COMMUNITY BANK SYSTEM, INC.
Form 10-Q
November 09, 2016
UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended September 30, 2016

OR

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)

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 No .

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 No .

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

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

(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 No

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.
44,380,735 shares of Common Stock, $1.00 par value per share, were outstanding on October 31, 2016.

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Part I. Financial Information
Item 1. Financial Statements

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

	September 30, 2016	December 31, 2015
Assets:		
Cash and cash equivalents	$161,542	$153,210
Available-for-sale investment securities (cost of $2,702,088 and $2,742,278, respectively)	2,842,255	2,808,113
Other securities, at cost	35,389	39,827
Loans held for sale, at fair value	633	932
Loans	4,940,621	4,801,375
Allowance for loan losses	(46,789)	(45,401)
Net loans	4,893,832	4,755,974
Goodwill, net	465,142	463,252
Core deposit intangibles, net	7,713	9,789
Other intangibles, net	9,264	11,105
Intangible assets, net	482,119	484,146
Premises and equipment, net	111,484	114,434
Accrued interest and fees receivable	28,700	25,904
Other assets	171,792	170,129
Total assets	$8,727,746	$8,552,669
Liabilities:		
Noninterest-bearing deposits	$1,577,194	$1,499,616
Interest-bearing deposits	5,500,225	5,373,858
Total deposits	7,077,419	6,873,474
Borrowings	133,900	301,300
Subordinated debt held by unconsolidated subsidiary trusts	102,164	102,146
Accrued interest and other liabilities	173,681	135,102
Total liabilities	7,487,164	7,412,022
Commitments and contingencies (See Note J)		
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; 44,856,077 and 44,442,568 shares issued, respectively	44,857	44,443
Additional paid-in capital	540,549	528,015
Retained earnings	602,513	566,591

Accumulated other comprehensive income	66,091	19,235
Treasury stock, at cost (498,681 and 667,708 shares, respectively)	(13,428)	(17,637)
Total shareholders' equity	1,240,582	1,140,647
Total liabilities and shareholders' equity	$8,727,746	$8,552,669

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 September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Interest income:				
Interest and fees on loans	$53,706	$47,040	$157,865	$138,422
Interest and dividends on taxable investments	13,344	13,454	40,956	38,802
Interest on nontaxable investments	4,272	4,790	13,367	14,394
Total interest income	71,322	65,284	212,188	191,618
Interest expense:				
Interest on deposits	1,776	1,694	5,542	5,225
Interest on borrowings	337	587	835	1,081
Interest on subordinated debt held by unconsolidated subsidiary trusts	746	640	2,161	1,881
Total interest expense	2,859	2,921	8,538	8,187
Net interest income	68,463	62,363	203,650	183,431
Provision for loan losses	1,790	1,906	5,436	3,120
Net interest income after provision for loan losses	66,673	60,457	198,214	180,311
Noninterest revenues:				
Deposit service fees	14,894	13,459	43,636	39,142
Other banking services	2,863	2,045	6,039	3,899
Employee benefit services	11,267	11,330	34,949	33,727
Insurance revenues	5,702	367	17,340	1,091
Wealth management services	5,226	4,185	15,041	12,292
Total noninterest revenues	39,952	31,386	117,005	90,151
Noninterest expenses:				
Salaries and employee benefits	38,300	31,179	115,388	93,218
Occupancy and equipment	7,373	6,652	22,445	20,891
Data processing and communications	8,744	7,643	25,886	22,106
Amortization of intangible assets	1,359	843	4,204	2,642
Legal and professional fees	1,928	1,564	6,302	4,952
Office supplies and postage	1,713	1,636	5,336	4,733
Business development and marketing	2,004	1,889	6,167	5,711
FDIC insurance premiums	707	968	2,899	2,920
Acquisition expenses	2	562	342	1,318
Other expenses	4,096	3,143	11,282	9,584
Total noninterest expenses	66,226	56,079	200,251	168,075
Income before income taxes	40,399	35,764	114,968	102,387
Income taxes	13,239	10,742	37,548	31,228
Net income	$27,160	$25,022	$77,420	$71,159
Basic earnings per share	$0.61	$0.61	$1.75	$1.74

