual agreements for commercial accounts. The Company's deposit services also include our ATM and debit card interchange revenue that is presented gross of the associated costs. Interchange revenue is generated by the Company's deposit customers' usage and volume of activity. Interchange rates are not controlled by the Company, which effectively acts as processor that collects and remits payments associated with customer debit card transactions.
- *Commission and fees on fiduciary activities.* Commission and fees on fiduciary activities includes fees and commissions from investment management, administrative and advisory services primarily for individuals, and to a lesser extent, partnerships and corporations. Revenue is recognized on an accrual basis at the time the services are performed and when the Company has a right to invoice and are based on either the market value of the assets managed or the services provided.
- *Wealth management income.* Wealth management income includes fees and commissions charged when the Company arranges for another party to transfer brokerage services to a customer. The fees and commissions under this agent relationship are based upon stated fee schedules based upon the type of transaction, volume, and value of the services provided.
- *Other noninterest income.* Other noninterest income includes, among other things, merchant services income. Merchant services revenue is derived from a third party vendor that processes credit card transactions on behalf of the Company's merchant customers. Merchant services revenue is primarily comprised of residual fee income based on the referred merchant's processing volumes and/or margin.

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 |

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.

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, 2019.

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 transferred 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 on certain 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. The policies

can be liquidated, if necessary, with associated tax costs. However, the Company intends to hold these policies and, accordingly, the Company has not provided for income taxes on the earnings from the increase in cash surrender value.

Pension and post-retirement benefit plans:

The Company sponsors a separate Employee Stock Ownership Plan (“ESOP”) and Retirement Profit Sharing 401(k) Plan and maintains Supplemental Executive Retirement Plans (“SERPs”) and an employee pension plan, which is currently frozen. 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:

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.

Derivative Instruments and Hedging Activities:

The Company records all derivatives on the balance sheet at fair value. The accounting for changes in the fair value of derivatives depends on the intended use of the derivative, whether the Company has elected to designate a derivative in a hedging relationship and apply hedge accounting and whether the hedging relationship has satisfied the criteria necessary to apply hedge accounting. Derivatives designated and qualifying as a hedge of the exposure to changes in the fair value of an asset, liability, or firm commitment attributable to a particular risk, such as interest rate risk, are considered fair value hedges. Derivatives designated and qualifying as a hedge of the exposure to variability in expected future cash flows, or other types of forecasted transactions, are considered cash flow hedges. Derivatives may also be designated as hedges of the foreign currency exposure of a net investment in a foreign operation. Hedge accounting generally provides for the matching of the timing of gain or loss recognition on the hedging instrument with the recognition of the changes in the fair value of the hedged asset or liability that are attributable to the hedged risk in a fair value hedge or the earnings effect of the hedged forecasted transactions in a cash flow hedge. The Company may enter into derivative contracts that are intended to economically hedge certain of its risk, even though hedge accounting does not apply or the Company elects not to apply hedge accounting.

The Company has elected to measure the credit risk of its derivative financial instruments that are subject to master netting agreements on a net basis by counterparty portfolio.

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.

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 measured at 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.

Impaired loans: Fair values for impaired loans are estimated using discounted cash flow analysis determined by the loan review function or underlying collateral values, where applicable.

Interest rate swaps and floors: 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.

Advertising:

The Company follows the policy of charging marketing and advertising costs to expense as incurred. Advertising expense for the years ended December 31, 2019, 2018 and 2017 was \$873, \$720 and \$942, respectively.

Income taxes:

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, 2019.

On December 22, 2017, the Tax Cuts and Jobs Act was signed into law, 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 remeasured its net deferred tax assets using the 21% rate. 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 state jurisdictions. With limited exception, the Company is no longer subject to federal and state income tax examinations by taxing authorities for years before 2015.

Other comprehensive loss:

The components of other comprehensive loss and their related tax effects are reported in the Consolidated Statements of Income and Comprehensive Income. The accumulated other comprehensive loss included in the Consolidated Balance Sheets relates to net unrealized gains and losses on investment securities available-for-sale, the net change in derivative fair value 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 to outstanding stock options and stock awards, and are determined using the treasury stock method.

| For the Year Ended December 31 | 2019 | | 2018 | | 2017 | |
|-----------------------------------|-----------|-----------|-----------|-----------|-----------|-----------|
| | Basic | Diluted | Basic | Diluted | Basic | Diluted |
| Net income | \$ 25,736 | \$ 25,736 | \$ 24,920 | \$ 24,920 | \$ 18,457 | \$ 18,457 |
| Average common shares outstanding | 7,395,429 | 7,395,429 | 7,397,797 | 7,397,797 | 7,395,837 | 7,395,837 |
| Earnings per share | \$ 3.48 | \$ 3.48 | \$ 3.37 | \$ 3.37 | \$ 2.50 | \$ 2.50 |

Stock-based compensation:

The Company recognizes all share-based payments to employees in the consolidated statements of income and comprehensive income 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 February 2016, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2016-02, "Leases". From the lessee's perspective, the new standard establishes a right-of-use ("ROU") model that requires a lessee to record a ROU asset and a lease liability on the balance sheet for all leases with terms longer than 12 months. The ROU asset and lease liability are calculated based on the present value of future lease payments using an

estimated incremental borrowing rate. The Company utilized the incremental borrowing rate of interest on a collateralized basis for the lease term as quoted by the FHLB.

Leases are classified as either finance or operating, with classification affecting the pattern of expense recognition in the statement of income for a lessee. From the lessor's perspective, the new standard requires a lessor to classify leases as either sales-type, finance or operating. A lease is treated as a sale if it transfers all of the risks and rewards, as well as control of the underlying asset, to the lessee. If risks and rewards are conveyed without the transfer of control, the lease is treated as a financing. If the lessor doesn't convey risks and rewards or control, an operating lease results. The amendments in this ASU were effective for annual periods, and interim periods within those annual periods, beginning after December 15, 2018.

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

In July 2018, the FASB issued ASU 2018-11, "Leases - Targeted Improvements" to provide entities with relief from the costs of implementing certain aspects of the new leasing standard, ASU No. 2016-02. Specifically, under the amendments in ASU 2018-11: (1) entities may elect not to recast the comparative periods presented when transitioning to the new leasing standard, and (2) lessors may elect not to separate lease and non-lease components when certain conditions are met. The amendments were adopted on January 1, 2019 and did not have a material impact on the Company's consolidated financial statements.

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

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

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

methodology. In addition, the ASU requires that disclosure of credit quality indicators in relation to the amortized cost of financing receivables, a current requirement, be further disaggregated by year of origination.

- This ASU requires that credit losses on available-for-sale debt securities be presented as an allowance rather than as a write-down, and limits the amount of the allowance for credit losses to the amount by which the fair value is below amortized cost. For purchased investment securities available-for-sale with a more-than-insignificant amount of credit deterioration since origination, the ASU requires an allowance be determined in a manner similar to other investment securities available-for-sale; however, the initial allowance would be added to the purchase price, with only subsequent changes in the allowance recorded in credit loss expense, and interest income recognized at the effective rate excluding the discount embedded in the purchase price related to estimated credit losses at acquisition.
- In November 2019, the FASB issued ASU 2019-11 which deferred the adoption date for smaller reporting companies from 2020 to 2023. The Company qualifies as a smaller reporting company and therefore guidance is effective for the Company in 2023. The Company will record the effect of implementing this ASU through a cumulative-effect adjustment through retained earnings as of the beginning of the reporting period in which Topic 326 is effective.

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

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

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

In August 2018, the FASB issued ASU 2018-14, "Compensation - Retirement Benefits - Defined Benefit Plans - General (Subtopic 715-20)", which provides changes to the disclosure requirements for defined benefit plans. The amended guidance modifies the disclosure requirements for employers that sponsor defined benefit pension or other postretirement plans. The amendments are a result of the disclosure framework project that focuses on improvements to the effectiveness of disclosures in the notes to financial statements. The amendments remove and add certain disclosure requirements. The disclosure requirements being removed relating to public companies are (1) the amounts in accumulated other comprehensive income expected to be recognized as components of net periodic benefit cost over the next fiscal year, (2) the amount and timing of plan assets expected to be returned to the employer, (3) the 2001 disclosure requirement relating to Japanese Welfare Pension Insurance Law, (4) related party disclosures about the amount of future annual benefits covered by insurance, and (5) the effects of a one-percentage-point change in assumed health care cost trends on the benefit cost and obligation. The disclosure requirements being added relating to public companies are (1) the weighted-average interest crediting rates for cash balance plans, and (2) an explanation of the reasons for significant gains and losses related to changes in the benefit obligation for the period. ASU 2018-14 is effective for the Company on January 1, 2021 and early adoption is permitted. The amendments should be applied retrospectively however, the Company does not expect the guidance to have a material impact on its disclosures to the consolidated financial statements.

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 \$2,545 and \$2,768 at December 31, 2019 and 2018, respectively.

3. Investment securities:

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

| December 31, 2019 | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|---|-------------------|------------------------------|-------------------------------|---------------|
| Available-for-sale: | | | | |
| U.S. Treasury securities | \$ 23,966 | \$ 162 | | \$ 24,128 |
| U.S. government-sponsored enterprises | 87,156 | 181 | \$ 227 | 87,110 |
| State and municipals: | | | | |
| Taxable | 35,418 | 295 | 815 | 34,898 |
| Tax-exempt | 59,127 | 1,056 | 20 | 60,163 |
| Residential mortgage-backed securities: | | | | |
| U.S. government agencies | 8,368 | 112 | 10 | 8,470 |
| U.S. government-sponsored enterprises | 101,914 | 1,011 | 77 | 102,848 |
| Commercial mortgage-backed securities: | | | | |
| U.S. government-sponsored enterprises | 12,694 | 171 | 4 | 12,861 |
| Total | \$ 328,643 | \$ 2,988 | \$ 1,153 | \$ 330,478 |
| Held-to-maturity: | | | | |
| Tax-exempt state and municipals | \$ 6,852 | \$ 208 | | \$ 7,060 |
| Residential mortgage-backed securities: | | | | |
| U.S. government agencies | 31 | | | 31 |
| U.S. government-sponsored enterprises | 773 | 25 | \$ | 798 |
| Total | \$ 7,656 | \$ 233 | \$ | \$ 7,889 |
| | | | | |
| December 31, 2018 | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
| Available-for-sale: | | | | |
| U.S. Treasury securities | \$ 25,948 | 9 | \$ 365 | \$ 25,592 |
| U.S. government-sponsored enterprises | 94,999 | \$ 2 | 2,183 | 92,818 |
| State and municipals: | | | | |
| Taxable | 13,544 | 309 | | 13,853 |
| Tax-exempt | 86,361 | 338 | 745 | 85,954 |
| Residential mortgage-backed securities: | | | | |
| U.S. government agencies | 12,663 | 50 | 84 | 12,629 |
| U.S. government-sponsored enterprises | 33,149 | 49 | 401 | 32,797 |
| Commercial mortgage-backed securities: | | | | |
| U.S. government-sponsored enterprises | 6,269 | | 230 | 6,039 |
| Total | \$ 272,933 | \$ 757 | \$ 4,008 | \$ 269,682 |
| Held-to-maturity: | | | | |
| Tax-exempt state and municipals | \$ 6,855 | \$ 12 | \$ 43 | \$ 6,824 |
| Residential mortgage-backed securities: | | | | |
| U.S. government agencies | 42 | | | 42 |
| U.S. government-sponsored enterprises | 1,464 | 55 | 5 | 1,514 |
| Total | \$ 8,361 | \$ 67 | \$ 48 | \$ 8,380 |

The Company had net unrealized gains on available-for-sale securities of \$1,450, net of deferred income taxes of \$385 at December 31, 2019, and net unrealized losses on available-for-sale securities of \$2,568, net of deferred income taxes of \$683, at December 31, 2018. During 2019, the Company sold available-for-sale municipal bonds and received proceeds

totaling \$9,677. Gross gains of \$66 and gross losses of \$43 were realized on the sale of investment securities in 2019. There were no sales of investment securities in 2018.

