COMMUNITY BANK SYSTEM INC
Form 10-K
March 11, 2010

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

FORM 10-K

x ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2009

o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from _____to_____ .

Commission file number 001-13695

COMMUNITY BANK SYSTEM, INC.
(Exact name of registrant as specified in its charter)

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

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

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

Title of each class	Name of each exchange on which registered
Common Stock, Par Value $1.00	New York Stock Exchange

Securities registered pursuant to Section 12(g) of the Act: None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes o No x .

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

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

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

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

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

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

State the aggregate market value of the voting and non-voting common equity held by non-affiliates computed by reference to the price at which the common equity was last sold, or the average bid and asked price of such common equity, as of the last business day of the registrant's most recently completed second fiscal quarter $462,629,396 .

Indicate the number of shares outstanding of each of the registrant's classes of common stock, as of the latest practicable date.
33,028,016 shares of Common Stock, $1.00 par value, were outstanding on February 28, 2010.

DOCUMENTS INCORPORATED BY REFERENCE.

Portions of Definitive Proxy Statement for Annual Meeting of Shareholders to be held on April 28, 2010 (the "Proxy Statement") is incorporated by reference in Part III of this Annual Report on Form 10-K.

TABLE OF CONTENTS

Part I

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

Item 1. Business

Community Bank System, Inc. ("the Company") was incorporated on April 15, 1983, under the Delaware General Corporation Law. Its principal office is located at 5790 Widewaters Parkway, DeWitt, New York 13214. The Company is a single bank holding company which wholly-owns five subsidiaries: Community Bank, N.A. ("the Bank" or "CBNA"), Benefit Plans Administrative Services, Inc. ("BPAS"), CFSI Closeout Corp. ("CFSICC"), First of Jermyn Realty Company, Inc. ("FJRC") and Town & Country Agency LLC ("T&C"). BPAS owns three subsidiaries, Benefit Plans Administrative Services LLC ("BPA"), a provider of defined contribution plan administration services; Harbridge Consulting Group LLC ("Harbridge"), a provider of actuarial and benefit consulting services; and Hand Benefits & Trust Company ("HB&T"), a provider of Collective Investment Fund administration and institutional trust services. CFSICC, FJRC and T&C are inactive companies. 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.

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

The Bank's business philosophy is to operate as a community bank with local decision-making, principally in non-metropolitan markets, providing a broad array of banking and financial services to retail, commercial, and municipal customers. The Bank operates 147 customer facilities throughout 28 counties of Upstate New York, where it operates as Community Bank, N.A. and five counties of Northeastern Pennsylvania, where it is known as First Liberty Bank & Trust, offering a range of commercial and retail banking services. The Bank owns the following subsidiaries: Community Investment Services, Inc. ("CISI"), CBNA Treasury Management Corporation ("TMC"), CBNA Preferred Funding Corporation ("PFC"), Nottingham Advisors, Inc. ("Nottingham"), First Liberty Service Corp. ("FLSC"), Brilie Corporation ("Brilie") and CBNA Insurance Agency, Inc. ("CBNA Insurance"). CISI provides broker-dealer and investment advisory services. TMC provides cash management, investment, and treasury services to the Bank. PFC primarily acts as an investor in residential real estate loans. Nottingham provides asset management services to individuals, corporate pension and profit sharing plans, and foundations. FLSC provides banking-related services to the Pennsylvania branches of the Bank. Brilie is an inactive company. CBNA Insurance is a full-service insurance agency offering primarily property and casualty products.

Acquisition History (2005-2009)

Citizens Branches Acquisition

On November 7, 2008, the Company acquired 18 branch-banking centers in northern New York from Citizens Financial Group, Inc. (“Citizens”) in an all cash transaction. The Company acquired approximately $109 million in loans and $565 million in deposits at a blended deposit premium of 13%. In support of the transaction, the Company issued approximately $50 million of equity capital in the form of common stock in October 2008.

Alliance Benefit Group MidAtlantic

On July 7, 2008, Benefit Plans Administrative Services, Inc. (“BPAS”), a wholly owned subsidiary of the Company, acquired the Philadelphia division of Alliance Benefit Group MidAtlantic (“ABG”) from BenefitStreet, Inc. in an all cash transaction. ABG was a provider of retirement plan consulting, daily valuation administration, actuarial and ancillary support services.

Hand Benefits & Trust, Inc.

On May 18, 2007, BPAS, a whollyowned subsidiary of the Company, acquired Hand Benefits & Trust, Inc. (“HB&T”) in an all cash transaction. HB&T was a Houston, Texas based provider of employee benefit plan administration and trust services.

TLNB Financial Corporation

On June 1, 2007, the Company acquired TLNB Financial Corporation, parent company of Tupper Lake National Bank ("TLNB"), in an all-cash transaction valued at approximately $17.8 million. Based in Tupper Lake, NewYork, TLNB operated five branches in the northeastern New York State cities of Tupper Lake, Plattsburgh and Saranac Lake, as well as an insurance subsidiary, TLNB Insurance Agency, Inc.

ONB Corporation

On December 1, 2006, the Company acquired ONB Corporation ("ONB"), the parent company of Ontario National Bank, a federally-chartered national bank, in an all-cash transaction valued at approximately $16 million. ONB operated four branches in the villages of Clifton Springs, Phelps, and Palmyra, New York.

ES&L Bancorp, Inc.

On August 11, 2006, the Company acquired ES&L Bancorp, Inc. ("Elmira"), the parent company of Elmira Savings and Loan, F.A., a federally-chartered thrift, in an all-cash transaction valued at approximately $40 million. Elmira operated two branches in the cities of Elmira and Ithaca, New York.

Services

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

Competition

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

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

				Number of			
County	State	Deposits as of 6/30/2009 (000's omitted)	Market Share(1)	Facilities	ATM's	Towns/ Cities	Towns Where Company Has 1st or 2nd Market Position
Franklin	NY	$253,090	54.3%	10	7	7	7
Hamilton	NY	34,031	52.6%	2	0	2	2
Allegany	NY	196,769	48.6%	9	8	8	8
Lewis	NY	106,776	41.8%	4	3	3	3
Seneca	NY	159,368	39.8%	4	3	4	3
Cattaraugus	NY	293,443	36.0%	10	8	7	6
St. Lawrence	NY	361,109	30.8%	15	7	11	10
Yates	NY	70,491	26.9%	2	2	1	0
Wyoming	PA	87,635	25.7%	4	3	4	3
Essex	NY	117,396	23.9%	5	4	5	5
Steuben	NY	173,948	21.9%	8	7	7	4
Clinton	NY	239,041	19.6%	5	10	2	2
Chautauqua	NY	232,318	15.8%	12	11	10	7
Jefferson	NY	184,626	12.7%	5	5	4	2
Schuyler	NY	19,746	12.6%	1	1	1	0
Livingston	NY	80,804	11.8%	3	4	3	3
Ontario	NY	149,753	9.3%	7	12	6	4
Lackawanna	PA	421,800	9.1%	12	12	8	4
Chemung	NY	90,175	7.7%	2	2	1	0
Tioga	NY	30,782	7.3%	2	2	2	1
Wayne	NY	57,731	7.2%	2	4	2	1
Herkimer	NY	34,521	5.9%	1	1	1	1
Susquehanna	PA	25,682	4.1%	2	0	2	2
Luzerne	PA	224,388	3.9%	6	7	6	3
Cayuga	NY	34,990	3.9%	2	2	2	1
Washington	NY	22,290	3.8%	1	0	1	1
Oswego	NY	44,589	3.5%	2	2	2	2
Warren	NY	35,959	2.7%	1	1	1	1
		3,783,251	11.8%	139	128	113	86
Bradford	PA	21,357	2.4%	2	2	2	1
Oneida	NY	56,309	1.8%	2	1	1	1
Tompkins	NY	8,055	0.5%	1	0	1	0
Onondaga	NY	13,521	0.2%	1	2	1	0
Erie	NY	39,496	0.1%	2	2	2	1
		$3,921,989	4.9%	147	135	120	89

(1) Deposit market share data as of June 30, 2009 the most recent information available. Source: SNL Financial LLC

Employees

As of December 31, 2009, the Company employed 1,595 full-time equivalent employees. The Company offers a variety of employment benefits and considers its relationship with its employees to be good.

Supervision and Regulation

Bank holding companies and national banks are regulated by state and federal law. The following is a summary of certain laws and regulations that govern the Company and the Bank. To the extent that the following information describes statutory or regulatory provisions, it is qualified in its entirety by reference to the actual statutes and regulations thereunder.

Federal Bank Holding Company Regulation

The Company is registered under, and is subject to, the Bank Holding Company Act of 1956, as amended. This Act limits the type of companies that Community Bank System, Inc. may acquire or organize and the activities in which it or they may engage. In general, the Company and the Bank are prohibited from engaging in or acquiring direct or indirect control of any corporation engaged in non-banking activities unless such activities are so closely related to banking as to be a proper incident thereto. In addition, the Company must obtain the prior approval of the Board of Governors of the Federal Reserve System (the “FRB”) to acquire control of any bank; to acquire, with certain exceptions, more than five percent of the outstanding voting stock of any other corporation; or to merge or consolidate with another bank holding company. As a result of such laws and regulation, the Company is restricted as to the types of business activities it may conduct and the Bank is subject to limitations on, among others, the types of loans and the amounts of loans it may make to any one borrower. The Financial Modernization Act of 1999 created, among other things, the "financial holding company", a new entity which may engage in a broader range of activities that are "financial in nature", including insurance underwriting, securities underwriting and merchant banking. Bank holding companies which are well capitalized and well managed under regulatory standards may convert to financial holding companies relatively easily through a notice filing with the FRB, which acts as the "umbrella regulator" for such entities. The Company may seek to become a financial holding company in the future.

Federal Reserve System

The Company is required by the Board of Governors of the Federal Reserve System to maintain cash reserves against its deposits. After exhausting other sources of funds, the Company may seek borrowings from the Federal Reserve for such purposes. Bank holding companies registered with the FRB are, among other things, restricted from making direct investments in real estate. Both the Company and the Bank are subject to extensive supervision and regulation, which focus on, among other things, the protection of depositors' funds.

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

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

The Company and the Bank are subject to minimum capital requirements established, respectively, by the FRB, the OCC (as defined below) and the Federal Deposit Insurance Corporation (“FDIC”). For information on these capital requirements and the Company’s and the Bank's capital ratios see "Management's Discussion and Analysis of Financial Condition and Results of Operations - Capital" and Note P to the Financial Statements.

Office of Comptroller of the Currency

The Bank is supervised and regularly examined by the Office of the Comptroller of the Currency (the “OCC”). The various laws and regulations administered by the OCC affect corporate practices such as payment of dividends, incurring debt, and acquisition of financial institutions and other companies. It also affects business practices, such as payment of interest on deposits, the charging of interest on loans, types of business conducted and location of offices. There are no regulatory orders or outstanding issues resulting from regulatory examinations of the Bank.

Insurance of Deposit Accounts

The Bank is a member of the Deposit Insurance Fund ("DIF"), which is administered by the FDIC. Deposit accounts at the Bank are insured by the FDIC, generally up to a maximum of $100,000 for each separately insured depositor and up to a maximum of $250,000 for self-directed retirement accounts. However, the FDIC increased the deposit insurance available on all deposit accounts to $250,000, effective until December 31, 2013. In addition, certain noninterest-bearing transaction accounts maintained with financial institutions participating in the FDIC's Transaction Account Guarantee Program are fully insured regardless of the dollar amount until June 30, 2010. The Bank has opted to participate in the FDIC's Transaction Account Guarantee Program.

The FDIC imposes an assessment against all depository institutions for deposit insurance. This assessment is based on the risk category of the institution and, prior to 2009, ranged from five to 43 basis points of the institution's deposits. On December 22, 2008, as a result of decreases in the reserve ratio of the DIF, the FDIC published a final rule raising the current deposit insurance assessment rates uniformly for all institutions by seven basis points for the first quarter of 2009. On May 22, 2009, the FDIC adopted a final rule imposing a five basis point special assessment on each insured depository institution's assets minus Tier 1 capital as of June 30, 2009, payable on September 30, 2009. The Company's special assessment amounted to $2.5 million.

In the fourth quarter of 2009, the FDIC adopted a rule that required insured depository institutions to prepay their quarterly risk-based assessments for the fourth quarter of 2009, and for all of 2010, 2011 and 2012, on December 30, 2009. For purposes of calculating the amount to prepay, the FDIC required that institutions use their total base assessment rate in effect on September 30, 2009 and increase that assessment base quarterly at a 5 percent annual growth rate through the end of 2012. The FDIC also increased annual assessment rates uniformly by three basis points beginning in 2011. The Company's prepayment for 2010, 2011 and 2012 amounted to $21.4 million.

Consumer Protection Laws

In connection with its lending activities, the Bank is subject to a number of federal and state laws designed to protect borrowers and promote lending to various sectors of the economy. These laws include the Equal Credit Opportunity Act, the Fair Credit Reporting Act, the Fair and Accurate Credit Transactions Act, the Truth in Lending Act, the Home Mortgage Disclosure Act, the Real Estate Settlement Procedures Act, and various state law counterparts.

In addition, federal law contains extensive customer privacy protection provisions. Under these provisions, a financial institution must provide to its customers, at the inception of the customer relationship and annually thereafter, the institution's policies and procedures regarding the handling of customers' nonpublic personal financial information. These provisions also provide that, except for certain limited exceptions, a financial institution may not provide such personal information to unaffiliated third parities unless the institution discloses to the customer that such information may be provided and the customer is given the opportunity to opt out of such disclosure.

USA Patriot Act

The Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 ("USA Patriot Act") imposes obligations on U.S. financial institutions, including banks and broker dealer subsidiaries, to implement policies, procedures and controls which are reasonably designed to detect and report instances of money laundering and the financing of terrorism. In addition, provisions of the USA Patriot Act require the federal financial institution regulatory agencies to consider the effectiveness of a financial institution's anti-money laundering activities when reviewing bank mergers and bank holding company acquisitions. The Company has approved policies and procedures that are designed to be compliant with the USA Patriot Act.

Sarbanes-Oxley Act of 2002

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

The Emergency Economic Stabilization Act of 2008

On October 3, 2008, The Emergency Economic Stabilization Act of 2008 ("EESA") was enacted that provides the U.S. Secretary of the Treasury with broad authority to implement certain actions to help restore stability and liquidity to U.S. markets. The EESA authorizes the U.S. Treasury to, among other things, purchase up to $700 billion of mortgages, mortgage-backed securities and certain other financial instruments from financial institutions for the purpose of stabilizing and providing liquidity to the U.S. financial markets. The Company did not originate or invest in sub-prime assets and, therefore, does not expect to participate in the sale of any of our assets into these programs. One of the provisions resulting from the legislation is the Troubled Asset Relief Program Capital Purchase Program ("TARP Capital Purchase Program"), which provides direct equity investment in perpetual preferred stock by the U.S. Treasury Department in qualified financial institutions. The program is voluntary and requires an institution to comply with a number of restrictions and provisions, including limits on executive compensation, stock redemptions, and declaration of dividends. The Company chose not to participate in the TARP Capital Purchase Program.

Item 1A. Risk Factors

Community Bank System, Inc. and its subsidiaries could be adversely impacted by various risks and uncertainties, which are difficult to predict. The material risks and uncertainties that management believes affect the Company are described below. Adverse experience with these or other risks could have a material impact on the Company's financial condition and results of operations.

Changes in interest rates affect our profitability, assets and liabilities
The Company's income and cash flow depends to a great extent on the difference between the interest earned on loans and investment securities, and the interest paid on deposits and borrowings. Interest rates are highly sensitive to many factors that are beyond the Company's control, including general economic conditions and polices of various governmental and regulatory agencies and, in particular, the Federal Reserve. Changes in monetary policy, including changes in interest rates, could influence not only the interest we receive on loans and securities and the amount of interest we pay on deposits and borrowings, but such changes could also affect (1) our ability to originate loans and obtain deposits, which could reduce the amount of fee income generated, (2) the fair value of our financial assets and liabilities and (3) the average duration of our mortgage-backed securities portfolio. If the interest rates paid on deposits and other borrowings increase at a faster rate than the interest rates received on loans and other investments, our net interest income could be adversely affected, which in turn could negatively affect our earnings. Earnings could also be adversely affected if the interest rates received on loans and other investments fall more quickly than the interest rates paid on deposit and other borrowings. Although management believes it has implemented effective asset and liability management strategies to reduce the potential effects of changes in interest rates on the result of operations, any substantial, unexpected, prolonged change in market interest rates could have a material adverse effect on the financial condition and results of operations.

Current levels of market volatility are unprecedented
The capital, credit and financial markets have experienced significant volatility and disruption for the last two years. These conditions have had significant adverse effects on our national and local economies, including declining real estate values, a widespread tightening of the availability of credit, illiquidity in certain securities markets, increasing loan delinquencies, declining consumer confidence and spending, and a reduction of manufacturing and service business activity. These conditions have also adversely affected the stock market generally, and have contributed to significant declines in the trading prices of stocks of financial institutions. Management does not expect these difficult market conditions to improve over the short term, and a continuation or worsening of these conditions could exacerbate their adverse effects.

There can be no assurance that the Emergency Economic Stabilization Act of 2008 and the American Recovery and Reinvestment Act will stabilize the U.S. economy and financial system

The U.S. Congress enacted the Emergency Economic Stabilization Act of 2008 ("EESA") in response to the impact of the volatility and disruption in the capital and credit markets on the financial sector. The U.S. Department of the Treasury and the federal banking regulators are implementing a number of programs under this legislation that are intended to address these conditions. In addition, the U.S. Congress recently enacted the American Recovery and Reinvestment Act ("ARRA") in an effort to save and create jobs, stimulate the U.S. economy and promote long-term growth and stability. There can be no assurance that EESA or ARRA will achieve their intended purposes. The failure of EESA or ARRA to achieve their intended purposes could result in a continuation or worsening of current economic and market conditions, and this could adversely effect the Company's financial condition, results of operations and/or the trading price of Company stock.

Regional economic factors may have an adverse impact on the Company's business
The Company's main markets are located in the states of New York and Pennsylvania. The local economic conditions in these areas have a significant impact on the demand for the Company's products and services as well as the ability of the Company's customers to repay loans, the value of the collateral securing loans and the stability of the Company's deposit funding sources. A prolonged economic downturn in these markets could negatively impact the Company.

The allowance for loan loss may be insufficient
The Company's business depends on the creditworthiness of its customers. The Company periodically reviews the allowance for loan losses for adequacy considering economic conditions and trends, collateral values and credit quality indicators, including past charge-off experience and levels of past due loans and nonperforming assets. There is no certainty that the allowance for loan losses will be adequate over time to cover credit losses in the portfolio because of unanticipated adverse changes in the economy, market conditions or events adversely affecting specific customers, industries or markets.

The Company may be adversely affected by changes in banking laws, regulations and regulatory practices
The Company and its subsidiaries are subject to extensive state and federal regulation, supervision and legislation that govern nearly every aspect of its operations. The bank holding company is subject to regulation by the FRB and the bank subsidiary is subject to regulation by the OCC. These regulations affect deposit and lending practices, capital levels and structure, investment practices, dividend policy and growth. In addition, the non-bank subsidiaries are engaged in providing investment management and insurance brokerage service, which industries are also heavily regulated on both a state and federal level. Changes to the regulatory laws governing these businesses could affect the Company's ability to deliver or expand its services and adversely impact its operations and financial condition.

There is the potential for new federal or state laws and regulations regarding lending and funding practices and liquidity standards, and financial institution regulatory agencies are expected to be aggressive in responding to concerns and trends identified in examinations. Negative developments in the financial services industry and the impact of recently enacted or new legislation in response to those developments could negatively impact our operations by restricting our business operations, increasing costs, limiting the types of financial services and products we may offer including restrictions on associated fee revenue, such as overdraft fees and interchange fees, and otherwise adversely impact our financial performance. Among other things legislation is pending in Congress to create a new consumer protection agency and authorize greater supervisory powers for the Federal Reserve Board. We cannot predict the full impact on our operations and financial condition of the various legislative and regulatory reform initiatives.

FDIC deposit insurance premiums have increased and may increase further in the future
The FDIC's reserve fund has declined over the past year due to costs associated with bank failures and is expected to continue to decline in the future. In addition, the FDIC basic insurance coverage limit was temporarily increased to $250,000 through December 31, 2013. These increases have increased the aggregate amount of deposits that the FDIC insures and thus have exposed the FDIC deposit insurance fund to potentially greater losses. The FDIC has adopted a plan to restore the reserve fund to the required level by increasing the deposit insurance assessment rates that it currently charges to insured depository institutions. Any increase will have an adverse impact on the Company's results of operations in 2010 and in future years, and if the FDIC is required to increase its deposit insurance assessment rate beyond the levels currently contemplated, the adverse impact will be greater.

Changes in the equity markets could materially affect the level of assets under management and the demand for other fee-based services
Economic downturns could affect the volume of income from and demand for fee-based services. Revenue from the wealth management and benefit plan administration businesses depend in large part on the level of assets under management and administration. Market volatility that leads customers to liquidate investment, as well as lower asset values can reduce our level of assets under management and administration and thereby decrease our investment

management and administration revenues.

Mortgage banking income may experience significant volatility

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

The Company depends on dividends from its banking subsidiary for cash revenues, but those dividends are subject to restrictions

The ability of the company to satisfy its obligations and pay cash dividends to its shareholders is primarily dependent on the earnings of and dividends from the subsidiary bank. However, payment of dividends by the bank subsidiary is limited by dividend restrictions and capital requirements imposed by bank regulations. As of December 31, 2009, the Bank had the capacity to pay up to $5.3 million in dividends to the Company without regulatory approval. The ability to pay dividends is also subject to the continued payment of interest that the Company owes on its subordinated junior debentures. As of December 31, 2009 the Company had $102 million of subordinated junior debentures outstanding. The Company has the right to defer payment of interest on the subordinated junior debentures for a period not exceeding 20 quarters although the Company has not done so to date. If the Company defers interest payments on the subordinated junior debentures, it will be prohibited, subject to certain exceptions, from paying cash dividends on the common stock until all deferred interest has been paid and interest payments on the subordinated junior debentures resumes.

The risks presented by acquisitions could adversely affect our financial condition and result of operations

The business strategy of the Company includes growth through acquisition. Any future acquisitions will be accompanied by the risks commonly encountered in acquisitions. These risks include among other things: the difficulty of integrating operations and personnel, the potential disruption of our ongoing business, the inability of our management to maximize our financial and strategic position, the inability to maintain uniform standards, controls, procedures and policies, and the impairment of relationships with employees and customers as a result of changes in ownership and management.

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

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

During 2009 rating agencies imposed a number of downgrades and credit watches on certain securities in the Company's investment securities portfolio, which contributed to the decline in fair value of such securities. Any further downgrades and credit watches may contribute to additional declines in the fair value of these securities. In addition, the measurement of the fair value of these securities involves significant judgment due to the complexity of the factors contributing to the measurement. Market volatility makes measurement of the fair value even more difficult and subjective. To the extent that any portion of the unrealized losses in the investment portfolio is determined to be other than temporary, and the loss is related to credit factors, the Company could be required to recognize a charge to earnings in the quarter during which such determination is made.

The Company relies on third party service providers

The Company relies on communication, information, operating and financial control systems from third-party service providers. Any failure or interruption or breach in security of these systems could result in failures or interruptions in our customer relationship management, general ledger, deposit, servicing and/or loan origination systems. While the Company has policies and procedures designed to prevent or limit the effect of a failure, interruption or security breach, there can be no assurance that any such failures, interruptions or security breaches will not occur or, if they do occur, that their impact can be adequately mitigated.

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

The Company owns common stock of Federal Home Loan Bank of New York ("FHLBNY") in order to qualify for membership in the FHLB system, which enables it to borrow funds under the FHLBNY advance program. The carrying value of the Company's FHLBNY common stock was $38.4 million as of December 31, 2009. There are 12 branches of the FHLB, including New York. Several members have warned that they have either breached risk-based capital requirement or that they are close to breaching those requirements. To conserve capital, some FHLB branches are suspending dividends, cutting dividend payments, and not buying back excess FHLB stock that members hold. FHLBNY has stated that they expect to be able to continue to pay dividends, redeem excess capital stock, and provide competitively priced advances in the future. The most severe problems in FHLB have been at some of the other FHLB branches. Nonetheless, the 12 FHLB branches are jointly liable for the consolidated obligations of the FHLB system. To the extent that one FHLB branch cannot meet its obligations to pay its share of the systems' debt, other FHLB branches can be called upon to make the payment.

The Company continually encounters technological change and may have to continue to invest in technological improvements

The financial services industry is continually undergoing rapid technological change with frequent introductions of new technology-driven products and services. The effective use of technology increases efficiency and enables financial institutions to better serve customers and to reduce costs. The Company's future success depends, in part, upon its ability to address the needs of its customers by using technology to provide products and services that will satisfy customer demands as well as to create additional efficiencies in the Company's operations. In late 2009, the Company made a decision to change its core banking system from an out-sourced, third-party provided system to an in-house, integrated solution expected to be implemented by the third quarter of 2010. Although the Company expects to benefit from the enhanced functionality and process efficiencies of the new system, the planned conversion does include meaningful execution risk.

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

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

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

Readers are cautioned that it is not possible to predict or identify all of the risks, uncertainties and other factors that may affect future results and that the above list should not be considered to be a complete list.

Item 1B. Unresolved Staff Comments

None

Item 2. Properties

The Company's primary headquarters is located at 5790 Widewaters Parkway, Dewitt, New York, which is leased. In addition, the Company has 168 properties located in the counties identified in the table on page 5, of which 101 are owned and 67 are under long-term lease arrangements. Real property and related banking facilities owned by the Company at December 31, 2009 had a net book value of $54.4 million and none of the properties were subject to any material encumbrances. For the year ended December 31, 2009, rental fees of $4.0 million were paid on facilities leased by the Company for its operations. The Company believes that its facilities are suitable and adequate for the Company's current operations.

Item 3. Legal Proceedings

The Company and its subsidiaries are subject in the normal course of business to various pending and threatened legal proceedings in which claims for monetary damages are asserted. Management, after consultation with legal counsel, does not anticipate that the aggregate liability, if any, arising out of litigation pending against the Company or its subsidiaries will have a material effect on the Company's consolidated financial position or results of operations.

Item 4. [Reserved]

Item 4A. Executive Officers of the Registrant

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

Name	Age	Position
Mark E. Tryniski	49	Director, President and Chief Executive Officer of the Company and the Bank. Mr. Tryniski assumed his current position in August 2006. He served as Executive Vice President and Chief Operating Officer from March 2004 to July 2006 and as the Treasurer and Chief Financial Officer from June 2003 to March 2004. He previously served as a partner in the Syracuse office of PricewaterhouseCoopers LLP.
Scott Kingsley	45	Executive Vice President and Chief Financial Officer of the Company. Mr. Kingsley joined the Company in August 2004 in his current position. He served as Vice President and Chief Financial Officer of Carlisle Engineered Products, Inc., a subsidiary of the Carlisle Companies, Inc., from 1997 until joining the Company.
Brian D. Donahue	53	Executive Vice President and Chief Banking Officer. Mr. Donahue assumed his current position in August 2004. He served as the Bank's Chief Credit Officer from February 2000 to July 2004 and as the Senior Lending Officer for the Southern Region of the Bank from 1992 until June 2004.
George J. Getman	53	Executive Vice President and General Counsel. Mr. Getman assumed his current position in January 2008. Prior to joining the Company, he was a member with Bond, Schoeneck & King, PLLC and served as corporate counsel to the Company.

Part II

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

The Company's common stock has been trading on the New York Stock Exchange under the symbol "CBU" since December 31, 1997. Prior to that, the common stock traded over-the-counter on the NASDAQ National Market under the symbol "CBSI" beginning on September 16, 1986. There were 32,800,308 shares of common stock outstanding on December 31, 2009, held by approximately 3,509 registered shareholders of record. The following table sets forth the high and low prices for the common stock, and the cash dividends declared with respect thereto, for the periods indicated. The prices do not include retail mark-ups, mark-downs or commissions.

Year / Qtr	High Price	Low Price	Quarterly Dividend
2009			
4th	$20.00	$16.36	$0.22
3rd	$20.33	$13.78	$0.22
2nd	$20.06	$14.22	$0.22
1st	$24.55	$13.24	$0.22
2008			
4th	$25.98	$19.00	$0.22
3rd	$33.00	$19.52	$0.22

2nd	$26.88	$20.50	$0.21
1st	$26.45	$17.91	$0.21

The Company has historically paid regular quarterly cash dividends on its common stock, and declared a cash dividend of $0.22 per share for the first quarter of 2010. The Board of Directors of the Company presently intends to continue the payment of regular quarterly cash dividends on the common stock, as well as to make payment of regularly scheduled dividends on the trust preferred stock when due, subject to the Company's need for those funds. However, because substantially all of the funds available for the payment of dividends by the Company are derived from the Bank, future dividends will depend upon the earnings of the Bank, its financial condition, its need for funds and applicable governmental policies and regulations.

The following graph compares cumulative total shareholders returns on the Company's common stock over the last five fiscal years to the S&P 600 Commercial Banks Index, the NASDAQ Bank Index, the S&P 500 Index, and the KBW Regional Banking Index. Total return values were calculated as of December 31 of each indicated year assuming a $100 investment on December 31, 2004 and reinvestment of dividends.

The following table provides information as of December 31, 2009 with respect to shares of common stock that may be issued under the Company's existing equity compensation plans.

Plan Category	Number of Securities to be Issued upon Exercise of Outstanding Options, Warrants and Rights (1)	Weighted-average Exercise Price on Outstanding Options, Warrants and Rights	Number of Securities Remaining Available for Future Issuance
Equity compensation plans approved by security holders:			
1994 Long-term Incentive Plan	1,016,467	$18.00	0
2004 Long-term Incentive Plan	2,240,356	$19.65	1,588,609
Total	3,256,823	$19.14	1,588,609

(1) The number of securities includes unvested restricted stock issued of 174,008.

On July 22, 2009, the Company announced an authorization to repurchase up to 1,000,000 of its outstanding shares in open market transactions or privately negotiated transactions in accordance with securities laws and regulations through December 31, 2011. 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 treasury stock purchases in 2009.

Item 6. Selected Financial Data

The following table sets forth selected consolidated historical financial data of the Company as of and for each of the years in the five-year period ended December 31, 2009. The historical information set forth under the captions "Income Statement Data" and "Balance Sheet Data" is derived from the audited financial statements while the information under the captions "Capital and Related Ratios", "Selected Performance Ratios" and "Asset Quality Ratios" for all periods is unaudited. All financial information in this table should be read in conjunction with the information contained in "Management's Discussion and Analysis of Financial Condition and Results of Operations" and with the Consolidated Financial Statements and the related notes thereto included elsewhere in this Annual Report on Form 10-K.

SELECTED CONSOLIDATED FINANCIAL INFORMATION

	Years Ended December 31,				
(In thousands except per share data and ratios)	2009	2008	2007	2006	2005
Income Statement Data:					
Loan interest income	$185,119	$186,833	$186,784	$167,113	$147,608
Investment interest income	63,663	64,026	69,453	64,788	71,836
Interest expense	83,282	102,352	120,263	97,092	75,572
Net interest income	165,500	148,507	135,974	134,809	143,872
Provision for loan losses	9,790	6,730	2,004	6,585	8,534
Noninterest income	83,528	73,244	63,260	51,679	48,401
Gain (loss) on investment securities & early retirement of long-term borrowings	7	230	(9,974)	(2,403)	12,195
Special charges/acquisition expenses	1,716	1,399	382	647	2,943
Noninterest expenses	184,462	157,163	141,692	126,556	124,446
Income before income taxes	53,067	56,689	45,182	50,297	68,545
Net income	41,445	45,940	42,891	38,377	50,805
Diluted earnings per share (1)	1.26	1.49	1.42	1.26	1.65
Balance Sheet Data:					
Cash equivalents	$257,812	$112,181	$4,533	$104,231	$5,039
Investment securities	1,487,127	1,395,011	1,391,872	1,229,271	1,303,117
Loans, net of unearned discount	3,099,485	3,136,140	2,821,055	2,701,558	2,411,769
Allowance for loan losses	(41,910)	(39,575)	(36,427)	(36,313)	(32,581)
Intangible assets	317,671	328,624	256,216	246,136	224,878
Total assets	5,402,813	5,174,552	4,697,502	4,497,797	4,152,529
Deposits	3,924,486	3,700,812	3,228,464	3,168,299	2,983,507
Borrowings	856,778	862,533	929,328	805,495	653,090
Shareholders' equity	565,697	544,651	478,784	461,528	457,595
Capital and Related Ratios:					
Cash dividend declared per share	$0.88	$0.86	$0.82	$0.78	$0.74
Book value per share	17.25	16.69	16.16	15.37	15.28
	8.09	6.62	7.51	7.17	7.77

Tangible book value per share					
Market capitalization (in millions)	633	796	589	690	676
Tier 1 leverage ratio	7.39%	7.22%	7.77%	8.81%	7.57%
Total risk-based capital to risk-adjusted assets	13.46%	12.53%	14.05%	15.47%	13.64%
Tangible equity to tangible assets(3)	5.20%	4.74%	5.01%	5.07%	5.93%
Dividend payout ratio	69.5%	57.3%	57.1%	60.7%	43.9%
Period end common shares outstanding	32,800	32,633	29,635	30,020	29,957
Diluted weighted-average shares outstanding	32,992	30,826	30,232	30,392	30,838
Selected Performance Ratios:					
Return on average assets	0.78%	0.97%	0.93%	0.90%	1.19%
Return on average equity	7.46%	9.23%	9.20%	8.36%	10.89%
Net interest margin	3.80%	3.82%	3.64%	3.91%	4.17%
Noninterest income/operating income (FTE)	31.6%	31.0%	26.1%	24.8%	27.7%
Efficiency ratio(2)	65.4%	62.7%	63.3%	59.9%	56.8%
Asset Quality Ratios:					
Allowance for loan losses/total loans	1.35%	1.26%	1.29%	1.34%	1.35%
Nonperforming loans/total loans	0.61%	0.40%	0.32%	0.47%	0.55%
Allowance for loan losses/nonperforming loans	222%	312%	410%	288%	245%
Net charge-offs/average loans	0.24%	0.20%	0.10%	0.24%	0.33%
Loan loss provision/net charge-offs	131%	117%	76%	108%	110%

(1) Earnings per share amounts have been restated to reflect the effects of ASC 260-10-65.

(2) Efficiency ratio excludes intangible amortization, gain (loss) on investment securities & debt extinguishments, goodwill impairment, and special charges/acquisition expenses. The efficiency ratio is not a financial measurement required by accounting principles generally accepted in the United States of America. However, the efficiency ratio

is used by management in its assessment of financial performance specifically as it relates to non-interest expense control and also believes such information is useful to investor in evaluating Company performance.

(3) The tangible equity to tangible asset ratio excludes goodwill and identifiable intangible assets. The ratio is not a financial measurement required by accounting principles generally accepted in the United States of America. However, management believes such information is useful to analyze the relative strength of the Company's capital position and is useful to investors in evaluating Company performance.

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

This Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") primarily reviews the financial condition and results of operations of Community Bank System, Inc. ("the Company") for the past two years, although in some circumstances a period longer than two years is covered in order to comply with Securities and Exchange Commission disclosure requirements or to more fully explain long-term trends. The following discussion and analysis should be read in conjunction with the Selected Consolidated Financial Information on page 15 and the Company's Consolidated Financial Statements and related notes that appear on pages 45 through 80. All references in the discussion to the financial condition and results of operations are to the consolidated position and results of the Company and its subsidiaries taken as a whole.

Unless otherwise noted, all earnings per share ("EPS") figures disclosed in the MD&A refer to diluted EPS; interest income, net interest income and net interest margin are presented on a fully tax-equivalent ("FTE") basis. The term "this year" and equivalent terms refer to results in calendar year 2009, "last year" and equivalent terms refer to calendar year 2008, and all references to income statement results correspond to full-year activity unless otherwise noted.

This Management's Discussion and Analysis of Financial Condition and Results of Operations contains certain forward-looking statements with respect to the financial condition, results of operations and business of Community Bank System, Inc. These forward-looking statements involve certain risks and uncertainties. Factors that may cause actual results to differ materially from those contemplated by such forward-looking statements are set herein under the caption "Forward-Looking Statements" on page 41.

Critical Accounting Policies

As a result of the complex and dynamic nature of the Company's business, management must exercise judgment in selecting and applying the most appropriate accounting policies for its various areas of operations. The policy decision process not only ensures compliance with the latest generally accepted accounting principles ("GAAP"), but also reflects on management's discretion with regard to choosing the most suitable methodology for reporting the Company's financial performance. It is management's opinion that the accounting estimates covering certain aspects of the business have more significance than others due to the relative importance of those areas to overall performance, or the level of subjectivity in the selection process. These estimates affect the reported amounts of assets and liabilities and disclosures of revenues and expenses during the reporting period. Actual results could differ from those estimates. Management believes that the critical accounting estimates include:

- Allowance for loan losses – The allowance for loan losses reflects management's best estimate of probable loan losses in the Company's loan portfolio. Determination of the allowance for loan losses is inherently subjective. It requires significant estimates including the amounts and timing of expected future cash flows on impaired loans and the amount of estimated losses on pools of homogeneous loans which is based on historical loss experience and consideration of current economic trends, all of which may be susceptible to significant change.

- Investment securities – Investment securities are classified as held-to-maturity, available-for-sale, or trading. The appropriate classification is based partially on the Company's ability to hold the securities to maturity and largely on management's intentions with respect to either holding or selling the securities. The classification of investment securities is significant since it directly impacts the accounting for unrealized gains and losses on securities. Unrealized gains and losses on available-for-sale securities are recorded in accumulated other comprehensive income or loss, as a separate component of shareholders' equity and do not affect earnings until realized. The fair values of investment securities are generally determined by reference to quoted market prices, where available. If quoted market prices are not available, fair values are based on quoted market prices of comparable instruments, or a discounted cash flow model using market estimates of interest rates and volatility. Investment securities with significant declines in fair value are evaluated to determine whether they should be considered other-than–temporarily impaired. An unrealized loss is generally deemed to be other-than-temporary and a credit loss is deemed to exist if the present value of the expected future cash flows is less than the amortized cost basis of the debt security. The credit loss component of an other-than-temporary impairment write-down is recorded in earnings, while the remaining portion of the impairment loss is recognized in other comprehensive income (loss), provided the Company does not intend to sell the underlying debt security and it is not more likely than not that the Company will be required to sell the debt security prior to recovery.

- Retirement benefits - The Company provides defined benefit pension benefits and post-retirement health and life insurance benefits to eligible employees. The Company also provides deferred compensation and supplemental executive retirement plans for selected current and former employees and officers. 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, but not limited to, discount rate, rate of future compensation increases, mortality rates, future health care costs and expected return on plan assets.

- Provision for income taxes – The Company is subject to examinations from various 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 judgments used to record tax-related assets or liabilities have been appropriate. 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.

- Intangible assets – As a result of acquisitions, the Company has acquired goodwill and identifiable intangible assets. Goodwill represents the cost of acquired companies in excess of the fair value of net assets at the acquisition date. Goodwill is evaluated at least annually, or when business conditions suggest an impairment may have occurred and will be reduced to its carrying value through a charge to earnings if impairment exists. Core deposits and other identifiable intangible assets are amortized to expense over their estimated useful lives. The determination of whether or not impairment exists 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 them to select a discount rate that reflects the current return requirements of the market in relation to present risk-free interest rates, required equity market premiums and company-specific risk indicators, all of which are susceptible to change based on changes in economic conditions and other factors. Future events or changes in the estimates used to determine the carrying value of goodwill and identifiable intangible assets could have a material impact on the Company's results of operations.

A summary of the accounting policies used by management is disclosed in Note A, "Summary of Significant Accounting Policies", starting on page 50.

Executive Summary

The Company's business philosophy is to operate as a community bank with local decision-making, principally in non-metropolitan markets, providing a broad array of banking and financial services to retail, commercial, and municipal customers.
The Company's core operating objectives are: (i) grow the branch network, primarily through a disciplined acquisition strategy, and certain selective de novo expansions, (ii) build profitable loan and deposit volume using both organic and acquisition strategies, (iii) increase the non-interest income component of total revenues through development of banking-related fee income, growth in existing financial services business units, and the acquisition of additional financial services and banking businesses, and (iv) utilize technology to deliver customer-responsive products and services and to reduce operating costs.

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

The Company's reported net income for the year of $41.4 million, or $1.26 per share, was 9.8% below 2008's reported earnings of $45.9 million, or $1.49 per share. Higher operating expenses, principally from acquisitions completed in 2008, significantly higher FDIC insurance assessments and higher loan loss provisions, were partially offset by higher net interest income generated through organic and acquired growth of both loans and deposits and higher noninterest income. The 2009 results included a $3.1 million non-cash charge for impairment of goodwill associated with the Company's wealth management businesses, a $6.9 million increase in FDIC assessments, as well as a $1.4 million special charge related to the planned early termination of its core banking system services contract in 2010. Excluding the aforementioned items, as well as acquisition expenses in both years, a $1.7 million goodwill impairment charge and a one-time tax gain in 2008, the Company's 2009 full year results improved by $0.01 per share over 2008.

Loan net charge-off, delinquency and nonperforming loan ratios rose and the provision for loan losses increased versus 2008, but all these metrics remained favorable to the Company's peers and long-term historical levels. The Company experienced year-over-year loan growth in the business lending portfolio with small decreases in the consumer installment and consumer mortgage portfolio. The investment portfolio, including cash equivalents, increased from the prior year due to the net liquidity created from the acquisition of Citizens' branches in the fourth quarter of 2008, as well as organic deposit growth. Average deposits increased in 2009 as compared to 2008 as a result of the acquisition of Citizens' branches as well as organic growth in core product relationships, offset by a reduction in time deposits. External borrowings decreased from the end of December 2008 as a portion of the net liquidity from the branch acquisition was used to eliminate certain obligations.

Net Income and Profitability

Net income for 2009 was $41.4 million, a decrease of $4.5 million, or 9.8%, from 2008's earnings of $45.9 million. Earnings per share for 2009 was $1.26 per share, down 15% from 2008's earnings per share. The 2009 results include a $3.1 million or $0.07 per share non-cash charge for impairment of goodwill associated with the Company's wealth management business as well as a $1.4 million or $0.03 per share special charge related to the planned early termination of its core banking system services contract in 2010. Additionally, during 2009, FDIC insurance costs increased $6.9 million or $0.16 per share. The Company's 2008 results included a $1.7 million or $0.04 per share goodwill impairment charge, $1.4 million or $0.03 per share of acquisition expenses related to the purchase of 18 branch-banking centers in northern New York State in November 2008 and ABG in July 2008, as well as a $1.7 million or $0.05 per share benefit related to settlement of certain previously unrecognized tax positions. Excluding the aforementioned items, the Company's 2009 full year results improved by $0.01 per share over 2008.

Net income for 2008 was $45.9 million, up $3.0 million, or 7.1% from 2007's earning of $42.9 million. Earnings per share for 2008 was $1.49 per share, up 4.9% from 2007's earnings per share. The 2008 results include a $1.7 million benefit related to a change in a position taken on certain previously unrecognized tax positions, a $1.7 million pre-tax, non-cash charge for impairment of goodwill associated with the Company's wealth management business and $1.4 million of acquisition expenses related to the purchase of 18 branch-banking centers in northern New York State from Citizens in November and the purchase of ABG in July. The 2007 results include a $9.9 million, or $0.20 per share, pre-tax charge related to the early redemption of $25 million of variable-rate, trust preferred obligations, as well as the refinancing of $150 million of Federal Home Loan Bank advances into lower cost instruments. The 2007 results also included a $6.9 million, or $0.23 per share, benefit related to the settlement and a related change in a position taken on certain previously unrecognized tax positions.

Table 1: Condensed Income Statements

	Years Ended December 31,				
(000's omitted, except per share data)	2009	2008	2007	2006	2005
Net interest income	$165,500	$148,507	$135,974	$134,809	$143,872
Loan loss provision	9,790	6,730	2,004	6,585	8,534
Noninterest income	83,535	73,474	53,286	49,276	60,596
Operating expenses	186,178	158,562	142,074	127,203	127,389
Income before taxes	53,067	56,689	45,182	50,297	68,545
Income taxes	11,622	10,749	2,291	11,920	17,740
Net income	$41,445	$45,940	$42,891	$38,377	$50,805
Diluted earnings per share	$1.26	$1.49	$1.42	$1.26	$1.65

The primary factors explaining 2009 performance are discussed in detail in the remaining sections of this document and are summarized as follows:

- As shown in Table 1 above, net interest income increased $17.0 million, or 11.4%, due to a $486 million increase in average earning assets partially offset by a two-basis point decrease in the net interest margin. Average loans grew $170 million or 5.8%, primarily due to organic business lending, consumer installment and retail mortgage growth as well as the addition of 18 branch banking centers in November 2008. The average book value of investments increased $92.6 million, or 7.1% in 2009. Short-term cash equivalents increased $223 million as compared to 2008, reflective of the net liquidity generated from the Citizens acquisition and organic deposit growth. Average borrowings decreased $42.8 million or 4.7% as a portion of the net liquidity from the Citizen acquisition was used to eliminate certain borrowings.

- The loan loss provision of $9.8 million increased $3.1 million, or 46%, from the prior year level. Net charge-offs of $7.5 million increased by $1.7 million from 2008, increasing the net charge-off ratio (net charge-offs / total average loans) to 0.24% for the year. The Company's asset quality remained strong as key metrics such as nonperforming loans as a percentage of total loans, nonperforming assets as a percentage of loans and other real estate owned, and delinquent loans (30+ days through nonaccruing) as a percentage of total loans increased but remained below the Company's peers and long-term historical levels. Additional information on trends and policy related to asset quality is provided in the asset quality section on pages 32 through 35.

- Noninterest income for 2009 of $83.5 million increased by $10.1 million, or 14%, from 2008's level, due both to organic growth and the two 2008 acquisitions. Fees from banking services were up $8.3 million or 21%, primarily due to higher ATM and debit card related revenues, incremental income from the acquired branches and increased activity in the secondary mortgage banking business. Financial services revenue was up $2.0 million, or 5.7% higher, mostly from growth at the Company's benefit trust, administration, and consulting business, primarily as a result of the acquisition of ABG.

- Total operating expenses increased $27.6 million or 17% in 2009 to $186.2 million. A significant portion of the increase was attributable to incremental operating expenses related to the Citizens' branches and ABG acquisitions. Additionally, expenses were up due to higher FDIC insurance premiums, higher personnel costs, higher pension costs related to the underlying asset performance in 2008, higher volume based processing costs, and increased expenses related to investments in technology and facilities infrastructure.

- The Company's combined effective federal and state income tax rate increased 2.9 percentage points in 2009 to 21.9%, reflective of the current mix of non-taxable and fully taxable securities. This compares to 19.0% in 2008, which included a $1.7 million benefit related to the settlement of certain previously unrecognized tax positions.

Selected Profitability and Other Measures

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

Table 2: Selected Ratios

	2009	2008	2007
Return on average assets	0.78%	0.97%	0.93%
Return on average equity	7.46%	9.23%	9.20%
Dividend payout ratio	69.5%	57.3%	57.1%
Average equity to average assets	10.44%	10.46%	10.14%

As displayed in Table 2 above, the return on average assets decreased in 2009 as compared to both 2008 and 2007. The decrease in comparison to both years was a result of lower net income primarily due to higher provision for loan losses and increased operating expenses in 2009 as compared to 2008 and 2007. Reported return on equity in 2009 was also lower than 2008 and 2007's levels for similar reasons.

The dividend payout ratio for 2009 was above 2008's level due to dividends declared increasing 9.6%, while net income declined 9.8%. The increase in dividends declared was the result of a 2.3% increase in the dividend paid per share as well as the additional 2.5 million shares issued through the common equity offering in the fourth quarter of

2008. The dividend payout ratio increased slightly in 2008 as compared to 2007 due to a 7.5% increase in dividends declared as compared to the 7.1% growth in net income.

Net Interest Income

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

As disclosed in Table 3, net interest income (with nontaxable income converted to a fully tax-equivalent basis) totaled $181.2 million in 2009, up $17.6 million, or 10.7%, from the prior year. A $486 million increase in average interest-earning assets more than offset a $393 million increase in average interest-bearing liabilities and a two basis point decrease in net interest margin. As reflected in Table 4, the volume changes increased net interest income by $18.4 million, while the lower net interest margin had a $0.9 million unfavorable impact.

The net interest margin decreased two basis points from 3.82% in 2008 to 3.80% in 2009. This decrease was primarily attributable to a 66 basis point decrease in earning-asset yields having a greater impact than 66-basis point decrease in the cost of funds. The yield on loans decreased 41 basis points in 2009, due to new volume coming on at lower yields in the current low-rate environment than the loans maturing or being prepaid and variable and adjustable rate loans repricing downward. The yield on investments, including cash equivalents, decreased from 5.81% in 2008 to 4.73% in 2009, mostly reflective of the net liquidity generated from the Citizens acquisition and organic deposit growth that remained in cash earning low overnight yields. The decreased cost of funds was reflective of disciplined deposit pricing, whereby interest rates on selected categories of deposit accounts were lowered throughout 2008 and 2009 in response to market conditions. Additionally, the proportion of customer deposits in higher cost time deposits has declined 7.9 percentage points over the last twelve months, while the percentage of deposits in non-interest bearing and lower cost checking accounts has increased.

The net interest margin in 2008 was 3.82%, compared to 3.64% in 2007. This 18-basis point increase was primarily attributable to a 52-basis point decrease in the cost of funds having a greater impact than the 34-basis point decrease in earning-asset yields. The decreased cost of funds was reflective of disciplined deposit pricing, in part due to the decreases in short-term market rates in 2008, as well as planned reductions of time deposit balances. Additionally, the rates on external borrowings decreased throughout the year, as a result of the refinancing of $150 million of Federal Home Loan Bank advances into lower cost instruments in the fourth quarter of 2007 and seven rate reductions by the Federal Reserve to the overnight federal funds rates since the end of 2007. The yield on loans decreased 44 basis points in 2008, again due in part to the declining interest rates throughout the market. The yield on investments decreased from 5.98% in 2007 to 5.81% in 2008 as cash flows from the maturing of higher yielding investments were used to fund loan growth rather than be reinvested at unfavorable market rates in the first half of the year, as well as the steep decline in yields earned on cash equivalents. In the second half of the year, the Company purchased modestly lower yielding investments in advance of the liquidity provided by the acquisition of the Citizens' branches in November 2008.

As shown in Table 3, total interest income decreased by $1.5 million, or 0.6%, in 2009. Table 4 reveals that higher average earning assets contributed a positive $28.5 million variance, offset by lower yields with a negative impact of $30.0 million. Average loans grew a total of $170.0 million in 2009, as a result of $81.0 million from the acquisition of 18 Citizens branches in November 2008 as well as $89.1 million of organic growth in all portfolios: business lending, consumer mortgage and consumer installment. Interest income and fees declined $1.8 million in 2009 as compared to 2008, attributable to a 41-basis point decrease in loan yields, partially offset by higher average loan balances. Total interest income decreased by $5.1 million, or 1.9% in 2008 from 2007's level. Table 4 indicates that higher average earning assets contributed a positive $9.2 million variance offset by lower yields with a negative impact of $14.4 million. Average loans grew $191.0 million in 2008 over 2007, as a result of $41.6 million from the acquisitions of 18 Citizens branches in November 2008 and TLNB in June 2007, as well as $149.3 million of organic growth in all portfolios. Interest and fees on loans were consistent with 2007, comprised of higher average loan balances offset by a 44-basis point decrease in loan yields.

Investment interest income in 2009 of $78.9 million was $0.3 million, or 0.4%, higher than the prior year as a result of a larger portfolio (positive $6.1 million impact), partially offset by a 108-basis point decrease in the investment yield. The increase in investments and cash equivalents was the result of the net liquidity generated from the Citizens acquisition and organic deposit growth. Investment interest income in 2008 of $78.5 million was $5.1 million, or 6.1%, lower than the prior year as a result of a smaller portfolio (negative $1.2 million impact) and a 17-basis point decrease in the investment yield. The decrease in balances was a result of cash flows from maturing investments being used to fund loan growth rather than be reinvested at unfavorable market rates for most of the year. Investment purchases were initiated in the third and fourth quarters of 2008 in anticipation of the net liquidity that would be supplied by the Citizens' branch acquisition.

The average earning asset yield declined 66 basis points to 5.54% in 2009 because of the previously mentioned decreases in loan and investment yields. The change in the earning-asset yield is primarily a result of variable and adjustable-rate loans repricing downward and lower rates on new loan volume due to the decline in interest rates to levels below those prevalent in prior years, as well as the Company's increased holding of lower yielding cash instruments, as it maintains a liquid position in anticipation of improved investment opportunities in future periods. The average earning asset yield declined 34 basis points to 6.20% in 2008 from 6.54% in 2007 because of the previously mentioned decrease in loan and investment yields. In 2008, the gap between loan and investment yields decreased to 58 basis points as the yield on the loan portfolio decreased 44 basis points while the yield on the investment portfolio decreased a smaller 17 basis points reflective of the loan portfolio having a significant proportion of variable and adjustable rate loans which declined as the interest rates decreased throughout 2008, whereas the investment portfolio was predominately comprised of fixed rate instruments.

Total average funding (deposits and borrowings) in 2009 increased $498.5 million or 12%. Deposits increased $541.2 million, $474.2 million attributable to the acquisitions of the 18 Citizens branches and a $67.0 million increase in organic deposits. Consistent with the Company's funding mix objective, average core deposit balances increased $575.9 million, while time deposits were allowed to decline $34.7 million over the year. Average external borrowings decreased $42.8 million in 2009 as compared to the prior year as a portion of the net liquidity from the branch acquisition was used to eliminate short-term borrowings. In 2008, total average funding increased $134.4 million or 3.3%. Average deposits increased $53.0 million, $102.8 million attributable to the acquisitions of the 18 Citizen branches and TLNB offset by a $49.8 million decrease in organic deposits. Average core deposit balances increased $150.5 million, while time deposits were allowed to decline $97.5 million over the year. Average external borrowings increased $81.4 million in 2008 as compared to the prior year due primarily to the all-cash acquisitions of ABG, TLNB and HB&T. However, year-end borrowings declined $66.8 million from the end of 2007 as a portion of the net liquidity from the branch acquisition was used to eliminate short-term borrowings.

The cost of funding, including the impact of non-interest checking deposits decreased 66 basis points during 2009 to 1.77% as compared to 2.43% for 2008. The decreased cost of funds was reflective of disciplined deposit pricing, whereby interest rates on selected categories of deposit accounts were lowered throughout 2008 and 2009 in response to market conditions. Additionally, the proportion of customer deposit in higher cost time deposits has declined 7.9 percentage points over the last twelve months, while the percentage of deposits in non-interest bearing and lower cost checking accounts has increased. The cost of funding decreased 52 basis points during 2008 impacted by the decreases to short-term rates by the Federal Reserve throughout the latter part of 2007 and all of 2008. Interest rates on deposit accounts were lowered throughout 2008, with decreases in all product offerings. Additionally, the Company focused on expanding core account relationships while time deposit balances were allowed to decline.

Total interest expense decreased by $19.1 million to $83.3 million in 2009. As shown in Table 4, lower interest rates on deposits, partially offset by a slight increase in rates on external borrowings resulted in $29.3 million of this decrease, while the higher deposit balance, partially offset by the lower external borrowings balance accounted for an increase of $10.2 million in interest expense. Interest expense as a percentage of earning assets decreased by 64 basis points to 1.75%. The rate on interest-bearing deposits decreased 86 basis points to 1.45%, due largely to reductions of time deposit and money market rates throughout 2009 and the previously discussed run off of higher rate deposit products. The rate on external borrowings increased two basis points to 4.37%. Total interest expense decreased by $17.9 million to $102.4 million in 2008 as compared to 2007. Lower interest rates on deposit and external borrowings accounted for $21.9 million of this decrease, while the higher deposit and borrowings balances accounted for an increase of $4.0 million in interest expense. The rate on interest-bearing deposits decreased 58 basis points to 2.31% and the rate on external borrowings decreased 84 basis points to 4.35% in 2008.

The following table sets forth information related to average interest-earning assets and interest-bearing liabilities and their associated yields and rates for the years ended December 31, 2009, 2008 and 2007. Interest income and yields are on a fully tax-equivalent basis using marginal income tax rates of 38.5% in 2009 and 2008, and 38.8% in 2007. Average balances are computed by totaling the daily ending balances in a period and dividing by the number of days in that period. Loan yields and amounts earned include loan fees. Average loan balances include nonaccrual loans and loans held for sale.

Table 3: Average Balance Sheet

	Year Ended December 31, 2009			Year Ended December 31, 2008			Year Ended December 31, 2007		
(000's omitted except yields and rates)	Average Balance	Interest	Avg. Yield/Rate Paid	Average Balance	Interest	Avg. Yield/Rate Paid	Average Balance	Interest	Avg. Yield/Rate Paid
Interest-earning assets:									
Cash equivalents	$262,479	$682	0.26%	$39,452	$614	1.56%	$79,827	$4,019	5.03%
Taxable investment securities (1)	848,963	40,481	4.77%	783,879	41,600	5.31%	830,276	46,048	5.55%
Nontaxable investment securities (1)	555,353	37,704	6.79%	527,805	36,327	6.88%	488,193	33,540	6.87%
Loans (net of unearned discount)(2)	3,104,808	185,587	5.98%	2,934,790	187,399	6.39%	2,743,804	187,480	6.83%
Total interest-earning assets	4,771,603	264,454	5.54%	4,285,926	265,940	6.20%	4,142,100	271,087	6.54%
Noninterest-earning assets	546,595			472,157			455,123		
Total assets	$5,318,198			$4,758,083			$4,597,223		
Interest-bearing liabilities:									
Interest checking, savings and money market deposits	$1,835,138	11,448	0.62%	$1,364,652	11,061	0.81%	$1,228,447	13,634	1.11%
Time deposits	1,325,598	34,328	2.59%	1,360,275	52,019	3.82%	1,457,768	64,048	4.39%
Borrowings	859,155	37,506	4.37%	901,909	39,272	4.35%	820,546	42,581	5.19%
Total interest-bearing liabilities	4,019,891	83,282	2.07%	3,626,836	102,352	2.82%	3,506,761	120,263	3.43%
Noninterest-bearing liabilities:									
Noninterest checking deposits	686,692			581,271			566,981		

Other liabilities	56,147		52,145		57,283	
Shareholders' equity	555,468		497,831		466,198	
Total liabilities and shareholders' equity	$5,318,198		$4,758,083		$4,597,223	
Net interest earnings		$181,172		$163,588		$150,824
Net interest spread		3.47%		3.38%		3.11%
Net interest margin on interest-earning assets		3.80%		3.82%		3.64%
Fully tax-equivalent adjustment		$15,672		$15,081		$14,850

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

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

22

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

Table 4: Rate/Volume

	2009 Compared to 2008 Increase (Decrease) Due to Change in (1)			2008 Compared to 2007 Increase (Decrease) Due to Change in (1)		
(000's omitted)	Volume	Rate	Net Change	Volume	Rate	Net Change
Interest earned on:						
Cash equivalents	$952	($884)	$68	($1,440)	($1,965)	($3,405)
Taxable investment securities	3,296	(4,415)	(1,119)	(2,523)	(1,925)	(4,448)
Nontaxable investment securities	1,876	(499)	1,377	2,742	45	2,787
Loans (net of unearned discount)	10,526	(12,338)	(1,812)	12,609	(12,690)	(81)
Total interest-earning assets (2)	28,479	(29,965)	(1,486)	9,217	(14,364)	(5,147)
Interest paid on:						
Interest checking, savings and money market deposits	3,286	(2,899)	387	1,393	(3,966)	(2,573)
Time deposits	(1,295)	(16,396)	(17,691)	(4,094)	(7,935)	(12,029)
Borrowings	(2,401)	635	(1,766)	1,875	(5,184)	(3,309)
Total interest-bearing liabilities (2)	10,238	(29,308)	(19,070)	4,000	(21,911)	(17,911)
Net interest earnings (2)	18,444	(860)	17,584	5,342	7,422	12,764

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

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

Noninterest Income

The Company's sources of noninterest income are of three primary types: 1) general banking services related to loans, deposits and other core customer activities typically provided through the branch network and electronic banking channels (performed by CBNA and First Liberty Bank and Trust); 2) employee benefit trust, administration, actuarial and consulting services (performed by BPAS); and 3) wealth management services, comprised of trust services (performed by the trust unit within CBNA), investment and insurance products and services (performed by CISI and CBNA Insurance), and asset management (performed by Nottingham). Additionally, the Company has periodic transactions, most often net gains (losses) from the sale of investment securities and prepayment of debt instruments.

Table 5: Noninterest Income

	Years Ended December 31,		
(000's omitted except ratios)	2009	2008	2007
Deposit service charges and fees	$29,819	$27,167	$24,178
Benefit trust, administration, consulting and actuarial fees	27,771	25,788	19,700
Wealth management services	8,631	8,648	8,264
Other fees	4,457	5,181	5,561
Electronic banking	8,904	5,693	4,595
Mortgage banking	3,946	767	962
Subtotal	83,528	73,244	63,260
Gain (loss) on investment securities & debt extinguishments	7	230	(9,974)
Total noninterest income	$83,535	$73,474	$53,286
Noninterest income/operating income (FTE)	31.6%	31.0%	26.1%

As displayed in Table 5, noninterest income, excluding security gains and debt extinguishments costs, increased by 14% to $83.5 million in 2009, largely as a result of increased recurring banking service fees and debit card related revenues (both organic and acquired) and increased activity in the secondary mortgage banking business. Benefit trust, administration, consulting, and actuarial revenues increased primarily as a result of the acquisition of ABG. Total noninterest income, excluding security gains and debt extinguishments costs, of $73.2 million for 2008 increased by 16% over 2007 largely as a result of increased recurring bank fees and both organic and acquired growth in benefit trust, administration, consulting and actuarial fees. The loss on the sale of investment securities and debt extinguishments decreased $10.2 million in 2008 as 2007 included a one-time $9.9 million charge related to the early redemption of $25 million of variable-rate trust preferred obligations, as well as the refinance of $150 million of Federal Home Loan Bank advances into lower cost instruments with no corresponding loss in 2008.

Noninterest income as a percent of operating income (FTE basis) was 31.6% in 2009, up 0.6 percentage points from the prior year. This increase was primarily driven by the aforementioned strong growth in recurring bank fees, and secondary mortgage banking revenues. This ratio is considered an important measure for determining the progress the Company is making on one of its primary long-term strategies, which is the expansion of noninterest income in order to diversify its revenue sources and reduce reliance on net interest margins that may be more directly impacted by general interest rate and other market conditions.

The largest portion of the Company's recurring noninterest income is the wide variety of fees earned from general banking services, which reached $47.1 million in 2009, up 21% from the prior year. A major part of the income growth was attributable to electronic banking fees, up $3.2 million, or 56%, over 2008's level, due in large part to a concerted effort to increase the penetration and utilization of consumer debit cards. Overdraft fees were also up $2.6 million, or 13%, over 2008's level, driven by core deposit account growth. Mortgage banking revenue for the year was $3.9 million, an increase of $3.2 million as compared to 2008. Residential mortgage banking income consist of realized gains or losses from the sale of residential mortgage loans and the origination of mortgage loan servicing rights, unrealized gains and losses on residential mortgage loans held for sale and related commitments, mortgage loan servicing fees and other mortgage loan-related fee income. Included in mortgage banking income is an impairment charge of $0.1 million in 2009 for the fair value of the mortgage servicing rights due primarily to an increase in the cost of servicing the loan and an increase in the expected prepayment speed of the Company's sold loan portfolio with servicing retained. Residential mortgage loans sold to investors, primarily Fannie Mae, totaled $177.8 million in 2009 as compared to $3.7 million and $17.2 million during 2008 and 2007, respectively. Residential mortgage loans held for sale recorded at fair value at December 31, 2009 totaled $1.8 million. The continuation of the level of revenue experienced in 2009 from mortgage banking will be dependent on market conditions and the trend in long-term interest rates.

Fees from general banking services were $38.8 million in 2008, up $3.5 million or 10.0% from 2007. A large portion of the income growth was attributable to electronic banking fees, up $1.1 million, or 24% over 2007's level and overdraft fees, up $1.5 million, or 8.6% over 2007's level.

As disclosed in Table 5, noninterest income from financial services (including revenues from benefit trust, administration, consulting and actuarial fees and wealth management services) rose $2.0 million, or 5.7%, in 2009 to $36.4 million. Financial services revenue now comprises 44% of total noninterest income, excluding net gains (losses) on the sale of investment securities and debt extinguishments. BPAS generated revenue growth of $2.0 million, or 7.7%, for the 2009 year, achieved primarily through the acquisition of ABG in July 2008, partially offset by a decrease in asset-based fees due to lower average financial market valuations in comparison to last year. BPAS offers their clients daily valuation, actuarial and employee benefit consulting services on a national basis from offices in Upstate New York, Texas, and Pennsylvania. BPAS revenue of $25.8 million in 2008 was $6.1 million higher than 2007's results, driven by the acquisition of ABG in July 2008 and HB&T in May 2007, new product offerings and expanded market coverage.

Wealth management services revenue remained consistent with the prior year at $8.6 million. CISI revenue increased $0.4 million from 2008, while revenue declined $0.2 million at both Nottingham and personal trust, primarily due to significant declines in equity market valuations in late 2008 and early 2009, as well as continued downward pressure on fee pricing due to competitive conditions. Revenue at CBNA Insurance remained consistent with the prior year. CBNA Insurance, acquired in June 2007 generated revenue growth of $0.6 million in 2008. Revenue in personal trust increased $0.1 million in 2008, while CISI and Nottingham revenue declined $0.2 million and $0.1 million, respectively primarily due to the adverse conditions prevalent throughout the financial markets.

Assets under management and administration increased $2.5 billion during 2009 from $3.7 billion at year-end 2008. Market-driven gains in equity-based assets were augmented by attraction of new client assets. BPA, in particular, was successful at growing its asset base, as demonstrated by the approximately $2.1 billion increase in its assets under administration during 2009. Assets under management and administration at the Company's financial services businesses declined during 2008 to $3.7 billion from $4.7 billion at the end of 2007 due to the significant declines in asset valuations experienced in the financial markets during 2008. This more than offset the new client assets attracted during the year.

In the fourth quarter of 2007, the Company incurred a $2.1 million charge related to the early redemption of its $25 million, variable-rate trust preferred obligations, which included a premium call provision at 6.15%. Additionally, the Company incurred a $7.8 million charge to refinance $150 million of Federal Home Loan Bank advances into similar duration, lower cost instruments.

Operating Expenses

As shown in Table 6, operating expenses increased $27.6 million, or 17%, in 2009 to $186.2 million, primarily due to the two acquisitions completed in 2008, as well as higher FDIC insurance premiums, a higher goodwill impairment charge related to one of the wealth management businesses, and higher employee compensation and benefit expenses, and volume-based processing costs. Operating expenses in 2008 increased $16.5 million or 11.6% from 2007 primarily due to the four acquisitions completed in 2008 and 2007, as well as a goodwill impairment charge on the wealth management businesses, and higher merit-based personnel expenses, FDIC insurance premiums, and volume-based processing costs. Operating expenses for 2009 as a percent of average assets were 3.50%, up 17 basis points from 3.33% in 2008. This ratio was negatively impacted by the non-recurring charges and the additional $6.9 million of FDIC expense in the current year.

The efficiency ratio, a performance measurement tool widely used by banks, is defined by the Company as operating expenses (excluding special charges/acquisition expenses, goodwill impairment and intangible amortization) divided by operating income (fully tax-equivalent net interest income plus noninterest income, excluding net securities and debt gains and losses). Lower ratios are often correlated to higher efficiency. The efficiency ratio for 2009 was 2.7 percentage points higher than the 62.7% ratio for 2008 due to a 16.6% increase in operating expenses having a greater impact than a 10.7% increase in net interest income and a 13.7% increase in noninterest income (excluding net securities gains and debt extinguishments costs). The significant increase in FDIC premiums with no corresponding income generation was the primary reason for the decline in the efficiency ratio for 2009. In 2008 the efficiency ratio improved 0.6 percentage points to 62.7% due to an 8.5% increase in net interest income and a 16% increase in noninterest income (excluding net securities gains and debt extinguishments costs) having a greater impact than a 9.7% increase in operating expenses. In addition, the efficiency ratios for both periods were adversely affected by the growing proportion of financial services activities, which due to the differing nature of their business, carry high efficiency ratios.

Table 6: Operating Expenses

	Years Ended December 31,		
(000's omitted)	2009	2008	2007
Salaries and employee benefits	$92,690	$82,962	$75,714
Occupancy and equipment	23,185	21,256	18,961
Customer processing and communications	20,684	16,831	15,691
Amortization of intangible assets	8,170	6,906	6,269
Legal and professional fees	5,240	4,565	4,987
Office supplies and postage	5,243	5,077	4,303
Business development and marketing	6,086	5,288	5,420
Foreclosed property	1,299	509	382
Goodwill impairment	3,079	1,745	0
FDIC insurance premiums	8,610	1,678	435
Special charges/acquisition expenses	1,716	1,399	382
Other	10,176	10,346	9,530
Total operating expenses	$186,178	$158,562	$142,074
Operating expenses/average assets	3.50%	3.33%	3.09%
Efficiency ratio	65.4%	62.7%	63.3%

Salaries and benefits increased $9.7 million or 11.7% in 2009, of which approximately 50% was the result of the two acquisitions in the last two years. Additionally, approximately $1.8 million of the increase can be attributed to annual merit increases, $0.9 million to higher medical costs, $3.3 million to retirement costs primarily related to the underlying asset performance in 2008, partially offset by a $0.9 million decrease in incentive compensation. Salaries and benefits increased $7.2 million or 9.6% in 2008 of which approximately 40% was the result of the four acquisitions in the prior two years. Additionally, approximately $2.3 million of the increase can be attributed to annual merit increase, $0.7 million to higher medical costs and the remaining growth to increased headcount, excluding acquisitions. Total full-time equivalent staff at the end of 2009 was 1,595, compared to 1,615 at December 31, 2008 and 1,453 at the end of 2007.

Medical expenses increased $1.3 million or 23% in 2009 primarily due to a greater number of covered employees as well as increases in the cost of medical care. Medical expenses increased $0.7 million in 2008, or 14%, due to a general rise in the cost of medical care, administration and insurance, as well as a greater number of covered employees. Additional vision and dental coverage was added in 2007 at an incremental cost of $0.2 million to bring the Company's benefit offerings more closely in line with peers. Qualified and nonqualified pension expense increased $3.3 million in 2009 primarily due to the underlying asset valuation decline in 2008 as a result of market conditions. Qualified and nonqualified pension expense decreased $1.7 million in 2008 primarily due to an increase in the discount rate utilized to calculate the pension expense as well as increased returns on assets contributed to the plan in 2007 and 2008. The three assumptions that have the largest impact on the calculation of annual pension expense are the discount rate utilized, the rate applied to future compensation increases and the expected rate of return on plan assets. See Note K to the financial statements for further information concerning the pension plan. The Company's contribution to the 401(k) Employee Stock Ownership Plan increased $0.7 million in 2008 primarily due to a half percentage point increase in the Company's matching contribution, as well as an increase in employee participation.

Total non-personnel operating expenses, excluding one-time special charges/acquisition expenses and goodwill impairment, increased $16.2 million or 22% in 2009. As displayed in Table 6, this was largely caused by higher FDIC insurance premiums (up $6.9 million), customer processing and communication expense (up $3.9 million), occupancy and equipment expense (up $1.9 million), amortization of intangible assets (up $1.3 million), business development and marketing (up $0.8 million), foreclosed property expenses (up $0.8 million), and legal and professional (up $0.7 million). During 2007 and the first half of 2008, FDIC premiums were met through the application of a credit balance created in prior years. This credit balance was depleted in the second quarter and resulted in higher FDIC premiums in the third and fourth quarters of 2008. Additionally, the FDIC's reserve fund has declined over the past year due to costs associated with recent bank failures and is expected to continue to decline in the future. In late 2008, the FDIC basic insurance coverage limit was temporarily increased to $250,000 through December 31, 2009 (on May 20, 2009 this was extended until December 31, 2013). These actions have resulted in significant increases in the FDIC assessment rates that are expected to remain at similar levels during 2010. The Company is also participating in the FDIC's Temporary Liquidity Guarantee Program ("TLGP") that provides unlimited coverage for transaction deposit accounts and for which a supplemental 10-basis point premium is assessed. In the second quarter of 2009, the FDIC assessed an emergency special assessment equal to five basis points on a bank's assets less Tier 1 capital. This amounted to $2.5 million of additional premiums recognized in June 2009. Several expense category increases continue to be impacted by the Company's investment in strategic technology and business development initiatives to grow and enhance its service offerings. A portion of the increase in data processing and communications costs reflects the Company's continued investments in strategic technology initiatives and enhancement of its service offerings. A majority of the remaining increase in non-personnel operating costs is attributable to $3.8 million of expenses added as a result of the two acquisitions in 2008.

The Company continually evaluates all aspects of its operating expense structure and is diligent about identifying opportunities to improve operating efficiencies. Over the last two years, the Company has consolidated several of its branch offices. This realignment will reduce market overlap and further strengthen its branch network, and reflects management's focus on achieving long-term performance improvements through proactive strategic decision making.

Total non-personnel operating expense, excluding one-time acquisition expenses and goodwill impairment, increased $6.5 million or 9.8% in 2008. As displayed in Table 6, this was largely caused by higher occupancy and equipment expense (up $2.3 million),
FDIC insurance premiums (up $1.2 million), customer processing and communication expense (up $1.1 million), office supplies and postage (up $0.8 million), other expenses (up $0.8 million), and amortization of intangible assets (up $0.6 million).

Special charges/acquisition expense totaled $1.7 million in 2009, an increase of $0.3 million from 2008, and were comprised of a $1.4 million charge related to the planned early termination of its core banking system services contract in 2010 as well as $0.3 million of acquisition expenses related to the Citizens transaction in late 2008. Special charges/acquisition expenses totaled $1.4 million in 2008 and $0.4 million in 2007 and in both years all of it relates solely to acquisitions. In 2009 and 2008 the Company recorded a $3.1 million and $1.7 million, respectively, non-cash goodwill impairment charge in its wealth management businesses, a result of equity market valuation declines, changes in customer asset mixes and pricing compression related to the competitive environment.

Income Taxes

The Company estimates its income tax expense based on the amount it expects to owe the respective tax authorities, plus the impact of deferred tax items. Taxes are discussed in more detail in Note I of the Consolidated Financial Statements beginning on page 63. Accrued taxes represent the net estimated amount due or to be received from taxing authorities. In estimating accrued taxes, management assesses the relative merits and risks of the appropriate tax treatment of transactions taking into account statutory, judicial and regulatory guidance in the context of the

Company's tax position. If the final resolution of taxes payable differs from its estimates due to regulatory determination or legislative or judicial actions, adjustments to tax expense may be required.

The effective tax rate for 2009 increased 2.9 percentage points to 21.9%, reflecting the current mix of non-taxable and fully taxable investment securities and the impact of a $3.1 million goodwill impairment charge. The effective tax rate for 2008 increased 13.9 percentage points to 19.0%. There were two notable items during 2008, which impacted the effective tax rate for the year. Upon settlement of open tax years with certain taxing authorities, the Company recorded $1.7 million of previously unrecognized tax benefits, as compared to a $6.9 million benefit recognized in 2007. Additionally, the Company recorded a non-cash goodwill impairment charge related to its wealth management businesses, reducing pre-tax net income. The effective tax rate for 2007 of 5.1% was the result of the aforementioned $6.9 million benefit related to the settlement and a related change in a position taken on certain previously unrecognized tax positions and a higher proportion of tax exempt income, due in part to the higher debt restructuring charges in 2007.

Capital

Shareholders’ equity ended 2009 at $565.7 million, up $21.0 million, or 3.9%, from one year earlier. This increase reflects net income of $41.4 million, $2.0 million from the issuance of shares through employee stock plans, $2.3 million from stock based compensation and a $4.1 million increase in other comprehensive income. These increases were partially offset by common stock dividends declared of $28.8 million. The change in other comprehensive income is comprised of a $7.7 million benefit based on the funded status of the Company’s employee retirement plans, a $1.0 million increase in the fair value of interest rate swaps designated as a cash flow hedges and a $4.6 million decrease in the market value adjustment (“MVA”, represents the after-tax, unrealized change in value of available-for-sale securities in the Company’s investment portfolio). The benefit from the funded status of the Company’s employee retirement plans is primarily the result of terminating the Company’s post-retirement medical program for current and future employees. Remaining plan participants will include only existing retirees, or those active and eligible employees who retire prior to December 31, 2010. This change was accounted for as a negative plan amendment and was recognized in accumulated other comprehensive income in the fourth quarter of 2009. Excluding accumulated other comprehensive income in both 2009 and 2008, capital rose by $17.0 million, or 3.0%. Shares outstanding increased by 167,000 during the year added through employee stock plans.

Shareholders’ equity ended 2008 at $544.7 million, up $65.9 million, or 13.8%, from one year earlier. This increase reflects net income of $45.9 million, $8.3 million from the issuance of shares through employee stock plans, $2.0 million from stock based compensation and $49.5 million from a public common stock offering. These increases were partially offset by common stock dividends declared of $26.3 million and a $13.6 million decrease in other comprehensive income. The other comprehensive income is comprised of a $2.4 million increase in the market value adjustment (“MVA”, represents the after-tax, unrealized change in value of available-for-sale securities in the Company’s investment portfolio), a $13.2 million charge based on the funded status of the Company’s employee retirement plans, and a $2.8 million decrease in the fair value of interest rate swaps designated as a cash flow hedges. Excluding accumulated other comprehensive income in both 2008 and 2007, capital rose by $79.4 million, or 17%. Shares outstanding increased by 2,999,000 during 2008, comprised of 2,530,000 added through the common stock offering in the fourth quarter and 469,000 added through employee stock plans.

The Company’s ratio of Tier 1 capital to assets (or tier 1 leverage ratio), the basic measure for which regulators have established a 5% minimum for an institution to be considered “well-capitalized,” increased 17 basis points at year-end 2009 to 7.39%. This was primarily the result of a 9.0% increase in Tier 1 capital primarily from net income generation and reduction of intangible asset levels, offset by a smaller 6.5% increase in fourth quarter average net assets (excludes investment market value adjustment, intangible assets and related deferred tax assets and disallowed mortgage service rights) due mostly to the acquisition of the Citizens branches and organic deposit growth. The tangible equity/tangible assets ratio was 5.20% at the end of 2009 versus 4.74% one year earlier. The increase was due to the increase in common shareholders equity and reduction of intangible assets having a proportionally greater impact on tangible equity than the growth in tangible assets. The Company manages organic and acquired growth in a manner that enables it to continue to build upon its strong capital base, and maintain the Company’s ability to take advantage of future strategic growth opportunities.

Cash dividends declared on common stock in 2009 of $28.8 million represented an increase of 9.6% over the prior year. This growth was mostly a result of the 2.5 million shares issued in the common equity offering completed in the fourth quarter of 2008, as well as dividends per share of $0.88 for 2009 increasing from $0.86 in 2008, a result of quarterly dividends per share being raised from $0.21 to $0.22 (+4.8%) in the third quarter of 2008. The dividend payout ratio for this year was 69.5% compared to 57.3% in 2008, and 57.1% in 2007. In 2009 dividends paid increased 9.6% while net income decreased 9.8%. In 2008 the increase in dividends paid was slightly larger than the 7.1% increase in net income.

Liquidity

Liquidity risk is measured by the Company’s ability to raise cash when needed at a reasonable cost and minimize any loss. The Company must be capable of meeting all obligations to its customers at any time and, therefore, the active management of its liquidity position is critical. Given the uncertain nature of our customers' demands as well as the Company's desire to take advantage of earnings enhancement opportunities, the Company must have available adequate sources of on and off-balance sheet funds that can be acquired in time of need. Accordingly, in addition to the liquidity provided by balance sheet cash flows, liquidity must be supplemented with additional sources such as credit lines from correspondent banks, the Federal Home Loan Bank and the Federal Reserve Bank. Other funding alternatives may also be appropriate from time to time, including wholesale and retail repurchase agreements, large certificates of deposit and brokered CD relationships.

The Company's primary approach to measuring liquidity is known as the Basic Surplus/Deficit model. It is used to calculate liquidity over two time periods: first, the amount of cash that could be made available within 30 days (calculated as liquid assets less short-term liabilities as a percentage of total assets); and second, a projection of subsequent cash availability over an additional 60 days. As of December 31, 2009, this ratio was 16.5% and 16.4% for the respective time periods, excluding the Company's capacity to borrow additional funds from the Federal Home Loan Bank and other sources, as compared to the internal policy that requires a minimum of 7.5%. At December 31, 2009 there is $287 million in additional Federal Home Loan Bank borrowing capacity based on the Company's year-end collateral levels. Additionally, the Company has $16 million in unused capacity at the Federal Reserve Bank and $100 million in unused capacity from unsecured lines of credit with other correspondent banks.

In addition to the 30 and 90-day basic surplus/deficit model, longer-term liquidity over a minimum of five years is measured and a liquidity analysis projecting sources and uses of funds is prepared. To measure longer-term liquidity, a baseline projection of loan and deposit growth for five years is made to reflect how liquidity levels could change over time. This five-year measure reflects ample liquidity for loan and other asset growth over the next five years.

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

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

Intangible Assets

The changes in intangible assets by reporting segment for the year ended December 31, 2009 are summarized as follows:

Table 7: Intangible Assets

(000's omitted)	Balance at December 31, 2008	Additions/ Reclass	Amortization	Impairment	Balance at December 31, 2009
Banking Segment					
Goodwill	$287,964	($552)	$0	$0	$287,412
Other intangibles	152	0	107	0	45