Diluted earnings per share	$0.61	$0.60	$1.74	$1.72
Cash dividends declared per share	$0.32	$0.31	$0.94	$0.91

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

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Pension and other post retirement obligations:				
Amortization of actuarial losses included in net periodic pension cost, gross	$376	$363	$1,127	$1,090
Tax effect	(144)	(140)	(432)	(421)
Amortization of actuarial losses included in net periodic pension cost, net	232	223	695	669
Amortization of prior service cost included in net periodic pension cost, gross	(34)	(43)	(101)	(127)
Tax effect	13	16	39	49
Amortization of prior service cost included in net periodic pension cost, net	(21)	(27)	(62)	(78)
Other comprehensive income related to pension and other post retirement obligations, net of taxes	211	196	633	591
Unrealized gains/(losses) on available-for-sale securities:				
Net unrealized holding (losses)/gains arising during period, gross	(24,465)	44,019	74,332	25,819
Tax effect	9,310	(16,979)	(28,109)	(11,223)
Net unrealized holding (losses)/gains arising during period, net	(15,155)	27,040	46,223	14,596
Other comprehensive (loss)/income related to unrealized (losses)/gains on available-for-sale securities, net of taxes	(15,155)	27,040	46,223	14,596
Other comprehensive (loss)/income, net of tax	(14,944)	27,236	46,856	15,187
Net income	27,160	25,022	77,420	71,159
Comprehensive income	$12,216	$52,258	$124,276	$86,346

	As of September 30, 2016	December 31, 2015
Accumulated Other Comprehensive Income By Component:		
Unrealized loss for pension and other post-retirement obligations	$ (33,321)	$ (34,347)
Tax effect	12,671	13,064
Net unrealized loss for pension and other post-retirement obligations	(20,650)	(21,283)
Unrealized gain on available-for-sale securities	140,167	65,835
Tax effect	(53,426)	(25,317)

Net unrealized gain on available-for-sale securities	86,741	40,518
Accumulated other comprehensive income	$ 66,091	$ 19,235

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

COMMUNITY BANK SYSTEM, INC.
CONSOLIDATED STATEMENT OF CHANGES IN SHAREHOLDERS' EQUITY (Unaudited)
Nine months ended September 30, 2016
(In Thousands, Except Share Data)

	Common Stock Shares Outstanding	Amount Issued	Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income	Treasury Stock	Total
Balance at December 31, 2015	43,774,860	$44,443	$528,015	$566,591	$ 19,235	$ (17,637)	$1,140,647
Net income				77,420			77,420
Other comprehensive income, net of tax					46,856		46,856
Cash dividends declared: Common, $0.94 per share				(41,498)			(41,498)
Common stock issued under employee stock plan, including tax benefits of $2,229	413,509	414	7,142				7,556
Stock-based compensation			3,392				3,392
Treasury stock issued to benefit plan, net	169,027		2,000			4,209	6,209
Balance at September 30, 2016	44,357,396	$44,857	$540,549	$602,513	$ 66,091	$ (13,428)	$1,240,582

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 (Unaudited)
(In Thousands)

