

PEOPLES FINANCIAL SERVICES CORP.
Form 10-Q
November 14, 2013

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549

Form 10-Q

Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the quarterly period ended September 30, 2013 or

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

0-23863
(Commission File Number)

PEOPLES FINANCIAL SERVICES CORP.
(Exact name of registrant as specified in its charter)

Pennsylvania 23-2391852
(State of incorporation) (IRS Employer ID Number)

82 Franklin Avenue, Hallstead, PA 18822
(Address of principal executive offices) (Zip code)

(570) 879-2175
(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T 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 or a smaller reporting company as defined in Rule 12b-2 of the Exchange Act.

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company

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

APPLICABLE ONLY TO CORPORATE REGISTRANTS:

Indicate the number of shares outstanding of the registrant's common stock, as of the latest practicable date: 3,087,406 at October 31, 2013.

Page 1 of 50

Exhibit index on page 46

PEOPLES FINANCIAL SERVICES CORP.
FORM 10-Q

For the Quarter Ended September 30, 2013

| Contents | Page No. |
|---|-------------|
| PART I. FINANCIAL INFORMATION: | |
| Item 1. Financial Statements (Unaudited) | |
| <u>Consolidated Balance Sheets at September 30, 2013 and December 31, 2012</u> | 3 |
| <u>Consolidated Statements of Income and Comprehensive Income for the Three and Nine Months Ended September 30, 2013 and 2012</u> | 4 |
| <u>Consolidated Statements of Changes in Stockholders' Equity for the Nine Months Ended September 30, 2013 and 2012</u> | 5 |
| <u>Consolidated Statements of Cash Flows for the Nine Months Ended September 30, 2013 and 2012</u> | 6 |
| <u>Notes to Consolidated Financial Statements</u> | 7 |
| Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u> | 26 |
| Item 3. <u>Quantitative and Qualitative Disclosures About Market Risk</u> | 42 |
| Item 4. <u>Controls and Procedures</u> | 42 |
| PART II OTHER INFORMATION | |
| Item 1. <u>Legal Proceedings</u> | 43 |
| Item 1A. <u>Risk Factors</u> | 43 |
| Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u> | 43 |
| Item 3. <u>Defaults upon Senior Securities</u> | 43 |
| Item 4. <u>Mine Safety Disclosures</u> | 43 |
| Item 5. <u>Other Information</u> | 43 |
| Item 6. <u>Exhibits</u> | 44 |
| <u>Signatures</u> | 45 |

Table of ContentsPEOPLES FINANCIAL SERVICES CORP.
CONSOLIDATED BALANCE SHEETS (UNAUDITED)

(Dollars in thousands, except per share data)

| | September 30, 2013 | December 31, 2012 |
|--|--------------------------|-------------------------|
| Assets: | | |
| Cash and due from banks | \$ 12,724 | \$ 9,777 |
| Interest-bearing deposits in other banks | 41 | 1,126 |
| Federal funds sold | 11,755 | 17,180 |
| Investment securities available-for-sale | 155,016 | 147,780 |
| Loans held for sale | 3,616 | 1,917 |
| Loans, net | 505,109 | 465,773 |
| Less: allowance for loan losses | 6,835 | 6,581 |
| Net loans | 498,274 | 459,192 |
| Premises and equipment, net | 8,621 | 8,685 |
| Accrued interest receivable | 3,395 | 3,272 |
| Other assets | 20,984 | 22,594 |
| Total assets | \$ 714,426 | \$ 671,523 |
| Liabilities: | | |
| Deposits: | | |
| Noninterest-bearing | \$ 117,170 | \$ 102,322 |
| Interest-bearing | 504,630 | 471,989 |
| Total deposits | 621,800 | 574,311 |
| Short-term borrowings | 17,854 | 12,764 |
| Long-term debt | 2,507 | 13,130 |
| Accrued interest payable | 219 | 425 |
| Other liabilities | 3,760 | 4,697 |
| Total liabilities | 646,140 | 605,327 |
| Stockholders' equity: | | |
| Common stock, par value \$2.00; authorized 12,500,000 shares; issued 3,341,251 shares | 6,683 | 6,683 |
| Capital surplus | 3,194 | 3,155 |
| Retained earnings | 61,956 | 57,781 |
| Accumulated other comprehensive income | 2,694 | 4,876 |
| Less: Treasury stock, at cost, September 30, 2013, 253,845 shares; December 31, 2012, 256,995 shares | 6,241 | 6,299 |
| Total stockholders' equity | 68,286 | 66,196 |
| Total liabilities and stockholders' equity | \$ 714,426 | \$ 671,523 |

See Notes to Consolidated Financial Statements

Table of Contents

PEOPLES FINANCIAL SERVICES CORP.

CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME (UNAUDITED)

(Dollars in thousands, except per share data)

| September 30 | Three Months Ended | | Nine Months Ended | |
|---|--------------------|---------|-------------------|----------|
| | 2013 | 2012 | 2013 | 2012 |
| Interest income: | | | | |
| Interest and fees on loans: | | | | |
| Taxable | \$6,042 | \$5,698 | \$17,675 | \$16,895 |
| Tax-exempt | 278 | 316 | 867 | 1,128 |
| Interest and dividends on investment securities available-for-sale: | | | | |
| Taxable | 630 | 558 | 1,795 | 1,797 |
| Tax-exempt | 345 | 325 | 1,041 | 1,012 |
| Dividends | 5 | 6 | 17 | 21 |
| Interest on interest-bearing deposits in other banks | | 2 | 2 | 7 |
| Interest on federal funds sold | 18 | 11 | 32 | 11 |
| Total interest income | 7,318 | 6,916 | 21,429 | 20,871 |
| Interest expense: | | | | |
| Interest on deposits | 1,032 | 1,115 | 3,004 | 3,234 |
| Interest on short-term borrowings | 36 | 29 | 100 | 140 |
| Interest on long-term debt | 32 | 163 | 144 | 506 |
| Total interest expense | 1,100 | 1,307 | 3,248 | 3,880 |
| Net interest income | 6,218 | 5,609 | 18,181 | 16,991 |
| Provision for loan losses | 165 | 330 | 495 | 1,365 |
| Net interest income after provision for loan losses | 6,053 | 5,279 | 17,686 | 15,626 |
| Noninterest income: | | | | |
| Service charges, fees, commissions and other | 895 | 804 | 2,527 | 2,344 |
| Wealth management income | 195 | 180 | 589 | 461 |
| Mortgage banking income | 45 | 277 | 458 | 653 |
| Net gain (loss) on sale of investment securities available-for-sale | | | (1 |) 383 |
| Total noninterest income | 1,135 | 1,261 | 3,573 | 3,841 |
| Noninterest expense: | | | | |
| Salaries and employee benefits expense | 2,307 | 1,792 | 6,265 | 5,271 |
| Net occupancy and equipment expense | 851 | 747 | 2,520 | 2,290 |
| Other expenses | 1,902 | 1,299 | 4,474 | 3,496 |
| Total noninterest expense | 5,060 | 3,838 | 13,259 | 11,057 |
| Income before income taxes | 2,128 | 2,702 | 8,000 | 8,410 |
| Provision for income taxes | 385 | 462 | 1,695 | 1,466 |
| Net income | 1,743 | 2,240 | 6,305 | 6,944 |
| Other comprehensive income (loss): | | | | |
| Unrealized gain (loss) on investment securities available-for-sale | (521 |) 321 | (3,307 |) 2,086 |
| Reclassification adjustment for gain on sales included in net income | | | 1 | (383 |
| Income tax expense (benefit) related to other comprehensive income (loss) | (177 |) 109 | (1,124 |) 580 |
| Other comprehensive income (loss), net of income taxes | (344 |) 212 | (2,182 |) 1,123 |
| Comprehensive income | \$1,399 | \$2,452 | \$4,123 | \$8,067 |

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Per share data:

Net income:

| | | | | |
|-------|--------|--------|--------|--------|
| Basic | \$0.56 | \$0.72 | \$2.04 | \$2.23 |
|-------|--------|--------|--------|--------|

| | | | | |
|---------|--------|--------|--------|--------|
| Diluted | \$0.56 | \$0.72 | \$2.04 | \$2.23 |
|---------|--------|--------|--------|--------|

Average common shares outstanding:

| | | | | |
|-------|-----------|-----------|-----------|-----------|
| Basic | 3,087,249 | 3,118,356 | 3,085,901 | 3,118,298 |
|-------|-----------|-----------|-----------|-----------|

| | | | | |
|---------|-----------|-----------|-----------|-----------|
| Diluted | 3,087,408 | 3,118,356 | 3,086,110 | 3,118,705 |
|---------|-----------|-----------|-----------|-----------|

| | | | | |
|--------------------|--------|--------|--------|--------|
| Dividends declared | \$0.23 | \$0.22 | \$0.69 | \$0.64 |
|--------------------|--------|--------|--------|--------|

See Notes to Consolidated Financial Statements

4

Table of Contents

PEOPLES FINANCIAL SERVICES CORP.

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY (UNAUDITED)

(Dollars in thousands, except per share data)

| | Common Stock | Capital Surplus | Retained Earnings | Accumulated Other Comprehensive Income (Loss) | Treasury Stock | Total |
|---|-----------------|--------------------|----------------------|--|-------------------|-----------|
| Balance, January 1, 2013 | \$ 6,683 | \$ 3,155 | \$ 57,781 | \$ 4,876 | \$ (6,299) | \$ 66,196 |
| Net income | | | 6,305 | | | 6,305 |
| Other comprehensive loss, net of income taxes | | | | (2,182) | | (2,182) |
| Dividends declared: \$0.69 per share | | | (2,130) | | | (2,130) |
| Reissuance under option plan: 3,150 shares | | 39 | | | 58 | 97 |
| Balance, September 30, 2013 | \$ 6,683 | \$ 3,194 | \$ 61,956 | \$ 2,694 | \$ (6,241) | \$ 68,286 |
| Balance, January 1, 2012 | \$ 6,683 | \$ 3,141 | \$ 51,342 | \$ 3,645 | \$ (5,198) | \$ 59,613 |
| Net income | | | 6,944 | | | 6,944 |
| Other comprehensive income, net of income taxes | | | | 1,123 | | 1,123 |
| Dividends declared: \$0.64 per share | | | (1,995) | | | (1,995) |
| Reissuance under option plan: 4,500 shares | | 12 | | | 82 | 94 |
| Purchase of treasury stock 5,000 shares | | | | | (143) | (143) |
| Balance, September 30, 2012 | \$ 6,683 | \$ 3,153 | \$ 56,291 | \$ 4,768 | \$ (5,259) | \$ 65,636 |

See Notes to Consolidated Financial Statements

5

Table of Contents

PEOPLES FINANCIAL SERVICES CORP.

CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

(Dollars in thousands, except per share data)

| For the Nine Months Ended September 30 | 2013 | 2012 |
|---|----------|----------|
| Cash flows from operating activities: | | |
| Net income | \$6,305 | \$6,944 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization of premises and equipment | 664 | 631 |
| Amortization of intangibles | 81 | 123 |
| Provision for loan losses | 495 | 1,365 |
| Loss on sale of other real estate owned | 109 | 7 |
| Net amortization of investment securities available-for-sale | 1,729 | 1,468 |
| Amortization of deferred loan costs | 211 | 203 |
| Loss (gain) on sale of investment securities available-for-sale | 1 | (383) |
| Net income from investment in life insurance | (274) | (284) |
| Net change in: | | |
| Loans held for sale | (1,699) | (635) |
| Accrued interest receivable | (123) | 57 |
| Other assets | 1,959 | 481 |
| Accrued interest payable | (206) | (21) |
| Other liabilities | (937) | (2,335) |
| Net cash provided by operating activities | 8,315 | 7,621 |
| Cash flows from investing activities: | | |
| Proceeds from sales of investment securities available-for-sale | 300 | 5,216 |
| Proceeds from repayments on investment securities available-for-sale | 14,593 | 12,809 |
| Purchases of investment securities available-for-sale | (27,165) | (16,591) |
| Net increase in loans | (39,878) | (27,421) |
| Purchases of premises and equipment | (600) | (1,296) |
| Purchases of investment in life insurance | | (450) |
| Proceeds from sale of other real estate owned | 949 | 62 |
| Net cash used in investing activities | (51,801) | (27,671) |
| Cash flows from financing activities: | | |
| Net increase in deposits | 47,489 | 60,129 |
| Repayment of long-term debt | (10,623) | (5,594) |
| Net increase (decrease) in short-term borrowings | 5,090 | (30,193) |
| Repurchase of common shares | | (143) |
| Reissuance of common shares | 97 | 94 |
| Cash dividends paid | (2,130) | (1,995) |
| Net cash provided by financing activities | 39,923 | 22,298 |
| Net increase (decrease) in cash and cash equivalents | (3,563) | 2,248 |
| Cash and cash equivalents at beginning of year | 28,083 | 10,559 |
| Cash and cash equivalents at end of period | \$24,520 | \$12,807 |
| Supplemental disclosures: | | |
| Cash paid during the period for: | | |
| Interest | \$3,454 | \$3,901 |
| Income taxes | \$2,200 | \$1,050 |
| Noncash items: | | |
| Transfers from loans to other real estate owned | \$90 | \$1,489 |

See Notes to Consolidated Financial Statements

6

Table of Contents

PEOPLES FINANCIAL SERVICES CORP.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Dollars in thousands, except per share data)

1. Basis of presentation:

The accompanying unaudited consolidated financial statements of Peoples Financial Services Corp, and subsidiaries (collectively, the “Company”) have been prepared in accordance with accounting principles generally accepted in the United States of America (“GAAP”) for interim financial information, Regulation S-X and reporting practices applied in the banking industry. In the opinion of management, all normal recurring adjustments necessary for a fair presentation of the financial position and results of operations for the periods presented have been included. All significant intercompany balances and transactions have been eliminated in consolidation. Prior-period amounts are reclassified when necessary to conform with the current year’s presentation. These reclassifications did not have any effect on the operating results or financial position of the Company. The operating results and financial position of the Company for the three and nine months ended and as of September 30, 2013, are not necessarily indicative of the results of operations and financial position that may be expected in the future.

The preparation of 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 financial statements and the reported amounts of revenues and expenses during the reported periods. Actual results could differ from those estimates. For additional information and disclosures required under GAAP, refer to the Notes to Consolidated Financial Statements for the year ended December 31, 2012, included in the Form S-4 filed with the Securities and Exchange Commission on August 13, 2013.

The Company has evaluated events and transactions occurring subsequent to the balance sheet date of September 30, 2013, 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.

2. Other comprehensive income (loss):

The reclassification adjustment for gain (loss) on investment securities available-for-sale is included in net gain (loss) on sale of investment securities available-for-sale in total noninterest income on the Consolidated Statements of Income and Comprehensive Income. The income tax expense (benefit) on the net gain (loss) on sale of investment securities available-for-sale is included in the provision for income taxes on the Consolidated Statements of Income and Comprehensive Income.

3. Earnings per share:

Basic earnings per share represent income available to common stockholders divided by the weighted-average number of common shares outstanding during the period. Diluted earnings per share reflect additional common shares that would have been outstanding if dilutive potential common shares had been issued, as well as any adjustment to income that would result from the assumed issuance. Potential common shares that may be issued by the Company relate solely to outstanding stock options, and are determined using the treasury stock method.

Table of ContentsPEOPLES FINANCIAL SERVICES CORP.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Dollars in thousands, except per share data)

Stock options for 2,878 and 5,800 shares of common stock were not considered in computing diluted earnings per share for the three and nine months ended September 30, 2013 and 2012, respectively, because they were antidilutive.

4. Investment securities available-for-sale:

The amortized cost and fair value of investment securities available-for-sale aggregated by investment category at September 30, 2013 and December 31, 2012 are summarized as follows:

| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|---------------------------------------|-------------------|------------------------------|-------------------------------|---------------|
| September 30, 2013 | | | | |
| U.S. Government-sponsored enterprises | \$ 29,147 | \$ 2,169 | | \$ 31,316 |
| State and municipals: | | | | |
| Taxable | 16,139 | 967 | \$ 3 | 17,103 |
| Tax-exempt | 47,263 | 880 | 384 | 47,759 |
| Corporate debt securities | 4,034 | 265 | | 4,299 |
| Mortgage-backed securities: | | | | |
| U.S. Government agencies | 21,144 | 156 | 190 | 21,110 |
| U.S. Government-sponsored enterprises | 32,720 | 256 | 98 | 32,878 |
| Common equity securities | 487 | 85 | 21 | 551 |
| Total | \$ 150,934 | \$ 4,778 | \$ 696 | \$ 155,016 |

| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|---------------------------------------|-------------------|------------------------------|-------------------------------|---------------|
| December 31, 2012 | | | | |
| U.S. Government-sponsored enterprises | \$ 29,375 | \$ 3,556 | | \$ 32,931 |
| State and municipals: | | | | |
| Taxable | 16,611 | 2,083 | | 18,694 |
| Tax-exempt | 45,480 | 2,035 | \$ 127 | 47,388 |
| Corporate debt securities | 4,038 | 139 | 306 | 3,871 |
| Mortgage-backed securities: | | | | |
| U.S. Government agencies | 21,532 | 173 | 151 | 21,554 |
| U.S. Government-sponsored enterprises | 22,868 | 129 | 129 | 22,868 |
| Common equity securities | 488 | 17 | 31 | 474 |
| Total | \$ 140,392 | \$ 8,132 | \$ 744 | \$ 147,780 |

Table of ContentsPEOPLES FINANCIAL SERVICES CORP.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Dollars in thousands, except per share data)

4. Investment securities available-for-sale
(continued)

The maturity distribution of the fair value, which is the net carrying amount, of the debt securities classified as available-for-sale at September 30, 2013, is summarized as follows:

| | Fair Value |
|---------------------------------|---------------|
| September 30, 2013 | |
| Within one year | \$ 1,518 |
| After one but within five years | 38,096 |
| After five but within ten years | 30,045 |
| After ten years | 30,818 |
| | 100,477 |
| Mortgage-backed securities | 53,988 |
| Total | \$ 154,465 |

Securities with a carrying value of \$103,457 and \$89,699 at September 30, 2013 and December 31, 2012, respectively, were pledged to secure public deposits and repurchase agreements as required or permitted by law.

At September 30, 2013 and December 31, 2012, there were no securities of any individual issuer, except for U.S. Government agencies and sponsored enterprises, which exceeded 10.0 percent of stockholders' equity.

The fair value and gross unrealized losses of investment securities available-for-sale with unrealized losses for which an other-than-temporary impairment ("OTTI") has not been recognized at September 30, 2013 and December 31, 2012, aggregated by investment category and length of time that the individual securities have been in a continuous unrealized loss position, are summarized as follows:

| | Less Than 12 Months | | 12 Months or More | | Total | |
|---------------------------------------|------------------------|----------------------|-------------------|----------------------|---------------|----------------------|
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| September 30, 2013 | | | | | | |
| U.S. Government-sponsored enterprises | | | | | | |
| State and municipals: | | | | | | |
| Taxable | \$ 497 | \$ 3 | | | \$ 497 | \$ 3 |
| Tax-Exempt | 13,828 | 384 | | | 13,828 | 384 |
| Corporate debt securities | | | | | | |
| Mortgage-backed securities: | | | | | | |
| U.S. Government agencies | 9,753 | 190 | | | 9,753 | 190 |
| U.S. Government-sponsored enterprises | 6,579 | 12 | \$ 3,086 | \$ 86 | 9,665 | 98 |
| Common equity securities | | | 116 | 21 | 116 | 21 |
| Total | \$ 30,657 | \$ 589 | \$ 3,202 | \$ 107 | \$ 33,859 | \$ 696 |

Table of Contents

PEOPLES FINANCIAL SERVICES CORP.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Dollars in thousands, except per share data)

4. Investment securities available-for-sale
(continued)

| | Less Than 12 Months | | 12 Months or More | | Total | |
|---------------------------------------|------------------------|----------------------|-------------------|----------------------|---------------|----------------------|
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| December 31, 2012 | | | | | | |
| U.S. Government-sponsored enterprises | | | | | | |
| State and municipals: | | | | | | |
| Taxable | | | | | | |
| Tax-exempt | \$12,483 | \$ 127 | | | \$12,483 | \$ 127 |
| Corporate debt securities | | | \$2,705 | \$ 306 | 2,705 | 306 |
| Mortgage-backed securities: | | | | | | |
| U.S. Government agencies | 11,934 | 146 | 838 | 5 | 12,772 | 151 |
| U.S. Government-sponsored enterprises | 9,042 | 83 | 4,229 | 46 | 13,271 | 129 |
| Common equity securities | | | 106 | 31 | 106 | 31 |
| Total | \$33,459 | \$ 356 | \$7,878 | \$ 388 | \$41,337 | \$ 744 |

The Company had 49 investment securities, consisting of 37 tax-exempt and one taxable state and municipal obligation, nine mortgage-backed securities and two common equity securities that were in unrealized loss positions at September 30, 2013. Of these securities, two mortgage-backed securities and two common equity securities were in continuous unrealized loss positions for 12 months or more. In comparison, the Company had 59 investment securities, consisting of 36 tax-exempt state and municipal obligations, two corporate debt securities, 19 mortgage-backed securities and two common equity securities, which were in unrealized loss positions at December 31, 2012. Of these securities, seven mortgage-backed securities, and each of the corporate debt securities and common equity securities were in continuous unrealized loss positions for 12 months or more. The unrealized losses on the common equity securities were a direct reflection of reductions in stock values in the financial industry sector, as a whole, and were not a result of credit or other issues that would cause the Company to recognize an OTTI charge. 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 did not consider the unrealized losses to be OTTI at September 30, 2013 and December 31, 2012. In addition, there was no OTTI recognized for the nine month periods ended September 30, 2013 and 2012.

10

Table of Contents

PEOPLES FINANCIAL SERVICES CORP.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Dollars in thousands, except per share data)

5. Loans, net and allowance for loan losses:

The major classifications of loans outstanding, net of deferred loan origination fees and costs at September 30, 2013 and December 31, 2012 are summarized as follows. Net deferred loan costs were \$679 at September 30, 2013, and \$589 at December 31, 2012.

| | September 30, 2013 | December 31, 2012 |
|--------------|-----------------------|----------------------|
| Commercial | \$ 187,462 | \$ 170,379 |
| Real estate: | | |
| Commercial | 181,557 | 158,798 |
| Residential | 117,796 | 117,527 |
| Consumer | 18,294 | 19,069 |
| Total | \$ 505,109 | \$ 465,773 |

Table of Contents

PEOPLES FINANCIAL SERVICES CORP.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Dollars in thousands, except per share data)

