COMMUNITY BANK SYSTEM, INC.
Form 10-K
March 01, 2019

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

FORM 10-K
ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended December 31, 2018

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from__________ to____________________ .
Commission file number 001-13695

(Exact name of registrant as specified in its charter)

| | |
|---|---|
| Delaware | 16 1213679 |
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification No.) |

| | |
|---|---|
| 5790 Widewaters Parkway, DeWitt, New York | 13214-1883 |
| (Address of principal executive offices) | (Zip Code) |

(315) 445 2282
(Registrant's telephone number, including area code)

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

| Title of each class | Name of each exchange on which registered. |
|---|---|
| Common Stock, Par Value $1.00 per share | New York Stock Exchange |

Securities registered pursuant to Section 12(g) of the Act: None
Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes No .

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

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

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit such files). Yes No .

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

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

| Large accelerated filer | Accelerated filer | Non-accelerated filer | Smaller reporting company | Emerging growth company |
|---|---|---|---|---|

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

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

The aggregate market value of the common stock, $1.00 par value per share, held by non-affiliates of the registrant computed by reference to the closing price as of the close of business on June 30, 2018 (the registrant's most recently completed second fiscal quarter): $2,967,005,765.

The number of shares of the common stock, $1.00 par value per share, outstanding as of the close of business on January 31, 2019: 51,318,005

DOCUMENTS INCORPORATED BY REFERENCE.

Portions of the Definitive Proxy Statement for the Annual Meeting of the Shareholders to be held on May 15, 2019 (the "Proxy Statement") is incorporated by reference in Part III of this Annual Report on Form 10-K.

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Part I

This Annual Report on Form 10-K contains certain forward-looking statements with respect to the financial condition, results of operations and business of Community Bank System, Inc. These forward-looking statements by their nature address matters that involve certain risks and uncertainties. Factors that may cause actual results to differ materially from those contemplated by such forward-looking statements are set forth herein under the caption "Forward-Looking Statements."

## Item 1. Business

Community Bank System, Inc. (the "Company") was incorporated on April 15, 1983, under the Delaware General Corporation Law. Its principal office is located at 5790 Widewaters Parkway, DeWitt, New York 13214. The Company is a registered financial holding company which wholly-owns two significant subsidiaries: Community Bank, N.A. (the "Bank" or "CBNA"), and Benefit Plans Administrative Services, Inc. ("BPAS"). As of December 31, 2018, BPAS owns five subsidiaries: Benefit Plans Administrative Services, LLC ("BPA"), a provider of defined contribution plan administration services; Northeast Retirement Services, LLC ("NRS"), a provider of institutional transfer agency, master recordkeeping services, fund administration, trust and retirement plan services; BPAS Actuarial & Pension Services, LLC ("BPAS-APS"), a provider of actuarial and benefit consulting services; BPAS Trust Company of Puerto Rico, a Puerto Rican trust company; and Hand Benefits & Trust Company ("HB&T"), a provider of collective investment fund administration and institutional trust services. NRS owns one subsidiary, Global Trust Company, Inc. ("GTC"), a non-depository trust company which provides fiduciary services for collective investment trusts and other products. HB&T owns one subsidiary, Hand Securities, Inc. ("HSI"), an introducing broker-dealer. The Company also sponsors two unconsolidated subsidiary business trusts formed for the purpose of issuing mandatorily-redeemable preferred securities which are considered Tier I capital under regulatory capital adequacy guidelines.

The Bank's business philosophy is to operate as a diversified financial services enterprise providing a broad array of banking and other financial services to retail, commercial and municipal customers. As of December 31, 2018, the Bank operates 224 full-service branches operating as Community Bank, N.A. throughout 35 counties of Upstate New York, six counties of Northeastern Pennsylvania, 12 counties of Vermont and one county of Western Massachusetts, offering a range of commercial and retail banking services. The Bank owns the following operating subsidiaries: The Carta Group, Inc. ("Carta Group"), CBNA Preferred Funding Corporation ("PFC"), CBNA Treasury Management Corporation ("TMC"), Community Investment Services, Inc. ("CISI"), NOTCH Investment Fund, LLC ("NOTCH"), Nottingham Advisors, Inc. ("Nottingham"), OneGroup NY, Inc. ("OneGroup"), and Oneida Preferred Funding II LLC ("OPFC II"). OneGroup is a full-service insurance agency offering personal and commercial property insurance and other risk management products and services. NOTCH, PFC and OPFC II primarily act as investors in residential and commercial real estate activities. TMC provides cash management, investment, and treasury services to the Bank. CISI and Carta Group provide broker-dealer and investment advisory services. Nottingham provides asset management services to individuals, corporations, corporate pension and profit sharing plans, and foundations.

The Company maintains a website at cbna.com. Annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to those reports, are available on the Company's website free of charge as soon as reasonably practicable after such reports or amendments are electronically filed with or furnished to the Securities and Exchange Commission ("SEC"). The information posted on the website is not incorporated into or a part of this filing. Copies of all documents filed with the SEC can also be obtained by visiting the SEC's Public Reference Room at 100 F Street, NE, Washington, DC 20549, by calling the SEC at 1-800-SEC-0330 or by accessing the SEC's website at https://www.sec.gov.

### Acquisition History (2014-2018)

#### Kinderhook Bank Corp. - Subsequent Event/ Pending Acquisition

On January 22, 2019, the Company announced that it had entered into a definitive agreement to acquire Kinderhook Bank Corp. ("Kinderhook"), parent company of The National Union Bank of Kinderhook headquartered in Kinderhook, New York, for approximately $93.4 million in cash. The acquisition will extend the Company's footprint into the Capital District of Upstate New York. Upon the completion of the merger, the Bank will add 11 branch locations across a five county area in the Capital District of Upstate New York with approximately $640 million in assets, and deposits of $560 million. The acquisition is expected to close during the third quarter of 2019, pending both customary regulatory and Kinderhook shareholder approval. The Company expects to incur certain one-time, transaction-related costs in 2019.

Wealth Resources Network, Inc. - Subsequent Event

On January 2, 2019, the Company, through its subsidiary, CISI, completed its acquisition of certain assets of Wealth Resources Network, Inc. ("Wealth Resources"), a financial services business headquartered in Liverpool, New York. The Company paid $1.2 million in cash to acquire the assets of Wealth Resources and recorded a $1.2 million customer list intangible asset in conjunction with the acquisition.

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HR Consultants, LLC

On April 2, 2018, the Company, through its subsidiary, BPAS, acquired certain assets of HR Consultants (SA), LLC ("HR Consultants"), a provider of actuarial and benefit consulting services headquartered in Puerto Rico. The Company paid $0.3 million in cash to acquire the assets of HR Consultants and recorded intangible assets of $0.3 million in conjunction with the acquisition.

Penna & Associates Agency, Inc.

On January 2, 2018, the Company, through its subsidiary, OneGroup, completed its acquisition of certain assets of Penna & Associates Agency, Inc. ("Penna"), an insurance agency headquartered in Johnson City, New York. The Company paid $0.8 million in cash to acquire the assets of Penna, and recorded goodwill in the amount of $0.3 million and a customer list intangible asset of $0.3 million in conjunction with the acquisition.

Styles Bridges Associates

On January 2, 2018, the Company, through its subsidiary, CISI, completed its acquisition of certain assets of Styles Bridges Associates ("Styles Bridges"), a financial services business headquartered in Canton, New York. The Company paid $0.7 million in cash to acquire a customer list from Styles Bridges, and recorded a $0.7 million customer list intangible asset in conjunction with the acquisition.

Gordon B. Roberts Agency, Inc.

On December 4, 2017, the Company, through its subsidiary, OneGroup, completed its acquisition of Gordon B. Roberts Agency, Inc. ("GBR"), an insurance agency headquartered in Oneonta, New York for $3.7 million in Company stock and cash, comprised of $1.35 million in cash and the issuance of 0.04 million shares of common stock. The transaction resulted in the acquisition of $0.6 million of assets, $0.6 million of other liabilities, goodwill in the amount of $2.1 million and other intangible assets of $1.6 million.

Northeast Capital Management, Inc.

On November 17, 2017, the Company, through its subsidiary, CISI, completed its acquisition of certain assets of Northeast Capital Management, Inc. ("NECM"), a financial services business headquartered in Wilkes-Barre, Pennsylvania. The Company paid $1.2 million in cash to acquire a customer list from NECM, and recorded a $1.2 million customer list intangible asset in conjunction with the acquisition.

Merchants Bancshares, Inc.

On May 12, 2017, the Company completed its acquisition of Merchants Bancshares, Inc. ("Merchants"), parent company of Merchants Bank headquartered in South Burlington, Vermont, for $345.2 million in Company stock and cash, comprised of $82.9 million in cash and the issuance of 4.68 million shares of common stock. The acquisition extended the Company's footprint into the Vermont and Western Massachusetts markets with the addition of 31 branch locations in Vermont and one location in Massachusetts. This transaction resulted in the acquisition of $2.0 billion of assets, including $1.49 billion of loans and $370.6 million of investment securities, as well as $1.45 billion of deposits and $189.0 million in goodwill.

Dryfoos Insurance Agency, Inc.

On March 1, 2017, the Company, through its subsidiary, OneGroup, completed its acquisition of certain assets of Dryfoos Insurance Agency, Inc. ("Dryfoos"), an insurance agency headquartered in Hazleton, Pennsylvania. The Company paid $3.0 million in cash to acquire the assets of Dryfoos, and recorded goodwill in the amount of $1.7 million and other intangible assets of $1.7 million in conjunction with the acquisition.

Northeast Retirement Services, Inc.

On February 3, 2017, the Company completed its acquisition of NRS and its subsidiary GTC, headquartered in Woburn, Massachusetts, for $148.6 million in Company stock and cash. NRS was a privately held corporation focused on providing institutional transfer agency, master recordkeeping services, custom target date fund

administration, trust product administration and customized reporting services to institutional clients. Its wholly-owned subsidiary, GTC, is chartered in the State of Maine as a non-depository trust company and provides fiduciary services for collective investment trusts and other products. The acquisition of NRS and GTC, hereafter referred to collectively as NRS, strengthens and complements the Company's existing employee benefit services businesses. Upon the completion of the merger, NRS became a wholly-owned subsidiary of BPAS and operates as Northeast Retirement Services, LLC, a Delaware limited liability company. This transaction resulted in the acquisition of $36.1 million in net tangible assets, principally cash and certificates of deposit, $60.2 million in customer list intangibles that will be amortized over 10 years, the creation of a $23.0 million deferred tax liability associated with the customer list intangible and $75.3 million in goodwill.

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Benefits Advisory Service, Inc.

On January 1, 2017, the Company, through its subsidiary, OneGroup, acquired certain assets of Benefits Advisory Service, Inc. ("BAS"), a benefits consulting group headquartered in Forest Hills, New York. The Company paid $1.2 million in cash to acquire the assets of BAS and recorded intangible assets of $1.2 million in conjunction with the acquisition.

WJL Agencies, Inc.

On January 4, 2016, the Company, through its subsidiary, CBNA Insurance Agency, Inc., completed its acquisition of WJL Agencies, Inc. doing business as The Clark Insurance Agencies ("WJL"), an insurance agency operating in Canton, New York. The Company paid $0.6 million in cash for the intangible assets of the company. Goodwill in the amount of $0.3 million and intangible assets in the amount of $0.3 million were recorded in conjunction with the acquisition. On August 19, 2016, the Company merged together its insurance subsidiaries and as of that date, CBNA Insurance Agency, Inc. was merged into OneGroup.

Oneida Financial Corp.

On December 4, 2015, the Company completed its acquisition of Oneida Financial Corp. ("Oneida"), parent company of Oneida Savings Bank, headquartered in Oneida, New York for $158.5 million in Company stock and cash, comprised of $56.3 million of cash and the issuance of 2.38 million common shares. Upon the completion of the merger, the Bank added 12 branch locations in Oneida and Madison counties and approximately $769.4 million of assets, including approximately $399.4 million of loans and $225.7 million of investment securities, along with $699.2 million of deposits. Through the acquisition of Oneida, the Company acquired OneGroup and Oneida Wealth Management, Inc. ("OWM") as wholly-owned subsidiaries primarily engaged in offering insurance and investment advisory services. These subsidiaries complement the Company's other non-banking financial services businesses. On April 22, 2016, the activities of OWM were merged into CISI.

EBS-RMSCO, Inc.

On January 1, 2014, BPAS-APS, formerly known as Harbridge Consulting Group LLC, completed its acquisition of a professional services practice from EBS-RMSCO, Inc., a subsidiary of The Lifetime Healthcare Companies ("EBS-RMSCO"). This professional services practice, which provides actuarial valuation and consulting services to clients who sponsor pension and post-retirement medical and welfare plans, enhanced the Company's participation in the Western New York marketplace.

Services

Banking

The Bank is a community bank committed to the philosophy of serving the financial needs of customers in local communities. The Bank's branches are generally located in smaller towns and cities within its geographic market areas of Upstate New York, Northeastern Pennsylvania, Vermont and Western Massachusetts. The Company believes that the local character of its business, knowledge of the customers and their needs, and its comprehensive retail and business products, together with responsive decision-making at the branch and regional levels, enable the Bank to compete effectively in its geographic market. The Bank is a member of the Federal Reserve System, the Federal Home Loan Bank of New York and the Federal Home Loan Bank of Boston (collectively referred to as "FHLB"), and its deposits are insured by the Federal Deposit Insurance Corporation ("FDIC") up to applicable limits.

Employee Benefit Services

Through BPAS and its subsidiaries, the Company operates a national practice that provides employee benefit trust, collective investment fund, retirement plan administration, fund administration, transfer agency, actuarial, VEBA/HRA and health and welfare consulting services to a diverse array of clients spanning the United States and Puerto Rico.

Wealth Management

Through the Bank, CISI, Carta Group, and Nottingham, the Company provides wealth management, retirement planning, higher educational planning, fiduciary, risk management, trust services and personal financial planning services. The Company offers investment alternatives including stocks, bonds, mutual funds and advisory products.

Insurance Agency

Through OneGroup, the Company offers personal and commercial property insurance and other risk management products and services. In addition, OneGroup offers employee benefit related services. OneGroup represents many leading insurance companies.

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Segment Information

The Company has identified three reportable operating business segments: Banking, Employee Benefit Services, and All Other. Included in the All Other segment are the smaller Wealth Management and Insurance operations. Information about the Company's reportable business segments is included in Note U of the "Notes to Consolidated Financial Statements" filed herewith in Part II.

Competition

The banking and financial services industry is highly competitive in the New York, Pennsylvania, Vermont and Massachusetts markets. The Company competes actively for loans, deposits, and financial services relationships with other national and state banks, thrift institutions, credit unions, retail brokerage firms, mortgage bankers, finance companies, insurance agencies, and other regulated and unregulated providers of financial services. In order to compete with other financial service providers, the Company stresses the community nature of its operations and the development of profitable customer relationships across all lines of business.

The Company's employee benefit trust and plan administration business competes on a national scale and provides geographic diversification for the Company. Certain lines of business are marketed primarily through unaffiliated financial advisors, while others are marketed directly to plan sponsors and fund companies. In order to compete with large national firms, the Company stresses its consultative approach to complex engagements.

The table below summarizes the Bank's deposits and market share by the fifty-four counties of New York, Pennsylvania, Vermont, and Massachusetts in which it has customer facilities. Market share is based on deposits of all commercial banks, credit unions, savings and loan associations, and savings banks.

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| County | State | Deposits as of 6/30/2018[1] (000's omitted) | Market Share [1] | Number of Branches | ATM's | Towns/ Cities | Towns Where Company Has 1st or 2nd Market Position |
|---|---|---|---|---|---|---|---|
| Grand Isle | VT | $37,681 | 100.00% | 1 | 1 | 1 | 1 |
| Lewis | NY | 201,318 | 73.46% | 4 | 4 | 3 | 3 |
| Hamilton | NY | 59,541 | 56.52% | 2 | 2 | 2 | 2 |
| Franklin | NY | 344,894 | 52.83% | 6 | 6 | 5 | 5 |
| Madison | NY | 418,397 | 45.71% | 8 | 8 | 5 | 5 |
| Allegany | NY | 280,196 | 44.50% | 9 | 10 | 8 | 8 |
| Cattaraugus | NY | 432,515 | 33.45% | 10 | 11 | 7 | 6 |
| Otsego | NY | 344,457 | 29.82% | 10 | 9 | 6 | 5 |
| Schuyler | NY | 53,185 | 24.97% | 1 | 1 | 1 | 1 |
| Seneca | NY | 127,217 | 24.94% | 4 | 3 | 4 | 4 |
| Saint Lawrence | NY | 456,884 | 24.58% | 13 | 13 | 11 | 10 |
| Yates | NY | 97,185 | 23.36% | 3 | 2 | 2 | 1 |
| Clinton | NY | 385,880 | 23.34% | 4 | 7 | 2 | 2 |
| Jefferson | NY | 440,124 | 23.29% | 7 | 9 | 6 | 6 |
| Wyoming | PA | 136,249 | 20.98% | 4 | 4 | 4 | 3 |
| Livingston | NY | 190,211 | 19.59% | 5 | 6 | 5 | 4 |
| Chautauqua | NY | 368,106 | 18.81% | 12 | 12 | 10 | 7 |
| Essex | NY | 130,903 | 15.74% | 5 | 5 | 4 | 3 |
| Orange | VT | 50,659 | 15.08% | 2 | 2 | 2 | 2 |
| Oswego | NY | 202,165 | 13.59% | 4 | 5 | 4 | 3 |
| Caledonia | VT | 69,740 | 10.92% | 2 | 2 | 2 | 1 |
| Wayne | NY | 133,223 | 10.52% | 3 | 4 | 2 | 2 |
| Ontario | NY | 236,577 | 10.33% | 8 | 13 | 5 | 3 |
| Addison | VT | 57,973 | 9.48% | 2 | 2 | 2 | 2 |
| Delaware | NY | 138,152 | 9.39% | 5 | 5 | 5 | 4 |
| Bennington | VT | 77,389 | 9.18% | 2 | 4 | 2 | 0 |
| Chittenden | VT | 589,812 | 8.90% | 9 | 10 | 6 | 4 |
| Tioga | NY | 38,382 | 8.53% | 2 | 2 | 2 | 1 |
| Franklin | VT | 50,716 | 7.88% | 2 | 2 | 2 | 1 |
| Rutland | VT | 107,221 | 7.46% | 3 | 3 | 2 | 1 |
| Chemung | NY | 75,227 | 6.88% | 2 | 2 | 1 | 0 |
| Susquehanna | PA | 59,611 | 6.72% | 3 | 1 | 3 | 2 |
| Herkimer | NY | 47,578 | 6.71% | 1 | 1 | 1 | 1 |
| Luzerne | PA | 463,068 | 6.68% | 10 | 13 | 8 | 4 |
| Lackawanna | PA | 405,557 | 6.40% | 11 | 11 | 8 | 4 |
| Steuben | NY | 193,545 | 6.29% | 8 | 9 | 7 | 4 |
| Schoharie | NY | 21,777 | 4.72% | 1 | 1 | 1 | 0 |
| Lamoille | VT | 27,326 | 4.68% | 1 | 1 | 1 | 1 |
| Windham | VT | 47,652 | 4.57% | 2 | 3 | 2 | 1 |
| Carbon | PA | 45,025 | 4.55% | 2 | 2 | 2 | 0 |
| Oneida | NY | 256,782 | 4.28% | 6 | 8 | 5 | 3 |
| Windsor | VT | 58,462 | 4.20% | 2 | 1 | 2 | 0 |
| Washington | VT | 87,601 | 3.63% | 3 | 5 | 3 | 1 |
| Cayuga | NY | 43,880 | 3.60% | 2 | 2 | 2 | 1 |
| Bradford | PA | 43,259 | 3.36% | 2 | 2 | 2 | 1 |

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| Chenango | NY | 22,822 | 2.56% | 2 | 2 | 1 | 0 |
| Washington | NY | 19,569 | 2.53% | 1 | 0 | 1 | 1 |
| Warren | NY | 37,977 | 1.96% | 1 | 1 | 1 | 1 |
| Onondaga | NY | 206,535 | 1.65% | 4 | 5 | 4 | 1 |
| Ulster | NY | 31,046 | 0.73% | 1 | 1 | 1 | 1 |
| Broome | NY | 32,672 | 0.52% | 1 | 1 | 1 | 0 |
| Erie | NY | 138,335 | 0.33% | 4 | 4 | 3 | 2 |
| Hampden | MA | 37,223 | 0.29% | 1 | 1 | 1 | 0 |
| Tompkins | NY | 4,867 | 0.16% | 1 | 0 | 1 | 0 |
| | | 8,664,348 | 5.67% | 224 | 244 | 184 | 129 |

(1) Deposits and Market Share data as of June 30, 2018, the most recent information available from SNL Financial LLC.  Deposit amounts include $150.4 million of intercompany balances that are eliminated upon consolidation.

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Employees

As of December 31, 2018, the Company employed 2,661 full-time employees and 272 part-time and temporary employees. None of the Company's employees are represented by a collective bargaining agreement. The Company offers a variety of employment benefits and considers its relationship with its employees to be good.

Supervision and Regulation

General

The banking industry is highly regulated with numerous statutory and regulatory requirements that are designed primarily for the protection of depositors and the financial system, and not for the purpose of protecting shareholders. Set forth below is a description of the material laws and regulations applicable to the Company and the Bank. This summary is not complete and the reader should refer to these laws and regulations for more detailed information. The Company's and the Bank's failure to comply with applicable laws and regulations could result in a range of sanctions and administrative actions imposed upon the Company and/or the Bank, including the imposition of civil money penalties, formal agreements and cease and desist orders. Changes in applicable law or regulations, and in their interpretation and application by regulatory agencies, cannot be predicted, and may have a material effect on the Company's business and results.

The Company and its subsidiaries are subject to the laws and regulations of the federal government and the states and jurisdictions in which they conduct business. The Company, as a bank holding company, is subject to extensive regulation, supervision and examination by the Board of Governors of the Federal Reserve System ("FRB") as its primary federal regulator. The Bank is a nationally-chartered bank and is subject to extensive regulation, supervision and examination by the Office of the Comptroller of the Currency ("OCC") as its primary federal regulator, and as to certain matters, the FRB, the Consumer Financial Protection Bureau ("CFPB"), and the Federal Deposit Insurance Corporation ("FDIC").

The Company is also subject to the jurisdiction of the SEC and is subject to disclosure and regulatory requirements under the Securities Act of 1933, as amended, and the Securities Exchange Act of 1934, as amended. The Company's common stock is listed on the New York Stock Exchange ("NYSE") and it is subject to NYSE's rules for listed companies. Affiliated entities, including BPAS, NRS, HB&T, HSI, BPAS Trust Company of Puerto Rico, Nottingham, CISI, OneGroup, and Carta Group are subject to the jurisdiction of certain state and federal regulators and self-regulatory organizations including, but not limited to, the SEC, the Texas Department of Banking, the State of Maine Bureau of Financial Institutions, the Financial Industry Regulatory Authority ("FINRA"), Puerto Rico Office of the Commissioner of Financial Institutions, and state securities and insurance regulators.

Federal Bank Holding Company Regulation

The Company was a bank holding company under the Bank Holding Company Act of 1956, (the "BHC Act"), and became a financial holding company effective September 30, 2015. As a bank holding company that has elected to become a financial holding company, the Company can affiliate with securities firms and insurance companies and engage in other activities that are "financial in nature" or "incidental" or "complementary" to activities that are financial in nature, as long as it continues to meet the eligibility requirements for financial holding companies (including requirements that the financial holding company and its depository institution subsidiary maintain their status as "well capitalized" and "well managed").

Generally, FRB approval is not required for the Company to acquire a company (other than a bank holding company, bank or savings association) engaged in activities that are financial in nature or incidental to activities that are financial in nature, as determined by the FRB. Prior notice to the FRB may be required, however, if the company to be acquired has total consolidated assets of $10 billion or more. Prior FRB approval is required before the Company may acquire the beneficial ownership or control of more than 5% of the voting shares or substantially all of the assets

of a bank holding company, bank or savings association.

Because the Company is a financial holding company, if the Bank were to receive a rating under the Community Reinvestment Act of 1977, as amended ("CRA"), of less than Satisfactory, the Company will be prohibited, until the rating is raised to Satisfactory or better, from engaging in new activities or acquiring companies other than bank holding companies, banks or savings associations, except that the Company could engage in new activities, or acquire companies engaged in activities, that are considered "closely related to banking" under the BHC Act. In addition, if the FRB determines that the Company or the Bank is not well capitalized or well managed, the Company would be required to enter into an agreement with the FRB to comply with all applicable capital and management requirements and may contain additional limitations or conditions. Until corrected, the Company could be prohibited from engaging in any new activity or acquiring companies engaged in activities that are not closely related to banking, absent prior FRB approval.

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Federal Reserve System Regulation

Because the Company is a financial holding company, it is subject to regulatory capital requirements and required by the FRB to, among other things, maintain cash reserves against its deposits. The Bank is under similar capital requirements administered by the OCC as discussed below. FRB policy has historically required a financial holding company to act as a source of financial and managerial strength to its subsidiary banks. The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act") codifies this historical policy as a statutory requirement. To the extent the Bank is in need of capital, the Company could be expected to provide additional capital, including borrowings from the FRB for such purpose. Both the Company and the Bank are subject to extensive supervision and regulation, which focus on, among other things, the protection of depositors' funds.

The FRB also regulates the national supply of bank credit in order to influence general economic conditions. These policies have a significant influence on overall growth and distribution of loans, investments and deposits, and affect the interest rates charged on loans or paid for deposits.

Fluctuations in interest rates, which may result from government fiscal policies and the monetary policies of the FRB, have a strong impact on the income derived from loans and securities, and interest paid on deposits and borrowings. While the Company and the Bank strive to model various interest rate changes and adjust our strategies for such changes, the level of earnings can be materially affected by economic circumstances beyond our control.

The Office of Comptroller of the Currency Regulation

The Bank is supervised and regularly examined by the OCC. The various laws and regulations administered by the OCC affect the Company's practices such as payment of dividends, incurring debt, and acquisition of financial institutions and other companies. It also affects the Bank's business practices, such as payment of interest on deposits, the charging of interest on loans, types of business conducted and the location of its offices. The OCC generally prohibits a depository institution from making any capital distributions, including the payment of a dividend, or paying any management fee to its parent holding company if the depository institution would become undercapitalized due to the payment. Undercapitalized institutions are subject to growth limitations and are required to submit a capital restoration plan to the OCC. The Bank is well capitalized under regulatory standards administered by the OCC. For additional information on our capital requirements see "Management's Discussion and Analysis of Financial Condition and Results of Operations – Shareholders' Equity" and Note P to the Financial Statements.

Federal Home Loan Bank

The Bank is a member of the FHLB, which provides a central credit facility primarily for member institutions for home mortgage and neighborhood lending. The Bank is subject to the rules and requirements of the FHLB, including the purchase of shares of FHLB activity-based stock in the amount of 4.5% of the dollar amount of outstanding advances and FHLB capital stock in an amount equal to the greater of $1,000 or the sum of 0.15% of the mortgage-related assets held by the Bank based upon the previous year-end financial information. The Bank was in compliance with the rules and requirements of the FHLB at December 31, 2018.

Deposit Insurance

Deposits of the Bank are insured up to the applicable limits by the Deposit Insurance Fund ("DIF") and are subject to deposit insurance assessments to maintain the DIF. The Dodd-Frank Act permanently increased the maximum amount of deposit insurance to $250,000 per deposit category, per depositor, per institution. A depository institution's DIF assessment is calculated by multiplying its assessment rate by the assessment base, which is defined as the average consolidated total assets less the average tangible equity of the depository institution. The initial base assessment rate is based on its capital level and supervisory ratings (its "CAMELS ratings"), certain financial measures to assess an institution's ability to withstand asset related stress and funding related stress and, in some cases, additional discretionary adjustments by the FDIC to reflect additional risk factors. The Bank's adjusted average consolidated total assets for 4 consecutive quarters exceeded $10.0 billion in 2018, which resulted in a deposit insurance assessment based on a large institution classification, rather than the small institution classification for years

prior to 2018.

For large insured depository institutions, generally defined as those with at least $10 billion in total assets, the FDIC has eliminated risk categories when calculating the initial base assessment rates and now combine CAMELS ratings and financial measures into two scorecards to calculate assessment rates, one for most large insured depository institutions and another for highly complex insured depository institutions (which are generally those with more than $50 billion in total assets that are controlled by a parent company with more than $500 billion in total assets). Each scorecard has two components - a performance score and loss severity score, which are combined and converted to an initial assessment rate. The FDIC has the ability to adjust a large or highly complex insured depository institution's total score by a maximum of 15 points, up or down, based upon significant risk factors that are not captured by the scorecard. Under the current assessment rate schedule, the initial base assessment rate for large and highly complex insured depository institutions ranges from three to 30 basis points, and the total base assessment rate, after applying the unsecured debt and brokered deposit adjustments, ranges from one and one-half to 40 basis points. The Bank's FDIC insurance for 2018 was based on an assessment rate of three basis points.

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In October 2010, the FDIC adopted a DIF restoration plan to ensure that the fund reserve ratio reached 1.35% by September 30, 2020, as required by the Dodd-Frank Act. In September 2018, the DIF reserve ratio reached 1.36%, exceeding the required reserve ratio of 1.35% ahead of the September 30, 2020 deadline. FDIC insurance expense totaled $3.2 million, $3.5 million and $3.7 million in 2018, 2017 and 2016, respectively.

Under the Federal Deposit Insurance Act, if the FDIC finds that an institution has engaged in unsafe and unsound practices, is in an unsafe or unsound condition to continue operations, or has violated any applicable law, regulation, rule, order or condition imposed by the FDIC, the FDIC may determine that such violation or unsafe or unsound practice or condition require the termination of deposit insurance.

Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010

On July 21, 2010, the Dodd-Frank Act was signed into law, which resulted in significant changes to the banking industry. As discussed further throughout this section, certain aspects of the Dodd-Frank Act are subject to implementing rules that have been taking effect over several years.

The Dodd-Frank Act contains numerous provisions that affect all banks and bank holding companies and impacts how the Company and the Bank handle their operations. The Dodd-Frank Act requires various federal agencies, including those that regulate the Company and the Bank, to promulgate new rules and regulations and to conduct various studies and reports for Congress. The federal agencies have either completed or are in the process of completing these rules and regulations and have been given significant discretion in drafting such rules and regulations. Several of the provisions of the Dodd-Frank Act may have the consequence of increasing the Bank's expenses, decreasing its revenues, and changing the activities in which it chooses to engage. The specific impact of the Dodd-Frank Act on the Company's current activities or new financial activities the Company may consider in the future, the Company's financial performance, and the markets in which the Company operates depends on the manner in which the relevant agencies continue to develop and implement the required rules and regulations and the reaction of market participants to these regulatory developments.

Pursuant to FRB regulations mandated by the Dodd-Frank Act, interchange fees on debit card transactions are limited to a maximum of $0.21 per transaction plus 5 basis points of the transaction amount. A debit card issuer may recover an additional one cent per transaction for fraud prevention purposes if the issuer complies with certain fraud-related requirements prescribed by the FRB. The FRB also adopted requirements in the final rule that issuers include two unaffiliated networks for routing debit transactions that are applicable to the Company and the Bank. The Company became subject to the interchange fee cap mandated by the Dodd-Frank Act beginning on July 1, 2018. As such, the fees the Company may receive for an electronic debit transaction will be capped at the statutory limit. Prior to July 1, 2018, the Company was exempt from the interchange fee cap under the "small issuer" exemption, which applies to any debit card issuer with total worldwide assets (including those of its affiliates) of less than $10 billion as of the end of the previous calendar year.

The Dodd-Frank Act established the CFPB and empowered it to exercise broad rulemaking, supervision, and enforcement authority for a wide range of consumer protection laws. Since the Company's total consolidated assets exceed $10 billion the Company is subject to the direct supervision of the CFPB. The CFPB has issued and continues to issue numerous regulations under which the Company and the Bank will continue to incur additional expense in connection with its ongoing compliance obligations. Significant recent CFPB developments that may affect operations and compliance costs include:

- positions taken by the CFPB on fair lending, including applying the disparate impact theory which could make it more difficult for lenders to charge different rates or to apply different terms to loans to different customers;
- the CFPB's final rule amending Regulation C, which implements the Home Mortgage Disclosure Act, requiring most lenders to report expanded information in order for the CFPB to more effectively monitor fair lending concerns and other information shortcomings identified by the CFPB;

- positions taken by the CFPB regarding the Electronic Fund Transfer Act and Regulation E, which require companies to obtain customer authorizations before automatically debiting a consumer's account for pre-authorized electronic funds transfers; and
- focused efforts on enforcing certain compliance obligations the CFPB deems a priority, such as automobile loan servicing, debt collection, mortgage origination and servicing, remittances, and fair lending, among others.

The final rules issued by the FRB, SEC, OCC, FDIC, and Commodity Futures Trading Commission implementing Section 619 of the Dodd-Frank Act (commonly known as the Volcker Rule) prohibit insured depository institutions and companies affiliated with insured depository institutions from engaging in short-term proprietary trading of certain securities, derivatives, commodity futures and options on these instruments, for their own account. The final rules also impose limits on banking entities' investments in, and other relationships with, hedge funds or private equity funds.

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In May of 2018, the Economic Growth, Regulatory Relief, and Consumer Protection Act ("Economic Growth Act") was enacted to amend the Dodd-Frank Act and modify certain post-crisis regulatory requirements, including a variety of provisions intended to promote economic growth, provide tailored regulatory relief for smaller and less complex financial institutions, and enhance consumer protections. Among other things, the law raised the asset size threshold for the filing of required company-run stress tests that the Dodd-Frank Act had applied to the Company and the Bank, from $10 billion to $250 billion in total assets. As implemented by the federal banking agencies, these changes became effective in 2018 for banking organizations with total assets of less than $100 billion, such as the Bank.

The ongoing effects of the Dodd-Frank Act, as well as the recent and possible future changes to the regulatory framework as a result of the Economic Growth Act and future proposals make it difficult to assess the overall financial impact of the Dodd-Frank Act and related regulatory developments on the Company and the banking industry. As a result, the Company cannot predict the ultimate impact of the Dodd-Frank Act on the Company or the Bank, including the extent to which it could increase costs or limit the Company's ability to pursue business opportunities in an efficient manner, or otherwise adversely affect its business, financial condition and results of operations. Nor can the Company predict the impact or substance of other future legislation or regulation. However, it is expected that future legislation or regulation at a minimum will increase the Company's and the Bank's operating and compliance costs. As rules and regulations continue to be implemented or issued, the Company may need to dedicate additional resources to ensure compliance, which may increase its costs of operations and adversely impact its earnings.

Capital Requirements

The Company and the Bank are required to comply with applicable capital adequacy standards established by the federal banking agencies. The risk-based capital standards that were applicable to the Company and the Bank through December 31, 2014 were based on the 1988 Capital Accord, known as Basel I ("Basel I"), of the Basel Committee on Banking Supervision (the "Basel Committee"). However, in July 2013, the FRB, the OCC and the FDIC approved final rules (the "Capital Rules") establishing a new comprehensive capital framework for U.S. banking organizations. These rules went into effect for the Company and the Bank on January 1, 2015, subject to phase-in periods for certain components.

The Capital Rules implement the Basel Committee's December 2010 capital framework (known as "Basel III") for strengthening international capital standards as well as certain provisions of the Dodd-Frank Act. The Capital Rules substantially revise the risk-based capital requirements applicable to bank holding companies and depository institutions, including the Company and the Bank, compared to the previous U.S. Basel I risk-based capital rules. The Capital Rules define the components of capital and address other issues affecting the numerator in banking institutions regulatory capital ratios and replace the Basel I risk-weighting approach, with a more risk-sensitive one, based in part, on the standardized approach set forth in "Basel II". The Capital Rules also implement the requirements of Section 939A of the Dodd-Frank Act to remove references to credit ratings from the Federal banking agencies' rules.

The Capital Rules, among other things: (i) introduces as a capital measure "Common Equity Tier 1," ("CET1"), (ii) specify that Tier 1 capital consists of CET1 and "Additional Tier 1 capital" instruments meeting specified revised requirements, (iii) defines CET1 narrowly by requiring that most deductions/adjustments to regulatory capital measures be made to CET1 and not to the other components of capital, and (iv) expands the scope of the deductions from and adjustments to capital as compared to existing regulations. Under the Capital Rules, the most common form of Additional Tier 1 capital is non-cumulative perpetual preferred stock, and the most common form of Tier 2 capital is subordinated notes and a portion of the allowance for loan and lease losses, in each case, subject to the Capital Rules specific requirements.

Under the Capital Rules, the minimum capital ratios as of January 1, 2016 are as follows:

·4.5% CET1 to total risk-weighted assets;

·6.0% Tier 1 capital (CET1 plus Additional Tier 1 capital) to total risk-weighted assets;

- 8.0% Total capital (Tier 1 Capital plus Tier 2 capital) to total risk-weighted assets;
- 4.0% Tier 1 capital to total adjusted quarterly average assets (known as "leverage ratio")

Beginning in 2016, the Capital Rules required the Company and the Bank to maintain a "capital conservation buffer" composed entirely of CET1. When it is fully phased-in by the beginning of 2019, banking organizations will be required to maintain a minimum capital conservation buffer of 2.5% (CET1 to Total risk-weighted assets), in addition to the minimum risk-based capital ratios. Therefore, to satisfy both the minimum risk-based capital ratios and the capital conservation buffer, a banking organization will be required to maintain the following: (i) CET1 to total risk-weighted assets of at least 7%, (ii) Tier 1 capital to total risk-weighted assets of at least 8.5%, and (iii) Total capital (Tier 1 capital plus Tier 2 capital) to total risk-weighted assets of at least 10.5% by January 1, 2019, upon full phase-in of the capital conservation buffer. The capital conservation buffer is designed to absorb losses during periods of economic stress. Banking institutions that do not maintain a capital conservation buffer of 2.5% or more will face constraints on dividends, common share repurchases and incentive compensation based on the amount of the shortfall.

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The Capital Rules provide for a number of deductions from and adjustments to CET1. These include, for example, the requirement that mortgage servicing rights, deferred tax assets dependent upon future taxable income and significant investments in non-consolidated financial entities be deducted from CET1 to the extent that any one such category exceeds 10% of CET1 or all such categories in the aggregate exceed 15% of CET1. Under the general Basel I risk-based capital rules, the effects of accumulated other comprehensive income or loss items included in shareholders' equity (for example, marks-to-market of securities held in the available for sale portfolio) were reversed for the purposes of determining regulatory capital. Under the Capital Rules, the effects of certain accumulated other comprehensive income or loss items are not excluded; however, banks not using the advanced approach, including the Company and the Bank, were permitted to, and in the case of the Company and the Bank they did, make a one-time permanent election to continue to exclude these items.