Our equity securities portfolio consists of stock of two other financial institutions. At December 31, 2019 and December 31, 2018, we had \$423 thousand and \$291 thousand, respectively, in equity securities recorded at fair value. Prior to January 1, 2018, equity securities were stated at fair value with unrealized gains and losses reported as a separate component of Accumulated Other Comprehensive Income (“AOCI”), net of tax. At December 31, 2018, net unrealized gains of \$3 thousand had been recognized in AOCI. On January 1, 2018, these unrealized gains, net of income tax were reclassified out of AOCI and into retained earnings with subsequent changes in fair value being recognized in net income. At December 31, 2019, the fair value of our equity portfolio exceeded the cost basis by \$146 thousand. The following is a summary of unrealized and realized gains and losses recognized in net income on equity securities during 2019 and 2018.

| Year Ended December 31, | 2019 | 2018 |
|---|---------------|--------------|
| Net gains recognized during the period on equity securities | \$ 132 | \$ 14 |
| Less: Net gains recognized during the period on equity securities sold during the period | | |
| Unrealized gains recognized during the reporting period on equity securities still held at the reporting date | <u>\$ 132</u> | <u>\$ 14</u> |

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, 2019, is summarized as follows:

| December 31, 2019 | Fair Value |
|---|-------------------|
| Within one year | \$ 41,486 |
| After one but within five years | 108,231 |
| After five but within ten years | 19,951 |
| After ten years | 33,297 |
| | <u>202,965</u> |
| Mortgage-backed and other amortizing securities | 127,513 |
| Total | <u>\$ 330,478</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, 2019, is summarized as follows:

| December 31, 2019 | Amortized Cost | Fair Value |
|---------------------------------|-----------------|-----------------|
| Within one year | | |
| After one but within five years | | |
| After five but within ten years | | |
| After ten years | \$ 6,852 | \$ 7,060 |
| | <u>6,852</u> | <u>7,060</u> |
| Mortgage-backed securities | 804 | 829 |
| Total | <u>\$ 7,656</u> | <u>\$ 7,889</u> |

Securities with a carrying value of \$157,047 and \$161,647 at December 31, 2019 and 2018, respectively, were pledged to secure public deposits and certain other deposits as required or permitted by law.

Securities and short-term investment activities are conducted with a diverse group of government entities, corporations and state and local municipalities. The counterparty's creditworthiness and type of collateral is evaluated on a case-by-case basis. At December 31, 2019 and 2018, there were no significant concentrations of credit risk from any one issuer, with the exception of U.S. government agencies and sponsored enterprises that exceeded 10.0 percent of stockholders' equity.

The fair value and gross unrealized losses of investment securities with unrealized losses for which an OTTI has not been recognized at December 31, 2019 and 2018, aggregated by investment category and length of time that the individual securities have been in a continuous unrealized loss position, are summarized as follows:

| | Less Than 12 Months | | 12 Months or More | | Total | |
|---|---------------------|-------------------|-------------------|-------------------|-------------------|-------------------|
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| December 31, 2019 | | | | | | |
| U.S. government-sponsored enterprises | \$ 13,695 | \$ 149 | \$ 36,070 | \$ 78 | \$ 49,765 | \$ 227 |
| State and municipals: | | | | | | |
| Taxable | 23,929 | 815 | | | 23,929 | 815 |
| Tax-exempt | 2,684 | 19 | 1,098 | 1 | 3,782 | 20 |
| Residential mortgage-backed securities: | | | | | | |
| U.S. government agencies | 992 | 1 | 2,362 | 9 | 3,354 | 10 |
| U.S. government-sponsored enterprises | 36,939 | 51 | 3,751 | 30 | 40,690 | 81 |
| Total | <u>\$ 78,239</u> | <u>\$ 1,035</u> | <u>\$ 43,281</u> | <u>\$ 118</u> | <u>\$ 121,520</u> | <u>\$ 1,153</u> |

| | Less Than 12 Months | | 12 Months or More | | Total | |
|---|---------------------|-------------------|-------------------|-------------------|-------------------|-------------------|
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| December 31, 2018 | | | | | | |
| U.S. Treasury securities | \$ 1,995 | \$ 2 | \$ 19,671 | \$ 363 | \$ 21,666 | \$ 365 |
| U.S. government-sponsored enterprises | 2,037 | 1 | 89,729 | 2,182 | 91,766 | 2,183 |
| State and municipals: | | | | | | |
| Tax-exempt | 9,022 | 74 | 52,352 | 714 | 61,374 | 788 |
| Residential mortgage-backed securities: | | | | | | |
| U.S. government agencies | | | 7,800 | 84 | 7,800 | 84 |
| U.S. government-sponsored enterprises | 12,851 | 55 | 13,881 | 351 | 26,732 | 406 |
| Commercial mortgage-backed securities: | | | | | | |
| U.S. government-sponsored enterprises | | | 6,039 | 230 | 6,039 | 230 |
| Total | <u>\$ 25,905</u> | <u>\$ 132</u> | <u>\$ 189,472</u> | <u>\$ 3,924</u> | <u>\$ 215,377</u> | <u>\$ 4,056</u> |

The Company had 70 investment securities, consisting of 6 tax-exempt and 22 taxable state and municipal obligations, 18 U.S. government-sponsored enterprise securities and 24 mortgage-backed securities that were in unrealized loss positions at December 31, 2019. Of these securities, 16 U.S. government-sponsored enterprise securities, 17 mortgage-backed securities and 2 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, 2019.

There was no OTTI recognized for each of the years in the three-year period ended December 31, 2019.

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, 2019 is 1.6228 shares of Class A stock for each share of Class B stock) for a total of 72,997 shares of Visa Class A stock.

There is a very limited market for this stock, as only current owners of Class B shares are permitted to transact in Class B. Due to the lack of orderly trades and public information of such trades, Visa Class B stock has no readily determinable fair value and is carried at cost.

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, 2019 and 2018 are summarized as follows. Net deferred loan costs included in loan balances were \$908 and \$744 in 2019 and 2018, respectively.

| | <u>December 31, 2019</u> | <u>December 31, 2018</u> |
|--------------|--------------------------|--------------------------|
| Commercial | \$ 522,957 | \$ 494,134 |
| Real estate: | | |
| Commercial | 1,011,423 | 907,803 |
| Residential | 301,378 | 299,876 |
| Consumer | 102,482 | 121,453 |
| Total | <u>\$ 1,938,240</u> | <u>\$ 1,823,266</u> |

Loans outstanding to directors, executive officers, principal stockholders or to their affiliates totaled \$12,248 and \$14,701 at December 31, 2019 and 2018, respectively. Advances and repayments during 2019 totaled \$7,857 and \$9,376 respectively. There were no related party loans that were classified as nonaccrual, past due, or restructured at December 31, 2019 and 2018.

Deposits from related parties amounted to \$12.9 million at December 31, 2019 and \$16.2 million at December 31, 2018.

At December 31, 2019, 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. 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, 2019, 2018, and 2017 were as follows:

| December 31, 2019 | Commercial | Real estate | | Consumer | Total |
|---|-------------------|---------------------|--------------------|-------------------|---------------------|
| | | Commercial | Residential | | |
| Allowance for loan losses: | | | | | |
| Beginning balance | \$ 5,516 | \$ 10,736 | \$ 3,892 | \$ 1,235 | \$ 21,379 |
| Charge-offs | (3,314) | (817) | (477) | (459) | (5,067) |
| Recoveries | 69 | 1 | 29 | 166 | 265 |
| Provisions | 4,617 | 1,576 | (218) | 125 | 6,100 |
| Ending balance | <u>\$ 6,888</u> | <u>\$ 11,496</u> | <u>\$ 3,226</u> | <u>\$ 1,067</u> | <u>\$ 22,677</u> |
| Ending balance: individually evaluated for impairment | 363 | 279 | 135 | | 777 |
| Ending balance: collectively evaluated for impairment | <u>\$ 6,525</u> | <u>\$ 11,217</u> | <u>\$ 3,091</u> | <u>\$ 1,067</u> | <u>\$ 21,900</u> |
| Loans receivable: | | | | | |
| Ending balance | <u>\$ 522,957</u> | <u>\$ 1,011,423</u> | <u>\$ 301,378</u> | <u>\$ 102,482</u> | <u>\$ 1,938,240</u> |
| Ending balance: individually evaluated for impairment | 4,658 | 3,048 | 2,153 | 261 | 10,120 |
| Ending balance: collectively evaluated for impairment | <u>\$ 518,299</u> | <u>\$ 1,008,375</u> | <u>\$ 299,225</u> | <u>\$ 102,221</u> | <u>\$ 1,928,120</u> |

The allowance for loan losses increased \$1.3 million to \$22.7 million at December 31, 2019, from \$21.4 million at the end of 2018. The increase resulted from a provision for loan losses of \$6.1 million less net loans charged-off of \$4.8 million. The charge-offs for fiscal 2019 primarily occurred in the fourth quarter. We charged-off \$3.3 million of commercial loans in 2019 substantially all of which were in the fourth quarter. Included in this amount was \$2.3 million related to certain small business lines of credit in our Greater Delaware Valley market.