5. Loans, net and allowance for loan losses (continued)

The changes in the allowance for loan losses account by major classification of loan for the three and nine months ended September 30, 2013 and 2012 are summarized as follows:

| September 30, 2013 | Real estate | | | | Unallocated | Total |
|--------------------------------|-------------|------------|-------------|----------|-------------|---------|
| | Commercial | Commercial | Residential | Consumer | | |
| Allowance for loan losses: | | | | | | |
| Beginning Balance July 1, 2013 | \$2,711 | \$2,831 | \$ 886 | \$ 176 | \$ 131 | \$6,735 |
| Charge-offs | (46) | | | (24) | | (70) |
| Recoveries | (2) | | (2) | 9 | | 5 |
| Provisions | 18 | (1) | 65 | 16 | 67 | 165 |
| Ending balance | \$2,681 | \$2,830 | \$ 949 | \$ 177 | \$ 198 | \$6,835 |

| September 30, 2013 | Real estate | | | | Unallocated | Total |
|-----------------------------------|-------------|------------|-------------|----------|-------------|---------|
| | Commercial | Commercial | Residential | Consumer | | |
| Allowance for loan losses: | | | | | | |
| Beginning Balance January 1, 2013 | \$2,024 | \$2,101 | \$ 1,206 | \$ 234 | \$ 1,016 | \$6,581 |
| Charge-offs | (46) | (58) | (187) | (53) | | (344) |
| Recoveries | 2 | | 77 | 24 | | 103 |
| Provisions | 701 | 787 | (147) | (28) | (818) | 495 |
| Ending balance | \$2,681 | \$2,830 | \$ 949 | \$ 177 | \$ 198 | \$6,835 |

| September 30, 2012 | Real estate | | | | Unallocated | Total |
|---------------------------------|-------------|------------|-------------|----------|-------------|---------|
| | Commercial | Commercial | Residential | Consumer | | |
| Allowance for loan losses: | | | | | | |
| Beginning Balance, July 1, 2012 | \$2,117 | \$1,970 | \$ 819 | \$ 197 | \$ 813 | \$5,916 |
| Charge-offs | (12) | | | (90) | | (102) |
| Recoveries | 1 | | | 152 | | 153 |
| Provisions | (10) | 21 | 137 | (68) | 250 | 330 |
| Ending balance | \$2,096 | \$1,991 | \$ 956 | \$ 191 | \$ 1,063 | \$6,297 |

| September 30, 2012 | Real estate | | | | Unallocated | Total |
|------------------------------------|-------------|------------|-------------|----------|-------------|---------|
| | Commercial | Commercial | Residential | Consumer | | |
| Allowance for loan losses: | | | | | | |
| Beginning Balance, January 1, 2012 | \$2,047 | \$1,515 | \$ 761 | \$ 198 | \$ 828 | \$5,349 |
| Charge-offs | (219) | (100) | (21) | (267) | | (607) |
| Recoveries | 2 | | | 188 | | 190 |
| Provisions | 266 | 576 | 216 | 72 | 235 | 1,365 |
| Ending balance | \$2,096 | \$1,991 | \$ 956 | \$ 191 | \$ 1,063 | \$6,297 |

Table of ContentsPEOPLES FINANCIAL SERVICES CORP.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Dollars in thousands, except per share data)

5. Loans, net and allowance for loan losses (continued)

The allocation of the allowance for loan losses and the related loans by major classifications of loans at September 30, 2013 and December 31, 2012 is summarized as follows:

| September 30, 2013 | Real estate | | | | | Unallocated Total |
|---|-------------|------------|-------------|-----------|----------|-------------------|
| | Commercial | Commercial | Residential | Consumer | | |
| Allowance for loan losses: | | | | | | |
| Ending balance | \$ 2,681 | \$ 2,830 | \$ 949 | \$ 177 | \$ 198 | \$ 6,835 |
| Ending balance: individually evaluated for impairment | 386 | 424 | 297 | | | 1,107 |
| Ending balance: collectively evaluated for impairment | \$ 2,295 | \$ 2,406 | \$ 652 | \$ 177 | \$ 198 | \$ 5,728 |
| Loans receivable: | | | | | | |
| Ending balance | \$ 187,462 | \$ 181,557 | \$ 117,796 | \$ 18,294 | | \$ 505,109 |
| Ending balance: individually evaluated for impairment | 3,275 | 13,388 | 1,891 | | | 18,554 |
| Ending balance: collectively evaluated for impairment | \$ 184,187 | \$ 168,169 | \$ 115,905 | \$ 18,294 | | \$ 486,555 |
| December 31, 2012 | Real estate | | | | | Unallocated Total |
| | Commercial | Commercial | Residential | Consumer | | |
| Allowance for loan losses: | | | | | | |
| Ending balance | \$ 2,024 | \$ 2,101 | \$ 1,206 | \$ 234 | \$ 1,016 | \$ 6,581 |
| Ending balance: individually evaluated for impairment | 327 | 239 | 283 | 6 | | 855 |
| Ending balance: collectively evaluated for impairment | \$ 1,697 | \$ 1,862 | \$ 923 | \$ 228 | \$ 1,016 | \$ 5,726 |
| Loans receivable: | | | | | | |
| Ending balance | \$ 170,379 | \$ 158,798 | \$ 117,527 | \$ 19,069 | | \$ 465,773 |
| Ending balance: individually evaluated for impairment | 5,169 | 7,137 | 1,522 | 6 | | 13,834 |
| Ending balance: collectively evaluated for impairment | \$ 165,210 | \$ 151,661 | \$ 116,005 | \$ 19,063 | | \$ 451,939 |

Table of ContentsPEOPLES FINANCIAL SERVICES CORP.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Dollars in thousands, except per share data)

5. Loans, net and allowance for loan losses (continued)

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 weakness 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 their 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.

The following tables present the major classifications of the loan portfolio summarized by the aggregate pass rating and the classified ratings of special mention, substandard and doubtful within the Company's internal risk rating system at September 30, 2013 and December 31, 2012:

| September 30, 2013 | Pass | Special Mention | Substandard | Doubtful | Total |
|--------------------|-----------|--------------------|-------------|----------|-----------|
| Commercial | \$179,054 | \$ 5,186 | \$ 815 | \$ 2,407 | \$187,462 |
| Real estate: | | | | | |
| Commercial | 165,829 | 3,960 | 8,029 | 3,739 | 181,557 |
| Residential | 115,557 | 348 | 227 | 1,664 | 117,796 |
| Consumer | 18,278 | 16 | | | 18,294 |
| Total | \$478,718 | \$ 9,510 | \$ 9,071 | \$ 7,810 | \$505,109 |

Table of ContentsPEOPLES FINANCIAL SERVICES CORP.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Dollars in thousands, except per share data)

5. Loans, net and allowance for loan losses (continued)

| | Pass | Special Mention | Substandard | Doubtful | Total |
|-------------------|------------|--------------------|-------------|----------|------------|
| December 31, 2012 | | | | | |
| Commercial | \$ 161,236 | \$ 5,752 | \$ 1,113 | \$ 2,278 | \$ 170,379 |
| Real estate: | | | | | |
| Commercial | 146,205 | 5,302 | 3,120 | 4,171 | 158,798 |
| Residential | 116,042 | | | 1,485 | 117,527 |
| Consumer | 19,058 | 11 | | | 19,069 |
| Total | \$ 442,541 | \$ 11,065 | \$ 4,233 | \$ 7,934 | \$ 465,773 |

Information concerning nonaccrual loans by major loan category at September 30, 2013 and December 31, 2012, is as follows:

| | September 30, 2013 | December 31, 2012 |
|--------------|-----------------------|----------------------|
| Commercial | \$ 2,407 | \$ 2,278 |
| Real estate: | | |
| Commercial | 3,739 | 4,171 |
| Residential | 1,664 | 1,485 |
| Consumer | | |
| Total | \$ 7,810 | \$ 7,934 |

The major categories of the loan portfolio by past due status at September 30, 2013 and December 31, 2012, are summarized as follows:

| | 30-59 Days Past Due | 60-89 Days Past Due | Greater than 90 Days | Total Past Due | Current | Total Loans | Loans > 90 Days and Accruing |
|--------------------|------------------------------|------------------------------|----------------------------|----------------------|------------|----------------|---------------------------------------|
| September 30, 2013 | | | | | | | |
| Commercial | \$ 272 | \$ 3 | \$ 2,254 | \$ 2,529 | \$ 184,933 | \$ 187,462 | \$ 53 |
| Real estate: | | | | | | | |
| Commercial | 1,041 | 1,540 | 429 | 3,010 | 178,547 | 181,557 | |
| Residential | 1,138 | 231 | 1,177 | 2,546 | 115,250 | 117,796 | |
| Consumer | 341 | 152 | 444 | 937 | 17,357 | 18,294 | 444 |
| Total | \$ 2,792 | \$ 1,926 | \$ 4,304 | \$ 9,022 | \$ 496,087 | \$ 505,109 | \$ 497 |

| | 30-59 Days Past Due | 60-89 Days Past Due | Greater than 90 Days | Total Past Due | Current | Total Loans | Loans > 90 Days and Accruing |
|-------------------|------------------------------|------------------------------|----------------------------|----------------------|------------|----------------|---------------------------------------|
| December 31, 2012 | | | | | | | |
| Commercial | \$ 883 | \$ 255 | \$ 324 | \$ 1,462 | \$ 168,917 | \$ 170,379 | \$ 324 |
| Real estate: | | | | | | | |
| Commercial | 2,268 | 245 | 22 | 2,535 | 156,263 | 158,798 | 22 |
| Residential | 1,528 | | 21 | 1,549 | 115,978 | 117,527 | 21 |
| Consumer | 411 | 192 | 494 | 1,097 | 17,972 | 19,069 | 494 |

| | | | | | | | |
|-------|---------|--------|--------|---------|-----------|-----------|--------|
| Total | \$5,090 | \$ 692 | \$ 861 | \$6,643 | \$459,130 | \$465,773 | \$ 861 |
|-------|---------|--------|--------|---------|-----------|-----------|--------|

15

Table of ContentsPEOPLES FINANCIAL SERVICES CORP.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Dollars in thousands, except per share data)

5. Loans, net and allowance for loan losses (continued)

The following tables summarize information in regards to impaired loans as of and for the three and nine months ended September 30, 2013 and 2012, and as of and for the year ended December 31, 2012, by loan portfolio class:

| | Recorded Investment | Unpaid Principal Balance | Related Allowance | This Quarter | | Year to Date | |
|-----------------------------|------------------------|--------------------------------|----------------------|----------------------------------|------------------------|----------------------------------|------------------------|
| | | | | Average Recorded Investmen | Interest Recognized | Average Recorded Investmen | Interest Recognized |
| September 30, 2013 | | | | | | | |
| With no related allowance: | | | | | | | |
| Commercial | \$ 755 | \$ 755 | | \$1,076 | \$ 17 | \$1,167 | \$ 59 |
| Real estate: | | | | | | | |
| Commercial | 10,133 | 10,133 | | 11,148 | 63 | 7,884 | 146 |
| Residential | 1,096 | 1,096 | | 1,201 | 2 | 983 | 5 |
| Consumer | | | | | | | |
| Total | 11,984 | 11,984 | | 13,425 | 82 | 10,034 | 210 |
| With an allowance recorded: | | | | | | | |
| Commercial | 2,520 | 2,520 | \$ 386 | 2,505 | 1 | 2,661 | 1 |
| Real estate: | | | | | | | |
| Commercial | 3,255 | 3,255 | 424 | 3,300 | 53 | 3,312 | 112 |
| Residential | 795 | 795 | 297 | 737 | 5 | 933 | 5 |
| Consumer | | | | | | | |
| Total | 6,570 | 6,570 | 1,107 | 6,542 | 59 | 6,906 | 118 |
| Commercial | 3,275 | 3,275 | 386 | 3,581 | 18 | 3,828 | 60 |
| Real estate: | | | | | | | |
| Commercial | 13,388 | 13,388 | 424 | 14,448 | 116 | 11,196 | 258 |
| Residential | 1,891 | 1,891 | 297 | 1,938 | 7 | 1,916 | 10 |
| Consumer | | | | | | | |
| Total | \$ 18,554 | \$ 18,554 | \$ 1,107 | \$19,967 | \$ 141 | \$16,940 | \$ 328 |

Table of ContentsPEOPLES FINANCIAL SERVICES CORP.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Dollars in thousands, except per share data)

5. Loans, net and allowance for loan losses (continued)

| December 31, 2012 | Recorded Investment | Unpaid Principal Balance | Related Allowance | For the Year Ended Average Interest Recorded Income Investment Recognized | |
|-----------------------------|------------------------|--------------------------------|----------------------|--|--------|
| With no related allowance: | | | | | |
| Commercial | \$ 3,782 | \$ 3,782 | | \$4,792 | \$ 114 |
| Real estate: | | | | | |
| Commercial | 3,354 | 3,354 | | 1,632 | 72 |
| Residential | 359 | 359 | | 771 | |
| Consumer | | | | | |
| Total | 7,495 | 7,495 | | 7,195 | 186 |
| With an allowance recorded: | | | | | |
| Commercial | 1,387 | 1,387 | \$ 327 | 2,798 | 10 |
| Real estate: | | | | | |
| Commercial | 3,783 | 3,783 | 239 | 3,749 | 120 |
| Residential | 1,163 | 1,163 | 283 | 910 | |
| Consumer | 6 | 6 | 6 | 2 | |
| Total | 6,339 | 6,339 | 855 | 7,459 | 130 |
| Commercial | 5,169 | 5,169 | 327 | 7,590 | 124 |
| Real estate: | | | | | |
| Commercial | 7,137 | 7,137 | 239 | 5,381 | 192 |
| Residential | 1,522 | 1,522 | 283 | 1,681 | |
| Consumer | 6 | 6 | 6 | 2 | |
| Total | \$ 13,834 | \$ 13,834 | \$ 855 | \$14,654 | \$ 316 |