Consistent with the section 171 of the Dodd-Frank Act, the Capital Rules allow certain bank holding companies to include certain hybrid securities, such as trust preferred securities, in Tier 1 capital if they had less than $15 billion in assets as of December 31, 2009 and the securities were issued before May 19, 2010. Accordingly, the trust preferred securities on the Company's balance sheet will be included as Tier 1 capital while they are outstanding, unless the Company completes an acquisition of a depository institution holding company that did not meet this criteria, or are acquired by such an organization, after January 1, 2014, at which time they would be subject to the stated phase-out requirements of the Capital Rules and would be included as Tier 2 capital.

Implementation of the deductions and other adjustments to CET1 began on January 1, 2015 and will be phased-in over a 4-year period (beginning at 40% on January 1, 2015 and an additional 20% per year thereafter). The implementation of the capital conservation buffer began on January 1, 2016 at the 0.625% level and will be phased in over a four-year period (increasing by that amount on each subsequent January 1, until it reaches 2.5% on January 1, 2019).

With respect to the Bank, the Capital Rules also revise the prompt corrective action ("PCA") regulations established pursuant to Section 38 of the Federal Deposit Insurance Act, by (i) introducing a CET1 ratio requirement for each capital category other than critically undercapitalized, with the required CET1 ratio being 6.5% for well-capitalized status; (ii) increasing the minimum Tier 1 capital ratio requirement for each capital category, with the minimum Tier 1 capital ratio for well-capitalized status being 8.0%; and (iii) eliminating the current provision that allows certain highly-rated banking organizations to maintain a 3.0% leverage ratio and still be adequately capitalized. The Capital Rules do not change the Total risk-based PCA capital requirement for any capital category.

The Capital Rules prescribe a standardized approach for risk weighted-assets that expands the risk-weight categories from the four Basel I-derived categories (0%, 20%, 50% and 100%) to a larger and more risk-sensitive number of categories, depending on the nature of the asset. The risk-weight categories generally range from 0% for U.S. government and agency securities, to 1,250% for certain securitized exposures, and result in higher risk weights for a variety of asset categories. The standardized approach requires financial institutions to transition assets that are 90 days or more past due or on nonaccrual from their original risk weight to 150 percent. Additionally, loans designated as high volatility commercial real estate ("HVCRE") are assigned a risk-weighting of 150 percent.

Requirements to maintain higher levels of capital or to maintain higher levels of liquid assets could adversely impact the Company's net income and return on equity. The current requirements and the Company's actual capital levels are detailed in Note P of "Notes to Consolidated Financial Statements" filed in Part II, Item 8, "Financial Statements and Supplementary Data."

Consumer Protection Laws

In connection with its banking activities, the Bank is subject to a number of federal and state laws designed to protect borrowers and promote lending to various sectors of the economy. These laws include the Equal Credit Opportunity Act, the Gramm-Leach-Bliley Act ("GLB Act"), the Fair Credit Reporting Act ("FCRA"), the Fair and Accurate Credit Transactions Act of 2003 ("FACT Act"), Electronic Funds Transfer Act, the Truth in Lending Act, the Home Mortgage

Disclosure Act, the Dodd-Frank Act, the Real Estate Settlement Procedures Act, the Secure and Fair Enforcement for Mortgage Licensing Act (“SAFE”), the Servicemembers Civil Relief Act (“SCRA”), the Military Lending Act (“MLA”), and various state law counterparts.

The Dodd-Frank Act created the CFPB with broad powers to supervise and enforce consumer protection laws, including laws that apply to banks in order to prohibit unfair, deceptive or abusive acts or practices. The CFPB has examination authority over all banks and savings institutions with more than $10 billion in assets. The Dodd-Frank Act also weakens the federal preemption rules that are applicable to national banks and gives attorney generals for the states certain powers to enforce federal consumer protection laws. Further, under the Dodd-Frank Act, it is unlawful for any provider of consumer financial products or services to engage in any unfair, deceptive, or abusive acts or practices (“UDAAP”). A violation of the consumer protection and privacy laws, and in particular UDAAP, could have serious legal, financial, and reputational consequences.



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In addition, the GLB Act requires all financial institutions to adopt privacy policies, restrict the sharing of nonpublic customer data with nonaffiliated parties and establishes procedures and practices to protect customer data from unauthorized access. In addition, the FCRA, as amended by the FACT Act, includes provisions affecting the Company, the Bank, and their affiliates, including provisions concerning obtaining consumer reports, furnishing information to consumer reporting agencies, maintaining a program to prevent identity theft, sharing of certain information among affiliated companies, and other provisions. The FACT Act requires persons subject to FCRA to notify their customers if they report negative information about them to a credit bureau or if they are granted credit on terms less favorable than those generally available. The FRB and the Federal Trade Commission have extensive rulemaking authority under the FACT Act, and the Company and the Bank are subject to the rules that have been created under the FACT Act, including rules regarding limitations on affiliate marketing and implementation of programs to identify, detect and mitigate certain identity theft red flags. The SCRA protects persons called to active military service and their dependents from undue hardship resulting from their military service, and the MLA extends specific protections if an accountholder, at the time of account opening, is a covered active duty member of the military or certain family members thereof. The SCRA applies to all debts incurred prior to the commencement of active duty and limits the amount of interest, including service and renewal charges and any other fees or charges (other than bona fide insurance) that are related to the obligation or liability. The MLA applies to certain consumer loans and extends specific protections if an accountholder, at the time of account opening, is a covered active duty member of the military or certain family members thereof. The Bank is also subject to data security standards and data breach notice requirements issued by the OCC and other regulatory agencies. The Bank has created policies and procedures to comply with these consumer protection requirements.

The CFPB issued the final rules implementing the ability-to-repay and qualified mortgage (QM) provisions of the Truth in Lending Act (the "QM Rule"). The ability-to-repay provision requires creditors to make reasonable, good faith determinations that borrowers are able to repay their mortgages before extending the credit based on a number of factors and consideration of financial information about the borrower derived from reasonably reliable third-party documents. Under the Dodd-Frank Act and the QM Rule, loans meeting the definition of "qualified mortgage" are entitled to a presumption that the lender satisfied the ability-to-repay requirements. The presumption is a conclusive presumption/safe harbor for loans meeting the QM requirements, and a rebuttable presumption for higher-priced loans meeting the QM requirements. The definition of a "qualified mortgage" incorporates the statutory requirements, such as not allowing negative amortization or terms longer than 30 years. The QM Rule also adds an explicit maximum 43% debt-to-income ratio for borrowers if the loan is to meet the QM definition, though some mortgages that meet government-sponsored enterprises, Federal Housing Administration, and Veterans Administration underwriting guidelines may, for a period not to exceed seven years, meet the QM definition without being subject to the 43% debt-to-income limits. The Bank has created policies and procedures to comply with these consumer protection requirements.

USA Patriot Act

The Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 ("USA Patriot Act") imposes obligations on U.S. financial institutions, including banks and broker-dealer subsidiaries, to implement policies, procedures and controls which are reasonably designed to detect and report instances of money laundering and the financing of terrorism. In addition, provisions of the USA Patriot Act require the federal financial institution regulatory agencies to consider the effectiveness of a financial institution's anti-money laundering activities when reviewing bank mergers and bank holding company acquisitions. The USA Patriot Act also encourages information-sharing among financial institutions, regulators, and law enforcement authorities by providing an exemption from the privacy provisions of the GLB Act for financial institutions that comply with the provision of the Act. Failure of a financial institution to maintain and implement adequate programs to combat money laundering and terrorist financing, or to comply with all of the relevant laws or regulations, could have serious legal, financial and reputational consequences for the institution. The Company has approved policies and procedures that are designed to comply with the USA Patriot Act and its regulations.

Office of Foreign Assets Control Regulation

The United States has imposed economic sanctions that affect transactions with designated foreign countries, nationals and others administrated by the Treasury's Office of Foreign Assets Control ("OFAC"). The OFAC administered sanctions can take many different forms; however, they generally contain one or more of the following elements: (i) restrictions on trade with or investment in a sanctioned country, entity or individual, including prohibitions against direct or indirect imports and exports and prohibitions on "U.S. persons" engaging in financial transactions relating to making investments, or providing investment related advice or assistance; and (ii) a blocking of assets in which the government or specially designated nationals have an interest, by prohibiting transfers of property subject to U.S. jurisdiction (including property in the possession or control of U.S. persons). Blocked assets (e.g., property and bank deposits) cannot be paid out, withdrawn, set off or transferred in any manner without a license from OFAC. Failure to comply with these sanctions could have serious legal, financial, and reputational consequences.

Sarbanes-Oxley Act of 2002

The Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley Act") implemented a broad range of corporate governance, accounting and reporting reforms for companies that have securities registered under the Securities Exchange Act of 1934, as amended. In particular, the Sarbanes-Oxley Act established, among other things: (i) new requirements for audit and other key Board of Directors committees involving independence, expertise levels, and specified responsibilities; (ii) additional responsibilities regarding the oversight of financial statements by the Chief Executive Officer and Chief Financial Officer of the reporting company; (iii) the creation of an independent accounting oversight board for the accounting industry; (iv) new standards for auditors and the regulation of audits, including independence provisions which restrict non-audit services that accountants may provide to their audit clients; (v) increased disclosure and reporting obligations for the reporting company and its directors and executive officers including accelerated reporting of company stock transactions; (vi) a prohibition of personal loans to directors and officers, except certain loans made by insured financial institutions on non-preferential terms and in compliance with other bank regulator requirements; and (vii) a range of new and increased civil and criminal penalties for fraud and other violations of the securities laws.

Electronic Fund Transfer Act

Among other provisions, the federal banking rule under the Electronic Fund Transfer Act prohibits financial institutions from charging consumers fees for paying overdrafts on automated teller machines and one-time debit card transactions, unless a consumer consents, or opts in, to the overdraft service for those types of transactions. The rule does not govern overdraft fees on the payment of checks and certain other forms of bill payments.

Community Reinvestment Act of 1977

Under the CRA, the Bank is required to help meet the credit needs of its communities, including low- and moderate-income neighborhoods. Although the Bank must follow the requirements of CRA, it does not limit the Bank's discretion to develop products and services that are suitable for a particular community or establish lending requirements or programs. In addition, the Equal Credit Opportunity Act and the Fair Housing Act prohibits discrimination in lending practices. The Bank's failure to comply with the provisions of the CRA could, at a minimum, result in regulatory restrictions on its activities and the activities of the Company. The Bank's failure to comply with the Equal Credit Opportunity Act and the Fair Housing Act could result in enforcement actions against it by its regulators as well as other federal regulatory agencies and the Department of Justice. The Bank's latest CRA rating was "Satisfactory".

The Bank Secrecy Act

The Bank Secrecy Act ("BSA") requires all financial institutions, including banks and securities broker-dealers, to, among other things, establish a risk-based system of internal controls reasonably designed to prevent money laundering and the financing of terrorism. The BSA includes a variety of recordkeeping and reporting requirements (such as currency transaction and suspicious activity reporting), as well as due diligence/know-your-customer documentation requirements. The Company has established a bank secrecy act /anti-money laundering program and taken other appropriate measures in order to comply with BSA requirements.

Item 1A. Risk Factors

There are risks inherent in the Company's business. The material risks and uncertainties that management believes affect the Company are described below. Adverse experience with these could have a material impact on the Company's financial condition and results of operations.

Changes in interest rates affect our profitability, assets and liabilities.

The Company's income and cash flow depends to a great extent on the difference between the interest earned on loans and investment securities, and the interest paid on deposits and borrowings. Interest rates are highly sensitive to many

factors that are beyond the Company's control, including general economic conditions and policies of various governmental and regulatory agencies and, in particular, the FRB. Changes in monetary policy, including changes in interest rates, could influence not only the interest the Company receives on loans and securities and the amount of interest it pays on deposits and borrowings, but such changes could also affect (1) its ability to originate loans and obtain deposits, which could reduce the amount of fee income generated, (2) the fair value of its financial assets and liabilities and (3) the average duration of the Company's various categories of earning assets. If the interest rates paid on deposits and other borrowings increase at a faster rate than the interest rates received on loans and other investments, the Company's net interest income could be adversely affected, which in turn could negatively affect its earnings. Earnings could also be adversely affected if the interest rates received on loans and other investments fall more quickly than the interest rates paid on deposits and other borrowings. Although management believes it has implemented effective asset and liability management strategies to reduce the potential effects of changes in interest rates on the results of operations, any substantial, unexpected, prolonged change in market interest rates could have a material adverse effect on the financial condition and results of operations.

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The Company operates in a highly regulated environment and may be adversely affected by changes in laws and regulations or the interpretation and examination of existing laws and regulations.

The Company and its subsidiaries are subject to extensive state and federal regulation, supervision and legislation that govern nearly every aspect of its operations. The Company, as a financial holding company, is subject to regulation by the FRB and its banking subsidiary is subject to regulation by the OCC. These regulations affect deposit and lending practices, capital levels and structure, investment practices, dividend policy and growth. In addition, the non-bank subsidiaries are engaged in providing services including, but not limited to, retirement plan administration, fiduciary services to collective investment funds, investment management and insurance brokerage services, which industries are also heavily regulated at both a state and federal level. Such regulators govern the activities in which the Company and its subsidiaries may engage. These regulatory authorities have extensive discretion in connection with their supervisory and enforcement activities, including the imposition of restrictions on the operation of a bank, the classification of assets by a bank and the adequacy of a bank's allowance for loan losses. Any change in such regulation and oversight, whether in the form of regulatory policy, regulations, legislation, interpretation or application, could have a material impact on the Company and its operations. Changes to the regulatory laws governing these businesses could affect the Company's ability to deliver or expand its services and adversely impact its operating and financial condition.

The Dodd-Frank Act, as amended by the Economic Growth Act, instituted major changes to the banking and financial institutions regulatory regimes based upon the performance of, and ultimate government intervention in, the financial services sector. The ongoing effects of the Dodd-Frank Act, as well as continued rule-making and possible future changes to the regulatory requirements make it difficult to assess the overall impact of the Dodd-Frank Act and related regulatory developments on the Company and the Bank. The implications of the Dodd-Frank Act for the Company's businesses continue to depend to a large extent on the implementation of the legislation by the FRB and other agencies as well as how market practices and structures change in response to the requirements of the Dodd-Frank Act. All of these changes in regulations could subject the Company, among other things, to additional costs and limit the types of financial services and products it can offer and/or increase the ability of non-banks to offer competing financial services and products.

The Company is also directly subject to the requirements of entities that set and interpret the accounting standards such as the Financial Accounting Standards Board, and indirectly subject to the actions and interpretations of the Public Company Accounting Oversight Board, which establishes auditing and related professional practice standards for registered public accounting firms and inspects registered firms to assess their compliance with certain laws, rules, and professional standards in public company audits. These regulations, along with the currently existing tax, accounting, securities, insurance, and monetary laws, regulations, rules, standards, policies and interpretations, control the methods by which financial institutions and their holding companies conduct business, engage in strategic and tax planning, implement strategic initiatives, and govern financial reporting.

The Company's failure to comply with laws, regulations or policies could result in civil or criminal sanctions, restrictions to its business model, and money penalties by state and federal agencies, and/or reputation damage, which could have a material adverse effect on the Company's business, financial condition and results of operations. See "Supervision and Regulation" for more information about the regulations to which the Company is subject.

The Company's total consolidated assets exceeded $10 billion and is therefore subject to additional regulation and increased supervision including the CFPB.

The Dodd-Frank Act imposes additional regulatory requirement on institutions with $10 billion or more in assets. The Company is now subject to the following: (1) supervision, examination and enforcement by the CFPB with respect to consumer financial protection laws, (2) a modified methodology for calculating FDIC insurance assessments and potentially higher assessment rates, (3) limitations on interchange fees for debit card transactions, (4) heightened

compliance standards under the Volcker Rule, and (5) enhanced supervision as a larger financial institution. The imposition of these regulatory requirements and increased supervision may continue to require additional commitment of financial resources to regulatory compliance and may increase the Company's cost of operations.

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Basel III capital rules generally require insured depository institutions and their holding companies to hold more capital, which could limit our ability to pay dividends, engage in share repurchases and pay discretionary bonuses.

The Federal Reserve, the FDIC and the OCC adopted final rules for the Basel III capital framework which substantially amended the regulatory risk-based capital rules applicable to the Company. The rules phase in over time becoming fully effective in 2019. Beginning in 2016, a capital conservation buffer will phase in over three years, ultimately resulting in a requirement of 2.5% on top of the common Tier 1, Tier 1 and total capital requirements, resulting in a required common Tier 1 equity ratio of 7%, a Tier 1 ratio of 8.5%, and a total capital ratio of 10.5%. Failure to satisfy any of these three capital requirements will result in limits on paying dividends, engaging in share repurchases and paying discretionary bonuses. These limitations will establish a maximum percentage of eligible retained income that could be utilized for such actions.

Regional economic factors may have an adverse impact on the Company's business.

The Company's main markets are located in the states of New York, Pennsylvania, Vermont and Massachusetts. Most of the Company's customers are individuals and small and medium-sized businesses which are dependent upon the regional economy. Accordingly, the local economic conditions in these areas have a significant impact on the demand for the Company's products and services as well as the ability of the Company's customers to repay loans, the value of the collateral securing loans and the stability of the Company's deposit funding sources. A prolonged economic downturn in these markets could negatively impact the Company.

The Company is subject to a variety of operational risks, including reputational risk, legal and compliance risk, the risk of fraud or theft by employees or outsiders, which may adversely affect the Company's business and results of operations.

The Company is exposed to many types of operational risks, including reputational risk, legal and compliance risk, the risk of fraud or theft by employees or outsiders, unauthorized transactions by employees, or operational errors, including clerical or record keeping errors or those resulting from faulty or disabled computer or telecommunications systems or disclosure of confidential proprietary information of its customers. Negative public opinion can result from actual or alleged conduct in any number of activities, including lending practices, sales practices, customer treatment, corporate governance and acquisitions and from actions taken by government regulators and community organizations in response to those activities. Negative public opinion can adversely affect the Company's ability to attract and keep customers and can expose the Company to litigation and regulatory action. Actual or alleged conduct by the Company can result in negative public opinion about its business.

If personal, nonpublic, confidential, or proprietary information of customers in the Company's possession were to be mishandled or misused, the Company could suffer significant regulatory consequences, reputational damage, and financial loss. Such mishandling or misuse could include, for example, if such information were erroneously provided to parties who are not permitted to have the information, either by fault of its systems, employees, or counterparties, or where such information is intercepted or otherwise inappropriately taken by third parties.

Because the nature of the financial services business involves a high volume of transactions, certain errors may be repeated or compounded before they are discovered and successfully rectified. The Company's necessary dependence upon automated systems to record and process transactions and the large transaction volumes may further increase the risk that technical flaws or employee tampering or manipulation of those systems will result in losses that are difficult to detect. The Company also may be subject to disruptions of its operating systems arising from events that are wholly or partially beyond its control (for example, computer viruses or electrical or telecommunications outages), which may give rise to disruption of service to customers and to financial loss or liability. The Company is further exposed to the risk that external vendors may be unable to fulfill their contractual obligations (or will be subject to the same risk of fraud or operational errors by their respective employees) and to the risk that business continuity and data

security systems prove to be inadequate. The occurrence of any of these risks could result in a diminished ability to operate the Company's business, potential liability to clients, reputational damage, and regulatory intervention, which could adversely affect our business, financial condition, and results of operations, perhaps materially.

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The financial services industry is highly competitive and creates competitive pressures that could adversely affect the Company's revenue and profitability.

The financial services industry in which the Company operates is highly competitive. The Company competes not only with commercial and other banks and thrifts, but also with insurance companies, mutual funds, hedge funds, securities brokerage firms and other companies offering financial services in the U.S., globally and over the Internet. The Company competes on the basis of several factors, including capital, access to capital, revenue generation, quality customer service, products, services, transaction execution, innovation, reputation and price. Over time, certain sectors of the financial services industry have become more concentrated, as institutions involved in a broad range of financial services have been acquired by or merged into other firms. These developments could result in the Company's competitors gaining greater capital and other resources, such as a broader range of products and services and geographic diversity. The Company may experience pricing pressures as a result of these factors and as some of its competitors seek to increase market share by reducing prices or paying higher rates of interest on deposits. Finally, technological change is influencing how individuals and firms conduct their financial affairs and changing the delivery channels for financial services, with the result that the Company may have to contend with a broader range of competitors including many that are not located within the geographic footprint of its banking office network.

Conditions in the insurance market could adversely affect the Company's earnings.

Revenue from insurance fees and commissions could be negatively affected by fluctuating premiums in the insurance markets or other factors beyond the Company's control. Other factors that affect insurance revenue are the profitability and growth of the Company's clients, the renewal rate of the current insurance policies, continued development of new product and services as well as access to new markets. The Company's insurance revenues and profitability may also be adversely affected by new laws and regulatory developments impacting the healthcare and insurance markets.

The allowance for loan losses may be insufficient.

The Company's business depends on the creditworthiness of its customers. The Company reviews the allowance for loan losses quarterly for adequacy considering economic conditions and trends, collateral values and credit quality indicators, including past charge-off experience and levels of past due loans and nonperforming assets. If the Company's assumptions prove to be incorrect, the Company's allowance for loan losses may not be sufficient to cover losses inherent in the Company's loan portfolio, resulting in additions to the allowance. Material additions to the allowance would materially decrease its net income. It is possible that over time the allowance for loan losses will be inadequate to cover credit losses in the portfolio because of unanticipated adverse changes in the economy, market conditions or events adversely affecting specific customers, industries or markets.

A new accounting standard may require us to increase the allowance for loan losses and may have a material adverse effect on the Company's financial condition and results of operations.

The Financial Accounting Standards Board has released a new accounting standard that will be effective for the Company and the Bank for fiscal years beginning after December 15, 2019. This standard, referred to as Current Expected Credit Loss, or CECL, will require financial institutions to determine periodic estimates of lifetime expected credit losses on loans, and recognize the expected credit losses as allowances for loan losses. This will change the current method of providing allowances for loan losses that are probable, which would likely require the Bank to increase the allowance for loan losses, and to increase the types of data the Bank would need to collect and review to determine the appropriate level of the allowance for loan losses. The extent of the increase to the allowance for loan losses will continue to be evaluated and will depend on economic conditions and the composition of the Company's loan portfolio at the time of adoption.

Changes in the equity markets could materially affect the level of assets under management and the demand for other fee-based services.

Economic downturns could affect the volume of income from and demand for fee-based services. Revenue from the wealth management and employee benefit trust businesses depends in large part on the level of assets under management and administration. Market volatility and the potential to lead customers to liquidate investments, as well as lower asset values, can reduce the level of assets under management and administration and thereby decrease the Company's investment management and employee benefit trust revenues.

Mortgage banking income may experience significant volatility.

Mortgage banking income is highly influenced by the level and direction of mortgage interest rates, and real estate and refinancing activity. In lower interest rate environments, the demand for mortgage loans and refinancing activity will tend to increase. This has the effect of increasing fee income, but could adversely impact the estimated fair value of the Company's mortgage servicing rights as the rate of loan prepayments increase. In higher interest rate environments, the demand for mortgage loans and refinancing activity will generally be lower. This has the effect of decreasing fee income opportunities.

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The Company depends on dividends from its banking subsidiary for cash revenues to support common dividend payments and other uses, but those dividends are subject to restrictions.

The ability of the Company to satisfy its obligations and pay cash dividends to its shareholders is primarily dependent on the earnings of and dividends from the subsidiary bank. However, payment of dividends by the bank subsidiary is limited by dividend restrictions and capital requirements imposed by bank regulations. The ability to pay dividends is also subject to the continued payment of interest that the Company owes on its subordinated junior debentures. As of December 31, 2018, the Company had $97.9 million of subordinated junior debentures outstanding. The Company has the right to defer payment of interest on the subordinated junior debentures for a period not exceeding 20 quarters, although the Company has not done so to date. If the Company defers interest payments on the subordinated junior debentures, it will be prohibited, subject to certain exceptions, from paying cash dividends on the common stock until all deferred interest has been paid and interest payments on the subordinated junior debentures resumes.

The risks presented by acquisitions could adversely affect the Company's financial condition and result of operations.

The business strategy of the Company includes growth through acquisition. Recently completed and future acquisitions will be accompanied by the risks commonly encountered in acquisitions. These risks include among other things: obtaining timely regulatory approval, the difficulty of integrating operations and personnel, the potential disruption of the Company's ongoing business, the inability of the Company's management to maximize its financial and strategic position, the inability to maintain uniform standards, controls, procedures and policies, and the impairment of relationships with employees and customers as a result of changes in ownership and management. Further, the asset quality or other financial characteristics of a company may deteriorate after the acquisition agreement is signed or after the acquisition closes.

A portion of the Company's loan portfolio is acquired and was not underwritten by the Company at origination.

At December 31, 2018, 20% of the loan portfolio was acquired and was not underwritten by the Company at origination, and therefore is not necessarily reflective of the Company's historical credit risk experience. The Company performed extensive credit due diligence prior to each acquisition and marked the loans to fair value upon acquisition, with such fair valuation considering expected credit losses that existed at the time of acquisition. Additionally, the Company evaluates the expected cash flows of these loans on a quarterly basis. However, there is a risk that credit losses could be larger than currently anticipated, thus adversely affecting earnings.

The Company may be required to record impairment charges related to goodwill, other intangible assets and the investment portfolio.

The Company may be required to record impairment charges in respect to goodwill, other intangible assets and the investment portfolio. Numerous factors, including lack of liquidity for resale of certain investment securities, absence of reliable pricing information for investment securities, the economic condition of state and local municipalities, adverse changes in the business climate, adverse actions by regulators, unanticipated changes in the competitive environment or a decision to change the operations or dispose of an operating unit could have a negative effect on the investment portfolio, goodwill or other intangible assets in future periods.

The Company's financial statements are based, in part, on assumptions and estimates, which, if conditions change, could cause unexpected losses in the future.

Pursuant to accounting principles generally accepted in the United States, the Company is required to use certain assumptions and estimates in preparing its financial statements, including in determining credit loss reserves, mortgage repurchase liability and reserves related to litigation, among other items. Certain of the Company's financial instruments, including available-for-sale securities and certain loans, among other items, require a determination of

their fair value in order to prepare the Company's financial statements. Where quoted market prices are not available, the Company may make fair value determinations based on internally developed models or other means which ultimately rely to some degree on management judgment. Some of these and other assets and liabilities may have no direct observable price levels, making their valuation particularly subjective, as they are based on significant estimation and judgment. In addition, sudden illiquidity in markets or declines in prices of certain loans and securities may make it more difficult to value certain balance sheet items, which may lead to the possibility that such valuations will be subject to further change or adjustment. If assumptions or estimates underlying the Company's financial statements are incorrect, it may experience material losses.



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Financial services companies depend on the accuracy and completeness of information about customers and counterparties.

In deciding whether to extend credit or enter into other transactions, the Company may rely on information furnished by or on behalf of customers and counterparties, including financial statements, credit reports and other financial information. The Company may also rely on representations of those customers, counterparties or other third parties, such as independent auditors, as to the accuracy and completeness of that information. Reliance on inaccurate or misleading financial statements, credit reports or other information could have a material adverse impact on business and, in turn, the Company's financial condition and results of operations.

The Company's information systems may experience an interruption or security breach.

The Company relies heavily on communications and information systems to conduct its business. The Company may be the subject of sophisticated and targeted attacks intended to obtain unauthorized access to assets or confidential information, destroy data, disable or degrade service, or sabotage systems, often through the introduction of computer viruses or malware, cyber-attacks and other means. Any failure, interruption or breach in security of these systems could result in failures or disruptions in the Company's online banking system, its general ledger, and its deposit and loan servicing and origination systems or other systems. Furthermore, if personal, confidential or proprietary information of customers or clients in the Company's possession were to be mishandled or misused, the Company could suffer significant regulatory consequences, reputational damage and financial loss. Such mishandling or misuse could include circumstances where, for example, such information was erroneously provided to parties who are not permitted to have the information, either by fault of the Company's systems, employees, or counterparties, or where such information was intercepted or otherwise inappropriately taken by third parties. The Company has policies and procedures designed to prevent or limit the effect of the possible failure, interruption or security breach of its information systems; however, any such failure, interruption or security breach could adversely affect the Company's business and results of operations through loss of assets or by requiring it to expend significant resources to correct the defect, as well as exposing the Company to customer dissatisfaction and civil litigation, regulatory fines or penalties or losses not covered by insurance.

The Company relies on third party vendors, which could expose the Company to additional cybersecurity risks.

Third party vendors provide key components of the Company's business infrastructure, including certain data processing and information services. On behalf of the Company, third parties may transmit confidential, propriety information. Although the Company requires third party providers to maintain certain levels of information security, such providers may remain vulnerable to breaches, unauthorized access, misuse, computer viruses, or other malicious attacks that could ultimately compromise sensitive information. While the Company may contractually limit liability in connection with attacks against third party providers, the Company remains exposed to the risk of loss associated with such vendors. In addition, a number of the Company's vendors are large national entities with dominant market presence in their respective fields. Their services could prove difficult to replace in a timely manner if a failure or other service interruption were to occur. Failures of certain vendors to provide contracted services could adversely affect the Company's ability to deliver products and services to customers and cause the Company to incur significant expense.

The Company is exposed to fraud in many aspects of the services and products that it provides.

The Company offers a wide variety of products and services. When account credentials and other access tools are not adequately protected by its customers, risks and potential costs may increase. As (a) sales of these services and products expand, (b) those who are committing fraud become more sophisticated and more determined, and (c) banking services and product offerings expand, the Company's operational losses could increase.

The Company may be adversely affected by the soundness of other financial institutions.

Financial services institutions are interrelated as a result of trading, clearing, counterparty, or other relationships. The Company has exposure to many different industries and counterparties, and routinely executes transactions with counterparties in the financial services industry. Many of these transactions expose the Company to credit risk in the event of a default by a counterparty or client. In addition, credit risk may be exacerbated when the collateral held by the Company cannot be realized upon or is liquidated at prices not sufficient to recover the full amount of the credit or derivative exposure due to the Company. Any such losses could have a material adverse effect on the Company's financial condition and results of operations.

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The Company is or may become involved in lawsuits, legal proceedings, information-gathering requests, investigations, and proceedings by governmental agencies or other parties that may lead to adverse consequences.

As a participant in the financial services industry, many aspects of the Company's business involve substantial risk of legal liability. The Company and its subsidiaries have been named or threatened to be named as defendants in various lawsuits arising from its or its subsidiaries' business activities (and in some cases from the activities of acquired companies). In addition, from time to time, the Company is, or may become, the subject of governmental and self-regulatory agency information-gathering requests, reviews, investigations and proceedings and other forms of regulatory inquiry, including by bank regulatory agencies, the SEC and law enforcement authorities. The results of such proceedings could lead to delays in or prohibition to acquire other companies, significant penalties, including monetary penalties, damages, adverse judgments, settlements, fines, injunctions, restrictions on the way in which the Company conducts its business, or reputational harm.

Although the Company establishes accruals for legal proceedings when information related to the loss contingencies represented by those matters indicates both that a loss is probable and that the amount of loss can be reasonably estimated, the Company does not have accruals for all legal proceedings where it faces a risk of loss. In addition, due to the inherent subjectivity of the assessments and unpredictability of the outcome of legal proceedings, amounts accrued may not represent the ultimate loss to the Company from the legal proceedings in question. Thus, the Company's ultimate losses may be higher than the amounts accrued for legal loss contingencies, which could adversely affect the Company's financial condition and results of operations.

The Company continually encounters technological change and the failure to understand and adapt to these changes could have a negative impact on the business.

The financial services industry is continually undergoing rapid technological change with frequent introductions of new technology-driven products and services. The effective use of technology increases efficiency and enables financial institutions to better serve customers and to reduce costs. The Company's future success depends, in part, upon its ability to address the needs of its customers by using technology to provide products and services that will satisfy customer demands, as well as to create additional efficiencies in the Company's operations. Many of the Company's competitors have substantially greater resources to invest in technological improvements. The Company may not be able to effectively implement new technology-driven products and services or be successful in marketing these products and services to its customers. Failure to successfully keep pace with technological changes affecting the financial services industry could have a material adverse impact on the Company's financial condition and results of operations.

Trading activity in the Company's common stock could result in material price fluctuations.

The market price of the Company's common stock may fluctuate significantly in response to a number of other factors including, but not limited to:

- Changes in securities analysts' expectations of financial performance;
- Volatility of stock market prices and volumes;
- Incorrect information or speculation;
- Changes in industry valuations;
- Variations in operating results from general expectations;
- Actions taken against the Company by various regulatory agencies;
- Changes in authoritative accounting guidance by the Financial Accounting Standards Board or other regulatory agencies;
- Changes in general domestic economic conditions such as inflation rates, tax rates, unemployment rates, oil prices, labor and healthcare cost trend rates, recessions, and changing government policies, laws and regulations; and
- Severe weather, natural disasters, acts of war or terrorism and other external events.

The Company's ability to attract and retain qualified employees is critical to the success of its business, and failure to do so may have a materially adverse effect on the Company's performance.

The Company's employees are its most important resource, and in many areas of the financial services industry, competition for qualified personnel is intense. The imposition on the Company or its employees of certain existing and proposed restrictions or taxes on executive compensation may adversely affect the Company's ability to attract and retain qualified senior management and employees. If the Company provides inadequate succession planning, is unable to continue to retain and attract qualified employees, the Company's performance, including its competitive position, could have a materially adverse effect.

Item 1B. Unresolved Staff Comments

None

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## Item 2. Properties

The Company's primary headquarters are located at 5790 Widewaters Parkway, Dewitt, New York, which is leased. In addition, the Company has 265 properties located in the counties identified in the table on page 7, of which 161 are owned and 104 are under lease arrangements. With respect to the Banking segment, the Company operates 224 full-service branches and 11 facilities for back office banking operations. With respect to the Employee Benefit Services segment, the Company operates 11 customer service facilities, all of which are leased. With respect to the All Other segment, the Company operates 19 customer service facilities, all of which are leased. Some properties contain tenant leases or subleases.

Real property and related banking facilities owned by the Company at December 31, 2018 had a net book value of $80.5 million and none of the properties were subject to any material encumbrances. For the year ended December 31, 2018, the Company paid $9.0 million of rental fees for facilities leased for its operations. Effective January 1, 2019, the Company adopted new lease accounting guidance in accordance with Accounting Standards Update 2016-02, Leases (Topic 842) that requires recognition of a liability associated with future payments under lease agreements and a right-of-use asset representing the right to use the underlying assets. The adoption of this new guidance resulted in the recognition of a lease liability of approximately $33.5 million and corresponding right-of-use asset of approximately $33.5 million. See the "New Accounting Pronouncements" Section of Note A on page 74 of the Notes to the Consolidated Financial Statements for further information about this guidance. The Company believes that its facilities are suitable and adequate for the Company's current operations.

## Item 3. Legal Proceedings

The Company and its subsidiaries are subject in the normal course of business to various pending and threatened legal proceedings in which claims for monetary damages are asserted. As of December 31, 2018, management, after consultation with legal counsel, does not anticipate that the aggregate ultimate liability arising out of litigation pending or threatened against the Company or its subsidiaries will be material to the Company's consolidated financial position. On at least a quarterly basis, the Company assesses its liabilities and contingencies in connection with such legal proceedings. For those matters where it is probable that the Company will incur losses and the amounts of the losses can be reasonably estimated, the Company records an expense and corresponding liability in its consolidated financial statements. To the extent the pending or threatened litigation could result in exposure in excess of that liability, the amount of such excess is not currently estimable. The range of reasonably possible losses for matters where an exposure is not currently estimable or considered probable, beyond the existing recorded liabilities, is between $0 and $1 million in the aggregate. Although the Company does not believe that the outcome of pending litigation will be material to the Company's consolidated financial position, it cannot rule out the possibility that such outcomes will be material to the consolidated results of operations for a particular reporting period in the future.

## Item 4. Mine Safety Disclosures

Not Applicable

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## Item 4A. Executive Officers of the Registrant

The executive officers of the Company and the Bank who are elected by the Board of Directors are as follows:

| Name | Age | Position |
|---|---|---|
| Mark E. Tryniski | 58 | Director, President and Chief Executive Officer. Mr. Tryniski assumed his current position in August 2006. He served as Executive Vice President and Chief Operating Officer from March 2004 to July 2006 and as the Treasurer and Chief Financial Officer from June 2003 to March 2004. He previously served as a partner in the Syracuse office of PricewaterhouseCoopers LLP. |
| Scott Kingsley | 54 | Executive Vice President and Chief Operating Officer. Mr. Kingsley assumed his current position in June 2018. He served as Executive Vice President and Chief Financial Officer from August 2004 to June 2018. He previously served as Vice President and Chief Financial Officer of Carlisle Engineered Products, Inc., a subsidiary of the Carlisle Companies, Inc., from 1997 until joining the Company. |
| George J. Getman | 62 | Executive Vice President and General Counsel. Mr. Getman assumed his current position in January 2008. Prior to joining the Company, he was a partner with Bond, Schoeneck & King, PLLC and served as corporate counsel to the Company. |
| Joseph E. Sutaris | 51 | Executive Vice President and Chief Financial Officer. Mr. Sutaris assumed his current position in June 2018. He served as Senior Vice President, Finance and Accounting from November 2017 to June 2018, as the Bank's Director of Municipal Banking from September 2016 to November 2017 and as the Senior Vice President of the Central Region of the Bank from April 2011 to September 2016. Mr. Sutaris joined the Company in April 2011 as part of the acquisition of Wilber National Bank where he served as the Executive Vice President, Chief Financial Officer, Treasurer and Secretary. |
| Joseph F. Serbun | 58 | Executive Vice President and Chief Credit Officer. Mr. Serbun assumed his current position in June 2018. He served as the Bank's Senior Vice President and Chief Credit Officer from June 2010 to June 2018 and as Vice President and Commercial Team Leader of the Bank from January 2008 until June 2010. Prior to joining the Company, he served as Vice President at JPMorgan Chase Bank, N.A. |

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Part II

## Item 5. Market for the Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

The Company's common stock has been trading on the New York Stock Exchange under the symbol "CBU" since December 31, 1997. Prior to that, the common stock traded over-the-counter on the NASDAQ National Market under the symbol "CBSI" beginning on September 16, 1986. There were 51,318,005 shares of common stock outstanding on January 31, 2019, held by approximately 3,514 registered shareholders of record. The following table sets forth the high and low closing prices for the common stock, and the cash dividends declared with respect thereto, for the periods indicated. The prices do not include retail mark-ups, mark-downs or commissions.

| Year / Qtr | High Price | Low Price | Quarterly Dividend |
|---|---|---|---|
| 2018 | | | |
| 4th | $ 65.66 | $ 54.72 | $ 0.38 |
| 3rd | $ 66.52 | $ 60.04 | $ 0.38 |
| 2nd | $ 61.98 | $ 52.61 | $ 0.34 |
| 1st | $ 57.00 | $ 51.22 | $ 0.34 |
| | | | |
| 2017 | | | |
| 4th | $ 56.80 | $ 51.38 | $ 0.34 |
| 3rd | $ 57.30 | $ 49.11 | $ 0.34 |
| 2nd | $ 58.03 | $ 51.66 | $ 0.32 |
| 1st | $ 62.32 | $ 51.71 | $ 0.32 |

The Company has historically paid regular quarterly cash dividends on its common stock, and declared a cash dividend of $0.38 per share for the first quarter of 2019. The Board of Directors of the Company presently intends to continue the payment of regular quarterly cash dividends on the common stock, as well as to make payment of regularly scheduled dividends on the trust preferred stock when due, subject to the Company's need for those funds. However, because the substantial majority of the funds available for the payment of dividends by the Company are derived from the subsidiary Bank, future dividends will depend largely upon the earnings of the Bank, its financial condition, its need for funds and applicable governmental policies and regulations.