In March 2020, we identified certain issues with a group of small business lines of credit, all of which had been originated by one of our lenders. All of these lines of credit were subject to credit review at origination and were considered satisfactory at such time. As a number of these lines of credit entered our annual renewal process, we identified changes in the credit quality of the borrowers which warranted action. We commenced a full review of this lender's portfolio, as well as a review of other loans in our portfolio with similar characteristics. As a result of our review, we determined a number of the small business lines of credit originated by the particular lender to be impaired and collection doubtful at December 31, 2019. As such, we have charged-off \$2.3 million of these loans and established a specific reserve of \$0.3 million on one other line of credit retrospectively to December 31, 2019. All remaining small business commercial lines of credit for this lender were downgraded to special mention. We believe that all of the other loans in our portfolio with similar characteristics that were subject to our review were properly reflected in our allowance methodology at December 31, 2019.

| December 31, 2018 | Commercial | Real estate | | | Total |
|---|-------------------|--------------------|--------------------|-------------------|---------------------|
| | | Commercial | Residential | Consumer | |
| Allowance for loan losses: | | | | | |
| Beginning balance | \$ 5,513 | \$ 8,944 | \$ 3,111 | \$ 1,392 | \$ 18,960 |
| Charge-offs | (154) | (1,250) | (405) | (545) | (2,354) |
| Recoveries | 137 | 136 | 98 | 202 | 573 |
| Provisions | 20 | 2,906 | 1,088 | 186 | 4,200 |
| Ending balance | <u>\$ 5,516</u> | <u>\$ 10,736</u> | <u>\$ 3,892</u> | <u>\$ 1,235</u> | <u>\$ 21,379</u> |
| Ending balance: individually evaluated for impairment | 50 | 403 | 666 | 60 | 1,179 |
| Ending balance: collectively evaluated for impairment | <u>\$ 5,466</u> | <u>\$ 10,333</u> | <u>\$ 3,226</u> | <u>\$ 1,175</u> | <u>\$ 20,200</u> |
| Loans receivable: | | | | | |
| Ending balance | <u>\$ 494,134</u> | <u>\$ 907,803</u> | <u>\$ 299,876</u> | <u>\$ 121,453</u> | <u>\$ 1,823,266</u> |
| Ending balance: individually evaluated for impairment | 2,237 | 3,121 | 4,071 | 212 | 9,641 |
| Ending balance: collectively evaluated for impairment | <u>\$ 491,897</u> | <u>\$ 904,682</u> | <u>\$ 295,805</u> | <u>\$ 121,241</u> | <u>\$ 1,813,625</u> |

| December 31, 2017 | Commercial | Real estate | | Consumer | Total |
|---|-------------------|--------------------|--------------------|-------------------|---------------------|
| | | Commercial | Residential | | |
| Allowance for loan losses: | | | | | |
| Beginning balance | \$ 4,452 | \$ 7,548 | \$ 2,961 | \$ 1,000 | \$ 15,961 |
| Charge-offs | (173) | (706) | (533) | (737) | (2,149) |
| Recoveries | 20 | 124 | 44 | 160 | 348 |
| Provisions | 1,214 | 1,978 | 639 | 969 | 4,800 |
| Ending balance | <u>\$ 5,513</u> | <u>\$ 8,944</u> | <u>\$ 3,111</u> | <u>\$ 1,392</u> | <u>\$ 18,960</u> |
| Ending balance: individually evaluated for impairment | 159 | 263 | 336 | 8 | 766 |
| Ending balance: collectively evaluated for impairment | <u>\$ 5,354</u> | <u>\$ 8,681</u> | <u>\$ 2,775</u> | <u>\$ 1,384</u> | <u>\$ 18,194</u> |
| Loans receivable: | | | | | |
| Ending balance | <u>\$ 476,199</u> | <u>\$ 786,210</u> | <u>\$ 287,935</u> | <u>\$ 142,721</u> | <u>\$ 1,693,065</u> |
| Ending balance: individually evaluated for impairment | 2,463 | 4,289 | 3,793 | 177 | 10,722 |
| Ending balance: collectively evaluated for impairment | <u>\$ 473,736</u> | <u>\$ 781,921</u> | <u>\$ 284,142</u> | <u>\$ 142,544</u> | <u>\$ 1,682,343</u> |

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, 2019 and 2018:

| December 31, 2019 | Pass | Special Mention | Substandard | Doubtful | Total |
|--------------------------|---------------------|----------------------------|--------------------|-----------------|---------------------|
| | | | | | |
| Real estate: | | | | | |
| Commercial | 993,645 | 2,508 | 15,270 | | 1,011,423 |
| Residential | 298,449 | 597 | 2,332 | | 301,378 |
| Consumer | 102,145 | | 337 | | 102,482 |
| Total | <u>\$ 1,908,233</u> | <u>\$ 6,942</u> | <u>\$ 23,065</u> | <u>\$</u> | <u>\$ 1,938,240</u> |

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

The increase in commercial special mention loans was primarily due to the downgrade of approximately \$2.5 million of small business loans originated by a specific lender that exhibit potential weaknesses that could impact collectability. The increase in substandard commercial loans is due to two relationships that have encountered some financial difficulties, however, both are considered adequately collateralized at December 31, 2019. The decrease in special mention commercial real estate loans and the resulting increase in substandard loans was primarily associated with the downgrade of a \$5.1 million commercial real estate credit relationship that was subsequently paid in full during January 2020. The decline in outstanding substandard residential real estate loans was primarily due to the sale of \$1.1 million in non-performing residential real estate loans during the first quarter of 2019.

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

| | December 31, 2019 | December 31, 2018 |
|--------------|-------------------|-------------------|
| Commercial | \$ 3,336 | \$ 776 |
| Real estate: | | |
| Commercial | 2,765 | 2,663 |
| Residential | 1,148 | 2,580 |
| Consumer | 261 | 212 |
| Total | <u>\$ 7,510</u> | <u>\$ 6,231</u> |

The major classification of loans by past due status at December 31, 2019 and 2018 are summarized as follows:

| December 31, 2019 | 30-59 Days Past Due | 60-89 Days Past Due | Greater than 90 Days | Total Past Due | Current | Total Loans | Loans > 90 Days and Accruing |
|-------------------|------------------------|------------------------|----------------------------|-------------------|---------------------|---------------------|------------------------------------|
| Commercial | \$ 75 | | \$ 3,036 | \$ 3,111 | \$ 519,846 | \$ 522,957 | |
| Real estate: | | | | | | | |
| Commercial | 926 | \$ 175 | 2,765 | 3,866 | 1,007,557 | 1,011,423 | |
| Residential | 2,164 | 1,227 | 1,526 | 4,917 | 296,461 | 301,378 | \$ 378 |
| Consumer | 523 | 123 | 261 | 907 | 101,575 | 102,482 | |
| Total | <u>\$ 3,688</u> | <u>\$ 1,525</u> | <u>\$ 7,588</u> | <u>\$ 12,801</u> | <u>\$ 1,925,439</u> | <u>\$ 1,938,240</u> | <u>\$ 378</u> |

| December 31, 2018 | 30-59 Days Past Due | 60-89 Days Past Due | Greater than 90 Days | Total Past Due | Current | Total Loans | Loans > 90 Days and Accruing |
|-------------------|------------------------|------------------------|----------------------------|-------------------|---------------------|---------------------|------------------------------------|
| Commercial | \$ 973 | \$ 79 | \$ 776 | \$ 1,828 | \$ 492,306 | \$ 494,134 | |
| Real estate: | | | | | | | |
| Commercial | 1,889 | 218 | 2,736 | 4,843 | 902,960 | 907,803 | \$ 73 |
| Residential | 2,486 | 1,545 | 3,430 | 7,461 | 292,415 | 299,876 | 850 |
| Consumer | 756 | 292 | 212 | 1,260 | 120,193 | 121,453 | |
| Total | <u>\$ 6,104</u> | <u>\$ 2,134</u> | <u>\$ 7,154</u> | <u>\$ 15,392</u> | <u>\$ 1,807,874</u> | <u>\$ 1,823,266</u> | <u>\$ 923</u> |

The increase in loans greater than ninety days delinquent at December 31, 2019 when compared to December 31, 2018 is due primarily to one commercial relationship involving four separate credits totaling \$2.6 million which were placed on non-accrual during 2019. As of December 31, 2019, sufficient collateral supported the outstanding balances.

The following tables summarize information concerning impaired loans as of and for the years ended December 31, 2019, 2018 and 2017 by major loan classification:

| December 31, 2019 | Recorded Investment | Unpaid Principal Balance | Related Allowance | For the Year Ended | |
|-----------------------------|---------------------|--------------------------|-------------------|-----------------------------|----------------------------|
| | | | | Average Recorded Investment | Interest Income Recognized |
| With no related allowance: | | | | | |
| Commercial | \$ 3,638 | \$ 4,175 | | \$ 3,907 | \$ 63 |
| Real estate: | | | | | |
| Commercial | 1,918 | 2,205 | | 2,385 | 38 |
| Residential | 1,718 | 2,060 | | 1,362 | 25 |
| Consumer | 261 | 274 | | 233 | |
| Total | <u>7,535</u> | <u>8,714</u> | | <u>7,887</u> | <u>126</u> |
| With an allowance recorded: | | | | | |
| Commercial | 1,020 | 1,038 | 363 | 1,012 | 32 |
| Real estate: | | | | | |
| Commercial | 1,130 | 1,811 | 279 | 1,050 | 10 |
| Residential | 435 | 450 | 135 | 1,408 | 29 |
| Consumer | | | | 20 | |
| Total | <u>2,585</u> | <u>3,299</u> | <u>777</u> | <u>3,490</u> | <u>71</u> |
| Total impaired loans | | | | | |
| Commercial | 4,658 | 5,213 | 363 | 4,919 | 95 |
| Real estate: | | | | | |
| Commercial | 3,048 | 4,016 | 279 | 3,435 | 48 |
| Residential | 2,153 | 2,510 | 135 | 2,770 | 54 |
| Consumer | 261 | 274 | | 253 | |
| Total | <u>\$ 10,120</u> | <u>\$ 12,013</u> | <u>\$ 777</u> | <u>\$ 11,377</u> | <u>\$ 197</u> |

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

| 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 | <u>6,532</u> | <u>7,482</u> | | <u>7,053</u> | <u>88</u> |
| 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 | <u>4,190</u> | <u>4,481</u> | <u>766</u> | <u>4,548</u> | <u>91</u> |
| Total impaired loans | | | | | |
| Commercial | 2,463 | 2,657 | 159 | 2,659 | 93 |
| Real estate: | | | | | |
| Commercial | 4,289 | 4,686 | 263 | 5,187 | 42 |
| Residential | 3,793 | 4,431 | 336 | 3,562 | 44 |
| Consumer | 177 | 189 | 8 | 193 | |
| Total | <u>\$ 10,722</u> | <u>\$ 11,963</u> | <u>\$ 766</u> | <u>\$ 11,601</u> | <u>\$ 179</u> |

There were no amounts of interest income recognized using the cash-basis method on impaired loans for the years ended December 31, 2019, 2018 and 2017.