Table of Contents

PEOPLES FINANCIAL SERVICES CORP.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Dollars in thousands, except per share data)

5. Loans, net and allowance for loan losses (continued)

| September 30, 2012 | Recorded Investment | Unpaid Principal Balance | Related Allowance | This Quarter Average Recorded Investment | Interest Recognized | Year to Date Average Recorded Investment | Interest Recognized |
|-----------------------------|---------------------|--------------------------|-------------------|--|---------------------|--|---------------------|
| With no related allowance: | | | | | | | |
| Commercial | \$ 4,953 | \$ 4,953 | | \$5,267 | \$ 100 | \$4,679 | \$ 132 |
| Real estate: | | | | | | | |
| Commercial | 862 | 862 | | 1,002 | 25 | 1,004 | 103 |
| Residential | 539 | 539 | | 716 | | 760 | |
| Consumer | | | | | | | |
| Total | 6,354 | 6,354 | | 6,985 | 125 | 6,443 | 235 |
| With an allowance recorded: | | | | | | | |
| Commercial | 1,528 | 1,528 | \$ 396 | 1,617 | 10 | 2,818 | 55 |
| Real estate: | | | | | | | |
| Commercial | 3,800 | 3,800 | 108 | 3,758 | 97 | 3,745 | 161 |
| Residential | 1,058 | 1,058 | 259 | 1,189 | | 781 | |
| Consumer | | | | | | | |
| Total | 6,386 | 6,386 | 763 | 6,564 | 107 | 7,344 | 216 |
| Commercial | 6,481 | 6,481 | 396 | 6,884 | 110 | 7,497 | 187 |
| Real estate: | | | | | | | |
| Commercial | 4,662 | 4,662 | 108 | 4,760 | 122 | 4,749 | 264 |
| Residential | 1,597 | 1,597 | 259 | 1,905 | | 1,541 | |
| Consumer | | | | | | | |
| Total | \$ 12,740 | \$ 12,740 | \$ 763 | \$13,549 | \$ 232 | \$13,787 | \$ 451 |

Included in the commercial loan and commercial real estate categories are troubled debt restructurings that are classified as impaired. 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 for which concessions have been granted. From time to time, the Company has modified loans and not accounted for them as troubled debt restructurings. Given the current economic environment, especially with respect to interest rates, there have been instances where a good customer has come in to renegotiate for a more favorable rate or one more in line with market rates. Given these and similar circumstances the Company has made modifications to keep the relationship. In such cases, these are not accounted for or reported as a troubled debt restructured loan as there was no deterioration in the borrower's condition. Trouble debt restructurings totaled \$3,693 at September 30, 2013, \$3,787 at December 31, 2012 and \$3,817 at September 30, 2012.

Table of ContentsPEOPLES FINANCIAL SERVICES CORP.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Dollars in thousands, except per share data)

5. Loans, net and allowance for loan losses (continued)

The Company offers a variety of modifications to borrowers. The modification categories offered can generally be described in the following categories:

Rate Modification - A modification in which the interest rate is changed.

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.

Information concerning trouble debt restructurings by major loan category at September 30, 2013 and December 31, 2012 is summarized as follows:

| | Number of Contracts | Accrual Status | Nonaccrual Status | Total Modifications |
|--------------------|---------------------------|-------------------|----------------------|------------------------|
| September 30, 2013 | | | | |
| Commercial | 2 | | \$ 2,074 | \$ 2,074 |
| Real estate: | | | | |
| Commercial | 1 | \$ 1,619 | | 1,619 |
| Residential | | | | |
| Consumer | | | | |
| Total | 3 | \$ 1,619 | \$ 2,074 | \$ 3,693 |

| | Number of Contracts | Accrual Status | Nonaccrual Status | Total Modifications |
|-------------------|---------------------------|-------------------|----------------------|------------------------|
| December 31, 2012 | | | | |
| Commercial | 2 | | \$ 2,146 | \$ 2,146 |
| Real estate: | | | | |
| Commercial | 1 | \$ 1,641 | | 1,641 |
| Residential | | | | |
| Consumer | | | | |
| Total | 3 | \$ 1,641 | \$ 2,146 | \$ 3,787 |

There were no new troubled debt restructurings that occurred during the nine months ended September 30, 2013 and 2012. There were no defaults of loans considered troubled debt restructurings for the nine months ended September 30, 2013 and 2012. There were no charge-offs as a result of the troubled debt restructurings.

6. Stock-based compensation:

As of September 30, 2013, all stock options were fully vested and there are no unrecognized compensation costs related to stock options. There were no stock options granted during the three and nine month periods ending

September 30, 2013 and 2012.

19

Table of Contents

PEOPLES FINANCIAL SERVICES CORP.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Dollars in thousands, except per share data)

7. Off-balance sheet financial instruments:

The Company does not issue any guarantees that would require liability recognition or disclosure, other than standby letters of credit. Outstanding letters of credit written are conditional commitments issued by the Company to guarantee the performance of a customer to a third party. The Company's exposure to credit loss in the event of nonperformance by the other party to the financial instrument for standby letters of credit is represented by the contractual amount of those instruments. The Company had \$14,100 of standby letters of credit at September 30, 2013. The Company uses the same credit policies in making conditional obligations as it does for on-balance sheet instruments.

The majority of these standby letters of credit expire within the next twelve months. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending other loan commitments. The Company requires collateral supporting these letters of credit as deemed necessary. The maximum undiscounted exposure related to these commitments at September 30, 2013 was \$14,100 and the approximate value of underlying collateral upon liquidation, that would be expected to cover this maximum potential exposure, was \$13,078.

8. Fair value estimates:

Fair value estimates are based on quoted market prices, if available, quoted market prices of similar assets or liabilities, or the present value of expected future cash flows and other valuation techniques. These valuations are significantly affected by discount rates, cash flow assumptions, and risk assumptions used. Therefore, fair value estimates may not be substantiated by comparison to independent markets and are not intended to reflect the proceeds that may be realizable in an immediate settlement of the instruments.

Fair value is determined at one point in time and is not representative of future value. These amounts do not reflect the total value of a going concern organization. Management does not have the intention to dispose of a significant portion of its assets and liabilities and therefore, the unrealized gains or losses should not be interpreted as a forecast of future earnings and cash flows.

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

Level 1: Unadjusted quoted prices of identical assets or liabilities in active markets that the entity has the ability to access as of the measurement date.

Level 2: Significant other observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data.

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

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

The following is a discussion of assets and liabilities measured at fair value on a recurring basis and the valuation techniques applied:

Table of Contents

PEOPLES FINANCIAL SERVICES CORP.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Dollars in thousands, except per share data)

8. Fair value estimates (continued)

Investment securities available-for-sale: The fair value of investment securities available-for-sale which are measured on a recurring basis are determined primarily by obtaining quoted prices on nationally recognized securities exchanges or matrix pricing, which is a mathematical technique used widely in the industry to value debt securities without relying exclusively on quoted prices for the specific securities but rather by relying on the securities' relationship to other similar securities. These securities are classified within Level 1 or 2 of the fair value hierarchy. Positions that are not traded in active markets for which valuations are generated using assumptions not observable in the market or management's best estimate are classified within Level 3 of the fair value hierarchy. The Company does not have any investment securities available-for-sale that it considers to be within Level 3 of the fair value hierarchy.

The Company may be required from time to time to measure certain assets at fair value on a nonrecurring basis in accordance with GAAP. These adjustments to fair value usually result from application of lower-of-cost-or-market accounting or write-downs of the following individual assets:

Impaired loans: Impaired loans are carried at the lower of cost or the fair value of the collateral for collateral-dependent loans. Collateral may be in the form of real estate or business assets including equipment, inventory and accounts receivable. The use of independent appraisals, discounted cash flow models and management's best judgment are significant inputs in arriving at the fair value measure of the underlying collateral and impaired loans are therefore classified within Level 3 of the fair value hierarchy.

Other real estate owned: Other real estate owned is recorded at fair value less cost to sell at the time of acquisition establishing a new cost basis. Other real estate owned is carried at the lower of the investment in the assets or the fair value of the assets less estimated selling costs. The use of independent appraisals and management's best judgment are significant inputs in arriving at the fair value measure of the underlying collateral and therefore other real estate owned and repossessed assets are classified within Level 3 of the fair value hierarchy.

Table of ContentsPEOPLES FINANCIAL SERVICES CORP.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Dollars in thousands, except per share data)

8. Fair value estimates (continued)

Assets and liabilities at fair value or a recurring and nonrecurring basis at September 30, 2013 and December 31, 2012, are summarized as follows:

| | Fair Value Measurement Using | | | | |
|--|------------------------------|---|--|---|--|
| | Amount | Quoted Prices in Active Markets for Identical Assets (Level 1) | | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| September 30, 2013 | | | | | |
| Recurring fair value measurements: | | | | | |
| Investment securities available-for-sale: | | | | | |
| U.S. Government-sponsored enterprises | \$31,316 | | | \$ 31,316 | |
| State and municipals: | | | | | |
| Taxable | 17,103 | | | 17,103 | |
| Tax-exempt | 47,759 | | | 47,759 | |
| Corporate debt securities | 4,299 | | | 4,299 | |
| Mortgage-backed securities: | | | | | |
| U.S. Government agencies | 21,110 | | | 21,110 | |
| U.S. Government-sponsored enterprises | 32,878 | | | 32,878 | |
| Common equity securities: | 551 | \$ 551 | | | |
| Total investment securities available-for-sale | \$155,016 | \$ 551 | | \$ 154,465 | |
| Total recurring fair value measurements | \$155,016 | \$ 551 | | \$ 154,465 | |
| Nonrecurring fair value measurements: | | | | | |
| Impaired loans | \$5,463 | | | | \$5,463 |
| Other real estate owned | | | | | |
| Total nonrecurring fair value measurements | \$5,463 | | | | \$5,463 |

| | Fair Value Measurement Using | | | | |
|---|------------------------------|---|--|---|--|
| | Amount | Quoted Prices in Active Markets for Identical Assets (Level 1) | | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| December 31, 2012 | | | | | |
| Recurring fair value measurements: | | | | | |
| Investment securities available-for-sale: | | | | | |
| U.S. Government-sponsored enterprises | \$32,931 | | | \$ 32,931 | |
| State and municipals: | | | | | |

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| | | | |
|--|------------|--------|------------|
| Taxable | 18,694 | | 18,694 |
| Tax-exempt | 47,388 | | 47,388 |
| Corporate debt securities | 3,871 | | 3,871 |
| Mortgage-backed securities: | | | |
| U.S. Government agencies | 21,554 | | 21,554 |
| U.S. Government-sponsored enterprises | 22,868 | | 22,868 |
| Common equity securities: | 474 | \$ 474 | |
| Total investment securities available-for-sale | \$ 147,780 | \$ 474 | \$ 147,306 |
| Total recurring fair value measurements | \$ 147,780 | \$ 474 | \$ 147,306 |

Nonrecurring fair value measurements:

| | | | |
|--|---------|--|---------|
| Impaired loans | \$5,484 | | \$5,484 |
| Other real estate owned | 2,003 | | 2,003 |
| Total nonrecurring fair value measurements | \$7,487 | | \$7,487 |

22

Table of ContentsPEOPLES FINANCIAL SERVICES CORP.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Dollars in thousands, except per share data)

8. Fair value estimates (continued)

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 | Valuation Techniques | Unobservable Input | Range (Weighted Average) |
| September 30, 2013 | Estimate | | | 0.0% to 25.0% |
| Impaired loans | \$ 5,463 | Appraisal of collateral | Appraisal adjustments | (23.8%) 0.0% to 6.0% |
| | | | Liquidation expenses | (5.0%) |
| Quantitative Information about Level 3 Fair Value Measurements | | | | |
| | Fair Value | Valuation Techniques | Unobservable Input | Range (Weighted Average) |
| December 31, 2012 | Estimate | | | 20.0% to 25.0% (24.6%) |
| Impaired loans | \$5,484 | Appraisal of collateral | Appraisal adjustments | 6.0% to 10.0% (8.8%) |
| | | | Liquidation expenses | 6.0% to 10.0% (8.8%) |
| Other real estate owned | \$2,003 | Appraisal of collateral | Appraisal adjustments | 20.0% to 25.0% (24.6%) |
| | | | Liquidation expenses | 6.0% to 10.0% (8.8%) |

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 downward 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. Higher downward adjustments are caused by adverse changes in the condition of the collateral, actual offers or sales contract received or age of the appraisal.

