COMMUNITY BANK SYSTEM, INC.
Form 10-Q
November 09, 2018

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, 2018

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from___________ to_____________________ .

Commission File Number: 001-13695

(Exact name of registrant as specified in its charter)

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

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

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

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

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted 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 such files). Yes No .

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

Large accelerated filer	Accelerated filer
Non-accelerated filer	Smaller reporting company .
	Emerging growth company .

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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. 51,186,421 shares of Common Stock, $1.00 par value per share, were outstanding on October 31, 2018.

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Part I. Financial Information

Item 1. Financial Statements

COMMUNITY BANK SYSTEM, INC.

CONSOLIDATED STATEMENTS OF CONDITION (Unaudited)

(In Thousands, Except Share Data)

	September 30, 2018	December 31, 2017
Assets:		
Cash and cash equivalents	$ 256,838	$ 221,038
Available-for-sale investment securities (cost of $2,957,819 and $3,007,148, respectively)	2,904,779	3,031,088
Equity and other securities (cost of $42,281 and $50,291, respectively)	43,278	50,291
Loans held for sale, at fair value	0	461
Loans	6,300,888	6,256,757
Allowance for loan losses	(50,133)	(47,583)
Net loans	6,250,755	6,209,174
Goodwill, net	733,479	734,430
Core deposit intangibles, net	20,112	25,025
Other intangibles, net	58,109	65,633
Intangible assets, net	811,700	825,088
Premises and equipment, net	120,273	123,393
Accrued interest and fees receivable	34,594	36,177
Other assets	237,350	249,488
Total assets	$ 10,659,567	$ 10,746,198
Liabilities:		
Noninterest-bearing deposits	$ 2,346,932	$ 2,293,057
Interest-bearing deposits	6,116,889	6,151,363
Total deposits	8,463,821	8,444,420
Short-term borrowings	0	24,000
Securities sold under agreement to repurchase, short-term	274,561	337,011
Other long-term debt	1,998	2,071
Subordinated debt held by unconsolidated subsidiary trusts	97,939	122,814
Accrued interest and other liabilities	152,903	180,567
Total liabilities	8,991,222	9,110,883
Commitments and contingencies (See Note J)		
Shareholders' equity:		
Preferred stock, $1.00 par value, 500,000 shares authorized, 0 shares issued	0	0
Common stock, $1.00 par value, 75,000,000 shares authorized; 51,547,253 and 51,263,841 shares issued, respectively	51,547	51,264
Additional paid-in capital	907,690	894,879

Retained earnings	774,403	700,557
Accumulated other comprehensive loss	(62,142)	(3,699)
Treasury stock, at cost (410,577 shares including 206,151 shares held by deferred compensation arrangements at September 30, 2018, and 567,764 shares including 237,494 shares held by deferred compensation arrangements at December 31, 2017, respectively)	(14,803)	(21,014)
Deferred compensation arrangements (206,151 and 237,494 shares, respectively)	11,650	13,328
Total shareholders' equity	1,668,345	1,635,315
Total liabilities and shareholders' equity	$ 10,659,567	$ 10,746,198

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

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2018	2017	2018	2017
Interest income:				
Interest and fees on loans	$ 72,256	$ 69,498	$ 212,849	$ 184,233
Interest and dividends on taxable investments	15,421	15,228	47,462	43,969
Interest on nontaxable investments	3,226	3,761	10,001	11,665
Total interest income	90,903	88,487	270,312	239,867
Interest expense:				
Interest on deposits	2,764	2,123	7,277	5,918
Interest on borrowings	796	902	1,722	1,443
Interest on subordinated debt held by unconsolidated subsidiary trusts	1,145	1,067	3,645	2,808
Total interest expense	4,705	4,092	12,644	10,169
Net interest income	86,198	84,395	257,668	229,698
Provision for loan losses	2,215	2,314	8,342	5,603
Net interest income after provision for loan losses	83,983	82,081	249,326	224,095
Noninterest revenues:				
Deposit service fees	16,127	18,419	54,268	49,781
Other banking services	1,536	1,704	3,942	4,270
Employee benefit services	23,265	20,767	68,813	58,618
Insurance services	8,270	6,344	23,044	19,709
Wealth management services	6,168	5,707	19,370	16,105
Unrealized gain on equity securities	743	0	722	0
Loss on debt extinguishment	(318)	0	(318)	0
Gain on sales of investment securities	0	0	0	2
Total noninterest revenues	55,791	52,941	169,841	148,485
Noninterest expenses:				
Salaries and employee benefits	51,062	48,426	155,323	137,897
Occupancy and equipment	9,770	9,106	29,738	25,939
Data processing and communications	10,509	9,313	29,463	28,229
Amortization of intangible assets	4,427	4,949	13,780	11,980
Legal and professional fees	2,522	2,764	8,047	7,796
Business development and marketing	2,587	2,586	7,301	7,119
Acquisition expenses	(832)	580	(769)	25,192
Other expenses	5,188	6,052	14,793	16,078
Total noninterest expenses	85,233	83,776	257,676	260,230
Income before income taxes	54,541	51,246	161,491	112,350
Income taxes	11,435	16,003	33,673	33,659
Net income	$ 43,106	$ 35,243	$ 127,818	$ 78,691
Basic earnings per share	$ 0.84	$ 0.69	$ 2.49	$ 1.62

Diluted earnings per share	$ 0.83	$ 0.68	$ 2.46	$ 1.60
Cash dividends declared per share	$ 0.38	$ 0.34	$ 1.06	$ 0.98

