COMMUNITY BANK SYSTEM INC
Form 10-Q
May 10, 2013

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

FORM 10-Q

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended March 31, 2013

OR

o 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 (State or other jurisdiction of incorporation or organization)	16-1213679 (I.R.S. Employer Identification No.)
5790 Widewaters Parkway, DeWitt, New York (Address of principal executive offices)	13214-1883 (Zip Code)

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

NONE
(Former name, former address and former fiscal year, if changed since last report)

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 x No o.

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

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

Large accelerated filer x	Accelerated filer o	Non-accelerated filer o	Smaller reporting company o.
	(Do not check if a smaller reporting company)		

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.
40,003,413 shares of Common Stock, $1.00 par value, were outstanding on April 30, 2013.

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Item 1. Financial Statements

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

	March 31, 2013	December 31, 2012
Assets:		
Cash and cash equivalents	$330,298	$228,558
Available-for-sale investment securities (cost of $1,708,841 and $1,989,938, respectively)	1,773,634	2,121,394
Held-to-maturity investment securities (fair value of $693,349 and $703,957, respectively)	631,984	637,894
Other securities, at cost	42,502	59,239
Loans	3,861,601	3,865,576
Allowance for loan losses	(42,913)	(42,888)
Net loans	3,818,688	3,822,688
Goodwill, net	369,703	369,703
Core deposit intangibles, net	13,554	14,492
Other intangibles, net	2,697	2,939
Intangible assets, net	385,954	387,134
Premises and equipment, net	89,360	89,938
Accrued interest and fee receivable	26,993	32,305
Other assets	121,660	117,650
Total assets	$7,221,073	$7,496,800
Liabilities:		
Noninterest-bearing deposits	$1,115,417	$1,110,994
Interest-bearing deposits	4,659,407	4,517,045
Total deposits	5,774,824	5,628,039
Borrowings	361,422	728,061
Subordinated debt held by unconsolidated subsidiary trusts	102,079	102,073
Accrued interest and other liabilities	105,454	135,849
Total liabilities	6,343,779	6,594,022
Commitments and contingencies (See Note J)		
Shareholders' equity:		
	-	-

Preferred stock $1.00 par value, 500,000 shares authorized, 0 shares issued		
Common stock, $1.00 par value, 50,000,000 shares authorized; 40,771,423 and 40,421,493 shares issued, respectively	40,771	40,421
Additional paid-in capital	383,902	378,413
Retained earnings	456,524	447,018
Accumulated other comprehensive income	13,212	54,334
Treasury stock, at cost (782,173 and 795,560 shares, respectively)	(17,115)	(17,408)
Total shareholders' equity	877,294	902,778
Total liabilities and shareholders' equity	$7,221,073	$7,496,800

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

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

	Three Months Ended March 31, 2013	2012
Interest income:		
Interest and fees on loans	$47,118	$47,638
Interest and dividends on taxable investments	15,216	14,275
Interest and dividends on nontaxable investments	5,591	5,598
Total interest income	67,925	67,511
Interest expense:		
Interest on deposits	3,142	5,509
Interest on borrowings	5,730	7,400
Interest on subordinated debt held by unconsolidated subsidiary trusts	628	693
Total interest expense	9,500	13,602
Net interest income	58,425	53,909
Less: Provision for loan losses	1,393	1,644
Net interest income after provision for loan losses	57,032	52,265
Noninterest income:		
Deposit service fees	11,595	10,369
Other banking services	1,038	994
Benefit trust, administration, consulting and actuarial fees	9,770	8,973
Wealth management services	3,698	3,132
Gain on sales of investment securities	47,791	0
Loss on debt extinguishments	(47,783)	0
Total noninterest income	26,109	23,468
Noninterest expenses:		
Salaries and employee benefits	30,483	27,425
Occupancy and equipment	7,065	6,463
Data processing and communications	6,277	5,583
Amortization of intangible assets	1,179	1,086
Legal and professional fees	2,399	2,208
Office supplies and postage	1,495	1,468
	1,479	1,172

Business development and marketing		
FDIC insurance premiums	1,055	906
Acquisition expenses	0	260
Other	3,120	2,832
Total noninterest expenses	54,552	49,403
Income before income taxes	28,589	26,330
Income taxes	8,348	7,504
Net income	$20,241	$18,826
Basic earnings per share	$0.51	$0.49
Diluted earnings per share	$0.50	$0.48
Cash dividends declared per share	$0.27	$0.26