Table of ContentsPEOPLES FINANCIAL SERVICES CORP.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Dollars in thousands, except per share data)

8. Fair value estimates (continued)

The carrying and fair values of the Company's financial instruments at September 30, 2013 and December 31, 2012, and their placement within the fair value hierarchy, are as follows:

| | | | Fair Value Hierarchy | | |
|--|-----------|-----------|----------------------|-------------|--------------|
| | | | Quoted | | |
| | | | Prices | | |
| | | | in | | |
| | | | Active | | |
| | | | Markets | | |
| | | | for | Significant | |
| | | | Identical | Other | Significant |
| | | | Assets | Observable | Unobservable |
| | Carrying | Fair | (Level | Inputs | Inputs |
| | Value | Value | 1) | (Level 2) | (Level 3) |
| September 30, 2013 | | | | | |
| Financial assets: | | | | | |
| Cash and cash equivalents | \$24,520 | \$24,520 | \$24,520 | | |
| Investment securities available-for-sale | 155,016 | 155,016 | \$551 | \$ 154,465 | |
| Loans held for sale | 3,616 | 3,616 | | 3,616 | |
| Net loans | 498,274 | 504,668 | | | \$ 504,668 |
| Accrued interest receivable | 3,395 | 3,395 | | 3,395 | |
| Restricted equity securities | 1,002 | 1,002 | | \$ 1,002 | |
| | \$685,823 | \$692,217 | | | |
| Financial liabilities: | | | | | |
| Deposits | \$621,800 | \$624,294 | | \$ 624,294 | |
| Short-term borrowings | 17,854 | 17,854 | | 17,854 | |
| Long-term debt | 2,507 | 2,599 | | 2,599 | |
| Accrued interest payable | 219 | 219 | | \$ 219 | |
| | \$642,380 | \$644,966 | | | |

| | | | Fair Value Hierarchy | | |
|--|----------|----------|----------------------|-------------|--------------|
| | | | Quoted | | |
| | | | Prices | | |
| | | | in | | |
| | | | Active | | |
| | | | Markets | Significant | |
| | | | for | Other | Significant |
| | | | Identical | Observable | Unobservable |
| | Carrying | Fair | Assets | Inputs | Inputs |
| | Value | Value | (level 1) | (level 2) | (Level 3) |
| December 31, 2012 | | | | | |
| Financial assets: | | | | | |
| Cash and cash equivalents | \$28,083 | \$28,083 | \$28,083 | | |
| Investment securities available-for-sale | 147,780 | 147,780 | \$474 | \$ 147,306 | |
| Loans held for sale | 1,917 | 1,917 | | 1,917 | |
| Net loans | 459,192 | 466,166 | | | \$ 466,166 |

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| | | | |
|------------------------------|-----------|-----------|------------|
| Accrued interest receivable | 3,272 | 3,272 | 3,272 |
| Restricted equity securities | 1,972 | 1,972 | \$ 1,972 |
| Total | \$642,216 | \$649,190 | |
| Financial liabilities: | | | |
| Deposits | \$574,311 | \$578,628 | \$ 578,628 |
| Short-term borrowings | 12,764 | 12,764 | 12,764 |
| Long-term debt | 13,130 | 13,354 | 13,354 |
| Accrued interest payable | 425 | 425 | \$ 425 |
| Total | \$600,630 | \$605,171 | |

24

Table of Contents

PEOPLES FINANCIAL SERVICES CORP.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Dollars in thousands, except per share data)

8. Fair value estimates (continued)

The following methods and assumptions were used to measure the fair value of certain assets and liabilities carried at cost on the Company's consolidated balance sheets:

Cash and cash equivalents: The carrying amount for cash and cash equivalents is a reasonable estimate of fair value.

Investment securities available-for-sale: 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.

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

Net loans: Fair values for loans are estimated using a discounted cash flow methodology. The discount rates take into account interest rates currently being offered to customers for loans with similar terms, the credit risk associated with the loan and market factors, including liquidity. The valuation of the loan portfolio reflects discounts that the Company believes are consistent with transactions occurring in the marketplace for both performing and distressed loan types. The carrying value that fair value is compared to is net of the allowance for loan losses and other associated premiums and discounts.

Accrued interest receivable: The carrying amount of accrued interest receivable approximates its fair value.

Restricted equity securities: The carrying amount of restricted equity securities approximates fair value.

Deposits: The carrying amount is considered a reasonable estimate of fair value for demand, savings and other variable rate deposit accounts. The fair value of fixed maturity certificates of deposit is estimated by a discounted cash flow method using the rates currently offered for deposits of similar remaining maturities.

Short-term borrowings: The carrying amount of short-term borrowings approximates fair value.

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

Accrued interest payable: The carrying amount of accrued interest payable approximates its fair value.

Off-balance sheet financial instruments: Off-balance sheet financial instruments consist of commitments to extend credit including letters of credit. Fair values for commitments to extend credit are estimated using the fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the present credit standing of the counterparties. The estimated fair value of the commitments to extend credit and letters of credit are insignificant and therefore are not presented in the above table.

Table of Contents

PEOPLES FINANCIAL SERVICES CORP.
MANAGEMENT'S DISCUSSION AND ANALYSIS

(Dollars in thousands, except per share data)

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

Forward Looking Discussion:

Except for historical information, this Report may be deemed to contain "forward looking" information. Examples of forward looking information may include, but are not limited to: (i) projections of or statements made regarding future earnings, interest income, other income, earnings or loss per share, asset mix and quality, growth prospects, capital structure and other financial terms; (ii) statements of plans and objectives of management or the Board of Directors; (iii) statements of future economic performance; and (iv) statements of assumptions, such as economic conditions in the market areas served by the Company and Peoples Neighborhood Bank (the "Bank"), underlying other statements and statements about the Company and the Bank or their respective businesses. Such forward looking information can be identified by the use of forward looking terminology such as "believes," "expects," "may," "intends," "will," "should," "anticipates," or the negative of any of the foregoing or other variations thereon or comparable terminology, or by discussion of strategy. No assurance can be given that the future results covered by the forward looking information will be achieved. Such statements are subject to risks, uncertainties, and other factors which could cause actual results to differ materially from future results expressed or implied by such forward looking information.

Important factors that could impact operating results include, but are not limited to, (i) the effects of changing economic conditions in both the market areas served by the Company and the Bank and nationally, (ii) credit risks of commercial, real estate, consumer and other lending activities, (iii) significant changes in interest rates, (iv) changes in federal and state banking laws and regulations which could affect operations, (v) funding costs, and (vi) other external developments which could materially affect business and operations.

Critical Accounting Policies:

Our financial statements are prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP"). The preparation of 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 financial statements, as well as the reported amounts of revenues and expenses during those reporting periods.

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 for the year ended December 31, 2012, included in the Form S-4 filed with the Securities and Exchange Commission on August 13, 2013. This note lists the significant accounting policies used by us in the development and presentation of the financial statements. This MD&A, 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.

Table of Contents

PEOPLES FINANCIAL SERVICES CORP.
MANAGEMENT'S DISCUSSION AND ANALYSIS

(Dollars in thousands, except per share data)

Operating Environment:

Economic activity in the United States improved moderately during the first three quarters of 2013 although unemployment remains stubbornly elevated at 7.2%. The American economy grew at an annual rate of 2.8% in the third quarter, significantly better than economists had expected and the fastest pace reported in 2013. In addition, the housing market index, as last reported, was at 57. Any reading over 50 indicates that more builders view the condition of the housing market to be good rather than poor. The Federal Open Market Committee's ("FOMC") Beige Book, which was released in advance of the October, 2013 meeting of the FOMC, indicated a moderate pace of growth in the economy. The report indicated that consumer spending has continued to rise, aided by lower energy prices. Additionally, the manufacturing sector continues to expand, with the automotive and aerospace industries leading the way.

On June 28, 2013, we entered into a merger agreement with Pensco Financial Services Corporation ("Pensco"), pursuant to which Pensco would merge with and into us. The merger agreement provides that shareholders of Pensco will receive a fixed ratio of 1.3636 shares of our common stock for each outstanding share of Pensco's common stock, subject to potential adjustment upon the occurrence of certain unforeseen events described in the merger agreement. Upon completion of the merger, the combined company is expected to have approximately \$1.6 billion in assets. The transaction has been unanimously approved by the Board of Directors of both Pensco and us, and has received required approvals from the Federal Deposit Insurance Corporation, the Pennsylvania Department of Banking, and the Federal Reserve Bank of Philadelphia. The transaction remains subject to the approvals of the shareholders of both Pensco and us and the satisfaction of other customary closing conditions. It is expected to be completed in the fourth quarter of 2013.

Review of Financial Position:

Total assets grew \$42,903 or at an annualized rate of 8.5% to \$714,426 at September 30, 2013, from \$671,523 at December 31, 2012. For the nine months ended September 30, 2013, total assets averaged \$684,125, an increase of \$50,887 or 8.0%, from \$633,238 for the same period of 2012. The 2013 balance sheet growth was driven by increases in total deposits of \$47,489, an annualized growth rate of 11.1%. Interest-bearing deposits increased \$32,641, while noninterest-bearing deposits grew \$14,848. Loans, net increased \$39,336 or at an annualized rate of 11.3% to \$505,109 at September 30, 2013, compared to \$465,773 at December 31, 2012. Total stockholders' equity increased \$2,090 or at an annualized rate of 4.2%, from \$66,196 at year-end 2012 to \$68,286 at September 30, 2013.

Investment Portfolio:

The entire securities portfolio is held as available for sale, which allows for greater flexibility in using the investment portfolio for liquidity purposes by allowing securities to be sold when market opportunities occur. Investment securities totaled \$155,016 at September 30, 2013, an increase of \$7,236 or 4.9% from \$147,780 at December 31, 2012. The increase resulted from the purchase of U.S. Government-sponsored mortgage-backed securities. The U.S. Government and Government-sponsored mortgage-backed securities sector totaled \$53,988, or 34.8% of the portfolio at September 30, 2013, as compared to \$44,422, or 30.1% at December 31, 2012. The purchases were of highly structured securities with short average lives and offering stable cash flows in order to fund future loan demand.

Table of Contents

PEOPLES FINANCIAL SERVICES CORP.
MANAGEMENT'S DISCUSSION AND ANALYSIS

(Dollars in thousands, except per share data)

For the nine months ended September 30, 2013, the investment portfolio averaged \$147,214, an increase of \$14,802 or 11.2% compared to \$132,412 for the same period last year. The tax-equivalent yield on the investment portfolio decreased 30 basis points to 3.08% for the nine months ended September 30, 2013, from 3.38% for the comparable period of 2012. The tax-equivalent yield decreased 2 basis points to 3.08% for the third quarter of 2013 from 3.10% for the second quarter of 2013.

Securities available for sale are accounted for at fair value, with unrealized gains or losses net of deferred income taxes reported in the accumulated other comprehensive income component of stockholders' equity. The carrying value of securities at September 30, 2013, included a net unrealized gain of \$4,082 reflected as accumulated other comprehensive income of \$2,694 in stockholders' equity, net of deferred income taxes of \$1,388. This compares to a net unrealized gain of \$7,388 at December 31, 2012, reflected as an accumulated other comprehensive income of \$4,876, net of deferred income taxes of \$2,512.