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

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

	Three Months Ended September 30, 2018	Three Months Ended September 30, 2017	Nine Months Ended September 30, 2018	Nine Months Ended September 30, 2017
Pension and other post retirement obligations:				
Amortization of actuarial losses included in net periodic pension cost, gross	$304	$150	$910	$625
Tax effect	(74)	(57)	(221)	(240)
Amortization of actuarial losses included in net periodic pension cost, net	230	93	689	385
Amortization of prior service cost included in net periodic pension cost, gross	(105)	(32)	(359)	(91)
Tax effect	25	12	87	35
Amortization of prior service cost included in net periodic pension cost, net	(80)	(20)	(272)	(56)
Initial projected benefit obligation recognized upon plan adoption, gross (See Note H)	(775)	0	(775)	0
Tax effect	189	0	189	0
Initial projected benefit obligation recognized upon plan adoption, net	(586)	0	(586)	0
Unamortized actuarial gain due to plan merger, gross (See Note H)	0	0	0	1,858
Tax effect	0	0	0	(710)
Unamortized actuarial gain due to plan merger, net	0	0	0	1,148
Other comprehensive (loss) income related to pension and other post retirement obligations, net of taxes	(436)	73	(169)	1,477
Unrealized (losses) gains on available-for-sale securities:				
Net unrealized holding (losses)/gains arising during period, gross	(20,094)	(2,490)	(76,705)	11,163
Tax effect	4,879	952	18,639	(4,306)
Net unrealized holding (losses)/gains arising during period, net	(15,215)	(1,538)	(58,066)	6,857
Reclassification of other comprehensive income due to change in accounting principle – equity securities	0	0	(208)	0
Other comprehensive (loss)/income related to unrealized (losses)/gains on available-for-sale securities, net of taxes	(15,215)	(1,538)	(58,274)	6,857
Other comprehensive (loss)/income, net of tax	(15,651)	(1,465)	(58,443)	8,334
Net income	43,106	35,243	127,818	78,691
Comprehensive income	$27,455	$33,778	$69,375	$87,025

	As of September 30, 2018	December 31, 2017
Accumulated Other Comprehensive Loss By Component:		
Unrealized loss for pension and other post-retirement obligations	$ (28,901)	$ (28,677)
Tax effect	7,099	7,044
Net unrealized loss for pension and other post-retirement obligations	(21,802)	(21,633)
Unrealized (loss) gain on available-for-sale securities	(53,040)	23,940

Tax effect	12,908	(6,006)
Reclassification of other comprehensive income due to change in accounting principle – equity securities	(208)	0
Net unrealized (loss) gain on available-for-sale securities	(40,340)	17,934
Accumulated other comprehensive loss	$ (62,142)	$ (3,699)

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

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COMMUNITY BANK SYSTEM, INC.
CONSOLIDATED STATEMENT OF CHANGES IN SHAREHOLDERS' EQUITY (Unaudited)
Nine months ended September 30, 2018
(In Thousands, Except Share Data)

	Common Stock Shares Outstanding	Amount Issued	Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Loss	Treasury Stock	Deferred Compensation Arrangements	Total
Balance at December 31, 2017	50,696,077	$51,264	$894,879	$700,557	$ (3,699)	$ (21,014)	$ 13,328	$1,635,315
Net income				127,818				127,818
Other comprehensive loss, net of tax					(58,235)			(58,235)
Cumulative effect of change in accounting principle – equity securities				208	(208)			0
Cash dividends declared: Common, $1.06 per share				(54,180)				(54,180)
Common stock issued under employee stock ownership plan	283,412	283	5,511					5,794
Stock-based compensation			4,607					4,607
Distribution of stock under deferred compensation arrangements	35,233					1,898	(1,898)	0
Treasury stock issued to benefit plans, net	121,954		2,693			4,313	220	7,226
	51,136,676	$51,547	$907,690	$774,403	$ (62,142)	$ (14,803)	$ 11,650	$1,668,345

Balance at
September 30,
2018

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

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

	Nine Months Ended September 30, 2018		Nine Months Ended September 30, 2017	
Operating activities:				
Net income	$ 127,818		$ 78,691	
Adjustments to reconcile net income to net cash provided by operating activities:				
Depreciation	11,854		12,026	
Amortization of intangible assets	13,780		11,980	
Net accretion on securities, loans and borrowings	(7,141	)	(4,412	)
Stock-based compensation	4,607		3,985	
Provision for loan losses	8,342		5,603	
Amortization of mortgage servicing rights	340		374	
Unrealized gain on equity securities	(722	)	0	
Loss on debt extinguishment	318		0	
Income from bank-owned life insurance policies	(1,177	)	(1,170	)
Net (gain) loss on sale of loans and other assets	(207	)	155	
Change in other assets and other liabilities	8,769		31,624	
Net cash provided by operating activities	166,581		138,856	
Investing activities:				
Proceeds from maturities of available-for-sale investment securities	102,549		110,160	
Proceeds from maturities of other investment securities	8,292		28,580	
Purchases of available-for-sale investment securities	(47,495	)	(59,425	)
Purchases of other securities	(31	)	(12,434	)
Net (increase) decrease in loans	(51,170	)	120,029	
Cash paid for acquisitions, net of cash acquired of $16 and $51,793, respectively	(1,737	)	(105,402	)
Settlement of bank-owned life insurance policies	0		1,779	
Purchases of premises and equipment, net	(8,903	)	(7,701	)
Net cash provided by investing activities	1,505		75,586	
Financing activities:				
Net increase in deposits	19,401		81,630	
Net decrease in borrowings	(86,523	)	(193,602	)
Payments on subordinated debt held by unconsolidated subsidiary trusts	(25,207	)	0	
Issuance of common stock	5,794		3,740	
Purchases of treasury stock	(220	)	(3,226	)
Sales of treasury stock	7,226		7,861	
Increase in deferred compensation arrangements	220		3,226	
Cash dividends paid	(52,006	)	(45,059	)
Withholding taxes paid on share-based compensation	(971	)	(1,389	)
Net cash used in financing activities	(132,286	)	(146,819	)
Change in cash and cash equivalents	35,800		67,623	
Cash and cash equivalents at beginning of period	221,038		173,857	
Cash and cash equivalents at end of period	$ 256,838		$ 241,480	
Supplemental disclosures of cash flow information:				
Cash paid for interest	$ 12,870		$ 10,092	