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

COMMUNITY BANK SYSTEM, INC.
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME/(LOSS)
(Unaudited)
(In Thousands)

	Three Months Ended March 31, 2013	2012
Pension and other post retirement obligations:		
Amortization of actuarial losses included in net periodic pension cost, net of taxes of $392 and $359 in 2013 and 2012, respectively	$618	$566
Amortization of prior service cost included in net periodic pension cost, net of taxes of $12 and $94 in 2013 and 2012, respectively	(18)	(148)
Other comprehensive income related to pension and other post retirement obligations, net of taxes	600	418
Unrealized gains on securities:		
Net unrealized holding losses arising during period, net of taxes of $7,098 and $2,424 in 2013 and 2012, respectively	(11,774)	(4,586)
Reclassification adjustment for gains included in net income, net of taxes of $17,844 and $0 in 2013 and 2012, respectively	(29,948)	0
Other comprehensive loss related to unrealized gain on available-for-sale securities, net of taxes	(41,722)	(4,586)
Other comprehensive loss, net of tax	(41,122)	(4,168)
Net income	20,241	18,826
Comprehensive (loss) income	($20,881)	$14,658

	As of March 31, 2013	December 31, 2012
Accumulated Other Comprehensive Income By Component:		
Unrealized loss for pension and other postretirement obligations	($44,252)	($45,232)
Tax effect	17,067	17,447
Net unrealized loss for pension and other postretirement obligations	(27,185)	(27,785)
Unrealized gain on available-for-sale securities	64,793	131,456
Tax effect	(24,396)	(49,337)
Net unrealized gain on available-for-sale securities	40,397	82,119
Accumulated other comprehensive income	$13,212	$54,334

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

COMMUNITY BANK SYSTEM, INC.
CONSOLIDATED STATEMENT OF CHANGES IN SHAREHOLDERS' EQUITY (Unaudited)
Three months ended March 31, 2013
(In Thousands, Except Share Data)

	Common Stock Shares Outstanding	Common Stock Amount Issued	Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Treasury Stock	Total
Balance at December 31, 2012	39,625,933	$40,421	$378,413	$447,018	$54,334	($17,408)	$902,778
Net income				20,241			20,241
Other comprehensive loss, net of tax					(41,122)		(41,122)
Cash dividends declared: Common, $0.27 per share				(10,735)			(10,735)
Common stock issued under employee stock plan, including tax benefits of $518	363,317	350	4,269			293	4,912
Stock-based compensation			1,220				1,220
Balance at March 31, 2013	39,989,250	$40,771	$383,902	$456,524	$13,212	($17,115)	$877,294

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

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

	Three Months Ended March 31,	
	2013	2012
Operating activities:		
Net income	$20,241	$18,826
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	3,007	2,809
Amortization of intangible assets	1,179	1,086
Net accretion of premiums and discounts on securities, loans and borrowings	(1,477)	(998)
Stock-based compensation	1,220	1,223
Provision for loan losses	1,393	1,644
Amortization of mortgage servicing rights	142	188
Income from bank-owned life insurance policies	(283)	(271)
Gain on sales of investment securities	(47,791)	0
Loss on debt extinguishments	47,783	0
Net loss/(gain) from sale of loans and other assets	71	(171)
Net change in loans held for sale	2	562
Change in other assets and liabilities	(3,964)	3,997
Net cash provided by operating activities	21,523	28,895
Investing activities:		
Proceeds from sales of available-for-sale investment securities	398,654	0
Proceeds from maturities of available-for-sale investment securities	52,802	36,742
Proceeds from maturities of held-to-maturity investment securities	8,315	4,555
Proceeds from sale of other investment securities	16,737	0
Purchases of available-for-sale investment securities	(121,665)	(549,254)
Purchases of held-to-maturity investment securities	(1,825)	(103,633)
Purchases of other securities	-	(8,190)
Net decrease in loans	2,607	8,238
Purchases of premises and equipment	(2,502)	(560)
Net cash provided by (used in) investing activities	353,123	(612,102)
Financing activities:		
Net increase in deposits	146,785	156,762
Net change in borrowings, net of payments of $414,422 and $54	(414,422)	182,146
Issuance of common stock	4,912	60,425
Cash dividends paid	(10,699)	(9,609)
	518	660