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The following graph compares cumulative total shareholders returns on the Company's common stock over the last five fiscal years to the S&P 600 Commercial Banks Index, the NASDAQ Bank Index, the S&P 500 Index, and the KBW Regional Banking Index. Total return values were calculated as of December 31 of each indicated year assuming a $100 investment on December 31, 2013 and reinvestment of dividends.

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Equity Compensation Plan Information

The following table provides information as of December 31, 2018 with respect to shares of common stock that may be issued under the Company's existing equity compensation plans.

| Plan Category | Number of Securities to be Issued upon Exercise of Outstanding Options, Warrants and Rights [(1)] | Weighted-average Exercise Price of Outstanding Options, Warrants and Rights | Number of Securities Remaining Available For Future Issuance Under Equity Compensation Plans (excluding securities reflected in the first column) |
|---|---|---|---|
| Equity compensation plans approved by security holders: | | | |
| 2004 Long-term Incentive Plan | 750,032 | $ 29.20 | 52,847 |
| 2014 Long-term Incentive Plan | 1,115,392 | 36.91 | 1,401,817 |
| Equity compensation plans not approved by security holders | 0 | 0 | 0 |
| Total | 1,865,424 | $ 33.81 | 1,454,664 |

(1) The number of securities includes 221,063 shares of unvested restricted stock.

Stock Repurchase Program

At its December 2017 meeting, the Board approved a stock repurchase program authorizing the repurchase, at the discretion of senior management, of up to 2,500,000 shares of the Company's common stock, in accordance with securities laws and regulations, during a twelve-month period starting January 1, 2018. There were no treasury stock purchases made under this authorization in 2018. At its December 2018 meeting, the Board approved a new stock repurchase program authorizing the repurchase, at the discretion of senior management, of up to 2,500,000 shares of the Company's common stock, in accordance with securities laws and regulations, during a twelve-month period starting January 1, 2019. Any repurchased shares will be used for general corporate purposes, including those related to stock plan activities. The timing and extent of repurchases will depend on market conditions and other corporate considerations as determined at the Company's discretion.

The following table presents stock purchases made during the fourth quarter of 2018:

Issuer Purchases of Equity Securities

| Period | Total Number of Shares Purchased | Average Price Paid Per share | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | Maximum Number of Shares That May Yet be Purchased Under the Plans or Programs |
|---|---|---|---|---|
| October 1-31, 2018 | 0 | $ 0.00 | 0 | 2,500,000 |
| November 1-30, 2018[(1)] | 498 | 63.28 | 0 | 2,500,000 |
| December 1-31, 2018 [(1)] | 334 | 57.21 | 0 | 2,500,000 |
| Total | 832 | $ 60.84 | | |

(1) Included in the common shares repurchased were shares acquired by the Company in connection with satisfaction of tax obligations on vested restricted stock issued pursuant to the employee benefit plan of 498 shares and 334 shares in November 2018 and December 2018, respectively. These shares were not repurchased as part of the publicly announced repurchase plan described above.

## Item 6. Selected Financial Data

The following table sets forth selected consolidated historical financial data of the Company as of and for each of the years in the five-year period ended December 31, 2018. The historical information set forth under the captions "Income Statement Data" and "Balance Sheet Data" is derived from the audited financial statements while the information under the captions "Capital and Related Ratios", "Selected Performance Ratios" and "Asset Quality Ratios" for all periods is unaudited. All financial information in this table should be read in conjunction with the information contained in "Management's Discussion and Analysis of Financial Condition and Results of Operations" and with the Consolidated Financial Statements and the related notes thereto included elsewhere in this Annual Report on Form 10-K.



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SELECTED CONSOLIDATED FINANCIAL INFORMATION

| (In thousands except per share data and ratios) | Years Ended December 31, 2018 | 2017 | 2016 | 2015 | 2014 |
|---|---|---|---|---|---|
| Income Statement Data: | | | | | |
| Loan interest income | $286,165 | $253,949 | $211,467 | $187,743 | $185,527 |
| Investment interest income | 76,568 | 75,506 | 73,720 | 71,879 | 70,693 |
| Interest expense | 17,678 | 13,780 | 11,291 | 11,202 | 11,792 |
| Net interest income | 345,055 | 315,675 | 273,896 | 248,420 | 244,428 |
| Provision for loan losses | 10,837 | 10,984 | 8,076 | 6,447 | 7,178 |
| Noninterest income | 223,720 | 202,421 | 155,625 | 123,303 | 119,020 |
| Gain (loss) on investment securities & loss on debt extinguishment, net | 339 | 2 | 0 | (4) | 0 |
| Acquisition expenses and litigation settlement | (769) | 25,986 | 1,706 | 7,037 | 2,923 |
| Other noninterest expenses | 346,058 | 321,163 | 265,142 | 226,018 | 223,657 |
| Income before income taxes | 212,988 | 159,965 | 154,597 | 132,217 | 129,690 |
| Net income | 168,641 | 150,717 | 103,812 | 91,230 | 91,353 |
| Diluted earnings per share | 3.24 | 3.03 | 2.32 | 2.19 | 2.22 |
| | | | | | |
| Balance Sheet Data: | | | | | |
| Cash equivalents | $29,083 | $19,652 | $24,243 | $21,931 | $12,870 |
| Investment securities | 2,981,658 | 3,081,379 | 2,784,392 | 2,847,940 | 2,512,974 |
| Loans | 6,281,121 | 6,256,757 | 4,948,562 | 4,801,375 | 4,236,206 |
| Allowance for loan losses | (49,284) | (47,583) | (47,233) | (45,401) | (45,341) |
| Intangible assets | 807,349 | 825,088 | 480,844 | 484,146 | 386,973 |
| Total assets | 10,607,295 | 10,746,198 | 8,666,437 | 8,552,669 | 7,489,440 |
| Deposits | 8,322,371 | 8,444,420 | 7,075,954 | 6,873,474 | 5,935,264 |
| Borrowings | 413,682 | 485,896 | 248,370 | 403,446 | 440,122 |
| Shareholders' equity | 1,713,783 | 1,635,315 | 1,198,100 | 1,140,647 | 987,904 |
| | | | | | |
| Capital and Related Ratios: | | | | | |
| Cash dividends declared per share | $1.44 | $1.32 | $1.26 | $1.22 | $1.16 |
| Book value per share | 33.43 | 32.26 | 26.96 | 26.06 | 24.24 |
| Tangible book value per share [1] | 18.59 | 16.94 | 17.12 | 15.90 | 15.63 |
| Market capitalization (in millions) | 2,988 | 2,725 | 2,746 | 1,748 | 1,554 |
| Tier 1 leverage ratio | 11.08% | 10.00% | 10.55% | 10.32% | 9.96% |
| Total risk-based capital to risk-adjusted assets | 19.06% | 17.45% | 19.10% | 18.08% | 18.75% |
| Tangible equity to tangible assets [1] | 9.68% | 8.61% | 9.24% | 8.59% | 8.92% |
| Dividend payout ratio | 43.8% | 43.5% | 53.7% | 55.5% | 51.6% |
| Period end common shares outstanding | 51,258 | 50,696 | 44,437 | 43,775 | 40,748 |
| Diluted weighted-average shares outstanding | 51,975 | 49,665 | 44,720 | 41,605 | 41,232 |
| | | | | | |
| Selected Performance Ratios: | | | | | |
| Return on average assets | 1.58% | 1.49% | 1.20% | 1.17% | 1.23% |
| Return on average equity | 10.20% | 10.21% | 8.57% | 8.87% | 9.65% |
| Net interest margin | 3.73% | 3.69% | 3.71% | 3.73% | 3.91% |

| | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| Noninterest revenues/operating revenues (FTE) [2] | 39.6 | % | 38.8 | % | 35.5 | % | 32.3 | % | 31.7 | % |
| Efficiency ratio [3] | 58.0 | % | 58.3 | % | 59.6 | % | 58.2 | % | 58.4 | % |
| | | | | | | | | | | |
| Asset Quality Ratios: | | | | | | | | | | |
| Allowance for loan losses/total loans | 0.78 | % | 0.76 | % | 0.95 | % | 0.95 | % | 1.07 | % |
| Nonperforming loans/total loans | 0.40 | % | 0.44 | % | 0.48 | % | 0.50 | % | 0.56 | % |
| Allowance for loan losses/nonperforming loans | 197 | % | 173 | % | 199 | % | 190 | % | 190 | % |
| Loan loss provision/net charge-offs | 119 | % | 103 | % | 129 | % | 101 | % | 117 | % |
| Net charge-offs/average loans | 0.15 | % | 0.18 | % | 0.13 | % | 0.15 | % | 0.15 | % |

(1) The tangible book value per share and the tangible equity to tangible asset ratio excludes goodwill and identifiable intangible assets, adjusted for deferred tax liabilities generated from tax deductible goodwill and other intangible assets. The ratio is not a financial measurement required by accounting principles generally accepted in the United States of America. However, management believes such information is useful to analyze the relative strength of the Company's capital position and is useful to investors in evaluating Company performance (See Table 20 for Reconciliation of GAAP to Non-GAAP Measures).

(2) For purposes of this ratio, noninterest revenues excludes unrealized gain on equity securities, loss on debt extinguishment and insurance-related recoveries. Operating revenues, a non-GAAP measure, is defined as net interest income on a fully-tax equivalent basis, plus noninterest revenues, excluding unrealized gain on equity securities, loss on debt extinguishment, insurance-related recoveries and acquired non-impaired loan accretion (See Table 20 for Reconciliation of GAAP to Non-GAAP measures).

(3) Efficiency ratio provides a ratio of operating expenses to operating income. It excludes intangible amortization, acquisition expenses, and litigation settlement from expenses and acquired non-impaired loan accretion, insurance-related recoveries, gains and losses on investment securities, and loss on debt extinguishment from income while adding a fully-taxable equivalent adjustment. The efficiency ratio is not a financial measurement required by accounting principles generally accepted in the United States of America. However, the efficiency ratio is used by management in its assessment of financial performance specifically as it relates to noninterest expense control. Management also believes such information is useful to investors in evaluating Company performance (See Table 20 for Reconciliation of GAAP to Non-GAAP Measures).

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

This Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") primarily reviews the financial condition and results of operations of the Company for the past two years, although in some circumstances a period longer than two years is covered in order to comply with SEC disclosure requirements or to more fully explain long-term trends. The following discussion and analysis should be read in conjunction with the Selected Consolidated Financial Information beginning on page 26 and the Company's Consolidated Financial Statements and related notes that appear on pages 60 through 109. All references in the discussion to the financial condition and results of operations refer to the consolidated position and results of the Company and its subsidiaries taken as a whole.

Unless otherwise noted, all earnings per share ("EPS") figures disclosed in the MD&A refer to diluted EPS; interest income, net interest income, and net interest margin are presented on a fully tax-equivalent ("FTE") basis, which is a non-GAAP measure. The term "this year" and equivalent terms refer to results in calendar year 2018, "last year" and equivalent terms refer to calendar year 2017, and all references to income statement results correspond to full-year activity unless otherwise noted.

This MD&A contains certain forward-looking statements with respect to the financial condition, results of operations, and business of the Company. These forward-looking statements involve certain risks and uncertainties. Factors that may cause actual results to differ materially from those contemplated by such forward-looking statements are set herein under the caption "Forward-Looking Statements" on page 54.

Critical Accounting Policies

As a result of the complex and dynamic nature of the Company's business, management must exercise judgment in selecting and applying the most appropriate accounting policies for its various areas of operations. The policy decision process not only ensures compliance with the current accounting principles generally accepted in the United States of America ("GAAP"), but also reflects management's discretion with regard to choosing the most suitable methodology for reporting the Company's financial performance. It is management's opinion that the accounting estimates covering certain aspects of the business have more significance than others due to the relative importance of those areas to overall performance, or the level of subjectivity in the selection process. These estimates affect the reported amounts of assets and liabilities as well as disclosures of revenues and expenses during the reporting period. Actual results could differ from these estimates. Management believes that the critical accounting estimates include the allowance for loan losses, actuarial assumptions associated with the pension, post-retirement and other employee benefit plans, the provision for income taxes, investment valuation and other-than-temporary impairment, the carrying value of goodwill and other intangible assets, and acquired loan valuations. A summary of the accounting policies used by management is disclosed in Note A, "Summary of Significant Accounting Policies", starting on page 65.

Supplemental Reporting of Non-GAAP Results of Operations

The Company also provides supplemental reporting of its results on an "operating," "net adjusted" or "tangible" basis, from which it excludes the after-tax effect of amortization of core deposit and other intangible assets (and the related goodwill, core deposit intangible and other intangible asset balances, net of applicable deferred tax amounts), accretion on non-impaired purchased loans, acquisition expenses, the unrealized gain (loss) on equity securities, loss on debt extinguishment and the one-time benefit from the revaluation of net deferred tax liabilities. Although "adjusted net income" as defined by the Company is a non-GAAP measure, the Company's management believes this information helps investors understand the effect of acquisition and other non-recurring activity in its reported results. Reconciliations of GAAP amounts with corresponding non-GAAP amounts are presented in Table 20.

Executive Summary

The Company's business philosophy is to operate as a diversified financial services enterprise providing a broad array of banking and other financial services to retail, commercial and municipal customers. The Company's banking subsidiary is Community Bank, N.A. (the "Bank" or "CBNA"). The Company also provides employee benefit and trust related services via its Benefit Plans Administrative Services, Inc. ("BPAS") subsidiary, and wealth management and insurance-related services.

The Company's core operating objectives are: (i) grow the branch network, primarily through a disciplined acquisition strategy, and certain selective de novo expansions, (ii) build profitable loan and deposit volume using both organic and acquisition strategies, (iii) manage an investment securities portfolio to complement the Company's loan and deposit strategies and optimize interest rate risk, yield and liquidity, (iv) increase the noninterest component of total revenues through development of banking-related fee income, growth in existing financial services business units, and the acquisition of additional financial services and banking businesses, and (v) utilize technology to deliver customer-responsive products and services and improve efficiencies.

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Significant factors reviewed by management to evaluate achievement of the Company's operating objectives and its operating results and financial condition include, but are not limited to: net income and earnings per share; return on assets and equity; net interest margins; noninterest revenues; noninterest expenses; asset quality; loan and deposit growth; capital management; performance of individual banking and financial services units; performance of specific product lines and customers; liquidity and interest rate sensitivity; enhancements to customer products and services and their underlying performance characteristics; technology advancements; market share; peer comparisons; and the performance of recently acquired businesses.

On January 2, 2018, the Company, through its subsidiary, OneGroup NY, Inc. ("OneGroup"), completed its acquisition of certain assets of Penna & Associates Agency, Inc. ("Penna"), an insurance agency headquartered in Johnson City, New York. The Company paid $0.8 million in cash to acquire the assets of Penna, and recorded goodwill in the amount of $0.3 million and a customer list intangible asset of $0.3 million in conjunction with the acquisition.

On January 2, 2018, the Company, through its subsidiary, Community Investment Services, Inc. ("CISI"), completed its acquisition of certain assets of Styles Bridges Associates ("Styles Bridges"), a financial services business headquartered in Canton, New York. The Company paid $0.7 million in cash to acquire a customer list from Styles Bridges, and recorded a $0.7 million customer list intangible asset in conjunction with the acquisition.

On April 2, 2018, the Company, through its subsidiary, Benefit Plans Administrative Services, Inc. ("BPAS"), acquired certain assets of HR Consultants (SA), LLC ("HR Consultants"), a provider of actuarial and benefit consulting services headquartered in Puerto Rico. The Company paid $0.3 million in cash to acquire the assets of HR Consultants and recorded intangible assets of $0.3 million in conjunction with the acquisition.

The Company reported net income and earnings per share for the year ended December 31, 2018 that were 11.9% and 6.9%, respectively, above the prior year amounts. The increase in net income was due primarily to the earnings generated by a full year of expanded business activities from the Merchants and NRS acquisitions. Contributing to the increase in net income was an increase in net interest income, higher noninterest revenues and lower noninterest expenses. Partially offsetting these items were an increase in weighted average diluted shares outstanding; attributable to shares issued in the Merchants and NRS transactions and shares issued in connection with the administration of the Company's 401(k) plan and employee stock plan and higher income taxes. Net income adjusted to exclude acquisition expenses, the one-time impact of the adjustment of net deferred tax liabilities associated with the enactment of the Tax Cuts and Jobs Act of 2017 ("Tax Cuts and Jobs Act"), unrealized gain on equity securities, loss on debt extinguishment, amortization of intangibles, and acquired non-impaired loan accretion ("Adjusted Net Income"), increased $37.1 million, or 26.7%, compared to the prior year. Earnings per share adjusted to exclude acquisition expenses, the one-time impact of the Tax Cuts and Jobs Act, unrealized gain on equity securities, loss on debt extinguishment, amortization of intangibles and acquired non-impaired loan accretion ("Adjusted Earnings Per Share"), of $3.39 increased $0.59, or 21.1%, compared to the prior year. See Table 20 for Reconciliation of GAAP to Non-GAAP Measures.

The Company experienced year-over-year growth in average interest-earning assets, primarily reflective of the Merchants acquisition completed in May 2017. Average deposits increased in 2018 as compared to 2017, reflective of organic growth in core deposits and the impact of the Merchants acquisition, partially offset by a decrease in time deposits. Average external borrowings in 2018 increased from 2017 reflective of the subordinated debt held by an unconsolidated subsidiary and long-term debt acquired in the Merchants transaction and an increase in securities sold under an agreement to repurchase ("customer repurchase agreements"), partially offset by the redemption of trust preferred subordinated debt held by Community Statutory Trust III, an unconsolidated subsidiary trust, during the third quarter of 2018. Asset quality in 2018 remained stable and favorable in comparison to the end of 2017, with nonperforming loan ratios, the delinquency ratio and the full year net charge-off ratio at December 31, 2018 all improved from the prior year.

Net Income and Profitability

Net income for 2018 was $168.6 million, an increase of $17.9 million, or 11.9%, from 2017's earnings. Earnings per share for 2018 was $3.24, up $0.21, or 6.9%, from 2017's results. The 2018 results included a $0.8 million recovery of vendor contract termination charges, which were recorded as an acquisition expense during the second quarter of 2017. The 2017 results included $26.0 million, or $0.37 per share, of acquisition expenses primarily related to the Merchants and NRS acquisitions. Adjusted Net Income increased $37.1 million, or 26.7%, compared to the prior year. Adjusted Earnings Per Share of $3.39 increased $0.59, or 21.1%, compared to the prior year. See Table 20 for Reconciliation of GAAP to Non-GAAP Measures.

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Net income for 2017 was $150.7 million, an increase of $46.9 million, or 45.2%, from 2016's earnings, while earnings per share for 2017 was $3.03, up $0.71, or 30.6%, from 2016's results due primarily to the Merchants and NRS acquisitions, as well as the one-time impact of the Tax Cuts and Jobs Act. The 2017 results included the aforementioned acquisition expenses.

Table 1: Condensed Income Statements

| | Years Ended December 31, | | | | |
|---|---|---|---|---|---|
| (000's omitted, except per share data) | 2018 | 2017 | 2016 | 2015 | 2014 |
| Net interest income | $345,055 | $315,675 | $273,896 | $248,420 | $244,428 |
| Provision for loan losses | 10,837 | 10,984 | 8,076 | 6,447 | 7,178 |
| Gain/(Loss) on sales of investment securities, net | 0 | 2 | 0 | (4) | 0 |
| Unrealized gain on equity securities | 657 | 0 | 0 | 0 | 0 |
| Loss on debt extinguishment | (318) | 0 | 0 | 0 | 0 |
| Noninterest revenue | 223,720 | 202,421 | 155,625 | 123,303 | 119,020 |
| Acquisition expenses and litigation settlement | (769) | 25,986 | 1,706 | 7,037 | 2,923 |
| Other noninterest expenses | 346,058 | 321,163 | 265,142 | 226,018 | 223,657 |
| Income before taxes | 212,988 | 159,965 | 154,597 | 132,217 | 129,690 |
| Income taxes | 44,347 | 9,248 | 50,785 | 40,987 | 38,337 |
| Net income | $168,641 | $150,717 | $103,812 | $91,230 | $91,353 |
| | | | | | |
| Diluted weighted average common shares outstanding | 51,975 | 49,665 | 44,720 | 41,605 | 41,232 |
| Diluted earnings per share | $3.24 | $3.03 | $2.32 | $2.19 | $2.22 |

The Company operates in three business segments: Banking, Employee Benefit Services and All Other. The banking segment provides a wide array of lending and depository-related products and services to individuals, businesses and municipal enterprises. In addition to these general intermediation services, the Banking segment provides treasury management solutions and payment processing services. Employee Benefit Services, consisting of BPAS and its subsidiaries, provides the following on a national basis: employee benefit trust services; collective investment fund; fund administration, transfer agency; retirement plan and VEBA/HRA and health savings account plan administration services; actuarial services; and healthcare consulting services. BPAS services more than 3,800 benefit plans with approximately 450,000 plan participants and holds more than $74 billion in employee benefit trust assets. In addition, BPAS employs 370 professionals located in 18 states, and occupies 10 offices located in Massachusetts, New York, New Jersey, Pennsylvania, Texas and Puerto Rico. The All Other segment is comprised of wealth management and insurance services. Wealth management activities include trust services provided by the personal trust unit of CBNA, investment products and services provided by CISI and The Carta Group, and asset advisory services provided by Nottingham. The insurance services activities include the offerings of personal and commercial property insurance and other risk management products and services provided by OneGroup. For additional financial information on the Company's segments, refer to Note U – Segment Information in the Notes to Consolidated Financial Statements.

The primary factors explaining 2018 earnings performance are discussed in the remaining sections of this document and are summarized by segment as follows:

BANKING

- Net interest income increased $29.6 million, or 9.4%. This was the result of a $553.7 million increase in average interest earning assets and an eight basis point increase in the average yield on earning assets, partially offset by a $179.0 million increase in average interest-bearing liabilities and a five basis point increase in the average rate on interest-bearing liabilities. Average loans grew $445.5 million driven primarily by a full year of loans acquired with Merchants, and the yield on loans increased 19 basis points from the prior year due primarily to the rising rate environment. Also contributing to the growth in interest income was a $108.2 million increase in the average book

value of investments, including cash equivalents, primarily due to investments acquired in the Merchants transaction, partially offset by a 21 basis-point decrease in the average yield on investments. Average interest-bearing deposits increased $150.9 million due primarily to the addition of deposits from the Merchants acquisition, partially offset by the continued trend of declining time deposit balances. Borrowing interest expense increased year-over-year as a result of an increase in average balances of $28.1 million, or 7.4%, and a blended rate that was 21 basis points higher than the prior year.

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- The loan loss provision of $10.8 million decreased $0.1 million, or 1.3%, from the prior year level. Net charge offs of $9.1 million were $1.5 million less than 2017, primarily due to a $3.1 million partial charge-off of a single commercial relationship in the fourth quarter of 2017. This resulted in an annual net charge-off ratio (net charge-offs / total average loans) of 0.15%, which was three basis points lower than the prior year. Year-end nonperforming loans as a percentage of total loans decreased four basis points and nonperforming assets as a percentage of loans and other real estate owned decreased five basis points compared to December 31, 2017 levels. Additional information on trends and policy related to asset quality is provided in the asset quality section on pages 44 through 48.

- Banking noninterest revenue for 2018, excluding unrealized gain on equity securities and loss on debt extinguishment, of $75.4 million increased by $2.0 million from 2017's level. This was primarily due to higher deposit service fees impacted by a full year of activity from deposit relationships associated with the Merchants acquisition, partially offset by a decrease in debit card-related revenue of approximately $7.1 million due to debit interchange fee limitations established by the Durbin amendment of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act") that were effective for the Company beginning in the third quarter of 2018.

- Total banking noninterest expenses, including acquisition expenses, decreased $11.4 million, or 4.6%, in 2018 primarily reflective of the $24.5 million in one-time expenses incurred in 2017 related to the Merchants acquisition compared to the $0.8 million recovery of acquisition-related contract termination charges in 2018, offset by an increase in expenses related to an expanded branch network and other acquired activities from the Merchants acquisition and continued investment in risk management capabilities and technology and data processing costs. Excluding acquisition expenses, banking noninterest expenses increased $13.9 million, or 6.2%, reflective of a full year of expanded operations resulting from the Merchants acquisition.

EMPLOYEE BENEFIT SERVICES

- Employee benefit services noninterest revenue for 2018 of $94.4 million increased $11.7 million, or 14.1%, from the prior year level, due to the combination of a full year of expanded business activities from the NRS acquisition and growth in employee benefit trust assets.

- Employee benefit services noninterest expenses including acquisition expenses for 2018 totaled $64.3 million. This represented an increase from 2017 of $3.4 million, or 5.6%, and was attributable to the expanded business operations from the NRS acquisition and the continued buildout of resources to support an expanding revenue base.

ALL OTHER (WEALTH MANAGEMENT AND INSURANCE SERVICES)

- Wealth management and insurance services noninterest revenue for 2018 was $57.2 million; an increase of $8.0 million from the prior year level. The increase was due to the additional customers generated by both organic and acquired growth sources, including the expansion of operations resulting from the Penna, Styles Bridges, BAS, Dryfoos, GBR and NECM acquisitions.

- Wealth management and insurance services noninterest expenses of $47.0 million increased $6.3 million from 2017 primarily due to increased personnel costs associated with the aforementioned organic and acquired growth.

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Selected Profitability and Other Measures

Return on average assets, return on average equity, dividend payout and equity to asset ratios for the years indicated are as follows:

Table 2: Selected Ratios

| | 2018 | 2017 | 2016 |
|---|---|---|---|
| Return on average assets | 1.58 % | 1.49 % | 1.20 % |
| Return on average equity | 10.20% | 10.21% | 8.57 % |
| Dividend payout ratio | 43.8 % | 43.5 % | 53.7 % |
| Average equity to average assets | 15.50% | 14.63% | 13.99% |

As displayed in Table 2, the 2018 return on average assets ratio increased nine basis points, while the return on average equity ratio decreased one basis point as compared to 2017. The increase in return on average assets was primarily the result of an increase in net income, reflective of a full year of activities from the Merchants and NRS transactions, which outpaced the increase in average assets. The return on average equity ratio decreased slightly in 2018 as the increase in average equity due primarily to the impact of the shares issued for the Merchants and NRS acquisitions and earnings retention slightly outpaced the increase in net income. The return on average assets ratio and the return on average equity increased in 2017, as compared to 2016. The increase in return on average assets and return on equity in 2017 was the result of an increase in net income, reflective of expanded activities from the Merchants and NRS transactions and the impact of the one-time adjustment to net deferred tax liabilities in the fourth quarter of 2017 related to the Tax Cuts and Jobs Act, which outpaced the increase in average assets and average equity. The return on average assets adjusted to exclude acquisition expenses, the one-time impact of the Tax Cuts and Jobs Act, unrealized gain on equity securities, loss on debt extinguishment, amortization of intangibles, and acquired non-impaired loan accretion increased 27 basis points to 1.65% in 2018, as compared to 1.38% in 2017. The return on average equity adjusted to exclude acquisition expenses, the one-time impact of the Tax Cuts and Jobs Act, amortization of intangibles, and acquired non-impaired loan accretion increased 123 basis points to 10.64% in 2018, from 9.41% in 2017. See Table 20 for Reconciliation of GAAP to Non-GAAP Measures.

The dividend payout ratio for 2018 increased 0.3% from 2017 as the 12.7% increase in dividends declared from 2017 was modestly higher than the 11.9% increase in net income. The increase in dividends declared in 2018 was a result of a 9.1% increase in the dividends declared per share and the issuance of shares in connection with the administration of the Company's 401(k) plan and employee stock plan. The dividend payout ratio for 2017 decreased 10.2% from 2016 as the 45.2% increase in net income from 2016 outweighed the 17.6% increase in dividends declared. The increase in dividends declared in 2017 was a result of a 4.8% increase in the dividends declared per share, an increase in the shares outstanding due to the issuance of shares as partial consideration in the Merchants, NRS and GBR transactions and the issuance of shares in connection with the administration of the Company's 401(k) plan and employee stock plan.

The average equity to average assets ratio continued to increase in 2018 as the growth in common shareholders' equity outpaced the growth in assets. During 2018, average equity increased 12.0% while average assets increased at a rate of 5.7%. In 2017 average equity rose 21.8% and average assets grew 16.5% in comparison to 2016.

Net Interest Income

Net interest income is the amount by which interest and fees on earning assets (loans, investments and cash equivalents) exceeds the cost of funds, which consists primarily of interest paid to the Company's depositors and interest on borrowings. Net interest margin is the difference between the yield on interest earning assets and the cost of interest-bearing liabilities as a percentage of earning assets.

As disclosed in Table 3, net interest income (with nontaxable income converted to a fully tax-equivalent basis) totaled $349.4 million in 2018, an increase of $24.3 million, or 7.5%, from the prior year. The increase is a result of a $553.7 million, or 6.3%, increase in average interest-earning assets and an eight basis point increase in the average yield on interest-earning assets, partially offset by a $179.0 million increase in average interest-bearing liabilities and a five basis point increase in the average rate on interest-bearing liabilities. As reflected in Table 4, the favorable impact of the increase in interest-earning assets ($21.6 million) and increase in the yield ($6.6 million) was partially offset by the unfavorable impact of the increase in interest-bearing liabilities ($0.4 million) and the higher rate on interest-bearing liabilities ($3.5 million).

The 2018 net interest margin increased four basis points to 3.73% from 3.69% reported in 2017. The increase was attributable to an eight basis point increase in the earning-asset yield, offset by a five basis point increase in the cost of interest-bearing liabilities. The 4.58% yield on loans increased 19 basis points in 2018 as compared to 4.39% in 2017, including the impact of incremental acquired loan accretion on the Merchants portfolio. The yield on investments, including cash equivalents, decreased from 2.79% in 2017 to 2.58% in 2018. This lower yield on investments is reflective of maturing higher rate investments being replaced with lower-yielding securities and interest-earning cash, as well as the result of a lower fully tax-equivalent adjustment due to the lower federal tax rate associated with the Tax Cuts and Jobs Act. The cost of interest-bearing liabilities was 0.27% during 2018 as compared to 0.22% for 2017. The increased cost reflects the three basis point increase in the average rate paid on deposits and the 21 basis point higher average rate paid on borrowings in 2018.

The net interest margin in 2017 decreased two basis points to 3.69% from 3.71% reported in 2016. The decrease was attributable to a one basis point decrease in the earning-asset yield combined with a two basis point increase in the cost of interest-bearing liabilities. The 4.39% yield on loans increased five basis points in 2017 as compared to 4.34% in 2016, due in part to incremental acquired loan accretion on the Merchants portfolio. The yield on investments, including cash equivalents, decreased from 2.99% in 2016 to 2.79% in 2017. This lower yield on investments is reflective of maturing higher rate investments being replaced with lower-yielding securities and interest-earning cash as well as the effect certain changes in state tax rates had on the fully tax-equivalent adjustment. The cost of interest-bearing liabilities was 0.22% during 2017 as compared to 0.20% for 2016. The increased cost primarily reflects the increase in the average rate paid on external borrowings in 2017.

As shown in Table 3, total FTE-basis interest income increased by $28.2 million, or 8.3%, in 2018 in comparison to 2017. Table 4 indicates that a higher average earning-asset balance created $21.6 million of incremental interest income and a higher yield on earning assets had a favorable impact of $6.6 million on interest income. Average loans increased $445.5 million, or 7.7%, in 2018. This increase was primarily due to acquired growth from the Merchants acquisition, which accounted for $351.9 million of the growth. FTE-basis loan interest income and fees increased $31.8 million, or 12.5%, in 2018 as compared to 2017, attributable to the higher average balances and a 19 basis point increase in the loan yield.

Investment interest income (FTE basis) in 2018 was $3.6 million, or 4.3%, lower than the prior year as a result of a 21 basis point decrease in the average investment yield from 2.79% in 2017 to 2.58% in 2018. This decrease in yield was partially offset by a $108.2 million, or 3.6%, higher average book basis balance (including cash equivalents) for 2018 versus the prior year. The lower average investment yield in 2018 was reflective of cash flows from higher rate maturing instruments in the investment portfolio being reinvested at lower interest rates or held in interest-earning cash.

Total interest income in 2017 increased $43.7 million, or 14.8%, from 2016's level. As shown in table 4, the higher average earning-asset balance created $44.4 million of incremental interest income, partially offset by a lower average yield on earning assets that had a negative impact of $0.7 million. Average loans increased $936.5 million, or 19.2%, in 2017, primarily a result of acquired growth, with the Merchants acquisition accounting for $899.8 million of the total increase. FTE-basis loan interest income and fees increased $43.2 million, or 20.4%, in 2017 as compared to 2016, attributable to the higher average balances and a five basis point increase in the loan yield. On a FTE basis, investment interest income, including interest on cash equivalents, totaled $83.6 million in 2017, $0.5 million, or 0.6%, higher than the prior year as a result of a $219.5 million, or 7.9%, higher average book basis balance (including cash equivalents) for 2017 versus the prior year. This was partially offset by a 20 basis point decrease in the average investment yield from 2.99% to 2.79%. During most of 2017, market interest rates continued to be low, and as a result, cash flows from higher rate maturing investments were reinvested at lower interest rates, including in interest earning cash, or were used to pay down overnight borrowings.

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Total interest expense increased by $3.9 million, or 28.3%, to $17.7 million in 2018. As shown in Table 4, higher interest rates on interest-bearing liabilities resulted in an increase in interest expense of $3.5 million, while higher deposit balances resulted in a $0.4 million increase in interest expense. Interest expense as a percentage of average earning assets for 2018 increased three basis points to 0.19%. The rate on interest-bearing deposits of 0.17% was four basis points higher than 2017, primarily due to an increase in certain product rates in response to the increase in the Federal Funds rate during 2018. The rate on borrowings increased 21 basis points to 1.72% in 2018, primarily due to the increase in the variable rate paid on subordinated debt held by unconsolidated subsidiary trusts and overnight borrowings. Total average funding balances (deposits and borrowings) in 2018 increased $433.4 million, or 5.1%. Average deposits increased $405.3 million, representing an increase of $428.6 million from the Merchants acquisition offset by a decrease of $23.3 million in legacy deposits. Average non-acquired, non-time ("core") deposit balances increased $420.1 million to 91.1% of total average deposits compared to 90.5% in 2017, while average time deposits increased by $14.9 million year-over-year, representing 8.9% of total average deposits for 2018 compared to 9.5% in 2017. Average external borrowings increased $28.1 million in 2018 as compared to 2017, as a year-over-year increase in average customer repurchase agreements of $88.9 million was offset by a decrease in average FHLB borrowings of $57.9 million and a decrease in average subordinated debt held by unconsolidated subsidiary trusts of $2.9 million. The increase in average customer repurchase agreements is primarily related to a full year of customer activity from the Merchants acquisition, while the decrease in FHLB borrowings is due to cash flows from investment maturities being used to pay down overnight borrowings. The decrease in average subordinated debt held by unconsolidated subsidiary trusts is due to the redemption of trust preferred debt held by Community Statutory Trust III during the third quarter of 2018 for a total of $25.2 million, offset by a full year of subordinated debt acquired with the Merchants transaction.

Total interest expense increased by $2.5 million to $13.8 million in 2017 as compared to 2016. As shown in Table 4, higher interest rates on interest-bearing liabilities resulted in an increase in interest expense of $1.2 million, while higher deposit balances resulted in a $1.3 million increase in interest expense. Interest expense as a percentage of average earning assets for 2017 increased one basis point to 0.16%. The rate on interest-bearing deposits of 0.13% was consistent with prior years as rates have been held relatively steady in all interest-bearing categories throughout 2017 and 2016, and deposit mix continued to shift towards a lower proportion of time deposit products. The rate on external borrowings increased five basis points to 1.51% in 2017, a result of lower-rate overnight FHLB borrowings becoming a smaller proportion of this funding component. Total average funding balances (deposits and borrowings) in 2017 increased $1.14 billion, or 15.6%. Average deposits increased $1.03 billion, of which approximately $862.8 million was attributable to the Merchants acquisition, with the remaining $166.8 million attributable to organic deposit growth. Consistent with the Company's funding mix objective and customers' unwillingness to commit to less liquid instruments in the low rate environment, average core deposit balances increased $1.01 billion to 90.5% of total average deposits compared to 89.3% in 2016, while time deposits increased at a slower rate of $14.7 million year-over-year representing 9.5% of total average deposits for 2017 compared to 10.7% in 2016. Average external borrowings increased $108.0 million in 2017 as compared to the prior year, due to securities sold under an agreement to repurchase, short-term advances, subordinated debt held by unconsolidated subsidiary trusts and long-term debt assumed as part of the Merchants transaction that added $187.6 million in average borrowings, partially offset by a decrease in average FHLB borrowings of $79.6 million.

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The following table sets forth information related to average interest-earning assets and interest-bearing liabilities and their associated yields and rates for the years ended December 31, 2018, 2017 and 2016. Interest income and yields are on a fully tax-equivalent basis using marginal income tax rates of 24.4% in 2018, 37.7% in 2017 and 38.2% in 2016. Average balances are computed by totaling the daily ending balances in a period and dividing by the number of days in that period. Loan interest income and yields include loan fees and acquired loan accretion. Average loan balances include acquired loan purchase discounts and premiums, nonaccrual loans and loans held for sale.