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

Loan Portfolio:

Loans, net increased \$39,336, or 11.3% annualized, to \$505,109 at September 30, 2013 from \$465,773 at December 31, 2012. The growth reflected increases in commercial loans, commercial real estate loans and residential real estate loans partially offset by a decrease in consumer loans. Commercial loans increased \$17,083, or 13.4% annualized, to \$187,462 at September 30, 2013 compared to \$170,379 at December 31, 2012. Commercial real estate loans increased \$22,759, or 19.2% annualized, to \$181,557 at September 30, 2013 compared to \$158,798 at December 31, 2012.

A gradual improvement in real estate markets has contributed to a slight increase in residential real estate mortgages of \$269, or 0.3% annualized, to \$117,796 at September 30, 2013 compared to \$117,527 at December 31, 2012. As our student loan portfolio continues to shrink from normal payments and prepayments, the overall consumer loan portfolio decreased in 2013. Our consumer loan portfolio decreased 5.4% annualized, or \$775, to \$18,294 at September 30, 2013 compared to \$19,069 at December 31, 2012.

For the nine months ended September 30, 2013, loans averaged \$486,200, an increase of \$26,747 or 5.8% compared to \$459,453 for the same period of 2012. The tax-equivalent yield on the loan portfolio was 5.22% for the nine months ended September 30, 2013, a decrease of 19 basis points from 5.41% for the same period last year. The tax-equivalent yield of the loan portfolio was 5.14% in the third quarter of 2013 compared to 5.30% in the second quarter of 2013.

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

Table of ContentsPEOPLES FINANCIAL SERVICES CORP.
MANAGEMENT'S DISCUSSION AND ANALYSIS

(Dollars in thousands, except per share data)

Unused commitments on September 30, 2013, totaled \$103,177, consisting of \$89,077 in unfunded commitments of existing loan facilities and \$14,100 in standby letters of credit. Due to fixed maturity dates, specified conditions within these instruments, and the ultimate needs of our customers, many will expire without being drawn upon. We believe that amounts actually drawn upon can be funded in the normal course of operations and therefore, do not represent a significant liquidity risk to us. In comparison, unused commitments, at December 31, 2012, totaled \$77,342, consisting of \$65,696 in unfunded commitments of existing loans and \$11,646 in standby letters of credit.

We record an allowance for off-balance sheet credit losses, if deemed necessary, separately as a liability. No allowance was deemed necessary at September 30, 2013 and December 31, 2012. 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.

Asset Quality:

National, Pennsylvania, New York and market area unemployment rates at September 30, 2013 and 2012, are summarized as follows:

| | September 30, 2013 | | September 30, 2012 | |
|--------------------------|-----------------------|---|-----------------------|---|
| United States | 7.2 | % | 7.8 | % |
| Pennsylvania (statewide) | 7.8 | % | 7.5 | % |
| Lackawanna county | 9.4 | % | 8.5 | % |
| Susquehanna county | 6.7 | % | 6.8 | % |
| Wyoming county | 8.9 | % | 8.8 | % |
| New York (statewide) | 7.5 | % | 8.1 | % |
| Broome county | 7.6 | % | 8.4 | % |

The employment conditions improved for the Nation, New York, Broome County in New York and Susquehanna County in Pennsylvania, but deteriorated in Pennsylvania and the counties of Lackawanna and Wyoming in Pennsylvania from one year ago. Despite some improvements, employment conditions continued to be weak as unemployment levels remained at historical highs.

In spite of these and other challenging economic factors, our asset quality has improved in 2013. Nonperforming assets decreased \$1,470 or 11.8% to \$10,969 at September 30, 2013, from \$12,439 at December 31, 2012. We experienced decreases in nonaccrual loans, accruing loans past due 90 days or more and foreclosed assets. As a percentage of loans, net and foreclosed assets, nonperforming assets equaled 2.17% at September 30, 2013 compared to 2.66% at December 31, 2012.

Loans on nonaccrual status decreased \$124 to \$7,810 at September 30, 2013 from \$7,934 at December 31, 2012. The reduction from year end was due primarily to a decrease of \$432 in commercial real estate loans partially offset by increases of \$129 in commercial loans and \$179 residential real estate loans. The decrease in foreclosed assets from \$2,003 at December 31, 2012 to \$1,043 as of September 30, 2013 was primarily due to one commercial property and one residential real estate property.

Table of Contents

PEOPLES FINANCIAL SERVICES CORP.
MANAGEMENT'S DISCUSSION AND ANALYSIS

(Dollars in thousands, except per share data)

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

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

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

The allowance for loan losses increased \$254 to \$6,835 at September 30, 2013, from \$6,581 at the end of 2012. In comparison to September 30, 2012, the allowance for loan losses increased \$538 from \$6,297. For the nine months ended September 30, net charge-offs were \$241 or 0.07% of average loans outstanding in 2013, a \$176 decrease compared to \$417 or 0.12% of average loans outstanding for the same period last year. Net charge-offs totaled \$65 in the third quarter of 2013 compared to net recoveries of \$51 in the third quarter of 2012.

30

Table of Contents

PEOPLES FINANCIAL SERVICES CORP.
MANAGEMENT'S DISCUSSION AND ANALYSIS

(Dollars in thousands, except per share data)

Deposits:

Deposits are attracted within our primary market area through the offering of various deposit instruments including demand deposit accounts, NOW accounts, money market deposit accounts, savings accounts, and time deposits, including certificates of deposit and individual retirement accounts. During the nine months ended September 30, 2013, total deposits increased \$47,489, or 11.1% annualized, to \$621,800 from \$574,311 at December 31, 2012. Time deposits less than \$100 increased \$897 or 1.5% annualized, to \$83,105 at September 30, 2013, compared to \$82,208 at December 31, 2012 while time deposits greater than \$100 decreased \$269 or 1.0% annualized, to \$34,956 from \$35,225 during that same time period. Demand deposits, increased \$14,848, or 19.4% annualized, to \$117,170 at September 30, 2013, compared to \$102,322 at December 31, 2012. Interest-bearing checking deposits, including NOW and money market accounts, increased \$22,847, or 21.9% annualized, to \$162,151 at September 30, 2013, compared to \$139,304 at December 31, 2012. Savings deposits increased \$9,166, or 5.7% annualized, to \$224,418 at September 30, 2013, compared to \$215,252 at December 31, 2012.

For the nine months ended September 30, 2013, average total deposits increased \$72,767 to \$591,485 compared to \$518,718 for the same period of 2012. Average noninterest-bearing deposits grew \$13,450, while interest-bearing accounts increased \$59,317. Our cost of interest-bearing deposits decreased 19 basis points to 0.83% for the nine months ended September 30, 2013, from 1.02% for the same nine months of 2012. For the quarter, total deposits averaged \$67,431 more in the third quarter of 2013 compared to the same quarter in 2012. The cost of interest-bearing deposits decreased to 0.82% from 0.99% comparing the third quarter of 2013 to the third quarter of 2012.

Interest rates have been at historic lows for an extended period. Short term and core deposit rates have remained flat. As such, deposits have been attracted by offering rates on longer term time deposit products which are higher than other investment alternatives available to customers elsewhere in the market place. The added benefit of expanded FDIC insurance up to \$250 has also made bank deposits an attractive investment vehicle for our customers.

Borrowings:

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

Total short-term borrowings at September 30, 2013, totaled \$17,854 compared to \$12,764 at December 31, 2012. The increase was due to increases in cash management balances carried by commercial deposit customers. Long-term debt was \$2,507 at September 30, 2013, compared to \$13,130 at year end 2012 due to the contractual maturities of those borrowings.

Table of Contents

PEOPLES FINANCIAL SERVICES CORP.
MANAGEMENT'S DISCUSSION AND ANALYSIS

(Dollars in thousands, except per share data)

Market Risk Sensitivity:

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

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

The ALCO, comprised of members of our Board of Directors, senior management and other appropriate officers, oversees our IRR management program. Specifically ALCO analyzes economic data and market interest rate trends, as well as competitive pressures, and utilizes 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") and rate-sensitive liabilities ("RSL"), and overall operating results and financial position. One such technique utilizes a static gap model that considers repricing frequencies of RSA and RSL in order to monitor IRR. Gap analysis attempts to measure our interest rate exposure by calculating the net amount of RSA and RSL that reprice within specific time intervals. A positive gap occurs when the amount of RSA repricing in a specific period is greater than the amount of RSL repricing within that same time frame and is indicated by a RSA/RSL ratio greater than 1.0. A negative gap occurs when the amount of RSL repricing is greater than the amount of RSA and is indicated by a RSA/RSL ratio 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.

Table of Contents

PEOPLES FINANCIAL SERVICES CORP.
MANAGEMENT'S DISCUSSION AND ANALYSIS

(Dollars in thousands, except per share data)

Our cumulative one-year RSA/RSL ratio equaled 0.65 at September 30, 2013. Given the length of time that market rates have been at historical lows and the potential for rates to rise in the future, the focus of ALCO has been to create a positive static gap position in the near term. With regard to RSA, we predominantly offered medium-term, fixed-rate loans as well as adjustable rate loans. With respect to RSL, we offered a promotional certificate of deposit with an 84-month term. The current RSA/RSL position indicates that the amount of RSA repricing within one year would be less than that of RSL, thereby causing a reduction in net interest income with market rate increases.

However, these forward-looking statements are qualified in the aforementioned section entitled "Forward-Looking Discussion" in this Management's Discussion and Analysis.

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. Variations occur daily as we adjust our rate sensitivity throughout the year. Finally, assumptions must be made in constructing such a table.

As the static gap report fails to address the dynamic changes in the balance sheet composition or prevailing interest rates, we utilize a simulation model to enhance our asset/liability management. This model is used to create pro forma net interest income scenarios under various interest rate shocks. Model results at September 30, 2013, produced results similar to those indicated by the one-year static gap position. In addition, parallel and instantaneous shifts in interest rates under various interest rate shocks resulted in changes in net interest income that were well within policy limits. We will continue to monitor our IRR for the remainder of 2013 and employ deposit and loan pricing strategies and direct the reinvestment of loan and investment repayments in order to maintain a favorable IRR position.

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

Liquidity:

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

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

Table of Contents

PEOPLES FINANCIAL SERVICES CORP.
MANAGEMENT'S DISCUSSION AND ANALYSIS

(Dollars in thousands, except per share data)

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

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

We employ a number of analytical techniques in assessing the adequacy of our liquidity position. One such technique is the use of ratio analysis related to our reliance on noncore funds to fund our investments and loans maturing after September 30, 2013. Our noncore funds at September 30, 2013, were comprised of time deposits in denominations of \$100 or more, repurchase agreements and other borrowings. These funds are not considered to be a strong source of liquidity since they are interest rate sensitive and are considered to be highly volatile. At September 30, 2013, our net noncore funding dependence ratio, the difference between noncore funds and short-term investments to long-term assets, was 4.4%, while our net short-term noncore funding dependence ratio, noncore funds maturing within one-year, less short-term investments to long-term assets equaled 0.2%. These ratios indicated that we had minimal reliance on noncore funds at September 30, 2013. Comparatively, our ratios weakened slightly from year-end 2012 when they were 3.7% and -1.7%, respectively. According to the most recent Bank Holding Company Performance Report for our Federal Reserve District, these ratios for our peer group were 14.4% and 4.6%.

The Consolidated Statements of Cash Flows present the changes in cash and cash equivalents from operating, investing and financing activities. Cash and cash equivalents, consisting of cash on hand, cash items in the process of collection, deposit balances with other banks and federal funds sold, decreased \$3,563 during the nine months ended September 30, 2013. Cash and cash equivalents increased \$2,248 for the same period last year. For the nine months ended September 30, 2013, net cash inflows of \$39,923 from financing activities and \$8,315 from operating activities were more than offset by a \$51,801 net cash outflow from investing activities. For the same period of 2012, net cash inflows of \$22,298 from financing activities and \$7,621 from operating activities were partially offset by a \$27,671 net cash outflow from investing activities.