Tax benefits from share-based payment arrangements		
Net cash (used in) provided by financing activities	(272,906)	390,384
Change in cash and cash equivalents	101,740	(192,823)
Cash and cash equivalents at beginning of period	228,558	324,878
Cash and cash equivalents at end of period	$330,298	$132,055
Supplemental disclosures of cash flow information:		
Cash paid for interest	$11,719	$13,824
Cash paid for income taxes	4,168	3,091
Supplemental disclosures of noncash financing and investing activities:		
Dividends declared and unpaid	10,735	10,216
Transfers from loans to other real estate	2,396	739

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

COMMUNITY BANK SYSTEM, INC.
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)
March 31, 2013

NOTE A: BASIS OF PRESENTATION

The interim financial data as of and for the three months ended March 31, 2013 is unaudited; however, in the opinion of Community Bank System, Inc. (the "Company"), the interim data includes all adjustments, consisting only of normal recurring adjustments, necessary for a fair statement of the results for the interim periods in conformity with accounting principles generally accepted in the United States of America ("GAAP"). The results of operations for the interim periods are not necessarily indicative of the results that may be expected for the full year or any other interim period.

NOTE B: ACQUISITIONS

On September 7, 2012, Community Bank, N.A. (the "Bank") completed its acquisition of three branches in Western New York from First Niagara Bank, N.A. ("First Niagara"), acquiring approximately $54 million of loans and $101 million of deposits. The assumed deposits consisted primarily of core deposits (checking, savings and money market accounts) and the purchased loans consisted of in-market performing loans, primarily residential real estate loans. Under the terms of the purchase agreement, the Bank paid a blended deposit premium of 3.1%, or approximately $3 million. The effects of the acquired assets and liabilities have been included in the consolidated financial statements since that date.

On July 20, 2012, the Bank completed its acquisition of 16 retail branches in Central, Northern and Western New York from HSBC Bank USA, N.A. ("HSBC"), acquiring approximately $106 million in loans and $697 million of deposits. The assumed deposits consisted primarily of core deposits (checking, savings and money markets accounts) and the purchased loans consisted of in-market performing loans, primarily residential real estate loans. Under the terms of the purchase agreement, the Bank paid First Niagara (who acquired HSBC's Upstate New York banking business and assigned its right to purchase the 16 branches to the Bank) a blended deposit premium of 3.4%, or approximately $24 million. The effects of the acquired assets and liabilities have been included in the consolidated financial statements since that date.

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 are subject to adjustment based on updated information not available at the time of acquisition. The following table summarizes the estimated fair value of the assets acquired and liabilities assumed during 2012.

(000s omitted)	
Consideration received:	
Cash/Total net consideration received	($595,462)
Recognized amounts of identifiable assets acquired and liabilities assumed:	
Cash and cash equivalents	5,510
Loans	160,116

Premises and equipment	4,941
Accrued interest receivable	588
Other assets and liabilities, net	171
Core deposit intangibles	6,521
Deposits	(797,962)
Total identifiable liabilities, net	(620,115)
Goodwill	$24,653

The following is a summary of the loans acquired from HSBC and First Niagara at the date of acquisition:

(000's omitted)	Acquired Impaired Loans	Acquired Non-Impaired Loans	Total Acquired Loans
Contractually required principal and interest at acquisition	$0	$201,745	$201,745
Contractual cash flows not expected to be collected	0	(3,555)	(3,555)
Expected cash flows at acquisition	0	198,190	198,190
Interest component of expected cash flows	0	(38,074)	(38,074)
Fair value of acquired loans	$0	$160,116	$160,116

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 as the present value of the certificates' expected contractual payments discounted at market rates for similar certificates.

The core deposit intangible related to the HSBC acquisition is being amortized using an accelerated method over the estimated useful life of eight years. The goodwill associated with the First Niagara and HSBC acquisitions, which is not amortized for book purposes, was assigned to the Banking segment. The goodwill arising from the HSBC branch and First Niagara branch acquisitions is deductible for tax purposes.

Direct costs related to the acquisitions were expensed as incurred. Merger and acquisition integration-related expenses amount to $0.3 million in the three months ended March 31, 2012, and have been separately stated in the Consolidated Statements of Income.

Supplemental pro forma financial information related to the HSBC and First Niagara acquisitions has not been provided as it would be impracticable to do so. Historical financial information regarding the acquired branches is not accessible and thus the amounts would require estimates so significant as to render the disclosure irrelevant.