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 \$2,193 and \$2,779 at December 31, 2019 and 2018 respectively.

There was one loan modified in 2019, one loan modified in 2018 and six loans modified in 2017 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, 2019 and 2018 and 2017.

| <u>December 31, 2019</u> | <u>Number of Contracts</u> | <u>Pre-Modification Outstanding Recorded Investment</u> | <u>Post-Modification Outstanding Recorded Investment</u> | <u>Recorded Investment</u> |
|--------------------------|--------------------------------|---|--|--------------------------------|
| Commercial real estate | 1 | \$ 346 | \$ 346 | \$ 241 |

| <u>December 31, 2018</u> | <u>Number of Contracts</u> | <u>Pre-Modification Outstanding Recorded Investment</u> | <u>Post-Modification Outstanding Recorded Investment</u> | <u>Recorded Investment</u> |
|--------------------------|--------------------------------|---|--|--------------------------------|
| Commercial real estate | 1 | \$ 340 | \$ 340 | \$ 340 |

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

There were no payment defaults within 12 months of its modification on loans considered troubled debt restructurings for the years ended December 31, 2019, December 31, 2018 and December 31, 2017.

The amount of residential loans in the formal process of foreclosure totaled \$665 at December 31, 2019 and \$1,823 at December 31, 2018.

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. The allowance is not significant.

The contractual amounts of off-balance sheet commitments at December 31, 2019 and 2018 are summarized as follows:

| <u>December 31</u> | <u>2019</u> | <u>2018</u> |
|------------------------------------|-------------------|-------------------|
| Commitments to extend credit | \$ 290,517 | \$ 294,122 |
| Unused portions of lines of credit | 52,168 | 51,790 |
| Standby letters of credit | 45,018 | 33,275 |
| | <u>\$ 387,703</u> | <u>\$ 379,187</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 \$31,893 at December 31, 2019 and \$22,415 at December 31, 2018. The carrying value of the liability for the Company's obligations under guarantees for standby letters of credit was not material at December 31, 2019 and 2018.

6. Premises and equipment, net:

Premises and equipment at December 31, 2019 and 2018 are summarized as follows:

| December 31 | 2019 | 2018 |
|-------------------------------------|------------------|------------------|
| Land | \$ 5,535 | \$ 5,535 |
| Premises and leasehold improvements | 47,705 | 44,813 |
| Right-of-use assets | 6,125 | |
| Furniture, fixtures and equipment | 17,422 | 14,812 |
| | <u>76,787</u> | <u>65,160</u> |
| Less: accumulated depreciation | 28,855 | 26,271 |
| | <u>\$ 47,932</u> | <u>\$ 38,889</u> |

7. Operating lease commitments and contingencies:

The Company is obligated under non-cancelable operating leases for certain branch locations and its loan production office. We determine if an arrangement is a lease at inception by assessing whether a contract contains a right to control an identified asset for a period of time in exchange for consideration. For all leases, we recognize a right-of-use asset and lease liability at the effective date of the lease. Operating leases right-of-use assets are included in premises and equipment, and lease liabilities are included in other liabilities in the consolidated balance sheet commencing at January 1, 2019. We have no finance leases. Leases with an initial term of 12 months or less are not recorded on the balance sheet and the related lease expense is recognized on a straight-line basis over the lease term.

Certain leases include options to renew, with renewal terms generally containing one or more five-year renewal options. At December 31, 2019, the Company's leases have remaining renewal terms that can extend the lease term from three years to twenty-two years that are reasonably certain of being exercised. The weighted average remaining lease term is sixteen years. The discount rate used in determining the lease liability for each individual lease was the FHLB fixed advance rate which corresponded with the remaining lease term as of January 1, 2019 for leases that existed at adoption and as of the lease commencement date for leases subsequently entered into after January 1, 2019. At December 31, 2019, discount rates ranged from 2.89% to 3.85% with an-average discount rate of 3.46%.

At December 31, 2019, right-of-use assets of \$6,125 were included in premises and equipment, and the related lease liability totaled \$6,194 and was included in other liabilities in the consolidated balance sheet. The lease liability decreased due to payments of \$578 offset by \$249 of lease expense. Rent expense for the years ended December 31, 2019, 2018 and 2017 amounted to \$601, \$492, and \$407, respectively, and are included in occupancy expenses.

Future minimum lease payments under operating leases are summarized as follows:

| | |
|--|-----------------|
| 2020 | \$ 597 |
| 2021 | 585 |
| 2022 | 589 |
| 2023 | 508 |
| 2024 | 435 |
| Thereafter | 5,513 |
| Total future minimum lease payments | <u>8,227</u> |
| Less amount representing interest | <u>(2,033)</u> |
| Present value of future minimum lease payments | <u>\$ 6,194</u> |

8. Intangible assets, net:

The gross carrying amount of core deposit intangible assets totaled \$8,146 at December 31, 2019 and 2018. The gross carrying amount of trade name intangible assets totaled \$203 at December 31, 2019 and 2018. 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, 2019 and 2018. The accumulated amortization on core deposit intangible assets was \$7,071 and \$6,515 at December 31, 2019 and 2018, respectively. The accumulated amortization trade name intangible assets was \$168 and \$149 at December 31, 2019 and 2018, respectively. The accumulated amortization on the asset management and retirement plan services intangible asset was \$636 and \$480 at December 31, 2019 and 2018, respectively.

The estimated amortization expense on intangible assets in years subsequent to December 31, 2019, is as follows:

| | |
|-------|-----------------|
| 2020 | \$ 606 |
| 2021 | 491 |
| 2022 | 363 |
| 2023 | 105 |
| Total | <u>\$ 1,565</u> |

9. Other assets:

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

| | <u>December 31, 2019</u> | <u>December 31, 2018</u> |
|---|--------------------------|--------------------------|
| Other real estate owned | \$ 450 | \$ 376 |
| Investment in low income housing partnership | 6,901 | 7,377 |
| Mortgage servicing rights | 738 | 718 |
| Bank owned life insurance | 35,041 | 34,288 |
| Restricted equity securities (FHLB and other) | 10,201 | 7,462 |
| Net deferred tax asset | 3,362 | 5,081 |
| Interest rate floor | 944 | 553 |
| Interest rate swaps | 4,728 | 108 |
| Other assets | 6,855 | 7,774 |
| Total | <u>\$ 69,220</u> | <u>\$ 63,737</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 \$159,587 at December 31, 2019 and \$165,610 at December 31, 2018.

10. Deposits:

The major components of interest-bearing and noninterest-bearing deposits at December 31, 2019 and 2018 are summarized as follows:

| December 31 | 2019 | 2018 |
|-----------------------------------|---------------------|---------------------|
| Interest-bearing deposits: | | |
| Money market accounts | \$ 365,463 | \$ 328,949 |
| Now accounts | 402,999 | 421,414 |
| Savings accounts | 370,270 | 378,157 |
| Time deposits less than \$250 | 231,450 | 250,456 |
| Time deposits \$250 or more | 138,069 | 85,786 |
| Total interest-bearing deposits | 1,508,251 | 1,464,762 |
| Noninterest-bearing deposits | 463,238 | 410,260 |
| Total deposits | <u>\$ 1,971,489</u> | <u>\$ 1,875,022</u> |

The aggregate amounts of maturities for all time deposits at December 31, 2019, are summarized as follows:

| | |
|------------|-------------------|
| 2020 | \$ 264,824 |
| 2021 | 50,398 |
| 2022 | 13,775 |
| 2023 | 19,837 |
| 2024 | 13,997 |
| Thereafter | 6,688 |
| | <u>\$ 369,519</u> |

The aggregate amount of deposits reclassified as loans was \$363 at December 31, 2019, and \$343 at December 31, 2018. Management evaluates transaction accounts that are overdrawn for collectability as part of its evaluation for credit losses.

11. Short-term borrowings:

Short-term borrowings consisted of FHLB advances representing overnight borrowings or borrowings with original terms of less than twelve months at December 31, 2019, 2018 and 2017:

| | At and for the year ended December 31, 2019 | | | | |
|---------------|---|--------------------|---------------------------------|---|---|
| | Ending Balance | Average Balance | Maximum Month-End Balance | Weighted Average Rate for the Year | Weighted Average Rate at End of Year |
| FHLB advances | <u>\$ 152,150</u> | <u>\$ 62,941</u> | <u>\$ 152,150</u> | 2.61 % | 1.84 % |

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

| | 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 | <u>\$ 123,675</u> | <u>\$ 76,846</u> | <u>\$ 123,675</u> | 1.17 % | 1.54 % |

The Company has an agreement with the FHLB which allows for borrowings up to its maximum borrowing capacity based on a percentage of qualifying collateral assets. At December 31, 2019, the maximum borrowing capacity was \$723,608 of which \$184,883 was outstanding in borrowings and \$185,750 was used to issue standby letters of credit to collateralize public fund deposits. 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.

The Company also has unsecured line of credit agreements with two correspondent banks, where the total line amount was \$18,000 at December 31, 2019 and 2018. There were no amounts outstanding on either line of credit at December 31, 2019 or 2018. Interest on these borrowings accrues daily based on the daily federal funds rate.

12. Long-term debt:

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

| Due | Interest Rate | | December 31, 2019 | December 31, 2018 |
|---------------|---------------|------------|-------------------|-------------------|
| | Fixed | Adjustable | | |
| December 2019 | | 3.48 % | \$ | 3,000 |
| December 2019 | | 3.37 | | 6,300 |
| December 2019 | 1.62 % | | | 10,000 |
| June 2020 | 1.74 | | 5,000 | 5,000 |
| June 2020 | 2.22 | | 6,000 | |
| December 2020 | 1.84 | | 5,000 | 5,000 |
| June 2021 | 1.99 | | 10,000 | |
| March 2023 | 4.69 | | 6,733 | 8,606 |
| | | | \$ 32,733 | \$ 37,906 |

Maturities of long-term debt, by contractual maturity, in years subsequent to December 31, 2019 are as follows:

| | |
|------|------------------|
| 2020 | \$ 17,963 |
| 2021 | 12,058 |
| 2022 | 2,157 |
| 2023 | 555 |
| | <u>\$ 32,733</u> |

None of the advances from the FHLB are convertible. At December 31, 2019, long-term debt are all at fixed rates. There were two new long-term advances entered into with the FHLB during 2019 totaling \$16,000 with terms of one year and two years. There were no new advances entered into during 2018.