Financing activities provided net cash of \$39,923 for the nine months ended September 30, 2013, and \$22,298 for the same nine months of 2012. Deposit gathering is our predominant financing activity. During the three quarters ended September 30, 2013 deposit gathering increased, which resulted in a \$47,489 increase in net cash. Similarly, deposit gathering provided net cash of \$60,129 for the same period of 2012. We continued to attract deposits from new and existing customers, including municipalities and school districts. Also, deposit gathering in relation to natural gas activity within existing markets in Susquehanna and Wyoming Counties of Pennsylvania has continued as many of the leased properties have generated significant royalty income.

Table of Contents

PEOPLES FINANCIAL SERVICES CORP.
MANAGEMENT'S DISCUSSION AND ANALYSIS

(Dollars in thousands, except per share data)

Operating activities provided net cash of \$8,315 for the nine months ended September 30, 2013, and \$7,621 for the same period of 2012. Net income, adjusted for the effects of gains and losses along with noncash transactions such as depreciation and the provision for loan losses, is the primary source of funds from operations.

Investing activities primarily include transactions related to our lending activities and investment portfolio. Investing activities used net cash of \$51,801 for the nine months ended September 30, 2013, compared to \$27,671 for the same period of 2012. In both 2013 and 2012, a net increase in lending activities was the primary factor causing the net cash outflow from investing activities with investment portfolio purchases also contributing to the 2013 increase.

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

Capital:

Stockholders' equity totaled \$68,286 or \$22.12 per share at September 30, 2013, compared to \$66,196 or \$21.46 per share at December 31, 2012. Net income of \$6,305 for the nine months ended September 30, 2013 was the primary factor leading to the improved capital position. Stockholders' equity was also affected by cash dividends declared of \$2,130, common stock issuances of \$97 and other comprehensive losses resulting from market value fluctuations in the investment portfolio of \$2,182.

Year-to-date dividends declared equaled \$0.69 per share in 2013, an increase of 7.8% compared to \$0.64 in 2012. The dividend payout ratio was 33.8% for the nine months ended September 30, 2013, compared to 28.7% for the same period in 2012. It is the intention of the Board of Directors to continue to pay cash dividends in the future. However, these decisions are affected by operating results, financial and economic decisions, capital and growth objectives, appropriate dividend restrictions and other relevant factors. Stockholders may automatically reinvest their dividends in shares of our common stock through our dividend reinvestment plan.

35

Table of Contents

PEOPLES FINANCIAL SERVICES CORP.
MANAGEMENT'S DISCUSSION AND ANALYSIS

(Dollars in thousands, except per share data)

We attempt to assure capital adequacy by monitoring our current and projected capital positions to support future growth, while providing stockholders with an attractive long-term appreciation of their investments. According to bank regulation, at a minimum, banks must maintain a Tier I capital to risk-adjusted assets ratio of 4.0 percent and a total capital to risk-adjusted assets ratio of 8.0 percent. Additionally, banks must maintain a Leverage ratio, defined as Tier I capital to total average assets less intangibles, of 3.0 percent. The minimum Leverage ratio of 3.0 percent only applies to institutions with a composite rating of 1 under the Uniform Interagency Bank Rating System that are not anticipating or experiencing significant growth and have well-diversified risk. An additional 100 to 200 basis points are required for all but these most highly-rated institutions. Our minimum Leverage ratio was 4.0 percent at September 30, 2013 and 2012. If an institution is deemed to be undercapitalized under these standards, banking law 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 significantly or critically undercapitalized institutions, including restrictions on interest payable on accounts, dismissal of management and appointment of a receiver. For well capitalized institutions, banking law provides authority for regulatory intervention where the institution is deemed to be engaging in unsafe and unsound practices or receives a less than satisfactory examination report rating.

The adequacy of capital is reviewed on an ongoing basis with reference to the size, composition and quality of resources and regulatory guidelines. We seek to maintain a level of capital sufficient to support existing assets and anticipated asset growth, maintain favorable access to capital markets, and preserve high quality credit ratings. As of September 30, 2013, the Bank's Tier I capital to total average assets was 9.19%. The Bank's Tier I capital to risk weighted asset ratio was 11.94% and the total capital to risk weighted asset ratio was 13.19% at September 30, 2013. The Bank was deemed to be well-capitalized under regulatory standards at September 30, 2013.

Review of Financial Performance:

Net income for the third quarter of 2013 equaled \$1,743 or \$0.56 per share, a decrease of \$497 or 22.2% compared to \$2,240 or \$0.72 per share for the third quarter of 2012. Return on average assets ("ROA") measures our net income in relation to total assets. Our ROA was 0.98% for the third quarter of 2013 compared to 1.38% for the same period of 2012. Return on average equity ("ROE") indicates how effectively we can generate net income on the capital invested by stockholders. Our ROE was 10.44% for the third quarter of 2013 compared to 14.26% for the third quarter of 2012. For the year, net income through the third quarter of 2013 equaled \$6,305 or \$2.04 per share, a decrease of \$639 or 9.2% compared to \$6,944 or \$2.23 per share for the same period of 2012. Our ROA and ROE were 1.23% and 12.81% through nine months in 2013 compared to 1.46% and 15.41% for the same period of 2012. The decreases in both year-to-date and quarter-to-date earnings were caused primarily by the recognition of necessary costs associated with the pending merger previously mentioned along with recording greater costs for self-funded health care coverage associated with higher claim experience.

Table of Contents

PEOPLES FINANCIAL SERVICES CORP.
MANAGEMENT'S DISCUSSION AND ANALYSIS

(Dollars in thousands, except per share data)

Net Interest Income:

Net interest income is still 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, short-term and long-term borrowings comprise interest-bearing liabilities. Net interest income is impacted by:

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

Changes in net interest income are measured by the net interest spread and net interest margin. Net interest spread, the difference between the average yield earned on earning assets and the average rate incurred on interest-bearing liabilities, illustrates the effects changing interest rates have on profitability. Net interest margin, net interest income as a percentage of earning assets, is a more comprehensive ratio, as it reflects not only the spread, but also the change in the composition of interest-earning assets and interest-bearing liabilities. Tax-exempt loans and investments carry pre-tax yields lower than their taxable counterparts. Therefore, in order to make the analysis of net interest income more comparable, tax-exempt income and yields are reported herein on a tax-equivalent basis using the prevailing federal statutory tax rate of 34.0%.

For the three months ended September 30, 2013, tax-equivalent net interest income increased \$600 or 10.1% to \$6,539 in 2013 from \$5,939 in 2012. The increase was attributable to a favorable volume variance offset partially by a slight deterioration in the rate variance. The net interest spread increased to 3.66% for the three months ended September 30, 2013 from 3.67% for the three months ended September 30, 2012. The net interest margin decreased to 3.86% for the third quarter of 2013 from 3.89% for the comparable period of 2012. For the three months ended September 30, 2013, tax equivalent interest revenue increased \$393, or 5.4%, to \$7,639 as compared to \$7,246 for the three months ended September 30, 2012. The increase was primarily due to the growth in average earning assets which increased \$65,504 to \$672,827 for the third quarter of 2013 from \$607,323 for the same period in 2012. The overall yield on earning assets, on a fully tax equivalent basis, decreased 25 basis points for the three months ended September 30, 2013 at 4.50% as compared to 4.75% for the three months ended September 30, 2012. This was a result of the continuation of the low interest rate environment along with increased market competition. The yield earned on loans decreased 20 basis points for the third quarter of 2013 to 5.14% from 5.34% for the third quarter of 2012. Average loans increased to \$498,983 for the quarter ended September 30, 2013 compared to \$460,592 for the same period in 2012. The resulting tax-equivalent interest earned on loans was \$6,464 for the three month period ended September 30, 2013 compared to \$6,177 for the same period in 2012, an increase of \$287 or 4.6%.

Table of Contents

PEOPLES FINANCIAL SERVICES CORP.
MANAGEMENT'S DISCUSSION AND ANALYSIS

(Dollars in thousands, except per share data)

Total interest expense decreased \$207 or 15.8%, to \$1,100 for the three months ended September 30, 2013 from \$1,307 for the three months ended September 30, 2012. This decrease was attributable to the decrease in the cost of funds since the average volume of interest bearing liabilities increased comparing the three months ended September 30, 2013 and 2012. The cost of funds decreased to 0.84% for the three months ended September 30, 2013 as compared to 1.08% for the same period in 2012. Conversely, the average volume of interest bearing liabilities increased to \$520,146 for the three months ended September 30, 2013 as compared to \$481,319 for the three months ended September 30, 2012. This increase was primarily due to the increase in average interest-bearing demand deposits and savings deposits. Average interest-bearing demand deposits increased to \$110,836 for the three months ended September 30, 2013 as compared to \$88,908 for the same period in 2012 while average savings deposits increased to \$225,577 for the three months ended September 30, 2013 as compared to \$209,251 for the same period in 2012. We continue to offer an above market rate on our certificate of savings account, which has attracted money that customers are not willing to invest elsewhere.

For the nine months ended September 30, 2013, tax-equivalent net interest income increased \$1,071 or 5.9% to \$19,164 in 2013 from \$18,093 in 2012. The net interest spread decreased to 3.75% for the nine months ended September 30, 2013 from 3.79% for the nine months ended September 30, 2012. The net interest margin decreased to 3.95% for the nine month period ended September 30, 2013 from 4.03% for the same period in 2012.

For the nine months ended September 30, 2013, tax equivalent interest revenue increased \$439, or 2.0%, to \$22,412 as compared to \$21,973 for the nine months ended September 30, 2012. The increase was primarily due to the growth in average earning assets which increased \$49,247 to \$649,417 for the nine months ended September 30, 2013 from \$600,170 for the same period in 2012. The overall yield on earning assets, on a fully tax equivalent basis, decreased 28 basis points for the nine months ended September 30, 2013 at 4.61% as compared to 4.89% for the nine months ended September 30, 2012. This was a result of the continuation of the low interest rate environment along with increased market competition. The yield earned on loans decreased 19 basis points through three quarters of 2013 to 5.22% from 5.41% for the same period in 2012. Average loans increased to \$486,200 for the nine months ended September 30, 2013 compared to \$459,453 for the comparable period of 2012. Tax equivalent interest earned on loans was \$18,989 in 2013 compared to \$18,604 in 2012, an increase of \$385 or 2.1%.

Total interest expense decreased by \$632 or 16.3%, to \$3,248 for the nine months ended September 30, 2013 from \$3,880 for the nine months ended September 30, 2012. This decrease was the result of a favorable rate variance as the cost of funds decreased to 0.86% for the nine months ended September 30, 2013 as compared to 1.10% for the same period in 2012. Counteracting the positive influence from the favorable rate variance was an increase in the average volume of interest bearing liabilities comparing the nine months ended September 30, 2013 and 2012. Average interest bearing liabilities increased to \$503,791 for the nine months ended September 30, 2013 as compared to \$473,219 for the nine months ended September 30, 2012. This increase was primarily due to the increase in average interest-bearing demand deposits and savings deposits. Average interest-bearing demand deposits increased to \$100,737 for the nine months ended September 30, 2013 as compared to \$68,854 for the same period in 2012 while average savings deposits increased to \$220,580 for the nine months ended September 30, 2013 as compared to \$206,675 for the same period in 2012.