	Nine Months Ended September 30,	
	2016	2015
Operating activities:		
Net income	$77,420	$71,159
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	10,742	9,820
Amortization of intangible assets	4,204	2,642
Net accretion on securities, loans and borrowings	(3,261)	(2,100)
Stock-based compensation	3,392	3,164
Provision for loan losses	5,436	3,120
Amortization of mortgage servicing rights	386	307
Income from bank-owned life insurance policies	(1,124)	(775)
Net gain on sale of loans and other assets	(624)	(48)
Change in other assets and liabilities	3,555	(5,637)
Net cash provided by operating activities	100,126	81,652
Investing activities:		
Proceeds from maturities of available-for-sale investment securities	86,885	131,709
Proceeds from maturities of other investment securities	9,050	172
Purchases of available-for-sale investment securities	(40,463)	(494,436)
Purchases of other securities	(4,612)	(9,947)
Net change in loans	(148,384)	(84,064)
Cash paid for acquisition, net of cash acquired of $0 and $0, respectively	(575)	0
Expenditure for intangible asset	0	(100)
Settlement of bank-owned life insurance policies	2,481	0
Purchases of premises and equipment, net	(7,832)	(9,184)
Net cash used in investing activities	(103,450)	(465,850)
Financing activities:		
Net increase in deposits	203,945	212,846
Net change in borrowings	(167,400)	220,100
Issuance of common stock	7,556	8,388
Purchases of treasury stock	(716)	(9,125)
Sales of treasury stock	6,925	5,472
Cash dividends paid	(40,883)	(36,584)
Tax benefits from share-based payment arrangements	2,229	1,541
Net cash provided by financing activities	11,656	402,638
Change in cash and cash equivalents	8,332	18,440
Cash and cash equivalents at beginning of period	153,210	138,396
Cash and cash equivalents at end of period	$161,542	$156,836
Supplemental disclosures of cash flow information:		
Cash paid for interest	$8,557	$8,249
Cash paid for income taxes	23,717	21,334
Supplemental disclosures of noncash financing and investing activities:		
Dividends declared and unpaid	14,220	12,793
Transfers from loans to other real estate	2,137	2,934

Purchase of intangible asset	0	93

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

COMMUNITY BANK SYSTEM, INC.
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)
SEPTEMBER 30, 2016

NOTE A: BASIS OF PRESENTATION

The interim financial data as of and for the three and nine months ended September 30, 2016 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 generally accepted accounting principles ("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

Pending Acquisition – Merchants Bancshares, Inc.
On October 24, 2016, the Company announced that it had entered into a definitive agreement to acquire Merchants Bancshares, Inc. ("Merchants"), parent company of Merchants Bank headquartered in South Burlington, Vermont, for approximately $304 million in Company stock and cash. The acquisition will extend the Company's footprint into the Vermont and Western Massachusetts markets. Upon the completion of the merger, Community Bank will add 31 branch locations in Vermont and one location in Massachusetts with approximately $1.9 billion of assets, and deposits of $1.5 billion. The acquisition is expected to close during the second quarter of 2017, pending both customary regulatory and Merchants shareholder approval. The Company expects to incur certain one-time, transaction-related costs in 2016 and 2017.

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 northern 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 NY, Inc. ("OneGroup").

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 approximately $158 million in Company stock and cash, comprised of $56.3 million of cash and the issuance of 2.38 million shares of common stock. Upon the completion of the merger, Community Bank, N.A. ("CBNA" or the "Bank") added 12 branch locations in Oneida and Madison counties and approximately $769 million of assets, including approximately $399 million of loans and $226 million of investment securities, along with $699 million of deposits. Through the acquisition of Oneida, the Company acquired, among others, 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. 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 date of the acquisition, and were subject to adjustment based on updated information not available at the time of acquisition. During the first quarter of 2016, the carrying amount of other assets decreased by $0.9 million and other liabilities increased by $0.7 million as a result of adjustments made to fair value estimates recorded for the Oneida acquisition. Other assets decreased as a result of new information obtained related to the fair value calculation of loans partially offset by a decrease in the fair value adjustment made to accounts receivable for uncollectible accounts as actual cash receipts exceed anticipated cash receipts. Other liabilities increased as a result of updated information related to deferred taxes. Goodwill increased $1.6 million as a result of these changes in fair value estimates.