13. Fair value of financial instruments:

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

| December 31, 2019 | 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 | \$ 24,128 | \$ 24,128 | | \$ |
| U.S. government-sponsored enterprises | 87,110 | | \$ 87,110 | |
| State and municipals: | | | | |
| Taxable | 34,898 | | 34,898 | |
| Tax-exempt | 60,163 | | 60,163 | |
| Mortgage-backed securities: | | | | |
| U.S. government agencies | 8,470 | | 8,470 | |
| U.S. government-sponsored enterprises | 115,709 | | 115,709 | |
| Common equity securities | 423 | 423 | | |
| Interest rate floor-other assets | 944 | | 944 | |
| Interest rate swap-other assets | 4,728 | | 4,728 | |
| Interest rate swap-other liabilities | (4,680) | | (4,680) | |
| Total | <u>\$ 331,893</u> | <u>\$ 24,551</u> | <u>\$ 307,342</u> | <u>\$</u> |

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

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

| December 31, 2019 | 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 | \$ 1,808 | | | \$ 1,808 |
| Other real estate owned | \$ 283 | | | \$ 283 |

| | 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) |
| December 31, 2018 | | | | |
| Impaired loans | \$ 2,809 | | | \$ 2,809 |
| Other real estate owned | \$ 234 | | | \$ 234 |

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) |
| December 31, 2019 | | | | |
| Impaired loans | \$ 1,808 | Appraisal of collateral | Appraisal adjustments | 8.6% to 97.0% (54.4)% |
| | | | Liquidation expenses | 3.0% to 6.0% (5.2)% |
| Other real estate owned | \$ 283 | Appraisal of collateral | Appraisal adjustments | 20.0% to 63.6% (43.7)% |
| | | | Liquidation expenses | 3.0% to 6.0% (5.0)% |

| | Quantitative Information about Level 3 Fair Value Measurements | | | |
|--------------------------|--|-------------------------|-----------------------|--------------------------|
| | Fair Value Estimate | Valuation Techniques | Unobservable Input | Range (Weighted Average) |
| December 31, 2018 | | | | |
| Impaired loans | \$ 2,809 | Appraisal of collateral | Appraisal adjustments | 7.1% to 97.0% (61.8)% |
| | | | Liquidation expenses | 3.0% to 6.0% (4.4)% |
| Other real estate owned | \$ 234 | Appraisal of collateral | Appraisal adjustments | 26.0% to 73.3% (38.9)% |
| | | | Liquidation expenses | 3.0% to 6.0% (5.0)% |

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

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

The carrying and fair values of the Company's financial instruments at December 31, 2019 and 2018 and their placement within the fair value hierarchy are as follows:

| December 31, 2019 | Fair Value Hierarchy | | | | |
|---|----------------------|---------------------|--|---|---|
| | Carrying Value | Fair Value | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (level 2) | Significant Unobservable Inputs (Level 3) |
| Financial assets: | | | | | |
| Cash and cash equivalents | \$ 31,153 | \$ 31,153 | \$ 31,153 | | |
| Investment securities: | | | | | |
| Available-for-sale | 330,478 | 330,478 | 24,128 | \$ 306,350 | |
| Common equity securities | 423 | 423 | 423 | | |
| Held-to-maturity | 7,656 | 7,889 | | 7,889 | |
| Loans held for sale | 986 | 986 | | 986 | |
| Net loans | 1,915,563 | 1,881,658 | | | \$ 1,881,658 |
| Accrued interest receivable | 6,981 | 6,981 | | 6,981 | |
| Mortgage servicing rights | 738 | 1,444 | | 1,444 | |
| Restricted equity securities (FHLB and other) | 10,201 | 10,201 | | 10,201 | |
| Interest rate floor | 944 | 944 | | 944 | |
| Interest rate swaps | 4,728 | 4,728 | | 4,728 | |
| Total | <u>\$ 2,309,851</u> | <u>\$ 2,276,885</u> | | | |
| Financial liabilities: | | | | | |
| Deposits | \$ 1,971,489 | \$ 1,972,084 | | \$ 1,972,084 | |
| Long-term debt | 32,733 | 33,075 | | 33,075 | |
| Accrued interest payable | 1,277 | 1,277 | | 1,277 | |
| Interest rate swaps | 4,680 | 4,680 | | 4,680 | |
| Total | <u>\$ 2,010,179</u> | <u>\$ 2,011,116</u> | | | |

| December 31, 2018 | 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) |
| Financial assets: | | | | | |
| Cash and cash equivalents | \$ 32,616 | \$ 32,616 | \$ 32,616 | | |
| Investment securities: | | | | | |
| Available-for-sale | 269,682 | 269,682 | 25,952 | \$ 244,090 | |
| Common equity securities | 291 | 291 | 291 | | |
| Held-to-maturity | 8,361 | 8,380 | | 8,380 | |
| Loans held for sale | 749 | 749 | | 749 | |
| Net loans | 1,801,887 | 1,762,449 | | | \$ 1,762,449 |
| Accrued interest receivable | 7,115 | 7,115 | | 7,115 | |
| Mortgage servicing rights | 718 | 1,710 | | 1,710 | |
| Restricted equity securities (FHLB and other) | 7,462 | 7,462 | | 7,462 | |
| Interest rate floor | 553 | 553 | | 553 | |
| Interest rate swaps | 108 | 108 | | 108 | |
| Total | <u>\$ 2,129,542</u> | <u>\$ 2,091,115</u> | | | |
| Financial liabilities: | | | | | |
| Deposits | \$ 1,875,022 | \$ 1,874,520 | | \$ 1,874,520 | |
| Short-term borrowings | 86,500 | 86,500 | | 86,500 | |
| Long-term debt | 37,906 | 38,071 | | 38,071 | |
| Accrued interest payable | 1,195 | 1,195 | | 1,195 | |
| Interest rate swaps | 138 | 138 | | 138 | |
| Total | <u>\$ 2,000,761</u> | <u>\$ 2,000,424</u> | | | |

14. Derivatives and hedging activities:

Risk Management Objective of Using Derivatives

The Company is exposed to certain risk arising from both its business operations and economic conditions. The Company principally manages its exposures to a wide variety of business and operational risks through management of its core business activities. The Company manages economic risks, including interest rate, liquidity, and credit risk primarily by managing the amount, sources, and duration of its assets and liabilities and the use of derivative financial instruments. Specifically, the Company enters into derivative financial instruments to manage exposures that arise from business activities that result in the receipt or payment of future known and uncertain cash amounts, the value of which are determined by interest rates. The Company's derivative financial instruments are used to manage differences in the amount, timing, and duration of the Company's known or expected cash receipts principally related to the Company's assets.

Cash Flow Hedges of Interest Rate Risk

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

For derivatives designated and that qualify as cash flow hedges of interest rate risk, the gain or loss on the derivative is recorded in accumulated other comprehensive loss and subsequently reclassified into interest income in the same period(s)

during which the hedged transaction affects earnings. Gains and losses on the derivative representing hedge components excluded from the assessment of effectiveness are recognized over the life of the hedge on a systematic and rational basis. The earnings recognition of excluded components is presented in interest income. Amounts reported in accumulated other comprehensive loss related to derivatives will be reclassified to interest income as interest payments are received on the Company's variable-rate assets. During 2020, the Company estimates that an additional \$64 will be reclassified as a reduction to interest income.

Non-designated Hedges

Derivatives not designated as hedges are not speculative and result from a service the Company provides to certain customers, 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, 2019, the Company had 30 interest rate swaps with an aggregate notional amount of \$172,096 related to this program.

Fair Values of Derivative Instruments on the Balance Sheet

The table below presents the fair value of the Company's derivative financial instruments as well as their classification on the Consolidated Balance Sheets as of December 31, 2019 and December 31, 2018.

| | Notional Amount | Asset Derivatives As of December 31, 2019 | | Asset Derivatives As of December 31, 2018 (1) | | Liability Derivatives As of December 31, 2019 | | Liability Derivatives As of December 31, 2018 (2) | |
|--|--------------------|--|------------|--|------------|--|------------|--|------------|
| | | Balance Sheet Location | Fair Value | Balance Sheet Location | Fair Value | Balance Sheet Location | Fair Value | Balance Sheet Location | Fair Value |
| Derivatives designated as hedging instruments | | | | | | | | | |
| Interest Rate Floor | \$ 25,000 | Other Assets | \$ 944 | Other Assets | \$ 553 | | | | |
| Total derivatives designated as hedging instruments | | | \$ 944 | | \$ 553 | | | | |
| Derivatives not designated as hedging instruments | | | | | | | | | |
| Interest Rate Swaps | \$ 172,096 | Other Assets | \$ 4,728 | Other Assets | \$ 108 | Other Liabilities | \$ 4,680 | Other Liabilities | \$ 138 |
| Total derivatives not designated as hedging instruments | | | \$ 4,728 | | \$ 108 | | \$ 4,680 | | \$ 138 |

(1) Assets amount does not include accrued interest receivable of \$55

(2) Liabilities amount does not include accrued interest payable of \$55

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

The table below presents the effect of fair value and cash flow hedge accounting on accumulated other comprehensive loss as of December 31, 2019 and December 31, 2018.

| Derivatives in Hedging Relationships | Amount of | Amount of | Amount of | Location of | Amount of | Amount of | Amount of |
|--|--------------------------------------|---|---|---|--|---|---|
| | Loss Recognized in OCI on Derivative | Gain Recognized in OCI Included Component December 31, 2019 | Gain Recognized in OCI Excluded Component | Gain or (Loss) Recognized from Accumulated Other Comprehensive Income into Income | Loss Reclassified from Accumulated OCI into Income | Gain Reclassified from Accumulated OCI into Income Included Component December 31, 2019 | Loss Reclassified from Accumulated OCI into Income Excluded Component |
| Derivatives in Cash Flow Hedging Relationships | | | | | | | |
| Interest Rate Floor (*) | \$ 192 | \$ 196 | \$ (4) | Interest Income | \$ 26 | \$ 42 | \$ (16) |

| Derivatives in Hedging Relationships | Amount of | Amount of | Amount of | Location of | Amount of | Amount of | Amount of |
|--|--------------------------------------|---|---|---|--|---|---|
| | Loss Recognized in OCI on Derivative | Gain Recognized in OCI Included Component December 31, 2018 | Gain Recognized in OCI Excluded Component | Gain or (Loss) Recognized from Accumulated Other Comprehensive Income into Income | Loss Reclassified from Accumulated OCI into Income | Gain Reclassified from Accumulated OCI into Income Included Component December 31, 2018 | Loss Reclassified from Accumulated OCI into Income Excluded Component |
| Derivatives in Cash Flow Hedging Relationships | | | | | | | |
| Interest Rate Floor (*) | \$ 243 | \$ 109 | \$ 134 | Interest Income | \$ (3) | \$ 13 | \$ (16) |

* Amounts disclosed are gross and not net of taxes.