Cash paid for income taxes	20,674	33,187
Supplemental disclosures of noncash financing and investing activities:		
Dividends declared and unpaid	19,634	17,412
Transfers from loans to other real estate	2,426	2,470
Acquisitions:		
Common stock issued	0	340,737
Fair value of assets acquired, excluding acquired cash and intangibles	115	1,960,922
Fair value of liabilities assumed	31	1,869,854

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

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COMMUNITY BANK SYSTEM, INC.
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)
SEPTEMBER 30, 2018

NOTE A: BASIS OF PRESENTATION

The interim financial data as of and for the three and nine months ended September 30, 2018 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 April 2, 2018, the Company, through its subsidiary, Benefit Plans Administrative Services, Inc. ("BPAS"), acquired certain assets of HR Consultants (SA), LLC ("HR Consultants"), a benefits consulting group headquartered in Puerto Rico. The Company paid $0.3 million in cash to acquire the assets of HR Consultants and recorded intangible assets of $0.3 million in conjunction with the acquisition. The effects of the acquired assets have been included in the consolidated financial statements since that date.

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

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

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

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

On May 12, 2017, the Company completed its acquisition of Merchants Bancshares, Inc. ("Merchants"), parent company of Merchants Bank, headquartered in South Burlington, Vermont, for $345.2 million in Company stock and cash, comprised of $82.9 million in cash and the issuance of 4.68 million shares of common stock. The acquisition extends the Company's footprint into the Vermont and Western Massachusetts markets with the addition of 31 branch locations in Vermont and one location in Massachusetts. This transaction resulted in the acquisition of $2.0 billion of assets, including $1.49 billion of loans and $370.6 million of investment securities, as well as $1.45 billion of deposits and $189.0 million in goodwill. The effects of the acquired assets and liabilities have been included in the consolidated financial statements since that date. Revenues of approximately $14.7 million and $46.8 million from Merchants were included in the consolidated income statement for the three and nine months ended September 30, 2018, respectively. Direct expenses, which may not include certain shared expenses, of approximately $7.4 million and $22.7 million from Merchants were included in the consolidated income statement for the three and nine months ended September 30, 2018, respectively. Revenues of approximately $16.8 million and $25.8 million from Merchants were included in the consolidated income statement for the three and nine months ended September 30, 2017, respectively. Direct expenses, which may not include certain shared expenses, of approximately $7.5 million and $11.5 million from Merchants were included in the consolidated income statement for the three and nine months ended September 30, 2017, respectively.

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

On February 3, 2017, the Company completed its acquisition of Northeast Retirement Services, Inc. (“NRS”) and its subsidiary Global Trust Company (“GTC”), headquartered in Woburn, Massachusetts, for $148.6 million in Company stock and cash. NRS was a privately held corporation focused on providing institutional transfer agency, master recordkeeping services, custom target date fund administration, trust product administration and customized reporting services to institutional clients. Its wholly-owned subsidiary, GTC, is chartered in the State of Maine as a non-depository trust company and provides fiduciary services for collective investment trusts and other products. The acquisition of NRS and GTC, hereafter referred to collectively as NRS, strengthens and complements the Company’s existing employee benefit services businesses. Upon the completion of the merger, NRS became a wholly-owned subsidiary of BPAS and operates as Northeast Retirement Services, LLC, a Delaware limited liability company. This transaction resulted in the acquisition of $36.1 million in net tangible assets, principally cash and certificates of deposit, $60.2 million in customer list intangibles that will be amortized using the 150% declining balance method over 10 years, a $23.0 million deferred tax liability associated with the customer list intangible, and $75.3 million in goodwill. The effects of the acquired assets and liabilities have been included in the consolidated financial statements since that date. Revenues of $10.3 million and $30.1 million from NRS were included in the consolidated statements of income for the three and nine months ended September 30, 2018, respectively. Expenses of $6.1 million and $18.1 million from NRS were included in the consolidated statements of income for the three and nine months ended September 30, 2018, respectively. Revenues of $8.7 million and $22.1 million from NRS were included in the consolidated income statement for the three and nine months ended September 30, 2017, respectively. Expenses of $5.8 million and $15.1 million from NRS were included in the consolidated income statement for the three and nine months ended September 30, 2017, respectively.

On January 1, 2017, the Company, through its subsidiary, OneGroup, acquired certain assets of Benefits Advisory Service, Inc. (“BAS”), a benefits consulting group headquartered in Forest Hills, New York. The Company paid $1.2 million in cash to acquire the assets of BAS and recorded intangible assets of $1.2 million in conjunction with the acquisition. The effects of the acquired assets 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 were subject to adjustment based on updated information not available at the time of acquisition. During the first quarter of 2018, the carrying amount of other liabilities associated with the NRS acquisition decreased by $1.2 million as a result of an adjustment to deferred taxes. Goodwill associated with the NRS acquisition decreased $1.2 million as a result of this adjustment. During the second quarter of 2018, the carrying amount of other liabilities associated with the GBR acquisition decreased by $0.09 million as a result of updated information not available at the time of acquisition. Goodwill associated with the GBR acquisition decreased $0.09 million as a result of this adjustment.