The above referenced acquisitions expanded the Company's geographical presence in New York 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)	2016	2015
Consideration paid :		
Cash	$575	$56,266
Community Bank System, Inc. common stock	0	102,202
Total net consideration paid	575	158,468
Recognized amounts of identifiable assets acquired and liabilities assumed:		
Cash and cash equivalents	0	81,772
Investment securities	0	225,729
Loans	0	399,422
Premises and equipment	0	22,212
Accrued interest receivable	0	1,133
Other assets	0	26,529
Core deposit intangibles	0	2,570
Other intangibles	288	9,994
Deposits	0	(699,241)
Other liabilities	0	(1,333)
Total identifiable assets, net	288	68,787
Goodwill	$287	$89,681

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 an estimated 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 Oneida at the date of acquisition:

(000s omitted)	Acquired Impaired Loans	Acquired Non-impaired Loans	Total Acquired Loans
Contractually required principal and interest at acquisition	$ 5,138	$ 484,937	$490,075
Contractual cash flows not expected to be collected	(1,977)	(4,833)	(6,810)
Expected cash flows at acquisition	3,161	480,104	483,265
Interest component of expected cash flows	(341)	(83,502)	(83,843)
Fair value of acquired loans	$ 2,820	$ 396,602	$399,422

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 Oneida acquisition and the other intangibles related to WJL 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 and All Other segments for the Oneida acquisition and the All Other segment for WJL. Goodwill arising from the Oneida acquisition is not deductible for tax purposes. Goodwill arising from the WJL acquisition is deductible for tax purposes.

Direct costs related to the acquisitions were expensed as incurred, and have been separately stated in the Consolidated Statements of Income. Merger and acquisition integration-related expenses were immaterial for the three months ended September 30, 2016 and $0.6 million during the three months ended September 30, 2015. Merger and acquisition integration-related expenses were $0.3 million and $1.3 million for the nine months ended September 30, 2016 and 2015, respectively.

Supplemental Pro Forma Financial Information
The following unaudited condensed pro forma information assumes the Oneida acquisition had been completed as of January 1, 2015 for the three months and nine months ended September 30, 2015. The pro forma information does not include amounts related to WJL as the amounts were immaterial and financial information is not readily available. 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 acquisition occurred as of the beginning of the years 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 or the impact of conforming certain acquiree accounting policies to the Company's policies 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 Oneida combined with the Company's consolidated statement of income with adjustments related to (a) certain purchase accounting fair value adjustments; (b) amortization of customer lists and core deposit intangibles and (c) changes to effective tax rate as a result of the Company's assets size being above $8 billion on a consolidated basis. Acquisition-related expenses totaling $0.6 million and $1.3 million are excluded from the pro forma information for the three and nine months ended September 30, 2015, respectively.

(000's omitted)	Pro Forma (Unaudited) Three Months Ended September 30, 2015	Pro Forma (Unaudited) Nine Months Ended September 30, 2015
Total revenue, net of interest expense	$ 106,563	$ 313,574
Net income	25,350	73,813

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 56 through 61 of the Annual Report on Form 10-K for the year ended December 31, 2015 filed with the Securities and Exchange Commission ("SEC") on February 29, 2016.

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.

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 Accounting Standards Codification ("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 credit 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 loans 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 are 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 into interest income. When the carrying value exceeds the net realizable value, an allowance for loan loss is recognized.

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 of 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.

Investment Securities
The Company can classify its investments in debt and equity 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. Securities classified as available-for-sale 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 September 30, 2016. Certain equity securities are stated at cost and include restricted stock of the Federal Reserve Bank of New York ("Federal Reserve") and Federal Home Loan Bank of New York ("FHLB").

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.

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.

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.

New 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. The ASU also requires additional disclosure about the nature, amount, timing and uncertainty of revenue and cash flows arising from customer contracts, including significant judgments and changes in judgments and assets recognized from costs incurred to obtain or fulfill a contract. This guidance is effective prospectively for the Company for annual and interim periods beginning after December 15, 2017. The Company is currently evaluating the effect the guidance will have on the Company's consolidated financial statements.