NOTE C: ACCOUNTING POLICIES

The accounting policies of the Company, as applied in the consolidated interim financial statements presented herein, are substantially the same as those followed on an annual basis as presented on pages 55 through 60 of the Annual Report on Form 10-K for the year ended December 31, 2012 filed with the Securities and Exchange Commission ("SEC") on March 1, 2013.

Critical Accounting Policies

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.

For acquired loans that are not deemed impaired at acquisition, credit discounts representing principal losses expected over the life of the loan are a component of the initial fair value. Subsequent to the purchase date, the methods used 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 credit discount. The remaining differences between the purchase price and the unpaid principal balance at the date of acquisition are recorded in interest income over the life of the loan.

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 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. The difference between contractually required payments at acquisition and the 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 expected to be incurred over the life of the loan. Subsequent decreases to the expected cash flows require the Company to evaluate the need for an allowance for loan losses on these loans. Subsequent improvements in expected cash flows result in the 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. For acquired loans that are not deemed impaired at acquisition, credit discounts representing the principal losses expected over the life of the loan are a component of the initial fair value and amortized over the life of the asset. 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 pooled discounts for loans evaluated collectively for impairment.

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 installment - direct, consumer installment - indirect, home equity and consumer mortgage. The first calculation 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. These two 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, if any, 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.

Investment Securities

The Company has classified its investments in debt and equity securities as held-to-maturity or available-for-sale. 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. Securities not classified as held-to-maturity are classified as available-for-sale and 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 March 31, 2013. Certain equity securities are stated at cost and include restricted stock of the Federal Reserve Bank of New York and Federal Home Loan Bank of New York.

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.

Equity securities are also evaluated to determine whether the unrealized loss is expected to be recoverable based on whether evidence exists to support a realizable value equal to or greater than the amortized cost basis. If it is probable that the amortized cost basis will not be recovered, taking into consideration the estimated recovery period and the ability to hold the equity security until recovery, OTTI is recognized in earnings equal to the difference between the fair value and the amortized cost basis of the security.

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.

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 financial statements. Deferred tax assets and liabilities are reported in the 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.

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 7 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.

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.

NOTE D: INVESTMENT SECURITIES

The amortized cost and estimated fair value of investment securities as of March 31, 2013 and December 31, 2012 are as follows:

	March 31, 2013				December 31, 2012			
(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
Held-to-Maturity Portfolio:								
U.S. Treasury and agency securities	$549,301	$55,429	$0	$604,730	$548,634	$59,081	$0	$607,715
Obligations of state and political subdivisions	62,372	4,955	0	67,327	65,742	5,850	0	71,592
Government agency mortgage-backed securities	17,379	920	0	18,299	20,578	1,079	0	21,657
Corporate debt securities	2,919	61	0	2,980	2,924	53	0	2,977

Other securities	13	0	0	13	16	0	0	16
Total held-to-maturity portfolio	$631,984	$61,365	$0	$693,349	$637,894	$66,063	$0	$703,957
Available-for-Sale Portfolio:								
U.S. Treasury and agency securities	$737,785	$32,035	$74	$769,746	$988,217	$91,040	$0	$1,079,257
Obligations of state and political subdivisions	618,853	28,775	935	646,693	629,883	33,070	61	662,892
Government agency mortgage-backed securities	240,909	12,833	397	253,345	253,013	16,989	51	269,951
Pooled trust preferred securities	57,973	0	10,487	47,486	61,979	0	12,379	49,600
Government agency collateralized mortgage obligations	28,861	1,775	0	30,636	32,359	1,579	3	33,935
Corporate debt securities	24,109	1,217	38	25,288	24,136	1,265	44	25,357
Marketable equity securities	351	119	30	440	351	94	43	402
Total available-for-sale portfolio	$1,708,841	$76,754	$11,961	$1,773,634	$1,989,938	$144,037	$12,581	$2,121,394
Other Securities:								
Federal Home Loan Bank common stock	$21,612			$21,612	$38,111			$38,111
Federal Reserve Bank common stock	16,050			16,050	16,050			16,050
Other equity securities	4,840			4,840	5,078			5,078
Total other securities	$42,502			$42,502	$59,239			$59,239