Table 3: Average Balance Sheet

| | Year Ended December 31, 2018 | | | Year Ended December 31, 2017 | | | Year Ended December 31, 2016 | | |
|---|---|---|---|---|---|---|---|---|---|
| (000's omitted except yields and rates) | Average Balance | Interest | Avg. Yield/Rate Paid | Average Balance | Interest | Avg. Yield/Rate Paid | Average Balance | Interest | Avg. Yield/Rate Paid |
| Interest-earning assets: | | | | | | | | | |
| Cash equivalents | $78,888 | $1,322 | 1.68% | $38,545 | $385 | 1.00% | $19,062 | $89 | 0.47% |
| Taxable investment securities [1] | 2,577,695 | 62,182 | 2.41% | 2,440,215 | 59,774 | 2.45% | 2,177,589 | 56,113 | 2.58% |
| Nontaxable investment securities [1] | 447,772 | 16,526 | 3.69% | 517,408 | 23,499 | 4.54% | 579,986 | 26,924 | 4.64% |
| Loans (net of unearned discount)[2] | 6,263,843 | 287,048 | 4.58% | 5,818,367 | 255,212 | 4.39% | 4,881,905 | 212,022 | 4.34% |
| Total interest-earning assets | 9,368,198 | 367,078 | 3.92% | 8,814,535 | 338,870 | 3.84% | 7,658,542 | 295,148 | 3.85% |
| Noninterest-earning assets | 1,297,011 | | | 1,274,680 | | | 1,001,525 | | |
| Total assets | $10,665,209 | | | $10,089,215 | | | $8,660,067 | | |
| Interest-bearing liabilities: | | | | | | | | | |
| Interest checking, savings and money market deposits | $5,403,013 | 6,292 | 0.12% | $5,237,282 | 4,854 | 0.09% | $4,712,212 | 4,121 | 0.09% |
| Time deposits | 750,814 | 4,366 | 0.58% | 765,666 | 3,177 | 0.41% | 750,944 | 3,204 | 0.43% |
| Repurchase agreements | 261,358 | 1,597 | 0.61% | 172,395 | 739 | 0.43% | 0 | 0 | 0.00% |
| FHLB borrowings | 34,374 | 746 | 2.17% | 92,307 | 1,106 | 1.20% | 169,769 | 1,017 | 0.60% |
| Subordinated debt held by unconsolidated subsidiary trusts | 112,322 | 4,677 | 4.16% | 115,231 | 3,904 | 3.39% | 102,158 | 2,949 | 2.89% |
| Total interest-bearing liabilities | 6,561,881 | 17,678 | 0.27% | 6,382,881 | 13,780 | 0.22% | 5,735,083 | 11,291 | 0.20% |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Noninterest-bearing liabilities: | | | | | | | | |
| Noninterest checking deposits | 2,302,806 | | | 2,048,414 | | | 1,558,548 | | |
| Other liabilities | 147,141 | | | 182,159 | | | 154,916 | | |
| Shareholders' equity | 1,653,381 | | | 1,475,761 | | | 1,211,520 | | |
| Total liabilities and shareholders' equity | $10,665,209 | | | $10,089,215 | | | $8,660,067 | | |
| | | | | | | | | |
| Net interest earnings | | $349,400 | | | $325,090 | | | $283,857 | |
| | | | | | | | | |
| Net interest spread | | | 3.65% | | | 3.62% | | | 3.65% |
| Net interest margin on interest-earning assets | | | 3.73% | | | 3.69% | | | 3.71% |
| | | | | | | | | |
| Fully tax-equivalent adjustment | | $4,345 | | | $9,415 | | | $9,961 | |

(1) Averages for investment securities are based on historical cost and the yields do not give effect to changes in fair value that is reflected as a component of noninterest-earning assets, shareholders' equity and deferred taxes.

(2) Includes nonaccrual loans. The impact of interest and fees not recognized on nonaccrual loans was immaterial.

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As discussed above, the change in net interest income (fully tax-equivalent basis) may be analyzed by segregating the volume and rate components of the changes in interest income and interest expense for each underlying category.

Table 4: Rate/Volume

| | 2018 Compared to 2017 Increase (Decrease) Due to Change in [1] | | | 2017 Compared to 2016 Increase (Decrease) Due to Change in [1] | | |
|---|---|---|---|---|---|---|
| (000's omitted) | Volume | Rate | Net Change | Volume | Rate | Net Change |
| Interest earned on: | | | | | | |
| Cash equivalents | $ 569 | $ 368 | $ 937 | $ 140 | $ 156 | $ 296 |
| Taxable investment securities | 3,327 | (919) | 2,408 | 6,530 | (2,869) | 3,661 |
| Nontaxable investment securities | (2,915) | (4,058) | (6,973) | (2,853) | (572) | (3,425) |
| Loans (net of unearned discount) | 20,092 | 11,744 | 31,836 | 41,057 | 2,133 | 43,190 |
| Total interest-earning assets [2] | 21,598 | 6,610 | 28,208 | 44,444 | (722) | 43,722 |
| Interest paid on: | | | | | | |
| Interest checking, savings and money market deposits | 158 | 1,280 | 1,438 | 477 | 256 | 733 |
| Time deposits | (63) | 1,252 | 1,189 | 63 | (90) | (27) |
| Repurchase agreements | 676 | 182 | 858 | 739 | 0 | 739 |
| FHLB borrowings | (940) | 580 | (360) | (609) | 698 | 89 |
| Subordinated debt held by unconsolidated subsidiary trusts | (101) | 874 | 773 | 405 | 550 | 955 |
| Total interest-bearing liabilities [2] | 396 | 3,502 | 3,898 | 1,341 | 1,148 | 2,489 |
| Net interest earnings [2] | $ 20,614 | $ 3,696 | $ 24,310 | $ 42,642 | $ (1,409) | $ 41,233 |

(1) The change in interest due to both rate and volume has been allocated to volume and rate changes in proportion to the relationship of the absolute dollar amounts of such change in each component.

(2) Changes due to volume and rate are computed from the respective changes in average balances and rates of the totals; they are not a summation of the changes of the components.

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## Noninterest Revenues

The Company's sources of noninterest revenues are of four primary types: 1) general banking services related to loans, deposits and other core customer activities typically provided through the branch network and electronic banking channels (performed by CBNA); 2) employee benefit trust and benefit plan administration services (performed by BPAS and its subsidiaries); 3) wealth management services, comprised of personal trust services (performed by the trust unit within CBNA), investment products and services (performed by CISI and The Carta Group) and asset management services (performed by Nottingham); and 4) insurance products and services (performed by OneGroup). Additionally, the Company has other transactions, including unrealized gains or losses on equity securities, realized gains or losses from the sale of investment securities and loss on debt extinguishment.

Table 5: Noninterest Revenues

| | Years Ended December 31, | | |
|---|---|---|---|
| (000's omitted except ratios) | 2018 | 2017 | 2016 |
| Employee benefit services | $92,279 | $80,830 | $46,628 |
| Deposit service charges and fees | 38,445 | 33,729 | 29,061 |
| Electronic banking | 26,748 | 29,722 | 25,781 |
| Insurance services | 30,317 | 26,150 | 23,149 |
| Wealth management services | 25,772 | 22,079 | 19,776 |
| Other banking revenues | 10,159 | 9,911 | 11,230 |
| Subtotal | 223,720 | 202,421 | 155,625 |
| Unrealized gain on equity securities | 657 | 0 | 0 |
| Loss on debt extinguishment | (318) | 0 | 0 |
| Gain on sales of investment securities, net | 0 | 2 | 0 |
| Total noninterest revenues | $224,059 | $202,423 | $155,625 |
| | | | |
| Noninterest revenues/operating revenues (FTE basis) [1] | 39.6 % | 38.8 % | 35.5 % |

[1] For purposes of this ratio noninterest revenues excludes unrealized gain on equity securities, loss on debt extinguishment and insurance-related recoveries. Operating revenues, a non-GAAP measure, is defined as net interest income on a fully-tax equivalent basis, plus noninterest revenues, excluding unrealized gain on equity securities, loss on debt extinguishment, insurance-related recoveries and acquired non-impaired loan accretion. See Table 20 for Reconciliation of GAAP to Non-GAAP measures.

As displayed in Table 5, total noninterest revenues, excluding unrealized gain on equity securities, gain on the sale of investment securities and loss on debt extinguishment, increased by $21.3 million, or 10.5%, to $223.7 million in 2018 as compared to 2017. The increase was comprised of growth in revenue from the Company's employee benefit services businesses, primarily from a full year of activity associated with the NRS acquisition and organic growth, an increase in wealth management and insurance services revenue and an increase in other banking revenues, partially offset by a decrease in debit card-related revenue related to Durbin amendment mandated debit interchange price restrictions and lower mortgage banking revenue. Noninterest revenues, excluding gain on the sale of investment securities, increased by $46.8 million, or 30.1%, to $202.4 million in 2017 as compared to 2016. The increase was comprised of growth in revenue from the Company's employee benefit services businesses, primarily from the acquisition of NRS, increased debit card-related revenue, and increased deposit service fees associated with the Merchants acquisition, partially offset by lower mortgage banking revenue and a decrease in other banking revenues related to a nonrecurring insurance-related gain recognized in 2016.

Noninterest revenues as a percent of operating revenues (FTE basis) were 39.6% in 2018, up 0.8% from the prior year. The current year increase was due to the 10.5% increase in noninterest revenues mentioned above, while

adjusted net interest income (FTE basis) increased 7.0%. The 3.3% increase in this ratio from 2016 to 2017 was driven by a 30.1% increase in noninterest revenues mentioned above, while net interest income increased 14.5%.

A significant portion of the Company's recurring noninterest revenue is comprised of the wide variety of fees earned from general banking services provided through the branch network, electronic banking channels and realized gains or losses from the sale of residential mortgage loans and origination of mortgage servicing rights, which totaled $75.4 million in 2018, an increase of $2.0 million, or 2.7%, from the prior year. The increase was primarily driven by the addition of new deposit relationships from the Merchants acquisition, offset by a decrease of approximately $7.1 million in debit card-related revenue due to the impact of Durbin amendment mandated debit interchange price restrictions that were effective beginning in the third quarter of 2018. Fees from general banking services were $73.4 million in 2017, an increase of $7.3 million, or 11.0%, from 2016. The increase was driven by the addition of new deposit relationships from both acquired growth related to the Merchants acquisition and organic sources, as well as increased debit card-related revenues and increased deposit service fees, partially offset by a decrease in other banking revenues related to a nonrecurring insurance-related gain recognized in 2016.

As disclosed in Table 5, noninterest revenue from financial services (revenues from employee benefit services, wealth management services and insurance services) increased $19.3 million, or 15.0%, in 2018 to $148.4 million. In 2018, financial services revenue accounted for 66% of total noninterest revenues, as compared to 64% in 2017. Employee benefit services generated revenue of $92.3 million in 2018 that reflected growth of $11.4 million, or 14.2%, driven primarily by a full year of activity from NRS, as well as organic increases in the number of supported plans and related participant levels. Employee benefit services revenue of $80.8 million in 2017 was $34.2 million higher than 2016's results, driven primarily by the acquisition of NRS.

Wealth management and insurance services revenues increased $7.9 million, or 16.3%, in 2018 due to revenue growth from OneGroup, which represented $4.2 million of the increase, an increase in revenue from CISI of $2.2 million and an increase in personal trust revenue of $1.4 million. Wealth management and insurance services revenue increased $5.3 million, or 12.4%, in 2017 primarily due to revenue growth from OneGroup, which represented $3.0 million of the increase, and an increase in personal trust revenue of $2.3 million from the prior year primarily due to the Merchants acquisition.

Employee benefit trust assets increased $11.5 billion to $74.4 billion for the employee benefit services segment in 2018 as compared to 2017 due primarily to organic growth in the collective investment trust business. Assets under administration decreased $667.9 million to $5.8 billion for the wealth management businesses at year end 2018 as compared to one year earlier due in part to a general decline in overall market valuations late in 2018. Trust assets within the Company's employee benefit services segment increased $45.1 billion to $62.9 billion at the end of 2017 from $17.8 billion at year-end 2016 due to acquired growth from the NRS acquisition and addition of new client assets. Assets under management with the Company's wealth management services segment increased $1.5 billion to $6.4 billion at the end of 2017 from $4.9 billion at year-end 2016 due to the addition of new client assets and increases in equity market valuations.

Noninterest Expenses

As shown in Table 6, noninterest expenses of $345.3 million in 2018 were $1.9 million, or 0.5%, lower than 2017, primarily reflective of the $26.0 million in one-time expenses incurred in 2017 related to the Merchants and NRS acquisitions, offset by the expenses associated with operating an expanded branch network and other business activities acquired with the Merchants and NRS transactions for a full year. Noninterest expenses in 2017 increased $80.3 million, or 30.1%, from 2016 to $347.1 million, and included expenses associated with operating an expanded branch network and other business activities acquired with the Merchants and NRS transactions, as well as increased acquisition expenses.

Operating expenses (excluding acquisition expenses and amortization of intangible assets) as a percent of average assets for 2018 was 3.07%, an increase of five basis points from 3.02% in 2017 and seven basis points higher than 3.00% in 2016. The increase in this ratio for 2018 was due to a 7.8% increase in operating expenses, primarily a result of a full year of expanded operations from the Merchants and NRS acquisitions, while average assets grew by 5.7% due primarily to a full year of acquired net assets and intangibles from the Merchants and NRS transactions. The increase in this ratio for 2017 was due to a 17.2% increase in operating expenses, primarily a result of expanded operations due to the Merchants and NRS acquisitions, while average assets grew by 16.5% due primarily to acquired net assets and intangibles from the Merchants and NRS transactions. The increases in this ratio in both years reflected the impact of the acquired financial services businesses that carry a low level of average assets compared to banking operations.

The efficiency ratio, a performance measurement tool widely used by banks, is defined by the Company as operating expenses (excluding acquisition expenses and intangible amortization) divided by operating revenue (fully tax equivalent net interest income plus noninterest revenue, excluding acquired non-impaired loan accretion, unrealized gain on equity securities, and insurance-related recoveries). Lower ratios are correlated to higher operating

efficiency. In 2018, the efficiency ratio was 0.3% lower than 2017 as the 8.4% increase in operating revenue, comprised of a 7.0% increase in adjusted net interest income and a 10.5% increase in adjusted noninterest revenue, as defined above, grew at a faster pace than the 7.8% increase in operating expenses. The ratio for 2017 was 1.30% below 2016 as the 19.7% increase in operating revenue, comprised of a 13.6% increase in adjusted net interest income and a 30.9% increase in noninterest revenue, as defined above, grew at a faster pace than the 17.2% increase in operating expenses. See Table 20 for Reconciliation of GAAP to Non-GAAP Measures.

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Table 6: Noninterest Expenses

| (000's omitted) | Years Ended December 31, 2018 | 2017 | 2016 |
|---|---|---|---|
| Salaries and employee benefits[1] | $207,363 | $186,903 | $156,396 |
| Occupancy and equipment | 39,948 | 35,561 | 30,078 |
| Data processing and communications | 39,094 | 37,579 | 34,501 |
| Amortization of intangible assets | 18,155 | 16,941 | 5,479 |
| Legal and professional fees | 10,644 | 11,576 | 8,455 |
| Business development and marketing | 9,383 | 9,994 | 7,484 |
| Acquisition expenses | (769) | 25,986 | 1,706 |
| Other | 21,471 | 22,609 | 22,749 |
| Total noninterest expenses | $345,289 | $347,149 | $266,848 |
| | | | |
| Operating expenses[2] /average assets | 3.07 % | 3.02 % | 3.00 % |
| Efficiency ratio[3] | 58.0 % | 58.3 % | 59.6 % |

[1]In accordance with ASU No. 2017-07, Compensation – Retirement Benefits (Topic 715): Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost, $6.9 million and $4.7 million of income from components of net periodic benefit income other than service cost was reclassified from Salaries and employee benefits to Other noninterest expenses for the year ended December 31, 2017 and the year ended December 31, 2016, respectively.

[2]Operating expenses are total noninterest expenses excluding acquisition expenses and amortization of intangible assets. See Table 20 for Reconciliation of GAAP to Non-GAAP Measures.

[3]Efficiency ratio, a non-GAAP measure, is calculated as operating expenses as defined in footnote [2] above divided by net interest income on a fully tax-equivalent basis excluding acquired non-impaired loan accretion plus noninterest revenues excluding unrealized gain on equity securities, loss on debt extinguishment, and insurance-related recoveries. See Table 20 for Reconciliation of GAAP to Non-GAAP Measures.

Total salaries and employee benefits increased $20.5 million, or 10.9%, in 2018, due to the impact of annual merit increases, a full year of expenses related to the employees from the Merchants acquisition in May 2017, a full year of expenses related to the employees from the NRS acquisition in February 2017, higher incentive compensation, an increase in retirement plan costs and higher severance expense. Salaries and employee benefits increased $30.5 million, or 19.5%, in 2017, due to the impact of annual merit increases, the addition of approximately 207 employees from the Merchants acquisition in May 2017, the addition of approximately 75 employees from the NRS acquisition in February 2017, higher incentive compensation and an increase in retirement plan costs. Total full-time equivalent staff at the end of 2018 was 2,675 compared to 2,617 at December 31, 2017 and 2,262 at the end of 2016. The increase in retirement plan expense in 2018 and 2017 is primarily due to the increase in service cost associated with an increase in the number of employees participating in the plan combined with an increase in eligible compensation associated with merit increases and increases in incentive compensation. See Note K to the financial statements for further information about the pension plan.

Total non-personnel, noninterest expenses, excluding one-time acquisition expenses, increased $4.4 million, or 3.3%, in 2018, mostly reflective of a full year of the additional costs associated with the acquired Merchants and NRS business activities. Increases in occupancy and equipment, data processing and communications, and amortization of intangible assets, all primarily a result of the additional costs associated with a full year of expanded business activities from the Merchants and NRS acquisitions, were partially offset by a decrease in legal and professional fees, business development and marketing and other expenses. Total non-personnel noninterest expenses, excluding one-time acquisition expenses, increased $25.5 million, or 23.5%, in 2017, mostly reflective of the additional costs associated with the acquired Merchants and NRS business activities. Increases in occupancy and equipment, data processing and communications, amortization of intangible assets, legal and professional fees and business

development and marketing, all primarily a result of the aforementioned additional costs associated with expanded business activities from the Merchants and NRS acquisitions, were only partially offset by a slight decrease in other expenses.

During 2018, the Company recovered $0.8 million of vendor contract termination charges associated with the Merchants acquisition, which were recorded as an acquisition expense during the second quarter of 2017. Acquisition expenses for 2017 totaled $26.0 million, including $24.6 million associated with the Merchants acquisition, $1.2 million associated with the NRS acquisition and $0.2 related to all other acquisitions. Acquisition expenses totaled $1.7 million in 2016, including $0.3 million associated with the Oneida acquisition, and $0.9 million and $0.5 million associated with the Merchants transaction and NRS acquisition, respectively.

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Income Taxes

The Company estimates its income tax expense based on the amount it expects to owe the respective taxing authorities, plus the impact of deferred tax items. Taxes are discussed in more detail in Note I of the Consolidated Financial Statements beginning on page 89. Accrued taxes represent the net estimated amount due or to be received from taxing authorities. In estimating accrued taxes, management assesses the relative merits and risks of the appropriate tax treatment of transactions, taking into account statutory, judicial and regulatory guidance in the context of the Company's tax position. If the final resolution of taxes payable differs from its estimates due to regulatory determination or legislative or judicial actions, adjustments to tax expense may be required.

On December 22, 2017, H.R.1, referred to as the "Tax Cuts and Jobs Act," was signed into law. Among other things, the Tax Cuts and Jobs Act permanently lowered the corporate tax rate to 21% from a maximum rate of 35%, effective for tax years including or commencing January 1, 2018. ASC 740, Income Taxes, requires deferred tax assets and liabilities to be measured at the enacted tax rate expected to be applied when the temporary differences are to be realized or settled. Thus, as of the December 22, 2017 date of enactment, deferred taxes were re-measured based upon the new 21% tax rate. Prior to the change in tax rate in 2017, the Company had recorded net deferred tax liabilities based on a marginal tax rate of 37.70%. The change in tax rate resulted in a decrease in the marginal tax rate to 24.29% and a deferred tax benefit of $38.0 million from the write-down of the net deferred tax liabilities in the fourth quarter of 2017. The effect of this change in tax law was recorded as a component of the income tax provision including those deferred assets and liabilities that were established through a financial statement component other than continuing operations.

The effective tax rate for 2018 was 20.8%, compared to 5.8% in 2017 and 32.8% in 2016. The effective tax rate of 5.8% for 2017 included the impact of the $38.0 million one-time gain from the revaluation of net deferred tax liabilities related to the enactment of the Tax Cuts and Jobs Act passed in the fourth quarter of 2017. The adjusted effective tax rate for 2017, excluding the one-time gain from revaluation of net deferred tax liabilities, was 29.5%. The decline in the effective rate for 2018, compared to the adjusted tax rate for 2017, is primarily attributable to the application of the lower federal tax rate due to the Tax Cuts and Jobs Act.

Shareholders' Equity

Shareholders' equity ended 2018 at $1.71 billion, up $78.5 million, or 4.8%, from the end of 2017. This increase reflects net income of $168.6 million, $6.4 million from the issuance of shares through the employee stock plan, $12.6 million for treasury stock issued to the Company's 401(k) plan and $6.1 million from stock-based compensation. These increases were partially offset by common stock dividends declared of $73.8 million and a $41.4 million decrease in accumulated other comprehensive income. The change in accumulated other comprehensive income was comprised of a $30.2 million decrease due to changes in the unrealized gains and losses in the Company's available-for-sale investment portfolio and an $11.2 million net decline in the overfunded status of the Company's employee retirement plans. Excluding accumulated other comprehensive income in both 2018 and 2017, shareholders' equity rose by $120.0 million, or 7.3%. Shares outstanding increased by 0.6 million during the year due to share issuances under the employee stock plan, deferred compensation arrangements and to the Company's 401(k) plan.

Shareholders' equity ended 2017 at $1.64 billion, up $437.2 million, or 36.5%, from the end of 2016. This increase reflects $262.3 million related to stock issued in connection with the Merchants acquisition, $78.5 million related to stock issued in connection with the NRS acquisition, $2.3 million related to stock issued in connection with the GBR acquisition, net income of $150.7 million, $4.6 million from the issuance of shares through the employee stock plan, $10.1 million for treasury stock issued to the Company's 401(k) plan and $5.1 million from stock-based compensation. These increases were partially offset by common stock dividends declared of $65.5 million and a $10.9 million decrease in accumulated other comprehensive income. The change in accumulated other comprehensive income was comprised of an $11.1 million decrease due to changes in the unrealized gains and losses in the

Company's available-for-sale investment portfolio, partially offset by a $0.2 million net increase in the overfunded status of the Company's employee retirement plans. Excluding accumulated other comprehensive income in both 2017 and 2016, shareholders' equity rose by $448.8 million, or 37.7%. Shares outstanding increased by 6.3 million during the year as 4.7 million shares were issued in connection with the Merchants acquisition, 1.3 million shares were issued in connection with the NRS acquisition, 0.04 million shares were issued in connection with the GBR acquisition and a net 0.3 million shares were issued under the employee stock plan, deferred compensation arrangements and to the Company's 401(k) plan.

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The Company's ratio of ending tier 1 capital to adjusted quarterly average assets (or tier 1 leverage ratio), the primary measure for which regulators have established a 5% minimum for an institution to be considered "well-capitalized," increased 1.08% from the prior year to end the year at 11.08%. This was the result of an increase of 9.8% in tier 1 capital from the prior year while average adjusted net assets (excludes investment market value adjustment, and a portion of intangible assets net of related deferred tax liabilities) decreased by 0.9%. For additional financial information on the Company's regulatory capital, refer to Note P – Regulatory Matters in the Notes to Consolidated Financial Statements. The tangible equity-to-tangible assets ratio (a non-GAAP measure) was 9.68% at the end of 2018 versus 8.61% one year earlier (See Table 20 for Reconciliation of GAAP to Non-GAAP Measures). The increase was due to tangible common shareholders' equity increasing from the prior year, while tangible assets decreased from the prior year. The Company manages organic and acquired growth in a manner that enables it to continue to maintain and grow its capital base and maintain its ability to take advantage of future strategic growth opportunities.

Cash dividends declared on common stock in 2018 of $73.8 million represented an increase of 12.7% over the prior year. This growth was a result of the increase in outstanding shares as noted above and a $0.12 increase in dividends per share for the year. Dividends per share for 2018 of $1.44 represents a 9.1% increase from $1.32 in 2017, a result of quarterly dividends per share increasing from $0.32 to $0.34, or 6.3%, during the third quarter of 2017 and from $0.34 to $0.38, or 11.8%, in the third quarter of 2018. The 2018 increase in quarterly dividends marked the 26th consecutive year of dividend increases for the Company. The dividend payout ratio for this year was 43.8% compared to 43.5% in 2017, and 53.7% in 2016. The dividend payout ratio increased during 2018 because dividends declared increased 12.7% while net income increased 11.9% from 2017. The payout ratio decreased during 2017 because net income increased 45.2% while dividends declared increased 17.6%.

Liquidity

Liquidity risk is a measure of the Company's ability to raise cash when needed at a reasonable cost and minimize any loss. The Bank maintains appropriate liquidity levels in both normal operating environments as well as stressed environments. The Company must be capable of meeting all obligations to its customers at any time and, therefore, the active management of its liquidity position remains an important management objective. The Bank has appointed the Asset Liability Committee ("ALCO") to manage liquidity risk using policy guidelines and limits on indicators of potential liquidity risk. The indicators are monitored using a scorecard with three risk level limits. These risk indicators measure core liquidity and funding needs, capital at risk and change in available funding sources. The risk indicators are monitored using such statistics as the core basic surplus ratio, unencumbered securities to average assets, free loan collateral to average assets, loans to deposits, deposits to total funding and borrowings to total funding ratios.

Given the uncertain nature of our customers' demands as well as the Company's desire to take advantage of earnings enhancement opportunities, the Company must have adequate sources of on and off-balance sheet funds available that can be utilized in time of need. Accordingly, in addition to the liquidity provided by balance sheet cash flows, liquidity must be supplemented with additional sources such as credit lines from correspondent banks and borrowings from the FHLB and the Federal Reserve Bank of New York ("Federal Reserve"). Other funding alternatives may also be appropriate from time to time, including wholesale and retail repurchase agreements, large certificates of deposit and the brokered CD market. The primary source of non-deposit funds is FHLB overnight advances, of which $54.4 million was outstanding at December 31, 2018.

The Bank's primary sources of liquidity are its liquid assets, as well as unencumbered loans and securities that can be used to collateralize additional funding. At December 31, 2018, the Bank had $211.8 million of cash and cash equivalents of which $29.1 million are interest-earning deposits held at the Federal Reserve, FHLB and other correspondent banks. The Bank also had $1.6 billion in unused FHLB borrowing capacity based on the Company's quarter-end collateral levels. Additionally, the Company has $1.6 billion of unencumbered securities that could be

pledged at the FHLB or Federal Reserve to obtain additional funding. There is $25.0 million available in unsecured lines of credit with other correspondent banks at year end.

The Company's primary approach to measuring short-term liquidity is known as the Basic Surplus/Deficit model. It is used to calculate liquidity over two time periods: first, the amount of cash that could be made available within 30 days (calculated as liquid assets less short-term liabilities as a percentage of average assets); and second, a projection of subsequent cash availability over an additional 60 days. As of December 31, 2018, this ratio was 14.2% for 30-days and 14.4% for 90-days, excluding the Company's capacity to borrow additional funds from the FHLB and other sources. This is considered to be a sufficient amount of liquidity based on the Company's internal policy requirement of 7.5%.

A sources and uses statement is used by the Company to measure intermediate liquidity risk over the next twelve months. As of December 31, 2018, there is more than enough liquidity available during the next year to cover projected cash outflows. In addition, stress tests on the cash flows are performed in various scenarios ranging from high probability events with a low impact on the liquidity position to low probability events with a high impact on the liquidity position. The results of the stress tests as of December 31, 2018 indicate the Bank has sufficient sources of funds for the next year in all simulated stressed scenarios.

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To measure longer-term liquidity, a baseline projection of loan and deposit growth for five years is made to reflect how liquidity levels could change over time. This five-year measure reflects ample liquidity for loan and other asset growth over the next five years.

Though remote, the possibility of a funding crisis exists at all financial institutions. Accordingly, management has addressed this issue by formulating a Liquidity Contingency Plan, which has been reviewed and approved by both the Company's Board of Directors and the Company's ALCO. The plan addresses the actions that the Company would take in response to both a short-term and long-term funding crisis.

A short-term funding crisis would most likely result from a shock to the financial system, either internal or external, which disrupts orderly short-term funding operations. Such a crisis would likely be temporary in nature and would not involve a change in credit ratings. A long-term funding crisis would most likely be the result of drastic credit deterioration at the Company. Management believes that both potential circumstances have been fully addressed through detailed action plans and the establishment of trigger points for monitoring such events.

Intangible Assets

The changes in intangible assets by reporting segment for the year ended December 31, 2018 are summarized as follows:

Table 7: Intangible Assets

| (000's omitted) | Balance at December 31, 2017 | Additions / Adjustments | Amortization | Impairment | Balance at December 31, 2018 |
|---|---|---|---|---|---|
| Banking Segment | | | | | |
| Goodwill | $ 629,916 | $ 0 | $ 0 | $ 0 | $ 629,916 |
| Core deposit intangibles | 25,025 | 0 | 6,429 | 0 | 18,596 |
| Total Banking Segment | 654,941 | 0 | 6,429 | 0 | 648,512 |
| Employee Benefit Services Segment | | | | | |
| Goodwill | 84,449 | (1,174) | 0 | 0 | 83,275 |
| Other intangibles | 52,288 | 272 | 8,015 | 0 | 44,545 |
| Total Employee Benefit Services Segment | 136,737 | (902) | 8,015 | 0 | 127,820 |
| All Other Segment | | | | | |
| Goodwill | 20,065 | 247 | 0 | 0 | 20,312 |
| Other intangibles | 13,345 | 1,071 | 3,711 | 0 | 10,705 |
| Total All Other Segment | 33,410 | 1,318 | 3,711 | 0 | 31,017 |
| Total | $ 825,088 | $ 416 | $ 18,155 | $ 0 | $ 807,349 |

Intangible assets at the end of 2018 totaled $807.3 million, a decrease of $17.7 million from the prior year due to $18.2 million of amortization during the year and a $1.2 million adjustment to goodwill, partially offset by the addition of $0.3 million of goodwill and $1.3 million of other intangibles arising from acquisition activity. During the first quarter of 2018, the carrying amount of other liabilities associated with the NRS acquisition decreased by $1.2 million as a result of an adjustment to deferred taxes. Goodwill associated with the NRS acquisition decreased $1.2 million as a result of this adjustment. The additional goodwill and other intangibles recorded in 2018 resulted from the Styles Bridges, Penna and HR Consultants acquisitions. Goodwill represents the excess cost of an acquisition over the fair value of the net assets acquired. Goodwill at December 31, 2018 totaled $733.5 million, comprised of $629.9 million related to banking acquisitions and $103.6 million arising from the acquisition of financial services

businesses. Goodwill is subject to periodic impairment analysis to determine whether the carrying value of the identified businesses exceeds their fair value, which would necessitate a write-down of goodwill. The Company completed its goodwill impairment analyses during the first quarters of 2018 and 2017 and no adjustments were necessary for the banking or financial services businesses. The impairment analyses were based upon discounted cash flow modeling techniques that require management to make estimates regarding the amount and timing of expected future cash flows. It also requires the selection of discount rates that reflect the current return characteristics of the market in relation to present risk-free interest rates, estimated equity market premiums and company-specific performance and risk indicators. Management believes that there is a low probability of future impairment with regard to the goodwill associated with its whole-bank, branch and financial services business acquisitions.

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Core deposit intangibles represent the value of acquired non-time deposits in excess of funding that could have been obtained in the capital markets. Core deposit intangibles are amortized on either an accelerated or straight-line basis over periods ranging from eight to twenty years. The recognition of customer relationship intangibles was determined based on a methodology that calculates the present value of the projected future net income derived from the acquired customer base. These customer relationship intangibles are being amortized on an accelerated basis over periods ranging from seven to twelve years.

Loans

The Company's loans outstanding, by type, as of December 31 are as follows:

Table 8: Loans Outstanding

| (000's omitted) | 2018 | 2017 | 2016 | 2015 | 2014 |
|---|---|---|---|---|---|
| Business lending | $2,396,977 | $2,424,223 | $1,490,076 | $1,497,271 | $1,262,484 |
| Consumer mortgage | 2,235,408 | 2,220,298 | 1,819,701 | 1,769,754 | 1,613,384 |
| Consumer indirect | 1,083,207 | 1,011,978 | 1,044,972 | 935,760 | 833,968 |
| Consumer direct | 178,820 | 179,929 | 191,815 | 195,076 | 184,028 |
| Home equity | 386,709 | 420,329 | 401,998 | 403,514 | 342,342 |
| Gross loans | 6,281,121 | 6,256,757 | 4,948,562 | 4,801,375 | 4,236,206 |
| Allowance for loan losses | (49,284 ) | (47,583 ) | (47,233 ) | (45,401 ) | (45,341 ) |
| Loans, net of allowance for loan losses | $6,231,837 | $6,209,174 | $4,901,329 | $4,755,974 | $4,190,865 |
| Daily average of total gross loans | $6,263,843 | $5,818,367 | $4,881,905 | $4,288,091 | $4,156,840 |

As disclosed in Table 8 above, gross loans outstanding of $6.28 billion as of December 31, 2018 increased $24.4 million, or 0.4%, compared to December 31, 2017, reflecting growth in the consumer mortgage and consumer indirect portfolios, partially offset by decreases in the business lending, home equity and consumer direct portfolios. Gross loans outstanding of $6.26 billion as of December 31, 2017 increased $1.31 billion, or 26.4%, compared to December 31, 2016, primarily reflecting growth in the consumer mortgage, business lending, and home equity portfolios attributable to the Merchants acquisition, partially offset by decreases in the consumer indirect and consumer direct portfolios. Excluding loans acquired from Merchants, loans decreased $53.1 million, or 1.1%, in 2017 reflective of muted demand in consumer and business markets, as well as continuation of above average levels of early pay-offs.

The compounded annual growth rate ("CAGR") for the Company's total loan portfolio between 2013 and 2018 was 8.9%, with approximately 13% of the total growth for the period attributable to organic growth and 87% attributable to acquired balances. The greatest overall expansion occurred in business loans, which grew at a 13.7% CAGR driven in most part by acquisitions during the five year period. The consumer mortgage portfolio grew at a compounded annual growth rate of 7.2% from 2013 to 2018. The consumer installment segment, including indirect and direct loans, grew at a CAGR of 6.5%. The home equity lending segment grew at a compounded annual growth rate of 2.2% from 2013 to 2018, including the impact from acquisitions.

The weighting of the components of the Company's loan portfolio enables it to be highly diversified. Approximately 62% of loans outstanding at the end of 2018 were made to consumers borrowing on an installment, line of credit or residential mortgage loan basis. The business lending portfolio is also broadly diversified by industry type as demonstrated by the following distributions at year-end 2018: commercial real estate (35%), restaurant & lodging (11%), general services (9%), healthcare (8%), manufacturing (7%), retail trade (5%), construction (5%), agriculture (4%), wholesale trade (3%) and motor vehicle and parts dealers (3%). A variety of other industries with less than a 3% share of the total portfolio comprise the remaining 10%.

The combined total of general-purpose business lending to commercial, industrial, non-profit and municipal customers, mortgages on commercial property and dealer floor plan financing is characterized as the Company's business lending activity. The business lending portfolio decreased $27.2 million, or 1.1%, in 2018 as contractual and unscheduled principal reductions outpaced organic loan originations. The portfolio increased $934.1 million, or 62.7%, in 2017 due to loans acquired in the Merchants transaction, partially offset by contractual and unscheduled principal reductions. Excluding loans from the Merchants acquisition, the portfolio decreased $42.8 million, or 2.9% in 2017 reflective of contractual and unscheduled principal reductions outpacing organic loan originations. Highly competitive conditions continue to prevail in the small and middle market commercial segments in which the Company primarily operates. The Company strives to generate growth in its business portfolio in a manner that adheres to its goals of maintaining strong asset quality and producing profitable margins. The Company continues to invest in additional personnel, technology, and business development resources to further strengthen its capabilities in this important product category.

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The following table shows the maturities and type of interest rates for business and construction loans as of December 31, 2018:

Table 9: Maturity Distribution of Business and Construction Loans [1]

| (000's omitted) | Maturing in One Year or Less | Maturing After One but Within Five Years | Maturing After Five Years | Total |
|---|---|---|---|---|
| Commercial, financial and agricultural | $ 318,275 | $ 617,477 | $1,348,778 | $2,284,530 |
| Real estate – construction | 18,615 | 40,713 | 61,276 | 120,604 |
| Total | $ 336,890 | $ 658,190 | $1,410,054 | $2,405,134 |
| | | | | |
| Fixed interest rates | $ 109,251 | $ 376,593 | $567,280 | $1,053,124 |
| Floating or adjustable interest rates | 227,639 | 281,597 | 842,774 | 1,352,010 |
| Total | $ 336,890 | $ 658,190 | $1,410,054 | $2,405,134 |

[1] Scheduled repayments are reported in the maturity category in which the payment is due.

The consumer mortgage loans include no exposure to high-risk mortgage products and are comprised of fixed (98%) and adjustable rate (2%) residential lending. Consumer mortgages increased $15.1 million, or 0.7%, in 2018, and excludes the $18.2 million of longer-term, fixed-rate residential mortgages that the Company originated and sold, principally to Fannie Mae. In 2017, consumer mortgages increased $400.6 million, or 22.0%, which does not include the $32.9 million of longer-term, fixed-rate residential mortgages that the Company originated and sold, principally to Fannie Mae. Excluding loans acquired in the Merchants transaction, the consumer mortgage portfolio grew $59.4 million, or 3.3% in 2017. The Company's solid performance is a reflection of the attractiveness of its product offerings and its ability to successfully meet customer needs. Market interest rates, expected duration, and the Company's overall interest rate sensitivity profile continue to be the most significant factors in determining whether the Company chooses to retain versus sell and service portions of its new consumer mortgage generation. Home equity loans decreased $33.6 million, or 8.0%, from the end of 2017, as rising interest rates have impacted the level of utilization of the Company's home equity product. Home equity loans increased $18.3 million, or 4.6%, from the end of 2016, including $39.5 million of loans acquired in the Merchants acquisition, partially offset by home equity loans being paid off or down as part of the heightened level of consumer mortgage refinancing that in some cases are used to pay down or pay off home equity balances in a low rate environment. Excluding the loans from the Merchants transaction, the home equity portfolio decreased $21.2 million, or 5.3% in 2017.