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

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

(000s omitted)	2018 Other [1]	2017 NRS	Merchants	Other [2]	Total
Consideration paid :					
Cash	$ 1,753	$70,073	$82,898	$6,775	$159,746
Community Bank System, Inc. common stock	0	78,483	262,254	2,395	343,132
Total net consideration paid	1,753	148,556	345,152	9,170	502,878
Recognized amounts of identifiable assets acquired and liabilities assumed:					
Cash and cash equivalents	16	11,063	40,730	339	52,132
Investment securities	0	20,294	370,648	0	390,942
Loans	0	0	1,488,157	0	1,488,157
Premises and equipment	10	411	16,608	27	17,046
Accrued interest receivable	0	72	4,773	0	4,845
Other assets	105	8,088	51,585	583	60,256
Core deposit intangibles	0	0	23,214	0	23,214
Other intangibles	1,343	60,200	2,857	5,626	68,683
Deposits	0	0	(1,448,406)	0	(1,448,406)
Other liabilities	(31)	(26,828)	(11,750)	(1,131)	(39,709)
Short-term advances	0	0	(80,000)	0	(80,000)
Securities sold under agreement to repurchase, short-term	0	0	(278,076)	0	(278,076)
Long-term debt	0	0	(3,615)	0	(3,615)
Subordinated debt held by unconsolidated subsidiary trusts	0	0	(20,619)	0	(20,619)
Total identifiable assets, net	1,443	73,300	156,106	5,444	234,850
Goodwill	$ 310	$75,256	$189,046	$3,726	$268,028

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

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

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

(000s omitted)	Acquired Impaired Loans	Acquired Non-impaired Loans	Total Acquired Loans
Contractually required principal and interest at acquisition	$ 15,454	$ 1,872,574	$ 1,888,028
Contractual cash flows not expected to be collected	(5,385)	(14,753)	(20,138)

Expected cash flows at acquisition	10,069	1,857,821	1,867,890
Interest component of expected cash flows	(793)	(378,940)	(379,733)
Fair value of acquired loans	$ 9,276	$ 1,478,881	$ 1,488,157

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

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

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Direct costs related to the acquisitions were expensed as incurred. During the three and nine months ended September 30, 2018, the Company recognized merger and acquisition integration-related recoveries in the amount of $0.8 million due to an adjustment of contract termination expenses related to the Merchants acquisition that have been separately stated in the Consolidated Statements of Income. Merger and acquisition integration-related expenses amount to $0.6 million and $25.2 million during the three and nine months ended September 30, 2017 and have been separately stated in the Consolidated Statements of Income.

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 63 through 71 of the Annual Report on Form 10-K for the year ended December 31, 2017 filed with the Securities and Exchange Commission ("SEC") on March 1, 2018.

Investment Securities

The Company can classify its investments in debt securities as held-to-maturity, available-for-sale, or trading. Held-to-maturity securities are those for which the Company has the positive intent and ability to hold until maturity, and are reported at cost, which is adjusted for amortization of premiums and accretion of discounts. Available-for-sale debt securities are reported at fair value with net unrealized gains and losses reflected as a separate component of shareholders' equity, net of applicable income taxes. Equity securities with a readily determinable fair value are reported at fair value with net unrealized gains and losses recognized in the consolidated statements of income. None of the Company's investment securities have been classified as trading securities at September 30, 2018. Certain equity securities that do not have a readily determinable fair value are stated at cost, less impairment, adjusted for observable price changes in orderly transactions for identical or similar investments of the same issuer. These securities include restricted stock of the Federal Reserve Bank of New York ("Federal Reserve"), the Federal Home Loan Bank of New York and the Federal Home Loan Bank of Boston (collectively referred to as "FHLB"), as well as other equity securities. During the third quarter of 2018, the Company adjusted the carrying value of an equity security without a readily determinable fair value based on observable price changes for identical investments of the same issuer. This adjustment resulted in a $0.8 million unrealized gain on equity securities.

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

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

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

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

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Revenue Recognition

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

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

Deposit Service Fees

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

Other Banking Services

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

Employee Benefit Services

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

Company’s Employee Benefit Services operating segment.

Insurance Services

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

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Wealth Management Services

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

Contract Balances

A contract asset balance occurs when an entity performs a service for a customer before the customer pays consideration (resulting in a contract receivable) or before payment is due (resulting in a contract asset). A contract liability balance is an entity's obligation to transfer a service to a customer for which the entity has already received payment (or payment is due) from the customer. The Company's noninterest revenue streams are largely based on transactional activity, or standard month-end revenue accruals such as asset management fees based on month-end market values. Consideration is often received immediately or shortly after the Company satisfies its performance obligation and revenue is recognized. The Company does not typically enter into long-term revenue contracts with customers, and therefore, does not experience significant contract balances. As of September 30, 2018, $26.9 million of accounts receivable, including $7.9 million of unbilled fee revenue, and $2.9 million of unearned revenue was recorded in the Consolidated Statements of Condition. As of December 31, 2017, $29.8 million of accounts receivable, including $6.5 million of unbilled fee revenue, and $3.9 million of unearned revenue was recorded in the Consolidated Statements of Condition.