In January 2016, the FASB issued ASU 2016-1, 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. Early adoption is permitted for all companies in any interim or annual period. The Company is currently evaluating the effect the guidance will have on the Company's consolidated financial statements.

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. Early adoption is permitted for all companies in any interim or annual period. The Company is currently evaluating the effect the guidance will have on the Company's consolidated financial statements.

In March 2016, the FASB issued ASU 2016-09, Compensation – Stock Compensation (Topic 718). The amendments simplify several aspects of the accounting for share-based payment transactions, including the income tax consequences, classification of awards as either equity or liabilities and classification on the statement of cash flows. The new guidance requires all excess tax benefits and tax deficiencies be recognized as income tax expense or benefit in the income statement. The tax effects of exercised or vested awards should be treated as discrete items in the reporting period in which they occur. This guidance requires certain amendments to be applied through a cumulative-effect adjustment to equity as of the beginning of the fiscal period in which the guidance is adopted while other amendments are required to be applied retrospectively or prospectively. This ASU is effective for fiscal periods beginning after December 15, 2016, and interim periods within those annual periods. Early adoption is permitted for any entity in any interim or annual period. The Company is currently evaluating the effect the guidance will have on the Company's consolidated financial statements.

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 effect the guidance will have on the Company's consolidated financial statements.

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. Early adoption is permitted, including adoption in an interim period. As this guidance only affects the classification within the statement of cash flows, this ASU is not expected to have a material impact on the Company's consolidated financial statements.

NOTE D: INVESTMENT SECURITIES

The amortized cost and estimated fair value of investment securities as of September 30, 2016 and December 31, 2015 are as follows:

	September 30, 2016				December 31, 2015			
(000's omitted)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available-for-Sale Portfolio:								
U.S. Treasury and agency securities	$1,873,698	$102,914	$0	$1,976,612	$1,866,819	$35,186	$2,027	$1,899,978

Obligations of state and political subdivisions	595,376	28,847	1	624,222	640,455	26,487	59	666,883
Government agency mortgage-backed securities	216,942	8,033	242	224,733	205,220	6,906	1,261	210,865
Corporate debt securities	5,735	39	0	5,774	16,672	66	58	16,680
Government agency collateralized mortgage obligations	10,086	418	0	10,504	12,862	446	0	13,308
Marketable equity securities	251	178	19	410	250	163	14	399
Total available-for-sale portfolio	$2,702,088	$140,429	$ 262	$2,842,255	$2,742,278	$69,254	$ 3,419	$2,808,113
Other Securities:								
Federal Home Loan Bank common stock	$11,682			$11,682	$19,317			$19,317
Federal Reserve Bank common stock	19,781			19,781	16,050			16,050
Other equity securities	3,926			3,926	4,460			4,460
Total other securities	$35,389			$35,389	$39,827			$39,827

A summary of investment securities that have been in a continuous unrealized loss position is as follows:

As of September 30, 2016

	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	4	$1,987	$ 1	0	$0	$ 0	4	$1,987	$ 1
Government agency mortgage-backed securities	9	10,116	40	15	23,228	202	24	33,344	242
Government agency collateralized mortgage obligations	0	0	0	2	2	0	2	2	0
Marketable equity securities	0	0	0	1	82	19	1	82	19
Total available-for-sale investment portfolio	13	$12,103	$ 41	18	$23,312	$ 221	31	$35,415	$ 262