Effect of Fair Value and Cash Flow Hedge Accounting on the Income Statement

The table below presents the effect of the Company's derivative financial instruments on the consolidated statements of income and comprehensive income as of December 31, 2019 and December 31, 2018.

| | Location and Amount of Gain or (Loss) Recognized in Income on Fair Value and Cash Flow Hedging Relationships | |
|---|--|----------------------|
| | 2019 Interest Income | 2018 Interest Income |
| Total amounts of income and expense line items presented in the statements of income and comprehensive income in which the effects of fair value or cash flow hedges are recorded | \$ 26 | \$ (3) |
| The effects of fair value and cash flow hedging: | | |
| Gain or (loss) on cash flow hedging relationships | | |
| Interest contracts | | |
| Amount of gain or (loss) reclassified from accumulated other comprehensive income into income | \$ 26 | \$ (3) |
| Amount of gain or (loss) reclassified from accumulated other comprehensive income into income - included component | 42 | 13 |
| Amount of gain or (loss) reclassified from accumulated other comprehensive income into income - excluded component | \$ (16) | \$ (16) |

Effect of Other Derivative Instruments on the Income Statement

The tables below present the effect of the Company's other derivative financial instruments on the consolidated statements of income and comprehensive income for the years ended December 31, 2019 and 2018.

| <u>Derivatives Not Designated as Hedging Instruments</u> | <u>Location of Gain or (Loss) Recognized in Income on Derivative</u> | <u>Amount of Loss Recognized in Income</u> | <u>Amount of Loss Recognized in Income</u> |
|--|--|--|--|
| | | <u>Twelve Months Ended December 31, 2019</u> | <u>Twelve Months Ended December 31, 2018</u> |
| Interest Rate Swaps | Other non-interest income | \$ 36 | \$ 49 |
| Fee Income | Other income / (expense) | \$ 36 | \$ 53 |

Offsetting Derivatives

The table below presents a gross presentation, the effects of offsetting, and a net presentation of the Company's derivatives as of December 31, 2019 and December 31, 2018. The net amounts of derivative assets or liabilities can be reconciled to the tabular disclosure of fair value. The tabular disclosure of fair value provides the location that derivative assets and liabilities are presented on the consolidated balance sheets.

Offsetting of Derivative Assets as of December 31, 2019

| | <u>Gross Amounts of Recognized Assets</u> | <u>Gross Amounts Offset in the Balance Sheet</u> | <u>Net Amounts of Assets presented in the Balance Sheet</u> | <u>Gross Amounts Not Offset in the Balance Sheet</u> | | |
|-------------|---|--|---|--|---------------------------------|-------------------|
| | | | | <u>Financial Instruments</u> | <u>Cash Collateral Received</u> | <u>Net Amount</u> |
| Derivatives | \$ 5,672 | \$ | \$ 5,672 | \$ | \$ | \$ 5,672 |

Offsetting of Derivative Liabilities as of December 31, 2019

| | <u>Gross Amounts of Recognized Assets</u> | <u>Gross Amounts Offset in the Balance Sheet</u> | <u>Net Amounts of Assets presented in the Balance Sheet</u> | <u>Gross Amounts Not Offset in the Balance Sheet</u> | | |
|-------------|---|--|---|--|---------------------------------|-------------------|
| | | | | <u>Financial Instruments</u> | <u>Cash Collateral Received</u> | <u>Net Amount</u> |
| Derivatives | \$ 4,680 | \$ | \$ 4,680 | \$ | \$ | \$ 4,680 |

Offsetting of Derivative Assets as of December 31, 2018

| | <u>Gross Amounts of Recognized Assets</u> | <u>Gross Amounts Offset in the Balance Sheet</u> | <u>Net Amounts of Assets presented in the Balance Sheet</u> | <u>Gross Amounts Not Offset in the Balance Sheet</u> | | |
|-------------|---|--|---|--|---------------------------------|-------------------|
| | | | | <u>Financial Instruments</u> | <u>Cash Collateral Received</u> | <u>Net Amount</u> |
| Derivatives | \$ 661 | \$ | \$ 661 | \$ | \$ | \$ 661 |

Offsetting of Derivative Liabilities as of December 31, 2018

| | <u>Gross Amounts of Recognized Assets</u> | <u>Gross Amounts Offset in the Balance Sheet</u> | <u>Net Amounts of Assets presented in the Balance Sheet</u> | <u>Gross Amounts Not Offset in the Balance Sheet</u> | | |
|-------------|---|--|---|--|---------------------------------|-------------------|
| | | | | <u>Financial Instruments</u> | <u>Cash Collateral Received</u> | <u>Net Amount</u> |
| Derivatives | \$ 138 | \$ | \$ 138 | \$ | \$ | \$ 138 |

Credit-risk-related Contingent Features

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

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

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

As of December 31, 2019 the termination value of derivatives in a net asset position, which includes accrued interest but excludes any adjustment for nonperformance risk, related to these agreements was \$48. The Company has minimum collateral posting thresholds with certain of its derivative counterparties under these agreements. The Company was in compliance with the terms of the above noted agreements at December 31, 2019.

15. Stock plans:

The 2008 long-term incentive plan ("2008 Plan") allowed for eligible participants to be granted equity awards. No awards may be made under the 2008 Plan after January 15, 2018.

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

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

Persons eligible to receive awards under the 2008 Plan and 2017 Plan include directors, officers, employees, consultants and other service providers of the Company and its subsidiaries.

As of December 31, 2019, 72,535 shares of the Company's common stock were available for grant as awards pursuant to the 2017 Plan. The 2008 Plan expired in January 2018 but will remain in effect in accordance with its terms to govern outstanding awards under that plan. If any outstanding awards under the 2017 Plan are forfeited by the holder or canceled by the Company, the underlying shares would be available for regrant to others.

The 2017 Plan authorizes grants of stock options, stock appreciation rights, cash awards, performance awards, restricted stock and restricted stock units. In 2019, the Company awarded 3,855 shares of non-performance-based restricted stock and 13,490 performance-based restricted stock units under the 2017 Plan. In 2018, the Company awarded 2,548 shares of non-performance-based restricted stock and 8,920 performance-based restricted stock units under the 2017 Plan. In 2017, 2,140 shares of non-performance-based restricted stock and 928 shares of performance-based shares granted under the 2017 Plan vested along with 673 shares of non-performance-based restricted stock and 6,379 of performance-based

shares granted under the 2008 Plan. There were 306 shares forfeited under the provisions of the 2017 Plan and 763 shares forfeited under the provisions of the 2008 plan. In 2018, 114 shares of non-performance-based restricted stock granted under the 2017 Plan vested along with 2,493 shares of non-performance-based restricted stock granted under the 2008 Plan.

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

The activity related to restricted stock for each of the years ended December 31, 2019, 2018 and 2017 was as follows:

| Year Ended December 31 | 2019 | 2018 | 2017 |
|-------------------------------|---------------|---------------|---------------|
| Nonvested, January 1 | 21,309 | 12,448 | 12,362 |
| Granted shares | 17,345 | 11,468 | 10,628 |
| Vested shares | 10,120 | 2,607 | 10,542 |
| Forfeited shares | 1,069 | | |
| Nonvested, December 31 | <u>27,465</u> | <u>21,309</u> | <u>12,448</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. Compensation is recognized over the vesting period and adjusted based on 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.

In 2019, the Company recognized \$433 for awards granted under the 2017 Plan and \$122 for awards granted under the 2008 plan. In 2018, the Company recognized \$149 for awards granted under the 2017 Plan and \$123 for awards granted under the 2008 plan. In 2017, the Company recognized \$21 for awards granted under the 2017 Plan and \$156 for awards granted under the 2008 Plan. As of December 31, 2019, the Company had \$486 of unrecognized compensation expense associated with restricted stock awards. The remaining cost is expected to be recognized over a weighted average vesting period of 1.8 years.

16. Employee benefit plans:

The Company sponsors a separate ESOP and Retirement Profit Sharing 401(k) Plan. The Company also maintains SERPs 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 participant is credited with an amount 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 participant was credited with an amount in proportion to their annual compensation. Upon retirement, death or termination, each participant 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 participants may elect deferrals of up to the maximum amounts permitted by law.

The Company contributed \$357, \$197 and \$185 to the ESOP in 2019, 2018 and 2017. In addition, the Company contribution of \$1,047, \$1,047 and \$923 to the Retirement Profit Sharing Plan in 2019, 2018 and 2017, was comprised of a safe harbor contribution of \$627, \$578 and \$509 and a discretionary match of \$512, \$469 and \$414.

The Company established a SERP Plan to replace certain 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 \$133 and \$116 at December 31, 2019 and 2018, respectively. The expense associated with the plan was \$17, \$20 and \$20 for 2019, 2018 and 2017 respectively.

The Company has SERPs for the benefit of certain officers. At December 31, 2019 and 2018, other liabilities include \$2,077 and \$1,845 accrued under the Plans. Compensation expense includes approximately \$360, \$335 and \$314 relating to these SERPs for the years ended December 31, 2019, 2018 and 2017, 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 the Company.

Information related to the Employees' Pension Plan is as follows:

| December 31 | Pension Benefits | |
|---|------------------|------------|
| | 2019 | 2018 |
| Change in benefit obligation: | | |
| Benefit obligation, beginning | \$ 16,338 | \$ 16,935 |
| Interest cost | 639 | 623 |
| Change in experience gain | 96 | 135 |
| Change in actuarial assumptions loss (gain) | 1,221 | (546) |
| Benefits paid | (803) | (809) |
| Benefit obligation, ending | 17,491 | 16,338 |
| Change in plan assets: | | |
| Fair value of plan assets, beginning | 14,919 | 13,264 |
| Actual return on plan assets | 2,814 | (236) |
| Employer contributions | | 2,700 |
| Benefits paid | (803) | (809) |
| Fair value of plan assets, ending | 16,930 | 14,919 |
| Funded status at end of year | \$ (561) | \$ (1,419) |

The Society of Actuaries released new mortality tables in 2019 and 2018 which the Company utilized in its pension plan remeasurements at December 31, 2019 and 2018. The change in mortality assumption, coupled with changes in the discount rate, resulted in an increase to the benefit obligation of \$1,221 in 2019 and a decrease of \$546 in 2018.

Amounts recognized in the consolidated balance sheets are as follows:

| December 31 | Pension Benefits | |
|--|------------------|------------|
| | 2019 | 2018 |
| Liabilities | \$ 561 | \$ 1,419 |
| Amounts recognized in the accumulated other comprehensive loss consist of: | | |
| Net actuarial gain | (6,579) | (7,218) |
| Deferred taxes | 1,382 | 1,516 |
| Net amount recognized | \$ (5,197) | \$ (5,702) |

The accumulated benefit obligation for the defined benefit pension plan was \$17,491 and \$16,338 at December 31, 2019 and 2018, respectively.