Table of ContentsPEOPLES FINANCIAL SERVICES CORP.
MANAGEMENT'S DISCUSSION AND ANALYSIS

(Dollars in thousands, except per share data)

The average balances of assets and liabilities, corresponding interest income and expense and resulting average yields or rates paid are summarized as follows. Averages for earning assets include nonaccrual loans. Investment averages include available-for-sale securities at amortized cost. Income on investment securities and loans is adjusted to a tax equivalent basis using the prevailing federal statutory tax rate of 34.0%.

| | Nine months ended | | | September 2012 | | |
|--|-------------------|----------|--------|----------------|----------|--------|
| | September 2013 | | Yield/ | September 2012 | | Yield/ |
| | Average | Interest | Rate | Average | Interest | Rate |
| Assets: | | | | | | |
| Earning assets: | | | | | | |
| Loans | | | | | | |
| Taxable | \$453,904 | \$17,675 | 5.21 % | \$419,695 | \$16,895 | 5.38 % |
| Tax exempt | 32,296 | 1,314 | 5.44 | 39,758 | 1,709 | 5.74 |
| Investments | | | | | | |
| Taxable | 100,174 | 1,812 | 2.42 | 97,946 | 1,818 | 2.48 |
| Tax exempt | 47,040 | 1,577 | 4.48 | 34,466 | 1,533 | 5.94 |
| Interest bearing deposits | 447 | 2 | 0.60 | 1,226 | 7 | 0.76 |
| Federal funds sold | 15,556 | 32 | 0.28 | 7,079 | 11 | 0.21 |
| Total earning assets | 649,417 | 22,412 | 4.61 % | 600,170 | 21,973 | 4.89 % |
| Less: allowance for loan losses | 6,677 | | | 5,734 | | |
| Cash and due from banks | 8,396 | | | 8,200 | | |
| Premises and equipment, net | 8,721 | | | 8,483 | | |
| Other assets | 24,268 | | | 22,119 | | |
| Total assets | \$684,125 | | | \$633,238 | | |
| Liabilities and Stockholders' Equity: | | | | | | |
| Interest bearing liabilities: | | | | | | |
| Money market accounts | 44,134 | 154 | 0.47 % | \$36,380 | 157 | 0.58 % |
| NOW accounts | 100,737 | 398 | 0.53 | 68,854 | 304 | 0.59 |
| Savings accounts | 220,580 | 725 | 0.44 | 206,675 | 979 | 0.63 |
| Time deposits less than \$100 | 82,143 | 1,172 | 1.91 | 79,379 | 1,281 | 2.15 |
| Time deposits \$100 or more | 35,050 | 555 | 2.12 | 32,039 | 513 | 2.14 |
| Short term borrowings | 16,728 | 100 | 0.80 | 31,490 | 140 | 0.59 |
| Long-term debt | 4,419 | 144 | 4.36 | 18,402 | 506 | 3.68 |
| Total interest bearing liabilities | 503,791 | 3,248 | 0.86 % | 473,219 | 3,880 | 1.10 % |
| Non-interest bearing demand deposits | 108,841 | | | 95,391 | | |
| Other liabilities | 5,662 | | | 4,437 | | |
| Stockholders' equity | 65,831 | | | 60,191 | | |
| Total liabilities and stockholders' equity | \$684,125 | | | \$633,238 | | |
| Net interest income/spread | | \$19,164 | 3.75 % | | \$18,093 | 3.79 % |
| Net interest margin | | | 3.95 % | | | 4.03 % |
| Tax equivalent adjustments: | | | | | | |
| Loans | | 447 | | | 581 | |
| Investments | | 536 | | | 521 | |
| Total adjustments | | \$983 | | | \$1,102 | |

Table of Contents

PEOPLES FINANCIAL SERVICES CORP.
MANAGEMENT'S DISCUSSION AND ANALYSIS

(Dollars in thousands, except per share data)

Provision for Loan Losses:

We evaluate the adequacy of the allowance for loan losses account on a quarterly basis utilizing our systematic analysis in accordance with procedural discipline. We take into consideration certain factors such as composition of the loan portfolio, volumes of nonperforming loans, volumes of net charge-offs, prevailing economic conditions and other relevant factors when determining the adequacy of the allowance for loan losses account. We make monthly provisions to the allowance for loan losses account in order to maintain the allowance at the appropriate level indicated by our evaluations. In addition, regulatory agencies, as an integral part of their examination process, periodically review our allowance for loan losses. These agencies may require us to recognize additions to the allowance based on information available to them at the time of their examination. We are unaware of any such requirements based on the results of our latest regulatory examination. Based on our most current evaluation, we believe that the allowance is adequate to absorb any known and inherent losses in the portfolio.

For the three months and nine months ended September 30, 2013, the provision for loan losses totaled \$165 and \$495. The provision for loan losses was \$330 and \$1,365 for those same periods in 2012. The reduction in the quarter-to-date and year-to-date provisions comparing 2013 and 2012 reflect the reduction in the level of nonperforming loans and net charge-offs as well as the moderate improvement in economic conditions.

Noninterest Income:

Noninterest income for the third quarter declined \$126 or 10.0% to \$1,135 in 2013 from \$1,261 in 2012. For the nine months ended September 30, 2013, noninterest income totaled \$3,573, a decrease of \$268 or 7.0% from \$3,841 for the comparable period of 2012. Mortgage banking income decreased \$195 to \$458 for the nine months ended September 30, 2013 from \$653 for the same period last year as a result of an increase in market rates in 2013. The recent increase in mortgage rates has caused a reduction in the number of mortgages originated in the secondary market in 2013. Similarly, gains from sales of available-for-sale investment securities decreased \$384 in 2013 as a result of the increase in the longer end of the US Treasury curve. Service charges, fees and commissions increased \$183 to \$2,527 in 2013 from \$2,344 in 2012 in correlation to the growth in loans and deposits. Revenue received from our Wealth Management Division increased \$128 for the nine months ended September 30, 2013 to \$589 from \$461 for the comparable period in 2012 as a result of an increased demand for investment type products and services as stock prices and market rates increased throughout 2013.

Noninterest Expenses:

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

Table of Contents

PEOPLES FINANCIAL SERVICES CORP.
MANAGEMENT'S DISCUSSION AND ANALYSIS

(Dollars in thousands, except per share data)

For the third quarter, noninterest expense increased \$1,222 or 31.8% to \$5,060 in 2013 from \$3,838 in 2012. Personnel costs rose 28.7%, while occupancy and equipment costs increased 13.9%. Other expenses increased 46.4% comparing the third quarters of 2013 and 2012. For the nine months ended September 30, noninterest expense increased \$2,202 or 19.9% to \$13,259 in 2013 from \$11,057 in 2012.

Salaries and employee benefits expense, which comprise the majority of noninterest expense, totaled \$2,307 for the third quarter of 2013. The \$515 or 28.7% increase was primarily due to the recognition of additional costs associated with the self funded health care plan. For the nine months ended September 30, 2013, salaries and benefit related expenses totaled \$6,265 or 47.3% of total noninterest expense, an increase of \$994 from \$5,271 or 47.7% of total noninterest expense for the same nine months of 2012.

We experienced a \$104 or 13.9% increase in net occupancy and equipment expense comparing the third quarters of 2013 and 2012. For the nine months ended September 30, 2013, net occupancy and equipment expense totaled \$2,520, an increase of \$230 or 10.0% from \$2,290 for the same nine months of 2012. Increased depreciation expense and other costs related to equipment and computer systems caused the increase between comparable periods as well as increased costs associated with the operation and maintenance of the new West Side office opened in Binghamton, New York on December 28, 2012.

For the third quarter, other expenses increased \$603 or 46.4% comparing 2013 and 2012. For the nine months ended September 30, 2013, other expenses totaled \$4,474, an increase of \$978 or 28.0% compared to \$3,496 for the same period of 2012. Merger related costs accounted for the most significant increase to other expenses when comparing the same periods of 2013 and 2012.

Income Taxes:

We recorded income tax expense of \$385 or 18.1% of pre-tax income, and \$462 or 17.1% of pre-tax income for the quarters ended September 30, 2013 and 2012. We recorded an income tax expense of \$1,695 and \$1,466 for the nine-months ended September 30, 2013 and 2012. The effective tax rate increased to 21.2% in 2013 from 17.4% in 2012. We recognized a benefit of \$283 in investment tax credits in 2013 compared to credits of \$544 in 2012 as a result of our limited partnership investment in elderly housing.

Table of Contents

PEOPLES FINANCIAL SERVICES CORP.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

The overnight borrowing rate has been subject to a range of 0% to 0.25% since the Federal Reserve adopted their accommodative monetary policy. The Federal Reserve and Treasury Department have also acted in concert to maintain longer term rates at historic lows. While some federal programs to aid the economy have expired, there remains only a slight chance that the current rate environment will change in the near term as high unemployment continues to be a deterrent to economic growth. As such, we are operating within a steep, albeit low yield curve environment which has allowed us to maintain a strong net interest margin. At September 30, 2013, we are subject to a greater level of interest rate sensitivity given a falling rate scenario. The results of the latest financial simulation indicate a possible decrease in net interest income of 2.6% given an instantaneous and parallel change of +200 basis points as compared to a decrease of 7.9% shown in the model at a -200 basis point rate shock scenario. Our net interest income risk position is within the guidelines established by the asset/liability policy for interest rate sensitivity testing. We continuously monitor this rate sensitivity and act accordingly to minimize the risk to our overall asset liability position. To mitigate our exposure from rising rates, we have implemented a plan to shorten the duration of earning assets and lengthen the duration of interest-bearing liabilities in order to improve net interest income in the future.

Equity value at risk is monitored regularly and was within established policy limits at September 30, 2013. For further discussion related to quantitative and qualitative disclosures about market risk, refer to our Annual Report for the period ended December 31, 2012.

Item 4. Controls and Procedures

(a) Evaluation of disclosure controls and procedures.

The Company's management, including the Company's Chief Executive Officer and Principal Financial Officer, evaluated the effectiveness of the design and operation of the Company's disclosure controls and procedures (as defined in Rule 13a-15(e) and 15(d)-15(e) under the Securities Exchange Act of 1934, as amended) as of September 30, 2013. Based upon that evaluation, the Chief Executive Officer and Principal Financial Officer concluded that, as of the Evaluation Date, the Company's disclosure controls and procedures were effective in timely alerting them to any material information relating to the Company and its subsidiaries required to be included in the Company's periodic SEC filings.

(b) Changes in internal controls.

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

Table of Contents

PEOPLES FINANCIAL SERVICES CORP.

PART II OTHER INFORMATION

Item 1. Legal Proceedings

None.

Item 1A. Risk Factors

No changes from those previously disclosed.

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

None.

Item 3. Defaults upon Senior Securities

None.

Item 4. Mine Safety Disclosures

Not applicable.

Item 5. Other Information

None.

43

Table of Contents

PEOPLES FINANCIAL SERVICES CORP.

Item 6. Exhibits

31 (i) Chief Executive Officer and Chief Financial Officer certifications pursuant to Rule 13a-14(a)/15d-14(a).

32.1 Chief Executive Officer certifications pursuant to Section 1350.

32.2 Chief Financial Officer certifications pursuant to Section 1350.

101+ Interactive Data File

+ As provided in Rule 406T of Regulation S-T, this information is furnished and not filed for purposes of Sections 11 and 12 of the Securities Act of 1933 and Section 18 of the Securities Exchange Act of 1934.

44

Table of Contents

PEOPLES FINANCIAL SERVICES CORP.

FORM 10-Q

SIGNATURE PAGE

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.

Registrant, Peoples Financial Services Corp.

Date: November 13, 2013 /s/ Alan W. Dakey
Alan W. Dakey
President and Chief Executive Officer
(Principal Executive Officer)

Registrant, Peoples Financial Services Corp.

Date: November 13, 2013 /s/ Scott A. Seasock
Scott A. Seasock
Senior Vice President and
Chief Financial Officer
(Principal Financial Officer)

Table of Contents
EXHIBIT INDEX

| Item Number | Description | Page |
|-------------|--|------|
| <u>31</u> | CEO and CFO Certifications (i) Pursuant to Rule 13a-14 (a) /15d-14 (a). | 47 |
| <u>32.1</u> | CEO Certifications Pursuant to Section 1350. | 49 |
| <u>32.2</u> | CFO Certifications Pursuant to Section 1350. | 50 |
| 101 | The following materials from Peoples Financial Services Corp. Quarterly Report on Form 10-Q for the period ended September 30, 2013, formatted in XBRL: (i) the Consolidated Balance Sheets, (ii) the Consolidated Statements of Income and Comprehensive Income, (iii) the Consolidated Statements of Changes in Stockholders' Equity, (iv) the Consolidated Statements of Cash Flows and (v) the Notes to | |

the
Consolidated
Financial
Statements.

46