Consumer installment loans, both those originated directly in the branches (referred to as "consumer direct") and indirectly in automobile, marine, and recreational vehicle dealerships (referred to as "consumer indirect"), increased $70.1 million, or 5.9%, from one year ago. In 2017 the portfolio decreased $44.9 million, or 3.6%, from the prior year. Excluding loans from the Merchants acquisition, the portfolio decreased $48.6 million, or 3.9% in 2017. Although the consumer indirect loan market is highly competitive, the Company is focused on maintaining the solid profitability produced by its in-market and contiguous market indirect portfolio, while continuing to pursue its disciplined, long-term approach to expanding its dealer network.

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Asset Quality

The following table presents information regarding nonperforming assets as of December 31:

Table 10: Nonperforming Assets

| (000's omitted) | 2018 | 2017 | 2016 | 2015 | 2014 |
|---|---|---|---|---|---|
| Nonaccrual loans | | | | | |
| Business lending | $8,370 | $8,272 | $5,063 | $6,567 | $2,780 |
| Consumer mortgage | 12,262 | 13,788 | 13,684 | 12,790 | 15,323 |
| Consumer indirect | 0 | 0 | 0 | 0 | 10 |
| Consumer direct | 0 | 0 | 0 | 15 | 20 |
| Home equity | 1,912 | 2,680 | 1,872 | 2,356 | 2,598 |
| Total nonaccrual loans | 22,544 | 24,740 | 20,619 | 21,728 | 20,731 |
| Accruing loans 90+ days delinquent | | | | | |
| Business lending | 179 | 571 | 145 | 126 | 350 |
| Consumer mortgage | 1,625 | 1,526 | 1,385 | 1,805 | 2,397 |
| Consumer indirect | 292 | 303 | 169 | 102 | 82 |
| Consumer direct | 52 | 48 | 58 | 51 | 36 |
| Home equity | 307 | 264 | 1,319 | 111 | 241 |
| Total accruing loans 90+ days delinquent | 2,455 | 2,712 | 3,076 | 2,195 | 3,106 |
| Nonperforming loans | | | | | |
| Business lending | 8,549 | 8,843 | 5,208 | 6,693 | 3,130 |
| Consumer mortgage | 13,887 | 15,314 | 15,069 | 14,595 | 17,720 |
| Consumer indirect | 292 | 303 | 169 | 102 | 92 |
| Consumer direct | 52 | 48 | 58 | 66 | 56 |
| Home equity | 2,219 | 2,944 | 3,191 | 2,467 | 2,839 |
| Total nonperforming loans | 24,999 | 27,452 | 23,695 | 23,923 | 23,837 |
| | | | | | |
| Other real estate (OREO) | 1,320 | 1,915 | 1,966 | 2,088 | 1,855 |
| Total nonperforming assets | $26,319 | $29,367 | $25,661 | $26,011 | $25,692 |
| | | | | | |
| Nonperforming loans / total loans | 0.40 % | 0.44 % | 0.48 % | 0.50 % | 0.56 % |
| Legacy nonperforming loans / legacy total loans [(1)] | 0.36 % | 0.40 % | 0.42 % | 0.49 % | 0.52 % |
| Nonperforming assets / total loans and other real estate | 0.42 % | 0.47 % | 0.52 % | 0.54 % | 0.61 % |
| Delinquent loans (30 days old to nonaccruing) to total loans | 1.00 % | 1.10 % | 1.19 % | 1.16 % | 1.46 % |
| Loan loss provision to net charge-offs | 119 % | 103 % | 129 % | 101 % | 117 % |
| Legacy loan loss provision to net charge-offs [(1)] | 125 % | 96 % | 130 % | 86 % | 125 % |

[(1)]Legacy loans exclude loans acquired after January 1, 2009.

The Company places a loan on nonaccrual status when the loan becomes 90 days past due, or sooner if management concludes collection of interest is doubtful, except when, in the opinion of management, it is well-collateralized and in the process of collection. As shown in Table 10 above, nonperforming loans, defined as nonaccruing loans and accruing loans 90 days or more past due, ended 2018 at $25.0 million. This represents a decrease of $2.5 million from the $27.5 million in nonperforming loans at the end of 2017. The ratio of nonperforming loans to total loans at December 31, 2018 decreased four basis points from the prior year to 0.40%. Excluding acquired loans, the ratio of nonperforming loans to total loans at the end of 2018 was down four basis points from the prior year to 0.36%. The ratio of nonperforming assets (which includes other real estate owned, or "OREO", in addition to nonperforming loans) to total loans plus OREO decreased to 0.42% at year-end 2018, down five basis points from one year earlier. The

Company's success at keeping these ratios at favorable levels throughout varying economic conditions is the result of continued focus on maintaining strict underwriting standards, early problem recognition, and effective collection and recovery efforts. At December 31, 2018, OREO consisted of 18 residential properties with a total value of $1.3 million. This compares to three commercial real estate properties with a total value of $0.6 million and 27 residential properties with a total value of $1.3 million at December 31, 2017.

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Approximately 56% of nonperforming loans at December 31, 2018 are related to the consumer mortgage portfolio. Collateral values of residential properties within the Company's market area have remained relatively stable over the past several years. Additionally, economic conditions, including lower unemployment levels, have positively impacted consumers and resulted in more favorable nonperforming mortgage ratios in 2017 and 2018. Approximately 34% of the nonperforming loans at December 31, 2018 are related to the business lending portfolio, which is comprised of business loans broadly diversified by industry type. The level of nonperforming business loans decreased slightly from the prior year. The remaining 10% percent of nonperforming loans relate to consumer installment and home equity loans. The allowance for loan losses to nonperforming loans ratio, a general measure of coverage adequacy, was 197% at the end of 2018 compared to 173% at year-end 2017 and 199% at December 31, 2016. Excluding acquired loans, the ratio of allowance for legacy loans to nonperforming legacy loans was 256% at the end of 2018, compared to 244% at year-end 2017 and 245% at December 31, 2016.

The Company's senior management, special asset officers and lenders review all delinquent and nonaccrual loans and OREO regularly in order to identify deteriorating situations, monitor known problem credits and discuss any needed changes to collection efforts, if warranted. Based on the group's consensus, a relationship may be assigned a special assets officer or other senior lending officer to review the loan, meet with the borrowers, assess the collateral and recommend an action plan. This plan could include foreclosure, restructuring loans, issuing demand letters or other actions. The Company's larger criticized credits are also reviewed on a quarterly basis by senior credit administration management, special assets officers and commercial lending management to monitor their status and discuss relationship management plans. Commercial lending management reviews the criticized loan portfolio on a monthly basis.

Total delinquencies, defined as loans 30 days or more past due or in nonaccrual status, finished the current year at 1.00% of total loans outstanding, compared to 1.10% at the end of 2017. As of year-end 2018, delinquency ratios for business lending, consumer installment loans, consumer mortgages and home equity loans were 0.62%, 1.34%, 1.22%, and 0.99%, respectively. These ratios reflected improvement across all portfolios compared to the year-end 2017 delinquency rates for business lending, consumer installment loans, consumer mortgages and home equity loans of 0.65%, 1.41%, 1.42%, and 1.12%, respectively. Delinquency levels, particularly in the 30 to 89 days category, tend to be somewhat volatile due to their measurement at a point in time, and therefore management believes that it is useful to evaluate this ratio over a longer time period. The average quarter-end delinquency ratio for total loans in 2018 was 0.96%, as compared to an average of 1.02% in 2017, and 1.09% in 2016, reflective of management's continued focus on maintaining strict underwriting standards, as well as the effective utilization of its collection capabilities.

Loans are considered modified in a troubled debt restructuring ("TDR") when, due to a borrower's financial difficulties, the Company makes one or more concessions to the borrower that it would not otherwise consider. These modifications primarily include, among others, an extension of the term of the loan or granting a period with reduced or no principal and/or interest payments, which can be recaptured through payments made over the remaining term of the loan or at maturity. Historically, the Company has created very few TDRs. Regulatory guidance by the OCC requires certain loans that have been discharged in Chapter 7 bankruptcy to be reported as TDRs. In accordance with this guidance, loans that have been discharged in Chapter 7 bankruptcy but not reaffirmed by the borrower are classified as TDRs, irrespective of payment history or delinquency status, even if the repayment terms for the loan have not been otherwise modified and the Company's lien position against the underlying collateral remains unchanged. Pursuant to that guidance, the Company records a charge-off equal to any portion of the carrying value that exceeds the net realizable value of the collateral. As of December 31, 2018, the Company had 62 loans totaling $2.4 million considered to be nonaccruing TDRs and 156 loans totaling $3.1 million considered to be accruing TDRs. This compares to 72 loans totaling $2.7 million considered to be nonaccruing TDRs and 154 loans totaling $3.4 million considered to be accruing TDRs at December 31, 2017.

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The changes in the allowance for loan losses for the last five years are as follows:

Table 11: Allowance for Loan Losses Activity

| | Years Ended December 31, | | | | |
|---|---|---|---|---|---|
| (000's omitted except for ratios) | 2018 | 2017 | 2016 | 2015 | 2014 |
| Allowance for loan losses at beginning of period | $47,583 | $47,233 | $45,401 | $45,341 | $44,319 |
| Charge-offs: | | | | | |
| Business lending | 3,947 | 5,229 | 1,969 | 2,249 | 1,596 |
| Consumer mortgage | 836 | 707 | 647 | 1,374 | 1,075 |
| Consumer indirect | 8,382 | 8,456 | 7,643 | 6,714 | 6,784 |
| Consumer direct | 1,777 | 2,081 | 1,706 | 1,490 | 1,595 |
| Home equity | 544 | 284 | 218 | 244 | 765 |
| Total charge-offs | 15,486 | 16,757 | 12,183 | 12,071 | 11,815 |
| Recoveries: | | | | | |
| Business lending | 485 | 656 | 616 | 877 | 750 |
| Consumer mortgage | 136 | 50 | 115 | 80 | 205 |
| Consumer indirect | 4,874 | 4,516 | 4,168 | 3,943 | 3,773 |
| Consumer direct | 807 | 849 | 901 | 722 | 846 |
| Home equity | 48 | 52 | 139 | 62 | 85 |
| Total recoveries | 6,350 | 6,123 | 5,939 | 5,684 | 5,659 |
| Net charge-offs | 9,136 | 10,634 | 6,244 | 6,387 | 6,156 |
| Provision for loan losses | 10,570 | 10,675 | 8,039 | 6,349 | 7,497 |
| Provision for acquired impaired loans | 267 | 309 | 37 | 98 | (319) |
| Allowance for loan losses at end of period | $49,284 | $47,583 | $47,233 | $45,401 | $45,341 |
| Allowance for loan losses / total loans | 0.78 % | 0.76 % | 0.95 % | 0.95 % | 1.07 % |
| Allowance for legacy loan losses / total legacy loans [1] | 0.93 % | 0.98 % | 1.02 % | 1.05 % | 1.14 % |
| Allowance for loan losses / nonperforming loans | 197 % | 173 % | 199 % | 190 % | 190 % |
| Allowance for legacy loans / nonperforming legacy loans [1] | 256 % | 244 % | 245 % | 212 % | 221 % |
| Net charge-offs to average loans outstanding: | | | | | |
| Business lending | 0.14 % | 0.22 % | 0.09 % | 0.11 % | 0.07 % |
| Consumer mortgage | 0.03 % | 0.03 % | 0.03 % | 0.08 % | 0.05 % |
| Consumer indirect | 0.33 % | 0.38 % | 0.35 % | 0.33 % | 0.38 % |
| Consumer direct | 0.52 % | 0.65 % | 0.40 % | 0.41 % | 0.40 % |
| Home equity | 0.12 % | 0.06 % | 0.02 % | 0.05 % | 0.20 % |
| Total loans | 0.15 % | 0.18 % | 0.13 % | 0.15 % | 0.15 % |

[1] Legacy loans exclude loans acquired after January 1, 2009.

As displayed in Table 11 above, total net charge-offs in 2018 were $9.1 million, $1.5 million less than the prior year due to a decrease in net charge-offs in the business lending portfolio, primarily related to a $3.1 million partial charge-off of a single relationship in the fourth quarter of 2017, a decrease in net charge-offs in the consumer indirect portfolio and consumer direct portfolios, partially offset by an increase in net charge-offs in the home equity and consumer mortgage portfolios. Net charge-offs in 2017 were $4.4 million more than 2016 due to a higher level of net charge-offs in the business lending portfolio, primarily related to the aforementioned $3.1 million partial charge-off in

the fourth quarter, and modestly higher net charge-offs in the consumer mortgage, home equity, consumer indirect and consumer direct portfolios.

Due to the significant increases in average loan balances over time as a result of acquisitions and organic growth, management believes that net charge-offs as a percent of average loans ("net charge-off ratio") offers the most meaningful representation of charge-off trends. The total net charge-off ratio of 0.15% for 2018 was three basis points lower than the 0.18% ratio from 2017, and two basis points higher than the 0.13% ratio from 2016. Gross charge-offs as a percentage of average loans was 0.25% in 2018, as compared to 0.29% in 2017, and 0.25% in 2016, evidence of management's continued focus on maintaining strict underwriting standards. Recoveries were $6.4 million in 2018, representing 39% of average gross charge-offs for the latest two years, compared to 42% in 2017 and 49% in 2016.

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Business loan net charge-offs decreased in 2018, totaling $3.5 million, or 0.14% of average business loans outstanding, compared to $4.6 million, or 0.22% of the average outstanding balance in 2017. This decrease is primarily due to a $3.1 million partial charge-off of a single relationship in 2017. Consumer installment loan net charge-offs decreased to $4.5 million this year from $5.2 million in 2017, with a net charge-off ratio of 0.36% in 2018 and 0.42% in 2017. The dollar amount of consumer mortgage net charge-offs and net charge-off ratio of 0.03% in 2018 was consistent with 2017. Home equity net charge-offs increased $0.3 million in 2018 while the net charge-off ratio increased six basis points to 0.12%.

Management continually evaluates the credit quality of the Company's loan portfolio and conducts a formal review of the adequacy of the allowance for loan losses on a quarterly basis. The two primary components of the loan review process that are used to determine proper allowance levels are specific and general loan loss allocations. Measurement of specific loan loss allocations is typically based on expected future cash flows, collateral values and other factors that may impact the borrower's ability to repay. Impaired loans with outstanding balances that are greater than $0.5 million are evaluated for specific loan loss allocations. Consumer mortgages, consumer installment and home equity loans are considered smaller balance homogeneous loans and are evaluated collectively. The Company considers a loan to be impaired when, based on current information and events, it is probable that the Company will be unable to collect all principal and interest according to the contractual terms of the loan agreement or the loan is delinquent 90 days or more.

The second component of the allowance establishment process, general loan loss allocations, is composed of two calculations that are computed on the five main loan segments: business lending, consumer mortgage, consumer indirect, consumer direct, and home equity. The first calculation determines an allowance level based on the latest 36 months of historical net charge-off data for each loan category (business loans exclude balances with specific loan loss allocations). The second calculation is qualitative and takes into consideration eight qualitative environmental factors: levels and trends in delinquencies and impaired loans; levels of and trends in charge-offs and recoveries; trends in volume and terms of loans; effects of any changes in risk selection and underwriting standards, and other changes in lending policies, procedure, and practices; experience, ability, and depth of lending management and other relevant staff; national and local economic trends and conditions; industry conditions; and effects of changes in credit concentrations. The allowance levels computed from the specific and general loan loss allocation methods are combined with unallocated allowances, if any, to derive the required allowance for loan losses to be reflected on the Consolidated Statement of Condition. As it has in prior periods, the Company strives to continually refine and enhance its loss evaluation and estimation processes.

The loan loss provision is calculated by subtracting the previous period allowance for loan losses, net of the interim period net charge-offs, from the current required allowance level. This provision is then recorded in the income statement for that period. Members of senior management and the Audit and Compliance Committee of the Board of Directors ("Audit Committee") review the adequacy of the allowance for loan losses quarterly. Management is committed to continually improving the credit assessment and risk management capabilities of the Company and has dedicated the resources necessary to ensure advancement in this critical area of operations.

Acquired loans are recorded at their acquisition date fair values and, therefore, are excluded from the calculation of loan loss reserves as of the acquisition date. To the extent there is a decrease in the present value of cash flows from the acquired impaired loans after the date of acquisition, the Company records a provision for potential losses. During the years ended December 31, 2018 and 2017, an additional provision for loan losses related to acquired impaired loans of $0.3 million was recorded in both years.

For acquired loans that are not deemed impaired at acquisition, a fair value adjustment is recorded that includes both credit and interest rate considerations. Subsequent to the purchase date, the methods utilized to estimate the required allowance for loan losses for these loans is similar to originated loans, however, the Company records a provision for loan losses only when the required allowance exceeds any remaining purchased discounts. During 2018, the

Company recorded a provision for loan losses on acquired non-impaired loans of $1.9 million. For full year 2017, the Company recorded a provision for loan losses on acquired non-impaired loans of $4.5 million, with approximately $3.1 million related to the partial charge-off of a single commercial relationship in the fourth quarter. During 2016, the Company recorded a provision for loan losses on acquired non-impaired loans of $0.8 million.

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The allowance for loan losses increased to $49.3 million at the end of 2018 from $47.6 million as of year-end 2017. The $1.7 million increase was primarily due to changes in asset quality metrics and the composition of the loan portfolio. The allowance for legacy loan losses increased $1.7 million, while the allowance for acquired loan losses was consistent with the prior year. The ratio of the allowance for loan losses to total loans of 0.78% for year-end 2018 increased two basis points from the 0.76% ratio for 2017 and was down 17 basis points from the 0.95% ratio for 2016, primarily due to acquired growth in the loan portfolio. The ratio of allowance for legacy loan losses to total legacy loans decreased five basis points to 0.93% for 2018 as compared 2017. Management believes the year-end 2018 allowance for loan losses to be adequate in light of the probable losses inherent in the Company's loan portfolio.

The loan loss provision for legacy loans of $8.7 million in 2018, was $2.5 million higher than the prior year, and reflects management's assessment of the probable losses in the loan portfolio, as discussed above. The loan loss provision as a percentage of average loans was 0.17% in 2018 as compared to 0.19% in 2017 and 0.17% in 2016. The loan loss provision was 119% of net charge-offs this year versus 103% in 2017 and 129% in 2016, reflective of the assessed risk in the overall portfolio.

The following table sets forth the allocation of the allowance for loan losses by loan category as of the end of the years indicated, as well as the proportional share each category is to total loans. This allocation is based on management's assessment, as of a given point in time, of the risk characteristics of each of the component parts of the total loan portfolio and is subject to changes when the risk factors of each component part change. The allocation is not indicative of either the specific amounts of the loan categories in which future charge-offs may be taken, nor should it be taken as an indicator of future loss trends. The allocation of the allowance to each category does not restrict the use of the allowance to absorb losses in any category.

Table 12: Allowance for Loan Losses by Loan Type

| (000's omitted except for ratios) | 2018 Allowance | 2018 Loan Mix | 2017 Allowance | 2017 Loan Mix | 2016 Allowance | 2016 Loan Mix | 2015 Allowance | 2015 Loan Mix | 2014 Allowance | 2014 Loan Mix |
|---|---|---|---|---|---|---|---|---|---|---|
| Business lending | $18,522 | 38.1 % | $17,257 | 38.5 % | $17,220 | 30.0 % | $15,749 | 31.0 % | $15,787 | 29.7 % |
| Consumer mortgage | 10,124 | 35.6 % | 10,465 | 35.5 % | 10,094 | 36.8 % | 10,198 | 36.8 % | 10,286 | 38.1 % |
| Consumer indirect | 14,366 | 17.2 % | 13,468 | 16.2 % | 13,782 | 21.1 % | 12,422 | 19.5 % | 11,544 | 19.7 % |
| Consumer direct | 3,095 | 2.8 % | 3,039 | 2.9 % | 2,979 | 3.9 % | 2,997 | 4.1 % | 3,083 | 4.3 % |
| Home equity | 2,144 | 6.2 % | 2,107 | 6.7 % | 2,399 | 8.1 % | 2,666 | 8.4 % | 2,701 | 8.1 % |
| Acquired impaired loans | 33 | 0.1 % | 147 | 0.2 % | 108 | 0.1 % | 168 | 0.2 % | 173 | 0.1 % |
| Unallocated | 1,000 | | 1,100 | | 651 | | 1,201 | | 1,767 | |
| Total | $49,284 | 100.0% | $47,583 | 100.0% | $47,233 | 100.0% | $45,401 | 100.0% | $45,341 | 100.0% |

As demonstrated in Table 12 above and discussed previously, business lending and consumer installment by their nature carry higher credit risk than residential real estate, and as a result these loans carry allowance for loan losses that cover a higher percentage of their total portfolio balances. The unallocated allowance is maintained for inherent losses in the portfolio that are not reflected in the historical loss ratios, model imprecision, and for acquired loan portfolios in the process of being fully integrated at year-end. The unallocated allowance decreased from $1.1 million at year-end 2017 to $1.0 million at December 31, 2018. The changes in year-over-year allowance allocations reflect management's continued refinement of its loss estimation techniques. However, given the inherent imprecision in the many estimates used in the determination of the allocated portion of the allowance, management remained conservative in establishing the overall allowance for loan losses. Management considers the allocated and unallocated portions of the allowance for loan losses to be prudent and reasonable. Furthermore, the Company's

allowance for loan losses is general in nature and is available to absorb losses from any loan category.

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Funding Sources

The Company utilizes a variety of funding sources to support the earning-asset base as well as to achieve targeted growth objectives. Overall funding is comprised of three primary sources that possess a variety of maturity, stability, and price characteristics; deposits of individuals, partnerships and corporations (nonpublic deposits), municipal deposits that are collateralized for amounts not covered by FDIC insurance (public funds), and external borrowings. The average daily amount of deposits and the average rate paid on each of the following deposit categories are summarized below for the years indicated:

Table 13: Average Deposits

| | 2018 | | 2017 | | 2016 | |
|---|---|---|---|---|---|---|
| (000's omitted, except rates) | Average Balance | Average Rate Paid | Average Balance | Average Rate Paid | Average Balance | Average Rate Paid |
| Noninterest checking deposits | $2,302,806 | 0.00 % | $2,048,414 | 0.00 % | $1,558,548 | 0.00 % |
| Interest checking deposits | 1,898,118 | 0.09 % | 1,782,668 | 0.06 % | 1,631,560 | 0.03 % |
| Savings deposits | 1,458,676 | 0.06 % | 1,385,386 | 0.06 % | 1,303,814 | 0.07 % |
| Money market deposits | 2,046,219 | 0.18 % | 2,069,228 | 0.14 % | 1,776,838 | 0.16 % |
| Time deposits | 750,814 | 0.58 % | 765,666 | 0.41 % | 750,944 | 0.43 % |
| Total deposits | $8,456,633 | 0.13 % | $8,051,362 | 0.10 % | $7,021,704 | 0.10 % |

As displayed in Table 13, average total deposits in 2018 increased $405.3 million, or 5.0%, from the prior year comprised of a $420.1 million, or 5.8%, increase in non-time ("core") deposits, and a $14.9 million, or 1.9%, decrease in time deposits. Excluding the impact of the Merchants acquisition, average total deposits decreased $23.3 million, or 0.3%, as compared to 2017. Consistent with the Company's focus on expanding core account relationships and reduced customer demand for time deposits, average core deposit balances, excluding deposits acquired in the Merchants acquisition, grew $27.8 million, or 0.4%, as compared to 2017, while time deposits, excluding the impact of Merchants acquired balances, declined $51.1 million, or 7.8%. The cost of deposits, including the impact of non-interest checking deposits, increased three basis points from 0.10% in 2017 to 0.13% in 2018.

Total average deposits for 2017 equaled $8.05 billion, up $1.03 billion, or 14.7%, from 2016 comprised of a $1.01 billion, or 16.2%, increase in core deposits, and a $14.7 million, or 2.0%, increase in time deposits. Excluding the impact of the Merchants acquisition, average deposits increased $166.8 million, or 2.4%, as compared to 2016. Average core deposit balances grew $260.2 million, or 4.1%, as compared to 2016 while non-acquired time deposit balances declined $93.4 million, or 12.4%. The cost of deposits, including the impact of non-interest checking deposits, was consistent with 2016 at 0.10%.

Nonpublic, core deposits are frequently considered to be a bank's most attractive source of funding because they are generally stable, do not need to be collateralized, carry a relatively low rate, generate solid fee income, and provide a strong customer base for which a variety of loan, deposit and other financial service-related products can be cross-sold. The Company's funding composition continues to benefit from a high level of nonpublic deposits, which reached an all-time high in 2018 with an average balance of $7.42 billion, an increase of $432.1 million, or 6.2%, over the comparable 2017 period. Excluding the impact of the Merchants acquisition, average nonpublic deposits increased $9.4 million during 2018.

Full-year average public fund deposits decreased $26.8 million, or 2.5%, during 2018 to $1.03 billion. Excluding the impact of the Merchants acquisition, average public fund deposits decreased $32.7 million, or 3.2%, during 2018. Public fund deposit balances tend to be more volatile than nonpublic deposits because they are heavily impacted by the seasonality of tax collection and fiscal spending patterns, as well as the longer-term financial position of the local government entities, which can change from year to year. However, the Company has many strong, long-standing

relationships with municipal entities throughout its markets and the diversified core deposits held by these customers have provided an attractive and comparatively stable funding source over an extended time period. The Company is required to collateralize local government deposits in excess of FDIC coverage with marketable securities from its investment portfolio. Because of this stipulation, as well as the competitive bidding nature of municipal time deposits, management considers this funding source to share some of the attributes of borrowings.



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The mix of average deposits has been changing throughout the last several years. The weighting of core (noninterest checking, interest checking, savings, and money market accounts) has increased, while time deposits' weighting has decreased. This change in deposit mix reflects the Company's focus on expanding core account relationships and customers' preference for unrestricted accounts in a low interest rate environment. The average balance for time deposit accounts decreased from 9.5% of total average deposits in 2017 to 8.9% of total average deposits for 2018. Correspondingly, average core deposit balances have increased from 90.5% in 2017 to 91.1% in 2018. This shift in mix contributed to a cost of interest-bearing deposits of 0.17% in 2018 that was only four basis points higher than the 0.13% cost of interest-bearing deposits in both 2017 and 2016. The total cost of deposit funding, which includes noninterest-bearing deposits, was 0.13% in 2018, a three basis point increase from the prior year, benefiting from the 12.4% increase in average non-interest bearing checking balances.

The remaining maturities of time deposits in amounts of $250,000 or more outstanding as of December 31 are as follows:

Table 14: Maturity of Time Deposits $250,000 or More

| (000's omitted) | 2018 | 2017 |
|---|---|---|
| Less than three months | $9,621 | $14,429 |
| Three months to six months | 15,032 | 16,111 |
| Six months to one year | 16,307 | 21,335 |
| Over one year | 28,660 | 15,811 |
| Total | $69,620 | $67,686 |

Borrowing sources for the Company include the FHLB, Federal Reserve, and other correspondent banks, as well as access to the brokered CD and repurchase markets through established relationships with primary market security dealers. The Company also had $97.9 million in floating-rate subordinated debt outstanding at the end of 2018 that is held by unconsolidated subsidiary trusts.

As shown in Table 15, year-end 2018 borrowings totaled $413.7 million, a decrease of $72.2 million from the $485.9 million outstanding at the end of 2017 primarily due to the redemption of the trust preferred subordinated debt held by Community Statutory Trust III, an unconsolidated subsidiary trust, during 2018 and a decrease in securities sold under an agreement to repurchase ("customer repurchase agreements"), partially offset by an increase in overnight FHLB borrowings. Borrowings averaged $408.1 million, or 4.6% of total funding sources for 2018, as compared to $379.9 million, or 4.5% of total funding sources for 2017. As shown in Table 16, at the end of 2018 the Company had $313.8 million, or 76% of borrowings, that had remaining terms of one year or less as compared to 74% of borrowings maturing within one year at December 31, 2017.

As displayed in Table 3 on page 34, after an increase in the percentage of funding from deposits in 2016 due to the pay down of borrowings after the Oneida acquisition was completed, the percentage of funding from deposits decreased slightly in 2017 due to the borrowings assumed as part of the Merchants transaction having a larger impact on this ratio than the acquired deposits. The percentage of funding from deposits in 2018 was slightly lower than the level in 2017, as the redemption of subordinated debt was offset by increases in average customer repurchase agreements and overnight borrowings. The percentage of average funding derived from deposits was 95.4% in 2018 as compared to 95.5% in 2017 and 96.3% in 2016. During 2018, average borrowings increased 7.4% while average deposits increased 5.0%.

The following table summarizes the outstanding balance of borrowings of the Company as of December 31:

Table 15: Borrowings

| (000's omitted, except rates) | 2018 | 2017 | 2016 |
|---|---|---|---|
| FHLB overnight advance | $54,400 | $24,000 | $146,200 |
| Subordinated debt held by unconsolidated subsidiary trusts | 97,939 | 122,814 | 102,170 |
| Securities sold under agreement to repurchase, short term | 259,367 | 337,011 | 0 |
| FHLB long term advances | 1,976 | 2,071 | 0 |
| Balance at end of period | $413,682 | $485,896 | $248,370 |
| | | | |
| Daily average during the year | $408,054 | $379,933 | $271,927 |
| Maximum month-end balance | $457,469 | $576,791 | $414,648 |
| Weighted-average rate during the year | 1.72 % | 1.51 % | 1.46 % |
| Weighted-average year-end rate | 1.84 % | 1.34 % | 1.70 % |

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The following table shows the contractual maturities of various obligations as of December 31, 2018:

Table 16: Maturities of Contractual Obligations

| (000's omitted) | Maturing Within One Year or Less | Maturing After One Year but Within Three Years | Maturing After Three Years but Within Five Years | Maturing After Five Years | Total |
|---|---|---|---|---|---|
| FHLB overnight advance | $54,400 | $ 0 | $ 0 | $ 0 | $54,400 |
| Subordinated debt held by unconsolidated subsidiary trusts | 0 | 0 | 0 | 97,939 | 97,939 |
| Securities sold under agreement to repurchase, short term | 259,367 | 0 | 0 | 0 | 259,367 |
| Other long-term debt | 0 | 0 | 1,059 | 917 | 1,976 |
| Interest on borrowings | 4,461 | 8,897 | 8,889 | 55,248 | 77,495 |
| Operating leases | 8,452 | 12,935 | 7,032 | 10,390 | 38,809 |
| Total | $326,680 | $ 21,832 | $ 16,980 | $ 164,494 | $529,986 |

Financial Instruments with Off-Balance Sheet Risk

The Company is a party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments consist primarily of commitments to extend credit and standby letters of credit. Commitments to extend credit are agreements to lend to customers, generally having fixed expiration dates or other termination clauses that may require payment of a fee. These commitments consist principally of unused commercial and consumer credit lines. Standby letters of credit generally are contingent upon the failure of the customer to perform according to the terms of an underlying contract with a third party. The credit risks associated with commitments to extend credit and standby letters of credit are essentially the same as that involved with extending loans to customers and are subject to normal credit policies. Collateral may be required based on management's assessment of the customer's creditworthiness. The fair value of these commitments is considered immaterial for disclosure purposes.

The contractual amounts of these off-balance sheet financial instruments as of December 31 were as follows:

Table 17: Off-Balance Sheet Financial Instruments

| (000's omitted) | 2018 | 2017 |
|---|---|---|
| Commitments to extend credit | $1,134,576 | $1,080,004 |
| Standby letters of credit | 33,169 | 23,782 |
| Total | $1,167,745 | $1,103,786 |

Investments

The objective of the Company's investment portfolio is to hold low-risk, high-quality earning assets that provide favorable returns and provide another effective tool to actively manage its earning asset/funding liability position in order to maximize future net interest income opportunities. This must be accomplished within the following constraints: (a) implementing certain interest rate risk management strategies which achieve a relatively stable level of net interest income; (b) providing both the regulatory and operational liquidity necessary to conduct day-to-day business activities; (c) considering investment risk-weights as determined by the regulatory risk-based capital

guidelines; and (d) generating a favorable return without undue compromise of the other requirements.

The carrying value of the Company's investment portfolio ended 2018 at $2.98 billion, a decrease of $99.7 million, or 3.2%, from the end of 2017. The book value (excluding unrealized gains and losses) of the portfolio decreased $60.5 million from December 31, 2017, and the unrealized loss on the portfolio was $15.3 million as of December 31, 2018. During 2018, the Company purchased $78.1 million of government agency mortgage-backed securities at an average yield of 3.64%. Offsetting these purchases were $140.8 million of maturities, calls and paydowns of available for sale securities and $5.9 million of maturities and redemptions of other securities.

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The carrying value of the Company’s investment portfolio increased $297.0 million during 2017 to end the year at $3.08 billion. The book value of available-for-sale investments increased $314.8 million from December 31, 2016, and the unrealized gain on the available-for-sale securities decreased $17.9 million. During 2017, the Company purchased $4.8 million of obligations of state and political subdivisions at an average yield of 4.23% and $82.5 million of government agency mortgage-backed securities at an average yield of 2.57%. Offsetting these purchases were $157.3 million of maturities, calls and paydowns. Additionally, $390.9 million of investment securities were acquired as part of the Merchants transaction and $20.3 million of certificates of deposit were acquired as part of the NRS acquisition, of which $19.1 million were subsequently redeemed.

The investment portfolio has limited credit risk due to the composition continuing to heavily favor U.S. Treasury debentures, U.S. Agency mortgage-backed pass-throughs, U.S. Agency CMOs and municipal bonds. The U.S. Treasury debentures, U.S. Agency mortgage-backed pass-throughs and U.S. Agency CMOs are all rated AAA (highest possible rating) by Moody’s and AA+ by Standard and Poor’s. The majority of the municipal bonds are rated A or higher. The portfolio does not include any private label mortgage-backed securities (MBS) or private label collateralized mortgage obligations. The overall mix of securities within the portfolio over the last year has changed, with an increase in the proportion of U.S. Treasury and agency securities and government agency mortgage-backed securities, while the proportion of obligations of state and political subdivisions and collateralized mortgage obligations decreased.

The net pre-tax unrealized market value loss on the available-for-sale investment portfolio as of December 31, 2018 was $15.3 million, as compared to an unrealized gain of $23.9 million one year earlier. This decrease is indicative of interest rate movements over the period and changes in the composition of the portfolio.

The following table sets forth the amortized cost and market value for the Company’s investment securities portfolio:

Table 18: Investment Securities

| (000’s omitted) | 2018 Amortized Cost/Book Value | Fair Value | 2017 Amortized Cost/Book Value | Fair Value | 2016 Amortized Cost/Book Value | Fair Value |
|---|---|---|---|---|---|---|
| Available-for-Sale Portfolio: | | | | | | |
| U.S. Treasury and agency securities | $2,036,474 | $2,023,753 | $2,043,023 | $2,054,071 | $1,876,358 | $1,902,762 |
| Obligations of state and political subdivisions | 453,640 | 459,154 | 514,949 | 528,956 | 582,655 | 594,990 |
| Government agency mortgage-backed securities | 390,234 | 382,477 | 358,180 | 357,538 | 232,657 | 235,230 |
| Corporate debt securities | 2,588 | 2,546 | 2,648 | 2,623 | 5,716 | 5,687 |
| Government agency collateralized mortgage obligations | 69,342 | 68,119 | 88,097 | 87,374 | 9,225 | 9,535 |
| Marketable equity securities | 0 | 0 | 251 | 526 | 252 | 452 |
| Total available-for-sale portfolio | 2,952,278 | 2,936,049 | 3,007,148 | 3,031,088 | 2,706,863 | 2,748,656 |
| | | | | | | |
| Equity and other Securities: | | | | | | |
| Equity securities, at fair value | 251 | 432 | 0 | 0 | 0 | 0 |
| Federal Home Loan Bank common stock | 8,768 | 8,768 | 9,896 | 9,896 | 12,191 | 12,191 |
| Federal Reserve Bank common stock | 30,690 | 30,690 | 30,690 | 30,690 | 19,781 | 19,781 |
| Certificates of deposit | 0 | 0 | 3,865 | 3,865 | 0 | 0 |
| | 4,969 | 5,719 | 5,840 | 5,840 | 3,764 | 3,764 |

| | | | | | | |
|---|---|---|---|---|---|---|
| Other equity securities, at adjusted cost | | | | | | |
| Total equity and other securities | 44,678 | 45,609 | 50,291 | 50,291 | 35,736 | 35,736 |
| Total investments | $2,996,956 | $2,981,658 | $3,057,439 | $3,081,379 | $2,742,599 | $2,784,392 |

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The following table sets forth as of December 31, 2018, the maturities of investment debt securities and the weighted-average yields of such securities, which have been calculated on the cost basis, weighted for scheduled maturity of each security:

Table 19: Maturities of Investment Debt Securities

| (000's omitted, except rates) | Maturing Within One Year or Less | Maturing After One Year But Within Five Years | Maturing After Five Years But Within Ten Years | Maturing After Ten Years | Total Amortized Cost/Book Value |
|---|---|---|---|---|---|
| Available-for-Sale Portfolio: | | | | | |
| U.S. Treasury and agency securities | $ 28,667 | $ 1,994,893 | $ 0 | $ 12,914 | $ 2,036,474 |
| Obligations of state and political subdivisions | 29,547 | 129,261 | 158,282 | 136,550 | 453,640 |
| Government agency mortgage-backed securities [2] | 4,477 | 13,006 | 41,787 | 330,964 | 390,234 |
| Corporate debt securities | 0 | 2,588 | 0 | 0 | 2,588 |
| Government agency collateralized mortgage obligations [2] | 0 | 325 | 4,028 | 64,989 | 69,342 |
| Available-for-sale portfolio | $ 62,691 | $ 2,140,073 | $ 204,097 | $ 545,417 | $ 2,952,278 |
| Weighted-average yield [1] | 1.91 % | 2.29 % | 2.86 % | 3.14 % | 2.48 % |

(1) Weighted-average yields are an arithmetic computation of income (not fully tax-equivalent adjusted) divided by book balance; they may differ from the yield to maturity, which considers the time value of money.

(2) Mortgage-backed securities and collateralized mortgage obligations are listed based on the contractual maturity. Actual maturities will differ from contractual maturities because borrowers may have the right to call or prepay certain obligations with or without penalties.