Components of net periodic pension income and other amounts recognized in other comprehensive loss are as follows:

| Years Ended December 31, | Pension Benefits | | |
|---|------------------|----------|--------|
| | 2019 | 2018 | 2017 |
| Net periodic pension income: | | | |
| Interest cost | \$ 639 | \$ 623 | \$ 650 |
| Expected return on plan assets | (1,084) | (960) | (915) |
| Amortization of unrecognized net loss | 227 | 194 | 195 |
| Net periodic pension income: | (218) | (143) | (70) |
| Other changes in plan assets and benefit obligations recognized in other comprehensive income (loss): | | | |
| Net loss (gain) | 639 | (590) | 318 |
| Deferred tax | (134) | 124 | (67) |
| Total recognized in other comprehensive loss | 505 | (466) | 251 |
| Total recognized in net period pension cost and other comprehensive loss | \$ 287 | \$ (609) | \$ 181 |

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 \$201.

Weighted-average assumptions used to determine benefit obligations and related expenses were as follows:

| December 31, | Pension Benefits | | |
|--|------------------|--------|--------|
| | 2019 | 2018 | 2017 |
| Discount rate: | | | |
| Obligation | 3.25 % | 4.00 % | 3.75 % |
| Expense | 4.00 | 3.75 | 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, 2019 and 2018, by asset category are as follows:

| December 31, | 2019 | 2018 |
|----------------------------|---------|---------|
| Asset Category: | | |
| Cash and cash equivalents | 6.2 % | 5.0 % |
| Equity securities | 61.9 | 56.2 |
| Corporate bonds | 20.6 | 23.6 |
| U.S. government securities | 11.3 | 15.2 |
| | 100.0 % | 100.0 % |

Fair value measurement of pension plan assets at December 31, 2019 and 2018 is as follows:

| December 31, 2019 | Total | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Observable Inputs (Level 2) | Significant Observable Inputs (Level 3) |
|--------------------------|------------------|---|--|--|
| Cash | \$ 1,053 | \$ 1,053 | | \$ |
| Equity securities: | | | | |
| U.S. large cap | 9,663 | 9,663 | | |
| International | 817 | 817 | | |
| Fixed income securities: | | | | |
| U.S. Treasuries | 202 | | \$ 202 | |
| U.S. government agencies | 1,713 | | 1,713 | |
| Corporate bonds | 3,482 | | 3,482 | |
| Total | <u>\$ 16,930</u> | <u>\$ 11,533</u> | <u>\$ 5,397</u> | <u>\$</u> |

| December 31, 2018 | Total | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Observable Inputs (Level 2) | Significant Observable Inputs (Level 3) |
|--------------------------|------------------|---|--|--|
| Cash | \$ 743 | \$ 743 | | \$ |
| Equity securities: | | | | |
| U.S. large cap | 7,687 | 7,687 | | |
| International | 694 | 694 | | |
| Fixed income securities: | | | | |
| U.S. Treasuries | 192 | | \$ 192 | |
| U.S. government agencies | 2,085 | | 2,085 | |
| Corporate bonds | 3,518 | | 3,518 | |
| Total | <u>\$ 14,919</u> | <u>\$ 9,124</u> | <u>\$ 5,795</u> | <u>\$</u> |

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, 2019 or 2018. The Company has not determined the amount of the expected contribution to the Employees' Pension Plan for 2020.

The following benefit payments are expected to be paid in the next five years and in the aggregate for the five years thereafter:

| | Pension Benefits |
|------------|-------------------------|
| 2020 | \$ 867 |
| 2021 | 867 |
| 2022 | 904 |
| 2023 | 919 |
| 2024 | 969 |
| Thereafter | 5,071 |

17. Income taxes:

The current and deferred amounts of the provision for income taxes expense (benefit) for each of the years ended December 31, 2019, 2018 and 2017 are summarized as follows:

| Year Ended December 31 | 2019 | 2018 | 2017 |
|------------------------|----------|----------|----------|
| Current | \$ 2,761 | \$ 4,072 | \$ 6,515 |
| Deferred | 394 | (681) | 1,665 |
| Total | \$ 3,155 | \$ 3,391 | \$ 8,180 |

The components of the net deferred tax asset at December 31, 2019 and 2018 are summarized as follows:

| December 31 | 2019 | 2018 |
|--|----------|----------|
| Deferred tax assets: | | |
| Allowance for loan losses | \$ 4,762 | \$ 4,490 |
| Lease liability | 1,301 | |
| Defined benefit plan | 815 | 1,516 |
| Deferred compensation | 682 | 593 |
| Deferred loan fees | 525 | 470 |
| Investment securities available-for-sale | | 683 |
| Other | 137 | 116 |
| Total | 8,222 | 7,868 |
| Deferred tax liabilities: | | |
| Lease right-of-use assets | 1,286 | |
| Premises and equipment, net | 1,350 | 985 |
| Merger related accounting | 850 | 1,083 |
| Deferred loan costs | 716 | 626 |
| Investment securities available-for-sale | 416 | |
| Other | 242 | 93 |
| Total | 4,860 | 2,787 |
| Net deferred tax asset | \$ 3,362 | \$ 5,081 |

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 21.0 percent for the years ended December 31, 2019 and December 31, 2018 and 35.0 percent for December 31, 2017 is summarized as follows:

| Year Ended December 31 | 2019 | | 2018 | | 2017 | |
|--|----------|---------|----------|---------|----------|---------|
| | Amount | % | Amount | % | Amount | % |
| Federal income tax at statutory rate | \$ 6,067 | 21.00 % | \$ 5,945 | 21.00 % | \$ 9,323 | 35.00 % |
| Effect of federal income tax rate changes (Note 1) | | | | | 2,623 | 9.85 |
| Tax exempt interest | (1,299) | (4.50) | (1,320) | (4.66) | (2,157) | (8.10) |
| Bank owned life insurance income | (159) | (0.55) | (236) | (0.83) | (269) | (1.01) |
| Residential housing program tax credits | (1,094) | (3.79) | (1,094) | (3.87) | (1,095) | (4.11) |
| Other, net | (360) | (1.25) | 96 | 0.34 | (245) | (0.92) |
| Total | \$ 3,155 | 10.91 % | \$ 3,391 | 11.98 % | \$ 8,180 | 30.71 % |

18. Parent Company financial statements:

CONDENSED BALANCE SHEETS

| December 31 | 2019 | 2018 |
|--|-------------------|-------------------|
| Assets: | | |
| Cash and cash equivalents | \$ 5,192 | \$ 3,736 |
| Equity securities | 423 | 291 |
| Investment in bank subsidiary | 293,415 | 272,617 |
| Due from subsidiaries | | 1,974 |
| Other assets | 19 | 35 |
| Total assets | <u>\$ 299,049</u> | <u>\$ 278,653</u> |
| Liabilities and Stockholders' Equity: | | |
| Other liabilities | \$ 39 | \$ 39 |
| Stockholders' equity | 299,010 | 278,614 |
| Total liabilities and stockholders' equity | <u>\$ 299,049</u> | <u>\$ 278,653</u> |

CONDENSED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME

| Year Ended December 31 | 2019 | 2018 | 2017 |
|--|------------------|------------------|------------------|
| Income: | | | |
| Dividends from subsidiaries | \$ 10,131 | \$ 9,691 | \$ 9,319 |
| Other income | 8 | 72 | 52 |
| Unrealized holding gains on equity securities | 132 | 13 | |
| Total income | <u>10,271</u> | <u>9,776</u> | <u>9,371</u> |
| Expense: | | | |
| Other expenses | 145 | 214 | 205 |
| Total expenses | <u>145</u> | <u>214</u> | <u>205</u> |
| Income before taxes and undistributed income | 10,126 | 9,562 | 9,166 |
| Income tax benefit | (1) | (27) | (54) |
| Income before undistributed income of subsidiaries | 10,127 | 9,589 | 9,220 |
| Equity in undistributed net income of subsidiaries | 15,609 | 15,331 | 9,237 |
| Net income | <u>\$ 25,736</u> | <u>\$ 24,920</u> | <u>\$ 18,457</u> |
| Comprehensive Income | <u>\$ 30,607</u> | <u>\$ 23,523</u> | <u>\$ 17,500</u> |

CONDENSED STATEMENTS OF CASH FLOWS

| Year Ended December 31 | 2019 | 2018 | 2017 |
|---|-----------|-----------|-----------|
| Cash flows from operating activities: | | | |
| Net income | \$ 25,736 | \$ 24,920 | \$ 18,457 |
| Adjustments: | | | |
| Net gains on investment securities | (132) | (14) | |
| Undistributed net income of subsidiaries | (15,609) | (15,331) | (9,237) |
| Decrease in other assets | (310) | (111) | (3) |
| Decrease in other liabilities | | (10) | (53) |
| Stock based compensation | 554 | 272 | 177 |
| Increase in due from subsidiaries | 1,974 | | |
| Net cash provided by operating activities | 12,213 | 9,726 | 9,341 |
| Cash flows from investing activities: | | | |
| Purchase of equity securities | | (234) | (43) |
| Cash flows used in financing activities: | | | |
| Stock awards | 8 | 5 | 5 |
| Purchase of treasury stock | (634) | | |
| Cash dividends paid | (10,131) | (9,693) | (9,319) |
| Net cash used in financing activities | (10,757) | (9,688) | (9,314) |
| Increase (decrease) in cash | 1,456 | (196) | (16) |
| Cash at beginning of year | 3,736 | 3,932 | 3,948 |
| Cash at end of year | \$ 5,192 | \$ 3,736 | \$ 3,932 |

19. 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, or 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, 2019 and 2018 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 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, 2019, the maximum amount available for transfer from Peoples Bank to the Company in the form of loans amounted to \$25,530. At December 31, 2019 and 2018, there were no loans outstanding, nor were any advances made during 2019 and 2018.

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.

Risk-based capital rules require 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 was 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, 2019. 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, 2019 and 2018, 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, 2019 | 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 | \$ 237,280 | 11.90 % | \$ 89,717 | 4.50 % | | |
| Peoples Bank | 231,685 | 11.64 | 89,576 | 4.50 | \$ 129,387 | 6.50 % |
| Tier 1 capital to risk-weighted assets: | | | | | | |
| Consolidated | 237,280 | 11.90 | 119,623 | 6.00 | | |
| Peoples Bank | 231,685 | 11.64 | 119,434 | 6.00 | 159,246 | 8.00 |
| Total capital to risk-weighted assets: | | | | | | |
| Consolidated | 259,957 | 13.04 | 159,497 | 8.00 | | |
| Peoples Bank | 254,362 | 12.78 | 159,246 | 8.00 | 199,057 | 10.00 |
| Tier 1 capital to average assets: | | | | | | |
| Consolidated | 237,280 | 10.14 | 93,633 | 4.00 | | |
| Peoples Bank | 231,685 | 9.91 % | 93,508 | 4.00 % | 116,884 | 5.00 % |

| December 31, 2018 | 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 | \$ 221,024 | 11.95 % | \$ 83,241 | 4.50 % | | |
| Peoples Bank | 215,027 | 11.64 | 83,144 | 4.50 | \$ 120,097 | 6.50 % |
| Tier 1 capital to risk-weighted assets: | | | | | | |
| Consolidated | 221,024 | 11.95 | 110,988 | 6.00 | | |
| Peoples Bank | 215,027 | 11.64 | 110,859 | 6.00 | 147,811 | 8.00 |
| Total capital to risk-weighted assets: | | | | | | |
| Consolidated | 242,403 | 13.10 | 147,984 | 8.00 | | |
| Peoples Bank | 236,406 | 12.80 | 147,811 | 8.00 | 184,764 | 10.00 |
| Tier 1 capital to average assets: | | | | | | |
| Consolidated | 221,024 | 10.03 | 88,119 | 4.00 | | |
| Peoples Bank | 215,027 | 9.78 % | 87,969 | 4.00 % | 109,962 | 5.00 % |

20. 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.