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 March 31, 2013

	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	3	$79,672	$74	0	$0	$0	3	$79,672	$74
Obligations of state and political subdivisions	87	53,061	919	2	929	16	89	53,990	935
Government agency mortgage-backed securities	14	30,772	397	0	0	0	14	30,772	397
Pooled trust preferred securities	0	0	0	3	47,486	10,487	3	47,486	10,487
Corporate debt securities	1	2,896	38	0	0	0	1	2,896	38
Government agency collateralized mortgage obligations	0	0	0	1	9	0	1	9	0
Marketable equity securities	0	0	0	1	171	30	1	171	30
Total available-for-sale/investment portfolio	105	$166,401	$1,428	7	$48,595	$10,533	112	$214,996	$11,961

As of December 31, 2012

	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:									
Obligations of state and political subdivisions	19	$11,503	$61	0	0	0	19	$11,503	$61
Pooled trust preferred securities	0	0	0	3	49,600	12,379	3	49,600	12,379
Government agency mortgage-backed securities	8	14,354	51	0	0	0	8	14,354	51
Corporate debt securities	1	2,905	44	0	0	0	1	2,905	44
Government agency collateralized mortgage obligations	4	426	2	2	1,041	1	6	1,467	3
Marketable equity securities	0	0	0	1	158	43	1	158	43
Total available-for-sale/investment	32	$29,188	$158	6	$50,799	$12,423	38	$79,987	$12,581

portfolio

Included in the available-for-sale portfolio are pooled trust preferred, class A-1 securities with a current total par value of $59.2 million and unrealized losses of $10.5 million at March 31, 2013. The underlying collateral of these assets is principally trust preferred securities of smaller regional banks and insurance companies. The Company's securities are in the super-senior cash flow tranche of the investment pools. All other tranches in these pools will incur losses before the super senior tranche is impacted. As of March 31, 2013, an additional 41% - 45% of the underlying collateral in these securities would have to be in deferral or default concurrently to result in an expectation of non-receipt of contractual cash flows.

A detailed review of the pooled trust preferred securities was completed as of March 31, 2013 and management concluded that it does not believe any individual unrealized loss represents an other-than-temporary impairment. This review included an analysis of collateral reports, a cash flow analysis, including varying degrees of projected deferral/default scenarios, and a review of various financial ratios of the underlying issuers. Based on the analysis performed, significant further deferral/defaults and further erosion in other underlying performance conditions would have to exist before the Company would incur a loss. To date, the Company has received all scheduled principal and interest payments and expects to fully collect all future contractual principal and interest payments. The Company does not intend to sell and it is not more likely than not that the Company will be required to sell the underlying securities. Subsequent changes in market or credit conditions could change those evaluations.

Management does not believe any individual unrealized loss as of March 31, 2013 represents OTTI. The unrealized losses reported pertaining to government guaranteed mortgage-backed securities relate primarily to securities issued by GNMA, FNMA and FHLMC, which are currently rated AAA by Moody's Investor Services, AA+ by Standard & Poor's and are guaranteed by the U.S. government. The obligations of state and political subdivisions are general purpose debt obligations of various states and political subdivisions. The majority of the obligations of state and political subdivisions carry a credit rating of A or better, as well as a secondary level of credit enhancement. The unrealized losses in the portfolios are primarily attributable to changes in interest rates. 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 amortized cost and estimated fair value of debt securities at March 31, 2013, 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.

	Held-to-Maturity		Available-for-Sale	
(000's omitted)	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Due in one year or less	$18,343	$18,495	$40,228	$40,612
Due after one through five years	269,592	296,031	154,607	161,312
Due after five years through ten years	275,681	303,861	787,866	828,678
Due after ten years	50,989	56,663	456,019	458,611
Subtotal	614,605	675,050	1,438,720	1,489,213
Government agency collateralized mortgage obligations	0	0	28,861	30,636
Government agency mortgage-backed securities	17,379	18,299	240,909	253,345
Total	$631,984	$693,349	$1,708,490	$1,773,194

During the three months ended March 31, 2013 the Company initiated a balance sheet restructuring program through the sale of certain longer duration investment securities and retirement of a portion of the company’s existing FHLB borrowings. During the three month period ending March 31, 2013 the Company sold $398.7 million of U.S. Treasury and agency securities, realizing $47.8 million of gains. The proceeds from those sales were utilized to retire $366.6 million of FHLB borrowings with $47.8 million of associated early extinguishments costs.

NOTE E: 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 15 – 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 - 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 of 15 years or less.