Contract Acquisition Costs

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

Recently Adopted Accounting Pronouncements

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

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

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

In March 2017, the FASB issued ASU No. 2017-07, Compensation – Retirement Benefits (Topic 715): Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost. This guidance requires the service cost component of net periodic pension and postretirement benefit costs to be presented separately from other components of net benefit cost in the statement of income. This ASU is effective for the Company for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The Company adopted this guidance on January 1, 2018 and applied the guidance on a modified retrospective basis for the presentation of other components of net periodic benefit cost in the Consolidated Statements of Income. The impact of the adoption of this guidance resulted in the reclassification of net periodic benefit income of $1.9 million and $5.1 million from salaries and employee benefits to other expenses in the Consolidated Statements of Income for the three and nine months ended September 30, 2017, respectively.

New Accounting Pronouncements

In February 2016, the FASB issued ASU 2016-02, Leases (Topic 842). This new guidance supersedes the lease requirements in Topic 840, Leases and is based on the principle that a lessee should recognize in the statement of financial position a liability to make lease payments (the lease liability) and a right-of-use asset representing its right to use the underlying asset for the lease term. The accounting applied by a lessor is largely unchanged from that applied under the previous guidance. In addition, the guidance requires an entity to separate the lease components from the nonlease components in a contract. The ASU requires disclosures about the amount, timing, and judgments related to a reporting entity’s accounting for leases and related cash flows. The standard is required to be applied to all leases in existence as of the date of adoption using a modified retrospective transition approach. This guidance is effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Early adoption is permitted for all companies in any interim or annual period. The Company occupies certain offices and uses certain equipment under non-cancelable operating lease agreements, which currently are not reflected in its consolidated statement of condition. The Company expects to recognize lease liabilities and right of use assets associated with these lease agreements; however, the extent of the impact on the Company’s consolidated financial statements is currently under evaluation. The Company is in the process of a system implementation to facilitate the change in accounting.

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

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

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

NOTE D: INVESTMENT SECURITIES

The amortized cost and estimated fair value of investment securities as of September 30, 2018 and December 31, 2017 are as follows:

	September 30, 2018				December 31, 2017			
(000's omitted)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available-for-Sale Portfolio:								
U.S. Treasury and agency securities	$2,039,086	$ 0	$40,991	$1,998,095	$2,043,023	$15,886	$4,838	$2,054,071
Obligations of state and political subdivisions	473,048	5,250	2,933	475,365	514,949	14,064	57	528,956
Government agency mortgage-backed securities	369,970	1,297	13,204	358,063	358,180	3,121	3,763	357,538
Corporate debt securities	2,603	0	53	2,550	2,648	0	25	2,623
Government agency collateralized mortgage obligations	73,112	25	2,431	70,706	88,097	155	878	87,374
Marketable equity securities	0	0	0	0	251	275	0	526
Total available-for-sale portfolio	$2,957,819	$ 6,572	$59,612	$2,904,779	$3,007,148	$33,501	$9,561	$3,031,088
Equity and other Securities:								
Equity securities, at fair value	$251	$ 247	$0	$498	$0	$0	$0	$0
	6,343	0	0	6,343	9,896	0	0	9,896

Federal Home Loan Bank common stock								
Federal Reserve Bank common stock	30,690	0	0	30,690	30,690	0	0	30,690
Certificates of deposit	0	0	0	0	3,865	0	0	3,865
Other equity securities, at cost	4,997	750	0	5,747	5,840	0	0	5,840
Total equity and other securities	$42,281	$ 997	$ 0	$43,278	$50,291	$ 0	$ 0	$50,291

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

As of September 30, 2018

	Less than 12 Months			12 Months or Longer			Total		
(000's omitted)	#	Fair Value	Gross Unrealized Losses	#	Fair Value	Gross Unrealized Losses	#	Fair Value	Gross Unrealized Losses
Available-for-Sale Portfolio:									
U.S. Treasury and agency securities	50	$1,633,859	$ 30,625	32	$364,236	$ 10,366	82	$1,998,095	$ 40,991
Obligations of state and political subdivisions	333	171,781	2,619	9	5,913	314	342	177,694	2,933
Government agency mortgage-backed securities	89	128,752	3,783	136	178,871	9,421	225	307,623	13,204
Corporate debt securities	0	0	0	1	2,550	53	1	2,550	53
Government agency collateralized mortgage obligations	12	8,371	199	36	59,825	2,232	48	68,196	2,431
Total available-for-sale investment portfolio	484	$1,942,763	$ 37,226	214	$611,395	$ 22,386	698	$2,554,158	$ 59,612

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As of December 31, 2017

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

The unrealized losses reported pertaining to securities issued by the U.S. government and its sponsored entities, include treasuries, agencies, and mortgage-backed securities issued by Ginnie Mae, Fannie Mae, and Freddie Mac, which are currently rated AAA by Moody's Investor Services, AA+ by Standard & Poor's and are guaranteed by the U.S. government. The majority of the obligations of state and political subdivisions and corporations carry a credit rating of A or better. Additionally, a majority of the obligations of state and political subdivisions carry a secondary level of credit enhancement. The Company does not intend to sell these securities, nor is it more likely than not that the Company will be required to sell these securities prior to recovery of the amortized cost. The unrealized losses in the portfolios are primarily attributable to changes in interest rates. As such, management does not believe any individual unrealized loss as of September 30, 2018 represents OTTI.

The amortized cost and estimated fair value of debt securities at September 30, 2018, by contractual maturity, are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties. Securities not due at a single maturity date are shown separately.