21. Accumulated Other Comprehensive Loss:

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

| | December 31, 2019 | December 31, 2018 |
|--|-------------------|-------------------|
| Net unrealized gain (loss) on investment securities available-for-sale | \$ 1,835 | \$ (3,251) |
| Income tax | 385 | (683) |
| Net of income taxes | 1,450 | (2,568) |
| Benefit plan adjustments | (6,579) | (7,218) |
| Income tax | (1,382) | (1,516) |
| Net of income taxes | (5,197) | (5,702) |
| Derivative adjustments | 687 | 246 |
| Income tax | 144 | 52 |
| Net of income taxes | 543 | 194 |
| Accumulated other comprehensive loss | <u>\$ (3,205)</u> | <u>\$ (8,076)</u> |

Other comprehensive loss and related tax effects for the years ended December 31, 2019, 2018 and 2017 are as follows:

| Year Ended December 31, | 2019 | 2018 | 2017 |
|--|-----------------|-------------------|-----------------|
| Unrealized loss on investment securities available-for-sale | \$ 5,109 | \$ (2,014) | \$ (1,790) |
| Net gain on the sale of investment securities available-for-sale | (23) | | |
| Benefit plans: | | | |
| Amortization of actuarial loss (2) | 227 | 194 | 195 |
| Actuarial gain (loss) | 412 | (785) | 123 |
| Net change in benefit plan liabilities | 639 | (591) | 318 |
| Net change in derivatives | 441 | 246 | |
| Other comprehensive loss before taxes | 6,166 | (2,359) | (1,472) |
| Income tax | 1,295 | (496) | (515) |
| Other comprehensive loss | <u>\$ 4,871</u> | <u>\$ (1,863)</u> | <u>\$ (957)</u> |

-
- (1) Represents amounts reclassified out of accumulated comprehensive loss and included in gains on sale of investment securities on the consolidated statements of income and comprehensive income.
 - (2) Represents amounts reclassified out of accumulated comprehensive loss and included in the computation of net periodic pension expense. Refer to Note 16 included in these consolidated financial statements.

22. Summary of quarterly financial information (unaudited):

| Quarter Ended | 2019 | | | |
|---|-----------|-----------|-----------|-----------|
| | March 31 | June 30 | Sept. 30 | Dec. 31 |
| Interest income | \$ 22,801 | \$ 23,332 | \$ 23,632 | \$ 23,616 |
| Interest expense | 4,504 | 4,604 | 4,396 | 4,364 |
| Net interest income | 18,297 | 18,728 | 19,236 | 19,252 |
| Provision for loan losses | 1,050 | 350 | 700 | 4,000 |
| Net interest income after provision for loan losses | 17,247 | 18,378 | 18,536 | 15,252 |
| Noninterest income | 3,416 | 4,152 | 3,682 | 3,870 |
| Noninterest expense | 13,490 | 14,429 | 14,079 | 13,644 |
| Income before income taxes | 7,173 | 8,101 | 8,139 | 5,478 |
| Income tax expense | 761 | 957 | 991 | 446 |
| Net income | \$ 6,412 | \$ 7,144 | \$ 7,148 | \$ 5,032 |
| Per share data: | | | | |
| Net income | \$ 0.87 | \$ 0.96 | \$ 0.97 | \$ 0.68 |
| Cash dividends declared | \$ 0.34 | \$ 0.34 | \$ 0.34 | \$ 0.35 |
| Average common shares outstanding | 7,399,054 | 7,399,302 | 7,394,992 | 7,388,488 |

| Quarter Ended | 2018 | | | |
|---|-----------|-----------|-----------|-----------|
| | March 31 | June 30 | Sept. 30 | Dec. 31 |
| Interest income | \$ 19,994 | \$ 20,766 | \$ 21,419 | \$ 22,482 |
| Interest expense | 2,807 | 3,115 | 3,466 | 3,934 |
| Net interest income | 17,187 | 17,651 | 17,953 | 18,548 |
| Provision for loan losses | 1,050 | 1,050 | 1,050 | 1,050 |
| Net interest income after provision for loan losses | 16,137 | 16,601 | 16,903 | 17,498 |
| Noninterest income | 3,572 | 3,663 | 3,253 | 3,171 |
| Noninterest expense | 13,081 | 13,496 | 12,537 | 13,373 |
| Income before income taxes | 6,628 | 6,768 | 7,619 | 7,296 |
| Income tax expense | 774 | 811 | 902 | 904 |
| Net income | \$ 5,854 | \$ 5,957 | \$ 6,717 | \$ 6,392 |
| Per share data: | | | | |
| Net income | \$ 0.79 | \$ 0.81 | \$ 0.91 | \$ 0.86 |
| Cash dividends declared | \$ 0.32 | \$ 0.33 | \$ 0.33 | \$ 0.33 |
| Average common shares outstanding | 7,396,505 | 7,396,533 | 7,399,054 | 7,399,054 |

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, 2019, the end of the period covered by this Annual Report on Form 10-K, the Chief Executive Officer (“CEO”) and Chief Financial Officer (“CFO”) evaluated the effectiveness of the Company’s disclosure controls and procedures as defined in Rule 13a-15(e) under the Exchange Act. Based upon that evaluation, the CEO and CFO concluded that the disclosure controls and procedures, at December 31, 2019, were effective to provide reasonable assurance that information required to be disclosed in the Company’s reports filed under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC’s rules and forms, and to provide reasonable assurance that information required to be disclosed in such reports is accumulated and communicated to the CEO and CFO to allow timely decisions regarding required disclosure.

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, 2019 and 2018, 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, 2019, 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 CFO, is responsible for establishing and maintaining adequate internal control over financial reporting for the Company. Our management, including our CEO and CFO, assessed the effectiveness of our internal controls over financial reporting as of December 31, 2019 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, 2019.

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, 2019 has issued an audit report on the Company's internal control over financial reporting as of December 31, 2019. 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
Executive Vice President and Chief Financial Officer
(Principal Financial Officer and
Principal Accounting Officer)

March 16, 2020

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, 2019, 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 2020 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 2020 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 2020 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 2020 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 2020 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 annual report of Pensco Financial Services Corp. 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 the current report of Pensco Financial Services Corp. 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 the current report of Pensco Financial Services Corp. 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)* |

| Exhibit No. | Description of Exhibit |
|--------------------|---|
| 10.12 | Second Amendment to Amended and Restated Deferred Compensation Plan #2, dated January 30, 2020, by and between Peoples Security Bank and Trust and Craig Best (incorporated by reference to Exhibit 10.01 to the registrant's Form 8-K filed with the Commission on January 31, 2020)* |
| 10.13 | Penn Security Bank & Trust Company Excess Benefit Plan, amended and restated December 31, 2008 (incorporated by reference to Exhibit 10.9 to the annual report of Pensco Financial Services Corp. on Form 10-K filed with the SEC on March 14, 2011)* |
| 10.14 | 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)* |
| 10.15 | 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)* |
| 10.16 | 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)* |
| 10.17 | 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)* |
| 10.18 | 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)* |
| 10.19 | 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)* |
| 10.20 | 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)* |
| 10.21 | Employment Agreement, dated as of August 27, 2014, by and between Peoples Bank and Neal D. Koplin (incorporated by reference to Exhibit 10.32 to the registrant's Form 10-K filed with the Commission on March 16, 2015)* |
| 10.22 | 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. Koplin (incorporated by reference to Exhibit 10.1 to registrant's current report on Form 8-K filed with the Commission on April 25, 2017.)* |
| 10.23 | 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 | Consulting and Confidentiality Agreement dated August 29, 2019 between Peoples Security Bank and Trust Company and Michael L. Jake (incorporated by reference to Exhibit 10.1 to the registrant's Form 10-Q filed with the Commission on November 7, 2019)* |
| 10.28 | 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)* |

| Exhibit No. | Description of Exhibit |
|--------------------|--|
| 10.29 | First Amendment to Employment Agreement dated as of December 5, 2017, by and between Peoples Security Bank and Trust Company and Timothy H. Kirtley(incorporated by reference to Exhibit 10.28 to the registrant's annual report on Form 10-K filed with the Commission on March 14, 2018* |
| 21.1 | List of Subsidiaries |
| 23.1 | Consent of Baker Tilly Virchow Krause, 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
Executive Vice President and Chief Financial Officer
(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 attorney-in-fact, with the full power of substitution, for him 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 16, 2020 |
| <u>/s/ Craig W. Best</u> Craig W. Best | Director, President and Chief Executive Officer (Principal Executive Officer) | March 16, 2020 |
| <u>/s/ John R. Anderson III</u> John R. Anderson III | Executive Vice President and Chief Financial Officer (Principal Financial Officer and Principal Accounting Officer) | March 16, 2020 |
| <u>/s/ Sandra L. Bodnyk</u> Sandra L. Bodnyk | Director | March 16, 2020 |
| <u>/s/ James G. Keisling</u> James G. Keisling | Director | March 16, 2020 |

| <i>Name</i> | <i>Title</i> | <i>Date</i> |
|---|--------------|----------------|
| <u>/s/ Ronald G. Kukuchka</u> Ronald G. Kukuchka | Director | March 16, 2020 |
| <u>/s/ Richard S. Lochen, Jr.</u> Richard S. Lochen, Jr. | Director | March 16, 2020 |
| <u>/s/ Robert Naismith</u> Robert Naismith | Director | March 16, 2020 |
| <u>/s/ James B. Nicholas</u> James B. Nicholas | Director | March 16, 2020 |
| <u>/s/ George H. Stover, Jr.</u> George H. Stover, Jr. | Director | March 16, 2020 |
| <u>/s/ Steven L. Weinberger</u> Steven L. Weinberger | Director | March 16, 2020 |
| <u>/s/ Joseph T. Wright, Jr.</u> Joseph T. Wright, Jr. | Director | March 16, 2020 |