The balance of these classes are summarized as follows:

(000's omitted)	March 31, 2013	December 31, 2012
Consumer mortgage	$1,480,192	$1,448,415
Business lending	1,222,835	1,233,944
Consumer indirect	639,560	647,518
Consumer direct	165,649	171,474
Home equity	353,365	364,225
Gross loans, including deferred origination costs	3,861,601	3,865,576
Allowance for loan losses	(42,913)	(42,888)
Loans, net of allowance for loan losses	$3,818,688	$3,822,688

The outstanding balance related to credit impaired acquired loans was $21.9 million and $22.4 million at March 31, 2013 and December 31, 2012, respectively. The changes in the accretable discount related to the credit impaired acquired loans are as follows:

(000's omitted)	
Balance at December 31, 2012	$1,770
Accretion recognized, year-to-date	(264)
Net reclassification from accretable to nonaccretable	35
Balance at March 31, 2013	$1,541

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 March 31, 2013:

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
Consumer mortgage	$12,106	$1,591	$8,814	$22,511	$1,360,191	$1,382,702
Business lending	6,659	71	9,238	15,968	988,604	1,004,572
Consumer indirect	7,133	191	0	7,324	624,116	631,440
Consumer direct	1,311	48	6	1,365	151,552	152,917
Home equity	1,899	263	1,698	3,860	267,037	270,897
Total	$29,108	$2,164	$19,756	$51,028	$3,391,500	$3,442,528

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
Consumer mortgage	$1,051	$75	$2,517	$3,643	$0	$93,847	$97,490
Business lending	1,282	52	2,134	3,468	13,435	201,360	218,263
Consumer indirect	310	24	0	334	0	7,786	8,120
Consumer direct	326	11	0	337	0	12,395	12,732
Home equity	307	234	399	940	0	81,528	82,468
Total	$3,276	$396	$5,050	$8,722	$13,435	$396,916	$419,073

(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, 2012:

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
Consumer mortgage	$16,334	$1,553	$8,866	$26,753	$1,318,534	$1,345,287
Business lending	6,012	167	12,010	18,189	984,665	1,002,854
Consumer indirect	9,743	73	0	9,816	627,541	637,357
Consumer direct	1,725	71	8	1,804	154,462	156,266
Home equity	4,124	491	1,044	5,659	270,798	276,457
Total	$37,938	$2,355	$21,928	$62,221	$3,356,000	$3,418,221

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
Consumer mortgage	$1,726	$265	$2,420	$4,411	$0	$98,717	$103,128
Business lending	3,665	80	1,681	5,426	13,761	211,903	231,090
Consumer indirect	434	0	0	434	0	9,727	10,161
Consumer direct	470	0	0	470	0	14,738	15,208
Home equity	959	48	331	1,338	0	86,430	87,768
Total	$7,254	$393	$4,432	$12,079	$13,761	$421,515	$447,355

(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", or "classified". 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 currently facts and conditions.

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

	March 31, 2013			December 31, 2012		
(000's omitted)	Legacy	Acquired	Total	Legacy	Acquired	Total
Pass	$818,639	$136,009	$954,648	$818,469	$144,869	$963,338
Special mention	101,301	30,909	132,210	92,739	32,328	125,067
Classified	83,345	37,910	121,255	90,035	40,132	130,167
Doubtful	1,287	0	1,287	1,611	0	1,611
Acquired impaired	0	13,435	13,435	0	13,761	13,761
Total	$1,004,572	$218,263	$1,222,835	$1,002,854	$231,090	$1,233,944

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 table details the balances in all other loan categories at March 31, 2013:

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

(000's omitted)	Consumer Mortgage	Consumer Indirect	Consumer Direct	Home Equity	Total
Performing	$1,372,297	$631,249	$152,863	$268,936	$2,425,345
Nonperforming	10,405	191	54	1,961	12,611
Total	$1,382,702	$631,440	$152,917	$270,897	$2,437,956

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

(000's omitted)	Consumer Mortgage	Consumer Indirect	Consumer Direct	Home Equity	Total
Performing	$94,898	$8,096	$12,721	$81,835	$197,550
Nonperforming	2,592	24	11	633	3,260
Total	$97,490	$8,120	$12,732	$82,468	$200,810

The following table details the balances in all other loan categories at December 31, 2012:

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

(000's omitted)	Consumer Mortgage	Consumer Indirect	Consumer Direct	Home Equity	Total
Performing	$1,334,868	$637,284	$156,187	$274,922	$2,403,261
Nonperforming	10,419	73	79	1,535	12,106
Total	$1,345,287	$637,357	$156,266	$276,457	$2,415,367

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

(000's omitted)	Consumer Mortgage	Consumer Indirect	Consumer Direct	Home Equity	Total
Performing	$100,443	$10,161	$15,208	$87,389	$213,201
Nonperforming	2,685	0	0	379	3,064
Total	$103,128	$10,161	$15,208	$87,768	$216,265

All loan classes are collectively evaluated for impairment except business lending, as described in Note B. A summary of individually evaluated impaired loans as of March 31, 2013 and December 31, 2012 follows:

(000's omitted)	March 31, 2013	December 31, 2012
Loans with allowance allocation	$1,586	$1,611
Loans without allowance allocation	4,443	7,798
Carrying balance	6,029	9,409
Contractual balance	7,249	12,804
Specifically allocated allowance	400	800

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 troubled debt restructurings is the same as detailed previously.

Loans are considered modified in a 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 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 that can be caught up with payments made over the remaining term of the loan or at maturity. During 2012, clarified guidance was issued by the OCC addressing the accounting for certain loans that have been discharged in Chapter 7 bankruptcy. In accordance with this clarified 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. 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 2012 and 2013 was immaterial. In reporting periods prior to December 31, 2012, such loans were classified as TDRs only if there had been a change in contractual payment terms that represented a concession to the borrower. The impact on prior periods was determined to be immaterial and therefore, prior period disclosure has not been made.

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. Included in the impaired loan balances above was one TDR totaling $1.6 million with a specific reserve of $0.4 million. TDRs less than $0.5 million are collectively included in the general loan loss allocation and the qualitative review if necessary.

Information regarding troubled debt restructurings as of March 31, 2013 and December 31, 2012 is as follows:

	March 31, 2013						December 31, 2012					
(000's omitted)	Nonaccrual		Accruing		Total		Nonaccrual		Accruing		Total	
	#	Amount	#	Amount	#	Amount	#	Amount	#	Amount	#	Amount
Consumer mortgage	11	$760	51	$2,380	62	$3,140	3	$160	45	$2,074	48	$2,234
Business lending	8	2,026	1	50	9	2,076	10	3,046	0	0	10	3,046
Consumer indirect	2	10	97	659	99	669	0	0	106	718	106	718
Consumer direct	0	0	26	134	26	134	0	0	19	116	19	116
Home equity	7	87	21	309	28	396	5	70	19	266	24	336
Total	28	$2,883	196	$3,532	224	$6,415	18	$3,276	189	$3,174	207	$6,450

The following table presents information related to loans modified in a TDR during the three months ended March 31, 2013:

(000's omitted)	Number of loans modified	Outstanding Balance
Consumer mortgage	13	$1,002
Business lending	3	72
Consumer indirect	11	107
Consumer direct	9	31
Home equity	5	97
Total	41	$1,309

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:

Three Months Ended March 31, 2013								
(000's omitted)	Consumer Mortgage	Business Lending	Consumer Indirect	Consumer Direct	Home Equity	Unallocated	Acquired Impaired	Total
Beginning balance	$7,070	$18,013	$9,606	$3,303	$1,451	$2,666	$779	$42,888
Charge-offs	(371)	(784)	(891)	(545)	(185)	0	0	(2,776)
Recoveries	6	142	958	298	4	0	0	1,408
Provision	587	186	(225)	28	413	261	143	1,393
Ending balance	$7,292	$17,557	$9,448	$3,084	$1,683	$2,927	$922	$42,913

Three Months Ended March 31, 2012								
(000's omitted)	Consumer Mortgage	Business Lending	Consumer Indirect	Consumer Direct	Home Equity	Unallocated	Acquired Impaired	Total
Beginning balance	$4,651	$20,574	$8,960	$3,290	$1,130	$3,222	$386	$42,213
Charge-offs	(269)	(1,565)	(1,039)	(457)	(116)	0	0	(3,446)
Recoveries	13	155	1,042	172	16	0	0	1,398
Provision	490	2,249	(1,025)	61	251	(452)	70	1,644
Ending balance	$4,885	$21,413	$7,938	$3,066	$1,281	$2,770	$456	$41,809

NOTE F: