

COMMUNITY BANK SYSTEM, INC.

Form 10-Q

November 07, 2014

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

FORM 10-Q

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

For the quarterly period ended September 30, 2014

OR

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

For the transition period from
to

Commission File Number: 001-13695

(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction of
incorporation or organization)

16-1213679
(I.R.S. Employer Identification No.)

5790 Widewaters Parkway, DeWitt,
New York
(Address of principal executive offices)

13214-1883
(Zip Code)

(315) 445-2282

(Registrant's telephone number, including area code)

NONE

(Former name, former address and former fiscal year, if changed since last report)

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

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

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

Edgar Filing: COMMUNITY BANK SYSTEM, INC. - Form 10-Q

Large accelerated filer ☒ Accelerated filer ☐ Non-accelerated filer ☐ Smaller reporting company ☐
(Do not check if a smaller reporting company)

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

40,598,363 shares of Common Stock, \$1.00 par value, were outstanding on October 31, 2014.

TABLE OF CONTENTS

Part Financial Information

I.

Item Financial Statements (Unaudited)

1.

Consolidated Statements of Condition
September 30, 2014 and December 31,
2013

Consolidated Statements of Income
Three and nine months ended September 30, 2014 and
2013

Consolidated Statements of Comprehensive Income/(Loss)
Three and nine months ended September 30, 2014 and
2013

Consolidated Statement of Changes in Shareholders' Equity
Nine months ended September 30,
2014

Consolidated Statements of Cash Flows
Nine months ended September 30, 2014 and
2013

Notes to the Consolidated Financial Statements
September 30,
2014

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

2.

Item Quantitative and Qualitative Disclosures about Market Risk

3.

Item Controls and

4. Procedures

Part Other Information

II.

Item Legal

1. Proceedings

ItemRisk

1A. Factors

ItemUnregistered Sales of Equity Securities and Use of Proceeds

2.

ItemDefaults Upon Senior

3. Securities

ItemMine Safety

4. Disclosures

ItemOther

5. Information

ItemExhibits

6.

2

Part I. Financial Information

Item 1. Financial Statements

COMMUNITY BANK SYSTEM, INC.

CONSOLIDATED STATEMENTS OF CONDITION (Unaudited)

(In Thousands, Except Share Data)

	September 30, 2014	December 31, 2013
Assets:		
Cash and cash equivalents	\$157,500	\$149,647
Available-for-sale investment securities (cost of \$2,421,718 and \$2,217,165, respectively)	2,465,931	2,186,163
Other securities, at cost	40,311	32,562
Loans held for sale, at fair value	726	728
Loans	4,217,244	4,109,083
Allowance for loan losses	(45,273)	(44,319)
Net loans	4,171,971	4,064,764
Goodwill, net	375,174	374,991
Core deposit intangibles, net	10,816	13,460
Other intangibles, net	1,976	2,048
Intangible assets, net	387,966	390,499
Premises and equipment, net	91,762	93,636
Accrued interest and fees receivable	27,564	25,475
Other assets	158,912	152,390
Total assets	\$7,502,643	\$7,095,864
Liabilities:		
Noninterest-bearing deposits	\$1,279,052	\$1,203,346
Interest-bearing deposits	4,688,279	4,692,698
Total deposits	5,967,331	5,896,044
Borrowings	343,805	141,913
Subordinated debt held by unconsolidated subsidiary trusts	102,115	102,097
Accrued interest and other liabilities	123,868	79,998
Total liabilities	6,537,119	6,220,052
Commitments and contingencies (See Note J)		
Shareholders' equity:		

Edgar Filing: COMMUNITY BANK SYSTEM, INC. - Form 10-Q

Preferred stock, \$1.00 par value, 500,000 shares authorized, 0 shares issued	0	0
Common stock, \$1.00 par value, 75,000,000 shares authorized; 41,483,376 and 41,213,491 shares issued, respectively	41,483	41,213
Additional paid-in capital	405,313	396,528
Retained earnings	515,040	481,732
Accumulated other comprehensive income/(loss)	20,670	(26,546)
Treasury stock, at cost (776,091 and 782,173 shares, respectively)	(16,982)	(17,115)
Total shareholders' equity	965,524	875,812
Total liabilities and shareholders' equity	\$7,502,643	\$7,095,864

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

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

	Three Months Ended September 30, 2014		Nine Months Ended September 30, 2014	
	2014	2013	2014	2013
Interest income:				
Interest and fees on loans	\$46,883	\$47,606	\$138,649	\$141,136
Interest and dividends on taxable investments	12,239	13,394	37,481	41,176
Interest and dividends on nontaxable investments	5,165	5,132	15,505	15,885
Total interest income	64,287	66,132	191,635	198,197
Interest expense:				
Interest on deposits	1,962	2,530	6,265	8,375
Interest on borrowings	308	2,368	846	10,473
Interest on subordinated debt held by unconsolidated subsidiary trusts	623	633	1,852	1,891
Total interest expense	2,893	5,531	8,963	20,739
Net interest income	61,394	60,601	182,672	177,458
Provision for loan losses	1,747	2,093	4,647	4,807
Net interest income after provision for loan losses	59,647	58,508	178,025	172,651
Noninterest income:				
Deposit service fees	13,833	12,703	39,260	36,643
Other banking services	1,867	1,671	4,665	3,729
Employee benefit services	10,755	9,397	31,638	28,564
Wealth management services	4,617	3,823	13,529	11,566
Gain on sales of investment securities	0	0	0	63,799
Loss on debt extinguishments	0	0	0	(63,500)
Total noninterest income	31,072	27,594	89,092	80,801
Noninterest expenses:				
Salaries and employee benefits	30,941	30,448	92,090	91,217
Occupancy and equipment	6,617	6,448	21,224	20,263
Data processing and communications	7,475	6,998	21,529	20,334
Amortization of intangible assets	1,051	1,089	3,293	3,408
Legal and professional fees	1,973	1,897	5,427	5,363
Office supplies and postage	1,466	1,566	4,664	4,579

Edgar Filing: COMMUNITY BANK SYSTEM, INC. - Form 10-Q

Business development and marketing	1,764	1,973	5,424	5,256
FDIC insurance premiums	952	923	2,918	2,923
Acquisition expenses and litigation settlement	2,800	71	2,923	76
Other	3,772	3,631	10,404	10,553
Total noninterest expenses	58,811	55,044	169,896	163,972
Income before income taxes	31,908	31,058	97,221	89,480
Income taxes	9,537	9,069	29,001	26,128
Net income	\$22,371	\$21,989	\$68,220	\$63,352
Basic earnings per share	\$0.55	\$0.55	\$1.67	\$1.58
Diluted earnings per share	\$0.54	\$0.54	\$1.65	\$1.56
Cash dividends declared per share	\$0.30	\$0.28	\$0.86	\$0.82

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

COMMUNITY BANK SYSTEM, INC.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME/(LOSS) (Unaudited)

(In Thousands)

	Three Months Ended September 30, 2014		Nine Months Ended September 30, 2014	
	2013		2014	2013
Pension and other post retirement obligations:				
Amortization of actuarial (gains)/losses included in net periodic pension cost, gross	(\$79)	\$1,011	(\$235)	\$3,032
Tax effect	31	(392)	92	(1,176)
Amortization of actuarial (gains)/losses included in net periodic pension cost, net	(48)	619	(143)	1,856
Amortization of prior service cost included in net periodic pension cost, gross	(43)	(30)	(130)	(91)
Tax effect	17	11	51	35
Amortization of prior service cost included in net periodic pension cost, net	(26)	(19)	(79)	(56)
Other comprehensive income related to pension and other post retirement obligations, net of taxes	(74)	600	(222)	1,800
Unrealized gains/(losses) on available-for-sale securities:				
Net unrealized holding gain/(loss) arising during period, gross	(1,808)	(1,852)	75,214	(71,501)
Tax effect	710	567	(27,776)	26,746
Net unrealized holding gain/(loss) arising during period, net	(1,098)	(1,285)	47,438	(44,755)
Reclassification adjustment for net gains included in net income, gross	0	0	0	(63,799)
Tax effect	0	0	0	24,019
Reclassification adjustment for net gains included in net income, net	0	0	0	(39,780)
Other comprehensive gain/(loss) related to unrealized gain/(loss) on available-for-sale securities, net of taxes	(1,098)	(1,285)	47,438	(84,535)
Other comprehensive income/(loss), net of tax	(1,172)	(685)	47,216	(82,735)
Net income	22,371	21,989	68,220	63,352
Comprehensive income/(loss)	\$21,199	\$21,304	\$115,436	(\$19,383)
As of				
	September 30, 2014	December 31, 2013		
Accumulated Other Comprehensive Income By Component:				

Unrealized loss for pension and other postretirement obligations	(\$11,704)	(\$11,339)
Tax effect	4,336	4,194
Net unrealized loss for pension and other postretirement obligations	(7,368)	(7,145)
Unrealized gain/(loss) on available-for-sale securities	44,214	(31,002)
Tax effect	(16,176)	11,601
Net unrealized gain/(loss) on available-for-sale securities	28,038	(19,401)
Accumulated other comprehensive income /(loss)	\$20,670	(\$26,546)

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

COMMUNITY BANK SYSTEM, INC.

CONSOLIDATED STATEMENT OF CHANGES IN SHAREHOLDERS' EQUITY (Unaudited)

Nine months ended September 30, 2014

(In Thousands, Except Share Data)

	Common Stock Shares Outstanding	Amount Issued	Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income/(Loss)	Treasury Stock	Total
Balance at December 31, 2013	40,431,318	\$41,213	\$396,528	\$481,732	(\$26,546)	(\$17,115)	\$875,812
Net income				68,220			68,220
Other comprehensive income, net of tax					47,216		47,216
Cash dividends declared: Common, \$0.86 per share				(34,912)			(34,912)
Common stock issued under employee stock plan, including tax benefits of \$1,476	275,967	270	5,712			133	6,115
Stock-based compensation			3,073				3,073
Balance at September 30, 2014	40,707,285	\$41,483	\$405,313	\$515,040	\$20,670	(\$16,982)	\$965,524

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

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

	Nine Months Ended September 30, 2014 2013	
Operating activities:		
Net income	\$68,220	\$63,352
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	9,801	9,058
Amortization of intangible assets	3,293	3,408
Net accretion of premiums and discounts on securities and borrowings	(5,643)	(4,081)
Stock-based compensation	3,073	3,014
Provision for loan losses	4,647	4,807
Amortization of mortgage servicing rights	337	409
Income from bank-owned life insurance policies	(760)	(775)
Gain on sales of investment securities	0	(63,799)
Loss on debt extinguishments	0	63,500
Net (gain)/loss from sale of loans and other assets	(344)	248
Net change in loans held for sale	258	(913)
Change in other assets and liabilities	5,448	(6,297)
Net cash provided by operating activities	88,330	71,931
Investing activities:		
Proceeds from sales of available-for-sale investment securities	0	711,540
Proceeds from maturities of available-for-sale investment securities	101,228	158,849
Proceeds from maturities of held-to-maturity investment securities	0	27,074
Proceeds from maturities of other investment securities	12	0
Proceeds from sale of other investment securities	0	7,229
Purchases of available-for-sale investment securities	(300,120)	(666,841)
Purchases of held-to-maturity investment securities	0	(5,298)
Purchases of other securities	(7,761)	(2)
Net increase in loans	(111,854)	(163,491)
Cash paid for acquisition, net of cash acquired of \$0 and \$0, respectively	(924)	0
Purchases of premises and equipment, net	(7,839)	(11,226)
Net cash (used in)/provided by investing activities	(327,258)	57,834
Financing activities:		

Edgar Filing: COMMUNITY BANK SYSTEM, INC. - Form 10-Q

Net increase in deposits	71,287	59,294
Net change in borrowings, net of payments of \$8 and \$565,145	201,892	(224,445)
Issuance of common stock	6,115	12,072
Cash dividends paid	(33,989)	(32,222)
Tax benefits from share-based payment arrangements	1,476	1,183
Net cash provided by/(used in) financing activities	246,781	(184,118)
Change in cash and cash equivalents	7,853	(54,353)
Cash and cash equivalents at beginning of period	149,647	228,558
Cash and cash equivalents at end of period	\$157,500	\$174,205
Supplemental disclosures of cash flow information:		
Cash paid for interest	\$9,079	\$23,935
Cash paid for income taxes	19,527	19,328
Supplemental disclosures of noncash financing and investing activities:		
Dividends declared and unpaid	12,255	11,279
Transfers from loans to other real estate	2,111	5,024

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

COMMUNITY BANK SYSTEM, INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

SEPTEMBER 30, 2014

NOTE A: BASIS OF PRESENTATION

The interim financial data as of and for the three and nine months ended September 30, 2014 is unaudited; however, in the opinion of Community Bank System, Inc. (the “Company”), the interim data includes all adjustments, consisting only of normal recurring adjustments, necessary for a fair statement of the results for the interim periods in conformity with generally accepted accounting principles (“GAAP”). The results of operations for the interim periods are not necessarily indicative of the results that may be expected for the full year or any other interim period.

NOTE B: ACQUISITIONS

On January 1, 2014, the Company, through its subsidiary, Harbridge Consulting Group, LLC (“Harbridge”), completed its acquisition of a professional services practice from EBS-RMSCO, Inc., a subsidiary of The Lifetime Healthcare Companies (“EBS-RMSCO”). This professional services practice, which provides actuarial valuation and consulting services to clients who sponsor pension and post-retirement medical and welfare plans, enhances the Company’s participation in the Western New York market. The effects of the acquired assets and liabilities have been included in the consolidated financial statements since that date.

On December 13, 2013, Community Bank, N.A. (the “Bank” or “CBNA”) completed its acquisition of eight branches in Northern Pennsylvania from Bank of America, N.A. (“B of A”), acquiring approximately \$303 million of deposits and \$1 million of loans. The assumed deposits consist primarily of core deposits (checking, savings and money market accounts) and the purchased loans consist of in-market performing commercial loans. Under the terms of the purchase agreement, the Bank paid a blended deposit premium of 2.4%, or approximately \$7.3 million. The effects of the acquired assets and liabilities have been included in the consolidated financial statements since that date.

The assets and liabilities assumed in the acquisitions were recorded at their estimated fair values based on management's best estimates using information available at the dates of the acquisition, and are subject to adjustment based on updated information not available at the time of acquisition. The following table summarizes the estimated fair value of the assets acquired and liabilities assumed during 2013 and the first nine months of 2014:

(000's omitted)	2014	2013
Consideration paid/(received):		
Cash/Total net consideration paid/(received)	\$924	(\$291,980)
Recognized amounts of identifiable assets acquired and liabilities assumed:		
Loans	0	1,106
Premises and equipment	0	2,549
	0	5

Accrued interest receivable		
Other assets and liabilities, net	163	(18)
Other intangibles	578	9
Core deposit intangibles	0	2,537
Deposits	0	(303,456)
Total identifiable assets/(liabilities), net	741	(297,268)
Goodwill	\$183	\$5,288

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

The core deposit intangible and other intangibles related to the B of A and EBS-RMSCO acquisitions are being amortized using an accelerated method over their estimated useful lives of eight years. The goodwill, which is not amortized for book purposes, was assigned to the Banking segment for the B of A acquisition and the Employee Benefit Services segment for the EBS-RMSCO acquisition. The goodwill arising from the B of A branch and the EBS-RMSCO acquisitions is deductible for tax purposes.

Direct costs related to the acquisitions were expensed as incurred. Merger and acquisition integration-related expenses amount to \$0.1 million in the nine months ended September 30, 2014 and have been separately stated in the Consolidated Statements of Income. There were no merger and acquisition integration-related expenses for the three months ended September 30, 2014.

Supplemental pro forma financial information related to the B of A and EBS-RMSCO acquisitions has not been provided as it would be impracticable to do so. Historical financial information regarding the acquired branches is not accessible and, thus, the amounts would require estimates so significant as to render the disclosure irrelevant.

NOTE C: ACCOUNTING POLICIES

The accounting policies of the Company, as applied in the consolidated interim financial statements presented herein, are substantially the same as those followed on an annual basis as presented on pages 56 through 61 of the Annual Report on Form 10-K for the year ended December 31, 2013 filed with the Securities and Exchange Commission ("SEC") on March 3, 2014.

Critical Accounting Policies

Acquired loans

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

Acquired impaired loans

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

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

Acquired non-impaired loans

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

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

accreted into interest income. When the carrying value exceeds the net realizable value, an allowance for loan losses is recognized.

Allowance for Loan Losses

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

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

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

Investment Securities

The Company has classified its investments in debt and equity securities as held-to-maturity or available-for-sale. Held-to-maturity securities are those for which the Company has the positive intent and ability to hold until maturity, and are reported at cost, which is adjusted for amortization of premiums and accretion of discounts. During December 2013, the Company reclassified its held-to-maturity portfolio to available-for-sale and the Company will not be able to use the held-to-maturity classification for the foreseeable future. Securities classified as available-for-sale are reported at fair value with net unrealized gains and losses reflected as a separate component of shareholders' equity, net of applicable income taxes. None of the Company's investment securities have been classified as trading securities at September 30, 2014. Certain equity securities are stated at cost and include restricted stock of the Federal Reserve Bank of New York ("Federal Reserve") and Federal Home Loan Bank of New York ("FHLB").

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

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

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

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

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

Intangible Assets

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

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

Retirement Benefits

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

New Accounting Pronouncements

In January 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2014-04, Receivables – Troubled Debt Restructurings by Creditors (Subtopic 310-40): Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure. This new guidance clarifies when an "in substance" repossession or foreclosure occurs, and requires all creditors who obtain physical possession (resulting from an in substance repossession or foreclosure) of residential real estate property collateralizing a consumer mortgage loan in satisfaction of a receivable to reclassify the collateralized mortgage loan such that the loan should be derecognized and the collateral asset recognized. This guidance is effective prospectively for the Company for annual and interim periods beginning after December 15, 2014. The adoption of this guidance is not expected to have a material impact on the Company's consolidated financial statements.

In May 2014, the FASB issued ASU No. 2014-09, Revenue from Contracts with Customers (Topic 606). This new guidance supersedes the revenue recognition requirements in ASC 605, Revenue Recognition, and is based on the principle that revenue is recognized to depict the transfer of goods or services to customers in an amount that reflects consideration to which the entity expects to be entitled in exchange for those goods and services. The ASU also requires additional disclosure about the nature, amount, timing and uncertainty of revenue and cash flows arising from customer contracts, including significant judgments and changes in judgments and assets recognized from costs incurred to obtain or fulfill a contract. This guidance is effective prospectively for the Company for annual and interim periods beginning after December 15, 2016. The Company is currently evaluating the effect the guidance will have on the Company's consolidated financial statements.

NOTE D: INVESTMENT SECURITIES

The amortized cost and estimated fair value of investment securities as of September 30, 2014 and December 31, 2013 are as follows:

Edgar Filing: COMMUNITY BANK SYSTEM, INC. - Form 10-Q

(000's omitted)	September 30, 2014				December 31, 2013			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available-for-Sale Portfolio:								
U.S. Treasury and agency securities	\$1,476,678	\$17,210	\$7,261	\$1,486,627	\$1,252,332	\$1,119	\$41,304	\$1,212,147
Obligations of state and political subdivisions	662,742	26,621	1,029	688,334	665,441	15,919	12,378	668,982
Government agency mortgage-backed securities	236,819	9,088	1,785	244,122	250,431	8,660	4,113	254,978
Corporate debt securities	26,835	539	87	27,287	26,932	873	218	27,587
Government agency collateralized mortgage obligations	18,394	736	0	19,130	21,779	362	93	22,048
Marketable equity securities	250	181	0	431	250	171	0	421
Total available-for-sale portfolio	\$2,421,718	\$54,375	\$10,162	\$2,465,931	\$2,217,165	\$27,104	\$58,106	\$2,186,163
Other Securities:								
Federal Home Loan Bank common stock	\$19,814			\$19,814	\$12,053			\$12,053
Federal Reserve Bank common stock	16,050			16,050	16,050			16,050
Other equity securities	4,447			4,447	4,459			4,459
Total other securities	\$40,311			\$40,311	\$32,562			\$32,562

Edgar Filing: COMMUNITY BANK SYSTEM, INC. - Form 10-Q

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

As of September 30, 2014

(000's omitted)	Less than 12 Months			12 Months or Longer			Total		
	#	Fair Value	Gross Unrealized Losses	#	Fair Value	Gross Unrealized Losses	#	Fair Value	Gross Unrealized Losses
Available-for-Sale Portfolio:									
U.S. Treasury and agency obligations	7	\$158,289	\$859	10	\$230,998	\$6,402	17	\$389,287	\$7,261
Obligations of state and political subdivisions	31	16,009	78	78	49,434	951	109	65,443	1,029
Government agency mortgage-backed securities	8	12,807	47	24	48,830	1,738	32	61,637	1,785
Corporate debt securities	0	0	0	1	2,756	87	1	2,756	87
Government agency collateralized mortgage obligations	1	0	0	1	5	0	2	5	0
Total available-for-sale/investment portfolio	47	\$187,105	\$984	114	\$332,023	\$9,178	161	\$519,128	\$10,162

As of December 31, 2013

(000's omitted)	Less than 12 Months			12 Months or Longer			Total		
	#	Fair Value	Gross Unrealized Losses	#	Fair Value	Gross Unrealized Losses	#	Fair Value	Gross Unrealized Losses
Available-for-Sale Portfolio:									
U.S. Treasury and agency obligations	43	\$1,181,214	\$41,304	0	\$0	\$0	43	\$1,181,214	\$41,304
Obligations of state and political subdivisions	302	195,526	11,774	9	4,974	604	311	200,500	12,378
Government agency mortgage-backed securities	43	68,917	3,262	6	8,713	851	49	77,630	4,113
Corporate debt securities	1	3,026	31	1	2,703	187	2	5,729	218
Government agency collateralized mortgage obligations	1	2,601	93	1	7	0	2	2,608	93
Total available-for-sale/investment portfolio	390	\$1,451,284	\$56,464	17	\$16,397	\$1,642	407	\$1,467,681	\$58,106

The unrealized losses reported pertaining to securities issued by the U.S. government and its sponsored entities, include treasuries, agencies, and mortgage-backed securities issued by GNMA, FNMA and FHLMC which are

currently rated AAA by Moody's Investor Services, AA+ by Standard & Poor's and are guaranteed by the U.S. government. The majority of the obligations of state and political subdivisions and corporations carry a credit rating of A or better. Additionally, a majority of the obligations of state and political subdivisions carry a secondary level of credit enhancement. The Company does not intend to sell these securities, nor is it more likely than not that the Company will be required to sell these securities prior to recovery of the amortized cost. The unrealized losses in the portfolios are primarily attributable to changes in interest rates. As such, management does not believe any individual unrealized loss as of September 30, 2014 represents OTTI.

The amortized cost and estimated fair value of debt securities at September 30, 2014, by contractual maturity, are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties. Securities not due at a single maturity date are shown separately.

(000's omitted)	Available-for-Sale	
	Amortized Cost	Fair Value
Due in one year or less	\$49,520	\$50,144
Due after one through five years	156,732	161,940
Due after five years through ten years	1,691,095	1,710,084
Due after ten years	268,908	280,080
Subtotal	2,166,255	2,202,248
Government agency mortgage-backed securities	236,819	244,122
Government agency collateralized mortgage obligations	18,394	19,130
Total	\$2,421,468	\$2,465,500

NOTE E: LOANS

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

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

The balances of these classes are summarized as follows:

	September 30, 2014	December 31, 2013
(000's omitted)		
Consumer mortgage	\$1,598,298	\$1,582,058
Business lending	1,251,178	1,260,364
Consumer indirect	841,975	740,002
Consumer direct	186,672	180,139
Home equity	339,121	346,520
Gross loans, including deferred origination costs	4,217,244	4,109,083
Allowance for loan losses	(45,273)	(44,319)
Loans, net of allowance for loan losses	\$4,171,971	\$4,064,764

The outstanding balance related to credit impaired acquired loans was \$7.0 million and \$13.1 million at September 30, 2014 and December 31, 2013, respectively. The changes in the accretable discount related to the credit impaired acquired loans are as follows:

(000's omitted)	
Balance at December 31, 2013	\$997
Accretion recognized, year-to-date	(567)
Net reclassification to accretable from	355

nonaccretable
 Balance at
 September 30,
 2014 \$785

Credit Quality

Management monitors the credit quality of its loan portfolio on an ongoing basis. Measurement of delinquency and past due status are based on the contractual terms of each loan. Past due loans are reviewed on a monthly basis to identify loans for non-accrual status. The following is an aged analysis of the Company's past due loans, by class as of September 30, 2014:

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

(000's omitted)	Past 90+ Days		Total Past Due	Total Current	Total Loans
	Due 30 – 89 Days	Past Due and Still Accruing Nonaccrual			
Consumer mortgage	\$12,044	\$2,074	\$12,228	\$26,346	\$1,499,800
Business lending	3,567	66	3,005	6,638	1,101,014
Consumer indirect	9,483	115	11	9,609	830,786
Consumer direct	1,201	20	2	1,223	179,165
Home equity	2,349	269	2,067	4,685	272,045
Total	\$28,644	\$2,544	\$17,313	\$48,501	\$3,882,810

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

(000's omitted)	Past Due 30 – 89 Days		90+ Days Past Due and Still Nonaccrual		Total Acquired		Total Loans
	Days	Accruing	Nonaccrual	Past Due	Impaired(1)	Current	
Consumer mortgage	\$2,303	\$53	\$2,033	\$4,389	\$0	\$67,763	\$72,152
Business lending	134	0	1,421	1,555	5,487	136,484	143,526
Consumer indirect	64	0	0	64	0	1,516	1,580
Consumer direct	148	18	0	166	0	6,118	6,284
Home equity	483	75	556	1,114	0	61,277	62,391
Total	\$3,132	\$146	\$4,010	\$7,288	\$5,487	\$273,158	\$285,933

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

The following is an aged analysis of the Company's past due loans by class as of December 31, 2013:

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

(000's omitted)	Past Due 30 – 89 Days	90+ Days Past Due and Still Accruing	Nonaccrual	Total		
	Days			Past Due	Current	Total Loans
Consumer mortgage	\$16,589	\$1,253	\$11,097	\$28,939	\$1,473,320	\$1,502,259
Business lending	2,960	164	3,083	6,207	1,079,818	1,086,025
Consumer indirect	11,647	738	14	12,399	723,878	736,277
Consumer direct	1,858	90	4	1,952	169,452	171,404
Home equity	2,635	173	1,867	4,675	271,235	275,910
Total	\$35,689	\$2,418	\$16,065	\$54,172	\$3,717,703	\$3,771,875

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

Edgar Filing: COMMUNITY BANK SYSTEM, INC. - Form 10-Q

(000's omitted)	Past 90+ Days Due Past 30 – 89		Due and Still Nonaccrual	Total Past Due	Acquired Impaired(1)	Current	Total Loans
	Days	Accruing					
Consumer mortgage	\$1,857	\$85	\$1,463	\$3,405	\$0	\$76,394	\$79,799
Business lending	531	0	1,472	2,003	7,090	165,246	174,339
Consumer indirect	157	17	0	174	0	3,551	3,725
Consumer direct	385	27	0	412	0	8,323	8,735
Home equity	592	8	473	1,073	0	69,537	70,610
Total	\$3,522	\$137	\$3,408	\$7,067	\$7,090	\$323,051	\$337,208

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

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

Pass	The condition of the borrower and the performance of the loans are satisfactory or better.
Special Mention	The condition of the borrower has deteriorated although the loan performs as agreed.
Classified	The condition of the borrower has significantly deteriorated and the performance of the loan could further deteriorate, if deficiencies are not corrected.
Doubtful	The condition of the borrower has deteriorated to the point that collection of the balance is improbable based on current facts and conditions.

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

	September 30, 2014			December 31, 2013		
(000's omitted)	Legacy	Acquired	Total	Legacy	Acquired	Total
Pass	\$927,154	\$95,640	\$1,022,794	\$908,885	\$116,271	\$1,025,156
Special mention	104,353	20,567	124,920	93,600	24,264	117,864
Classified	76,145	21,832	97,977	83,379	26,714	110,093
Doubtful	0	0	0	161	0	161
Acquired impaired	0	5,487	5,487	0	7,090	7,090
Total	\$1,107,652	\$143,526	\$1,251,178	\$1,086,025	\$174,339	\$1,260,364

All other loans are underwritten and structured using standardized criteria and characteristics, primarily payment performance, and are normally risk rated and monitored collectively on a monthly basis. These are typically loans to individuals in the consumer categories and are delineated as either performing or nonperforming. Performing loans include current, 30 - 89 days past due and acquired impaired loans. Nonperforming loans include 90+ days past due and still accruing and nonaccrual loans. The following table details the balances in all other loan categories at September 30, 2014:

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

(000's omitted)	Consumer Mortgage	Consumer Indirect	Consumer Direct	Home Equity	Total
Performing	\$1,511,844	\$840,269	\$180,366	\$274,394	\$2,806,873
Nonperforming	14,302	126	22	2,336	16,786
Total	\$1,526,146	\$840,395	\$180,388	\$276,730	\$2,823,659

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

(000's omitted)	Consumer Mortgage	Consumer Indirect	Consumer Direct	Home Equity	Total
Performing	\$70,066	\$1,580	\$6,266	\$61,760	\$139,672
Nonperforming	2,086	0	18	631	2,735
Total	\$72,152	\$1,580	\$6,284	\$62,391	\$142,407

The following table details the balances in all other loan categories at December 31, 2013:

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

(000's omitted)	Consumer Mortgage	Consumer Indirect	Consumer Direct	Home Equity	Total
Performing	\$1,489,909	\$735,525	\$171,310	\$273,870	\$2,670,614
Nonperforming	12,350	752	94	2,040	15,236
Total	\$1,502,259	\$736,277	\$171,404	\$275,910	\$2,685,850

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

	Consumer	Consumer	Consumer	Home	
(000's omitted)	Mortgage	Indirect	Direct	Equity	Total
Performing	\$78,251	\$3,708	\$8,708	\$70,129	\$160,796
Nonperforming	1,548	17	27	481	2,073
Total	\$79,799	\$3,725	\$8,735	\$70,610	\$162,869

All loan classes are collectively evaluated for impairment except business lending, as described in Note C. A summary of individually evaluated impaired loans as of September 30, 2014 and December 31, 2013 follows:

	September	December
(000's omitted)	30, 2014	31, 2013
Loans with allowance allocation	\$945	\$945
Loans without allowance allocation	0	600
Carrying balance	945	1,545
Contractual balance	1,003	1,852
Specifically allocated allowance	50	50

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

In accordance with the clarified guidance issued by the Office of the Comptroller of the Currency (“OCC”) in 2012 addressing the accounting for certain loans that have been discharged in Chapter 7 bankruptcy, loans that have been discharged in Chapter 7 bankruptcy but not reaffirmed by the borrower, are classified as TDRs, irrespective of payment history or delinquency status, even if the repayment terms for the loan have not been otherwise modified. The Company’s lien position against the underlying collateral remains unchanged. Pursuant to that guidance, the Company records a charge-off equal to any portion of the carrying value that exceeds the net realizable value of the collateral. The amount of loss incurred in 2014 and 2013 was immaterial.

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

Information regarding TDRs as of September 30, 2014 and December 31, 2013 is as follows:

(000’s omitted)	September 30, 2014						December 31, 2013					
	Nonaccrual		Accruing		Total		Nonaccrual		Accruing		Total	
	#	Amount	#	Amount	#	Amount	#	Amount	#	Amount	#	Amount
Consumer mortgage	37	\$1,796	50	\$2,215	87	\$4,011	31	\$1,682	48	\$2,171	79	\$3,853
Business lending	7	609	2	93	9	702	4	162	1	47	5	209
Consumer indirect	0	0	81	693	81	693	0	0	98	692	98	692
Consumer direct	0	0	19	80	19	80	0	0	46	116	46	116
Home equity	14	297	14	328	28	625	12	202	20	363	32	565
Total	58	\$2,702	166	\$3,409	224	\$6,111	47	\$2,046	213	\$3,389	260	\$5,435

The following table presents information related to loans modified in a TDR during the three and nine months ended September 30, 2014. Of the loans noted in the table below, all but two loans for the three and nine months ended September 30, 2014 were modified due to a Chapter 7 bankruptcy as described previously. The two exceptions were business loans restructured via granting a waiver of payments for a period of time. The financial effects of these restructurings were immaterial.

Edgar Filing: COMMUNITY BANK SYSTEM, INC. - Form 10-Q

	Three Month Ended September 30, 2014		Nine Month Ended September 30, 2014	
	Number		Number	
(000's omitted)	of loans modified	Outstanding Balance	of loans modified	Outstanding Balance
Consumer mortgage	6	\$283	22	\$1,016
Business lending	0	0	7	556
Consumer indirect	16	165	29	334
Consumer direct	5	7	7	14
Home equity	0	0	5	173
Total	27	\$455	70	\$2,093

Allowance for Loan Losses

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

Three Months Ended September 30, 2014								
	Consumer	Business	Consumer	Consumer	Home	Acquired		
(000's omitted)	Mortgage	Lending	Indirect	Direct	Equity	Unallocated	Impaired	Total
Beginning balance	\$9,375	\$16,553	\$11,354	\$3,298	\$1,860	\$2,012	\$163	\$44,615
Charge-offs	(203)	(435)	(1,711)	(307)	(74)	0	(10)	(2,740)
Recoveries	14	335	1,025	239	38	0	0	1,651
Provision	268	138	1,231	100	77	(65)	(2)	1,747
Ending balance	\$9,454	\$16,591	\$11,899	\$3,330	\$1,901	\$1,947	\$151	\$45,273

Three Months Ended September 30, 2013								
	Consumer	Business	Consumer	Consumer	Home	Acquired		
(000's omitted)	Mortgage	Lending	Indirect	Direct	Equity	Unallocated	Impaired	Total
Beginning balance	\$7,373	\$18,283	\$9,369	\$3,054	\$1,674	\$2,745	\$975	\$43,473
Charge-offs	(217)	(1,012)	(1,186)	(348)	(59)	0	(59)	(2,881)
Recoveries	2	375	811	206	4	0	0	1,398
Provision	443	625	1,074	253	95	(500)	103	2,093
Ending balance	\$7,601	\$18,271	\$10,068	\$3,165	\$1,714	\$2,245	\$1,019	\$44,083

Nine Months Ended September 30, 2014								
	Consumer	Business	Consumer	Consumer	Home	Acquired		
(000's omitted)	Mortgage	Lending	Indirect	Direct	Equity	Unallocated	Impaired	Total
Beginning balance	\$8,994	\$17,507	\$10,248	\$3,181	\$1,830	\$2,029	\$530	\$44,319
Charge-offs	(734)	(940)	(4,573)	(1,219)	(450)	0	(30)	(7,946)
Recoveries	67	607	2,826	677	76	0	0	4,253
Provision	1,127	(583)	3,398	691	445	(82)	(349)	4,647
Ending balance	\$9,454	\$16,591	\$11,899	\$3,330	\$1,901	\$1,947	\$151	\$45,273

Nine Months Ended September 30, 2013								
	Consumer	Business	Consumer	Consumer	Home	Acquired		
(000's omitted)	Mortgage	Lending	Indirect	Direct	Equity	Unallocated	Impaired	Total
	\$7,070	\$18,013	\$9,606	\$3,303	\$1,451	\$2,666	\$779	\$42,888

Beginning balance								
Charge-offs	(817)	(2,075)	(3,075)	(1,300)	(379)	0	(59)	(7,705)
Recoveries	15	619	2,682	761	16	0	0	4,093
Provision	1,333	1,714	855	401	626	(421)	299	4,807
Ending balance	\$7,601	\$18,271	\$10,068	\$3,165	\$1,714	\$2,245	\$1,019	\$44,083

NOTE F: GOODWILL AND IDENTIFIABLE INTANGIBLE ASSETS

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

	September 30, 2014		December 31, 2013	
	Gross Carrying Amount	Net Accumulated Amortization	Gross Carrying Amount	Net Accumulated Amortization
(000's omitted)	Amount	Amount	Amount	Amount
Amortizing intangible assets:				
Core deposit intangibles	\$40,326	(\$29,510)	\$40,326	(\$26,866)
Other intangibles	10,019	(8,043)	9,441	(7,393)
Total amortizing intangibles	\$50,345	(\$37,553)	\$49,767	(\$34,259)

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

Oct - Dec	
2014	\$993
2015	3,408
2016	2,612
2017	1,908
2018	1,424
Thereafter	2,447
Total	\$12,792

Shown below are the components of the Company's goodwill at December 31, 2013 and September 30, 2014:

(000's omitted)	December 31, 2013	Activity	September 30, 2014
Goodwill	\$379,815	\$183	\$379,998
Accumulated impairment	(4,824)	0	(4,824)
Goodwill, net	\$374,991	\$183	\$375,174

NOTE G: MANDATORILY REDEEMABLE PREFERRED SECURITIES

The Company sponsors two business trusts, Community Statutory Trust III and Community Capital Trust IV, of which 100% of the common stock is owned by the Company. The trusts were formed for the purpose of issuing company-obligated mandatorily redeemable preferred securities to third-party investors and investing the proceeds from the sale of such preferred securities solely in junior subordinated debt securities of the Company. The debentures held by each trust are the sole assets of that trust. Distributions on the preferred securities issued by each trust are payable quarterly at a rate per annum equal to the interest rate being earned by the trust on the debentures held by that trust and are recorded as interest expense in the consolidated financial statements. The preferred securities are subject to mandatory redemption, in whole or in part, upon repayment of the debentures. The Company has entered into agreements which, taken collectively, fully and unconditionally guarantee the preferred securities subject to the terms of each of the guarantees. The terms of the preferred securities of each trust are as follows:

Trust	Issuance		Interest Rate	Maturity		Call Price
	Date	Par Amount		Date		
III	7/31/2001	\$24.5 million	3 month LIBOR	7/31/2031	Par	
			plus 3.58% (3.82%)			
IV	12/8/2006	\$75 million	3 month LIBOR	12/15/2036	Par	
			plus 1.65% (1.88%)			

NOTE H: BENEFIT PLANS

Edgar Filing: COMMUNITY BANK SYSTEM, INC. - Form 10-Q

The Company provides a qualified defined benefit pension to eligible employees and retirees, other post-retirement health and life insurance benefits to certain retirees, an unfunded supplemental pension plan for certain key executives, and an unfunded stock balance plan for certain of its nonemployee directors. The Company accrues for the estimated cost of these benefits through charges to expense during the years that employees earn these benefits. No contributions to the defined benefit pension plan are required or planned for 2014.

The net periodic benefit cost for the three and nine months ended September 30, 2014 and 2013 is as follows:

	Pension Benefits				Post-retirement Benefits			
	Three Months		Nine Months		Three		Nine	
	Ended		Ended		Months		Months	
	September 30,		September 30,		September		September	
(000's omitted)	2014	2013	2014	2013	2014	2013	2014	2013
Service cost	\$882	\$985	\$2,647	\$2,955	\$0	\$0	\$0	\$0
Interest cost	1,318	1,029	3,953	3,086	26	22	76	66
Expected return on plan assets	(2,980)	(2,710)	(8,941)	(7,612)	0	0	0	0
Amortization of unrecognized net loss	(77)	1,008	(230)	3,023	(2)	3	(5)	9
Amortization of prior service cost	1	14	4	43	(45)	(45)	(134)	(134)
Net periodic benefit cost	(\$856)	\$326	(\$2,567)	\$1,495	(\$21)	(\$20)	(\$63)	(\$59)

NOTE I: EARNINGS PER SHARE

Basic earnings per share are computed based on the weighted-average of the common shares outstanding for the period. Diluted earnings per share are based on the weighted-average of the shares outstanding adjusted for the dilutive effect of restricted stock and the assumed exercise of stock options during the year. The dilutive effect of options is calculated using the treasury stock method of accounting. The treasury stock method determines the number of common shares that would be outstanding if all the dilutive options (those where the average market price is greater than the exercise price) were exercised and the proceeds were used to repurchase common shares in the open market at the average market price for the applicable time period. There were approximately 0.3 million weighted-average anti-dilutive stock options outstanding for the three months ended September 30, 2014, and approximately 0.2 million weighted-average anti-dilutive stock options outstanding for the nine months ended September 30, 2014, compared to approximately 0.3 million weighted-average anti-dilutive stock options outstanding for the three months ended September 30, 2013, and approximately 0.5 million weighted-average anti-dilutive stock options outstanding for the nine months ended September 30, 2013 that were not included in the computation below.

The following is a reconciliation of basic to diluted earnings per share for the three and nine months ended September 30, 2014 and 2013:

	Three Months Ended September 30,		Nine Months Ended September 30,	
(000's omitted, except per share data)	2014	2013	2014	2013
Net income	\$22,371	\$21,989	\$68,220	\$63,352
Income attributable to unvested stock-based compensation awards	(115)	(121)	(337)	(315)
Income available to common shareholders	22,256	21,868	67,883	63,037
Weighted-average common shares outstanding – basic	40,596	40,121	40,543	39,914
Basic earnings per share	\$0.55	\$0.55	\$1.67	\$1.58
Net income	\$22,371	\$21,989	\$68,220	\$63,352
Income attributable to unvested stock-based compensation awards	(115)	(121)	(337)	(315)
Income available to common shareholders	22,256	21,868	67,883	63,037
Weighted-average common shares outstanding – basic	40,596	40,121	40,543	39,914
Assumed exercise of stock options	453	506	482	474
Weighted-average common shares outstanding – diluted	41,049	40,627	41,025	40,388
Diluted earnings per share	\$0.54	\$0.54	\$1.65	\$1.56

Stock Repurchase Program

At its December 2013 meeting, the Company's Board of Directors (the "Board") approved a new repurchase program authorizing the repurchase of up to 2,000,000 shares of the Company's common stock, in accordance with securities laws and regulations, through December 31, 2014. 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 open market treasury stock purchases in 2013 or the first nine months of 2014.

NOTE J: COMMITMENTS, CONTINGENT LIABILITIES AND RESTRICTIONS

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

The contract amount of commitments and contingencies are as follows:

	September	December
(000's omitted)	30, 2014	31, 2013
Commitments to extend credit	\$674,401	\$704,904
Standby letters of credit	23,892	24,449
Total	\$698,293	\$729,353

The Company and its subsidiaries are subject in the normal course of business to various pending and threatened legal proceedings in which claims for monetary damages are asserted. As of September 30, 2014, management, after consultation with legal counsel, does not anticipate that the aggregate ultimate liability arising out of litigation pending or threatened against the Company or its subsidiaries will be material to the Company's consolidated financial position. On at least a quarterly basis the Company assesses its liabilities and contingencies in connection with such legal proceedings. For those matters where it is probable that the Company will incur losses and the amounts of the losses can be reasonably estimated, the Company records an expense and corresponding liability in its consolidated financial statements. To the extent the pending or threatened litigation could result in exposure in excess of that liability, the amount of such excess is not currently estimable. The range of reasonably possible losses for matters where an exposure is not currently estimable or considered probable, beyond the existing recorded liabilities, is between \$0 and \$1 million in the aggregate. Although the Company does not believe that the outcome of pending litigation will be material to the Company's consolidated financial position, it cannot rule out the possibility that such outcomes will be material to the consolidated results of operations for a particular reporting period in the future.

The Bank reached a settlement in two class actions pending in the United States District Court for the Middle District of Pennsylvania which were commenced October 30, 2013 and May 29, 2014, respectively. The first action alleged that notices provided by the Bank in connection with the repossession of the named plaintiff's automobile failed to comply with certain requirements of the Pennsylvania and New York Uniform Commercial Code (UCC) and related statutes. The plaintiff sought to pursue the action as a class action on behalf of herself and similarly situated plaintiffs who had their automobiles repossessed and sought to recover statutory damages under the UCC. The second action filed May 29, 2014 contained similar allegations, which the plaintiff also sought to pursue as a class action for statutory damages. In both cases, the Bank contested the allegations that the notices were deficient, asserted various legal defenses and counterclaims, and opposed class certification in both of the cases. On September 30, 2014, the Bank reached an agreement in principle to settle both actions for \$2.8 million in exchange for releases of all claims. The settlement is subject to final documentation, notice to the class members and Court approval. A litigation settlement charge of \$2.8 million with respect to the settlement of the class actions was recorded in the third quarter.

NOTE K: FAIR VALUE

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

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

- Level 1 – Quoted prices in active markets for identical assets or liabilities.
- Level 2 – Quoted prices in active markets for similar assets or liabilities, or quoted prices for identical or similar assets or liabilities in markets that are not active, or inputs other than quoted prices that are observable for the asset or liability.
- Level 3 – Significant valuation assumptions not readily observable in a market.

Edgar Filing: COMMUNITY BANK SYSTEM, INC. - Form 10-Q

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

September 30, 2014

(000's omitted)	Level 1	Level 2	Level 3	Total Fair Value
Available-for-sale investment securities:				
U.S. Treasury and agency securities	\$1,465,231	\$21,396	\$0	\$1,486,627
Obligations of state and political subdivisions	0	688,334	0	688,334
Government agency mortgage-backed securities	0	244,122	0	244,122
Corporate debt securities	0	27,287	0	27,287
Government agency collateralized mortgage obligations	0	19,130	0	19,130
Marketable equity securities	431	0	0	431
Total available-for-sale investment securities	1,465,662	1,000,269	0	2,465,931
Mortgage loans held for sale	0	726	0	726
Commitments to originate real estate loans for sale	0	0	170	170
Forward sales commitments	0	(7)	0	(7)
Total	\$1,465,662	\$1,000,988	\$170	\$2,466,820

(000's omitted)	December 31, 2013			Total Fair Value
	Level 1	Level 2	3	
Available-for-sale investment securities:				
U.S. Treasury and agency securities	\$1,182,261	\$29,886	\$0	\$1,212,147
Obligations of state and political subdivisions	0	668,982	0	668,982
Government agency mortgage-backed securities	0	254,978	0	254,978
Corporate debt securities	0	27,587	0	27,587
Government agency collateralized mortgage obligations	0	22,048	0	22,048
Marketable equity securities	421	0	0	421
Total available-for-sale investment securities	1,182,682	1,003,481	0	2,186,163
Mortgage loans held for sale	0	728	0	728
Commitments to originate real estate loans for sale	0	0	44	44
Forward sales commitments	0	27	0	27
Total	\$1,182,682	\$1,004,236	\$44	\$2,186,962

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

- Available for sale investment securities – The fair value of available-for-sale investment securities is based upon quoted prices, if available. If quoted prices are not available, fair values are measured using quoted market prices for similar securities or model-based valuation techniques. Level 1 securities include U.S. Treasury obligations and marketable equity securities that are traded by dealers or brokers in active over-the-counter markets. Level 2 securities include U.S. agency securities, mortgage-backed securities issued by government-sponsored entities, municipal securities and corporate debt securities that are valued by reference to prices for similar securities or through model-based techniques in which all significant inputs, such as reported trades, trade execution data, LIBOR swap yield curve, market prepayment speeds, credit information, market spreads, and security's terms and conditions, are observable. See Note D for further disclosure of the fair value of investment securities.
- Mortgage loans held for sale – Mortgage loans held for sale are carried at fair value, which is determined using quoted secondary-market prices of loans with similar characteristics and, as such, have been classified as a Level 2 valuation. The unpaid principal value of mortgage loans held for sale at September 30, 2014 is approximately \$0.7 million. The unrealized gain on mortgage loans held for sale of approximately \$0.02 million was recognized in mortgage banking and other income in the consolidated statement.
- Forward sales commitments – The Company enters into forward sales commitments to sell certain residential real estate loans. Such commitments are considered to be derivative financial instruments and, therefore, are carried at estimated fair value in the other asset or other liability section of the consolidated balance sheet. The fair value of these forward sales commitments is primarily measured by obtaining pricing from certain government-sponsored entities and reflects the underlying price the entity would pay the Company for an immediate sale on these mortgages. As such, these instruments are

classified as Level 2 in the fair value hierarchy.

- Commitments to originate real estate loans for sale – The Company enters into various commitments to originate residential real estate loans for sale. Such commitments are considered to be derivative financial instruments and, therefore, are carried at estimated fair value in the other asset or other liability section of the consolidated balance sheet. The estimated fair value of these commitments is determined using quoted secondary market prices obtained from certain government-sponsored entities. Additionally, accounting guidance requires the expected net future cash flows related to the associated servicing of the loan to be included in the fair value measurement of the derivative. The expected net future cash flows are based on a valuation model that calculates the present value of estimated net servicing income. The valuation model incorporates assumptions that market participants would use in estimating future net servicing income. Such assumptions include estimates of the cost of servicing loans, appropriate discount rate and prepayment speeds. The determination of expected net cash flows is considered a significant unobservable input contributing to the Level 3 classification of commitments to originate real estate loans for sale.

The changes in Level 3 assets measured at fair value on a recurring basis are summarized in the following tables:

	Three Months Ended September 30, 2014		2013	
	Commitments to Originate Real Estate Loans for Sale	Pooled Trust Preferred Securities	Commitments to Originate Real Estate Loans for Sale	Total
(000's omitted)				
Beginning balance	\$142	\$47,290	(\$19)	\$47,271
Total (losses)/gains included in earnings (1)(3)	(142)	16	19	35
Total gains included in other comprehensive income(2)	0	4,217	0	4,217
Principal reductions	0	(272)	0	(272)
Commitments to originate real estate loans held for sale, net	170	0	268	268
Ending balance	\$170	\$51,251	\$268	\$51,519

(1) Amounts included in earnings associated with the pooled trust preferred securities relate to accretion of related discount, which are reported in interest and dividends on taxable investments

(2) Amounts included in other comprehensive income associated with the pooled trust preferred securities relate to changes in unrealized loss and are reported as a component of net unrealized gains/(losses) on available-for sale securities in the Statement of Comprehensive Income.

(3) Amounts included in earnings associated with the commitments to originate real estate loans for sale are reported as a component of other banking services in the Consolidated Statement of Income.

	Nine Months Ended September 30, 2014		2013	
	Commitments to Originate Real Estate Loans for Sale	Pooled Trust Preferred Securities	Commitments to Originate Real Estate Loans for Sale	Total
(000's omitted)				

Edgar Filing: COMMUNITY BANK SYSTEM, INC. - Form 10-Q

Beginning balance	\$44	\$49,600	\$0	\$49,600
Total (losses)/gains included in earnings (1)(3)	(253)	166	0	166
Total gains included in other comprehensive income(2)	0	7,090	0	7,090
Principal reductions	0	(5,605)	0	(5,605)
Commitments to originate real estate loans held for sale, net	379	0	268	268
Ending balance	\$170	\$51,251	\$268	\$51,519

(1) Amounts included in earnings associated with the pooled trust preferred securities relate to accretion of related

discount, which are reported in interest and dividends on taxable investments.

(2) Amounts included in other comprehensive income associated with the pooled trust preferred securities relate to

changes in unrealized loss and are reported as a component of net unrealized gains/(losses) on available-for sale

securities in the Statement of Comprehensive Income.

(3) Amounts included in earnings associated with the commitments to originate real estate loans for sale are reported

as a component of other banking services in the Consolidated Statement of Income.

Assets and liabilities measured on a non-recurring basis:

	September 30, 2014				December 31, 2013			
	Level 1	Level 2	Level 3	Total Fair Value	Level 1	Level 2	Level 3	Total Fair Value
(000's omitted)								
Impaired loans	\$0	\$0	\$0	\$0	\$0	\$600	\$0	\$600
Other real estate owned	0	0	3,619	3,619	0	0	5,060	5,060
Total	\$0	\$0	\$3,619	\$3,619	\$0	\$600	\$5,060	\$5,660

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

therefore, such valuations classify as Level 3. At December 31, 2013, impaired loans recorded at fair value consisted of one loan that was valued using a purchase offer that did not require an adjustment for estimated costs. As such, no unobservable inputs were utilized and it was classified as a Level 2 valuation.

Other real estate owned ("OREO") is valued at the time the loan is foreclosed upon and the asset is transferred to OREO. The value is based primarily on third party appraisals, less costs to sell. The appraisals are sometimes further discounted based on management's historical knowledge, changes in market conditions from the time of valuation, and/or management's expertise and knowledge of the customer and customer's business. Such discounts are significant, ranging from 10% to 75% at September 30, 2014 and result in a Level 3 classification of the inputs for determining fair value. OREO is reviewed and evaluated on at least a quarterly basis for additional impairment and adjusted accordingly, based on the same factors identified above. The Company recovers the carrying value of OREO through the sale of the property. The ability to affect future sales prices is subject to market conditions and factors beyond the Company's control and may impact the estimated fair value of a property.

Originated mortgage servicing rights are recorded at their fair value at the time of sale of the underlying loan, and are amortized in proportion to and over the estimated period of net servicing income. The fair value of mortgage servicing rights is based on a valuation model incorporating inputs that market participants would use in estimating future net servicing income. Such inputs include estimates of the cost of servicing loans, appropriate discount rate and prepayment speeds and are considered to be unobservable and contribute to the Level 3 classification of mortgage servicing rights. In accordance with GAAP, the Company must record impairment charges, on a nonrecurring basis, when the carrying value of a stratum exceeds its estimated fair value. Impairment is recognized through a valuation allowance. There is no valuation allowance at September 30, 2014 as the fair value of mortgage servicing rights of approximately \$1.4 million exceeded the carrying value of approximately \$1.1 million.

The Company evaluates goodwill for impairment on an annual basis, or more often if events or circumstances indicate there may be impairment. The fair value of each reporting unit is compared to the carrying amount of that reporting unit in order to determine if impairment is indicated. If so, the implied fair value of the reporting unit's goodwill is compared to its carrying amount and the impairment loss is measured by the excess of the carrying value of the goodwill over fair value of the goodwill. In such situations, the Company performs a discounted cash flow modeling technique that requires management to make estimates regarding the amount and timing of expected future cash flows of the assets and liabilities of the reporting unit that enable the Company to calculate the implied fair value of the goodwill. It also requires use of a discount rate that reflects the current return expectation of the market in relation to present risk-free interest rates, expected equity market premiums, peer volatility indicators and company-specific risk indicators. The Company did not recognize an impairment charge during 2013 or thus far in 2014.

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

	Fair Value at September (000's omitted) 30, 2014	Valuation Technique	Significant Unobservable Inputs	Significant Unobservable Input Range (Weighted Average)
Other real estate owned	\$3,619	Fair Value of Collateral	Estimated cost of disposal/market adjustment	10.0%-75.1% (25.9%)
Commitments to originate real estate loans for sale	170	Discounted cash flow	Embedded servicing value	1%

Edgar Filing: COMMUNITY BANK SYSTEM, INC. - Form 10-Q

The significant unobservable inputs used in the determination of fair value of assets classified as Level 3 on a recurring or non-recurring basis as of December 31, 2013 are as follows:

	Fair Value at December (000's omitted)	Valuation Technique	Significant Unobservable Inputs	Significant Unobservable Input Range (Weighted Average)
Other real estate owned	\$5,060	Fair value of collateral	Estimated cost of disposal/market adjustment	11.0% - 54.4% (28.1%)
Commitments to originate real estate loans for sale	44	Discounted cash flow	Embedded servicing value	1%

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

The carrying amounts and estimated fair values of the Company's other financial instruments that are not accounted for at fair value at September 30, 2014 and December 31, 2013 are as follows:

(000's omitted)	September 30, 2014		December 31, 2013	
	Carrying Value	Fair Value	Carrying Value	Fair Value
Financial assets:				
Net loans	\$4,171,971	\$4,217,967	\$4,064,764	\$4,044,449
Financial liabilities:				
Deposits	5,967,331	5,967,675	5,896,044	5,898,138
Borrowings	343,805	343,805	141,913	141,913
Subordinated debt held by unconsolidated subsidiary trusts	102,115	93,435	102,097	109,284

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

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

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

Borrowings have been classified as a Level 2 valuation. The fair value of FHLB overnight advances is the amount payable on demand at the reporting date. Fair values for long-term borrowings are estimated using discounted cash flows and interest rates currently being offered on similar borrowings, and are immaterial as of the reporting dates.

Subordinated debt held by unconsolidated subsidiary trusts have been classified as a Level 2 valuation. The fair value of subordinated debt held by unconsolidated subsidiary trusts are estimated using discounted cash flows and interest rates currently being offered on similar securities.

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

NOTE L: DERIVATIVE INSTRUMENTS

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

The Company enters into forward sales commitments for the future delivery of residential mortgage loans, and interest rate lock commitments to fund loans at a specified interest rate. The forward sales commitments are utilized to reduce interest rate risk associated with interest rate lock commitments and loans held for sale. Changes in the estimated fair

value of the forward sales commitments and interest rate lock commitments subsequent to inception are based on changes in the fair value of the underlying loan resulting from the fulfillment of the commitment and changes in the probability that the loan will fund within the terms of the commitment, which is affected primarily by changes in interest rates and the passage of time. At inception and during the life of the interest rate lock commitment, the Company includes the expected net future cash flows related to the associated servicing of the loan as part of the fair value measurement of the interest rate lock commitments. These derivatives are recorded at fair value.

The following table presents the Company's derivative financial instruments, their estimated fair values, and balance sheet location as of September 30, 2014:

(000's omitted)	Location	Notional	Fair Value
Derivatives not designated as hedging instruments:			
Forward sales commitments	Other liabilities	\$5,024	(\$7)
Commitments to originate real estate loans for sale	Other assets	7,541	170
Total derivatives, net			\$163

The following table presents the Company's derivative financial instruments and the location of the net gain or loss recognized in the statement of income for the three and nine months ended September 30, 2014:

(000's omitted)	Location	Gain/(Loss) Recognized in the Statement of Income	
		Three Months Ending September 30, 2014	Nine Months Ending September 30, 2014
Forward sales commitments	Mortgage banking and other services	\$4	(\$34)
Commitments to originate real estate loans for sale	Mortgage banking and other services	28	126
Total, net		\$32	\$92

NOTE M: SEGMENT INFORMATION

Operating segments are components of an enterprise, which are evaluated regularly by the "chief operating decision maker" in deciding how to allocate resources and assess performance. The Company's chief operating decision maker is the President and Chief Executive Officer of the Company. The Company has identified Banking, Employee Benefit Services and Wealth Management as its reportable operating business segments. CBNA operates the banking segment that provides full-service banking to consumers, businesses and governmental units in northern, central and western New York as well as northern Pennsylvania. Employee benefit services, which includes Benefit Plans Administrative Services, Inc. ("BPAS") and subsidiaries with offices throughout the U.S. and Puerto Rico, provides employee benefit trust, collective investment fund, retirement plan administration, actuarial, VEBA/HRA and health and welfare consulting services. Wealth management services activities include trust services provided by the personal trust unit within the Bank, investment and insurance products and services provided by Community Investment Services, Inc. ("CISI") and CBNA Insurance Agency, Inc., and asset management provided by Nottingham Advisors, Inc. The accounting policies used in the disclosure of business segments are the same as those described in

the summary of significant accounting policies (See Note A, Summary of Significant Accounting Policies of the most recent Form 10-K for the year ended December 31, 2013 filed with the SEC on March 3, 2014).

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

(000's omitted)	Banking	Employee Benefit Services	Wealth Management	Eliminations	Consolidated Total
Three Months Ended September 30, 2014					
Net interest income	\$61,350	\$21	\$23	\$0	\$61,394
Provision for loan losses	1,747	0	0	0	1,747
Noninterest income	15,700	11,049	4,809	(486)	31,072
Amortization of intangible assets	850	153	48	0	1,051
Other operating expenses	46,837	8,140	3,269	(486)	57,760
Income before income taxes	\$27,616	\$2,777	\$1,515	\$0	\$31,908
Assets	\$7,476,030	\$29,605	\$14,965	(\$17,957)	\$7,502,643
Goodwill	\$364,495	\$8,019	\$2,660	\$0	\$375,174
Three Months Ended September 30, 2013					
Net interest income	\$60,566	\$16	\$19	\$0	\$60,601
Provision for loan losses	2,093	0	0	0	2,093
Noninterest income	14,372	9,619	3,960	(357)	27,594
Amortization of intangible assets	875	157	57	0	1,089
Other operating expenses	43,497	7,810	3,005	(357)	53,955
Income before income taxes	\$28,473	\$1,668	\$917	\$0	\$31,058
Assets	\$7,276,673	\$27,228	\$12,635	(\$14,519)	\$7,302,017
Goodwill	\$359,207	\$7,836	\$2,660	\$0	\$369,703
Nine Months Ended September 30, 2014					
Net interest income	\$182,537	\$67	\$68	\$0	\$182,672
Provision for loan losses	4,647	0	0	0	4,647
Noninterest income	43,922	32,434	14,101	(1,365)	89,092
Amortization of intangible assets	2,644	496	153	0	3,293
Other operating expenses	133,680	24,622	9,666	(1,365)	166,603
Income before income taxes	\$85,488	\$7,383	\$4,350	\$0	\$97,221
Nine Months Ended September 30, 2013					
Net interest income	\$177,319	\$81	\$58	\$0	\$177,458
Provision for loan losses	4,807	0	0	0	4,807
Noninterest income	40,667	29,249	12,095	(1,210)	80,801

Edgar Filing: COMMUNITY BANK SYSTEM, INC. - Form 10-Q

Amortization of intangible assets	2,720	507	181	0	3,408
Other operating expenses	129,674	23,019	9,081	(1,210)	160,564
Income before income taxes	\$80,785	\$5,804	\$2,891	\$0	\$89,480

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

Introduction

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" or "CBSI") as of and for the three and nine months ended September 30, 2014 and 2013, although in some circumstances the second quarter of 2014 is also discussed in order to more fully explain recent trends. The following discussion and analysis should be read in conjunction with the Company's Consolidated Financial Statements and related notes that appear on pages 3 through 26. All references in the discussion to the financial condition and results of operations are to those of the Company and its subsidiaries taken as a whole. Unless otherwise noted, the term "this year" refers to results in calendar year 2014, "third quarter" refers to the quarter ended September 30, 2014 and earnings per share ("EPS") figures refer to diluted EPS.

This MD&A contains certain forward-looking statements with respect to the financial condition, results of operations and business of the Company. These forward-looking statements involve certain risks and uncertainties. Factors that may cause actual results to differ materially from those proposed by such forward-looking statements are set herein under the caption, "Forward-Looking Statements," on page 44.

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 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, liabilities and shareholders' equity and disclosures of revenues and expenses during the reporting period. Actual results could differ from those estimates. Management believes that critical accounting estimates include:

- Acquired loans – Acquired loans are initially recorded at their acquisition date fair values based on a discounted cash flow methodology that involves assumptions and judgments as to credit risk, prepayment risk, liquidity risk, default rates, loss severity, payment speeds, collateral values and discount rate.

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

For acquired loans that are not deemed impaired at acquisition, the difference between the acquisition date fair value and the outstanding balance represents the fair value adjustment for a loan and includes both credit and interest rate

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

- 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 and evaluation of collateral values 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 the amount and timing of future cash flows, prepayment speed assumptions, expected interest rate curve, and the selection of discount rates that appropriately reflect market and credit risks. Investment securities with significant declines in fair value are evaluated to determine whether they should be considered other-than-temporarily impaired (“OTTI”). 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 OTTI 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 of the full value of its amortized cost basis.
- **Retirement benefits** – The Company provides defined benefit pension benefits to eligible employees and post-retirement health and life insurance benefits to certain eligible retirees. The Company also provides deferred compensation and supplemental executive retirement plans for selected current and former employees 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.
- **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 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, expected equity market premiums, peer volatility indicators and company-specific market and performance metrics, 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” on pages 56-61 of the most recent Form 10-K (fiscal year ended December 31, 2013) filed with the Securities and Exchange Commission (“SEC”) on March 3, 2014.

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 banking subsidiary is Community Bank, N.A. (the "Bank" or "CBNA").

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 noninterest 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 improve efficiencies.

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; liquidity and interest rate sensitivity; enhancements to customer products and services and their underlying performance characteristics; technology advancements; market share; peer comparisons; and the performance of acquisition activities.

On December 13, 2013, the Company completed its acquisition of eight retail branch-banking locations across its Northeast Pennsylvania markets from Bank of America, N.A. ("B of A"), acquiring approximately \$0.9 million in loans and \$303 million of deposits. The assumed deposits consisted of \$220 million of core deposits (checking, savings and money market accounts) and \$83 million of time deposits. Under the terms of the agreement, the Bank paid B of A a blended deposit premium of 2.4%, or approximately \$7.3 million.

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

Third quarter and September year-to-date net income of \$22.4 million and \$68.2 million, respectively, increased \$0.4 million or 1.7% and \$4.9 million or 7.7% compared to the respective prior year periods. Earnings per share was \$0.54 and \$1.65 for the three and nine months ended September 30, 2014, respectively, consistent with the third quarter of 2013 and \$0.09 higher than the first nine months of 2013. The higher net income was due to higher net interest income that resulted from earning asset growth, generated organically and from the B of A branch acquisition, partially offset by a lower net interest margin for the three and nine month periods. Also contributing to the higher net income were higher noninterest income due to incremental deposit service fees, including those from the B of A branch acquisition, higher debit card-related revenue, higher employee benefit services revenue, solid revenue growth from the wealth management group, as well as a lower provision for loan losses. These were partially offset by higher operating expenses, due in large part to the additional operating costs from the B of A branch acquisition, and a higher effective income tax rate. Third quarter 2014's results include a \$2.8 million litigation settlement charge, or \$0.05 per share after-tax. Excluding acquisition and the litigation settlement charge, operating earnings per share for the quarter and year-to-date periods were \$0.59 and \$1.70, respectively.

Asset quality in the third quarter of 2014 remained stable and favorable in comparison to averages for peer financial organizations. Third quarter net charge-off and nonperforming loan ratios were lower than those experienced in the second quarter of 2014 and the third quarter of 2013. The loan delinquency ratio was higher than the second quarter of 2014 but remains favorable as compared to the third quarter of 2013. The current quarter provision for loan losses was lower than the second quarter of 2014 and the third quarter of 2013, reflective of lower levels of net charge-offs and improved non-performing loan ratios. The Company generated an increase in year-over-year average loan balances due to strong organic loan growth. Average deposits in the third quarter of 2014 were higher than the third quarter of 2013 and the fourth quarter of 2013, driven by the B of A branch acquisition and organic core deposit growth.

Net Income and Profitability

As shown in Table 1, net income for the third quarter and September YTD of \$22.4 million and \$68.2 million, respectively, was up \$0.4 million or 1.71% as compared to the third quarter of 2013 and was up \$4.9 million or 7.7% as compared to the first nine months of 2013. Earnings per share of \$0.54 for the third quarter was consistent with the EPS generated in the third quarter of 2013, and earnings per share for the first nine months of 2014 increased \$0.09 from the amount earned in the first nine months of 2013.

As reflected in Table 1, third quarter net interest income of \$61.4 million was up \$0.8 million or 1.3% from the comparable prior year period, and net interest income for the first nine months of 2014 increased \$5.2 million or 2.9% over the first nine months of 2013. The improvement resulted from a year-over-year increase in average interest-earning assets, primarily due to organic loan growth, partially offset by a lower net interest margin for the three and nine month periods as compared to the comparable prior year periods. The provision for loan losses

decreased \$0.3 million and \$0.2 million, as compared to the third quarter and first nine months of 2013, respectively, reflective of loan growth, a decline in quarterly net charge-offs and an improved non-performing and delinquency loan ratios.

Third quarter and year-to-date noninterest income was \$31.1 million and \$89.1 million, respectively, up \$3.5 million or 12.6% from the third quarter of 2013 and up \$8.6 million or 10.7% from the first nine months of 2013, primarily due to the B of A branch acquisition and organic growth across the franchise. Contributing to the increase was a \$5.0 million increase in revenue generated during the first nine months of 2014 in comparison to the equivalent prior year period from the Company's employee benefit services and wealth management groups, principally resulting from new customer generation and favorable financial market conditions. During the first nine months of 2013, the Company sold \$648.7 million of investment securities, realizing \$63.8 million of gains and utilized the proceeds to retire \$501.6 million of FHLB borrowings with \$63.5 million of early extinguishment costs.

Operating expenses of \$58.8 million and \$169.9 for the third quarter and September YTD periods increased \$3.8 million or 6.8% and \$5.9 million or 3.6% from the comparable prior year periods, respectively, reflective of the additional operating costs associated with operating a larger enterprise. Included in third quarter 2014 operating expenses is a \$2.8 million litigation settlement charge pertaining to class action lawsuits involving the sufficiency of consumer notice requirements for certain of the Company's collateral recovery activities. The Company contests the allegations and asserted affirmative defenses to the claims, however, the settlement the Company was able to achieve was, in its judgment, a superior outcome for the shareholders when measured against the risks and resources required for litigation. The settlement is subject to final court approval. Excluding the litigation settlement charge, operating expenses for the quarter and year-to-date periods were \$56.0 and \$167.1, respectively, an increase of \$1.0 million or 1.8% from the third quarter of 2013 and an increase of \$3.1 million or 1.9% as compared to the first nine months of 2013.

A condensed income statement is as follows:

Table 1: Condensed Income Statements

	Three Months Ended September 30,		Nine Months Ended September 30,	
(000's omitted, except per share data)	2014	2013	2014	2013
Net interest income	\$61,394	\$60,601	\$182,672	\$177,458
Provision for loan losses	1,747	2,093	4,647	4,807
Noninterest income	31,072	27,594	89,092	80,502
Gain on sales of investment securities	0	0	0	63,799
Loss on debt extinguishments	0	0	0	(63,500)
Noninterest expenses	58,811	55,044	169,896	163,972
Income before income taxes	31,908	31,058	97,221	89,480
Income taxes	9,537	9,069	29,001	26,128
Net income	\$22,371	\$21,989	\$68,220	\$63,352
Diluted weighted average common shares outstanding	41,260	40,850	41,227	40,587
Diluted earnings per share	\$0.54	\$0.54	\$1.65	\$1.56

Net Interest Income

Net interest income is the amount by which interest and fees on earning assets (loans, investments and cash equivalents) exceed the cost of funds, primarily 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 shown in Table 2a, net interest income (with nontaxable income converted to a fully tax-equivalent basis) for the third quarter of 2014 was \$65.3 million, a \$1.0 million or 1.5% increase from the same period last year, resulting from a \$192.7 million increase in average interest-bearing assets partially offset by a five-basis point decrease in the net interest margin. As reflected in Table 3, the third quarter rate decrease on interest bearing liabilities, combined with the volume increase in interest bearing assets had a \$4.7 million favorable impact on net interest income, while the rate decrease on interest-bearing assets had a \$3.7 million unfavorable impact on net interest income. As presented in table 2b, September YTD net interest income of \$194.4 million increased \$5.6 million or 2.9% from the year-earlier period. A \$195.3 million increase in interest-earning assets had a greater impact than the \$23.7 million increase in average interest-bearing liabilities and a one-basis point decrease in the net interest margin. The increase in interest-earning assets and the lower rate on interest-bearing liabilities and an increased proportion of funding from non-interest bearing deposits had an \$18.1 million favorable impact that was partially offset by a \$12.6 million unfavorable impact from the decrease in the yield on interest-bearing assets and the increase in interest-bearing liability balances.

Average investments, including cash equivalents, for the third quarter and YTD periods were \$1.8 million and \$23.2 million lower than the comparable periods of 2013, respectively, reflective of the balance sheet restructuring program

completed in the first half of 2013 and the sale of the Company's collateralized debt obligation ("CDO") portfolio and certain Treasury securities at the end of 2013, partially offset by the purchase of Treasury securities at various times throughout the last 12 months. During the first nine months of 2013, the Company sold \$648.7 million of U.S. Treasury and agency securities, using the proceeds to retire \$501.6 million of higher rate FHLB borrowings. During the second and third quarters of 2013, the Company purchased \$525 million of U.S. Treasury securities in anticipation of the excess funding expected from the pending branch acquisition and certain other expected cash flows. In late December 2013, the Company sold its entire portfolio, \$56.2 million, of bank and insurance trust preferred CDO securities in response to the uncertainties created by the announcement of the final rules implementing Section 619 of the Dodd-Frank Act, commonly known as the "Volcker Rule". In conjunction with the liquidation of the trust preferred CDOs, the Company extinguished \$226.4 million of FHLB term advances and sold \$417.6 million of U.S. Treasury securities previously classified as held-to-maturity. The Company also reinvested the net cash proceeds of \$246 million created from these transactions into U.S. Treasury securities with similar blended durations to the assets sold in order to mitigate the net interest income impact of the security sales and debt extinguishment. In the first quarter of 2014, the Company purchased another \$225 million of U.S. Treasury securities.

Third quarter and September YTD average loan balances increased \$194.5 million or 4.9% and \$218.5 million or 5.6%, respectively, as compared to the same periods of 2013, due principally to strong organic loan growth in the consumer mortgage and indirect loan portfolios. In comparison to the prior year, total average interest-bearing deposits were up \$160.0 million or 3.5% for the quarter and \$163.0 million or 3.6% for the YTD period, as a result of the B of A branch acquisition in the fourth quarter of 2013 and organic growth during the first half of 2014. Quarterly average borrowings decreased \$162.0 million while YTD average borrowings decreased \$139.4 million, reflective of earning-asset growth in 2014 and the restructuring program in the first half of 2013 which retired \$501.6 million of FHLB borrowings as well as the extinguishment of \$226.4 million of FHLB term advances in December 2013.

The net interest margin of 3.89% for the third quarter decreased five basis points as compared to the third quarter of 2013. The rates on interest-bearing liabilities decreased 20 basis points, due primarily to the balance sheet restructuring previously discussed, as well as the continued decline in rates paid on interest-bearing deposits. In addition, the margin was positively impacted by average quarterly non-interest bearing deposit balances growing \$143.6 million from the previous year and YTD balances increasing \$125.1 million due to the B of A acquisition and solid organic growth. This was partially offset by a 22-basis point reduction in interest-earning asset yields, reflective of lower yields on loans and investment securities versus last year's third quarter. The net interest margin of 3.92% for the first nine months of 2014 decreased one basis point from the comparable period of 2013. The yield on interest-earning assets declined 26 basis points and the rates on interest-bearing liabilities declined 31 basis points for the first nine months of 2014 as compared to the first nine months of 2013. Net interest margin was positively impacted by the balance sheet restructuring activities in 2013. Proactive management of deposit funding costs continue to have a positive effect on margin results, but have not been able to fully offset declining asset yields.

The decrease in the earning-asset yield was partially attributable to a 15-basis point and a 18-basis point decrease in investment yield, including cash equivalents, for the third quarter and YTD periods, respectively, as compared to the prior year periods, due to the sale and maturing of higher rate investments being replaced with lower rate instruments. Additionally, contributing to the decrease in earning-asset yield for the quarter was a 28-basis point and a 33-basis point decline in the loan yield as compared to the third quarter and YTD periods of 2013, respectively, a result of yields on fixed-rate new loan volume being below rates on the overall portfolio due to the decline in interest rates to levels below those prevalent in prior periods and certain existing longer-term adjustable rate loans repricing downward.

The third quarter cost of funds decreased versus the prior year quarter due to a five-basis point decrease in interest-bearing deposit rates, and a higher proportion of funding being supplied from low and noninterest bearing deposits, as well as a 115-basis point decrease in the average interest rate paid on external borrowings as a result of the balance sheet restructuring completed during 2013. The cost of funds for the first nine months of 2014 decreased versus the prior year period due to an seven-basis point decrease in interest-bearing deposit rates and a higher proportion of funding being supplied from low and noninterest bearing deposits, as well as a 215-basis point decrease in the average interest rate paid on external borrowings. The decrease in the deposit cost of funds was reflective of disciplined deposit pricing, whereby interest rates on all categories of deposit accounts are lower in response to market conditions. Additionally, the proportion of customer deposits held in higher cost time deposits has continued to decline over the last several quarters.

Tables 2a and 2b below sets forth information related to average interest-earning assets and interest-bearing liabilities and their associated yields and rates for the periods indicated. Interest income and yields are on a fully tax-equivalent basis ("FTE") using a marginal income tax rate of 39.1% and 38.8% in 2014 and 2013, respectively. Average balances are computed by accumulating 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, deferred loan costs and accretion of acquired loan marks. Average loan balances include nonaccrual loans and loans held for sale.

Table 2a: Quarterly Average Balance Sheet

	Three Months Ended September 30, 2014			Three Months Ended September 30, 2013		
	Average	Avg. Yield/Rate		Average	Avg. Yield/Rate	
(000's omitted except yields and rates)	Balance	Interest	Paid	Balance	Interest	Paid
Interest-earning assets:						
Cash equivalents	\$8,225	\$4	0.17%	\$8,644	\$5	0.22%
Taxable investment securities (1)	1,834,590	12,745	2.76%	1,833,355	13,858	3.00%
Nontaxable investment securities (1)	642,114	8,274	5.11%	644,728	8,138	5.01%
Loans (net of unearned discount)(2)	4,180,283	47,187	4.48%	3,985,755	47,859	4.76%
Total interest-earning assets	6,665,212	68,210	4.06%	6,472,482	69,860	4.28%
Noninterest-earning assets	792,197			682,314		
Total assets	\$7,457,409			\$7,154,796		
Interest-bearing liabilities:						
Interest checking, savings, and money market deposits	\$3,848,511	899	0.09%	\$3,591,563	886	0.10%
Time deposits	822,705	1,063	0.51%	919,636	1,644	0.71%
Borrowings	427,051	931	0.87%	589,065	3,001	2.02%
Total interest-bearing liabilities	5,098,267	2,893	0.23%	5,100,264	5,531	0.43%
Noninterest-bearing liabilities:						

Edgar Filing: COMMUNITY BANK SYSTEM, INC. - Form 10-Q

Noninterest		
checking deposits	1,281,626	1,138,039
Other liabilities	118,032	66,255
Shareholders' equity	959,484	850,238
Total liabilities and shareholders' equity	\$7,457,409	\$7,154,796
Net interest earnings	\$65,317	\$64,329
Net interest spread	3.83%	3.85%
Net interest margin on interest-earning assets	3.89%	3.94%
Fully tax-equivalent adjustment	\$3,923	\$3,728

- (1) Averages for investment securities are based on historical cost basis 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) Includes nonaccrual loans. The impact of interest and fees not recognized on nonaccrual loans was immaterial.

Table 2b: Year-to-Date Quarterly Average Balance Sheet

	Nine Months Ended September 30, 2014			Nine Months Ended September 30, 2013		
	Average		Avg. Yield/Rate	Average		Avg. Yield/Rate
(000's omitted except yields and rates)	Balance	Interest	Paid	Balance	Interest	Paid
Interest-earning assets:						
Cash equivalents	\$9,175	\$15	0.22%	\$79,939	\$153	0.26%
Taxable investment securities (1)	1,835,797	38,991	2.84%	1,787,579	42,387	3.17%
Nontaxable investment securities (1)	646,928	24,826	5.13%	647,575	25,182	5.20%
Loans (net of unearned discount)(2)	4,134,324	139,532	4.51%	3,915,865	141,868	4.84%
Total interest-earning assets	6,626,224	203,364	4.10%	6,430,958	209,590	4.36%
Noninterest-earning assets	773,446			744,100		
Total assets	\$7,399,670			\$7,175,058		
Interest-bearing liabilities:						
Interest checking, savings, and money market deposits	\$3,857,970	2,695	0.09%	\$3,597,983	2,879	0.11%
Time deposits	862,656	3,570	0.55%	959,606	5,496	0.77%
Borrowings	405,006	2,698	0.89%	544,368	12,364	3.04%
Total interest-bearing liabilities	5,125,632	8,963	0.23%	5,101,957	20,739	0.54%
Noninterest-bearing liabilities:						
Noninterest checking deposits	1,234,995			1,109,847		
Other liabilities	104,249			91,049		
Shareholders' equity	934,794			872,205		
Total liabilities and shareholders' equity	\$7,399,670			\$7,175,058		

Net interest earnings	\$194,401	\$188,851
Net interest spread	3.87%	3.82%
Net interest margin on interest-earning assets	3.92%	3.93%
Fully tax-equivalent adjustment	\$11,729	\$11,393

- (1) Averages for investment securities are based on historical cost basis 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) Includes nonaccrual loans. The impact of interest and fees not recognized on nonaccrual loans was immaterial.

As discussed above and disclosed in Table 3 below, the quarterly 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 3: Rate/Volume

	Three months ended September 30, 2014 versus September 30, 2013 Increase (Decrease) Due to Change in (1)			Nine months ended September 30, 2014 versus September 30, 2013 Increase (Decrease) Due to Change in (1)		
	Volume	Rate	Net Change	Volume	Rate	Net Change
(000's omitted)						
Interest earned on:						
Cash equivalents	\$0	(\$1)	(\$1)	(\$120)	(\$18)	(\$138)
Taxable investment securities	9	(1,122)	(1,113)	1,119	(4,515)	(3,396)
Nontaxable investment securities	(33)	169	136	(25)	(331)	(356)
Loans	2,273	(2,945)	(672)	7,671	(10,007)	(2,336)
Total interest-earning assets (2)	2,041	(3,691)	(1,650)	6,237	(12,463)	(6,226)
Interest paid on:						
Interest checking, savings and money market deposits	61	(48)	13	198	(382)	(184)
Time deposits	(160)	(421)	(581)	(514)	(1,412)	(1,926)
Borrowings	(673)	(1,397)	(2,070)	(2,571)	(7,095)	(9,666)
Total interest-bearing liabilities (2)	(2)	(2,636)	(2,638)	96	(11,872)	(11,776)
Net interest earnings (2)	1,899	(911)	988	5,729	(179)	5,550

- (1) The change in interest due to both rate and volume has been allocated to volume and rate changes in proportion to the relationship of the absolute dollar amounts of such change in each component.
- (2) Changes due to volume and rate are computed from the respective changes in average balances and rates of the totals; they are not a summation of the changes of the components.

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); 2) employee benefit services (performed by Benefit Plans Administrative Services, Inc. ("BPAS") and its subsidiaries); and 3) wealth management services, comprised of trust services (performed by the trust unit within CBNA), investment and insurance products and services (performed by Community Investment Services, Inc. and CBNA Insurance Agency, Inc.) and asset management (performed by Nottingham Advisors, Inc. or "Nottingham"). Additionally, the Company has periodic transactions, most often net gains or losses from the sale of

investment securities and prepayment of debt instruments.

Table 4: Noninterest Income

(000's omitted)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Deposit service fees	\$13,833	\$12,703	\$39,260	\$36,643
Employee benefit services	10,755	9,397	31,638	28,564
Wealth management services	4,617	3,823	13,529	11,566
Other banking services	1,503	1,072	3,672	2,618
Mortgage banking	364	599	993	1,111
Subtotal	31,072	27,594	89,092	80,502
Gain on sales of investment securities	0	0	0	63,799
Loss on debt extinguishments	0	0	0	(63,500)
Total noninterest income	\$31,072	\$27,594	\$89,092	\$80,801
Noninterest income/operating income (FTE basis)				
(1)	32.2%	30.0%	31.4%	29.9%

(1) For purposes of this ratio noninterest income excludes gains and losses on sales of investment securities and debt extinguishments. Operating income is defined as net interest income on a fully-tax equivalent basis plus noninterest income, excluding gains and losses on sales of investment securities and debt extinguishments.

As displayed in Table 4, noninterest income was \$31.1 million in the third quarter of 2014 and \$89.1 million for the first nine months of 2014. This represents an increase of \$3.5 million or 12.6% for the quarter and \$8.3 million or 10.3% for the YTD period in comparison to 2013. General recurring banking revenue (deposit service fees and other banking services) of \$15.3 million for the third quarter and \$42.9 million for the first nine months of 2014 were up \$1.6 million or 11.3% and \$3.7 million or 9.4%, respectively, as compared to the prior year periods. This growth was driven by the addition of new deposit relationships from both acquired and organic sources, as well as solid growth in debit card-related revenue and the annual dividend from retail insurance programs that more than offset the continuing trend of lower utilization of overdraft protection programs and other deposit-related services.

Residential mortgage banking income totaled \$0.4 million for the third quarter of 2014 and \$1.0 million for the first nine months of 2014, down \$0.2 million and \$0.1 million as compared to the third quarter and first nine months of 2013, respectively. Residential mortgage banking income consists 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. Residential mortgage loans sold to investors, primarily Fannie Mae, totaled \$6.5 million in the third quarter of 2014 and \$15.4 million for the first nine months of 2014. Residential mortgage loans held for sale at September 30, 2014 totaled \$0.7 million. Realization of the unrealized gains or losses on mortgage loans held for sale and the related commitments, as well as future revenue generation from mortgage banking activities, will be dependent on market conditions and long-term interest rate trends.

Employee benefit services revenue increased \$1.4 million or 14.5% and \$3.1 million or 10.8% for the three and nine months ended September 30, 2014, respectively, as compared to the prior year periods. This business benefited from new customer generation, favorable market conditions and additional service offerings. Wealth management services revenue increased \$0.8 million or 21% and \$2.0 million or 17% for the third quarter and YTD periods, respectively, as compared to the prior year periods, driven by solid organic growth in trust, investment product sales and asset advisory services, as well as favorable market conditions.

For the first nine months of 2013, the Company sold \$648.7 million of investments securities, realizing \$63.8 million of gains, and utilized the proceeds to retire FHLB borrowings of \$501.6 million with \$63.5 million of early extinguishment costs. These actions improved the Company's regulatory capital position and positively impacted net interest income generation.

The ratio of noninterest income to total income (FTE basis) was 32.2% for the quarter and 31.4% for the year-to-date period, versus 30.0% and 29.9%, respectively, for the comparable periods of 2013. The increase for the year-to-date period is a function of a 10.7 % increase in non-interest income, primarily from the B of A branch acquisitions as well as strong organic growth at the Company's employee benefit services and wealth management businesses, while net interest income increased at a lesser 2.9% rate due to a lower level of growth in the interest-bearing balance sheet.

Operating Expenses

Table 5 below sets forth the quarterly and year-to-date results of the major operating expense categories for the current and prior year, as well as efficiency ratios (defined below), a standard measure of expense utilization effectiveness commonly used in the banking industry.

Table 5: Noninterest Expenses

Three Months Ended September 30,	Nine Months Ended September 30,
--	---------------------------------------

(000's omitted)	2014	2013	2014	2013
Salaries and employee benefits	\$30,941	\$30,448	\$92,090	\$91,217
Occupancy and equipment	6,617	6,448	21,224	20,263
Data processing and communications	7,475	6,998	21,529	20,334
Amortization of intangible assets	1,051	1,089	3,293	3,408
Legal and professional fees	1,973	1,897	5,427	5,363
Office supplies and postage	1,466	1,566	4,664	4,579
Business development and marketing	1,764	1,973	5,424	5,256
FDIC insurance premiums	952	923	2,918	2,923
Acquisition expenses and litigation settlement	2,800	71	2,923	76
Other	3,772	3,631	10,404	10,553
Total noninterest expenses	\$58,811	\$55,044	\$169,896	\$163,972
Operating expenses(1)/average assets	2.92%	2.99%	2.96%	2.99%
Efficiency ratio(2)	57.0%	58.6%	57.7%	59.6%

- (1) Operating expenses is calculated as total noninterest expenses less acquisition expenses, amortization of intangibles and litigation settlement.
- (2) Efficiency ratio is calculated as operating expenses as defined in (1) divided by net interest income on a fully tax-equivalent basis plus noninterest income less gains and losses on investment securities and debt extinguishments.

As shown in Table 5, operating expenses were \$58.8 million and \$169.9 million for the third quarter and YTD periods of 2014, respectively, an increase of \$3.8 million or 6.8% and \$5.9 million or 3.6% from the prior year periods, respectively. Included in third quarter 2014 operating expenses is a \$2.8 million litigation settlement charge. Excluding the litigation settlement charge, operating expenses for the quarter and year-to-date periods were \$56.0 million and \$167.1 million, respectively, an increase of \$1.0 million or 1.8% from the third quarter of 2013 and an increase of \$3.1 million or 1.9% as compared to the first nine months of 2013, primarily reflective of additional operating costs associated with the eight branches acquired from B of A in December of 2013. Salaries and employee benefits increased \$0.5 million or 1.6% and \$0.9 million or 1.0% for the third quarter and YTD periods of 2014, respectively as compared to the comparable periods of 2013. Merit-based personnel cost increases were offset by lower defined benefit plan costs of \$1.0 million for the quarter and \$3.3 million for the YTD period related to the combination of strong plan asset performance and higher pension discount rates. Additional changes to operating expenses can be attributable to higher occupancy and equipment (up \$0.2 million for the quarter and up \$1.0 million YTD), and data processing and communications (up \$0.5 million for the quarter and \$1.2 million YTD). The aforementioned acquisitions had an impact on the increases of each of these expense categories, reflecting the additional cost of operating an expanded franchise. Additionally contributing to the higher occupancy and equipment costs were higher weather-related maintenance and utility costs for the first quarter of 2014 as compared to the first quarter of 2013. The litigation settlement charge pertains to class action lawsuits involving the sufficiency of consumer notice requirements for certain of the Company's collateral recovery activities. The Company contests the allegations and asserted affirmative defenses to the claims, however, the settlement the Company was able to achieve was, in its judgment, a superior outcome for the shareholders when measured against the risks and resources required for litigation. The settlement is subject to final court approval.

The Company's efficiency ratio (total operating expenses excluding intangible amortization, acquisition expenses and litigation settlement charge divided by the sum of net interest income (FTE) and noninterest income excluding gains/(losses) on investment securities and debt extinguishment costs) was 57.0% for the third quarter, 1.6 percentage points favorable to the comparable quarter of 2013. This improvement resulted from operating income increasing 4.9%, driven by solid growth in noninterest income and net interest income, while operating expenses (as described above) increased at a lower 2.0% rate. The efficiency ratio of 57.7% for the first nine of 2014 was 1.9 percentage points favorable as compared to the first nine months of 2013 due to operating income increasing at a 5.3% rate, while core operating expenses increased at a slower 2.0% rate. Operating expenses, excluding intangible amortization, acquisition expenses and litigation settlement, as a percentage of average assets decreased seven basis points and three basis points versus the prior year quarter and year-to-date periods, respectively. Operating expenses (as defined above) increased 2.0% for the quarterly and year-to-date periods, while average assets increased at a faster 4.2% pace for the quarter and 3.1% for the year-to-date period, benefitting from the B of A acquisition and organic loan growth.

Income Taxes

The third quarter and YTD 2014 effective income tax rates were 29.9% and 29.8%, respectively, as compared to the 29.2% effective tax rate for both of the comparable periods of 2013, reflective of a higher proportion of income being generated from fully taxable sources.

Investments

The carrying value of investments (including unrealized gains and losses on available-for-sale securities) was \$2.51 billion at the end of the third quarter, an increase of \$287.5 million from December 31, 2013 and a decrease of \$12.3 million from September 30, 2013. The book value (excluding unrealized gains and losses) of investments increased \$212.3 million from December 31, 2013 and decreased \$60.4 million from September 30, 2013. As part of the ongoing asset/liability management process, the Company had been evaluating the opportunity to restructure certain portions of the balance sheet. During the first half of 2013, the Company initiated a balance sheet restructuring

program through the sale of certain longer duration investment securities and retired a portion of the Company's existing FHLB borrowings. During the first six months of 2013, the Company sold \$648.7 million of U.S. Treasury and Agency securities, realizing \$63.8 million of gains that supported the retirement of \$501.6 million of FHLB borrowings. These actions enhanced the Company's regulatory capital position and reduced the expected duration of the investment portfolio, while positively impacting expected future net interest income generation. During the second and third quarters of 2013, the Company purchased \$525 million of U.S. Treasury securities in anticipation of the excess funding expected from the pending branch acquisition and certain other expected cash flows.

In late December 2013, the Company sold its entire portfolio, \$56.2 million, of bank and insurance trust preferred CDO securities in response to the uncertainties created by the announcement of the final rules implementing Section 619 of the Dodd-Frank Act, commonly known as the "Volcker Rule", recognizing a \$15.5 million loss. In conjunction with the liquidation of the trust preferred CDOs, the Company extinguished \$226.4 million of FHLB term advances and sold \$417.6 million of U.S. Treasury securities, previously classified as held-to-maturity, at a gain of \$32.4 million. The Company also reinvested the net cash proceeds of \$246 million created from these transactions into U.S. Treasury securities with similar blended durations to the assets sold in order to mitigate the net interest income impact of the security sales and debt extinguishment. As a result of the securities sold from the held-to-maturity classification, the remaining unsold securities within the held-to-maturity classification were transferred to the available-for-sale classification prior to December 31, 2013. As a result of the transaction, the Company will not be able to use the held-to-maturity classification for the foreseeable future. During the first nine months of 2014, the Company purchased another \$225 million of U.S. Treasury securities.

With these transactions, the overall mix of securities within the portfolio over the last twelve months has changed, with an increase in the proportion of U.S. Treasury and Agency securities and a decrease in the proportion of obligations of state and political subdivisions and pooled trust preferred securities. The change in the carrying value of investments is also impacted by the amount of net unrealized gains in the available-for-sale portfolio at a point in time. At September 30, 2014, the portfolio had a \$44.2 million net unrealized gain, an increase of \$75.2 million from the unrealized loss at December 31, 2013 and a \$48.1 million increase from the unrealized loss at September 30, 2013. These changes in the unrealized gain (loss) are indicative of the sale of securities in 2013 as well as the recent decline in longer-term interest rates.

Table 6: Investment Securities

(000's omitted)	September 30, 2014		December 31, 2013		September 30, 2013	
	Amortized Cost/Book Value	Fair Value	Amortized Cost/Book Value	Fair Value	Amortized Cost/Book Value	Fair Value
Held-to-Maturity Portfolio:						
U.S. Treasury and agency securities	\$0	\$0	\$0	\$0	\$540,649	\$576,485
Obligations of state and political subdivisions	0	0	0	0	61,638	64,501
Government agency mortgage-backed securities	0	0	0	0	12,706	12,746
Corporate debt securities	0	0	0	0	2,909	2,948
Other securities	0	0	0	0	8	8
Total held-to-maturity portfolio	0	0	0	0	617,910	656,688
Available-for-Sale Portfolio:						
U.S. Treasury and agency securities	1,476,678	1,486,627	1,252,332	1,212,147	888,404	877,272
Obligations of state and political subdivisions	662,742	688,334	665,441	668,982	621,802	625,995
Government agency mortgage-backed securities	236,819	244,122	250,431	254,978	238,348	244,899
Pooled trust preferred securities	0	0	0	0	56,540	51,251
Corporate debt securities	26,835	27,287	26,932	27,587	24,055	24,807
	18,394	19,130	21,779	22,048	22,996	23,936

Government agency collateralized mortgage obligations						
Marketable equity securities	250	431	250	421	351	492
Total available-for-sale portfolio	2,421,718	2,465,931	2,217,165	2,186,163	1,852,496	1,848,652
Other Securities:						
Federal Home Loan Bank common stock	19,814	19,814	12,053	12,053	31,187	31,187
Federal Reserve Bank common stock	16,050	16,050	16,050	16,050	16,050	16,050
Other equity securities	4,447	4,447	4,459	4,459	4,775	4,775
Total other securities	40,311	40,311	32,562	32,562	52,012	52,012
Total investments	\$2,462,029	\$2,506,242	\$2,249,727	\$2,218,725	\$2,522,418	\$2,557,352

Loans

As shown in Table 7, loans ended the third quarter at \$4.22 billion, up \$191.8 million or 4.8% from one year earlier and up \$108.2 million or 2.6% from the end of 2013. The growth during the last twelve months was attributable to strong organic growth in the consumer indirect and direct installment portfolios and moderate growth in consumer mortgage and business lending balances, partially offset by the continued soft demand for home equity loans.

Table 7: Loans

(000's omitted)	September 30, 2014		December 31, 2013		September 30, 2013	
Consumer mortgage	\$1,598,298	37.9%	\$1,582,058	38.5%	\$1,570,607	39.0%
Business lending	1,251,178	29.7%	1,260,364	30.7%	1,214,796	30.2%
Consumer indirect	841,975	20.0%	740,002	18.0%	713,310	17.7%
Consumer direct	186,672	4.4%	180,139	4.4%	178,496	4.4%
Home equity	339,121	8.0%	346,520	8.4%	348,246	8.7%
Total loans	\$4,217,244	100.0%	\$4,109,083	100.0%	\$4,025,455	100.0%

Consumer mortgages increased \$27.7 million or 1.8% from one year ago and increased \$16.2 million or 1.0% from December 31, 2013. Consumer mortgage volume has been strong over the last few years due to historically low long-term rates and comparatively stable real estate valuations in the Company's primary markets. Consumer mortgage volume has slowed during 2014 as the market opportunities for refinancing have declined. The consumer real estate portfolio does not include exposure to Alt-A or other higher-risk mortgage products. The Company chose to retain in portfolio almost all of mortgage production in the first half of 2013 and sold \$15.4 million in the secondary market during the first nine months of 2014. Interest rate levels and expected duration continue to be the most significant factors in determining whether the Company chooses to retain, versus sell and service, portions of its new mortgage production.

The combined total of general-purpose business lending to commercial and industrial customers, mortgages on commercial property and dealer floor plan financing is characterized as the Company's business lending activity. The business lending portfolio increased \$36.4 million from September 30, 2013 and decreased \$9.2 million from December 31, 2013, as contractual and other unscheduled principal reductions continued to offset new loan generation in certain periods. Soft customer demand and highly competitive conditions continue to prevail in the small and middle market segments the Company operates in due primarily to general economic conditions. Further, the Company proactively managed payout of certain unprofitable acquired loan relationships during the last few years. The Company maintains its commitment to generating growth in its business portfolio in a manner that adheres to its twin goals of maintaining strong asset quality and producing profitable margins. The Company continues to invest in additional personnel, technology and business development resources to further strengthen its capabilities in this important product category.

Consumer installment loans, both those originated directly (such as personal installment and lines of credit), and indirectly (originated predominantly in automobile, marine and recreational vehicle dealerships), increased \$136.8 million or 15% on a year-over-year basis and increased \$108.5 million or 11.8% as compared to December 31, 2013. The volume of new and used vehicle sales to upper tier credit profile customers in the Company's primary markets has grown in recent periods. The Company is focused on maintaining the solid profitability produced by its in-market and contiguous market indirect portfolio, while continuing to pursue its disciplined, long-term approach to expanding its dealer network. Market trends predict moderate vehicle sales increases over the prior year levels and this should create opportunity for the Company to continue to produce indirect loan growth.

Home equity loans decreased \$9.1 million or 2.6% from one year ago and decreased \$7.4 million or 2.1% from December 31, 2013, in part due to home equity loans being paid off or down as part of the above average level of mortgage refinancing activity that occurred over the past 24 months in the low rate environment. In addition, home equity utilization has been adversely impacted by the heightened level of consumer deleveraging that is occurring in response to continued low-growth economic conditions.

Asset Quality

Table 8 below exhibits the major components of nonperforming loans and assets and key asset quality metrics for the periods ending September 30, 2014 and 2013 and December 31, 2013.

Table 8: Nonperforming Assets

(000's omitted)	September 30, 2014	December 31, 2013	September 30, 2013
Nonaccrual loans			
Consumer mortgage	\$14,261	\$12,560	\$11,622
Business lending	4,426	4,555	7,705
Consumer indirect	11	14	14
Consumer direct	2	4	4
Home equity	2,623	2,340	2,368
Total nonaccrual loans	21,323	19,473	21,713
Accruing loans 90+ days delinquent			
Consumer mortgage	2,127	1,338	1,971
Business lending	66	164	5
Consumer indirect	115	755	380
Consumer direct	38	117	161
Home equity	344	181	133
Total accruing loans 90+ days delinquent	2,690	2,555	2,650
Nonperforming loans			
Consumer mortgage	16,388	13,898	13,593
Business lending	4,492	4,719	7,710
Consumer indirect	126	769	394
Consumer direct	40	121	165
Home equity	2,967	2,521	2,501
Total nonperforming loans	24,013	22,028	24,363
Other real estate owned (OREO)			
Total nonperforming assets	3,619	5,060	5,218
	\$27,632	\$27,088	\$29,581
Nonperforming loans / total loans	0.57%	0.54%	0.61%
Nonperforming assets / total loans and other real estate	0.65%	0.66%	0.73%
Delinquent loans (30 days old to nonaccruing) to total loans	1.32%	1.49%	1.48%

Net charge-offs to average loans outstanding (quarterly)	0.10%	0.29%	0.15%
Net charge-offs to average legacy loans outstanding (quarterly)	0.11%	0.21%	0.17%
Loan loss provision to net charge-offs (quarterly)	160%	108%	147%
Legacy loan loss provision to net charge-offs (quarterly) (1)	160%	130%	126%

(1) Legacy loans exclude loans acquired after January 1, 2009. These ratios are included for comparative purposes to prior periods.

As displayed in Table 8, nonperforming assets at September 30, 2014 were \$27.6 million, a \$0.5 million increase versus the level at the end of 2013 and a \$1.9 million decrease as compared to one year earlier. Nonperforming loans increased \$2.0 million from year-end 2013 and were down \$0.4 million from September 30, 2013. Other real estate owned ("OREO") at September 30, 2014 of \$3.6 million decreased \$1.4 million from December 31, 2013 and decreased \$1.6 million from September 30, 2013. The Company is managing 36 OREO properties at September 30, 2014 as compared to 46 OREO properties at December 31, 2013 and 39 OREO properties at September 30, 2013. The OREO properties at September 30, 2014 are comprised of 9 commercial real estate properties and 27 residential properties, as compared to 13 commercial properties and 26 residential properties at September 30, 2013. Nonperforming loans were 0.57% of total loans outstanding at the end of the third quarter, three basis points higher than the level at December 31, 2013 and four basis points lower than the level at September 30, 2013.

Approximately 19% of the nonperforming loans at September 30, 2014 are related to the business lending portfolio, which is comprised of business loans broadly diversified by industry type. The level of nonperforming business loans have continued to decline and are now below the Company's longer-term average results as a proportion of total business loans. Approximately 68% of nonperforming loans at September 30, 2014 are related to the consumer mortgage portfolio. Collateral values of residential properties within the Company's market area have generally trended lower over the past few years, although they did not experience the significant decline in values that other parts of the country encountered. However, the continued soft economic conditions and comparatively high unemployment levels have adversely impacted both consumers and businesses, and have resulted in higher mortgage nonperforming levels. Additionally, contributing to the increased level of nonperforming consumer mortgages is the increased length of time required to complete the consumer foreclosure process which is driven by new regulatory requirements. The remaining 13% of nonperforming loans relate to consumer installment and home equity loans with home equity non-performing loan levels being driven by the same factors identified for consumer mortgage. The allowance for loan losses to nonperforming loans ratio, a general measure of coverage adequacy, was 189% at the end of the third quarter, as compared to 201% at year-end 2013 and 181% at September 30, 2013.

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

Delinquent loans (30 days past due through nonaccruing) as a percent of total loans was 1.32% at the end of the third quarter, 17 basis points below the 1.49% at year-end 2013 and 16 basis points lower than the 1.48% at September 30, 2013. The business lending delinquency ratio at the end of the third quarter was consistent with the level at December 31, 2013 and was lower than the level at September 30, 2013. The delinquency rate for consumer direct and consumer indirect loans decreased as compared to both December 31, 2013 and September 30, 2013. The delinquency ratio for consumer mortgages was lower than the level at December 31, 2013, but slightly higher than the level one year ago. The home equity delinquency ratio at the end of the third quarter increased in comparison to both December 31, 2013 and September 30, 2013. The Company's success at keeping the non-performing and delinquency ratios at manageable levels despite soft economic conditions has been the result of its continued focus on maintaining strict underwriting standards, as well as the effective utilization of its collection and recovery capabilities.

Table 9: Allowance for Loan Losses Activity

	Three Months Ended September 30, 2014		Nine Months Ended September 30, 2014	
(000's omitted)	2014	2013	2014	2013
Allowance for loan losses at beginning of period	\$44,615	\$43,473	\$44,319	\$42,888
Charge-offs:				
Consumer mortgage	203	217	734	817
Business lending	445	1,071	970	2,134
Consumer indirect	1,711	1,186	4,573	3,075
Consumer direct	307	348	1,219	1,300
Home equity	74	59	450	379
Total charge-offs	2,740	2,881	7,946	7,705
Recoveries:				
Consumer mortgage	14	2	67	15
Business lending	335	375	607	619
Consumer indirect	1,025	811	2,826	2,682
Consumer direct	239	206	677	761
Home equity	38	4	76	16
Total recoveries	1,651	1,398	4,253	4,093
Net charge-offs	1,089	1,483	3,693	3,612
Provision for loans losses	1,747	2,093	4,647	4,807
Allowance for loan losses at end of period	\$45,273	\$44,083	\$45,273	\$44,083
Allowance for loan losses / total loans	1.07%	1.10%	1.07%	1.10%
Allowance for legacy loan losses / total legacy loans (1)	1.14%	1.16%	1.14%	1.16%
Allowance for loan losses / nonperforming loans	189%	181%	189%	181%
Allowance for legacy loan losses / nonperforming loans (1)	226%	215%	226%	215%
Net charge-offs (annualized) to average loans outstanding:				
Consumer mortgage	0.05%	0.05%	0.06%	0.07%
Business lending	0.03%	0.21%	0.04%	0.16%
Consumer indirect	0.33%	0.22%	0.30%	0.08%
Consumer direct	0.14%	0.31%	0.39%	0.41%
Home equity	0.04%	0.06%	0.15%	0.14%
Total loans	0.10%	0.15%	0.12%	0.12%

(1) Legacy loans exclude loans acquired after January 1, 2009. These ratios are included for comparative purposes to

prior periods.

As displayed in Table 9, net charge-offs during the third quarter of 2014 were \$1.1 million, \$0.4 million lower than the third quarter of 2013. Net charge-offs for the nine months ended September 30, 2014 were \$3.7 million, \$0.1 million higher than the first nine months of 2013. Net charge-offs for the first nine months of 2014 for the business lending and consumer mortgage portfolios decreased as compared to the equivalent prior year period. Net charge-offs for the consumer indirect, consumer direct and home equity portfolios experienced higher levels of net charge-offs in the first nine months of 2014 as compared to the first nine months of 2013. The net charge-off ratio (net charge-offs as a percentage of average loans outstanding) for the third quarter of 2014 was 0.10%, 19 basis points lower than the fourth quarter of 2013 and five basis points lower than the third quarter of 2013, respectively. Net charge-offs and the corresponding net charge-off ratios continue to be below average long-term historical levels.

Provision for loan losses was \$1.7 million in the third quarter, and all of it was associated with legacy loans. The provision was \$0.3 million lower than the equivalent prior year period. The third quarter 2014 loan loss provision was \$0.7 million higher than the level of net charge-offs for the quarter, reflective of the growth in certain loan categories and the continuation of generally stable and favorable asset quality metrics. The allowance for loan losses of \$45.3 million as of September 30, 2014 increased \$1.2 million from the level one year ago, reflective of a larger loan portfolio. The increased proportion of lower-risk consumer loans in the portfolio, along with lower net charge off ratios have resulted in an allowance for loan loss to total legacy loans ratio of 1.14% at September 30, 2014, two basis points lower than September 30, 2013 and December 31, 2013.

As of September 30, 2014, the purchase discount related to the \$290 million of remaining non-impaired loan balances acquired from HSBC Bank USA, N.A., First Niagara Bank, N.A. and Wilber National Bank approximated \$9.7 million or 3.3% of that portfolio, with an additional \$0.2 million included in the allowance for loan losses for acquired loans where the carrying value exceeded the estimated net recoverable value.

Deposits

As shown in Table 10, average deposits of \$5.95 billion in the third quarter were up \$303.6 million compared to the third quarter of 2013 and increased \$256.4 million versus the fourth quarter of last year. The mix of average deposits has been changing throughout the last several years. The weightings of core deposits (noninterest checking, interest checking, savings and money markets accounts) have increased from their year-ago levels, while the proportion of time deposits decreased. This change in deposit mix reflects the Company's goal of expanding core account relationships and reducing higher cost time deposit balances, as well as the preference of certain customers to hold more funds in liquid accounts in the low interest rate environment. This shift in mix, combined with the Company's ability to reduce rates due to market conditions, resulted in the quarterly cost of interest-bearing deposits declining from 0.22% in the third quarter of 2013 to 0.17% in the most recent quarter. The Company continues to focus heavily on growing its core deposit relationships through its proactive marketing efforts, competitive product offerings and high quality customer service.

Average third quarter non-public fund deposits increased \$241.1 million or 4.7% versus the fourth quarter of 2013 and increased \$253.4 million or 4.9% compared to the year earlier period. Average public fund deposits for the third quarter increased \$15.3 million, or 2.8%, from the fourth quarter of 2013 and \$50.2 million or 9.7%, from the third quarter of 2013. Public fund deposits as a percentage of total deposits increased from 9.1% in the third quarter of 2013 to 9.5% in the third quarter 2014.

Table 10: Quarterly Average Deposits

	September 30, 2014	December 31, 2013	September 30, 2013
(000's omitted)			
Noninterest checking deposits	\$1,281,626	\$1,149,873	\$1,138,039
Interest checking deposits	1,331,239	1,238,414	1,191,928
Regular savings deposits	1,048,057	999,274	999,293
Money market deposits	1,469,215	1,426,707	1,400,342
Time deposits	822,705	882,196	919,636
Total deposits	\$5,952,842	\$5,696,464	\$5,649,238
Nonpublic fund deposits	\$5,386,604	\$5,145,532	\$5,133,202
Public fund deposits	566,238	550,932	516,036
	\$5,952,842	\$5,696,464	\$5,649,238

Total
deposits

Borrowings

At the end of the third quarter, external borrowings of \$445.9 million were \$201.9 million or 83% higher than borrowings at December 31, 2013, and were \$223.3 million lower than the end of the third quarter of 2013. Short term borrowings from the FHLB were used to fund the purchase of investment securities during the first nine months of 2014. As part of the ongoing asset liability management process, the Company had been evaluating the opportunity to restructure certain portions of the balance sheet. During the first half of 2013, the Company initiated a balance sheet restructuring program through the sale of certain longer duration investment securities and retired \$501.6 million of the Company's existing FHLB borrowings with \$63.5 million of early extinguishment costs. These actions combined with the sale of investment securities with offsetting gains improved the Company's regulatory capital position and positively impacted net interest income generation. During the second and third quarter of 2013, the Company used \$300 million of short-term borrowings to purchase U.S. Treasury securities in anticipation of the excess funding expected from the pending branch acquisition in the fourth quarter of 2013. In December, in conjunction with the liquidation of the trust preferred CDOs, the Company extinguished an additional \$226 million of FHLB advances with \$23.8 million of early extinguishment costs. The 0.87% cost of funds on total borrowings in the third quarter was 115 basis points lower than the year-earlier period due to the balance sheet restructuring and a higher level of overnight borrowings.

Shareholders' Equity

Total shareholders' equity of \$965.5 million at the end of the third quarter increased \$89.7 million from the balance at December 31, 2013. This increase consisted of a \$47.2 million increase in other comprehensive income, net income of \$68.2 million, \$6.1 million from shares issued under the employee stock plan and \$3.1 million from employee stock options earned, partially offset by dividends declared of \$34.9 million. The change in other comprehensive income/(loss) was comprised of a \$47.4 million increase in the after-tax market value adjustment on the available for sale investment portfolio, partially offset by a negative \$0.2 million adjustment to the funded status of the Company's retirement plans. Over the past 12 months, total shareholders' equity increased by \$99.8 million, as net income, a higher market value adjustment on investments, the change in the funded status of the Company's defined benefit pension and other postretirement plans and the issuance of common stock more than offset dividends declared.

The Company's Tier I leverage ratio, a primary measure of regulatory capital for which 5% is the requirement to be "well-capitalized", was 9.79% at the end of the third quarter, up 50 basis points from year-end 2013 and 40 basis points higher than its level one year earlier. The increase in the Tier I leverage ratio compared to December 31, 2013 is the result of shareholders' equity excluding intangibles and other comprehensive income items increasing 7.4%, primarily from net earnings retention, while average assets excluding intangibles and the market value adjustment on investments increased at a slower 1.9% pace. The Tier I leverage ratio increased as compared to the prior year's third quarter as shareholders' equity, excluding intangibles and other comprehensive income increased 7.9% due to strong earnings retention, while average assets excluding intangibles and the market value adjustment increased 3.5%, driven by the B of A branch acquisition and solid organic loan growth. The net tangible equity-to-assets ratio (a non-GAAP measure) of 8.57% increased 89 basis points from December 31, 2013 and 119 basis points versus September 30, 2013. The increase in the tangible equity ratio from the prior year was mostly attributable to a proportionally larger increase in tangible equity than the increase in tangible asset levels due to income generation, a higher investment market value adjustment and the balance sheet restructuring conducted in 2013.

The dividend payout ratio (dividends declared divided by net income) for the first nine months of 2014 was 51.2%, down from 51.8% for the nine months ended September 30, 2013. September 2014 YTD net income increased 7.7% over the prior year period, while dividends declared increased 6.4%. The Company's quarterly dividend per share was raised from \$0.28 to \$0.30 in July 2014 and the number of common shares outstanding increased 1.0% over the last twelve months. This marks the Company's 22nd consecutive year of increased dividend payouts to shareholders.

Liquidity

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

Given the uncertain nature of our customers' demands as well as the Company's desire to take advantage of earnings enhancement opportunities, the Company must have 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 and borrowings from the FHLB and the Federal Reserve Bank of New York. Other funding alternatives may also be appropriate from time to time, including wholesale and retail repurchase agreements, large certificates of deposit and the brokered CD market. The primary source of non-deposit funds are FHLB advances, of which \$344 million are outstanding.

The Bank's primary sources of liquidity are its liquid assets, as well as unencumbered securities that can be used to collateralize additional funding. At September 30, 2014, the Bank had \$157 million of cash and cash equivalents of which \$18 million are interest earning deposits held at the Federal Reserve, FHLB and other correspondent banks. The Bank also had \$822 million in unused FHLB borrowing capacity based on the Company's quarter-end collateral levels. Additionally, the Company has \$1.5 billion of unencumbered securities that could be pledged at the FHLB or Federal Reserve to obtain additional funding. There is \$25 million available in unsecured lines of credit with other correspondent banks.

The Company's primary approach to measuring short-term liquidity is known as the Basic Surplus/Deficit model. It is used to calculate liquidity over two time periods: first, the amount of cash that could be made available within 30 days (calculated as liquid assets less short-term liabilities as a percentage of average assets); and second, a projection of subsequent cash availability over an additional 60 days. As of September 30, 2014, this ratio was 19.7% for 30-days and 19.5% for 90-days, excluding the Company's capacity to borrow additional funds from the FHLB and other sources. There is a sufficient amount of liquidity given the Company's internal policy requirement of 7.5%.

A sources and uses statement is used by the Company to measure intermediate liquidity risk over the next twelve months. As of September 30, 2014, there is more than enough liquidity available during the next year to cover projected cash outflows. In addition, stress tests on the cash flows are performed in various scenarios ranging from high probability events with a low impact on the liquidity position to low probability events with a high impact on the liquidity position. The results of the stress tests as of September 30, 2014 indicate the Bank has sufficient sources of funds for the next year in all stressed scenarios.

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

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

A short-term funding crisis would most likely result from a shock to the financial system, either internal or external, which disrupts orderly short-term funding operations. Such a crisis 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 potential circumstances have been fully addressed through detailed action plans and the establishment of trigger points for monitoring such events.

Forward-Looking Statements

This document contains comments or information that constitute forward-looking statements (within the meaning of the Private Securities Litigation Reform Act of 1995), which involve significant risks and uncertainties. Forward-looking statements often use words such as “anticipate,” “target,” “expect,” “estimate,” “intend,” “plan,” “goal,” “believe,” or other words of similar meaning. Actual results may differ materially from the results discussed in the forward-looking statements. Moreover, the Company’s plans, objectives and intentions are subject to change based on various factors (some of which are beyond the Company’s control). Factors that could cause actual results to differ from those discussed in the forward-looking statements include: (1) risks related to credit quality, interest rate sensitivity and liquidity; (2) the strength of the U.S. economy in general and the strength of the local economies where the Company conducts its business; (3) the effect of, and changes in, monetary and fiscal policies and laws, including interest rate policies of the Board of Governors of the Federal Reserve System; (4) inflation, interest rate, market and monetary fluctuations; (5) the timely development of new products and services and customer perception of the overall value thereof (including, but not limited to, features, pricing and quality) compared to competing products and services; (6) changes in consumer spending, borrowing and savings habits; (7) technological changes and implementation and cost/financial risks with respect to transitioning to new computer and technology based systems involving large multi-year contracts; (8) the ability of the Company to maintain the security of its financial, accounting, technology, data processing and other operating systems and facilities; (9) any acquisitions or mergers that might be considered or consummated by the Company and the costs and factors associated therewith, including differences in the actual financial results of the acquisition or merger compared to expectations and the realization of anticipated cost savings and revenue enhancements; (10) the ability to maintain and increase market share and control expenses; (11) the nature, timing and effect of changes in banking regulations or other regulatory or legislative requirements affecting the respective businesses of the Company and its subsidiaries, including changes in laws and regulations concerning taxes, accounting, banking, securities and other aspects of the financial services industry, specifically the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010; (12) changes in the Company’s organization, compensation and benefit plans and in the availability of, and compensation levels for, employees in its geographic markets; (13) the outcome of pending or future litigation and government proceedings; (14) other risk factors outlined in the Company’s filings with the SEC from time to time; and (15) the success of the Company at managing the risks of the foregoing.

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

Item 3. Quantitative and Qualitative Disclosures about Market Risk

Market risk is the risk of loss in a financial instrument arising from adverse changes in market rates, prices or credit risk. Credit risk associated with the Company's loan portfolio has been previously discussed in the asset quality section of the MD&A. Management believes that the tax risk of the Company's municipal investments associated

with potential future changes in statutory, judicial and regulatory actions is minimal. Treasury, agency, mortgage-backed and CMO securities issued by government agencies comprise 72% of the total portfolio and are currently rated AAA by Moody's Investor Services and AA+ by Standard & Poor's. Municipal and corporate bonds account for 28% of the total portfolio, of which, 98% carry a minimum rating of A-. The remaining 2% of the portfolio is comprised of other investment grade securities. The Company does not have material foreign currency exchange rate risk exposure. Therefore, almost all the market risk in the investment portfolio is related to interest rates.

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

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

- Asset and liability levels using September 30, 2014 as a starting point.
- There are assumed to be conservative levels of balance sheet growth, low to mid single digit growth in loans and deposits, while using the cash flows from investment contractual maturities and prepayments to repay short-term capital market borrowings or reinvest into securities or cash equivalents.
- The prime rate and federal funds rates are assumed to move up 200 basis points over a 12-month period while moving the long end of the treasury curve to spreads over federal funds that are more consistent with historical norms (normalized yield curve). In the 0 basis point model, the prime and federal funds rates remain at current levels while moving the long end of the curve to levels over federal funds using spreads at a time when the yield curve was flat. Deposit rates are assumed to move in a manner that reflects the historical relationship between deposit rate movement and changes in the federal funds rate.
- Cash flows are based on contractual maturity, optionality, and amortization schedules along with applicable prepayments derived from internal historical data and external sources.

Net Interest Income Sensitivity Model

	Calculated annualized decrease in projected net interest income
Change in interest rates	at September 30, 2014
+200 basis points	(\$5,819,000)
0 basis points	(\$652,000)

The modeled net interest income (NII) decreases in a rising rate environment from a flat rate scenario. The decrease is largely a result of assumed deposit and funding costs increasing faster than the repricing of corresponding assets. In the short term (years 1-2) the assumed increase of deposit rates in the rising rate environment temporarily outweighs the benefit of earning asset yields increasing to higher levels. However, over a longer time period (year 3-5), the growth in NII improves significantly in a rising rate environment as lower yielding assets mature and are replaced at higher rates.

In the 0 basis point model, the Bank shows interest rate risk exposure if the yield curve continues to flatten. Net interest income declines during the first twelve months largely from additional investment cash flows that are assumed to repay short term advances. Corresponding deposit rates are assumed to remain constant. Despite Fed Funds trading near 0%, the Company believes long-term Treasury rates could potentially fall further in this scenario, and thus, the model tests the impact of this lower Treasury rate scenario.

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

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

The Company maintains disclosure controls and procedures, as defined in Rule 13a -15(e) and 15d – 15(e) under the Securities Exchange Act of 1934 as amended (the “Exchange Act”), designed to ensure information required to be disclosed by the Company in the reports that it files or submits under the Exchange Act is: (i) recorded, processed, summarized, and reported within the time periods specified in the SEC rules and forms, and (ii) accumulated and communicated to management, including the principal executive and principal financial officers, as appropriate, to allow timely decisions regarding required disclosure. Based on management’s evaluation of the effectiveness of the Company’s disclosure controls and procedures, with the participation of the Chief Executive Officer and the Chief Financial Officer, it has concluded that, as of the end of the period covered by this Quarterly Report on Form 10-Q, these disclosure controls and procedures were effective as of September 30, 2014.

Changes in Internal Control over Financial Reporting

The Company regularly assesses the adequacy of its internal controls over financial reporting. There have been no changes in the Company’s internal controls over financial reporting in connection with the evaluation referenced in the paragraph above that occurred during the Company’s quarter ended September 30, 2014 that have materially affected, or are reasonably likely to materially affect, the Company’s internal control over financial reporting.

Part II. Other Information

Item 1. Legal Proceedings

The Company and its subsidiaries are subject in the normal course of business to various pending and threatened legal proceedings in which claims for monetary damages are asserted. As of September 30, 2014, management, after consultation with legal counsel, does not anticipate that the aggregate ultimate liability arising out of litigation pending or threatened against the Company or its subsidiaries will be material to the Company's consolidated financial position. On at least a quarterly basis the Company assesses its liabilities and contingencies in connection with such legal proceedings. For those matters where it is probable that the Company will incur losses and the amounts of the losses can be reasonably estimated, the Company records an expense and corresponding liability in its consolidated financial statements. To the extent the pending or threatened litigation could result in exposure in excess of that liability, the amount of such excess is not currently estimable. The range of reasonably possible losses for matters where an exposure is not currently estimable or considered probable, beyond the existing recorded liabilities, is between \$0 and \$1 million in the aggregate. Although the Company does not believe that the outcome of pending litigation will be material to the Company's consolidated financial position, it cannot rule out the possibility that such outcomes will be material to the consolidated results of operations for a particular reporting period in the future.

The Bank reached a settlement in two class actions pending in the United States District Court for the Middle District of Pennsylvania which were commenced October 30, 2013 and May 29, 2014, respectively. The first action alleged that notices provided by the Bank in connection with the repossession of the named plaintiff's automobile failed to comply with certain requirements of the Pennsylvania and New York Uniform Commercial Code (UCC) and related statutes. The plaintiff sought to pursue the action as a class action on behalf of herself and similarly situated plaintiffs who had their automobiles repossessed and sought to recover statutory damages under the UCC. The second action filed May 29, 2014 contained similar allegations, which the plaintiff also sought to pursue as a class action for statutory damages. In both cases, the Bank contested the allegations that the notices were deficient, asserted various legal defenses and counterclaims, and opposed class certification in both of the cases. On September 30, 2014, the Bank reached an agreement in principle to settle both actions for \$2.8 million in exchange for releases of all claims. The settlement is subject to final documentation, notice to the class members and Court approval. A litigation settlement charge of \$2.8 million with respect to the settlement of the class actions was recorded in the third quarter.

Item 1A. Risk Factors

There has not been any material change in the risk factors disclosure from that contained in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2013 filed with the SEC on March 3, 2014.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

a) Not applicable.

b) Not applicable.

c) At its December 2013 meeting, the Company's Board approved a new repurchase program authorizing the repurchase of up to 2,000,000 of its outstanding shares in open market or privately negotiated transactions in accordance with securities laws and regulations, through December 31, 2014. Any repurchased shares will be used for general corporate purposes, including those related to stock plan activities. The timing and extent of repurchases will depend on market conditions and other corporate considerations as determined at the Company's discretion.

The following table presents stock purchases made during the third quarter of 2014:
Issuer Purchases of Equity Securities

Period	Total Number of Shares Purchased	Average Price Paid Per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number of Shares That May Yet Be Purchased Under the Plans or Programs
July 1-31, 2014	0	\$ 0.00	0	2,000,000
August 1-31, 2014 (1)	349	35.96	0	2,000,000
September 1-30, 2014	0	0.00	0	2,000,000
Total	349	\$35.96		2,000,000

(1) The common shares repurchased were acquired by the Company in connection with satisfaction of tax withholding obligations on vested restricted stock issued pursuant to an employee benefit plan. These shares were not repurchased as part of the publicly announced repurchase plan described above.

Item 3. Defaults Upon Senior Securities
Not applicable.

Item 4. Mine Safety Disclosures

Not applicable.

Item 5. Other Information

Not applicable.

Item 6. Exhibits

Exhibit No.	Description
31.1	Certification of Mark E. Tryniski, President and Chief Executive Officer of the Registrant, pursuant to Rule 13a-15(e) or Rule 15d-15(e) under the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. (1)
31.2	Certification of Scott Kingsley, Treasurer and Chief Financial Officer of the Registrant, pursuant to Rule 13a-15(e) or Rule 15d-15(e) under the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. (1)
32.1	Certification of Mark E. Tryniski, President and Chief Executive Officer of the Registrant, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. (2)
32.2	Certification of Scott Kingsley, Treasurer and Chief Financial Officer of the Registrant, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. (2)
101	Interactive data files pursuant to Rule 405 of Regulation S-T: (i) the Consolidated Statements of Condition, (ii) the Consolidated Statements of Income, (iii) the Consolidated Statements of Comprehensive Income, (iv) the Consolidated Statements of Changes in Stockholders' Equity, (v) the Consolidated Statements of Cash Flows, and (vi) the Notes to Consolidated Financial Statements tagged as blocks of text and in detail.(3)

(1) Filed herewith.

(2) Furnished herewith.

(3) XBRL (Extensible Business Reporting Language) information is furnished and not filed or a part of a registration statement or prospectus for purposes of sections 11 or 12 of the Securities Act of 1933,

is deemed not filed for purposes of section 18 of the Securities Exchange Act of 1934, and otherwise is not subject to liability under these sections.

Signatures

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Community Bank System, Inc.

Date: November 7, 2014

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

Date: November 7, 2014

/s/ Scott Kingsley
Scott Kingsley, Treasurer and Chief
Financial Officer