	Available-for-Sale	
(000's omitted)	Amortized Cost	Fair Value
Due in one year or less	$61,112	$60,985
Due after one through five years	2,020,525	1,985,501
Due after five years through ten years	274,222	270,449
Due after ten years	158,878	159,075
Subtotal	2,514,737	2,476,010
Government agency mortgage-backed securities	369,970	358,063
Government agency collateralized mortgage obligations	73,112	70,706
Total	$2,957,819	$2,904,779

As of September 30, 2018, $289.0 million of U.S. Treasury securities were pledged as collateral for securities sold under agreement to repurchase. All securities sold under agreement to repurchase as of September 30, 2018 have an overnight and continuous maturity.

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, municipal lending, 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.

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The balances of these classes are summarized as follows:

(000's omitted)	September 30, 2018	December 31, 2017
Business lending	$ 2,403,624	$ 2,424,223
Consumer mortgage	2,220,022	2,220,298
Consumer indirect	1,098,943	1,011,978
Consumer direct	184,349	179,929
Home equity	393,950	420,329
Gross loans, including deferred origination costs	6,300,888	6,256,757
Allowance for loan losses	(50,133)	(47,583)
Loans, net of allowance for loan losses	$ 6,250,755	$ 6,209,174

The outstanding balance related to credit impaired acquired loans was $7.8 million and $13.4 million at September 30, 2018 and December 31, 2017, respectively. The changes in the accretable discount related to the credit impaired acquired loans are as follows:

(000's omitted)	
Balance at December 31, 2017	$976
Accretion recognized, year-to-date	(722)
Net reclassification between accretable and non-accretable	239
Balance at September 30, 2018	$493

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, 2018:

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

(000's omitted)	Past Due 30 – 89 Days	90+ Days Past Due and Still Accruing	Nonaccrual	Total Past Due	Current	Total Loans
Business lending	$5,751	$ 355	$ 3,335	$9,441	$1,573,366	$1,582,807
Consumer mortgage	10,189	1,767	9,915	21,871	1,793,227	1,815,098
Consumer indirect	12,408	175	0	12,583	1,073,607	1,086,190
Consumer direct	1,510	20	0	1,530	179,399	180,929
Home equity	1,191	371	1,433	2,995	311,817	314,812
Total	$31,049	$ 2,688	$ 14,683	$48,420	$4,931,416	$4,979,836

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

(000's omitted)	Past Due 30 – 89 Days	90+ Days Past Due and Still Accruing	Nonaccrual	Total Past Due	Acquired Impaired(1)	Current	Total Loans
Business lending	$ 1,134	$ 0	$ 3,711	$4,845	$ 5,851	$810,121	$820,817
Consumer mortgage	977	215	2,438	3,630	0	401,294	404,924
Consumer indirect	100	34	0	134	0	12,619	12,753
Consumer direct	74	0	0	74	0	3,346	3,420

Home equity	618	14	1,150	1,782	0	77,356	79,138
Total	$ 2,903	$ 263	$ 7,299	$ 10,465	$ 5,851	$ 1,304,736	$ 1,321,052

(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.

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

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

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

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

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

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

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

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

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

	September 30, 2018			December 31, 2017		
(000's omitted)	Legacy	Acquired	Total	Legacy	Acquired	Total
Pass	$1,394,290	$740,329	$2,134,619	$1,170,156	$963,981	$2,134,137
Special mention	112,777	47,773	160,550	129,076	37,321	166,397

Classified	75,740	25,285	101,025	77,367	34,628	111,995
Doubtful	0	1,579	1,579	0	1,579	1,579
Acquired impaired	0	5,851	5,851	0	10,115	10,115
Total	$1,582,807	$820,817	$2,403,624	$1,376,599	$1,047,624	$2,424,223

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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 loans classified as current as well as those classified as 30 - 89 days past due. 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, 2018:

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

(000's omitted)	Consumer Mortgage	Consumer Indirect	Consumer Direct	Home Equity	Total
Performing	$1,803,416	$1,086,015	$180,909	$313,008	$3,383,348
Nonperforming	11,682	175	20	1,804	13,681
Total	$1,815,098	$1,086,190	$180,929	$314,812	$3,397,029

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

(000's omitted)	Consumer Mortgage	Consumer Indirect	Consumer Direct	Home Equity	Total
Performing	$402,271	$ 12,719	$ 3,420	$77,974	$496,384
Nonperforming	2,653	34	0	1,164	3,851
Total	$404,924	$ 12,753	$ 3,420	$79,138	$500,235

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

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

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

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

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

All loan classes are collectively evaluated for impairment except business lending. A summary of individually evaluated impaired loans as of September 30, 2018 and December 31, 2017 follows:

(000's omitted)	September 30, 2018	December 31, 2017
Loans with allowance allocation	$ 3,956	$ 5,125
Loans without allowance allocation	1,151	884
Carrying balance	5,107	6,009
Contractual balance	9,688	9,165

Specifically allocated allowance	956	804

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.

In accordance with the clarified guidance issued by the Office of the Comptroller of the Currency ("OCC"), loans that have been discharged in Chapter 7 bankruptcy but not reaffirmed by the borrower, are classified as TDRs, irrespective of payment history or delinquency status, even if the repayment terms for the loan have not been otherwise modified. The Company's lien position against the underlying collateral remains unchanged. Pursuant to that guidance, the Company records a charge-off equal to any portion of the carrying value that exceeds the net realizable value of the collateral. The amount of loss incurred in the three and nine months ended September 30, 2018 and 2017 was immaterial.

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TDRs that are less than $0.5 million are collectively included in the general loan loss allocation and the qualitative review. TDRs that are commercial loans and greater than $0.5 million are individually evaluated for impairment, and if necessary, a specific allocation of the allowance for loan losses is provided. As a result, the determination of the amount of allowance for loan losses related to TDRs is the same as detailed in the critical accounting policies.

Information regarding TDRs as of September 30, 2018 and December 31, 2017 is as follows:

	September 30, 2018						December 31, 2017					
(000's omitted)	Nonaccrual		Accruing		Total		Nonaccrual		Accruing		Total	
	#	Amount	#	Amount	#	Amount	#	Amount	#	Amount	#	Amount
Business lending	5	$ 165	3	$ 319	8	$ 484	8	$ 218	7	$ 501	15	$ 719
Consumer mortgage	45	2,000	46	1,783	91	3,783	51	2,265	44	1,750	95	4,015
Consumer indirect	0	0	76	814	76	814	0	0	71	883	71	883
Consumer direct	0	0	22	70	22	70	0	0	25	69	25	69
Home equity	12	215	8	279	20	494	13	245	7	204	20	449
Total	62	$ 2,380	155	$ 3,265	217	$ 5,645	72	$ 2,728	154	$ 3,407	226	$ 6,135

The following table presents information related to loans modified in a TDR during the three months and nine months ended September 30, 2018 and 2017. Of the loans noted in the table below, all loans for the three months and nine months ended September 30, 2018 and 2017 were modified due to a Chapter 7 bankruptcy as described previously. The financial effects of these restructurings were immaterial.

	Three Months Ended September 30, 2018		Three Months Ended September 30, 2017	
(000's omitted)	Number of loans modified	Outstanding Balance	Number of loans modified	Outstanding Balance
Business lending	0	$ 0	1	$ 51
Consumer mortgage	4	195	8	540
Consumer indirect	14	117	8	181
Consumer direct	2	10	1	1
Home equity	1	0	1	8
Total	21	$ 322	19	$ 781

	Nine Months Ended September 30, 2018		Nine Months Ended September 30, 2017	
(000's omitted)	Number of loans modified	Outstanding Balance	Number of loans modified	Outstanding Balance
Business lending	1	$ 93	4	$ 414
Consumer mortgage	7	407	15	1,040
Consumer indirect	24	176	22	323
Consumer direct	5	21	4	7
Home equity	2	85	3	106
Total	39	$ 782	48	$ 1,890

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, 2018							
(000's omitted)	Business Lending	Consumer Mortgage	Consumer Indirect	Consumer Direct	Home Equity	Unallocated	Acquired Impaired	Total
Beginning balance	$18,439	$ 10,473	$ 14,424	$ 3,164	$2,015	$ 1,070	$ 33	$49,618
Charge-offs	(73)	(144)	(2,364)	(465)	(221)	0	0	(3,267)
Recoveries	93	46	1,190	223	15	0	0	1,567
Provision	321	(205)	1,719	299	225	(159)	15	2,215
Ending balance	$18,780	$ 10,170	$ 14,969	$ 3,221	$2,034	$ 911	$ 48	$50,133

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	Three Months Ended September 30, 2017							
(000's omitted)	Business Lending	Consumer Mortgage	Consumer Indirect	Consumer Direct	Home Equity	Unallocated	Acquired Impaired	Total
Beginning balance	$17,230	$ 10,197	$ 13,918	$ 2,945	$2,242	$ 856	$ 63	$47,451
Charge-offs	(124)	(198)	(2,328)	(574)	0	0	0	(3,224)
Recoveries	127	24	1,058	221	12	0	0	1,442
Provision	399	280	1,130	426	(52)	142	(11)	2,314
Ending balance	$17,632	$ 10,303	$ 13,778	$ 3,018	$2,202	$ 998	$ 52	$47,983

	Nine Months Ended September 30, 2018							
(000's omitted)	Business Lending	Consumer Mortgage	Consumer Indirect	Consumer Direct	Home Equity	Unallocated	Acquired Impaired	Total
Beginning balance	$17,257	$ 10,465	$ 13,468	$ 3,039	$2,107	$ 1,100	$ 147	$47,583
Charge-offs	(2,000)	(588)	(6,031)	(1,324)	(325)	0	(368)	(10,636)
Recoveries	404	109	3,688	612	31	0	0	4,844
Provision	3,119	184	3,844	894	221	(189)	269	8,342
Ending balance	$18,780	$ 10,170	$ 14,969	$ 3,221	$2,034	$ 911	$ 48	$50,133

	Nine Months Ended September 30, 2017							
(000's omitted)	Business Lending	Consumer Mortgage	Consumer Indirect	Consumer Direct	Home Equity	Unallocated	Acquired Impaired	Total
Beginning balance	$17,220	$ 10,094	$ 13,782	$ 2,979	$2,399	$ 651	$ 108	$47,233
Charge-offs	(1,062)	(541)	(5,969)	(1,463)	(228)	0	(184)	(9,447)
Recoveries	481	42	3,379	648	44	0	0	4,594
Provision	993	708	2,586	854	(13)	347	128	5,603
Ending balance	$17,632	$ 10,303	$ 13,778	$ 3,018	$2,202	$ 998	$ 52	$47,983

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, 2018			December 31, 2017		
(000's omitted)	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Amortizing intangible assets:						
Core deposit intangibles	$62,902	$ (42,790)	$20,112	$62,902	$ (37,877)	$25,025
Other intangibles	87,616	(29,507)	58,109	86,535	(20,902)	65,633
Total amortizing intangibles	$150,518	$ (72,297)	$78,221	$149,437	$ (58,779)	$90,658