As of December 31, 2015

	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 obligations	9	$353,844	$ 2,027	0	$0	$ 0	9	$353,844	$ 2,027
Obligations of state and political subdivisions	18	8,804	34	2	735	25	20	9,539	59
Government agency mortgage-backed securities	17	24,178	161	19	30,103	1,100	36	54,281	1,261
Corporate debt securities	1	3,024	0	1	2,710	58	2	5,734	58
Government agency collateralized mortgage obligations	0	0	0	2	3	0	2	3	0
Marketable equity securities	1	87	14	0	0	0	1	87	14
Total available-for-sale investment portfolio	46	$389,937	$ 2,236	24	$33,551	$ 1,183	70	$423,488	$ 3,419

The unrealized losses reported pertain to securities issued by the U.S. government and its sponsored entities, include treasuries, agencies, and mortgage-backed securities issued by the Government National Mortgage Association ("GNMA"), the Federal National Mortgage Association ("FNMA"), and the Federal Home Loan Corporation ("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 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 September 30, 2016 represents OTTI.

The amortized cost and estimated fair value of debt securities at September 30, 2016, 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	
	Amortized	Fair
(000's omitted)	Cost	Value
Due in one year or less	$34,640	$34,835
Due after one through five years	872,160	910,105
Due after five years through ten years	1,360,056	1,440,555
Due after ten years	207,953	221,113
Subtotal	2,474,809	2,606,608
Government agency mortgage-backed securities	216,942	224,733
Government agency collateralized mortgage obligations	10,086	10,504
Total	$2,701,837	$2,841,845

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 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 properties.
- 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.

The balances of these classes are summarized as follows:

(000's omitted)	September 30, 2016	December 31, 2015
Consumer mortgage	$1,798,748	$1,769,754
Business lending	1,506,878	1,497,271
Consumer indirect	1,037,077	935,760
Consumer direct	196,134	195,076
Home equity	401,784	403,514
Gross loans, including deferred origination costs	4,940,621	4,801,375
Allowance for loan losses	(46,789)	(45,401)
Loans, net of allowance for loan losses	$4,893,832	$4,755,974

The outstanding balance related to credit impaired acquired loans was $8.0 million and $8.5 million at September 30, 2016 and December 31, 2015, respectively. The changes in the accretable discount related to the credit impaired acquired loans are as follows:

(000's omitted)	
Balance at December 31, 2015	$810
Accretion recognized, year-to-date	(359)
Net reclassification to accretable from non-accretable	129
Balance at September 30, 2016	$580

<u>Credit Quality</u>

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 September 30, 2016:

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	$9,672	$ 927	$ 11,663	$22,262	$1,608,451	$1,630,713
Business lending	2,995	390	3,774	7,159	1,267,092	1,274,251
Consumer indirect	10,657	162	0	10,819	993,023	1,003,842
Consumer direct	1,318	86	0	1,404	183,576	184,980
Home equity	1,205	304	1,529	3,038	310,262	313,300
Total	$25,847	$ 1,869	$ 16,966	$44,682	$4,362,404	$4,407,086

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	$1,237	$ 61	$ 2,464	$3,762	$ 0	$164,273	$168,035
Business lending	226	0	1,460	1,686	6,863	224,078	232,627
Consumer indirect	208	15	0	223	0	33,012	33,235
Consumer direct	166	0	0	166	0	10,988	11,154
Home equity	1,474	70	411	1,955	0	86,529	88,484
Total	$3,311	$ 146	$ 4,335	$7,792	$ 6,863	$518,880	$533,535

(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, 2015:

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	$10,482	$ 1,411	$ 11,394	$23,287	$1,558,171	$1,581,458
Business lending	4,442	126	5,381	9,949	1,223,679	1,233,628
Consumer indirect	11,575	102	0	11,677	878,662	890,339
Consumer direct	1,414	51	1	1,466	176,585	178,051
Home equity	1,093	111	2,029	3,233	297,012	300,245
Total	$29,006	$ 1,801	$ 18,805	$49,612	$4,134,109	$4,183,721

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	$1,373	$ 394	$ 1,396	$3,163	$ 0	$185,133	$188,296
Business lending	535	0	1,186	1,721	7,299	254,623	263,643
Consumer indirect							