Mann George
Form SC 13D
March 25, 2009

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

SCHEDULE 13D

(Rule 13d-101)

INFORMATION TO BE INCLUDED IN STATEMENTS FILED PURSUANT

TO RULE 13d-1(a) AND AMENDMENTS THERETO FILED PURSUANT TO

RULE 13d-2(a)

Under the Securities Exchange Act of 1934

(Amendment No.______)*

Lawson Products, Inc.

(Name of Issuer)

Common Stock, $1.00 par value

(Title of Class of Securities)

520776105

(CUSIP Number)

H. George Mann

1186 Linden Ave.

Highland Park, Illinois 60035

(847) 433-2298

Copy to:

Matthew S. Brown, Esq.

Katten Muchin Rosenman LLP

525 West Monroe Street

Suite 1900

Chicago, Illinois 60661

(312) 902-5200

(Name, Address and Telephone Number of Person Authorized to Receive Notices and Communications)

March 20, 2009

(Date of Event which Requires Filing of this Statement)

If the filing person has previously filed a statement on Schedule 13G to report the acquisition that is the subject of this Schedule 13D, and is filing this schedule because of Rule 13d-1(e), 13d-1(f) or 13d-1(g), check the following box. ¨

Note: Schedules filed in paper format shall include a signed original and five copies of the schedule, including all exhibits. See Rule 13d-7 for other parties to whom copies are to be sent.

* The remainder of this cover page shall be filled out for a reporting person s initial filing on this form with respect to the subject class of securities, and for any subsequent amendment containing information which would alter disclosures provided in a prior cover page. The information required on the remainder of this cover page shall not be deemed to be filed for the purpose of Section 18 of the Securities Exchange Act of 1934 (Act) or otherwise subject to the liabilities of that section of the Act but shall be subject to all other provisions of the Act (however, see the Notes).

CUSIP No. 520776105 **Page 2 of 10 Pages**

1 NAMES OF REPORTING PERSON

H. George Mann, solely as trustee of each of SLP 2003 Trust A, created March 6, 2008; SLP 2003 Trust B, created March 6, 2008; SLP 2003 Trust C, created March 6, 2008; and SLP 2003 Trust D, created March 6, 2008

2 CHECK THE APPROPRIATE BOX IF A MEMBER OF A GROUP

(a) x

(b) ¨

3 SEC USE ONLY

4 SOURCE OF FUNDS

OO

5 CHECK BOX IF DISCLOSURE OF LEGAL PROCEEDINGS IS REQUIRED PURSUANT TO ITEMS 2(d) OR 2(e) ¨

6 CITIZENSHIP OR PLACE OF ORGANIZATION

United States

NUMBER OF SHARES BENEFICIALLY OWNED BY EACH REPORTING PERSON WITH	**7**	SOLE VOTING POWER 0
	8	SHARED VOTING POWER 0
	9	SOLE DISPOSITIVE POWER 2,345,000 shares*
	10	SHARED DISPOSITIVE POWER 0

11 AGGREGATE AMOUNT BENEFICIALLY OWNED BY EACH REPORTING PERSON ¨

See Row 9 above.

12 CHECK BOX IF THE AGGREGATE AMOUNT IN ROW (11) EXCLUDES CERTAIN SHARES ¨

13 PERCENT OF CLASS REPRESENTED BY AMOUNT IN ROW (11)

27.52 percent based on 8,511,022 shares of common stock outstanding as of March 5, 2009**

14 TYPE OF REPORTING PERSON

IN

* The Reporting Persons are pledgees of the shares and, due to the occurrence of certain events, have acquired the right to sell the shares. The owners of the shares also have the right to sell the shares under certain conditions. See Item 6 below.

** See Item 3 and Item 6 below.

CUSIP No. 520776105 **Page 3 of 10 Pages**

1 NAME OF REPORTING PERSON

SLP 2003 Trust A, created March 6, 2008

2 CHECK THE APPROPRIATE BOX IF A MEMBER OF A GROUP

(a) x

(b) ¨

3 SEC USE ONLY

4 SOURCE OF FUNDS

OO

5 CHECK BOX IF DISCLOSURE OF LEGAL PROCEEDINGS IS REQUIRED PURSUANT TO ITEMS 2(d) OR 2(e) ¨

6 CITIZENSHIP OR PLACE OF ORGANIZATION

Illinois

NUMBER OF SHARES BENEFICIALLY OWNED BY EACH REPORTING PERSON WITH		
	7	SOLE VOTING POWER 0
	8	SHARED VOTING POWER 0
	9	SOLE DISPOSITIVE POWER 781, 667 shares*
	10	SHARED DISPOSITIVE POWER 0

11 AGGREGATE AMOUNT BENEFICIALLY OWNED BY EACH REPORTING PERSON ¨

See Row 9 above.

12 CHECK BOX IF THE AGGREGATE AMOUNT IN ROW (11) EXCLUDES CERTAIN SHARES ¨

13 PERCENT OF CLASS REPRESENTED BY AMOUNT IN ROW (11)

9.17 percent based on 8,511,022 shares of common stock outstanding as of March 5, 2009**

14 TYPE OF REPORTING PERSON

OO

* The Reporting Persons are pledgees of the shares and, due to the occurrence of certain events, have acquired the right to sell the shares. The owners of the shares also have the right to sell the shares under certain conditions. See Item 6 below.

** See Item 3 and Item 6 below.

1 NAME OF REPORTING PERSON

SLP 2003 Trust B, created March 6, 2008

2 CHECK THE APPROPRIATE BOX IF A MEMBER OF A GROUP

(a) x

(b) ¨

3 SEC USE ONLY

4 SOURCE OF FUNDS

OO

5 CHECK BOX IF DISCLOSURE OF LEGAL PROCEEDINGS IS REQUIRED PURSUANT TO ITEMS 2(d) OR 2(e) ¨

6 CITIZENSHIP OR PLACE OF ORGANIZATION

Illinois

NUMBER OF SHARES BENEFICIALLY OWNED BY EACH REPORTING PERSON WITH	**7** SOLE VOTING POWER	0
	8 SHARED VOTING POWER	0
	9 SOLE DISPOSITIVE POWER	781, 667 shares*
	10 SHARED DISPOSITIVE POWER	0

11 AGGREGATE AMOUNT BENEFICIALLY OWNED BY EACH REPORTING PERSON ¨

See Row 9 above.

12 CHECK BOX IF THE AGGREGATE AMOUNT IN ROW (11) EXCLUDES CERTAIN SHARES ¨

13 PERCENT OF CLASS REPRESENTED BY AMOUNT IN ROW (11)

9.17 percent based on 8,511,022 shares of common stock outstanding as of March 5, 2009**

14 TYPE OF REPORTING PERSON

OO

* The Reporting Persons are pledgees of the shares and, due to the occurrence of certain events, have acquired the right to sell the shares. The owners of the shares also have the right to sell the shares under certain conditions. See Item 6 below.

** See Item 3 and Item 6 below.

CUSIP No. 520776105 **Page 5 of 10 Pages**

1 NAME OF REPORTING PERSON

SLP 2003 Trust C, created March 6, 2008

2 CHECK THE APPROPRIATE BOX IF A MEMBER OF A GROUP

(a) x

(b) ¨

3 SEC USE ONLY

4 SOURCE OF FUNDS

OO

5 CHECK BOX IF DISCLOSURE OF LEGAL PROCEEDINGS IS REQUIRED PURSUANT TO ITEMS 2(d) OR 2(e) ¨

6 CITIZENSHIP OR PLACE OF ORGANIZATION

Illinois

NUMBER OF SHARES BENEFICIALLY OWNED BY EACH REPORTING PERSON WITH		
	7	SOLE VOTING POWER 0
	8	SHARED VOTING POWER 0
	9	SOLE DISPOSITIVE POWER 390,833 shares*
	10	SHARED DISPOSITIVE POWER 0

11 AGGREGATE AMOUNT BENEFICIALLY OWNED BY EACH REPORTING PERSON ¨

See Row 9 above.

12 CHECK BOX IF THE AGGREGATE AMOUNT IN ROW (11) EXCLUDES CERTAIN SHARES ¨

13 PERCENT OF CLASS REPRESENTED BY AMOUNT IN ROW (11)

4.59 percent based on 8,511,022 shares of common stock outstanding as of March 5, 2009**

14 TYPE OF REPORTING PERSON

OO

* The Reporting Persons are pledgees of the shares and, due to the occurrence of certain events, have acquired the right to sell the shares. The owners of the shares also have the right to sell the shares under certain conditions. See Item 6 below.

** See Item 3 and Item 6 below.

1 NAME OF REPORTING PERSON

SLP 2003 Trust D, created March 6, 2008

2 CHECK THE APPROPRIATE BOX IF A MEMBER OF A GROUP

(a) x

(b) ¨

3 SEC USE ONLY

4 SOURCE OF FUNDS

OO

5 CHECK BOX IF DISCLOSURE OF LEGAL PROCEEDINGS IS REQUIRED PURSUANT TO ITEMS 2(d) OR 2(e) ¨

6 CITIZENSHIP OR PLACE OF ORGANIZATION

Illinois

NUMBER OF SHARES BENEFICIALLY OWNED BY EACH REPORTING PERSON WITH		
	7	SOLE VOTING POWER 0
	8	SHARED VOTING POWER 0
	9	SOLE DISPOSITIVE POWER 390,833 shares*
	10	SHARED DISPOSITIVE POWER 0

11 AGGREGATE AMOUNT BENEFICIALLY OWNED BY EACH REPORTING PERSON ¨

See Row 9 above.

12 CHECK BOX IF THE AGGREGATE AMOUNT IN ROW (11) EXCLUDES CERTAIN SHARES ¨

13 PERCENT OF CLASS REPRESENTED BY AMOUNT IN ROW (11)

4.59 percent based on 8,511,022 shares of common stock outstanding as of March 5, 2009**

14 TYPE OF REPORTING PERSON

OO

* The Reporting Persons are pledgees of the shares and, due to the occurrence of certain events, have acquired the right to sell the shares. The owners of the shares also have the right to sell the shares under certain conditions. See Item 6 below.

** See Item 3 and Item 6 below.

ITEM 1. SECURITY AND ISSUER

This Schedule 13D relates to the Common Stock, $1.00 par value (the Common Stock), of Lawson Products, Inc, a Delaware corporation (the Issuer). The principal executive offices of the Issuer are located at 1666 East Touhy Avenue, Des Plaines, Illinois 60018.

ITEM 2. IDENTITY AND BACKGROUND

(a) The persons filing this Schedule 13D are H. George Mann (Mann), solely as trustee of each of SLP 2003 Trust A, created March 6, 2008, SLP 2003 Trust B, created March 6, 2008, SLP 2003 Trust C, created March 6, 2008, and SLP Trust D, created March 6, 2008 (each an SLP 2003 Trust and collectively the SLP 2003 Trusts), and each of the SLP 2003 Trusts (Mann and the SLP 2003 Trusts, collectively the Reporting Persons). Mann is the sole trustee of the SLP 2003 Trusts and has sole power to act on behalf of the SLP 2003 Trusts.

(b) Mann s and the SLP 2003 Trusts address is 1186 Linden Ave., Highland Park, Illinois, 60035.

(c) Mann is retired. The SLP 2003 Trusts are family planning vehicles of the family of Sidney L. Port.

(d) None of the Reporting Persons has, during the last five years, been convicted in a criminal proceeding (excluding traffic violations or similar misdemeanors).

(e) None of the Reporting Persons has, during the last five years, been a party to a civil proceeding of a judicial or administrative body of competent jurisdiction and, as a result of such proceeding, was or is subject to a judgment, decree or final order enjoining future violations of or prohibiting or mandating activities subject to, federal or state securities laws or finding any violation with respect thereto.

(f) Mann is a United States citizen and the SLP 2003 Trusts are formed under the law of the State of Illinois.

ITEM 3. SOURCE AND AMOUNT OF FUNDS OR OTHER CONSIDERATION

Pursuant to certain secured promissory notes (the Notes), the SLP 2003 Trusts loaned an aggregate of $11,625,000 to the Sidney L. Port Trust, dated July 22, 1970 (the Estate) for family estate tax planning purposes. The Estate and Port Investments, L.P., another Port family entity, pledged an aggregate of 2,345,000 shares (the Shares) of the Issuer as collateral for those loans. The SLP 2003 Trusts made loans to the Estate with cash obtained from assets held by the SLP 2003 Trusts.

ITEM 4. PURPOSE OF TRANSACTION

Due to the market price of the Issuer s common shares falling below a certain level, the Reporting Persons acquired the right, but are not obligated, to dispose of the Shares. The Reporting Persons may dispose of the Shares at any time and from time to time in the open market, in privately negotiated transactions or otherwise. All proceeds from any sale of Shares would be held as collateral to satisfy the obligations of the Estate under the Notes. Although the foregoing represents the range of activities presently contemplated by the Reporting Persons, the scope of possible activities is subject to change. Except as set forth in this Item 4, the Reporting Persons do not have any present plans or proposals which relate to or would result in any of the actions described in paragraphs (a) through (j) of Item 4 of Schedule 13D.

ITEM 5. INTEREST IN SECURITIES OF THE ISSUER

(a) Number of shares: 2,345,000 shares
Percentage of shares: 27.52%

(b) Sole power to vote or direct the vote: 0 shares
Shared power to vote or direct the vote: 0 shares

Sole power to dispose or to direct the disposition: 2,345,000 shares*

Shared power to dispose or direct the disposition: 0

(c) Other than acquiring the right to dispose of the Shares as reported in Item 4 above, the Reporting Persons have not had any transactions in the Issuer s shares of common stock in the past 60 days.

(d) Not applicable.

(e) Not applicable.

* The Reporting Persons are pledgees of the shares and, due to the occurrence of certain events, have acquired the right to sell the shares. The owners of the shares also have the right to sell the shares under certain conditions. See Item 6 below.

ITEM 6. CONTRACTS, ARRANGEMENTS, UNDERSTANDINGS OR RELATIONSHIPS WITH RESPECT TO SECURITIES OF THE ISSUER

Mann is the trustee of the SLP 2003 Trusts. As noted above in Item 3, the SLP 2003 Trusts loaned an aggregate of $11,625,000 to the Estate for family estate tax planning purposes, and the Estate and Port Investments, L.P. pledged the Shares as collateral for those loans. Those pledges are pursuant to Pledge Agreements between each of the SLP 2003 Trusts and the Estate and Port Investments, L.P., respectively. Under the terms of these Pledge Agreements , the SLP 2003 Trusts were granted the right to sell some or all of the Shares upon the occurrence of certain events, including if the value of the Shares plus one and one half times the amount of any cash collateral posted for the Notes (including cash proceeds from the sale of Shares) fell below a certain level (a Coverage Event). Such Coverage Event occurred as of March 20, 2009 and the Reporting Persons became entitled, but not obligated, to sell Shares until the sales generate aggregate cash up to the Adjusted Aggregate Loan Exposure under the Pledge Agreements, which, as of the date hereof, is approximately $22,686,000. Under the terms of the Pledge Agreements, this amount increases over time. The owners of the Shares still retain the sole right to vote them. The owners of the Shares also remain entitled to sell all or part of the Shares if, after giving effect to such sale, a Coverage Event would no longer be continuing and the cash proceeds of such sale is pledged as additional collateral for the obligations under the Notes. Under the terms of the Pledge Agreements, at all times that a Coverage Event exists and is continuing, the SLP 2003 Trusts are entitled to receive and to hold any dividends paid on the Shares.

The description of the terms of the Pledge Agreements and the Notes contained in this Item 6 is a summary, does not purport to be complete, and is qualified in its entirety by reference to the Pledge Agreements and the Notes referred to in Item 7 below as Exhibits 99.2 through and including 99.13, respectively, and each of which is incorporated herein by reference.

ITEM 7. MATERIAL TO BE FILED AS EXHIBITS

The following documents are filed as exhibits (or incorporated by reference herein):

Exhibit 99.1:	Joint Filing Agreement.
Exhibit 99.2:	Secured Promissory Note, dated March 11, 2008, by The Sidney L. Port Trust Dated July 22, 1970, dated July 22, 1970 as restated, in favor of the SLP 2003 Trust A, created March 6, 2008.
Exhibit 99.3:	Pledge Agreement, dated March 11, 2008, by and between The Sidney L. Port Trust Dated July 22, 1970, dated July 22, 1970 as restated, and the SLP 2003 Trust A, created March 6, 2008.
Exhibit 99.4:	Pledge Agreement, dated March 11, 2008, by and between Port Investments, L.P. and the SLP 2003 Trust A, created March 6, 2008.
Exhibit 99.5:	Secured Promissory Note, dated March 11, 2008, by The Sidney L. Port Trust Dated July 22, 1970, dated July 22, 1970 as restated, in favor of the SLP 2003 Trust B, created March 6, 2008.
Exhibit 99.6:	Pledge Agreement, dated March 11, 2008, by and between The Sidney L. Port Trust Dated July 22, 1970, dated July 22, 1970 as restated, and the SLP 2003 Trust B, created March 6, 2008.
Exhibit 99.7:	Pledge Agreement, dated March 11, 2008, by and between Port Investments, L.P. and the SLP 2003 Trust B, created March 6, 2008.
Exhibit 99.8:	Secured Promissory Note, dated March 11, 2008, by The Sidney L. Port Trust Dated July 22, 1970, dated July 22, 1970 as restated, in favor of the SLP 2003 Trust C, created March 6, 2008.
Exhibit 99.9:	Pledge Agreement, dated March 11, 2008, by and between The Sidney L. Port Trust Dated July 22, 1970, dated July 22, 1970 as restated, and the SLP 2003 Trust C, created March 6, 2008.
Exhibit 99.10:	Pledge Agreement, dated March 11, 2008, by and between Port Investments, L.P. and the SLP 2003 Trust C, created March 6, 2008.
Exhibit 99.11:	Secured Promissory Note, dated March 11, 2008, by The Sidney L. Port Trust Dated July 22, 1970, dated July 22, 1970 as restated, in favor of the SLP 2003 Trust D, created March 6, 2008.
Exhibit 99.12:	Pledge Agreement, dated March 11, 2008, by and between The Sidney L. Port Trust Dated July 22, 1970, dated July 22, 1970 as restated, and the SLP 2003 Trust D, created March 6, 2008.
Exhibit 99.13:	Pledge Agreement, dated March 11, 2008, by and between Port Investments, L.P. and the SLP 2003 Trust D, created March 6, 2008.

Signature

After reasonable inquiry and to the best of its knowledge and belief, the undersigned certify that the information set forth in this statement is true, complete and correct.

Dated this 23rd day of March, 2009

SLP 2003 Trust A, created March 6, 2008

By: /s/ H. George Mann
H. George Mann, solely as Trustee

SLP 2003 Trust B, created March 6, 2008

By: /s/ H. George Mann
H. George Mann, solely as Trustee

SLP 2003 Trust C, created March 6, 2008

By: /s/ H. George Mann
H. George Mann, solely as Trustee

SLP 2003 Trust D, created March 6, 2008

By: /s/ H. George Mann
H. George Mann, solely as Trustee

/s/ H. George Mann
H. George Mann, solely as Trustee

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

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

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

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

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

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

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

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

Table 15: Borrowings

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

50

Table of Contents

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

Table 16: Maturities of Contractual Obligations

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

Financial Instruments with Off-Balance Sheet Risk

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

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

Table 17: Off-Balance Sheet Financial Instruments

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

Investments

The objective of the Company's investment portfolio is to hold low-risk, high-quality earning assets that provide favorable returns and provide another effective tool to actively manage its earning asset/funding liability position in order to maximize future net interest income opportunities. This must be accomplished within the following constraints: (a) implementing certain interest rate risk management strategies which achieve a relatively stable level of net interest income; (b) providing both the regulatory and operational liquidity necessary to conduct day-to-day business activities; (c) considering investment risk-weights as determined by the regulatory risk-based capital guidelines; and (d) generating a favorable return without undue compromise of the other requirements.

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

51

Table of Contents

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

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

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

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

Table 18: Investment Securities

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

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

52

Table of Contents

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

Table 19: Maturities of Investment Debt Securities

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

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

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

Impact of Inflation and Changing Prices

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

New Accounting Pronouncements

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

Table of Contents

Forward-Looking Statements

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

Table of Contents

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

Reconciliation of GAAP to Non-GAAP Measures

Table 20: GAAP to Non-GAAP Reconciliations

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

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

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

Table of Contents

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

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

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

Table of Contents

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

Item 7A. Quantitative and Qualitative Disclosures about Market Risk

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

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

Table of Contents

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

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

Net Interest Income Sensitivity Model

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

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

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

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

Table of Contents

Item 8. Financial Statements and Supplementary Data

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

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

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

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

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

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

60

Table of Contents

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

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

Cash dividends declared per share	$1.44	$1.32	$1.26

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

61

Table of Contents

COMMUNITY BANK SYSTEM, INC.
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

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

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

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

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

62

Table of Contents

COMMUNITY BANK SYSTEM, INC.

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

Years ended December 31, 2016, 2017 and 2018

(In Thousands, Except Share Data)

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

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

2018

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

63

Table of Contents

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

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

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

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

64

Table of Contents
COMMUNITY BANK SYSTEM, INC.

NOTE A: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

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

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

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

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

Critical Accounting Estimates in the Preparation of Financial Statements
The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

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

Risk and Uncertainties

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

Table of Contents

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

Revenue Recognition

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

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

Deposit Service Fees

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

Other Banking Services

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

Employee Benefit Services

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

66

Table of Contents

Insurance Services

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

Wealth Management Services

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

Contract Balances

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

Contract Acquisition Costs

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

Cash and Cash Equivalents

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

Table of Contents

Investment Securities

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

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

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

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

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

Loans

Loans are stated at unpaid principal balances, net of unearned income. Mortgage loans held for sale are carried at fair value and are included in loans held for sale on the consolidated statements of condition. Fair values for variable rate loans that reprice frequently are based on carrying values. Fair values for fixed rate loans are estimated using discounted cash flows and interest rates currently being offered for loans with similar terms to borrowers of similar credit quality. The carrying amount of accrued interest approximates its fair value.

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

Table of Contents

Acquired loans

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

Acquired impaired loans

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

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

Acquired non-impaired loans

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

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

Impaired and Other Nonaccrual Loans

The Company places a loan on nonaccrual status when the loan becomes 90 days past due (or sooner, if management concludes collection is doubtful), except when, in the opinion of management, it is well-collateralized and in the process of collection. A loan may be placed on nonaccrual status earlier than ninety days past due if there is deterioration in the financial position of the borrower or if other conditions of the loan so warrant. When a loan is placed on nonaccrual status, uncollected accrued interest is reversed against interest income and the amortization of nonrefundable loan fees and related direct costs is discontinued. Interest income during the period the loan is on nonaccrual status is recorded on a cash basis after recovery of principal is reasonably assured. Nonaccrual loans are returned to accrual status when management determines that the borrower’s performance has improved and that both principal and interest are collectible. This generally requires a sustained period of timely principal and interest payments and a well-documented credit evaluation of the borrower’s financial condition.

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

Table of Contents

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

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

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

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

Allowance for Loan Losses

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

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

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

Intangible Assets

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

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

Table of Contents

Premises and Equipment

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

Other Real Estate

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

Mortgage Servicing Rights

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

Treasury Stock

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

Income Taxes

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

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

Investments in Real Estate Limited Partnerships

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

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

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

Table of Contents

Repurchase Agreements

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

Retirement Benefits

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

Derivative Financial Instruments and Hedging Activities

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

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

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

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

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

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

Table of Contents

Bank Owned Life Insurance

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

Earnings Per Share

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

Stock-based Compensation

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

Fair Values of Financial Instruments

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

Reclassifications

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

Recently Adopted Accounting Pronouncements

In May 2014, the FASB issued ASU No. 2014-09, Revenue from Contracts with Customers (Topic 606). This new guidance supersedes the revenue recognition requirements in ASC 605, Revenue Recognition, and is based on the principle that revenue is recognized to depict the transfer of goods or services to customers in an amount that reflects consideration to which the entity expects to be entitled in exchange for those goods and services. In doing so, companies generally will be required to use more judgment and make more estimates than under prior guidance. These may include identifying performance obligations in the contract, estimating the amount of variable consideration to include in the transaction price and allocating the transaction price to each separate performance obligation. Since the guidance does not apply to revenue associated with financial instruments, including loans and securities that are accounted for under other GAAP, the new guidance did not have a material impact on revenue most closely associated with financial instruments, including interest income, interest expense and mortgage banking income. The Company completed a comprehensive assessment of the revenue streams and reviewed related contracts potentially affected by the ASU for all segments of its business. Based on this assessment, the Company concluded that ASU 2014-09 did not materially change the manner in which the Company recognized revenue for these revenue streams. The Company also completed its evaluation of certain costs related to these revenue streams to determine whether such costs should be presented as expenses or contra-revenue (i.e. gross versus net) and timing of compensatory payments to producers. Based on the Company's evaluation, it was determined that changes in the presentation of expenses and timing of the recognition of compensation expense did not materially affect noninterest income or expense. The Company adopted this guidance on January 1, 2018 utilizing the modified retrospective approach. Since there was no net income impact upon adoption of the new guidance, a cumulative effect adjustment to opening retained earnings was not deemed necessary.

73

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

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

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

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

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

Table of Contents

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

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

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

NOTE B: ACQUISITIONS

Subsequent Event/ Pending Acquisition – Kinderhook Bank Corp.

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

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

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

Table of Contents

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

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

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

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

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

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

On February 3, 2017, the Company completed its acquisition of NRS and its subsidiary GTC, headquartered in Woburn, Massachusetts, for $148.6 million in Company stock and cash. NRS was a privately held corporation focused on providing institutional transfer agency, master recordkeeping services, custom target date fund administration, trust product administration and customized reporting services to institutional clients. Its wholly-owned subsidiary, GTC, is chartered in the State of Maine as a non-depository trust company and provides fiduciary services for collective investment trusts and other products. The acquisition of NRS and GTC, hereafter referred to collectively as NRS, strengthens and complements the Company's existing employee benefit services businesses. Upon the completion of the merger, NRS became a wholly-owned subsidiary of BPAS and operates as Northeast Retirement Services, LLC, a Delaware limited liability company. This transaction resulted in the acquisition of $36.1 million in net tangible assets, principally cash and certificates of deposit, $60.2 million in customer list intangibles that will be amortized using the 150% declining balance method over 10 years, a $23.0 million deferred tax liability associated with the customer list intangible, and $75.3 million in goodwill. The effects of the acquired assets and liabilities have been included in the consolidated financial statements since that date. Revenues of $40.6 million and expenses of $24.6 million from NRS were included in the consolidated statement of income for the year ended December 31, 2018. Revenues of $31.5 million and expenses of $21.5 million from NRS were included in the consolidated statement of income for the year ended December 31, 2017.

Table of Contents

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

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

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

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

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

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

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

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

77

Table of Contents

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

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

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

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

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

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

Supplemental Pro Forma Financial Information

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

The pro forma information set forth below reflects the historical results of Merchants and NRS combined with the Company's consolidated statement of income with adjustments related to (a) certain purchase accounting fair value adjustments and (b) amortization of customer lists and core deposit intangibles. Acquisition expenses related to the Merchants and NRS transactions totaling $25.7 million for the year ended December 31, 2017 were included in the pro forma information as if they were incurred in 2016.

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

78

Table of Contents

NOTE C: INVESTMENT SECURITIES

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

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

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

As of December 31, 2018

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

79

Table of Contents

As of December 31, 2017

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

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

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

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

Investment securities with a carrying value of $1.447 billion and $1.530 billion at December 31, 2018 and 2017, respectively, were pledged to collateralize certain deposits and borrowings. Securities pledged to collateralize certain deposits and borrowings included $492.4 million and $473.2 million of U.S. Treasury securities that were pledged as collateral for securities sold under agreement to repurchase at December 31, 2018, and 2017, respectively. All securities sold under agreement to repurchase as of December 31, 2018 and 2017 have an overnight and continuous maturity.

NOTE D: LOANS

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

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

80

Table of Contents

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

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

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

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

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

Acquired loans

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

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

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

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

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

81

Table of Contents

Credit Quality

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

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

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

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

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

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

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

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

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

Table of Contents

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

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

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

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

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

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

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

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

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

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

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

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

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

83

Table of Contents

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

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

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

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

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

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

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

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

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

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

In accordance with clarified guidance issued by the OCC, loans that have been discharged in Chapter 7 bankruptcy but not reaffirmed by the borrower, are classified as TDRs, irrespective of payment history or delinquency status, even if the repayment terms for the loan have not been otherwise modified. The Company's lien position against the underlying collateral remains unchanged. Pursuant to that guidance, the Company records a charge-off equal to any portion of the carrying value that exceeds the net realizable value of the collateral. The amount of loss incurred in 2018, 2017 and 2016 was immaterial.

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

Table of Contents

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

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

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

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

Allowance for Loan Losses

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

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

85

Table of Contents

NOTE E: PREMISES AND EQUIPMENT

Premises and equipment consist of the following at December 31:

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

NOTE F: GOODWILL AND IDENTIFIABLE INTANGIBLE ASSETS

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

	December 31, 2018			December 31, 2017		
(000's omitted)	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Amortizing intangible assets:						
Core deposit intangibles	$62,902	$ (44,306)	$18,596	$62,902	$ (37,877)	$25,025
Other intangibles	87,616	(32,366)	55,250	86,535	(20,902)	65,633
Total amortizing intangibles	$150,518	$ (76,672)	$73,846	$149,437	$ (58,779)	$90,658

The estimated aggregate amortization expense for each of the five succeeding fiscal years ended December 31 is as follows:

2019	$15,296
2020	12,722
2021	10,853
2022	9,317
2023	7,814
Thereafter	17,844
Total	$73,846

Shown below are the components of the Company's goodwill at December 31, 2018 and 2017:

(000's omitted)	Year Ended December 31, 2016	Activity	Year Ended December 31, 2017	Activity	Year Ended December 31, 2018
Goodwill	$ 469,966	$269,288	$ 739,254	$ (927)	$ 738,327
Accumulated impairment	(4,824)	0	(4,824)	0	(4,824)
Goodwill, net	$ 465,142	$269,288	$ 734,430	$ (927)	$ 733,503

During the first quarter of 2018, the Company performed its annual internal valuation of goodwill and impairment analysis by comparing the fair value of each reporting unit to its carrying value. Results of the valuations indicate there was no goodwill impairment.

Mortgage Servicing Rights

Under certain circumstances, the Company sells consumer residential mortgage loans in the secondary market and typically retains the right to service the loans sold. Generally, the Company's residential mortgage loans sold to third parties are sold on a non-recourse basis. Upon sale, a mortgage servicing right ("MSR") is established, which represents the current fair value of future net cash flows expected to be realized for performing the servicing activities. The Company stratifies these assets based on predominant risk characteristics, namely expected term of the underlying financial instruments, and uses a valuation model that calculates the present value of future cash flows to determine the fair value of servicing rights. MSRs are recorded in other assets at the lower of the initial capitalized amount, net of accumulated amortization or fair value. Mortgage loans serviced for others are not included in the accompanying consolidated statements of condition.

Table of Contents

The following table summarizes the changes in carrying value of MSRs and the associated valuation allowance:

(000's omitted)	2018	2017
Carrying value before valuation allowance at beginning of period	$1,358	$1,435
Additions	228	358
Merchants acquisition	0	64
Amortization	(449)	(499)
Carrying value before valuation allowance at end of period	1,137	1,358
Valuation allowance balance at beginning of period	0	0
Impairment charges	0	0
Impairment recoveries	0	0
Valuation allowance balance at end of period	0	0
Net carrying value at end of period	$1,137	$1,358
Fair value of MSRs at end of period	$2,397	$2,473
Principal balance of loans sold during the year	$18,228	$32,937
Principal balance of loans serviced for others	$333,862	$358,518
Custodial escrow balances maintained in connection with loans serviced for others	$4,982	$5,363

The following table summarizes the key economic assumptions used to estimate the value of the MSRs at December 31:

	2018	2017
Weighted-average contractual life (in years)	21.4	21.3
Weighted-average constant prepayment rate (CPR)	9.3 %	11.1%
Weighted-average discount rate	3.6 %	3.3 %

NOTE G: DEPOSITS

Deposits recorded in the consolidated statements of condition consist of the following at December 31:

(000's omitted)	2018	2017
Noninterest checking	$2,312,816	$2,293,057
Interest checking	1,920,545	1,830,914
Savings	1,448,208	1,421,512
Money market	1,901,262	2,124,633
Time	739,540	774,304
Total deposits	$8,322,371	$8,444,420

Interest on deposits recorded in the consolidated statements of income consists of the following at December 31:

(000's omitted)	2018	2017	2016
Interest on interest checking	$1,796	$1,032	$504
Interest on savings	858	841	863
Interest on money market	3,638	2,981	2,754
Interest on time	4,366	3,177	3,204
Total interest on deposits	$10,658	$8,031	$7,325

The approximate maturities of time deposits at December 31, 2018 are as follows:

(000's omitted) All Accounts Accounts $250,000

		or Greater
2019	$ 448,708	$ 40,960
2020	94,585	4,886
2021	123,021	20,100
2022	31,786	587
2023	41,223	3,087
Thereafter	217	0
Total	$ 739,540	$ 69,620

87

Table of Contents
NOTE H: BORROWINGS

Outstanding borrowings at December 31 are as follows:

(000's omitted)	2018	2017
FHLB overnight advance	$54,400	$24,000
Subordinated debt held by unconsolidated subsidiary trusts, net of discount of $0 and $332, respectively	97,939	122,814
Securities sold under agreement to repurchase, short term	259,367	337,011
FHLB Long term advances	1,976	2,071
Total borrowings	$413,682	$485,896

FHLB advances are collateralized by a blanket lien on the Company's residential real estate loan portfolio and various investment securities.

Borrowings at December 31, 2018 have contractual maturity dates as follows:

(000's omitted, except rate)	Carrying Value	Weighted-average Rate at December 31, 2018	
January 2, 2019	$313,767	1.01	%
July 3, 2023	575	2.25	%
October 23, 2023	484	1.50	%
October 1, 2025	315	1.50	%
March 1, 2029	602	2.50	%
December 15, 2034	20,619	4.74	%
December 15, 2036	77,320	4.44	%
Total	$413,682	1.84	%

The weighted-average interest rate on borrowings for the years ended December 31, 2018 and 2017 was 1.72% and 1.51%, respectively.

As of December 31, 2018, the Company sponsors two business trusts, Community Capital Trust IV ("CCT IV") and MBVT Statutory Trust I ("MBVT I"), of which 100% of the common stock is owned by the Company. The common stock of MBVT Statutory Trust I was acquired in the Merchants acquisition. The Company previously sponsored Community Statutory Trust III ("CST III") until July 31, 2018 when the Company exercised its right to redeem all of the CST III debentures and associated preferred securities for a total of $25.2 million. The trusts were formed for the purpose of issuing company-obligated mandatorily redeemable preferred securities to third-party investors and investing the proceeds from the sale of such preferred securities solely in junior subordinated debt securities of the Company. The debentures held by each trust are the sole assets of such trust. Distributions on the preferred securities issued by each trust are payable quarterly at a rate per annum equal to the interest rate being earned by the trust on the debentures held by that trust and are recorded as interest expense in the consolidated financial statements. The preferred securities are subject to mandatory redemption, in whole or in part, upon repayment of the debentures. The Company has entered into agreements which, taken collectively, fully and unconditionally guarantee the preferred securities subject to the terms of each of the guarantees. The terms of the preferred securities of each trust are as follows:

Trust	Issuance Date	Par Amount	Interest Rate	Maturity Date	Call Price
CCT IV	12/8/2006	$75.0 million	3 month LIBOR plus 1.65% (4.44%)	12/15/2036	Par

MBVT I	12/15/2004	$20.6 million	3 month LIBOR plus 1.95% (4.74%)	12/15/2034	Par

88

Table of Contents

NOTE I: INCOME TAXES

The provision for income taxes for the years ended December 31 is as follows:

(000's omitted)	2018	2017	2016
Current:			
Federal	$32,504	$31,152	$32,829
State and other	9,180	6,788	4,890
Deferred:			
Federal	2,122	(28,146)	11,444
State and other	541	(546)	1,622
Provision for income taxes	$44,347	$9,248	$50,785

Components of the net deferred tax liability, included in other liabilities, as of December 31 are as follows:

(000's omitted)	2018	2017
Allowance for loan losses	$ 12,131	$ 11,675
Employee benefits	4,479	4,216
Other, net	541	0
Deferred tax asset	17,151	15,891
Investment securities	14,451	22,690
Tax-deductible goodwill	39,540	39,154
Loan origination costs	6,851	6,109
Depreciation	3,098	2,372
Mortgage servicing rights	277	330
Pension	11,078	13,228
Other, net	0	542
Deferred tax liability	75,295	84,425
Net deferred tax liability	$ (58,144)	$ (68,534)

The Company has determined that no valuation allowance is necessary as it is more likely than not that the gross deferred tax assets will be realized through future reversals of existing temporary differences and through future taxable income.

A reconciliation of the differences between the federal statutory income tax rate and the effective tax rate for the years ended December 31 is shown in the following table:

	2018	2017	2016
Federal statutory income tax rate	21.0 %	35.0 %	35.0%
Increase (reduction) in taxes resulting from:			
Tax-exempt interest	(1.6)	(3.8)	(4.0)
State income taxes, net of federal benefit	3.4	2.5	2.7
Stock-based compensation	(0.9)	(2.0)	0
Federal deferred tax revaluation adjustment	0	(23.7)	0
Federal tax credits	(1.4)	(1.5)	0
Other, net	0.3	(0.7)	(0.9)
Effective income tax rate	20.8 %	5.8 %	32.8%

A reconciliation of the unrecognized tax benefits for the years ended December 31 is shown in the following table:

(000's omitted)	2018	2017	2016
Unrecognized tax benefits at beginning of year	$24	$92	$127
Changes related to:			
Lapse of statutes of limitations	(24)	(68)	(35)
Unrecognized tax benefits at end of year	$0	$24	$92

89

Table of Contents

As of December 31, 2018, there was no amount of unrecognized tax benefits that would impact the Company's effective tax rate if recognized. It is reasonably possible that the amount of unrecognized tax benefits could change in the next twelve months as a result of various examinations and expiration of statutes of limitations on prior tax returns.

The Company's policy is to recognize interest and penalties related to unrecognized tax benefits as part of income taxes in the consolidated statement of income. The accrued interest related to tax positions was immaterial.

The Company's federal and state income tax returns are routinely subject to examination from various governmental taxing authorities. Such examinations may result in challenges to the tax return treatment applied by the Company to specific transactions. Management believes that the assumptions and judgment used to record tax-related assets or liabilities have been appropriate. Future examinations by taxing authorities of the Company's federal or state tax returns could have a material impact on the Company's results of operations. The Company's federal income tax returns for years after 2014 may still be examined by the Internal Revenue Service. New York State income tax returns for years after 2014 may still be examined by the New York Department of Taxation and Finance. It is not possible to estimate, if and when those examinations may be completed.

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

NOTE J: LIMITS ON DIVIDENDS AND OTHER REVENUE SOURCES

The Company's ability to pay dividends to its shareholders is largely dependent on the Bank's ability to pay dividends to the Company. In addition to the capital requirements discussed below, the circumstances under which the Bank may pay dividends are limited by federal statutes, regulations, and policies. For example, as a national bank, the Bank must obtain the approval of the Office of the Comptroller of the Currency ("OCC") for payments of dividends if the total of all dividends declared in any calendar year would exceed the total of the Bank's net profits, as defined by applicable regulations, for that year, combined with its retained net profits for the preceding two years. Furthermore, the Bank may not pay a dividend in an amount greater than its undivided profits then on hand after deducting its losses and bad debts, as defined by applicable regulations. At December 31, 2018, the Bank had approximately $101.2 million in undivided profits legally available for the payment of dividends.

In addition, the Board of Governors of the Federal Reserve System ("FRB") and the OCC are authorized to determine under certain circumstances that the payment of dividends would be an unsafe or unsound practice and to prohibit payment of such dividends. The FRB has indicated that banking organizations should generally pay dividends only out of current operating earnings.

There are also statutory limits on the transfer of funds to the Company by its banking subsidiary, whether in the form of loans or other extensions of credit, investments or assets purchases. Such transfer by the Bank to the Company generally is limited in amount to 10% of the Bank's capital and surplus, or 20% in the aggregate. Furthermore, such loans and extensions of credit are required to be collateralized in specific amounts.

Table of Contents

NOTE K: BENEFIT PLANS

Pension and post-retirement plans

The Company provides a qualified defined benefit pension to eligible employees and retirees, other post-retirement health and life insurance benefits to certain retirees, an unfunded supplemental pension plan for certain key executives, and an unfunded stock balance plan for certain of its nonemployee directors. Using a measurement date of December 31, the following table shows the funded status of the Company's plans reconciled with amounts reported in the Company's consolidated statements of condition:

	Pension Benefits		Post-retirement Benefits	
(000's omitted)	2018	2017	2018	2017
Change in benefit obligation:				
Benefit obligation at the beginning of year	$147,450	$127,084	$ 1,785	$ 1,806
Service cost	4,561	4,181	0	0
Interest cost	5,676	5,717	69	76
Plan amendment / acquisition	883	11,646	0	0
Participant contributions	0	0	479	467
Deferred actuarial (gain)/loss	(4,177)	8,978	191	245
Benefits paid	(10,182)	(10,156)	(867)	(809)
Benefit obligation at end of year	144,211	147,450	1,657	1,785
Change in plan assets:				
Fair value of plan assets at beginning of year	217,107	180,400	0	0
Actual return of plan assets	(3,858)	22,954	0	0
Participant contributions	0	0	479	467
Employer contributions	605	9,839	388	342
Plan acquisition	0	14,070	0	0
Benefits paid	(10,182)	(10,156)	(867)	(809)
Fair value of plan assets at end of year	203,672	217,107	0	0
Over/(Under) funded status at year end	$59,461	$69,657	$ (1,657)	$ (1,785)
Amounts recognized in the consolidated statement of condition were:				
Other assets	$72,659	$81,000	$ 0	$ 0
Other liabilities	(13,198)	(11,343)	(1,657)	(1,785)
Amounts recognized in accumulated other comprehensive loss/(income) ("AOCI") were:				
Net loss	$39,410	$26,935	$ 592	$ 420
Net prior service cost (credit)	4,939	2,944	(1,444)	(1,622)
Pre-tax AOCI	44,349	29,879	(852)	(1,202)
Taxes	(10,870)	(7,340)	210	296
AOCI at year end	$33,479	$22,539	$ (642)	$ (906)

The benefit obligation for the defined benefit pension plan was $131.0 million and $136.1 million as of December 31, 2018 and 2017, respectively, and the fair value of plan assets as of December 31, 2018 and 2017 was $203.7 million and $217.1 million, respectively. Effective May 12, 2017, the Merchants Bank Pension Plan was merged into the Community Bank System, Inc. Pension Plan and the combined plan was revalued resulting in an additional unamortized actuarial gain of approximately $1.9 million, due primarily to a gain on plan assets that was partially offset by a decrease in the discount rate from 4.50% to 4.40% as of the valuation date. The defined benefit pension plan was amended effective December 31, 2018 to transfer certain obligations from the Company's non-qualified supplemental pension plan and restoration plan into the qualified defined benefit pension plan.

The Company has unfunded supplemental pension plans for certain key active and retired executives. The projected benefit obligation for the unfunded supplemental pension plan for certain key executives was $13.2 million and $11.3 million for 2018 and 2017, respectively. The Company also has an unfunded stock balance plan for certain of its nonemployee directors. The projected benefit obligation for the unfunded stock balance plan was $0.1 million for 2018 and 2017. The plan was frozen effective December 31, 2009.

Table of Contents

Effective June 1, 2018, the Company adopted the Community Bank System, Inc. Restoration Plan ("Restoration Plan"). The Restoration Plan is a non-qualified deferred compensation plan for certain employees whose benefits under tax-qualified retirement plans are restricted by the Internal Revenue Code Section 401(a)(17) limitation on compensation. Adoption of the plan resulted in an unfunded initial projected benefit obligation of approximately $0.8 million. The Restoration Plan was amended effective December 31, 2018 to transfer certain obligations into the Company's qualified defined benefit pension plan. The projected benefit obligation for the unfunded Restoration Plan is immaterial as of December 31, 2018.

Effective December 31, 2009, the Company terminated its post-retirement medical program for current and future employees. Remaining plan participants will include only existing retirees as of December 31, 2010. This change was accounted for as a negative plan amendment and a $3.5 million, net of income taxes, benefit for prior service was recognized in AOCI in 2009. This negative plan amendment is being amortized over the expected benefit utilization period of remaining plan participants.

Amounts recognized in accumulated other comprehensive income, net of tax, for the year ended December 31, are as follows:

	Pension Benefits		Post-retirement Benefits	
(000's omitted)	2018	2017	2018	2017
Prior service cost/(credit)	$1,509	$ 424	$ 135	$ 111
Net (gain) loss	9,431	(851)	129	148
Total	$10,940	$ (427)	$ 264	$ 259

The estimated costs, net of tax, that will be amortized from accumulated other comprehensive (income) loss into net periodic (income) cost over the next fiscal year are as follows:

(000's omitted)	Pension Benefits	Post-retirement Benefits
Prior service credit	$ 64	$ (179)
Net loss	2,376	36
Total	$ 2,440	$ (143)

The weighted-average assumptions used to determine the benefit obligations as of December 31 are as follows:

	Pension Benefits		Post-retirement Benefits	
	2018	2017	2018	2017
Discount rate	4.50 %	4.00 %	4.45 %	4.00 %
Expected return on plan assets	7.00 %	7.00 %	N/A	N/A
Rate of compensation increase	3.50 %	3.50 %	N/A	N/A

The net periodic benefit cost as of December 31 is as follows:

	Pension Benefits			Post-retirement Benefits		
(000's omitted)	2018	2017	2016	2018	2017	2016
Service cost	$ 4,561	$ 4,181	$ 4,106	$ 0	$ 0	$ 0
Interest cost	5,676	5,717	5,624	69	76	82
Expected return on plan assets	(14,820)	(13,354)	(11,842)	0	0	0
Plan amendment	13	0	20	0	0	0
Amortization of unrecognized net loss/(gain)	1,193	767	1,508	21	8	(5)
Amortization of prior service cost	(293)	55	43	(179)	(179)	(179)
Net periodic (benefit)	$ (3,670)	$ (2,634)	$ (541)	$ (89)	$ (95)	$ (102)

Prior service costs in which all or almost all of the plan's participants are fully eligible for benefits under the plan are amortized on a straight-line basis over the expected future working years of all active plan participants. Unrecognized gains or losses are amortized using the "corridor approach", which is the minimum amortization required. Under the corridor approach, the net gain or loss in excess of 10 percent of the greater of the projected benefit obligation or the market-related value of the assets is amortized on a straight-line basis over the expected future working years of all active plan participants.

Table of Contents

The weighted-average assumptions used to determine the net periodic pension cost for the years ended December 31 are as follows:

	Pension Benefits			Post-retirement Benefits		
	2018	2017	2016	2018	2017	2016
Discount rate	4.00%	4.40%	4.70%	4.00 %	4.40 %	4.70 %
Expected return on plan assets	7.00%	7.00%	7.00%	N/A	N/A	N/A
Rate of compensation increase	3.50%	3.50%	3.50%	N/A	N/A	N/A

The amount of benefit payments that are expected to be paid over the next ten years are as follows:

(000's omitted)	Pension Benefits	Post-retirement Benefits
2019	$ 9,250	$ 175
2020	9,547	139
2021	10,142	136
2022	10,607	133
2023	11,092	130
2024-2028	59,372	598

The payments reflect future service and are based on various assumptions including retirement age and form of payment (lump-sum versus annuity). Actual results may differ from these estimates.

The assumed discount rate is used to reflect the time value of future benefit obligations. The discount rate was determined based upon the yield on high-quality fixed income investments expected to be available during the period to maturity of the pension benefits. This rate is sensitive to changes in interest rates. A decrease in the discount rate would increase the Company's obligation and future expense while an increase would have the opposite effect. The expected long-term rate of return was estimated by taking into consideration asset allocation, reviewing historical returns on the type of assets held and current economic factors. Based on the Company's anticipation of future experience under the defined benefit pension plan, the mortality tables used to determine future benefit obligations under the plan were updated as of December 31, 2018 to the RP-2014 Mortality Table for employees and healthy annuitants, adjusted backward to 2006 with Scale MP-2014, and then adjusted for mortality improvements with the Scale MP-2017 mortality improvement scale on a generational basis. The appropriateness of the assumptions are reviewed annually.

Plan Assets

The investment objective for the defined benefit pension plan is to achieve an average annual total return over a five-year period equal to the assumed rate of return used in the actuarial calculations. At a minimum performance level, the portfolio should earn the return obtainable on high quality intermediate-term bonds. The Company's perspective regarding portfolio assets combines both preservation of capital and moderate risk-taking. Asset allocation favors fixed income securities, with a target allocation of approximately 60% equity securities and 40% fixed income securities and money market funds. Due to the volatility in the market, the target allocation is not always desirable and asset allocations will fluctuate between acceptable ranges. Prohibited transactions include purchase of securities on margin, uncovered call options, and short sale transactions.

Table of Contents

The fair values of the Company’s defined benefit pension plan assets at December 31, 2018 by asset category are as follows:

Asset category (000’s omitted)	Quoted Prices in Active Markets for Identical Assets Level 1	Significant Observable Inputs Level 2	Significant Unobservable Inputs Level 3	Total
Cash equivalents	$ 4,856	$ 0	$ 0	$4,856
Equity securities:				
U.S. large-cap	39,122	0	0	39,122
U.S mid/small cap	9,881	0	0	9,881
CBU stock	7,692	0	0	7,692
International	32,506	0	0	32,506
	89,201	0	0	89,201
Fixed income securities:				
Government securities	64,417	11,370	0	75,787
Investment grade bonds	12,054	0	0	12,054
High yield[(a)]	6,712	0	0	6,712
	83,183	11,370	0	94,553
Other investments [(b)]	14,267	66	0	14,333
Total [(c)]	$ 191,507	$ 11,436	$ 0	$202,943

The fair values of the Company’s defined benefit pension plan assets at December 31, 2017 by asset category are as follows:

Asset category (000’s omitted)	Quoted Prices in Active Markets for Identical Assets Level 1	Significant Observable Inputs Level 2	Significant Unobservable Inputs Level 3	Total
Money Market Accounts	$ 0	$ 10,381	$ 0	$10,381
Equity securities:				
U.S. large-cap	53,154	0	0	53,154
U.S mid/small cap	26,309	0	0	26,309
CBU stock	8,344	0	0	8,344
International	47,723	0	0	47,723
	135,530	0	0	135,530
Fixed income securities:				
Government securities	13,929	9,686	0	23,615
Investment grade bonds	19,278	0	0	19,278
High yield[(a)]	16,297	0	0	16,297
	49,504	9,686	0	59,190

Other investments [b]	11,302	73	0	11,375
Total [c]	$ 196,336	$ 20,140	$ 0	$216,476

(a) This category is exchange-traded funds representing a diversified index of high yield corporate bonds.

(b) This category is comprised of exchange-traded funds and mutual funds holding non-traditional investment classes including private equity funds and alternative exchange funds.

(c) Excludes dividends and interest receivable totaling $0.7 million and $0.6 million at December 31, 2018 and 2017, respectively.

94

Table of Contents

The valuation techniques used to measure fair value for the items in the table above are as follows:

- Money market funds - Managed portfolios, including commercial paper and other fixed income securities issued by U.S. and foreign corporations, asset-backed commercial paper, U.S. government securities, obligations of foreign governments and U.S. and foreign banks, which are valued at the closing price reported on the market on which the underlying securities are traded.
- Equity securities and other investments – Mutual funds, equity securities and common stock of the Company which are valued at the quoted market price of shares held at year-end.
- Fixed income securities - U.S. Treasuries, municipal bonds and notes, government sponsored entities, and corporate debt valued at the closing price reported on the active market on which the individual securities are traded or for municipal bonds and notes based on quoted prices for similar assets in the active market.

The Company makes contributions to its funded qualified pension plan as required by government regulation or as deemed appropriate by management after considering the fair value of plan assets, expected return on such assets, and the value of the accumulated benefit obligation. The Company funds the payment of benefit obligations for the supplemental pension and post-retirement plans because such plans do not hold assets for investment.

401(k) Employee Stock Ownership Plan

The Company has a 401(k) Employee Stock Ownership Plan in which employees can contribute from 1% to 90% of eligible compensation, with the first 3% being eligible for a 100% matching contribution in the form of Company common stock and the next 3% being eligible for a 50% matching contributions in the form of Company common stock. The expense recognized under this plan for the years ended December 31, 2018, 2017 and 2016 was $5.9 million, $5.3 million, and $4.3 million, respectively. Effective January 1, 2010, the defined benefit pension plan was modified to a new plan design that includes an interest credit contribution to be made to the 401(k) plan. The expense recognized for this interest credit contribution for the years ended December 31, 2018, 2017, and 2016 was $0.9 million, $0.8 million, and $0.7 million, respectively.

The Company acquired The Merchants Bank 401(k) ESOP Plan with the Merchants acquisition and The Gordon B. Roberts 401(k) Plan with the GBR acquisition. Effective January 1, 2018, The Merchants Bank 401(k) ESOP Plan and The Gordon B. Roberts 401(k) Plan were merged into and became part of the Community Bank System, Inc. 401(k) Employee Stock Ownership Plan.

Other Deferred Compensation Arrangements

In addition to the supplemental pension plans for certain executives, the Company has nonqualified deferred compensation arrangements for several former directors, officers and key employees. All benefits provided under these plans are unfunded and payments to plan participants are made by the Company. At December 31, 2018 and 2017, the Company has recorded a liability of $2.8 million and $3.1 million, respectively. The expense recognized under these plans for the years ended December 31, 2018, 2017, and 2016 was approximately $0.08 million, $0.3 million, and $0.03 million, respectively.

Deferred Compensation Plans for Directors

Directors of the Company may defer all or a portion of their director fees under the Deferred Compensation Plan for Directors. Under this plan, there is a separate account for each participating director which is credited with the amount of shares that could have been purchased with the director's fees as well as any dividends on such shares. On the distribution date, the director will receive common stock equal to the accumulated share balance in their account. As of December 31, 2018 and 2017, there were 151,977 and 150,110 shares credited to the participants' accounts, for which a liability of $4.6 million and $4.2 million was accrued, respectively. The expense recognized under the plan for the years ended December 31, 2018, 2017 and 2016, was $0.2 million, $0.2 million, and $0.2 million, respectively.

The Company acquired deferred compensation plans for certain non-employee directors and trustees of Merchants. Under the terms of these acquired deferred compensation plans, participating directors could elect to have all, or a specified percentage, of their Merchants director's fees for a given year paid in the form of cash or deferred in the form of restricted shares of Merchants' common stock. Directors who elected to have their compensation deferred were credited with a number of shares of Merchants' common stock equal in value to the amount of fees deferred. These shares were converted to shares of Company stock in connection with the acquisition and are held in a rabbi trust. The shares held in the rabbi trust are considered outstanding for purposes of computing earnings per share. The participating director may not sell, transfer or otherwise dispose of these shares prior to distribution. With respect to shares of common stock issued or otherwise transferred to a participating director, the participating director has the right to receive dividends or other distributions thereon.

Table of Contents

NOTE L: STOCK-BASED COMPENSATION PLANS

The Company has a long-term incentive program for directors, officers and employees. Under this program, the Company initially authorized four million shares of Company common stock for the grant of incentive stock options, nonqualified stock options, restricted stock awards, and retroactive stock appreciation rights. The long-term incentive program was amended effective May 25, 2011, May 14, 2014 and May 17, 2017 to authorize an additional 900,000 shares, 1,000,000 shares and 1,000,000 shares of Company common stock, respectively, for the grant of incentive stock options, nonqualified stock options, restricted stock awards, and retroactive stock appreciation rights. As of December 31, 2018, the Company has authorization to grant up to approximately 1.5 million additional shares of Company common stock for these instruments. The nonqualified (offset) stock options in its Director's Stock Balance Plan vest and become exercisable immediately and expire one year after the date the director retires or two years in the event of death. The remaining options have a ten-year term, and vest and become exercisable on a grant-by-grant basis, ranging from immediate vesting to ratably over a five-year period.

Activity in this long-term incentive program is as follows:

	Stock Options	
	Outstanding	Weighted-average Exercise Price of Shares
Outstanding at December 31, 2016	1,755,992	$ 30.85
Granted	197,943	57.02
Exercised	(238,499)	25.72
Forfeited	(7,140)	37.47
Outstanding at December 31, 2017	1,708,296	34.57
Granted	213,504	55.92
Exercised	(268,004)	27.94
Forfeited	(9,435)	45.54
Outstanding at December 31, 2018	1,644,361	$ 38.36
Exercisable at December 31, 2018	1,010,795	$ 32.66

The following table summarizes the information about stock options outstanding under the Company's stock option plan at December 31, 2018:

	Options outstanding			Options exercisable	
Range of Exercise Price	Shares	Weighted-average Exercise Price	Weighted-average Remaining Life (years)	Shares	Weighted-average Exercise Price
$ 0.00 – $18.00	10,978	$ 17.82	0.31	10,978	$ 17.82
$ 18.001 – $28.00	215,014	23.26	2.67	215,014	23.26
$ 28.001 – $29.00	142,691	28.78	3.22	142,691	28.78
$ 29.001 – $30.00	185,866	29.79	4.21	185,866	29.79
$ 30.001 – $40.00	686,103	37.09	6.34	391,658	37.06
$ 40.001 – $60.00	403,709	56.45	8.73	64,588	56.72
TOTAL	1,644,361	$ 38.36	5.90	1,010,795	$ 32.66

The weighted-average remaining contractual term of outstanding and exercisable stock options at December 31, 2018 is 5.90 years and 4.71 years, respectively. The aggregate intrinsic value of outstanding and exercisable stock options at December 31, 2018 is $32.8 million and $25.9 million, respectively.

The Company recognized stock-based compensation expense related to non-qualified stock options of $2.6 million, $2.2 million and $2.2 million for the years ended December 31, 2018, 2017 and 2016, respectively. A related income tax benefit was recognized of $0.6 million, $0.8 million and $0.8 million for the 2018, 2017 and 2016 years, respectively. Compensation expense related to restricted stock vesting recognized in the income statement for 2018, 2017 and 2016 was approximately $3.2 million, $2.7 million and $2.4 million, respectively.

Table of Contents

Management estimated the fair value of options granted using the Black-Scholes option-pricing model. This model was originally developed to estimate the fair value of exchange-traded equity options, which (unlike employee stock options) have no vesting period or transferability restrictions. As a result, the Black-Scholes model is not necessarily a precise indicator of the value of an option, but it is commonly used for this purpose. The Black-Scholes model requires several assumptions, which management developed based on historical trends and current market observations.

	2018	2017	2016
Weighted-average Fair Value of Options Granted	$13.44	$12.78	$7.90
Assumptions:			
Weighted-average expected life (in years)	6.50	6.50	6.50
Future dividend yield	2.91 %	3.19 %	3.43 %
Share price volatility	29.44%	29.71%	30.00%
Weighted-average risk-free interest rate	2.82 %	2.31 %	1.72 %

Unrecognized stock-based compensation expense related to non-vested stock options totaled $4.7 million at December 31, 2018. The weighted-average period over which this unrecognized expense would be recognized is 3.3 years. The total fair value of stock options vested during 2018, 2017, and 2016 were $2.3 million, $2.2 million and $2.1 million, respectively.

During the 12 months ended December 31, 2018 and 2017, proceeds from stock option exercises totaled $9.4 million and $7.7 million, respectively, and the related tax benefits from exercise were approximately $1.6 million and $2.3 million, respectively. During the twelve months ended December 31, 2018 and 2017, approximately 0.3 million and 0.2 million shares, respectively, were issued in connection with stock option exercises each year. The total intrinsic value of options exercised during 2018, 2017 and 2016 were $8.4 million, $7.6 million and $10.3 million, respectively.

A summary of the status of the Company's unvested restricted stock awards as of December 31, 2018, and changes during the twelve months ended December 31, 2018 and 2017, is presented below:

	Restricted Shares	Weighted-average grant date fair value
Unvested at December 31, 2016	253,830	$ 29.98
Awards	46,428	57.02
Forfeitures	(4,863)	24.78
Vestings	(64,522)	33.69
Unvested at December 31, 2017	230,873	34.06
Awards	50,133	55.92
Forfeitures	(3,429)	34.95
Vestings	(56,514)	39.40
Unvested at December 31, 2018	221,063	$ 37.72

Unrecognized stock-based compensation expense related to unvested restricted stock totaled $4.6 million at December 31, 2018, which will be recognized as expense over the next five years. The weighted-average period over which this unrecognized expense would be recognized is 3.2 years. The total fair value of restricted stock vested during 2018, 2017, and 2016 were $2.3 million, $2.2 million and $2.5 million, respectively.

NOTE M: EARNINGS PER SHARE

The two class method is used in the calculations of basic and diluted earnings per share. Under the two class method, earnings available to common shareholders for the period are allocated between common shareholders and participating securities according to dividends declared and participation rights in undistributed earnings. The Company has determined that all of its outstanding non-vested stock awards are participating securities as of December 31, 2018.

Basic earnings per share are computed based on the weighted-average of the common shares outstanding for the period. Diluted earnings per share are based on the weighted-average of the shares outstanding and the assumed exercise of stock options during the year. The dilutive effect of options is calculated using the treasury stock method of accounting. The treasury stock method determines the number of common shares that would be outstanding if all the dilutive options (those where the average market price is greater than the exercise price) were exercised and the proceeds were used to repurchase common shares in the open market at the average market price for the applicable time period. There were approximately 0.4 million, 0.2 million and 0.3 million weighted-average anti-dilutive stock options outstanding at December 31, 2018, 2017 and 2016, respectively, which were not included in the computation below.

Table of Contents

The following is a reconciliation of basic to diluted earnings per share for the years ended December 31, 2018, 2017 and 2016.

(000's omitted, except per share data)	2018	2017	2016
Net income	$168,641	$150,717	$103,812
Income attributable to unvested stock-based compensation awards	(744)	(597)	(550)
Income available to common shareholders	$167,897	$150,120	$103,262
Weighted-average common shares outstanding - basic	51,165	48,843	44,091
Basic earnings per share	$3.28	$3.07	$2.34
Net income	$168,641	$150,717	$103,812
Income attributable to unvested stock-based compensation awards	(744)	(597)	(550)
Income available to common shareholders	$167,897	$150,120	$103,262
Weighted-average common shares outstanding	51,165	48,843	44,091
Assumed exercise of stock options	583	627	394
Weighted-average common shares outstanding – diluted	51,748	49,470	44,485
Diluted earnings per share	$3.24	$3.03	$2.32
Cash dividends declared per share	$1.44	$1.32	$1.26

Stock Repurchase Program

At its December 2017 meeting, the Company's Board of Directors (the "Board") approved a stock repurchase program authorizing the repurchase of up to 2.5 million shares of the Company's common stock in accordance with securities laws and regulations, through December 31, 2018. At its December 2018 meeting, the Board approved a similar program for 2019, authorizing the repurchase of up to 2.5 million shares of the Company's common stock through December 31, 2019. Any repurchased shares will be used for general corporate purposes, including those related to stock plan activities. The timing and extent of repurchases will depend on market conditions and other corporate considerations as determined at the Company's discretion. There were no stock repurchases pursuant to the announced plans in 2018 or 2017.

NOTE N: COMMITMENTS, CONTINGENT LIABILITIES AND RESTRICTIONS

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

The contract amounts of commitments and contingencies are as follows at December 31:

(000's omitted)	2018	2017
Commitments to extend credit	$1,134,576	$1,080,004

Standby letters of credit	33,169	23,782
Total	$1,167,745	$1,103,786

The Bank has unused lines of credit of $25.0 million at December 31, 2018. The Bank has unused borrowing capacity of approximately $1.62 billion through collateralized transactions with the FHLB and $23.5 million through collateralized transactions with the Federal Reserve.

The Company is required to maintain a reserve balance, as established by the FRB. The required average total reserve for the 14-day maintenance period of December 20, 2018 through January 2, 2019 was $89.7 million, with $76.6 million represented by cash on hand and the remaining $13.1 million was required to be on deposit with the Federal Reserve.

Table of Contents

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

NOTE O: LEASES

The Company leases buildings, office space, and equipment under agreements that expire in various years. Rental expense included in operating expenses amounted to $9.0 million, $7.3 million and $5.8 million in 2018, 2017 and 2016, respectively. The future minimum rental commitments as of December 31, 2018 for all non-cancelable operating leases are as follows:

2019	$8,452
2020	7,262
2021	5,673
2022	4,411
2023	2,621
Thereafter	10,390
Total	$38,809

NOTE P: REGULATORY MATTERS

The Company and the Bank are subject to various regulatory capital requirements administered by federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Company's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company and the Bank must meet specific capital guidelines that involve quantitative measures of the Company's and the Bank's assets, liabilities, and certain off-balance sheet items as calculated under regulatory accounting practices. The Company's and the Bank's capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors. Management believes, as of December 31, 2018, that the Company and Bank meet all applicable capital adequacy requirements.

Basel III Transitional rules became effective for the Company on January 1, 2015 with all of the requirements being phased in over a multi-year schedule, and fully phased in by January 1, 2019. Beginning in 2016, the Company and the Bank are required to maintain a "capital conservation buffer," composed entirely of common equity Tier 1 capital, in addition to minimum risk-based capital ratios. The required capital conservation buffer is 1.875% for 2018 and 1.25% for 2017. Therefore, to satisfy both the minimum risk-based capital ratios and the capital conservation buffer in 2018, the Company and the Bank must maintain: (i) Common equity Tier 1 capital to total risk-weighted assets of at least 6.375%, (ii) Tier 1 capital to total risk-weighted assets of at least 7.875%, and (iii) Total capital (Tier 1 capital plus Tier 2 capital) to total risk-weighted assets of at least 9.875%. To satisfy both the minimum risk-based capital ratios and the capital conservation buffer in 2017, the Company and the Bank must maintain: (i) Common equity Tier 1 capital to total risk-weighted assets of at least 5.75%, (ii) Tier 1 capital to total risk-weighted assets of at least 7.25%, and (iii) Total capital (Tier 1 capital plus Tier 2 capital) to total risk-weighted assets of at least 9.25%. As of December 31, 2018 and 2017, the amounts, ratios and requirements for the Company are presented below calculated under the Basel III Standardized Transitional Approach. As of December 31, 2018, the OCC categorized the Company and Bank as "well capitalized" under the regulatory framework for prompt corrective action.

Table of Contents

(000's omitted)	Actual Amount	Ratio	For capital adequacy purposes Amount	Ratio	For capital adequacy purposes plus Capital Conservation Buffer Amount	Ratio	To be well-capitalized under prompt corrective action Amount	Ratio
Community Bank System, Inc.:								
2018								
Tier 1 Leverage ratio	$1,093,166	11.08%	$394,700	4.00 %			$493,375	5.00 %
Tier 1 risk-based capital	1,093,166	18.23%	359,747	6.00 %	$472,168	7.875 %	479,662	8.00 %
Total risk-based capital	1,142,927	19.06%	479,662	8.00 %	592,083	9.875 %	599,578	10.00 %
Common equity tier 1 capital	998,111	16.65%	269,810	4.50 %	382,231	6.375 %	389,726	6.50 %
2017								
Tier 1 Leverage ratio	$995,860	10.00%	$398,183	4.00 %			$497,729	5.00 %
Tier 1 risk-based capital	995,860	16.64%	358,988	6.00 %	$433,777	7.25 %	478,651	8.00 %
Total risk-based capital	1,043,910	17.45%	478,651	8.00 %	553,440	9.25 %	598,314	10.00 %
Common equity tier 1 capital	876,685	14.65%	269,241	4.50 %	344,030	5.75 %	388,904	6.50 %
Community Bank, N.A.:								
2018								
Tier 1 Leverage ratio	$912,995	9.32 %	$391,953	4.00 %			$489,941	5.00 %
Tier 1 risk-based capital	912,995	15.35%	356,973	6.00 %	$468,527	7.875 %	475,964	8.00 %
Total risk-based capital	962,756	16.18%	475,964	8.00 %	587,518	9.875 %	594,955	10.00 %
Common equity tier 1 capital	912,940	15.35%	267,730	4.50 %	379,284	6.375 %	386,721	6.50 %
2017								
Tier 1 Leverage ratio	$859,538	8.71 %	$394,981	4.00 %			$493,726	5.00 %
Tier 1 risk-based capital	859,538	14.50%	355,641	6.00 %	$429,733	7.25 %	474,188	8.00 %
Total risk-based capital	907,588	15.31%	474,188	8.00 %	548,280	9.25 %	592,736	10.00 %
Common equity tier 1 capital	859,483	14.50%	266,731	4.50 %	340,823	5.75 %	385,278	6.50 %

NOTE Q: PARENT COMPANY STATEMENTS

The condensed statements of condition of the parent company, Community Bank System, Inc., at December 31 are as follows:

(000's omitted)	2018	2017
Assets:		
Cash and cash equivalents	$116,133	$84,460
Investment securities	3,452	4,322
Investment in and advances to:		
Bank subsidiary	1,522,109	1,511,780
Non-bank subsidiaries	182,617	169,341
Other assets	8,957	9,150
Total assets	$1,833,268	$1,779,053

Liabilities and shareholders' equity:		
Accrued interest and other liabilities	$21,546	$20,924
Borrowings	97,939	122,814
Shareholders' equity	1,713,783	1,635,315
Total liabilities and shareholders' equity	$1,833,268	$1,779,053

100

Table of Contents

The condensed statements of income of the parent company for the years ended December 31 is as follows:

(000's omitted)	2018	2017	2016
Revenues:			
Dividends from subsidiaries:			
Bank subsidiary	$98,000	$91,000	$89,000
Non-bank subsidiaries	9,250	35,500	1,750
Interest and dividends on investments	161	133	102
Total revenues	107,411	126,633	90,852
Expenses:			
Interest on borrowings	4,677	3,904	2,949
Acquisition expenses	0	91	429
Loss on debt prepayment	318	0	0
Other expenses	131	26	11
Total expenses	5,126	4,021	3,389
Income before tax benefit and equity in undistributed net income of subsidiaries	102,285	122,612	87,463
Income tax benefit	1,330	1,930	866
Income before equity in undistributed net income of subsidiaries	103,615	124,542	88,329
Equity in undistributed net income of subsidiaries	65,026	26,175	15,483
Net income	$168,641	$150,717	$103,812
Other comprehensive (loss), net of tax:			
Changes in other comprehensive (loss)/income related to pension and other post retirement obligations	(11,204)	168	3,322
Changes in other comprehensive loss related to unrealized losses on available-for-sale securities	(30,402)	(11,065)	(14,714)
Other comprehensive loss	(41,606)	(10,897)	(11,392)
Comprehensive income	$127,035	$139,820	$92,420

Table of Contents

The statements of cash flows of the parent company for the years ended December 31 is as follows:

(000's omitted)	2018	2017	2016
Operating activities:			
Net income	$168,641	$150,717	$103,812
Adjustments to reconcile net income to net cash provided by operating activities			
Equity in undistributed net income of subsidiaries	(65,026)	(26,175)	(15,483)
Net change in other assets and other liabilities	(1,084)	1,870	(215)
Net cash provided by operating activities	102,531	126,412	88,114
Investing activities:			
Proceeds from redemption of investment securities	776	0	0
Cash paid for acquisitions, net of cash acquired of $0, $150,534, and $0, respectively	0	(139,471)	0
Capital contributions to subsidiaries	0	(11,063)	0
Net cash provided by/(used in) investing activities	776	(150,534)	0
Financing activities:			
Repayment of borrowings	(25,207)	0	0
Issuance of common stock	12,507	9,700	15,326
Purchase of treasury stock	(298)	(3,306)	(3,470)
Sale of treasury stock	12,561	10,060	8,888
Increase in deferred compensation arrangements	298	3,306	0
Cash dividends paid	(71,495)	(62,305)	(55,048)
Net cash used in financing activities	(71,634)	(42,545)	(34,304)
Change in cash and cash equivalents	31,673	(66,667)	53,810
Cash and cash equivalents at beginning of year	84,460	151,127	97,317
Cash and cash equivalents at end of year	$116,133	$84,460	$151,127
Supplemental disclosures of cash flow information:			
Cash paid for interest	$4,857	$3,826	$2,909
Supplemental disclosures of noncash financing activities			
Dividends declared and unpaid	$19,808	$17,460	$14,268
Capital contributions to subsidiaries	0	513,769	0
Common stock issued for acquisition	0	343,132	0

NOTE R: FAIR VALUE

Accounting standards allow entities an irrevocable option to measure certain financial assets and financial liabilities at fair value. Unrealized gains and losses on items for which the fair value option has been elected are reported in earnings. The Company has elected to value mortgage loans held for sale at fair value in order to more closely match the gains and losses associated with loans held for sale with the gains and losses on forward sales contracts. Accordingly, the impact on the valuation will be recognized in the Company's consolidated statement of income. All mortgage loans held for sale are current and in performing status.

Accounting standards establish a framework for measuring fair value and require certain disclosures about such fair value instruments. It defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (i.e. exit price). Inputs used to measure fair value are classified into the following hierarchy:

Level 1 – Quoted prices in active markets for identical assets or liabilities.
Level 2 – Quoted prices in active markets for similar assets or liabilities, or quoted prices for identical or similar assets or liabilities in markets that are not active, or inputs other than quoted prices that are observable for the asset or

liability.

Level 3 – Significant valuation assumptions not readily observable in a market.

Table of Contents

A financial instrument's categorization within the valuation hierarchy is based upon the lowest level of input that is significant to the fair value measurement. The following tables set forth the Company's financial assets and liabilities that were accounted for at fair value on a recurring basis. There were no transfers between any of the levels for the periods presented.

	December 31, 2018			
(000's omitted)	Level 1	Level 2	Level 3	Total Fair Value
Available-for-sale investment securities:				
U.S. Treasury and agency securities	$1,896,931	$126,822	$ 0	$2,023,753
Obligations of state and political subdivisions	0	459,154	0	459,154
Government agency mortgage-backed securities	0	382,477	0	382,477
Corporate debt securities	0	2,546	0	2,546
Government agency collateralized mortgage obligations	0	68,119	0	68,119
Total available-for-sale investment securities	1,896,931	1,039,118	0	2,936,049
Equity securities	432	0	0	432
Mortgage loans held for sale	0	83	0	83
Interest rate swap agreements asset	0	793	0	793
Interest rate swap agreements liability	0	(742)	0	(742)
Total	$1,897,363	$1,039,252	$ 0	$2,936,615

	December 31, 2017			
(000's omitted)	Level 1	Level 2	Level 3	Total Fair Value
Available-for-sale investment securities:				
U.S. Treasury and agency securities	$1,909,290	$144,781	$ 0	$2,054,071
Obligations of state and political subdivisions	0	528,956	0	528,956
Government agency mortgage-backed securities	0	357,538	0	357,538
Corporate debt securities	0	2,623	0	2,623
Government agency collateralized mortgage obligations	0	87,374	0	87,374
Marketable equity securities	526	0	0	526
Total available-for-sale investment securities	1,909,816	1,121,272	0	3,031,088
Mortgage loans held for sale	0	461	0	461
Commitments to originate real estate loans for sale	0	0	89	89
Forward sales commitments	0	4	0	4
Interest rate swap agreements asset	0	1,064	0	1,064
Interest rate swap agreements liability	0	(904)	0	(904)
Total	$1,909,816	$1,121,897	$ 89	$3,031,802

The valuation techniques used to measure fair value for the items in the table above are as follows:

- Available for sale investment securities – The fair value of available-for-sale investment securities is based upon quoted prices, if available. If quoted prices are not available, fair values are measured using quoted market prices for similar securities or model-based valuation techniques. Level 1 securities include U.S. Treasury obligations and marketable equity securities that are traded by dealers or brokers in active over-the-counter markets. Level 2 securities include U.S. agency securities, mortgage-backed securities issued by government-sponsored entities, municipal securities and corporate debt securities that are valued by reference to prices for similar securities or through model-based techniques in which all significant inputs, such as reported trades, trade execution data, LIBOR swap yield curve, market prepayment speeds, credit information, market spreads, and security's terms and conditions, are observable. See Note C for further disclosure of the fair value of investment securities.

- Mortgage loans held for sale – Mortgage loans held for sale are carried at fair value, which is determined using quoted secondary-market prices of loans with similar characteristics and, as such, have been classified as a Level 2 valuation. The unpaid principal value of mortgage loans held for sale at December 31, 2018 is approximately $0.1 million. The unrealized gain on mortgage loans was recognized in other banking services revenues in the Consolidated Statement of Income for the year ended December 31, 2018 and was immaterial.

Table of Contents

- Forward sales commitments – The Company enters into forward sales commitments to sell certain residential real estate loans. Such commitments are considered to be derivative financial instruments and, therefore, are carried at estimated fair value in the other asset or other liability section of the consolidated statement of condition. The fair value of these forward sales commitments is primarily measured by obtaining pricing from certain government-sponsored entities and reflects the underlying price the entity would pay the Company for an immediate sale on these mortgages. As such, these instruments are classified as Level 2 in the fair value hierarchy.
- Commitments to originate real estate loans for sale – The Company enters into various commitments to originate residential real estate loans for sale. Such commitments are considered to be derivative financial instruments and, therefore, are carried at estimated fair value in the other asset or other liability section of the consolidated statement of condition. The estimated fair value of these commitments is determined using quoted secondary market prices obtained from certain government-sponsored entities. Additionally, accounting guidance requires the expected net future cash flows related to the associated servicing of the loan to be included in the fair value measurement of the derivative. The expected net future cash flows are based on a valuation model that calculates the present value of estimated net servicing income. The valuation model incorporates assumptions that market participants would use in estimating future net servicing income. Such assumptions include estimates of the cost of servicing loans, appropriate discount rate and prepayment speeds. The determination of expected net cash flows is considered a significant unobservable input contributing to the Level 3 classification of commitments to originate real estate loans for sale.
- Interest rate swap agreements – The interest rate swaps are reported at their fair value utilizing Level 2 inputs from third parties. The fair value of our interest rate swaps are determined using prices obtained from a third party advisor. The fair value measurement of the interest rate swap is determined by netting the discounted future fixed cash payments and the discounted expected variable cash receipts. The variable cash receipts are based on the expectation of future interest rates derived from observed market interest rate curves.

The changes in Level 3 assets measured at fair value on a recurring basis are immaterial.

Assets and liabilities measured on a non-recurring basis:

	December 31, 2018				December 31, 2017			
(000's omitted)	Level 1	Level 2	Level 3	Total Fair Value	Level 1	Level 2	Level 3	Total Fair Value
Impaired loans	$0	$ 0	$1,102	$ 1,102	$0	$ 0	$0	$ 0
Other real estate owned	0	0	1,320	1,320	0	0	1,915	1,915
Total	$0	$ 0	$2,422	$ 2,422	$0	$ 0	$1,915	$ 1,915

Loans are generally not recorded at fair value on a recurring basis. Periodically, the Company records nonrecurring adjustments to the carrying value of loans based on fair value measurements for partial charge-offs of the uncollectible portions of those loans. Nonrecurring adjustments also include certain impairment amounts for collateral-dependent loans calculated when establishing the allowance for credit losses. Such amounts are generally based on the fair value of the underlying collateral supporting the loan and, as a result, the carrying value of the loan less the calculated valuation amount does not necessarily represent the fair value of the loan. Real estate collateral is typically valued using independent appraisals or other indications of value based on recent comparable sales of similar properties or assumptions generally observable in the marketplace, adjusted for non-observable inputs. Thus, the resulting nonrecurring fair value measurements are generally classified as Level 3. Estimates of fair value used for other collateral supporting commercial loans generally are based on assumptions not observable in the marketplace and, therefore, such valuations classify as Level 3.

Other real estate owned ("OREO") is valued at the time the loan is foreclosed upon and the asset is transferred to OREO. The value is based primarily on third party appraisals, less estimated costs to sell. The appraisals are sometimes further discounted based on management's historical knowledge, changes in market conditions from the time of valuation, and/or management's expertise and knowledge of the customer and customer's business. Such discounts are significant, ranging from 9% to 69% at December 31, 2018, and result in a Level 3 classification of the inputs for determining fair value. OREO is reviewed and evaluated on at least a quarterly basis for additional impairment and adjusted accordingly, based on the same factors identified above. The Company recovers the carrying value of OREO through the sale of the property. The ability to affect future sales prices is subject to market conditions and factors beyond the Company's control and may impact the estimated fair value of a property.

Table of Contents

Originated mortgage servicing rights are recorded at their fair value at the time of sale of the underlying loan, and are amortized in proportion to and over the estimated period of net servicing income. The fair value of mortgage servicing rights is based on a valuation model incorporating inputs that market participants would use in estimating future net servicing income. Such inputs include estimates of the cost of servicing loans, appropriate discount rate, and prepayment speeds and are considered to be unobservable and contribute to the Level 3 classification of mortgage servicing rights. In accordance with GAAP, the Company must record impairment charges, on a nonrecurring basis, when the carrying value of a stratum exceeds its estimated fair value. Impairment is recognized through a valuation allowance. There is no valuation allowance at December 31, 2018 as the fair value of mortgage servicing rights of approximately $2.4 million exceeded the carrying value of approximately $1.1 million.

The Company evaluates goodwill for impairment on an annual basis, or more often if events or circumstances indicate there may be impairment. 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. If so, the implied fair value of the reporting unit's goodwill is compared to its carrying amount and the impairment loss is measured by the excess of the carrying value of the goodwill over fair value of the goodwill. In such situations, the Company performs a discounted cash flow modeling technique that requires management to make estimates regarding the amount and timing of expected future cash flows of the assets and liabilities of the reporting unit that enable the Company to calculate the implied fair value of the goodwill. It also requires use of a discount rate that reflects the current return expectation of the market in relation to present risk-free interest rates, expected equity market premiums, peer volatility indicators and company-specific risk indicators. The Company did not recognize an impairment charge during 2018 or 2017.

The significant unobservable inputs used in the determination of fair value of assets classified as Level 3 on a recurring or non-recurring basis as of December 31, 2018 are as follows:

(000's omitted)	Fair Value	Valuation Technique	Significant Unobservable Inputs	Significant Unobservable Input Range (Weighted Average)	
Impaired loans	$ 1,102	Fair value of collateral	Estimated cost of disposal/market adjustment	9.0% - 35.4% (28.8	%)
Other real estate owned	1,320	Fair value of collateral	Estimated cost of disposal/market adjustment	9.0% - 69.3% (23.8	%)

The significant unobservable inputs used in the determination of fair value of assets classified as Level 3 on a recurring or non-recurring basis as of December 31, 2017 are as follows:

(000's omitted)	Fair Value	Valuation Technique	Significant Unobservable Inputs	Significant Unobservable Input Range (Weighted Average)	
Other real estate owned	$ 1,915	Fair value of collateral	Estimated cost of disposal/market adjustment	9.0% - 99.0% (38.5	%)
Commitments to originate real estate loans for sale	89	Discounted cash flow	Embedded servicing value	1	%

The Company determines fair values based on quoted market values, where available, estimates of present values, or other valuation techniques. Those techniques are significantly affected by the assumptions used, including, but not limited to, the discount rate and estimates of future cash flows. In that regard, the derived fair value estimates cannot be substantiated by comparison to independent markets and, in many cases, may not be realized in immediate settlement of the instrument. Certain financial instruments and all nonfinancial instruments are excluded from fair value disclosure requirements. Accordingly, the aggregate fair value amounts presented do not represent the underlying value of the Company.

The carrying amounts and estimated fair values of the Company's other financial instruments that are not accounted for at fair value at December 31, 2018 and 2017 are as follows:

	December 31, 2018		December 31, 2017	
(000's omitted)	Carrying Value	Fair Value	Carrying Value	Fair Value
Financial assets:				
Net loans	$6,231,837	$6,247,939	$6,209,174	$6,244,941
Financial liabilities:				
Deposits	8,322,371	8,308,765	8,444,420	8,431,481
Short-term borrowings	54,400	54,400	24,000	24,000
Securities sold under agreement to repurchase, short-term	259,367	259,367	337,011	337,011
Other long-term debt	1,976	1,921	2,071	2,021
Subordinated debt held by unconsolidated subsidiary trusts	97,939	97,939	122,814	122,814

Table of Contents

The following is a further description of the principal valuation methods used by the Company to estimate the fair values of its financial instruments.

Loans have been classified as a Level 3 valuation. Fair values for variable rate loans that reprice frequently are based on carrying values. Fair values for fixed rate loans are estimated using discounted cash flows and interest rates currently being offered for loans with similar terms to borrowers of similar credit quality.

Deposits have been classified as a Level 2 valuation. The fair value of demand deposits, interest-bearing checking deposits, savings accounts and money market deposits is the amount payable on demand at the reporting date. The fair value of time deposit obligations are based on current market rates for similar products.

Borrowings and subordinated debt held by unconsolidated subsidiary trusts have been classified as a Level 2 valuation. The fair value of FHLB overnight advances and securities sold under agreement to repurchase, short-term, is the amount payable on demand at the reporting date. Fair values for long-term borrowings and subordinated debt held by unconsolidated subsidiary trusts are estimated using discounted cash flows and interest rates currently being offered on similar securities. The difference between the carrying values of long-term borrowings and subordinated debt held by unconsolidated subsidiary trusts, and their fair values, are not material as of the reporting dates.

Other financial assets and liabilities – Cash and cash equivalents have been classified as a Level 1 valuation, while accrued interest receivable and accrued interest payable have been classified as a Level 2 valuation. The fair values of each approximate the respective carrying values because the instruments are payable on demand or have short-term maturities and present relatively low credit risk and interest rate risk.

NOTE S: DERIVATIVE INSTRUMENTS

The Company is party to derivative financial instruments in the normal course of its business to meet the financing needs of its customers and to manage its own exposure to fluctuations in interest rates. These financial instruments have been limited to interest rate swap agreements, commitments to originate real estate loans held for sale and forward sales commitments. The Company does not hold or issue derivative financial instruments for trading or other speculative purposes.

The Company enters into forward sales commitments for the future delivery of residential mortgage loans, and interest rate lock commitments to fund loans at a specified interest rate. The forward sales commitments are utilized to reduce interest rate risk associated with interest rate lock commitments and loans held for sale. Changes in the estimated fair value of the forward sales commitments and interest rate lock commitments subsequent to inception are based on changes in the fair value of the underlying loan resulting from the fulfillment of the commitment and changes in the probability that the loan will fund within the terms of the commitment, which is affected primarily by changes in interest rates and the passage of time. At inception and during the life of the interest rate lock commitment, the Company includes the expected net future cash flows related to the associated servicing of the loan as part of the fair value measurement of the interest rate lock commitments. These derivatives are recorded at fair value, which were immaterial at December 31, 2018. The effect of the changes to these derivatives for the year then ended was also immaterial.

The Company acquired interest rate swaps from the Merchants acquisition with notional amounts with certain commercial customers which totaled $37.0 million at December 31, 2018. In order to minimize the Company's risk, these customer derivatives (pay floating/receive fixed swaps) have been offset with essentially matching interest rate swaps (pay fixed/receive floating swaps) with the Company's counterparty totaling $37.0 million. The weighted average receive rate of these interest rate swaps was 4.34%, the weighted average pay rate was 3.84% and the weighted average maturity was 5.5 years. The fair values of $0.7 million and $0.7 million were reflected in other assets and other liabilities, respectively, in the accompanying consolidated statement of condition at December 31,

2018. Hedge accounting has not been applied for these derivatives. Since the terms of the swaps with our customer and the other financial institution offset each other, with the only difference being counterparty credit risk, changes in the fair value of the underlying derivative contracts are not materially different and do not significantly impact our results of operations.

The Company also acquired interest rate swaps from the Merchants acquisition with notional amounts totaling $6.6 million at December 31, 2018 that were designated as fair value hedges of certain fixed rate loans with municipalities. At December 31, 2018, the weighted average receive rate of these interest rate swaps was 2.92%, the weighted average pay rate was 3.11% and the weighted average maturity was 14.5 years. The fair value of $0.1 million at December 31, 2018, was reflected as a reduction to loans and an increase to other assets. The ineffective portion of the interest swaps was immaterial and as such, amounts are not recognized in earnings.

The Company assessed its counterparty risk at December 31, 2018 and determined any credit risk inherent in our derivative contracts was not material. Information about the fair value of derivative financial instruments can be found in Note R to these consolidated financial statements.

Table of Contents

NOTE T: VARIABLE INTEREST ENTITIES

The Company's wholly-owned subsidiaries, Community Capital Trust IV and MBVT Statutory Trust I, are VIEs for which the Company is not the primary beneficiary. Accordingly, the accounts of these entities are not included in the Company's consolidated financial statements. See further information regarding Community Capital Trust IV and MBVT Statutory Trust I in Note H: Borrowings.

In connection with the Company's acquisition of Oneida Financial Corp, the Company acquired OPFC II which holds a 50% membership interest in 706 North Clinton, LLC ("706 North Clinton"), an entity formed for the purpose of acquiring and rehabilitating real property. The real property held by 706 North Clinton is principally occupied by subsidiaries of the Company. The Company analyzed the operating agreement and capital structure of 706 North Clinton and determined that it was the primary beneficiary and therefore should consolidate 706 North Clinton in its financial statements. This conclusion was based on the determination that the Company has a de facto agency relationship because of the financing arrangement between the other member of 706 North Clinton and the Bank which provides OPFC II with both the power to direct the activities of 706 North Clinton and the obligation to absorb any losses of 706 North Clinton.

The carrying amount of the assets and liabilities of 706 North Clinton and the classification of these assets and liabilities in the Company's consolidated statements of condition at December 31 is as follows:

(000's omitted)	2018	2017
Cash and cash equivalents	$104	$74
Premises and equipment, net	6,109	6,266
Other assets	33	5
Total assets	$6,246	$6,345
Total liabilities	$0	$0

In addition to the assets and liabilities of 706 North Clinton, the minority interest in 706 North Clinton of $3.1 million at December 31, 2018 is included in the Company's consolidated statement of condition. The creditors of 706 North Clinton do not have a claim on the general assets of the Company. The Company's maximum loss exposure net of minority interest in 706 North Clinton is approximately $4.8 million as of December 31, 2018, including a $1.7 million loss exposure related to the financing agreement between the other member of 706 North Clinton and the Bank.

Table of Contents
NOTE U: SEGMENT INFORMATION

Operating segments are components of an enterprise, which are evaluated regularly by the “chief operating decision maker” in deciding how to allocate resources and assess performance. The Company’s chief operating decision maker is the President and Chief Executive Officer of the Company. The Company has identified Banking, Employee Benefit Services and All Other as its reportable operating business segments. CBNA operates the Banking segment that provides full-service banking to consumers, businesses, and governmental units in Upstate New York as well as Northeastern Pennsylvania, Vermont and Western Massachusetts. Employee Benefit Services, which includes operating subsidiaries of BPAS, BPAS-APS, BPAS Trust Company of Puerto Rico, NRS and HB&T, provides employee benefit trust, collective investment fund, retirement plan administration, fund administration, transfer agency, actuarial, VEBA/HRA, and health and welfare consulting services. The All Other segment is comprised of; (a) wealth management services including trust services provided by the personal trust unit within the Bank, broker-dealer and investment advisory services provided by CISI and The Carta Group, and asset management provided by Nottingham, and (b) full-service insurance, risk management and employee benefit services provided by OneGroup. The accounting policies used in the disclosure of business segments are the same as those described in the summary of significant accounting policies (See Note A).

Information about reportable segments and reconciliation of the information to the consolidated financial statements follows:

(000’s omitted)	Banking	Employee Benefit Services	All Other	Eliminations	Consolidated Total
2018					
Net interest income	$344,551	$ 376	$128	$ 0	$345,055
Provision for loan losses	10,837	0	0	0	10,837
Noninterest revenue	75,399	94,449	57,204	(2,993)	224,059
Amortization of intangible assets	6,429	8,015	3,711	0	18,155
Acquisition expenses	(782)	7	6	0	(769)
Other operating expenses	231,362	56,275	43,259	(2,993)	327,903
Income before income taxes	$172,104	$ 30,528	$10,356	$ 0	$212,988
Assets	$10,397,623	$ 207,460	$68,288	$ (66,076)	$10,607,295
Goodwill	$629,916	$ 83,275	$20,312	$ 0	$733,503
Core deposit intangibles & Other intangibles	$18,596	$ 44,545	$10,705	$ 0	$73,846
2017					
Net interest income	$315,025	$ 396	$254	$ 0	$315,675
Provision for loan losses	10,984	0	0	0	10,984
Noninterest revenue	73,337	82,743	49,201	(2,858)	202,423
Amortization of intangible assets	5,296	8,578	3,067	0	16,941
Acquisition expenses	24,549	1,194	243	0	25,986
Other operating expenses	218,608	51,138	37,334	(2,858)	304,222
Income before income taxes	$128,925	$ 22,229	$8,811	$ 0	$159,965
Assets	$10,505,919	$ 203,369	$66,548	$ (29,638)	$10,746,198
Goodwill	$629,916	$ 84,449	$20,065	$ 0	$734,430
Core deposit intangibles & Other intangibles	$25,025	$ 52,288	$13,345	$ 0	$90,658
2016					
Net interest income	$273,542	$ 162	$192	$ 0	$273,896
Provision for loan losses	8,076	0	0	0	8,076

Noninterest revenue	66,059	48,261	43,747	(2,442)	155,625
Amortization of intangible assets	2,682	420	2,377	0	5,479
Acquisition expenses	1,005	445	256	0	1,706
Other operating expenses	190,263	36,892	34,950	(2,442)	259,663
Income before income taxes	$137,575	$ 10,666	$ 6,356	$ 0	$154,597
Assets	$8,598,057	$ 38,742	$ 71,428	$ (41,790)	$8,666,437
Goodwill	$440,870	$ 8,019	$ 16,253	$ 0	$465,142
Core deposit intangibles & Other intangibles	$7,107	$ 666	$ 7,929	$ 0	$15,702

108

Table of Contents
NOTE V: SUBSEQUENT EVENTS

Companies are required to evaluate events and transactions that occur after the balance sheet date but before the date the financial statements are issued, or available to be issued in the case of non-public entities. They must recognize in the financial statements the effect of all events or transactions that provide additional evidence of conditions that existed at the balance sheet date, including the estimates inherent in the financial preparation process. Entities do not recognize the impact of events or transactions that provide evidence about conditions that did not exist at the balance sheet date but arose after that date.

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

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

Table of Contents

Report on Internal Control Over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Exchange Act Rule 13a-15(f). Under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, we conducted an evaluation of the effectiveness of our internal control over financial reporting based on the framework in Internal Control – Integrated Framework (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on our evaluation, management concluded that our internal control over financial reporting was effective as of December 31, 2018.

The consolidated financial statements of the Company have been audited by PricewaterhouseCoopers LLP, an independent registered public accounting firm that was engaged to express an opinion as to the fairness of presentation of such financial statements. PricewaterhouseCoopers LLP was also engaged to audit the effectiveness of the Company's internal control over financial reporting. The report of PricewaterhouseCoopers LLP follows this report.

Community Bank System, Inc.

By: /s/ Mark E. Tryniski
Mark E. Tryniski,
President, Chief Executive Officer and Director

By: /s/ Joseph E. Sutaris
Joseph E. Sutaris,
Treasurer and Chief Financial Officer

Table of Contents

Report of Independent Registered Public Accounting Firm

To the Board of Directors and Shareholders of Community Bank System, Inc.

Opinions on the Financial Statements and Internal Control over Financial Reporting

We have audited the accompanying consolidated statements of condition of Community Bank System, Inc. and its subsidiaries (the “Company”) as of December 31, 2018 and 2017, and the related consolidated statements of income, comprehensive income, changes in shareholders’ equity, and cash flows for each of the three years in the period ended December 31, 2018, including the related notes (collectively referred to as the “consolidated financial statements”). We also have audited the Company’s internal control over financial reporting as of December 31, 2018, based on criteria established in Internal Control - Integrated Framework (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of the Company as of December 31, 2018 and 2017, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2018 in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2018, based on criteria established in Internal Control - Integrated Framework (2013) issued by the COSO.

Basis for Opinions

The Company’s management is responsible for these consolidated financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Report on Internal Control over Financial Reporting. Our responsibility is to express opinions on the Company’s consolidated financial statements and on the Company’s internal control over financial reporting based on our audits. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) (PCAOB) and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement, whether due to error or fraud, and whether effective internal control over financial reporting was maintained in all material respects.

Our audits of the consolidated financial statements included performing procedures to assess the risks of material misstatement of the consolidated financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the consolidated financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

Definition and Limitations of Internal Control over Financial Reporting

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Table of Contents

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

/s/PricewaterhouseCoopers LLP
Buffalo, New York
March 1, 2019

We have served as the Company's auditor since 1984.

Table of Contents

TWO YEAR SELECTED QUARTERLY DATA (Unaudited)

2018 Results (000's omitted, except per share data)	4th Quarter	3rd Quarter	2nd Quarter	1st Quarter	Total
Net interest income	$87,387	$86,198	$86,846	$84,624	$345,055
Provision for loan losses	2,495	2,215	2,448	3,679	10,837
Net interest income after provision for loan losses	84,892	83,983	84,398	80,945	334,218
Noninterest income	54,218	55,791	56,559	57,491	224,059
Noninterest expenses	87,613	85,233	86,112	86,331	345,289
Income before income taxes	51,497	54,541	54,845	52,105	212,988
Income taxes	10,674	11,435	10,239	11,999	44,347
Net income	$40,823	$43,106	$44,606	$40,106	$168,641
Basic earnings per share	$0.79	$0.84	$0.87	$0.78	$3.28
Diluted earnings per share	$0.78	$0.83	$0.86	$0.78	$3.24

2017 Results (000's omitted, except per share data)	4th Quarter	3rd Quarter	2nd Quarter	1st Quarter	Total
Net interest income	$85,977	$84,395	$78,029	$67,274	$315,675
Provision for loan losses	5,381	2,314	1,461	1,828	10,984
Net interest income after provision for loan losses	80,596	82,081	76,568	65,446	304,691
Noninterest income	53,938	52,941	51,226	44,318	202,423
Noninterest expenses	86,919	83,776	102,879	73,575	347,149
Income before income taxes	47,615	51,246	24,915	36,189	159,965
Income taxes	(24,411)	16,003	7,724	9,932	9,248
Net income	$72,026	$35,243	$17,191	$26,257	$150,717
Basic earnings per share	$1.41	$0.69	$0.35	$0.58	$3.07
Diluted earnings per share	$1.40	$0.68	$0.35	$0.57	$3.03

Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure

None

Item 9A. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

The Company maintains disclosure controls and procedures, as defined in Rule 13a -15(e) and 15d – 15(e) under the Securities Exchange Act of 1934, as amended, designed to: (i) record, process, summarize, and report within the time periods specified in the SEC's rules and forms, and (ii) accumulate and communicate to management, including the principal executive and principal financial officers, as appropriate, to allow timely decisions regarding disclosure. Based on evaluation of the Company's disclosure controls and procedures, with the participation of the Chief Executive Officer ("CEO") and the Chief Financial Officer ("CFO"), the CEO and CFO have concluded that, as of the end of the period covered by this Annual Report on Form 10-K, these disclosure controls and procedures were effective as of December 31, 2018.

Management's Annual Report on Internal Control over Financial Reporting

Management's annual report on internal control over financial reporting is included under the heading "Report on Internal Control Over Financial Reporting" at Item 8 of this Annual Report on Form 10-K.

Report of the Registered Public Accounting Firm

The report of the Company’s registered public accounting firm is included under the heading “Report of the Independent Registered Public Accounting Firm” at Item 8 of this Annual Report on Form 10-K.

Table of Contents

Changes in Internal Control over Financial Reporting

The Company continually assesses the adequacy of its internal control over financial reporting and enhances its controls in response to internal control assessments, and internal and external audit and regulatory recommendations. No change in internal control over financial reporting during the quarter ended December 31, 2018 has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate due to changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Item 9B. Other Information

None

Part III

Item 10. Directors, Executive Officers and Corporate Governance

The information concerning the Directors of the Company required by this Item 10 is incorporated herein by reference to the sections entitled "Nominees for Director and Directors Continuing in Office" in the Company's Definitive Proxy Statement for its 2019 Annual Meeting of Shareholders, which will be filed with the SEC on or about April 1, 2019 (the "Proxy Statement"). The information concerning executive officers of the Company required by this Item 10 is presented in Item 4A of this Annual Report on Form 10-K. Disclosure of compliance with Section 16(a) of the Securities Exchange Act of 1934, as amended, by the Company's directors and executive officers is incorporated by reference to the section entitled "Section 16(a) Beneficial Ownership Reporting Compliance" in the Proxy Statement. In addition, information concerning Audit Committee and Audit Committee Financial Expert is included in the Proxy Statement under the caption "Audit Committee Report" and is incorporated herein by reference.

The Company has adopted a code of ethics that applies to its principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions. The text of the code of ethics is posted on the Company's website at www.cbna.com, and is available free of charge in print to any person who requests it. The Company intends to satisfy the requirements under Item 5.05 of Form 8-K regarding an amendment to, or a waiver from, the code of ethics that relates to certain elements thereof, by posting such information on its website referenced above.

Item 11. Executive Compensation

The information required by this Item 11 is incorporated herein by reference to the sections entitled "Compensation Discussion and Analysis," "Compensation Committee Report," "Compensation Committee Interlocks and Insider Reporting," and "Executive Compensation Disclosure Tables" in the Company's Proxy Statement.

Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

The information required by this Item 12 is incorporated herein by reference to the section entitled "Nominees for Director and Directors Continuing in Office" in the Company's Proxy Statement.

Item 13. Certain Relationships and Related Transactions and Director Independence

The information required by this Item 13 is incorporated herein by reference to the sections entitled "Corporate Governance" and "Transactions with Related Parties" in the Company's Proxy Statement.

Item 14. Principal Accounting Fees and Services

The information required by this Item 14 is incorporated herein by reference to the section entitled “Fees Paid to PricewaterhouseCoopers LLP” in the Company’s Proxy Statement.

Table of Contents

Part IV

Item 15. Exhibits, Financial Statement Schedules

(a) Documents filed as part of this report

(1) All financial statements. The following consolidated financial statements of Community Bank System, Inc. and subsidiaries are included in Item 8:

Consolidated Statements of Condition,
December 31, 2018 and 2017

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

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

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

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

Notes to Consolidated Financial Statements,
December 31, 2018

Report of Independent Registered Public Accounting Firm

Quarterly selected data,
Years ended December 31, 2018 and 2017 (unaudited)

(2) Financial statement schedules. Schedules are omitted since the required information is either not applicable or shown elsewhere in the financial statements.

(3) Exhibits. The exhibits filed as part of this report and exhibits incorporated herein by reference to other documents are listed below:

2.1	Assignment, Purchase and Assumption Agreement, dated as of January 19, 2012, by and among Community Bank, N.A. and First Niagara Bank, N.A. Incorporated by reference to Exhibit 2.1 to the Current Report on Form 8-K filed on January 20, 2012 (Registration No. 001-13695).
2.2	Purchase and Assumption Agreement, dated as of January 19, 2012, by and among Community Bank, N.A. and First Niagara Bank, N.A. Incorporated by reference to Exhibit 2.2 to the Current Report on Form 8-K filed on January 20, 2012 (Registration No. 001-13695).
2.3	Assignment, Purchase and Assumption Agreement, dated as of January 19, 2012, by and between Community Bank, N.A. and First Niagara Bank, N.A., as amended as restated as of July 19, 2012. Incorporated by reference to Exhibit No. 99.1 to the Current Report on Form 8-K filed on July 24, 2012 (Registration No. 001-13695).

2.4	Amendment No. 1 to Purchase and Assumption Agreement, dated as of September 6, 2012, by and among Community Bank, N.A. and First Niagara Bank, N.A. Incorporated by reference to Exhibit 99.1 to the Current Report on Form 8-K filed on September 13, 2012 (Registration No. 001-13695).
2.5	Purchase and Assumption Agreement, dated as of July 23, 2013, by and between Community Bank, N.A. and Bank of America, N.A. Incorporated by reference to Exhibit No. 2.1 to the Current Report on Form 8-K filed on July 26, 2013 (Registration No. 001-13695).
2.6	Agreement and Plan of Merger, dated as of February 24, 2015, by and between Community Bank System, Inc. and Oneida Financial Corp. Incorporated by reference to Exhibit 2.1 to the Current Report on Form 8-K filed on February 25, 2015 (Registration No. 001-13695).

Table of Contents

2.7	Agreement and Plan of Merger, dated as of October 22, 2016, by and between Community Bank System, Inc. and Merchants Bancshares, Inc. Incorporated by reference to Exhibit 2.1 to the Current Report on Form 8-K filed on October 27, 2016 (Registration No. 001-13695).
2.8	Agreement and Plan of Merger, dated as of December 2, 2016, by and among Community Bank System, Inc., Northeast Retirement Services, Inc., Cohiba Merger Sub, LLC and Shareholder Representative Services LLC. Incorporated by reference to Exhibit 2.1 to the Current Report on Form 8-K filed on December 8, 2016 (Registration No. 001-13695).
2.9	Agreement and Plan of Merger, dated as of January 21, 2019, by and among Community Bank System, Inc., VB Merger Sub Inc., and Kinderhook Bank Corp. Incorporated by reference to Exhibit 2.1 to the Current Report on Form 8-K filed on January 25, 2019 (Registration No. 001-13695).
3.1	Certificate of Incorporation of Community Bank System, Inc., as amended. Incorporated by reference to Exhibit No. 3.1 to the Registration Statement on Form S-4 filed on October 20, 2000 (Registration No. 333-48374).
3.2	Certificate of Amendment of Certificate of Incorporation of Community Bank System, Inc. Incorporated by reference to Exhibit No. 3.1 to the Quarterly Report on Form 10-Q filed on May 7, 2004 (Registration No. 001-13695).
3.3	Certificate of Amendment of Certificate of Incorporation of Community Bank System, Inc. Incorporated by reference to Exhibit No. 3.1 to the Quarterly Report on Form 10-Q filed on August 9, 2013 (Registration No. 001-13695).
3.4	Bylaws of Community Bank System, Inc., amended July 18, 2007. Incorporated by reference to Exhibit 3.2 to the Current Report on Form 8-K filed on July 24, 2007 (Registration No. 001-13695).
4.1	Form of Common Stock Certificate. Incorporated by reference to Exhibit No. 4.1 to the Amendment No. 1 to the Registration Statement on Form S-3 filed on September 29, 2008 (Registration No. 333-153403).
4.2	Registration Rights Agreement, dated February 3, 2017, by and among Community Bank System, Inc. and the individuals and entities set forth on Schedule 1 thereto. Incorporated by reference to Exhibit No. 10.1 to the Registration Statement on Form S-3 filed on February 3, 2017 (Registration No. 333-215894).
4.3	Form of Replacement Organizers' Warrant to purchase Community Bank System, Inc. Common Stock. Incorporated by reference to Exhibit No. 4.1 to the Current Report on Form 8-K filed on May 18, 2017 (Registration No. 001-13695). (2)
4.4	First Supplemental Indenture, dated as of May 12, 2017, by and among Wilmington Trust Company, Community Bank System, Inc., and Merchants Bancshares, Inc. Incorporated by reference to Exhibit No. 4.2 to the Current Report on Form 8-K filed on May 18, 2017 (Registration No. 001-13695). (2)
10.1	Indenture, dated as of December 8, 2006, between Community Bank System, Inc. and Wilmington Trust Company, as trustee. Incorporated by reference to Exhibit No. 4.1 to the Current Report on Form 8-K filed on December 12, 2006 (Registration No. 001-13695).
10.2	Amended and Restated Declaration of Trust, dated as of December 8, 2006, among Community Bank System, Inc., as sponsor, Wilmington Trust Company, as Delaware trustee, Wilmington Trust Company, as institutional trustee, and Mark E. Tryniski, Scott A. Kingsley, and Joseph J. Lemchak as administrators. Incorporated by reference to Exhibit 10.1 to the Current Report on Form 8-K filed on December 12, 2006 (Registration No.

001-13695).

116

Table of Contents

10.3	Guarantee Agreement, dated as of December 8, 2006, between Community Bank System, Inc., as guarantor, and Wilmington Trust Company, as guarantee trustee. Incorporated by reference to Exhibit 10.2 to the Form 8-K filed on December 12, 2006 (Registration No. 001-13695).
10.4	Employment Agreement, dated as of January 5, 2018, by and between Community Bank System, Inc., Community Bank, N.A., and Mark E. Tryniski. Incorporated by reference to Exhibit No. 10.1 to the Current Report on Form 8-K filed on January 5, 2018 (Registration No. 001-13695).(2)
10.5	Supplemental Retirement Plan Agreement, effective as of December 31, 2008, by and among Community Bank, N.A., Community Bank System, Inc., and Mark E. Tryniski. Incorporated by reference to Exhibit No. 10.2 to the Current Report on Form 8-K filed on March 19, 2009 (Registration No. 001-13695).(2)
10.6	Amendment to Supplemental Retirement Plan Agreement, dated January 5, 2018, by and among Community Bank System, Inc., Community Bank, N.A. and Mark E. Tryniski. Incorporated by reference to Exhibit No. 10.2 to the Current Report on Form 8-K filed on January 5, 2018 (Registration No. 001-13695).(2)
10.7	Employment Agreement, dated as of January 1, 2017, by and among Community Bank System, Inc., Community Bank N.A., and Scott Kingsley. Incorporated by reference to Exhibit No. 10.1 to the Current Report on Form 8-K filed on January 6, 2017 (Registration No. 001-13695).(2)
10.8	Amendment to Employment Agreement, dated May 21, 2018, by and among Community Bank System, Inc., Community Bank, N.A. and Scott Kingsley. Incorporated by reference to Exhibit No. 10.1 to the Current Report on Form 8-K filed on May 21, 2018 (Registration No. 001-13695).(2)
10.9	Supplemental Retirement Plan Agreement, effective September 29, 2009, by and between Community Bank System Inc., Community Bank, N.A., and Scott Kingsley. Incorporated by reference to Exhibit No. 10.1 to the Current Report on Form 8-K filed on October 1, 2009 (Registration No. 001-13695).(2)
10.10	Employment Agreement, dated as of March 11, 2016, by and between Community Bank System, Inc., Community Bank N.A., and Brian D. Donahue. Incorporated by reference to Exhibit No. 10.1 to the Current Report on Form 8-K filed on March 16, 2016 (Registration No. 001-13695).(2)
10.11	Amendment to Employment Agreement, dated March 19, 2018, by and among Community Bank System, Inc., Community Bank, N.A. and Brian D. Donahue. Incorporated by reference to Exhibit No. 10.1 to the Current Report on Form 8-K filed on March 20, 2018 (Registration No. 001-13695).(2)
10.12	Supplemental Retirement Plan Agreement, dated as of October 18, 2013, by and between Community Bank System Inc., Community Bank, N.A., and Brian D. Donahue. Incorporated by reference to Exhibit No. 10.2 to the Current Report on Form 8-K filed on October 23, 2013 (Registration No. 001-13695).(2)
10.13	Employment Agreement, dated as of January 1, 2017, by and among Community Bank System, Inc., Community Bank N.A., and George J. Getman. Incorporated by reference to Exhibit No. 10.2 to the Current Report on Form 8-K filed on January 6, 2017 (Registration No. 001-13695).(2)
10.14	Supplemental Retirement Plan Agreement, dated as of October 18, 2013, by and among Community Bank System, Inc., Community Bank, N.A., and George J. Getman. Incorporated by reference to Exhibit 10.3 to the Current Report on Form 8-K filed on October 23, 2013 (Registration No. 001-13695).(2)
10.15	Employment Agreement, dated as of March 11, 2016, by and among Community Bank System, Inc., Community Bank N.A., and Joseph F. Serbun. Incorporated by reference to Exhibit No. 10.2 to the Current

Report on Form 8-K filed on March 16, 2016 (Registration No. 001-13695).(2)

117

Table of Contents

10.16	Amendment to Employment Agreement, dated May 21, 2018, by and among Community Bank System, Inc., Community Bank, N.A. and Joseph F. Serbun. Incorporated by reference to Exhibit No. 10.3 to the Current Report on Form 8-K filed on May 21, 2018 (Registration No. 001-13695).(2)
10.17	Employment Agreement, dated January 4, 2019, by and among Community Bank System, Inc., Community Bank, N.A. and Joseph F. Serbun. Incorporated by reference to Exhibit No. 10.1 to the Current Report on Form 8-K filed on January 8, 2019 (Registration No. 001-13695).(2)
10.18	Employment Agreement, dated as of May 21, 2018, by and between Community Bank System, Inc., Community Bank, N.A., and Joseph E. Sutaris. Incorporated by reference to Exhibit No. 10.2 to the Current Report on Form 8-K filed on May 21, 2018 (Registration No. 001-13695).(2)
10.19	Pre-2005 Supplemental Retirement Agreement, effective December 31, 2004, by and between Community Bank System, Inc., Community Bank, N.A., and Sanford Belden. Incorporated by reference to Exhibit No. 10.3 to the Annual Report on Form 10-K filed on March 15, 2005 (Registration No. 001-13695).(2)
10.20	Post-2004 Supplemental Retirement Agreement, effective January 1, 2005, by and between Community Bank System, Inc., Community Bank, N.A., and Sanford Belden. Incorporated by reference to Exhibit No. 10.2 to the Annual Report on Form 10-K filed on March 15, 2005 (Registration No. 001-13695).(2)
10.21	Supplemental Retirement Plan Agreement, effective March 26, 2003, by and between Community Bank System Inc. and Thomas McCullough. Incorporated by reference to Exhibit No. 10.11 to the Annual Report on Form 10-K filed on March 12, 2004 (Registration No. 001-13695).(2)
10.22	2004 Long-Term Incentive Compensation Program, as amended. Incorporated by reference to Exhibit No. 99.1 to the Registration Statement on Form S-8 filed on December 19, 2012 (Registration No. 001-13695).(2)
10.23	2014 Long-Term Incentive Plan, as amended. Incorporated by reference to Exhibit No. 10.1 to the Current Report on Form 8-K filed on May 2, 2017 (Registration No. 001-13695).(2)
10.24	Stock Balance Plan for Directors, as amended. Incorporated by reference to Annex I to the Definitive Proxy Statement on Schedule 14A filed on March 31, 1998 (Registration No. 001-13695).(2)
10.25	Community Bank System, Inc. Deferred Compensation Plan for Directors. Incorporated by reference to Exhibit No. 99.1 to the Registration Statement on Form S-8 filed on June 30, 2017 (Registration No. 333-219098).(2)
10.26	Community Bank System, Inc. Pension Plan Amended and Restated as of January 1, 2004. Incorporated by reference to Exhibit No. 10.27 to the Annual Report on Form 10-K filed on March 15, 2005 (Registration No. 001-13695).(2)
10.27	Amendment #1 to the Community Bank System, Inc. Pension Plan, as amended and restated as of January 1, 2004 (“Plan”). Incorporated by reference to Exhibit No. 10.27 to the Annual Report on Form 10-K filed on March 15, 2005 (Registration No. 001-13695).(2)
10.28	Community Bank System, Inc. 401(k) Employee Stock Ownership Plan, dated as of December 20, 2011. Incorporated by reference to Exhibit 4.5 to the Registration Statement on Form S-8 filed on December 20, 2013 (Registration No. 001-13695).(2)

Table of Contents

10.29	Merchants Bancshares, Inc. and Subsidiaries Amended and Restated 1996 Compensation Plan for Non-Employee Directors. Incorporated by reference to Exhibit 10.3 to Merchants Bancshares, Inc.'s Annual Report on Form 10-K filed with the Commission on March 15, 2011. (2)
10.30	Merchants Bancshares, Inc. and Subsidiaries Amended and Restated 2008 Compensation Plan for Non-Employee Directors and Trustees. Incorporated by reference to Exhibit 10.4 to Merchants Bancshares, Inc.'s Annual Report on Form 10-K filed with the Commission on March 15, 2011. (2)
10.31	Merchants Bank Amended and Restated Deferred Compensation Plan for Directors. Incorporated by reference to Exhibit 10.7 to Merchants Bancshares, Inc.'s Annual Report on Form 10-K filed with the Commission on March 15, 2011. (2)
10.32	Merchants Bank Salary Continuation Plan. Incorporated by reference to Exhibit 10.9 to Merchants Bancshares, Inc.'s Annual Report on Form 10-K filed with the Commission on March 15, 2011. (2)
10.33	Community Bank System, Inc. Restoration Plan, effective June 1, 2018. Incorporated by reference to Exhibit No. 10.4 to the Current Report on Form 8-K filed on May 21, 2018 (Registration No. 001-13695).(2)
21.1	Subsidiaries of Registrant.(1)
23.1	Consent of PricewaterhouseCoopers LLP.(1)
31.1	Certification of Mark E. Tryniski, President and Chief Executive Officer of the Registrant, pursuant to Rule 13a-15(e) or Rule 15d-15(e) under the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.(1)
31.2	Certification of Joseph E. Sutaris, Treasurer and Chief Financial Officer of the Registrant, pursuant to Rule 13a-15(e) or Rule 15d-15(e) under the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.(1)
32.1	Certification of Mark E. Tryniski, President and Chief Executive Officer of the Registrant, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.(3)
32.2	Certification of Joseph E. Sutaris, Treasurer and Chief Financial Officer of the Registrant, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.(3)
101	Interactive data files pursuant to Rule 405 of Regulation S-T: (i) the Consolidated Statements of Condition, (ii) the Consolidated Statements of Income, (iii) the Consolidated Statements of Comprehensive Income, (iv) the Consolidated Statements of Changes in Stockholders' Equity, (v) the Consolidated Statements of Cash Flows, and (vi) the Notes to Consolidated Financial Statements tagged as blocks of text and in detail.(4)

(1) Filed herewith.
(2) Denotes management contract or compensatory plan or arrangement.
(3) Furnished herewith.
(4) XBRL (Extensible Business Reporting Language) information is furnished and not filed or a part of a registration statement or prospectus for purposes of sections 11 or 12 of the Securities Act of 1933, is deemed not filed for purposes of section 18 of the Securities Exchange Act of 1934, and otherwise is not subject to liability under these sections.

B. Not applicable

C. Not applicable.

Item 16. Form 10-K Summary

None

Table of Contents
SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

COMMUNITY BANK SYSTEM, INC.

By:
/s/ Mark E. Tryniski
Mark E. Tryniski
President and Chief Executive Officer
March 1, 2019

Pursuant to the requirements of the Securities and Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities indicated on the 1st day of March 2019.

By:
/s/ Mark E. Tryniski
Mark E. Tryniski
President, Chief Executive Officer and Director
(Principal Executive Officer)

By:
/s/ Joseph E. Sutaris
Joseph E. Sutaris
Treasurer and Chief Financial Officer
(Principal Financial Officer and Principal Accounting Officer)

Directors:

/s/ Brian R. Ace Brian R. Ace, Director	/s/ Raymond C. Pecor, III Raymond C. Pecor, III, Director
/s/ Mark J. Bolus Mark J. Bolus, Director	/s/ Sally A. Steele Sally A. Steele, Director and Chair of the Board of Directors
/s/ Jeffrey L. Davis Jeffrey L. Davis, Director	/s/ Eric E. Stickels Eric E. Stickels, Director
/s/ Neil E. Fesette Neil E. Fesette, Director	/s/ John F. Whipple, Jr. John F. Whipple Jr., Director
/s/ Michael R. Kallet Michael R. Kallet, Director	
/s/ John Parente John Parente, Director	