Impact of Inflation and Changing Prices

The Company's financial statements have been prepared in terms of historical dollars, without considering changes in the relative purchasing power of money over time due to inflation. Unlike most industrial companies, virtually all of the assets and liabilities of a financial institution are monetary in nature. As a result, interest rates have a more significant impact on a financial institution's performance than the effect of general levels of inflation. Interest rates do not necessarily move in the same direction or in the same magnitude as the prices of goods and services. Notwithstanding this, inflation can directly affect the value of loan collateral, real estate in particular.

New Accounting Pronouncements

See "New Accounting Pronouncements" Section of Note A of the notes to the consolidated financial statements on page 74 for recently issued accounting pronouncements applicable to the Company that have not yet been adopted.

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Forward-Looking Statements

This document contains comments or information that constitute forward-looking statements (within the meaning of the Private Securities Litigation Reform Act of 1995), which involve significant risks and uncertainties. Forward-looking statements often use words such as “anticipate,” “target,” “expect,” “estimate,” “intend,” “plan,” “goal,” “fore “believe,” or other words of similar meaning. Actual results may differ materially from the results discussed in the forward-looking statements. Moreover, the Company’s plans, objectives and intentions are subject to change based on various factors (some of which are beyond the Company’s control). Factors that could cause actual results to differ from those discussed in the forward-looking statements include: (1) risks related to credit quality, interest rate sensitivity and liquidity; (2) the strength of the U.S. economy in general and the strength of the local economies where the Company conducts its business; (3) the effect of, and changes in, monetary and fiscal policies and laws, including interest rate policies of the Board of Governors of the Federal Reserve System; (4) inflation, interest rate, market and monetary fluctuations; (5) the timely development of new products and services and customer perception of the overall value thereof (including features, pricing and quality) compared to competing products and services; (6) changes in consumer spending, borrowing and savings habits; (7) technological changes and implementation and financial risks associated with transitioning to new technology-based systems involving large multi-year contracts; (8) the ability of the Company to maintain the security of its financial, accounting, technology, data processing and other operating systems and facilities; (9) effectiveness of the Company’s risk management processes and procedures, reliance on models which may be inaccurate or misinterpreted, the Company’s ability to manage its credit risk, the sufficiency of its allowance for loan losses and the accuracy of the assumptions or estimates used in preparing the Company’s financial statements; (10) failure of third parties to provide various services that are important to the Company’s operations; (11) any acquisitions or mergers that might be considered or consummated by the Company and the costs and factors associated therewith, including differences in the actual financial results of the acquisition or merger compared to expectations and the realization of anticipated cost savings and revenue enhancements; (12) the ability to maintain and increase market share and control expenses; (13) the nature, timing and effect of changes in banking regulations or other regulatory or legislative requirements affecting the respective businesses of the Company and its subsidiaries, including changes in laws and regulations concerning taxes, accounting, banking, risk management, securities and other aspects of the financial services industry, specifically the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010; (14) changes in the Company’s organization, compensation and benefit plans and in the availability of, and compensation levels for, employees in its geographic markets; (15) the outcome of pending or future litigation and government proceedings; (16) other risk factors outlined in the Company’s filings with the SEC from time to time; and (17) the success of the Company at managing the risks of the foregoing.

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The foregoing list of important factors is not all-inclusive. Such forward-looking statements speak only as of the date on which they are made and the Company does not undertake any obligation to update any forward-looking statement, whether written or oral, to reflect events or circumstances after the date on which such statement is made. If the Company does update or correct one or more forward-looking statements, investors and others should not conclude that the Company will make additional updates or corrections with respect thereto or with respect to other forward-looking statements.

Reconciliation of GAAP to Non-GAAP Measures

Table 20: GAAP to Non-GAAP Reconciliations

| (000's omitted) | 2018 | 2017 | 2016 | 2015 | 2014 |
|---|---|---|---|---|---|
| Income statement data | | | | | |
| Net income | | | | | |
| Net income (GAAP) | $168,641 | $150,717 | $103,812 | $91,230 | $91,353 |
| Acquisition expenses | (769) | 25,986 | 1,706 | 7,037 | 123 |
| Tax effect of acquisition expenses | 160 | (7,677) | (560) | (2,182) | (36) |
| Tax Cuts and Jobs Act deferred impact | 0 | (38,010) | 0 | 0 | 0 |
| Subtotal (non-GAAP) | 168,032 | 131,016 | 104,958 | 96,085 | 91,440 |
| Unrealized gain on equity securities | (657) | 0 | 0 | 0 | 0 |
| Tax effect of unrealized gain on equity securities | 137 | 0 | 0 | 0 | 0 |
| Subtotal (non-GAAP) | 167,512 | 131,016 | 104,958 | 96,085 | 91,440 |
| Loss on debt extinguishment | 318 | 0 | 0 | 0 | 0 |
| Tax effect of loss on debt extinguishment | (66) | 0 | 0 | 0 | 0 |
| Subtotal (non-GAAP) | 167,764 | 131,016 | 104,958 | 96,085 | 91,440 |
| Litigation settlement | 0 | 0 | 0 | 0 | 2,800 |
| Tax effect of litigation settlement | 0 | 0 | 0 | 0 | (828) |
| Operating net income (non-GAAP) | 167,764 | 131,016 | 104,958 | 96,085 | 93,412 |
| Amortization of intangibles | 18,155 | 16,941 | 5,479 | 3,663 | 4,287 |
| Tax effect of amortization of intangibles | (3,780) | (5,005) | (1,800) | (1,135) | (1,267) |
| Subtotal (non-GAAP) | 182,139 | 142,952 | 108,637 | 98,613 | 96,432 |
| Acquired non-impaired loan accretion | (7,921) | (5,888) | (2,868) | (2,256) | (3,338) |
| Tax effect of acquired non-impaired loan accretion | 1,649 | 1,739 | 942 | 700 | 987 |
| Adjusted net income (non-GAAP) | $175,867 | $138,803 | $106,711 | $97,057 | $94,081 |

| Return on average assets | | | | | |
|---|---|---|---|---|---|
| Adjusted net income (non-GAAP) | $175,867 | $138,803 | $106,711 | $97,057 | $94,081 |
| Average total assets | 10,665,209 | 10,089,215 | 8,660,067 | 7,814,564 | 7,423,903 |
| Adjusted return on average assets (non-GAAP) | 1.65 % | 1.38 % | 1.23 % | 1.24 % | 1.27 % |

| Return on average equity | | | | | |
|---|---|---|---|---|---|
| Adjusted net income (non-GAAP) | $175,867 | $138,803 | $106,711 | $97,057 | $94,081 |
| Average total equity | 1,653,381 | 1,475,761 | 1,211,520 | 1,028,038 | 946,626 |
| Adjusted return on average equity (non-GAAP) | 10.64 % | 9.41 % | 8.81 % | 9.44 % | 9.94 % |

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| (000's omitted) | 2018 | 2017 | 2016 | 2015 | 2014 |
|---|---|---|---|---|---|
| Income statement data (continued) | | | | | |
| Earnings per common share | | | | | |
| Diluted earnings per share (GAAP) | $3.24 | $3.03 | $2.32 | $2.19 | $2.22 |
| Acquisition expenses | (0.01) | 0.52 | 0.04 | 0.17 | 0.00 |
| Tax effect of acquisition expenses | 0.00 | (0.15) | (0.01) | (0.05) | (0.00) |
| Tax Cuts and Jobs Act deferred impact | 0.00 | (0.76) | 0.00 | 0.00 | 0.00 |
| Subtotal (non-GAAP) | 3.23 | 2.64 | 2.35 | 2.31 | 2.22 |
| Unrealized gain on equity securities | (0.01) | 0.00 | 0.00 | 0.00 | 0.00 |
| Tax effect of unrealized gain on equity securities | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 |
| Subtotal (non-GAAP) | 3.22 | 2.64 | 2.35 | 2.31 | 2.22 |
| Loss on debt extinguishment | 0.01 | 0.00 | 0.00 | 0.00 | 0.00 |
| Tax effect of loss on debt extinguishment | (0.00) | 0.00 | 0.00 | 0.00 | 0.00 |
| Subtotal (non-GAAP) | 3.23 | 2.64 | 2.35 | 2.31 | 2.22 |
| Litigation settlement | 0.00 | 0.00 | 0.00 | 0.00 | 0.07 |
| Tax effect of litigation settlement | 0.00 | 0.00 | 0.00 | 0.00 | (0.02) |
| Operating net income (non-GAAP) | 3.23 | 2.64 | 2.35 | 2.31 | 2.27 |
| Amortization of intangibles | 0.35 | 0.34 | 0.12 | 0.09 | 0.10 |
| Tax effect of amortization of intangibles | (0.07) | (0.10) | (0.04) | (0.03) | (0.03) |
| Subtotal (non-GAAP) | 3.51 | 2.88 | 2.43 | 2.37 | 2.34 |
| Acquired non-impaired loan accretion | (0.15) | (0.12) | (0.06) | (0.05) | (0.08) |
| Tax effect of acquired non-impaired loan accretion | 0.03 | 0.04 | 0.02 | 0.01 | 0.02 |
| Adjusted net income (non-GAAP) | $3.39 | $2.80 | $2.39 | $2.33 | $2.28 |

| Noninterest operating expenses | | | | | |
|---|---|---|---|---|---|
| Noninterest expenses (GAAP) | $345,289 | $347,149 | $266,848 | $233,055 | $226,580 |
| Amortization of intangibles | (18,155) | (16,941) | (5,479) | (3,663) | (4,287) |
| Acquisition expenses | 769 | (25,986) | (1,706) | (7,037) | (123) |
| Litigation settlement | (0) | (0) | (0) | (0) | (2,800) |
| Total adjusted noninterest expenses (non-GAAP) | $327,903 | $304,222 | $259,663 | $222,355 | $219,370 |

| Efficiency ratio | | | | | |
|---|---|---|---|---|---|
| Adjusted noninterest expenses (non-GAAP) - numerator | $327,903 | $304,222 | $259,663 | $222,355 | $219,370 |
| Fully tax-equivalent net interest income | $349,400 | $325,090 | $283,857 | $260,824 | $259,961 |
| Noninterest revenues | 224,059 | 202,423 | 155,625 | 123,299 | 119,020 |
| Acquired non-impaired loan accretion | (7,921) | (5,888) | (2,868) | (2,256) | (3,338) |
| Insurance-related recovery | 0 | 0 | (950) | 0 | 0 |
| Unrealized gain on equity securities | (657) | 0 | 0 | 0 | 0 |
| Loss on debt extinguishment | 318 | 0 | 0 | 0 | 0 |
| Operating revenues (non-GAAP) - denominator | $565,199 | $521,625 | $435,664 | $381,867 | $375,643 |
| Efficiency ratio (non-GAAP) | 58.0 % | 58.3 % | 59.6 % | 58.2 % | 58.4 % |

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| (000's omitted) | 2018 | 2017 | 2016 | 2015 | 2014 |
|---|---|---|---|---|---|
| Balance sheet data | | | | | |
| Total assets | | | | | |
| Total assets (GAAP) | $10,607,295 | $10,746,198 | $8,666,437 | $8,552,669 | $7,489,440 |
| Intangible assets | (807,349 ) | (825,088 ) | (480,844 ) | (484,146 ) | (386,973 ) |
| Deferred taxes on intangible assets | 46,370 | 48,419 | 43,504 | 39,724 | 35,842 |
| Total tangible assets (non-GAAP) | $9,846,316 | $9,969,529 | $8,229,097 | $8,108,247 | $7,138,309 |
| | | | | | |
| Total common equity | | | | | |
| Shareholders' Equity (GAAP) | $1,713,783 | $1,635,315 | $1,198,100 | $1,140,647 | $987,904 |
| Intangible assets | (807,349 ) | (825,088 ) | (480,844 ) | (484,146 ) | (386,973 ) |
| Deferred taxes on intangible assets | 46,370 | 48,419 | 43,504 | 39,724 | 35,842 |
| Total tangible common equity (non-GAAP) | $952,804 | $858,646 | $760,760 | $696,225 | $636,773 |
| | | | | | |
| Net tangible equity-to-assets ratio | | | | | |
| Total tangible common equity (non-GAAP) - numerator | $952,804 | $858,646 | $760,760 | $696,225 | $636,773 |
| Total tangible assets (non-GAAP) - denominator | $9,846,316 | $9,969,529 | $8,229,097 | $8,108,247 | $7,138,309 |
| Net tangible equity-to-assets ratio (non-GAAP) | 9.68 % | 8.61 % | 9.24 % | 8.59 % | 8.92 % |

## Item 7A. Quantitative and Qualitative Disclosures about Market Risk

Market risk is the risk of loss in a financial instrument arising from adverse changes in market rates, prices or credit risk. Credit risk associated with the Company's loan portfolio has been previously discussed in the asset quality section of the MD&A. Management believes that the tax risk of the Company's municipal investments associated with potential future changes in statutory, judicial and regulatory actions is minimal. Treasury, agency, mortgage-backed and CMO securities issued by government agencies comprise 85% of the total portfolio and are currently rated AAA by Moody's Investor Services and AA+ by Standard & Poor's. Municipal and corporate bonds account for 15% of the total portfolio, of which, 99% carry a minimum rating of A-. The remaining 1% of the portfolio is comprised of other investment grade securities. The Company does not have material foreign currency exchange rate risk exposure. Therefore, almost all the market risk in the investment portfolio is related to interest rates.

The ongoing monitoring and management of both interest rate risk and liquidity, in the short and long term time horizons is an important component of the Company's asset/liability management process, which is governed by limits established in the policies reviewed and approved annually by the Company's Board of Directors. The Board of Directors delegates responsibility for carrying out the policies to the ALCO, which meets each month. The committee is made up of the Company's senior management as well as regional and line-of-business managers who oversee specific earning asset classes and various funding sources. As the Company does not believe it is possible to reliably predict future interest rate movements, it has maintained an appropriate process and set of measurement tools, which enables it to identify and quantify sources of interest rate risk in varying rate environments. The primary tool used by the Company in managing interest rate risk is income simulation.

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While a wide variety of strategic balance sheet and treasury yield curve scenarios are tested on an ongoing basis, the following reflects the Company's projected net interest income sensitivity over the subsequent twelve months based on:

- Asset and liability levels using December 31, 2018 as a starting point.
- There are assumed to be conservative levels of balance sheet growth, low-to-mid single digit growth in loans and deposits, while using the cash flows from investment contractual maturities and prepayments to repay short-term capital market borrowings or reinvest into securities or cash equivalents.
- The prime rate and federal funds rates are assumed to move over a 12-month period while moving the long end of the treasury curve to spreads over the three month treasury that are more consistent with historical norms (normalized yield curve). Deposit rates are assumed to move in a manner that reflects the historical relationship between deposit rate movement and changes in the federal funds rate.
- Cash flows are based on contractual maturity, optionality, and amortization schedules along with applicable prepayments derived from internal historical data and external sources.

Net Interest Income Sensitivity Model

| Change in interest rates | Calculated annualized increase (decrease) in projected net interest income at December 31, 2018 |
|---|---|
| +200 basis points | ($2,540,000) |
| +100 basis points | ($308,000) |
| -100 basis points | ($2,754,000) |
| -200 basis points | ($8,544,000) |

The modeled net interest income (NII) decreases in rising rate environments from the flat rate scenario. The decrease is largely a result of assumed deposit and funding costs increasing faster than the repricing of corresponding assets. In the short term (year one) the assumed increase of deposit rates in the rising rate environment temporarily outweighs the benefit of earning asset yields increasing to higher levels. However, over a longer time period (years two and beyond), the growth in NII improves in the rising rate environments as lower yielding assets mature and are replaced at higher rates.

In the falling rate environments, the Bank shows interest rate risk exposure to lower short term rates. During the first twelve months, net interest income declines largely due to lower assumed rates on new loans, including adjustable and variable rate assets. Modestly lower funding costs associated with deposits and borrowings only partially offset the decrease in interest income.

The analysis does not represent a Company forecast and should not be relied upon as being indicative of expected operating results. These hypothetical estimates are based upon numerous assumptions: the nature and timing of interest rate levels (including yield curve shape), prepayments on loans and securities, deposit decay rates, pricing decisions on loans and deposits, reinvestment/replacement of asset and liability cash flows, and other factors. While the assumptions are developed based upon reasonable economic and local market conditions, the Company cannot make any assurances as to the predictive nature of these assumptions, including how customer preferences or competitor influences might change. Furthermore, the sensitivity analysis does not reflect actions that the ALCO might take in responding to or anticipating changes in interest rates.

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Item 8. Financial Statements and Supplementary Data

The following consolidated financial statements and independent registered public accounting firm's report of Community Bank System, Inc. are contained on pages 60 through 109 of this item.


- Consolidated Statements of Condition,
December 31, 2018 and 2017

- Consolidated Statements of Income,
Years ended December 31, 2018, 2017, and 2016

- Consolidated Statements of Comprehensive Income,
Years ended December 31, 2018, 2017, and 2016

- Consolidated Statements of Changes in Shareholders' Equity,
Years ended December 31, 2018, 2017, and 2016

- Consolidated Statements of Cash Flows,
Years ended December 31, 2018, 2017, and 2016

- Notes to Consolidated Financial Statements,
December 31, 2018

- Management's Report on Internal Control Over Financial Reporting

- Report of Independent Registered Public Accounting Firm


Selected Quarterly Data (Unaudited) for 2018 and 2017 are contained on page 113.

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COMMUNITY BANK SYSTEM, INC.
CONSOLIDATED STATEMENTS OF CONDITION
(In Thousands, Except Share Data)

| | December 31, 2018 | 2017 |
|---|---|---|
| Assets: | | |
| Cash and cash equivalents | $211,834 | $221,038 |
| Available-for-sale investment securities (cost of $2,952,278 and $3,007,148, respectively) | 2,936,049 | 3,031,088 |
| Equity and other securities (cost of $44,678 and $50,291, respectively) | 45,609 | 50,291 |
| Loans held for sale, at fair value | 83 | 461 |
| | | |
| Loans | 6,281,121 | 6,256,757 |
| Allowance for loan losses | (49,284) | (47,583) |
| Net loans | 6,231,837 | 6,209,174 |
| | | |
| Goodwill, net | 733,503 | 734,430 |
| Core deposit intangibles, net | 18,596 | 25,025 |
| Other intangibles, net | 55,250 | 65,633 |
| Intangible assets, net | 807,349 | 825,088 |
| | | |
| Premises and equipment, net | 119,988 | 123,393 |
| Accrued interest and fees receivable | 31,048 | 36,177 |
| Other assets | 223,498 | 249,488 |
| | | |
| Total assets | $10,607,295 | $10,746,198 |
| | | |
| Liabilities: | | |
| Noninterest-bearing deposits | $2,312,816 | $2,293,057 |
| Interest-bearing deposits | 6,009,555 | 6,151,363 |
| Total deposits | 8,322,371 | 8,444,420 |
| | | |
| Short-term borrowings | 54,400 | 24,000 |
| Securities sold under agreement to repurchase, short-term | 259,367 | 337,011 |
| Other long-term debt | 1,976 | 2,071 |
| Subordinated debt held by unconsolidated subsidiary trusts | 97,939 | 122,814 |
| Accrued interest and other liabilities | 157,459 | 180,567 |
| Total liabilities | 8,893,512 | 9,110,883 |
| | | |
| Commitments and contingencies (See Note N) | | |
| | | |
| Shareholders' equity: | | |
| Preferred stock, $1.00 par value, 500,000 shares authorized, 0 shares issued | 0 | 0 |
| Common stock, $1.00 par value, 75,000,000 shares authorized; 51,576,839 and 51,263,841 shares issued, respectively | 51,577 | 51,264 |
| Additional paid-in capital | 911,748 | 894,879 |
| Retained earnings | 795,563 | 700,557 |
| Accumulated other comprehensive (loss) | (45,305) | (3,699) |
| | (11,528) | (21,014) |

| | | |
|---|---|---|
| Treasury stock, at cost (319,015 shares including 207,403 shares held by deferred compensation arrangements at December 31, 2018, and 567,764 shares including 237,494 shares held by deferred compensation arrangements at December 31, 2017) | | |
| Deferred compensation arrangements (207,403 shares at December 31, 2018 and 237,494 shares at December 31, 2017) | 11,728 | 13,328 |
| Total shareholders' equity | 1,713,783 | 1,635,315 |
| Total liabilities and shareholders' equity | $10,607,295 | $10,746,198 |

The accompanying notes are an integral part of the consolidated financial statements.

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COMMUNITY BANK SYSTEM, INC.
CONSOLIDATED STATEMENTS OF INCOME
(In Thousands, Except Per-Share Data)

| | Years Ended December 31, | | |
|---|---|---|---|
| | 2018 | 2017 | 2016 |
| Interest income: | | | |
| Interest and fees on loans | $286,165 | $253,949 | $211,467 |
| Interest and dividends on taxable investments | 63,504 | 60,159 | 56,201 |
| Interest and dividends on nontaxable investments | 13,064 | 15,347 | 17,519 |
| Total interest income | 362,733 | 329,455 | 285,187 |
| | | | |
| Interest expense: | | | |
| Interest on deposits | 10,658 | 8,031 | 7,325 |
| Interest on borrowings | 2,343 | 1,845 | 1,017 |
| Interest on subordinated debt held by unconsolidated subsidiary trusts | 4,677 | 3,904 | 2,949 |
| Total interest expense | 17,678 | 13,780 | 11,291 |
| | | | |
| Net interest income | 345,055 | 315,675 | 273,896 |
| Provision for loan losses | 10,837 | 10,984 | 8,076 |
| Net interest income after provision for loan losses | 334,218 | 304,691 | 265,820 |
| | | | |
| Noninterest revenues: | | | |
| Deposit service fees | 70,384 | 67,896 | 58,595 |
| Other banking revenues | 4,968 | 5,466 | 7,477 |
| Employee benefit services | 92,279 | 80,830 | 46,628 |
| Insurance services | 30,317 | 26,150 | 23,149 |
| Wealth management services | 25,772 | 22,079 | 19,776 |
| Unrealized gain on equity securities | 657 | 0 | 0 |
| Loss on debt extinguishment | (318) | 0 | 0 |
| Gain on sales of investment securities, net | 0 | 2 | 0 |
| Total noninterest revenues | 224,059 | 202,423 | 155,625 |
| | | | |
| Noninterest expenses: | | | |
| Salaries and employee benefits | 207,363 | 186,903 | 156,396 |
| Occupancy and equipment | 39,948 | 35,561 | 30,078 |
| Data processing and communications | 39,094 | 37,579 | 34,501 |
| Amortization of intangible assets | 18,155 | 16,941 | 5,479 |
| Legal and professional fees | 10,644 | 11,576 | 8,455 |
| Business development and marketing | 9,383 | 9,994 | 7,484 |
| Acquisition expenses | (769) | 25,986 | 1,706 |
| Other expenses | 21,471 | 22,609 | 22,749 |
| Total noninterest expenses | 345,289 | 347,149 | 266,848 |
| | | | |
| Income before income taxes | 212,988 | 159,965 | 154,597 |
| Income taxes | 44,347 | 9,248 | 50,785 |
| Net income | $168,641 | $150,717 | $103,812 |
| | | | |
| Basic earnings per share | $3.28 | $3.07 | $2.34 |
| Diluted earnings per share | $3.24 | $3.03 | $2.32 |

| | | | |
|---|---|---|---|
| Cash dividends declared per share | $1.44 | $1.32 | $1.26 |

The accompanying notes are an integral part of the consolidated financial statements.

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COMMUNITY BANK SYSTEM, INC.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

| (In Thousands) | Years Ended December 31, | | |
|---|---|---|---|
| | 2018 | 2017 | 2016 |
| Pension and other post retirement obligations: | | | |
| Amortization of actuarial (losses)/gains included in net periodic pension cost, gross | $ (12,647) | $ (707) | $ 5,514 |
| Tax effect | 3,087 | 263 | (2,108) |
| Amortization of actuarial (losses)/gains included in net periodic pension cost, net | (9,560) | (444) | 3,406 |
| Amortization of prior service cost included in net periodic pension cost, gross | (1,398) | (859) | (136) |
| Tax effect | 340 | 324 | 52 |
| Amortization of prior service cost included in net periodic pension cost, net | (1,058) | (535) | (84) |
| Initial projected benefit obligation recognized upon plan adoption, gross | (775) | 0 | 0 |
| Tax effect | 189 | 0 | 0 |
| Initial projected benefit obligation recognized upon plan adoption, net | (586) | 0 | 0 |
| Unamortized actuarial gain due to plan merger, gross | 0 | 1,858 | 0 |
| Tax effect | 0 | (711) | 0 |
| Unamortized actuarial gain due to plan merger, net | 0 | 1,147 | 0 |
| Other comprehensive (loss)/income related to pension and other post retirement obligations, net of taxes | (11,204) | 168 | 3,322 |
| Unrealized (losses)/gains on securities: | | | |
| Net unrealized holding (losses) arising during period, gross | (39,894) | (17,851) | (24,042) |
| Tax effect | 9,700 | 6,787 | 9,328 |
| Net unrealized holding losses arising during period, net | (30,194) | (11,064) | (14,714) |
| Reclassification of other comprehensive income due to change in accounting principle – equity securities | (208) | 0 | 0 |
| Reclassification adjustment for net (gains) included in net income, gross | 0 | (2) | 0 |
| Tax effect | 0 | 1 | 0 |
| Reclassification adjustment for net gains included in net income, net | 0 | (1) | 0 |
| Other comprehensive (loss) related to unrealized (losses)/gains on available-for-sale securities, net of taxes | (30,402) | (11,065) | (14,714) |
| Other comprehensive (loss), net of tax | (41,606) | (10,897) | (11,392) |
| Net income | 168,641 | 150,717 | 103,812 |
| Comprehensive income | $ 127,035 | $ 139,820 | $ 92,420 |

| | As of December 31, | | |
|---|---|---|---|
| | 2018 | 2017 | 2016 |
| Accumulated Other Comprehensive Income/(Loss) By Component: | | | |
| Unrealized (loss) for pension and other postretirement obligations | $ (43,497) | $ (28,677) | $ (28,969) |
| Tax effect | 10,660 | 7,044 | 11,008 |

| | | | |
|---|---|---|---|
| Net unrealized (loss) for pension and other postretirement obligations | (32,837) | (21,633) | (17,961) |
| | | | |
| Unrealized (loss) gain on available-for-sale securities | (16,229) | 23,940 | 41,793 |
| Tax effect | 3,969 | (6,006) | (15,989) |
| Reclassification of other comprehensive income due to change in accounting principle – equity securities | (208) | 0 | 0 |
| Net unrealized (loss) gain on available-for-sale securities | (12,468) | 17,934 | 25,804 |
| | | | |
| Accumulated other comprehensive (loss)/income | $ (45,305) | $ (3,699) | $ 7,843 |

The accompanying notes are an integral part of the consolidated financial statements.

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COMMUNITY BANK SYSTEM, INC.
CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY
Years ended December 31, 2016, 2017 and 2018
(In Thousands, Except Share Data)

| | Common Stock | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | Shares Outstanding | Amount Issued | Additional Paid-in Capital | Retained Earnings | Accumulated Other Comprehensive Income/(Loss) | Treasury Stock | Deferred Compensation Arrangements | Total |
| Balance at December 31, 2015 | 43,774,860 | $44,443 | $ 528,015 | $566,591 | $ 19,235 | $ (17,637) | $ 0 | $1,140,647 |
| Net income | | | | 103,812 | | | | 103,812 |
| Other comprehensive income, net of tax | | | | | (11,392 ) | | | (11,392 ) |
| Dividends declared: Common, $1.26 per share | | | | (55,711 ) | | | | (55,711 ) |
| Common stock issued under employee stock plan, including tax benefits of $3,091 | 507,784 | 507 | 10,036 | | | | | 10,543 |
| Stock-based compensation | | | 4,783 | | | | | 4,783 |
| Treasury stock purchased | (67,826 ) | | | | | (3,470 ) | | (3,470 ) |
| Treasury stock issued to benefit plan | 222,597 | | 2,941 | | | 5,947 | | 8,888 |
| Balance at December 31, 2016 | 44,437,415 | 44,950 | 545,775 | 614,692 | 7,843 | (15,160) | 0 | 1,198,100 |
| Net income | | | | 150,717 | | | | 150,717 |
| Other comprehensive loss, net of tax | | | | | (10,897 ) | | | (10,897 ) |
| Reclassification related to tax effect of Tax Cuts and Jobs Act | | | | 645 | (645 ) | | | 0 |
| Dividends declared: Common, $1.32 per share | | | | (65,497 ) | | | | (65,497 ) |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Common stock issued under employee stock plan | 264,640 | 265 | 4,298 | | | | | 4,563 |
| Stock-based compensation | | | 5,137 | | | | | 5,137 |
| Stock issued for acquisitions | 6,048,849 | 6,049 | 337,083 | | | | | 343,132 |
| Deferred compensation arrangements acquired | (179,003 ) | | | | | (10,022) | 10,022 | 0 |
| Treasury stock purchased | (58,491 ) | | | | | (3,306 ) | 3,306 | 0 |
| Treasury stock issued to benefit plan | 182,667 | | 2,586 | | | 7,474 | 0 | 10,060 |
| Balance at December 31, 2017 | 50,696,077 | 51,264 | 894,879 | 700,557 | (3,699 ) | (21,014) | 13,328 | 1,635,315 |
| Net income | | | | 168,641 | | | | 168,641 |
| Other comprehensive loss, net of tax | | | | | (41,398 ) | | | (41,398 ) |
| Cumulative effect of change in accounting principle – equity securities | | | | 208 | (208 ) | | | 0 |
| Dividends declared: | | | | | | | | |
| Common, $1.44 per share | | | | (73,843 ) | | | | (73,843 ) |
| Common stock issued under employee stock plan | 312,998 | 313 | 6,130 | | | | | 6,443 |
| Stock-based compensation | | | 6,064 | | | | | 6,064 |
| Distribution of stock under deferred compensation arrangements | 35,233 | | | | | 1,898 | (1,898 ) | 0 |
| Treasury stock purchased | (5,142 ) | | | | | (298 ) | 298 | 0 |
| Treasury stock issued to benefit plan | 218,658 | | 4,675 | | | 7,886 | 0 | 12,561 |
| Balance at December 31, | 51,257,824 | $51,577 | $911,748 | $795,563 | $ (45,305 ) | $ (11,528) | $ 11,728 | $1,713,783 |

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The accompanying notes are an integral part of the consolidated financial statements.

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COMMUNITY BANK SYSTEM, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(In Thousands of Dollars)

| | Years Ended December 31, | | |
|---|---|---|---|
| | 2018 | 2017 | 2016 |
| Operating activities: | | | |
| Net income | $168,641 | $150,717 | $103,812 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | | |
| Depreciation | 15,749 | 16,024 | 14,398 |
| Amortization of intangible assets | 18,155 | 16,941 | 5,479 |
| Net accretion on securities, loans and borrowings | (9,404) | (6,619) | (4,405) |
| Stock-based compensation | 6,064 | 5,137 | 4,783 |
| Provision for loan losses | 10,837 | 10,984 | 8,076 |
| Provision/(benefit) for deferred income taxes | 2,663 | (28,692) | 13,066 |
| Amortization of mortgage servicing rights | 449 | 499 | 518 |
| Unrealized gain on equity securities | (657) | 0 | 0 |
| Loss on debt extinguishment | 318 | 0 | 0 |
| Income from bank-owned life insurance policies | (1,579) | (1,586) | (1,505) |
| Gain on sales of investment securities, net | 0 | (2) | 0 |
| Net (gain)/loss on sale of loans and other assets | (80) | 181 | (837) |
| Change in other assets and liabilities | 10,252 | 26,090 | (7,614) |
| Net cash provided by operating activities | 221,408 | 189,674 | 135,771 |
| Investing activities: | | | |
| Proceeds from maturities, calls and paydowns of available-for-sale investment securities | 140,784 | 157,278 | 109,638 |
| Proceeds from maturities and redemptions of other investment securities | 5,867 | 30,116 | 8,703 |
| Purchases of available-for-sale investment securities | (78,131) | (90,380) | (65,966) |
| Purchases of equity and other securities | (31) | (13,302) | (4,612) |
| Net (increase) decrease in loans | (35,414) | 164,846 | (159,871) |
| Cash paid for acquisition, net of cash acquired of $16, $52,132, and $0, respectively | (1,737) | (107,414) | (575) |
| Settlement of bank owned life insurance policies | 0 | 1,779 | 3,127 |
| Purchases of premises and equipment, net | (12,646) | (10,819) | (12,442) |
| Real estate limited partnership investments | (1,197) | (733) | 0 |
| Net cash provided by/(used in) investing activities | 17,495 | 131,371 | (121,998) |
| Financing activities: | | | |
| Net change in deposits | (122,049) | (79,940) | 202,480 |
| Net decrease in borrowings, net of payments of $95, $81,544 and $0 | (47,339) | (144,809) | (155,100) |
| Payments on subordinated debt held by unconsolidated subsidiary trusts | (25,207) | 0 | 0 |
| Issuance of common stock | 6,443 | 4,563 | 10,543 |
| Purchase of treasury stock | (298) | (3,306) | (3,470) |
| Sale of treasury stock | 12,561 | 10,060 | 8,888 |
| Increase in deferred compensation agreements | 298 | 3,306 | 0 |
| Cash dividends paid | (71,495) | (62,305) | (55,048) |
| Withholding taxes paid on share-based compensation | (1,021) | (1,433) | (1,419) |
| Net cash (used in)/provided by financing activities | (248,107) | (273,864) | 6,874 |
| Change in cash and cash equivalents | (9,204) | 47,181 | 20,647 |
| Cash and cash equivalents at beginning of year | 221,038 | 173,857 | 153,210 |
| Cash and cash equivalents at end of year | $211,834 | $221,038 | $173,857 |

| | | | |
|---|---|---|---|
| Supplemental disclosures of cash flow information: | | | |
| Cash paid for interest | $17,926 | $13,705 | $11,268 |
| Cash paid for income taxes | 30,266 | 41,231 | 32,239 |
| Supplemental disclosures of noncash financing and investing activities: | | | |
| Dividends declared and unpaid | 19,808 | 17,460 | 14,268 |
| Transfers from loans to other real estate | 3,299 | 3,518 | 2,612 |
| Acquisitions: | | | |
| Common stock issued | 0 | 343,132 | 0 |
| Fair value of assets acquired, excluding acquired cash and intangibles | 115 | 1,961,246 | 0 |
| Fair value of liabilities assumed | 31 | 1,870,449 | 0 |

The accompanying notes are an integral part of the consolidated financial statements.

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COMMUNITY BANK SYSTEM, INC.

NOTE A: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Nature of Operations
Community Bank System, Inc. (the "Company") is a registered financial holding company which wholly-owns two significant consolidated subsidiaries: Community Bank, N.A. (the "Bank" or "CBNA"), and Benefit Plans Administrative Services, Inc. ("BPAS"). As of December 31, 2018, BPAS owns five subsidiaries: Benefit Plans Administrative Services, LLC ("BPA"), a provider of defined benefit contribution plan administration services; Northeast Retirement Services, LLC ("NRS"), a provider of institutional transfer agency, master recordkeeping services, fund administration, trust and retirement plan services; BPAS Actuarial & Pension Services, LLC ("BPAS-APS"), a provider of actuarial and benefit consulting services; BPAS Trust Company of Puerto Rico, a Puerto Rican trust company; and Hand Benefits & Trust Company ("HB&T"), a provider of collective investment fund administration and institutional trust services. NRS owns one subsidiary, Global Trust Company, Inc. ("GTC"), a non-depository trust company which provides fiduciary services for collective investment trusts and other products. HB&T owns one subsidiary, Hand Securities Inc. ("HSI"), an introducing broker-dealer. The Company also wholly-owns two unconsolidated subsidiary business trusts formed for the purpose of issuing mandatorily-redeemable preferred securities which are considered Tier I capital under regulatory capital adequacy guidelines (see Note P).

As of December 31, 2018, the Bank operated 224 full service branches operating as Community Bank, N.A. throughout 35 counties of Upstate New York, six counties of Northeastern Pennsylvania, 12 counties of Vermont and one county of Western Massachusetts, offering a range of commercial and retail banking services. The Bank owns the following operating subsidiaries: The Carta Group, Inc. ("Carta Group"), CBNA Preferred Funding Corporation ("PFC"), CBNA Treasury Management Corporation ("TMC"), Community Investment Services, Inc. ("CISI"), NOTCH Investment Fund, LLC ("NOTCH"), Nottingham Advisors, Inc. ("Nottingham"), OneGroup NY, Inc. ("OneGroup"), and Oneida Preferred Funding II LLC ("OPFC II"). OneGroup is a full-service insurance agency offering personal and commercial property insurance and other risk management products and services. NOTCH, PFC and OPFC II primarily act as investors in residential and commercial real estate activities. TMC provides cash management, investment, and treasury services to the Bank. CISI and Carta Group provide broker-dealer and investment advisory services. Nottingham provides asset management services to individuals, corporations, corporate pension and profit sharing plans, and foundations.

Principles of Consolidation
The consolidated financial statements include the accounts of the Company and its subsidiaries. All intercompany accounts and transactions have been eliminated in consolidation.

Variable Interest Entities ("VIE") are legal entities in which equity investors do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the legal entities to finance its activities without additional subordinated financial support. VIEs may be required to be consolidated by a company if it is determined the company is the primary beneficiary of a VIE. The primary beneficiary of a VIE is the enterprise that has: (1) the power to direct the activities of the VIE that most significantly impact the VIE's economic performance, and (2) the obligation to absorb losses of the VIE that could potentially be significant to the VIE or the right to receive benefits of the VIE that could potentially be significant to the VIE. The Company's VIE's are described in more detail in Note T to the consolidated financial statements.

Critical Accounting Estimates in the Preparation of Financial Statements
The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America 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 reporting period. Actual results could differ from those estimates.

Critical accounting estimates include the allowance for loan losses, actuarial assumptions associated with the pension, post-retirement and other employee benefit plans, the provision for income taxes, investment valuation and other-than-temporary impairment, the carrying value of goodwill and other intangible assets, and acquired loan valuations.

Risk and Uncertainties

In the normal course of its business, the Company encounters economic and regulatory risks. There are three main components of economic risk: interest rate risk, credit risk and market risk. The Company is subject to interest rate risk to the degree that its interest-bearing liabilities mature or reprice at different speeds, or on different basis, from its interest-earning assets. The Company's primary credit risk is the risk of default on the Company's loan portfolio that results from the borrowers' inability or unwillingness to make contractually required payments. Market risk reflects potential changes in the value of collateral underlying loans, the fair value of investment securities, and loans held for sale.

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The Company is subject to regulations of various governmental agencies. These regulations can change significantly from period to period. The Company also undergoes periodic examinations by the regulatory agencies which may subject it to further changes with respect to asset valuations, amounts of required loan loss allowances, and operating restrictions resulting from the regulators' judgments based on information available to them at the time of their examinations.

Revenue Recognition

On January 1, 2018, the Company adopted ASU No. 2014-09 Revenue from Contracts with Customers (Topic 606) and all subsequent ASUs that modified Topic 606. The implementation of the new standard did not have a material impact on the measurement or recognition of revenue; as such, a cumulative effect adjustment to opening retained earnings was not deemed necessary. Results for reporting periods beginning after January 1, 2018 are presented under Topic 606, while prior period amounts were not adjusted and continue to be reported in accordance with our historic accounting under Topic 605.

Topic 606 does not apply to revenue associated with financial instruments, including revenue from loans and securities. In addition, certain noninterest income streams such as fees associated with mortgage servicing rights, financial guarantees, derivatives, and certain credit card fees are also not in scope of the newly adopted guidance. Topic 606 is applicable to the Company's noninterest revenue streams including its deposit related fees, electronic payment interchange fees, merchant income, trust, asset management and other wealth management revenues, insurance commissions and benefit plan services income. However, the recognition of these revenue streams did not change significantly upon adoption of Topic 606. Noninterest revenue streams in-scope of Topic 606 are discussed below.

Deposit Service Fees

Deposit service fees consist of account activity fees, monthly service fees, check orders, debit and credit card income, ATM fees, Merchant services income and other revenues from processing wire transfers, bill pay service, cashier's checks and foreign exchange. Debit and credit card income is primarily comprised of interchange fees earned at the time the Company's debit and credit cards are processed through card payment networks such as Visa. ATM fees are primarily generated when a Company cardholder uses a non-Company ATM or a non-Company cardholder uses a Company ATM. Merchant services income mainly represents fees charged to merchants to process their debit and credit card transactions, in addition to account management fees. The Company's performance obligation for deposit service fees is generally satisfied, and the related revenue recognized, when the services are rendered or the transaction has been completed. Payment for deposit service fees is typically received at the time it is assessed through a direct charge to customers' accounts or on a monthly basis. Deposit service fees revenue primarily relates to the Company's Banking operating segment.

Other Banking Services

Other banking services consists of other recurring revenue streams such as commissions from sales of credit life insurance, safe deposit box rental fees, mortgage banking income, bank owned life insurance income and other miscellaneous revenue streams. Commissions from the sale of credit life insurance are recognized at the time of sale of the policies. Safe deposit box rental fees are charged to the customer on an annual basis and recognized upon receipt of payment. The Company determined that since rentals and renewals occur fairly consistently over time, revenue is recognized on a basis consistent with the duration of the performance obligation. Mortgage banking income and bank owned life insurance income are not within the scope of Topic 606. Other banking services revenue primarily relates to the Company's Banking operating segment.

Employee Benefit Services

Employee benefit services income consists of revenue received from retirement plan services, collective investment fund services, fund administration, transfer agency, consulting and actuarial services. The Company's performance obligation that relates to plan services are satisfied over time and the resulting fees are recognized monthly or

quarterly, based upon the market value of the assets under management and the applicable fee rate or on a time expended basis. Payment is generally received a few days after month end or quarter end. The Company does not earn performance-based incentives. Transactional services such as consulting services, mailings, or other ad hoc services are provided to existing trust and asset management customers. The Company's performance obligation for these transactional-based services is generally satisfied, and related revenue recognized, at a point in time (i.e., as incurred). Payment is received shortly after services are rendered.  Employee benefit services revenue primarily relates to the Company's Employee Benefit Services operating segment.

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Insurance Services

Insurance services primarily consists of commissions received on insurance product sales and consulting services. The Company acts in the capacity of a broker or agent between the Company's customer and the insurance carrier. The Company's performance obligation related to insurance sales for both property and casualty insurance and employee benefit plans is generally satisfied upon the later of the issuance or effective date of the policy. The Company's performance obligation related to consulting services is considered transactional in nature and is generally satisfied when the services have been completed and related revenue recognized at a point in time. Payment is received at the time services are rendered. The Company earns performance based incentives, commonly known as contingency payments, which usually are based on certain criteria established by the insurance carrier such as premium volume, growth and insured loss ratios. Contingent payments are accrued for based upon management's expectations for the year. Commission expense associated with sales of insurance products is expensed as incurred. Insurance services revenue primarily relates to the Company's All Other operating segment.

Wealth Management Services

Wealth management services income is primarily comprised of fees earned from the management and administration of trusts and other customer assets. The Company generally has two types of performance obligations related to these services. The Company's performance obligation that relates to advisory and administration services are satisfied over time and the resulting fees are recognized monthly, based upon the market value of the assets under management and the applicable fee rate. Payment is generally received soon after month end or quarter end through a direct charge to customers' accounts. The Company does not earn performance-based incentives. Transactional services such as tax return preparation services, purchases and sales of investments and insurance products are also available to existing trust and asset management customers. The Company's performance obligation for these transactional-based services is generally satisfied, and related revenue recognized, at a point in time (i.e. as incurred). Payment is generally received on a monthly basis. Wealth management services revenue primarily relates to the Company's All Other operating segment.

Contract Balances

A contract asset balance occurs when an entity performs a service for a customer before the customer pays consideration (resulting in a contract receivable) or before payment is due (resulting in a contract asset). A contract liability balance is an entity's obligation to transfer a service to a customer for which the entity has already received payment (or payment is due) from the customer. The Company's noninterest revenue streams are largely based on transactional activity, or standard month-end revenue accruals such as asset management fees based on month-end market values. Consideration is often received immediately or shortly after the Company satisfies its performance obligation and revenue is recognized. The Company does not typically enter into long-term revenue contracts with customers, and therefore, does not experience significant contract balances. As of December 31, 2018, $26.4 million of accounts receivable, including $7.8 million of unbilled fee revenue, and $2.2 million of unearned revenue was recorded in the Consolidated Statements of Condition. As of December 31, 2017, $29.8 million of accounts receivable, including $6.5 million of unbilled fee revenue, and $3.9 million of unearned revenue was recorded in the Consolidated Statements of Condition.

Contract Acquisition Costs

In connection with the adoption of Topic 606, an entity is required to capitalize, and subsequently amortize into expense, certain incremental costs of obtaining a contract with a customer if these costs are expected to be recovered. The incremental costs of obtaining a contract are those costs that an entity incurs to obtain a contract with a customer that it would not have incurred if the contract had not been obtained (for example, sales commission). The Company utilizes the practical expedient method which allows entities to immediately expense contract acquisition costs when the asset that would have resulted from capitalizing these costs would have been amortized in one year or less. Upon adoption of Topic 606, the Company did not capitalize any contract acquisition costs.

Cash and Cash Equivalents

For purposes of reporting cash flows, cash and cash equivalents include cash on hand, amounts due from banks, and highly liquid investments with original maturities of less than 90 days. The carrying amounts reported in the consolidated statements of condition for cash and cash equivalents approximate those assets' fair values. As of December 31, 2018 and 2017, cash and cash equivalents reported in the consolidated statements of condition included cash due from banks of $15.0 million and $36.0 million, respectively.

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Investment Securities

The Company can classify its investments in debt securities as held-to-maturity, available-for-sale, or trading. Held-to-maturity securities are those for which the Company has the positive intent and ability to hold until maturity, and are reported at cost, which is adjusted for amortization of premiums and accretion of discounts. The Company did not use the held-to-maturity classification in 2017 or 2018. Available-for-sale debt securities are reported at fair value with net unrealized gains and losses reflected as a separate component of shareholders' equity, net of applicable income taxes. None of the Company's investment securities have been classified as trading securities at December 31, 2018. Equity securities with a readily determinable fair value are reported at fair value with net unrealized gains and losses recognized in the consolidated statement of income. Certain equity securities that do not have a readily determinable fair value are stated at cost, less impairment, adjusted for observable price changes in orderly transactions for identical or similar investments of the same issuer. These securities include restricted stock of the Federal Reserve Bank of New York ("Federal Reserve") and the Federal Home Loan Bank of New York and the Federal Home Loan Bank of Boston (collectively referred to as "FHLB"), as well as other equity securities.

Fair values for investment securities are based upon quoted market prices, where available. If quoted market prices are not available, fair values are based upon quoted market prices of comparable instruments, or a discounted cash flow model using market estimates of interest rates and volatility.

The Company conducts an assessment of all securities in an unrealized loss position to determine if other-than-temporary impairment ("OTTI") exists on a quarterly basis. An unrealized loss exists when the current fair value of an individual security is less than its amortized cost basis. The OTTI assessment considers the security structure, recent security collateral performance metrics, if applicable, external credit ratings, failure of the issuer to make scheduled interest or principal payments, judgment about and expectations of future performance, and relevant independent industry research, analysis, and forecasts. The severity of the impairment and the length of time the security has been impaired is also considered in the assessment. The assessment of whether an OTTI decline exists is performed on each security, regardless of the classification of the security as available-for-sale or held-to-maturity, and involves a high degree of subjectivity and judgment that is based on the information available to management at a point in time.

An OTTI loss must be recognized for a debt security in an unrealized loss position if there is intent to sell the security or it is more likely than not the Company will be required to sell the security prior to recovery of its amortized cost basis. In this situation, the amount of loss recognized in income is equal to the difference between the fair value and the amortized cost basis of the security. Even if management does not have the intent, and it is not more likely than not that the Company will be required to sell the securities, an evaluation of the expected cash flows to be received is performed to determine if a credit loss has occurred. For debt securities, a critical component of the evaluation for OTTI is the identification of credit-impaired securities, where the Company does not expect to receive cash flows sufficient to recover the entire amortized cost basis of the security. In the event of a credit loss, only the amount of impairment associated with the credit loss would be recognized in income. The portion of the unrealized loss relating to other factors, such as liquidity conditions in the market or changes in market interest rates, is recorded in accumulated other comprehensive loss.

The specific identification method is used in determining the realized gains and losses on sales of investment securities and OTTI charges. Premiums and discounts on securities are amortized and accreted, respectively, on the interest method basis over the period to maturity or estimated life of the related security. Purchases and sales of securities are recognized on a trade date basis.

Loans

Loans are stated at unpaid principal balances, net of unearned income. Mortgage loans held for sale are carried at fair value and are included in loans held for sale on the consolidated statements of condition. Fair values for variable rate loans that reprice frequently are based on carrying values. Fair values for fixed rate loans are estimated using

discounted cash flows and interest rates currently being offered for loans with similar terms to borrowers of similar credit quality. The carrying amount of accrued interest approximates its fair value.

Interest on loans is accrued and credited to operations based upon the principal amount outstanding. Nonrefundable loan fees and related direct costs are deferred and included in the loan balances where they are amortized over the life of the loan as an adjustment to loan yield using the effective yield method. Premiums and discounts on purchased loans are amortized using the effective yield method over the life of the loans.

Acquired loans

Acquired loans are initially recorded at their acquisition date fair values. The carryover of allowance for loan losses is prohibited as any credit losses in the loans are included in the determination of the fair value of the loans at the acquisition date. Fair values for acquired loans are based on a discounted cash flow methodology that involves assumptions and judgments as to credit risk, prepayment risk, liquidity risk, default rates, loss severity, payment speeds, collateral values and discount rate.

Acquired impaired loans

Acquired loans that have evidence of deterioration in credit quality since origination and for which it is probable, at acquisition, that the Company will be unable to collect all contractually required payments are accounted for as impaired loans under ASC 310-30. The excess of undiscounted cash flows expected at acquisition over the estimated fair value is referred to as the accretable discount and is recognized into interest income over the remaining life of the loans using the interest method. The difference between contractually required payments at acquisition and the undiscounted cash flows expected to be collected at acquisition is referred to as the non-accretable discount. The non-accretable discount represents estimated future credit losses and other contractually required payments that the Company does not expect to collect. Subsequent decreases in expected cash flows are recognized as impairments through a charge to the provision for loan losses resulting in an increase in the allowance for loan losses. Subsequent improvements in expected cash flows result in a recovery of previously recorded allowance for loan losses or a reversal of a corresponding amount of the non-accretable discount, which the Company then reclassifies as an accretable discount that is recognized into interest income over the remaining life of the loans using the interest method.

Acquired loans that met the criteria for non-accrual of interest prior to acquisition may be considered performing upon acquisition, regardless of whether the customer is contractually delinquent, if the Company can reasonably estimate the timing and amount of the expected cash flows on such loans and if the Company expects to fully collect the new carrying value of the loans. As such, the Company may no longer consider the loan to be non-accrual or non-performing and may accrue interest on these loans, including the impact of any accretable discount.

Acquired non-impaired loans

Acquired loans that do not meet the requirements under ASC 310-30 are considered acquired non-impaired loans. The difference between the acquisition date fair value and the outstanding balance represents the fair value adjustment for a loan and includes both credit and interest rate considerations. Fair value adjustments may be discounts (or premiums) to a loan's cost basis and are accreted (or amortized) to net interest income (or expense) over the loan's remaining life in accordance with ASC 310-20. Fair value adjustments for revolving loans are accreted (or amortized) using a straight line method. Term loans are accreted (or amortized) using the constant effective yield method.

Subsequent to the purchase date, the methods used to estimate the allowance for loan losses for the acquired non-impaired loans is consistent with the policy described below. However, the Company compares the net realizable value of the loans to the carrying value, for loans collectively evaluated for impairment. The carrying value represents the net of the loan's unpaid principal balance and the remaining purchase discount (or premium) that has yet to be accreted (or amortized) into interest income (or interest expense). When the carrying value exceeds the net realizable value, an allowance for loan losses is recognized.

Impaired and Other Nonaccrual Loans

The Company places a loan on nonaccrual status when the loan becomes 90 days past due (or sooner, if management concludes collection is doubtful), except when, in the opinion of management, it is well-collateralized and in the process of collection. A loan may be placed on nonaccrual status earlier than ninety days past due if there is deterioration in the financial position of the borrower or if other conditions of the loan so warrant. When a loan is placed on nonaccrual status, uncollected accrued interest is reversed against interest income and the amortization of nonrefundable loan fees and related direct costs is discontinued. Interest income during the period the loan is on

nonaccrual status is recorded on a cash basis after recovery of principal is reasonably assured. Nonaccrual loans are returned to accrual status when management determines that the borrower's performance has improved and that both principal and interest are collectible. This generally requires a sustained period of timely principal and interest payments and a well-documented credit evaluation of the borrower's financial condition.

A loan is considered modified in a troubled debt restructuring ("TDR") when, due to a borrower's financial difficulties, the Company makes a concession(s) to the borrower that it would not otherwise consider. These modifications may include, among others, an extension for the term of the loan, or granting a period when interest–only payments can be made with the principal payments and interest caught up over the remaining term of the loan or at maturity. Generally, a nonaccrual loan that has been modified in a TDR remains on nonaccrual status for a period of 12 months to demonstrate that the borrower is able to meet the terms of the modified loan. If the borrower's ability to meet the revised payment schedule is uncertain, the loan remains on nonaccrual status.

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Regulatory guidance issued by the OCC requires certain loans that have been discharged in Chapter 7 bankruptcy to be reported as TDRs. In accordance with this guidance, loans that have been discharged in Chapter 7 bankruptcy but not reaffirmed by the borrower are classified as TDRs, irrespective of payment history or delinquency status, even if the repayment terms for the loan have not been otherwise modified and the Company's lien position against the underlying collateral remains unchanged. Pursuant to that guidance, the Company records a charge-off equal to any portion of the carrying value that exceeds the net realizable value of the collateral.

Commercial loans greater than $0.5 million are evaluated individually for impairment. A loan is considered impaired, based on current information and events, if it is probable that the Company will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. The measurement of impaired loans is generally based upon the present value of expected future cash flows or the fair value of the collateral, if the loan is collateral-dependent.

The Company's charge-off policy by loan type is as follows:

- Business lending loans are generally charged-off to the extent outstanding principal exceeds the fair value of estimated proceeds from collection efforts, including liquidation of collateral. The charge-off is recognized when the loss becomes reasonably quantifiable.
- Consumer installment loans are generally charged-off to the extent outstanding principal exceeds the fair value of collateral, and are recognized by the end of the month in which the loan becomes 90 days past due.
- Consumer mortgage and home equity loans are generally charged-off to the extent outstanding principal exceeds the fair value of the property, less estimated costs to sell, and are recognized when the loan becomes 180 days past due.

Allowance for Loan Losses

Management continually evaluates the credit quality of the Company's loan portfolio, and performs a formal review of the adequacy of the allowance for loan losses on a quarterly basis. The allowance reflects management's best estimate of probable losses inherent in the loan portfolio. Determination of the allowance is subjective in nature and requires significant estimates. The Company's allowance methodology consists of two broad components - general and specific loan loss allocations.

The general loan loss allocation is composed of two calculations that are computed on five main loan segments: business lending, consumer direct, consumer indirect, home equity and consumer mortgage. The first calculation is quantitative and determines an allowance level based on the latest 36 months of historical net charge-off data for each loan class (commercial loans exclude balances with specific loan loss allocations). The second calculation is qualitative and takes into consideration eight qualitative environmental factors: levels and trends in delinquencies and impaired loans; levels of and trends in charge-offs and recoveries; trends in volume and terms of loans; effects of any changes in risk selection and underwriting standards, and other changes in lending policies, procedures, and practices; experience, ability, and depth of lending management and other relevant staff; national and local economic trends and conditions; industry conditions; and effects of changes in credit concentrations. A component of the qualitative calculation is the unallocated allowance for loan loss. The qualitative and quantitative calculations are added together to determine the general loan loss allocation. The specific loan loss allocation relates to individual commercial loans that are both greater than $0.5 million and in a nonaccruing status with respect to interest. Specific loan losses are based on discounted estimated cash flows, including any cash flows resulting from the conversion of collateral or collateral shortfalls. The allowance levels computed from the specific and general loan loss allocation methods are combined with unallocated allowances and allowances needed for acquired loans to derive the total required allowance for loan losses to be reflected on the Consolidated Statement of Condition.

Loan losses are charged off against the allowance, while recoveries of amounts previously charged off are credited to the allowance. A provision for loan losses is charged to operations based on management's periodic evaluation of factors previously mentioned.

Intangible Assets

Intangible assets include core deposit intangibles, customer relationship intangibles and goodwill arising from acquisitions. Core deposit intangibles and customer relationship intangibles are amortized on either an accelerated or straight-line basis over periods ranging from seven to 20 years. The initial and ongoing carrying value of goodwill and other intangible assets is based upon discounted cash flow modeling techniques that require management to make estimates regarding the amount and timing of expected future cash flows. It also requires use of a discount rate that reflects the current return requirements of the market in relation to present risk-free interest rates, required equity market premiums, peer volatility indicators, and company-specific risk indicators.

The Company evaluates goodwill for impairment on an annual basis, or more often if events or circumstances indicate there may be impairment. The implied fair value of a reporting unit's goodwill is compared to its carrying amount and the impairment loss is measured by the excess of the carrying value over fair value. The fair value of each reporting unit is compared to the carrying amount of that reporting unit in order to determine if impairment is indicated.

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Premises and Equipment

Premises and equipment are stated at cost less accumulated depreciation. Computer software costs that are capitalized only include external direct costs of obtaining and installing the software. The Company has not developed any internal use software. Depreciation is calculated using the straight-line method over the estimated useful lives of the assets. Useful lives range from three to 10 years for equipment; three to seven years for software and hardware; and 10 to 40 years for building and building improvements. Land improvements are depreciated over 20 years and leasehold improvements are amortized over the shorter of the term of the respective lease plus any optional renewal periods that are reasonably assured or life of the asset. Maintenance and repairs are charged to expense as incurred.

Other Real Estate

Other real estate owned is comprised of properties acquired through foreclosure, or by deed in lieu of foreclosure. These assets are carried at fair value less estimated costs of disposal. At foreclosure, if the fair value, less estimated costs to sell, of the real estate acquired is less than the Company's recorded investment in the related loan, a write-down is recognized through a charge to the allowance for loan losses. Any subsequent reduction in value is recognized by a charge to income. Operating costs associated with the properties are charged to expense as incurred. At December 31, 2018 and 2017, other real estate totaled $1.3 million and $1.9 million, respectively, and is included in other assets.

Mortgage Servicing Rights

Originated mortgage servicing rights are recorded at their fair value at the time of sale of the underlying loan, and are amortized in proportion to and over the period of estimated net servicing income or loss. The Company uses a valuation model that calculates the present value of future cash flows to determine the fair value of servicing rights. In using this valuation method, the Company incorporates assumptions that market participants would use in estimating future net servicing income, which includes estimates of the servicing cost per loan, the discount rate, and prepayment speeds. The carrying value of the originated mortgage servicing rights is included in other assets and is evaluated quarterly for impairment using these same market assumptions. The amount of impairment recognized is the amount by which the carrying value of the capitalized servicing rights for a stratum exceeds estimated fair value. Impairment is recognized through a valuation allowance.

Treasury Stock

Repurchases of shares of the Company's common stock are recorded at cost as a reduction of shareholders' equity. Reissuance of shares of treasury stock is recorded at average cost.

Income Taxes

The Company and its subsidiaries file a consolidated federal income tax return. Provisions for income taxes are based on taxes currently payable or refundable as well as deferred taxes that are based on temporary differences between the tax basis of assets and liabilities and their reported amounts in the consolidated financial statements. Deferred tax assets and liabilities are reported in the consolidated financial statements at currently enacted income tax rates applicable to the period in which the deferred tax assets and liabilities are expected to be realized or settled.

Benefits from tax positions should be recognized in the financial statements only when it is more likely than not that the tax position will be sustained upon examination by the appropriate taxing authority having full knowledge of all relevant information. A tax position meeting the more-likely-than-not recognition threshold should be measured at the largest amount of benefit for which the likelihood of realization upon ultimate settlement exceeds 50 percent. Should tax laws change or the taxing authorities determine that management's assumptions were inappropriate, an adjustment may be required which could have a material effect on the Company's results of operations.

Investments in Real Estate Limited Partnerships

The Company has investments in various real estate limited partnerships that acquire, develop, own and operate low and moderate-income housing. The Company's ownership interest in these limited partnerships ranges from 5.00% to

99.99% as of December 31, 2018. These investments are made directly in Low Income Housing Tax Credit, or LIHTC, partnerships formed by third parties. As a limited partner in these operating partnerships, the Company receives tax credits and tax deductions for losses incurred by the underlying properties.

The Company accounts for its ownership interest in LIHTC partnerships in accordance with Accounting Standards Update (“ASU”) 2014-01, Investments – Equity Method and Joint Ventures (Topic 323): Accounting for Investments in Qualified Affordable Housing Projects. The standard permits an entity to amortize the initial cost of the investment in proportion to the amount of the tax credits and other tax benefits received and recognize the net investment performance in the income statement as a component of income tax expense. The Company has unfunded commitments of $2.0 million at year-end related to qualified affordable housing project investments, which will be funded in 2019. There were no impairment losses during the year resulting from the forfeiture or ineligibility of tax credits related to qualified affordable housing project investments.

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Repurchase Agreements

The Company sells certain securities under agreements to repurchase. These agreements are treated as collateralized financing transactions. These secured borrowings are reflected as liabilities in the accompanying consolidated statements of condition and are recorded at the amount of cash received in connection with the transaction. Short-term securities sold under agreements to repurchase generally mature within one day from the transaction date. Securities, generally U.S. government and federal agency securities, pledged as collateral under these financing arrangements can be repledged by the secured party. Additional collateral may be required based on the fair value of the underlying securities.

Retirement Benefits

The Company provides defined benefit pension benefits to eligible employees and post-retirement health and life insurance benefits to certain eligible retirees. The Company also provides deferred compensation and supplemental executive retirement plans for selected current and former employees, officers, and directors. Expense under these plans is charged to current operations and consists of several components of net periodic benefit cost based on various actuarial assumptions regarding future experience under the plans, including discount rate, rate of future compensation increases and expected return on plan assets.

Derivative Financial Instruments and Hedging Activities

The Company accounts for derivative financial instruments at fair value. If certain conditions are met, a derivative may be specifically designated as (1) a hedge of the exposure to changes in the fair value of a recognized asset or liability or an unrecognized firm commitment ("fair value hedge"), (2) a hedge of the exposure to variable cash flows of a forecasted transaction or the variability of cash flows to be received or paid related to a recognized asset or liability ("cash flow hedge"), or (3) an instrument with no hedging designation ("stand-alone derivative"). For a fair value hedge, the gain or loss on the derivative, as well as the offsetting loss or gain on the hedged item, are recognized in current earnings as fair values change. For a cash flow hedge, the gain or loss on the derivative is reported in other comprehensive income and is reclassified into earnings in the same periods during which the hedged transaction affects earnings. For both types of hedges, changes in the fair value of derivatives that are not highly effective in hedging the changes in fair value or expected cash flows of the hedged item are recognized immediately in current earnings. Changes in the fair value of derivatives that do not qualify for hedge accounting are reported currently in earnings, as noninterest income.

Net cash settlements on derivatives that qualify for hedge accounting are recorded in interest income or interest expense, based on the item being hedged. Net cash settlements on derivatives that do not qualify for hedge accounting are reported in noninterest income. Cash flows on hedges are classified in the consolidated statement of cash flow statement the same as the cash flows of the items being hedged.

The Company formally documents the relationship between derivatives and hedged items, as well as the risk-management objective and strategy for undertaking hedge transactions at the inception of the hedging relationship. This documentation includes linking the fair value or cash flow hedges to specific assets and liabilities on the statement of condition or to specific commitments or forecasted transactions. The Company also formally assesses, both at the hedge's inception and on an ongoing basis, whether the derivative instruments that are used are highly effective in offsetting changes in fair values or cash flows of the hedged items.

When hedge accounting is discontinued, subsequent changes in fair value of the derivative are recorded in noninterest income. When a fair value hedge is discontinued, the hedged asset or liability is no longer adjusted for changes in fair value and the existing basis adjustment is amortized or accreted over the remaining life of the asset or liability. When a cash flow hedge is discontinued, but the hedged cash flows or forecasted transactions are still expected to occur, gains or losses that were accumulated in other comprehensive income are amortized into earnings over the same periods which the hedged transactions will affect earnings.

Assets Under Management or Administration

Assets held in fiduciary or agency capacities for customers are not included in the accompanying consolidated statements of condition as they are not assets of the Company. All fees associated with providing asset management services are recorded on an accrual basis of accounting and are included in noninterest income.

Advertising

Advertising costs amounting to approximately $5.1 million, $5.7 million and $3.9 million for the years ending December 31, 2018, 2017 and 2016, respectively, are nondirect response in nature and expensed as incurred.

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Bank Owned Life Insurance

The Company owns life insurance policies on certain current and former employees and directors where the Bank is the beneficiary. Bank owned life insurance is recorded at the amount that can be realized under the insurance contract at the balance sheet date, which is the cash surrender value ("CSV") adjusted for other charges or other amounts due that are probable at settlement. Increases in the CSV of the policies, as well as the death benefits received, net of any CSV, are recorded in noninterest income, and are not subject to income taxes.

Earnings Per Share

Using the two-class method, basic earnings per common share is computed based upon net income available to common shareholders divided by the weighted average number of common shares outstanding during each period, which excludes the outstanding unvested restricted stock. Diluted earnings per share is computed using the weighted average number of common shares determined for the basic earnings per common share computation plus the dilutive effect of stock options using the treasury stock method. Stock options where the exercise price is greater than the average market price of common shares were not included in the computation of earnings per diluted share as they would have been anti-dilutive. Shares held in rabbi trusts related to deferred compensation plans are considered outstanding for purposes of computing earnings per share.

Stock-based Compensation

Companies are required to measure and record compensation expense for stock options and other share-based payments on the instruments' fair value on the date of grant. Stock-based compensation expense is recognized ratably over the requisite service period for all awards (see Note L).

Fair Values of Financial Instruments

The Company determines fair values based on quoted market values where available or on estimates using present values or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. In that regard, the derived fair value estimates cannot be substantiated by comparison to independent markets and, in many cases, could not be realized in immediate settlement of the instrument. Certain financial instruments and all nonfinancial instruments are excluded from this disclosure requirement. Accordingly, the aggregate fair value amounts presented do not represent the underlying value of the Company. The fair values of investment securities, loans, deposits, and borrowings have been disclosed in Note R.

Reclassifications

Certain reclassifications have been made to prior years' balances to conform to the current year presentation.

Recently Adopted Accounting Pronouncements

In May 2014, the FASB issued ASU No. 2014-09, Revenue from Contracts with Customers (Topic 606). This new guidance supersedes the revenue recognition requirements in ASC 605, Revenue Recognition, and is based on the principle that revenue is recognized to depict the transfer of goods or services to customers in an amount that reflects consideration to which the entity expects to be entitled in exchange for those goods and services. In doing so, companies generally will be required to use more judgment and make more estimates than under prior guidance. These may include identifying performance obligations in the contract, estimating the amount of variable consideration to include in the transaction price and allocating the transaction price to each separate performance obligation. Since the guidance does not apply to revenue associated with financial instruments, including loans and securities that are accounted for under other GAAP, the new guidance did not have a material impact on revenue most closely associated with financial instruments, including interest income, interest expense and mortgage banking income. The Company completed a comprehensive assessment of the revenue streams and reviewed related contracts potentially affected by the ASU for all segments of its business. Based on this assessment, the Company concluded that ASU 2014-09 did not materially change the manner in which the Company recognized revenue for these revenue streams. The Company also completed its evaluation of certain costs related to these revenue streams to determine whether such costs should be presented as expenses or contra-revenue (i.e. gross versus net) and timing of

compensatory payments to producers. Based on the Company's evaluation, it was determined that changes in the presentation of expenses and timing of the recognition of compensation expense did not materially affect noninterest income or expense. The Company adopted this guidance on January 1, 2018 utilizing the modified retrospective approach. Since there was no net income impact upon adoption of the new guidance, a cumulative effect adjustment to opening retained earnings was not deemed necessary.

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In January 2016, the FASB issued ASU 2016-01, Financial Instruments - Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities. This guidance addresses certain aspects of recognition, measurement, presentation and disclosure of financial instruments. The primary focus of this guidance is to supersede the guidance to classify equity securities with readily determinable fair values into different categories (trading or available-for-sale) and requires equity securities to be measured at fair value with changes in the fair value recognized through net income. This guidance requires adoption through a cumulative-effect adjustment to the balance sheet as of the beginning of the fiscal year of adoption. This ASU is effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The Company adopted this guidance on January 1, 2018. The impact of the adoption of this guidance resulted in the reclassification of $0.2 million of other comprehensive income to retained earnings. See the Consolidated Statements of Comprehensive Income and Consolidated Statement of Changes in Shareholders' Equity.

In August 2016, the FASB issued ASU No. 2016-15, Statement of Cash Flows (Topic 230). The amendments provide guidance on the following eight specific cash flow issues: 1) debt prepayment or debt extinguishment costs; 2) settlement of zero-coupon debt instruments or other debt instruments with coupon interest rates that are insignificant in relation to the effective interest rate of the borrowing; 3) contingent consideration payments made after a business combination; 4) proceeds from the settlement of insurance claims; 5) proceeds from the settlement of corporate-owned life insurance policies, including bank-owned life insurance policies; 6) distributions received from equity method investees; 7) beneficial interests in securitization transactions; and 8) separately identifiable cash flows and application of the predominance principle. This ASU is effective for fiscal years beginning after December 31, 2017, including interim periods within those fiscal years. The Company adopted this guidance on January 1, 2018 on a retrospective basis. The adoption of this ASU did not have a material impact on the Company's consolidated financial statements.

In March 2017, the FASB issued ASU No. 2017-07, Compensation – Retirement Benefits (Topic 715): Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost. This new guidance requires the service cost component of net periodic pension and postretirement benefit costs to be presented separately from other components of net benefit cost in the statement of income. This ASU is effective for the Company for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The Company adopted this guidance on January 1, 2018 and applied the guidance on a modified retrospective basis for the presentation of other components of net periodic benefit cost in the Consolidated Statements of Income. The impact of the adoption of this guidance resulted in the reclassification of net periodic benefit income of $6.9 million and $4.7 million from salaries and employee benefits to other expenses in the Consolidated Statement of Income for the year ended December 31, 2017 and December 31, 2016, respectively.

New Accounting Pronouncements

In February 2016, the FASB issued ASU 2016-02, Leases (Topic 842). This new guidance supersedes the lease requirements in Topic 840, Leases and is based on the principle that a lessee should recognize in the statement of financial position a liability to make lease payments (the lease liability) and a right-of-use asset representing its right to use the underlying asset for the lease term. The accounting applied by a lessor is largely unchanged from that applied under the previous guidance. In addition, the guidance requires an entity to separate the lease components from the nonlease components in a contract. The ASU requires disclosures about the amount, timing, and judgments related to a reporting entity's accounting for leases and related cash flows. The standard is required to be applied to all leases in existence as of the date of adoption using a modified retrospective transition approach. This guidance is effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. The Company occupies certain offices and uses certain equipment under non-cancelable operating lease agreements, which currently are not reflected in its consolidated statement of condition. The Company adopted this standard on January 1, 2019 using the cumulative-effect adjustment method and elected certain practical expedients allowed under the standard. The cumulative-effect adjustment was not material. The Company has implemented processes and a lease accounting system to ensure adequate internal controls were in place to assess our contracts and enable proper

accounting and reporting of financial information upon adoption. The increase in total assets and total liabilities was approximately $33.5 million. The impact on the Company's results of operations and cash flows was not material.



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In June 2016, the FASB issued ASU No. 2016-13, Financial Instruments – Credit Losses (Topic 326). This new guidance significantly changes how entities will measure credit losses for most financial assets and certain other instruments that are not measured at fair value through net income. This ASU will replace the "incurred loss" model under existing guidance with an "expected loss" model for instruments measured at amortized cost, and require entities to record allowances for available-for-sale debt securities rather than reduce the carrying amount, as they do today under the other-than-temporary impairment model. This ASU also simplifies the accounting model for purchased credit-impaired debt securities and loans. This guidance requires adoption through a cumulative-effect adjustment to retained earnings as of the beginning of the first reporting period in which the guidance is adopted. This ASU is effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. Early adoption is permitted for all companies as of fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. The Company is currently evaluating the impact the guidance will have on the Company's consolidated financial statements, and expects a change in the allowance for loan losses resulting from the change to expected losses for the estimated life of the financial asset. The amount of the change in the allowance for loan losses resulting from the new guidance will be impacted by the portfolio composition and asset quality at the adoption date, as well as economic conditions and forecasts at the time of adoption. Implementation efforts include evaluation of data requirements, segmentation of the Company's loan portfolio, guidance interpretation and consideration of relevant internal processes and controls.

In January 2017, the FASB issued ASU No. 2017-04, Intangibles-Goodwill and Other (Topic 350). The amendments simplify how an entity is required to test goodwill for impairment by eliminating the requirement to measure a goodwill impairment loss by comparing the implied fair value of a reporting unit's goodwill with the carrying amount of that goodwill. Instead, an entity will perform its goodwill impairment test by comparing the fair value of a reporting unit with its carrying amount, and recognize an impairment charge for the amount by which the carrying amount of the reporting unit exceeds its fair value. Impairment loss recognized under this new guidance will be limited to the goodwill allocated to the reporting unit. This ASU is effective prospectively for the Company for annual or interim goodwill impairment tests in fiscal years beginning after December 15, 2019. Early adoption is permitted for interim or annual goodwill impairment tests performed on testing dates after January 1, 2017. This ASU is not expected to have a material impact on the Company's consolidated financial statements.

In August 2017, the FASB issued ASU No. 2017-12, Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities. This new guidance amends current guidance to better align hedge accounting with risk management activities and reduce the complexity involved in applying hedge accounting. Under this new guidance, the concept of hedge ineffectiveness will be eliminated. Ineffective income generated by cash flow and net investment hedges will be recognized in the same financial reporting period and income statement line item as effective income, so as to reflect the full cost of hedging at one time and in one place. Ineffective income generated by fair value hedges will continue to be reflected in current period earnings; however, it will be recognized in the same income statement line item as effective income. The guidance will also allow any contractually specified variable rate to be designated as the hedged risk in a cash flow hedge. With respect to fair value hedges of interest rate risk, the guidance will allow changes in the fair value of the hedged item to be calculated solely using changes in the benchmark interest rate component of the instrument's total contractual coupon cash flows. This ASU is effective for the Company for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Early adoption is permitted, including adoption in an interim period. This ASU is not expected to have a material impact on the Company's consolidated financial statements.

## NOTE B: ACQUISITIONS

### Subsequent Event/ Pending Acquisition – Kinderhook Bank Corp.

On January 22, 2019, the Company announced that it had entered into a definitive agreement to acquire Kinderhook Bank Corp. ("Kinderhook"), parent company of The National Union Bank of Kinderhook headquartered in Kinderhook, New York (See Note V).

Subsequent Event – Wealth Resources Network, Inc.
On January 2, 2019, the Company, through its subsidiary, CISI, completed its acquisition of certain assets of Wealth Resources Network, Inc. ("Wealth Resources"), a financial services business headquartered in Liverpool, New York (See Note V).

On April 2, 2018, the Company, through its subsidiary, BPAS, acquired certain assets of HR Consultants (SA), LLC ("HR Consultants"), a provider of actuarial and benefit consulting services headquartered in Puerto Rico. The Company paid $0.3 million in cash to acquire the assets of HR Consultants and recorded intangible assets of $0.3 million in conjunction with the acquisition. The effects of the acquired assets have been included in the consolidated financial statements since that date.

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On January 2, 2018, the Company, through its subsidiary, OneGroup, completed its acquisition of certain assets of Penna & Associates Agency, Inc. ("Penna"), an insurance agency headquartered in Johnson City, New York. The Company paid $0.8 million in cash to acquire the assets of Penna, and recorded goodwill in the amount of $0.3 million and a customer list intangible asset of $0.3 million in conjunction with the acquisition. The effects of the acquired assets have been included in the consolidated financial statements since that date.

On January 2, 2018, the Company, through its subsidiary, CISI, completed its acquisition of certain assets of Styles Bridges Associates ("Styles Bridges"), a financial services business headquartered in Canton, New York. The Company paid $0.7 million in cash to acquire a customer list from Styles Bridges, and recorded a $0.7 million customer list intangible asset in conjunction with the acquisition. The effects of the acquired assets have been included in the consolidated financial statements since that date.

On December 4, 2017, the Company, through its subsidiary, OneGroup, completed its acquisition of Gordon B. Roberts Agency, Inc. ("GBR"), an insurance agency headquartered in Oneonta, New York for $3.7 million in Company stock and cash, comprised of $1.35 million in cash and the issuance of 0.04 million shares of common stock. The transaction resulted in the acquisition of $0.6 million of assets, $0.6 million of other liabilities, goodwill in the amount of $2.1 million and other intangible assets of $1.6 million. The effects of the acquired assets and liabilities have been included in the consolidated financial statements since that date.

On November 17, 2017, the Company, through its subsidiary, CISI, completed its acquisition of certain assets of Northeast Capital Management, Inc. ("NECM"), a financial services business headquartered in Wilkes-Barre, Pennsylvania. The Company paid $1.2 million in cash to acquire a customer list from NECM, and recorded a $1.2 million customer list intangible asset in conjunction with the acquisition. The effects of the acquired assets have been included in the consolidated financial statements since that date.

On May 12, 2017, the Company completed its acquisition of Merchants Bancshares, Inc. ("Merchants"), parent company of Merchants Bank, headquartered in South Burlington, Vermont, for $345.2 million in Company stock and cash, comprised of $82.9 million in cash and the issuance of 4.68 million shares of common stock. The acquisition extends the Company's footprint into the Vermont and Western Massachusetts markets with the addition of 31 branch locations in Vermont and one location in Massachusetts. This transaction resulted in the acquisition of $2.0 billion of assets, including $1.49 billion of loans and $370.6 million of investment securities, as well as $1.45 billion of deposits and $189.0 million in goodwill. The effects of the acquired assets and liabilities have been included in the consolidated financial statements since that date. Revenues of approximately $61.2 million and direct expenses, which may not include certain shared expenses, of approximately $30.8 million from Merchants were included in the consolidated income statement for the year ended December 31, 2018. Revenues of approximately $42.6 million and direct expenses, which may not include certain shared expenses, of approximately $19.9 million from Merchants were included in the consolidated income statement for the year ended December 31, 2017.

On March 1, 2017, the Company, through its subsidiary, OneGroup, completed its acquisition of certain assets of Dryfoos Insurance Agency, Inc. ("Dryfoos"), an insurance agency headquartered in Hazleton, Pennsylvania. The Company paid $3.0 million in cash to acquire the assets of Dryfoos, and recorded goodwill in the amount of $1.7 million and other intangible assets of $1.7 million in conjunction with the acquisition. The effects of the acquired assets and liabilities have been included in the consolidated financial statements since that date.

On February 3, 2017, the Company completed its acquisition of NRS and its subsidiary GTC, headquartered in Woburn, Massachusetts, for $148.6 million in Company stock and cash. NRS was a privately held corporation focused on providing institutional transfer agency, master recordkeeping services, custom target date fund administration, trust product administration and customized reporting services to institutional clients. Its wholly-owned subsidiary, GTC, is chartered in the State of Maine as a non-depository trust company and provides fiduciary services for collective investment trusts and other products. The acquisition of NRS and GTC, hereafter

referred to collectively as NRS, strengthens and complements the Company's existing employee benefit services businesses. Upon the completion of the merger, NRS became a wholly-owned subsidiary of BPAS and operates as Northeast Retirement Services, LLC, a Delaware limited liability company. This transaction resulted in the acquisition of $36.1 million in net tangible assets, principally cash and certificates of deposit, $60.2 million in customer list intangibles that will be amortized using the 150% declining balance method over 10 years, a $23.0 million deferred tax liability associated with the customer list intangible, and $75.3 million in goodwill. The effects of the acquired assets and liabilities have been included in the consolidated financial statements since that date. Revenues of $40.6 million and expenses of $24.6 million from NRS were included in the consolidated statement of income for the year ended December 31, 2018. Revenues of $31.5 million and expenses of $21.5 million from NRS were included in the consolidated statement of income for the year ended December 31, 2017.

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On January 1, 2017, the Company, through its subsidiary, OneGroup, acquired certain assets of Benefits Advisory Service, Inc. (“BAS”), a benefits consulting group headquartered in Forest Hills, New York. The Company paid $1.2 million in cash to acquire the assets of BAS and recorded intangible assets of $1.2 million in conjunction with the acquisition. The effects of the acquired assets and liabilities have been included in the consolidated financial statements since that date.

On January 4, 2016, the Company, through its subsidiary, CBNA Insurance Agency, Inc. (“CBNA Insurance”), completed its acquisition of WJL Agencies Inc. doing business as The Clark Insurance Agencies (“WJL”), an insurance agency operating in Canton, New York. The Company paid $0.6 million in cash for the intangible assets of the company. Goodwill in the amount of $0.3 million and intangible assets in the amount of $0.3 million were recorded in conjunction with the acquisition. The effects of the acquired assets and liabilities have been included in the consolidated financial statements since that date. On August 19, 2016, the Company merged together its insurance subsidiaries and as of that date, the activities of CBNA Insurance were merged into OneGroup.

The assets and liabilities assumed in the acquisitions were recorded at their estimated fair values based on management’s best estimates using information available at the dates of the acquisition, and were subject to adjustment based on updated information not available at the time of acquisition. During the first quarter of 2018, the carrying amount of other liabilities associated with the NRS acquisition decreased by $1.2 million as a result of an adjustment to deferred taxes. Goodwill associated with the NRS acquisition decreased $1.2 million as a result of this adjustment. During the second quarter of 2018, the carrying amount of other liabilities associated with the GBR acquisition decreased by $0.09 million as a result of updated information not available at the time of acquisition. Goodwill associated with the GBR acquisition decreased $0.09 million as a result of this adjustment. During the fourth quarter of 2018, the carrying amount of other liabilities associated with the GBR acquisition increased $0.02 million as a result of updated information not available at the time of acquisition. Goodwill associated with the GBR acquisition increased $0.02 million as a result of this adjustment.

The above referenced acquisitions generally expanded the Company’s geographical presence in New York, Pennsylvania, Vermont, and Western Massachusetts and management expects that the Company will benefit from greater geographic diversity and the advantages of other synergistic business development opportunities.

The following table summarizes the estimated fair value of the assets acquired and liabilities assumed after considering the measurement period adjustments described above:

| (000s omitted) | 2018 Other [1] | 2017 NRS | Merchants | Other [2] | Total | 2016 WJL |
|---|---|---|---|---|---|---|
| Consideration paid : | | | | | | |
| Cash | $ 1,753 | $ 70,073 | $ 82,898 | $ 6,775 | $ 159,746 | $ 575 |
| Community Bank System, Inc. common stock | 0 | 78,483 | 262,254 | 2,395 | 343,132 | 0 |
| Total net consideration paid | $ 1,753 | 148,556 | 345,152 | 9,170 | 502,878 | 575 |
| Recognized amounts of identifiable assets acquired and liabilities assumed: | | | | | | |
| Cash and cash equivalents | 16 | 11,063 | 40,730 | 339 | 52,132 | 0 |
| Investment securities | 0 | 20,294 | 370,648 | 0 | 390,942 | 0 |
| Loans | 0 | 0 | 1,488,157 | 0 | 1,488,157 | 0 |
| Premises and equipment | 10 | 411 | 16,608 | 27 | 17,046 | 0 |
| Accrued interest receivable | 0 | 72 | 4,773 | 0 | 4,845 | 0 |
| Other assets | 105 | 8,088 | 51,585 | 583 | 60,256 | 0 |
| Core deposit intangibles | 0 | 0 | 23,214 | 0 | 23,214 | 0 |
| Other intangibles | 1,343 | 60,200 | 2,857 | 5,626 | 68,683 | 288 |
| Deposits | 0 | 0 | (1,448,406) | 0 | (1,448,406) | 0 |

| | | | | | | |
|---|---|---|---|---|---|---|
| Other liabilities | (31) | (26,828) | (11,750) | (1,155) | (39,733) | 0 |
| Short-term advances | 0 | 0 | (80,000) | 0 | (80,000) | 0 |
| Securities sold under agreement to repurchase, short-term | 0 | 0 | (278,076) | 0 | (278,076) | 0 |
| Long-term debt | 0 | 0 | (3,615) | 0 | (3,615) | 0 |
| Subordinated debt held by unconsolidated subsidiary trusts | 0 | 0 | (20,619) | 0 | (20,619) | 0 |
| Total identifiable assets, net | 1,443 | 73,300 | 156,106 | 5,420 | 234,826 | 288 |
| Goodwill | $ 310 | $75,256 | $189,046 | $ 3,750 | $268,052 | $287 |

(1) Includes amounts related to the Penna, Styles Bridges and HR Consultants acquisitions.
(2) Includes amounts related to the BAS, Dryfoos, NECM and GBR acquisitions.

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Acquired loans that have evidence of deterioration in credit quality since origination and for which it is probable, at acquisition, that the Company will be unable to collect all contractually required payments were aggregated by comparable characteristics and recorded at fair value without a carryover of the related allowance for loan losses. Cash flows for each loan were determined using an estimate of credit losses and rate of prepayments. Projected monthly cash flows were then discounted to present value using a market-based discount rate. The excess of the undiscounted expected cash flows over the estimated fair value is referred to as the "accretable yield" and is recognized into interest income over the remaining lives of the acquired loans.

The following is a summary of the loans acquired from Merchants at the date of acquisition:

| (000s omitted) | Acquired Impaired Loans | Acquired Non-impaired Loans | Total Acquired Loans |
|---|---|---|---|
| Contractually required principal and interest at acquisition | $ 15,454 | $ 1,872,574 | $ 1,888,028 |
| Contractual cash flows not expected to be collected | (5,385 ) | (14,753 ) | (20,138 ) |
| Expected cash flows at acquisition | 10,069 | 1,857,821 | 1,867,890 |
| Interest component of expected cash flows | (793 ) | (378,940 ) | (379,733 ) |
| Fair value of acquired loans | $ 9,276 | $ 1,478,881 | $ 1,488,157 |

The fair value of checking, savings and money market deposit accounts acquired were assumed to approximate the carrying value as these accounts have no stated maturity and are payable on demand. Certificate of deposit accounts were valued at the present value of the certificates' expected contractual payments discounted at market rates for similar certificates.

The core deposit intangibles and other intangibles related to the Penna, Styles Bridges, HR Consultants, Merchants, Dryfoos, BAS, NECM, GBR, and WJL acquisitions are being amortized using an accelerated method over their estimated useful life of eight years. The goodwill, which is not amortized for book purposes, was assigned to the Banking segment for the Merchants acquisition, the Employee Benefit Services segment for NRS, and All Other segments for the Penna, Dryfoos, BAS, GBR, and WJL acquisitions. Goodwill arising from the Merchants, NRS, and GBR acquisitions is not deductible for tax purposes. Goodwill arising from the Penna, Dryfoos, BAS, GBR, and WJL acquisitions is deductible for tax purposes.

Direct costs related to the acquisitions were expensed as incurred. Merger and acquisition integration-related (recoveries) expenses amount to $(0.8) million, $26.0 million and $1.7 million during 2018, 2017 and 2016, respectively, and have been separately stated in the consolidated statements of income.

Supplemental Pro Forma Financial Information

The following unaudited condensed pro forma information assumes the Merchants and NRS acquisitions had been completed as of January 1, 2016 for the year ended December 31, 2017 and December 31, 2016. The pro forma information does not include amounts related to BAS, Dryfoos, NECM and GBR as the amounts were immaterial. The table below has been prepared for comparative purposes only and is not necessarily indicative of the actual results that would have been attained had the acquisitions occurred as of the beginning of the year presented, nor is it indicative of the Company's future results. Furthermore, the unaudited pro forma information does not reflect management's estimate of any revenue-enhancing opportunities nor anticipated cost savings that may have occurred as a result of the integration and consolidation of the acquisitions.

The pro forma information set forth below reflects the historical results of Merchants and NRS combined with the Company's consolidated statement of income with adjustments related to (a) certain purchase accounting fair value adjustments and (b) amortization of customer lists and core deposit intangibles. Acquisition expenses related to the Merchants and NRS transactions totaling $25.7 million for the year ended December 31, 2017 were included in the

pro forma information as if they were incurred in 2016.

| | Pro Forma (Unaudited) | |
|---|---|---|
| | Year Ended December 31, | |
| (000's omitted) | 2017 | 2016 |
| Total revenue, net of interest expense | $ 546,977 | $ 536,183 |
| Net income | 176,257 | 109,186 |

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NOTE C: INVESTMENT SECURITIES

The amortized cost and estimated fair value of investment securities as of December 31 are as follows:

| | 2018 | | | | 2017 | | | |
|---|---|---|---|---|---|---|---|---|
| (000's omitted) | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Estimated Fair Value | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Estimated Fair Value |
| Available-for-Sale Portfolio: | | | | | | | | |
| U.S. Treasury and agency securities | $2,036,474 | $2,190 | $14,911 | $2,023,753 | $2,043,023 | $15,886 | $4,838 | $2,054,071 |
| Obligations of state and political subdivisions | 453,640 | 6,563 | 1,049 | 459,154 | 514,949 | 14,064 | 57 | 528,956 |
| Government agency mortgage-backed securities | 390,234 | 1,526 | 9,283 | 382,477 | 358,180 | 3,121 | 3,763 | 357,538 |
| Corporate debt securities | 2,588 | 0 | 42 | 2,546 | 2,648 | 0 | 25 | 2,623 |
| Government agency collateralized mortgage obligations | 69,342 | 60 | 1,283 | 68,119 | 88,097 | 155 | 878 | 87,374 |
| Marketable equity securities | 0 | 0 | 0 | 0 | 251 | 275 | 0 | 526 |
| Total available-for-sale portfolio | $2,952,278 | $10,339 | $26,568 | $2,936,049 | $3,007,148 | $33,501 | $9,561 | $3,031,088 |
| | | | | | | | | |
| Equity and other Securities: | | | | | | | | |
| Equity securities, at fair value | $251 | $200 | $19 | $432 | $0 | $0 | $0 | $0 |
| Federal Home Loan Bank common stock | 8,768 | 0 | 0 | 8,768 | 9,896 | 0 | 0 | 9,896 |
| Federal Reserve Bank common stock | 30,690 | 0 | 0 | 30,690 | 30,690 | 0 | 0 | 30,690 |
| Certificates of deposit | 0 | 0 | 0 | 0 | 3,865 | 0 | 0 | 3,865 |
| Other equity securities, at adjusted cost | 4,969 | 750 | 0 | 5,719 | 5,840 | 0 | 0 | 5,840 |
| Total equity and other securities | $44,678 | $950 | $19 | $45,609 | $50,291 | $0 | $0 | $50,291 |

A summary of investment securities that have been in a continuous unrealized loss position for less than or greater than twelve months is as follows:

As of December 31, 2018

| | Less than 12 Months | | | 12 Months or Longer | | | Total | | |
|---|---|---|---|---|---|---|---|---|---|
| (000's omitted) | # | Fair Value | Gross Unrealized Losses | # | Fair Value | Gross Unrealized Losses | # | Fair Value | Gross Unrealized Losses |
| Available-for-Sale Portfolio: | | | | | | | | | |
| U.S. Treasury and agency securities | 7 | $473,082 | $ 682 | 64 | $1,213,276 | $ 14,229 | 71 | $1,686,358 | $ 14,911 |
| Obligations of state and political subdivisions | 118 | 55,671 | 216 | 97 | 51,753 | 833 | 215 | 107,424 | 1,049 |
| Government agency mortgage-backed securities | 43 | 47,708 | 258 | 181 | 253,931 | 9,025 | 224 | 301,639 | 9,283 |
| Corporate debt securities | 0 | 0 | 0 | 1 | 2,546 | 42 | 1 | 2,546 | 42 |
| Government agency collateralized mortgage obligations | 1 | 66 | 0 | 41 | 63,112 | 1,283 | 42 | 63,178 | 1,283 |
| Total available-for-sale investment portfolio | 169 | $576,527 | $ 1,156 | 384 | $1,584,618 | $ 25,412 | 553 | $2,161,145 | $ 26,568 |
| Equity and other Securities: | | | | | | | | | |
| Equity securities, at fair value | 1 | $82 | $ 19 | 0 | $0 | $0 | 1 | $82 | $ 19 |
| Total equity and other securities | 1 | $82 | $ 19 | 0 | $0 | $0 | 1 | $82 | $ 19 |

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As of December 31, 2017

| | Less than 12 Months | | | 12 Months or Longer | | | Total | | |
|---|---|---|---|---|---|---|---|---|---|
| (000's omitted) | # | Fair Value | Gross Unrealized Losses | # | Fair Value | Gross Unrealized Losses | # | Fair Value | Gross Unrealized Losses |
| Available-for-Sale Portfolio: | | | | | | | | | |
| U.S. Treasury and agency securities | 44 | $699,709 | $ 4,838 | 0 | $ 0 | $ 0 | 44 | $699,709 | $ 4,838 |
| Obligations of state and political subdivisions | 45 | 23,432 | 57 | 0 | 0 | 0 | 45 | 23,432 | 57 |
| Government agency mortgage-backed securities | 120 | 185,716 | 1,433 | 55 | 75,712 | 2,330 | 175 | 261,428 | 3,763 |
| Corporate debt securities | 1 | 2,623 | 25 | 0 | 0 | 0 | 1 | 2,623 | 25 |
| Government agency collateralized mortgage obligations | 39 | 80,041 | 878 | 1 | 1 | 0 | 40 | 80,042 | 878 |
| Total available-for-sale investment portfolio | 249 | $991,521 | $ 7,231 | 56 | $ 75,713 | $ 2,330 | 305 | $1,067,234 | $ 9,561 |

The unrealized losses reported pertaining to securities issued by the U.S. government and its sponsored entities, include treasuries, agencies, and mortgage-backed securities issued by Ginnie Mae, Fannie Mae, and Freddie Mac which are currently rated AAA by Moody's Investor Services, AA+ by Standard & Poor's and are guaranteed by the U.S. government. The majority of the obligations of state and political subdivisions and corporations carry a credit rating of A or better. Additionally, a majority of the obligations of state and political subdivisions carry a secondary level of credit enhancement. The Company does not intend to sell these securities, nor is it more likely than not that the Company will be required to sell these securities prior to recovery of the amortized cost. The unrealized losses in the portfolios are primarily attributable to changes in interest rates. As such, management does not believe any individual unrealized loss as of December 31, 2018 represents OTTI.

The amortized cost and estimated fair value of debt securities at December 31, 2018, by contractual maturity, are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties. Securities not due at a single maturity date are shown separately.

| | Available-for-Sale | |
|---|---|---|
| (000's omitted) | Amortized Cost | Fair Value |
| Due in one year or less | $58,214 | $58,128 |
| Due after one through five years | 2,126,742 | 2,115,304 |
| Due after five years through ten years | 158,282 | 160,694 |
| Due after ten years | 149,464 | 151,327 |
| Subtotal | 2,492,702 | 2,485,453 |
| Government agency mortgage-backed securities | 390,234 | 382,477 |
| Government agency collateralized mortgage obligations | 69,342 | 68,119 |
| Total | $2,952,278 | $2,936,049 |

Investment securities with a carrying value of $1.447 billion and $1.530 billion at December 31, 2018 and 2017, respectively, were pledged to collateralize certain deposits and borrowings. Securities pledged to collateralize certain

deposits and borrowings included $492.4 million and $473.2 million of U.S. Treasury securities that were pledged as collateral for securities sold under agreement to repurchase at December 31, 2018, and 2017, respectively. All securities sold under agreement to repurchase as of December 31, 2018 and 2017 have an overnight and continuous maturity.

NOTE D: LOANS

The segments of the Company's loan portfolio are disaggregated into the following classes that allow management to monitor risk and performance:

- Consumer mortgages consist primarily of fixed rate residential instruments, typically 10 – 30 years in contractual term, secured by first liens on real property.
- Business lending is comprised of general purpose commercial and industrial loans including, but not limited to agricultural-related and dealer floor plans, as well as mortgages on commercial property.
- Consumer indirect consists primarily of installment loans originated through selected dealerships and are secured by automobiles, marine and other recreational vehicles.
- Consumer direct consists of all other loans to consumers such as personal installment loans and lines of credit.
- Home equity products are consumer purpose installment loans or lines of credit most often secured by a first or second lien position on residential real estate with terms up to 30 years.

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The balances of these classes at December 31 are summarized as follows:

| (000's omitted) | 2018 | 2017 |
|---|---|---|
| Business lending | $2,396,977 | $2,424,223 |
| Consumer mortgage | 2,235,408 | 2,220,298 |
| Consumer indirect | 1,083,207 | 1,011,978 |
| Consumer direct | 178,820 | 179,929 |
| Home equity | 386,709 | 420,329 |
| Gross loans, including deferred origination costs | 6,281,121 | 6,256,757 |
| Allowance for loan losses | (49,284 ) | (47,583 ) |
| Loans, net of allowance for loan losses | $6,231,837 | $6,209,174 |

The Company had approximately $28.4 million and $25.3 million of net deferred loan origination costs included in gross loans as of December 31, 2018 and 2017, respectively.

Certain directors and executive officers of the Company, as well as associates of such persons, are loan customers. Loans to these individuals were made in the ordinary course of business under normal credit terms and do not have more than a normal risk of collection. Following is a summary of the aggregate amount of such loans during 2018 and 2017.

| (000's omitted) | 2018 | 2017 |
|---|---|---|
| Balance at beginning of year | $22,344 | $10,950 |
| New loans | 2,600 | 16,617 |
| Payments | (4,283 ) | (5,223 ) |
| Balance at end of year | $20,661 | $22,344 |

Acquired loans

Acquired loans are recorded at fair value as of the date of purchase with no allowance for loan loss. The outstanding principal balance and the related carrying amount of acquired loans included in the Consolidated Statement of Condition at December 31 are as follows:

| (000's omitted) | 2018 | 2017 |
|---|---|---|
| Credit impaired acquired loans: | | |
| Outstanding principal balance | $6,936 | $13,242 |
| Carrying amount | 5,446 | 10,115 |
| | | |
| Non-impaired acquired loans: | | |
| Outstanding principal balance | 1,271,584 | 1,658,780 |
| Carrying amount | 1,247,691 | 1,626,979 |
| | | |
| Total acquired loans: | | |
| Outstanding principal balance | 1,278,520 | 1,672,022 |
| Carrying amount | 1,253,137 | 1,637,094 |

The outstanding balance related to credit impaired acquired loans was $7.0 million and $13.4 million at December 31, 2018 and 2017, respectively. The changes in the accretable discount related to the credit impaired acquired loans are as follows:

| (000's omitted) | 2018 | 2017 |
|---|---|---|
| Balance at beginning of year | $976 | $498 |

| | | |
|---|---|---|
| Merchants acquisition | 0 | 793 |
| Accretion recognized | (783) | (905) |
| Net reclassification to accretable from nonaccretable | 244 | 590 |
| Balance at end of year | $437 | $976 |

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Credit Quality

Management monitors the credit quality of its loan portfolio on an ongoing basis. Measurement of delinquency and past due status are based on the contractual terms of each loan. Past due loans are reviewed on a monthly basis to identify loans for non-accrual status. The following is an aged analysis of the Company's past due loans by class as of December 31, 2018:

Legacy Loans (excludes loans acquired after January 1, 2009)

| (000's omitted) | Past Due 30 - 89 days | 90+ Days Past Due and Still Accruing | Nonaccrual | Total Past Due | Current | Total Loans |
|---|---|---|---|---|---|---|
| Business lending | $ 5,261 | $ 179 | $ 4,872 | $ 10,312 | $ 1,608,515 | $ 1,618,827 |
| Consumer mortgage | 12,468 | 1,393 | 9,872 | 23,733 | 1,824,717 | 1,848,450 |
| Consumer indirect | 14,609 | 258 | 0 | 14,867 | 1,057,525 | 1,072,392 |
| Consumer direct | 1,778 | 48 | 0 | 1,826 | 173,948 | 175,774 |
| Home equity | 983 | 228 | 1,438 | 2,649 | 309,892 | 312,541 |
| Total | $ 35,099 | $ 2,106 | $ 16,182 | $ 53,387 | $4,974,597 | $ 5,027,984 |

Acquired Loans (includes loans acquired after January 1, 2009)

| (000's omitted) | Past Due 30 - 89 days | 90+ Days Past Due and Still Accruing | Nonaccrual | Total Past Due | Acquired Impaired(1) | Current | Total Loans |
|---|---|---|---|---|---|---|---|
| Business lending | $ 974 | $ 0 | $ 3,498 | $ 4,472 | $ 5,446 | $ 768,232 | $ 778,150 |
| Consumer mortgage | 841 | 232 | 2,390 | 3,463 | 0 | 383,495 | 386,958 |
| Consumer indirect | 78 | 34 | 0 | 112 | 0 | 10,703 | 10,815 |
| Consumer direct | 115 | 4 | 0 | 119 | 0 | 2,927 | 3,046 |
| Home equity | 613 | 79 | 474 | 1,166 | 0 | 73,002 | 74,168 |
| Total | $ 2,621 | $ 349 | $ 6,362 | $ 9,332 | $ 5,446 | $ 1,238,359 | $ 1,253,137 |

(1) Acquired impaired loans were not classified as nonperforming assets as the loans are considered to be performing under ASC 310-30. As a result interest income, through the accretion of the difference between the carrying amount of the loans and the expected cashflows, is being recognized on all acquired impaired loans.

The following is an aged analysis of the Company's past due loans by class as of December 31, 2017:

Legacy Loans (excludes loans acquired after January 1, 2009)

| (000's omitted) | Past Due 30 - 89 days | 90+ Days Past Due and Still Accruing | Nonaccrual | Total Past Due | Current | Total Loans |
|---|---|---|---|---|---|---|
| Business lending | $ 2,283 | $ 571 | $ 3,944 | $ 6,798 | $ 1,369,801 | $ 1,376,599 |
| Consumer mortgage | 13,564 | 1,500 | 10,722 | 25,786 | 1,728,823 | 1,754,609 |
| Consumer indirect | 14,197 | 295 | 0 | 14,492 | 977,344 | 991,836 |
| Consumer direct | 1,875 | 48 | 0 | 1,923 | 172,556 | 174,479 |
| Home equity | 1,116 | 94 | 1,354 | 2,564 | 319,576 | 322,140 |
| Total | $ 33,035 | $ 2,508 | $ 16,020 | $ 51,563 | $4,568,100 | $ 4,619,663 |

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Acquired Loans (includes loans acquired after January 1, 2009)

| (000's omitted) | Past Due 30 - 89 days | 90+ Days Past Due and Still Accruing | Nonaccrual | Total Past Due | Acquired Impaired[1] | Current | Total Loans |
|---|---|---|---|---|---|---|---|
| Business lending | $ 4,661 | $ 0 | $ 4,328 | $ 8,989 | $ 10,115 | $ 1,028,520 | $ 1,047,624 |
| Consumer mortgage | 2,603 | 26 | 3,066 | 5,695 | 0 | 459,994 | 465,689 |
| Consumer indirect | 245 | 8 | 0 | 253 | 0 | 19,889 | 20,142 |
| Consumer direct | 100 | 0 | 0 | 100 | 0 | 5,350 | 5,450 |
| Home equity | 634 | 170 | 1,326 | 2,130 | 0 | 96,059 | 98,189 |
| Total | $ 8,243 | $ 204 | $ 8,720 | $ 17,167 | $ 10,115 | $ 1,609,812 | $ 1,637,094 |

(1) Acquired impaired loans were not classified as nonperforming assets as the loans are considered to be performing under ASC 310-30. As a result interest income, through the accretion of the difference between the carrying amount of the loans and the expected cashflows, is being recognized on all acquired impaired loans.

The Company uses several credit quality indicators to assess credit risk in an ongoing manner. The Company's primary credit quality indicator for its business lending portfolio is an internal credit risk rating system that categorizes loans as "pass", "special mention", "classified", or "doubtful". Credit risk ratings are applied individually to those classes of loans that have significant or unique credit characteristics that benefit from a case-by-case evaluation. In general, the following are the definitions of the Company's credit quality indicators:

Pass The condition of the borrower and the performance of the loans are satisfactory or better.

Special Mention The condition of the borrower has deteriorated although the loan performs as agreed.

Classified The condition of the borrower has significantly deteriorated and the performance of the loan could further deteriorate if deficiencies are not corrected.

Doubtful The condition of the borrower has deteriorated to the point that collection of the balance is improbable based on current facts and conditions.

The following table shows the amount of business lending loans by credit quality category:

| | December 31, 2018 | | | December 31, 2017 | | |
|---|---|---|---|---|---|---|
| (000's omitted) | Legacy | Acquired | Total | Legacy | Acquired | Total |
| Pass | $1,439,337 | $702,493 | $2,141,830 | $1,170,156 | $963,981 | $2,134,137 |
| Special mention | 105,065 | 40,107 | 145,172 | 129,076 | 37,321 | 166,397 |
| Classified | 74,425 | 28,525 | 102,950 | 77,367 | 34,628 | 111,995 |
| Doubtful | 0 | 1,579 | 1,579 | 0 | 1,579 | 1,579 |
| Acquired impaired | 0 | 5,446 | 5,446 | 0 | 10,115 | 10,115 |
| Total | $1,618,827 | $778,150 | $2,396,977 | $1,376,599 | $1,047,624 | $2,424,223 |

All other loans are underwritten and structured using standardized criteria and characteristics, primarily payment performance, and are normally risk rated and monitored collectively on a monthly basis. These are typically loans to individuals in the consumer categories and are delineated as either performing or nonperforming. Performing loans include current, 30 – 89 days past due and acquired impaired loans. Nonperforming loans include 90+ days past due and still accruing and nonaccrual loans. The following tables detail the balances in all loan categories except for business lending at December 31, 2018:

Legacy loans (excludes loans acquired after January 1, 2009)

| (000's omitted) | Consumer Mortgage | Consumer Indirect | Consumer Direct | Home Equity | Total |
|---|---|---|---|---|---|
| Performing | $1,837,185 | $1,072,134 | $175,726 | $310,875 | $3,395,920 |
| Nonperforming | 11,265 | 258 | 48 | 1,666 | 13,237 |
| Total | $1,848,450 | $1,072,392 | $175,774 | $312,541 | $3,409,157 |

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Acquired loans (includes loans acquired after January 1, 2009)

| (000's omitted) | Consumer Mortgage | Consumer Indirect | Consumer Direct | Home Equity | Total |
|---|---|---|---|---|---|
| Performing | $384,336 | $ 10,781 | $ 3,042 | $73,615 | $471,774 |
| Nonperforming | 2,622 | 34 | 4 | 553 | 3,213 |
| Total | $386,958 | $ 10,815 | $ 3,046 | $74,168 | $474,987 |

The following table details the balances in all other loan categories at December 31, 2017:

Legacy loans (excludes loans acquired after January 1, 2009)

| (000's omitted) | Consumer Mortgage | Consumer Indirect | Consumer Direct | Home Equity | Total |
|---|---|---|---|---|---|
| Performing | $1,742,387 | $991,541 | $174,431 | $320,692 | $3,229,051 |
| Nonperforming | 12,222 | 295 | 48 | 1,448 | 14,013 |
| Total | $1,754,609 | $991,836 | $174,479 | $322,140 | $3,243,064 |

Acquired loans (includes loans acquired after January 1, 2009)

| (000's omitted) | Consumer Mortgage | Consumer Indirect | Consumer Direct | Home Equity | Total |
|---|---|---|---|---|---|
| Performing | $462,597 | $ 20,134 | $ 5,450 | $96,693 | $584,874 |
| Nonperforming | 3,092 | 8 | 0 | 1,496 | 4,596 |
| Total | $465,689 | $ 20,142 | $ 5,450 | $98,189 | $589,470 |

All loan classes are collectively evaluated for impairment except business lending, as described in Note A. A summary of individually evaluated impaired loans as of December 31, 2018 and 2017 is as follows:

| (000's omitted) | 2018 | 2017 |
|---|---|---|
| Loans with allowance allocation | $3,956 | $5,125 |
| Loans without allowance allocation | 2,230 | 884 |
| Carrying balance | 6,186 | 6,009 |
| Contractual balance | 12,078 | 9,165 |
| Specifically allocated allowance | 956 | 804 |
| Average impaired loans | 7,618 | 9,517 |
| Interest income recognized | 0 | 0 |

In the course of working with borrowers, the Company may choose to restructure the contractual terms of certain loans. In this scenario, the Company attempts to work-out an alternative payment schedule with the borrower in order to optimize collectability of the loan. Any loans that are modified are reviewed by the Company to identify if a troubled debt restructuring ("TDR") has occurred, which is when, for economic or legal reasons related to a borrower's financial difficulties, the Company grants a concession to the borrower that it would not otherwise consider. Terms may be modified to fit the ability of the borrower to repay in line with its current financial standing and the restructuring of the loan may include the transfer of assets from the borrower to satisfy the debt, a modification of loan terms, or a combination of the two. With regard to determination of the amount of the allowance for loan losses, troubled debt restructured loans are considered to be impaired. As a result, the determination of the amount of allowance for loan losses related to impaired loans for each portfolio segment within TDRs is the same as detailed previously.

In accordance with clarified guidance issued by the OCC, loans that have been discharged in Chapter 7 bankruptcy but not reaffirmed by the borrower, are classified as TDRs, irrespective of payment history or delinquency status, even if

the repayment terms for the loan have not been otherwise modified. The Company's lien position against the underlying collateral remains unchanged. Pursuant to that guidance, the Company records a charge-off equal to any portion of the carrying value that exceeds the net realizable value of the collateral. The amount of loss incurred in 2018, 2017 and 2016 was immaterial.

TDRs less than $0.5 million are collectively included in the general loan loss allocation and the qualitative review, if necessary. Commercial loans greater than $0.5 million are individually evaluated for impairment, and if necessary, a specific allocation of the allowance for loan losses is provided.

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Information regarding TDRs as of December 31, 2018 and December 31, 2017 is as follows

| | December 31, 2018 | | | | | | December 31, 2017 | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| (000's omitted) | Nonaccrual | | Accruing | | Total | | Nonaccrual | | Accruing | | Total | |
| | # | Amount | # | Amount | # | Amount | # | Amount | # | Amount | # | Amount |
| Business lending | 4 | $ 162 | 2 | $ 165 | 6 | $ 327 | 8 | $ 218 | 7 | $ 501 | 15 | $ 719 |
| Consumer mortgage | 46 | 1,986 | 46 | 1,769 | 92 | 3,755 | 51 | 2,265 | 44 | 1,750 | 95 | 4,015 |
| Consumer indirect | 0 | 0 | 77 | 857 | 77 | 857 | 0 | 0 | 71 | 883 | 71 | 883 |
| Consumer direct | 0 | 0 | 22 | 71 | 22 | 71 | 0 | 0 | 25 | 69 | 25 | 69 |
| Home equity | 12 | 240 | 9 | 275 | 21 | 515 | 13 | 245 | 7 | 204 | 20 | 449 |
| Total | 62 | $ 2,388 | 156 | $ 3,137 | 218 | $ 5,525 | 72 | $ 2,728 | 154 | $ 3,407 | 226 | $ 6,135 |

The following table presents information related to loans modified in a TDR during the years ended December 31, 2018 and 2017. Of the loans noted in the table below, all loans for the years ended December 31, 2018 and December 31, 2017, were modified due to a Chapter 7 bankruptcy as described previously. The financial effects of these restructurings were immaterial.

| | December 31, 2018 | | December 31, 2017 | |
|---|---|---|---|---|
| (000's omitted) | # | Amount | # | Amount |
| Business lending | 2 | $ 103 | 8 | $ 412 |
| Consumer mortgage | 9 | 470 | 23 | 1,254 |
| Consumer indirect | 32 | 320 | 33 | 490 |
| Consumer direct | 6 | 24 | 6 | 17 |
| Home equity | 3 | 118 | 4 | 95 |
| Total | 52 | $ 1,035 | 74 | $ 2,268 |

Allowance for Loan Losses

The allowance for loan losses is general in nature and is available to absorb losses from any loan type despite the analysis below. The following presents by class the activity in the allowance for loan losses:

| (000's omitted) | Business Lending | Consumer Mortgage | Consumer Indirect | Consumer Direct | Home Equity | Unallocated | Acquired Impaired | Total |
|---|---|---|---|---|---|---|---|---|
| Balance at December 31, 2015 | $ 15,749 | $ 10,198 | $ 12,422 | $ 2,997 | $ 2,666 | $ 1,201 | $ 168 | $ 45,401 |
| Charge-offs | (1,872 ) | (647 ) | (7,643 ) | (1,706 ) | (218 ) | 0 | (97 ) | (12,183) |
| Recoveries | 616 | 115 | 4,168 | 901 | 139 | 0 | 0 | 5,939 |
| Provision | 2,727 | 428 | 4,835 | 787 | (188 ) | (550 ) | 37 | 8,076 |
| Balance at December 31, 2016 | 17,220 | 10,094 | 13,782 | 2,979 | 2,399 | 651 | 108 | 47,233 |
| Charge-offs | (4,959 ) | (707 ) | (8,456 ) | (2,081 ) | (284 ) | 0 | (270 ) | (16,757) |
| Recoveries | 656 | 50 | 4,516 | 849 | 52 | 0 | 0 | 6,123 |
| Provision | 4,340 | 1,028 | 3,626 | 1,292 | (60 ) | 449 | 309 | 10,984 |
| Balance at December 31, 2017 | 17,257 | 10,465 | 13,468 | 3,039 | 2,107 | 1,100 | 147 | 47,583 |
| Charge-offs | (3,566 ) | (836 ) | (8,382 ) | (1,777 ) | (544 ) | 0 | (381 ) | (15,486) |
| Recoveries | 485 | 136 | 4,874 | 807 | 48 | 0 | 0 | 6,350 |
| Provision | 4,346 | 359 | 4,406 | 1,026 | 533 | (100 ) | 267 | 10,837 |
| Balance at December 31, 2018 | $ 18,522 | $ 10,124 | $ 14,366 | $ 3,095 | $ 2,144 | $ 1,000 | $ 33 | $ 49,284 |

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NOTE E: PREMISES AND EQUIPMENT

Premises and equipment consist of the following at December 31:

| (000's omitted) | 2018 | 2017 |
|---|---|---|
| Land and land improvements | $24,340 | $23,869 |
| Bank premises | 133,259 | 131,647 |
| Equipment and construction in progress | 89,950 | 86,059 |
| Premises and equipment, gross | 247,549 | 241,575 |
| Accumulated depreciation | (127,561 ) | (118,182) |
| Premises and equipment, net | $119,988 | $123,393 |

NOTE F: GOODWILL AND IDENTIFIABLE INTANGIBLE ASSETS

The gross carrying amount and accumulated amortization for each type of identifiable intangible asset are as follows:

| | December 31, 2018 | December 31, 2017 |
|---|---|---|