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

(000's omitted)	
Oct - Dec 2018	$4,375
2019	15,296
2020	12,722
2021	10,853
2022	9,317
Thereafter	25,658

Total	$78,221

Shown below are the components of the Company's goodwill at December 31, 2017 and September 30, 2018:

(000's omitted)	December 31, 2017	Activity	September 30, 2018
Goodwill	$ 739,254	$ (951)	$ 738,303
Accumulated impairment	(4,824)	0	(4,824)
Goodwill, net	$ 734,430	$ (951)	$ 733,479

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NOTE G: MANDATORILY REDEEMABLE PREFERRED SECURITIES

As of September 30, 2018, the Company sponsors two business trusts, Community Capital Trust IV (“CCT IV”) and MBVT Statutory Trust I (“MBVT I”), of which 100% of the common stock is owned by the Company. The common stock of MBVT Statutory Trust I was acquired in the Merchants acquisition. The Company previously sponsored Community Statutory Trust III (“CST III”) until July 31, 2018 when the Company exercised its right to redeem all of the CST III debentures and associated preferred securities for a total of $25.2 million. The trusts were formed for the purpose of issuing company-obligated mandatorily redeemable preferred securities to third-party investors and investing the proceeds from the sale of such preferred securities solely in junior subordinated debt securities of the Company. The debentures held by each trust are the sole assets of such trust. Distributions on the preferred securities issued by each trust are payable quarterly at a rate per annum equal to the interest rate being earned by the trust on the debentures held by that trust and are recorded as interest expense in the consolidated financial statements. The preferred securities are subject to mandatory redemption, in whole or in part, upon repayment of the debentures. The Company has entered into agreements which, taken collectively, fully and unconditionally guarantee the preferred securities subject to the terms of each of the guarantees. The terms of the preferred securities of each trust are as follows:

Trust	Issuance Date	Par Amount	Interest Rate	Maturity Date	Call Price
CCT IV	12/8/2006	$75.0 million	3 month LIBOR plus 1.65% (3.98%)	12/15/2036	Par
MBVT I	12/15/2004	$20.6 million	3 month LIBOR plus 1.95% (4.28%)	12/31/2034	Par

NOTE H: BENEFIT PLANS

The Company provides a qualified defined benefit pension to eligible employees and retirees, other post-retirement health and life insurance benefits to certain retirees, an unfunded supplemental pension plan for certain key executives, and an unfunded stock balance plan for certain of its nonemployee directors. The Company accrues for the estimated cost of these benefits through charges to expense during the years that employees earn these benefits.

Effective May 12, 2017, the Merchants Bank Pension Plan was merged into the Community Bank System, Inc. Pension Plan and the combined plan was revalued resulting in an additional unamortized actuarial gain of approximately $1.9 million, due primarily to a gain on plan assets that was partially offset by a decrease in the discount rate from 4.50% to 4.40% as of the valuation date.

Effective June 1, 2018, the Company adopted the Community Bank System, Inc. Restoration Plan (“Restoration Plan”). The Restoration Plan is a non-qualified deferred compensation plan for certain employees whose benefits under tax-qualified retirement plans are restricted by the Internal Revenue Code Section 401(a)(17) limitation on compensation. Adoption of the plan resulted in an unfunded initial projected benefit obligation of approximately $0.8 million that will be amortized over the average expected future years of service of active plan participants.

The net periodic benefit cost for the three and nine months ended September 30, 2018 and 2017 is as follows:

	Pension Benefits				Post-retirement Benefits			
	Three Months Ended September 30,		Nine Months Ended September 30,		Three Months Ended September 30,		Nine Months Ended September 30,	
(000's omitted)	2018	2017	2018	2017	2018	2017	2018	2017
Service cost	$ 1,154	$ 1,037	$ 3,396	$ 3,143	$ 0	$ 0	$ 0	$ 0

Interest cost	1,422	1,453	4,251	4,265	18	19	52	57
Expected return on plan assets	(3,705)	(3,448)	(11,115)	(9,977)	0	0	0	0
Amortization of unrecognized net loss	299	148	895	619	5	2	15	6
Amortization of prior service cost	(60)	13	(225)	43	(45)	(45)	(134)	(134)
Net periodic benefit cost (income)	$ (890)	$ (797)	$ (2,798)	$ (1,907)	$ (22)	$ (24)	$ (67)	$ (71)

NOTE I: EARNINGS PER SHARE

The two class method is used in the calculations of basic and diluted earnings per share. Under the two class method, earnings available to common shareholders for the period are allocated between common shareholders and participating securities according to dividends declared and participation rights in undistributed earnings. The Company has determined that all of its outstanding non-vested stock awards are participating securities as of September 30, 2018.

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Basic earnings per share are computed based on the weighted-average of the common shares outstanding for the period. Diluted earnings per share are based on the weighted-average of the shares outstanding and the assumed exercise of stock options during the year. The dilutive effect of options is calculated using the treasury stock method of accounting. The treasury stock method determines the number of common shares that would be outstanding if all the dilutive options (those where the average market price is greater than the exercise price) were exercised and the proceeds were used to repurchase common shares in the open market at the average market price for the applicable time period. There were approximately 0.4 million weighted-average anti-dilutive stock options outstanding for the three months and nine months ended September 30, 2018, compared to 0.2 million weighted-average anti-dilutive stock options outstanding for the three months ended September 30, 2017, and 0.1 million weighted-average anti-dilutive stock options outstanding for the nine months ended September 30, 2017 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, 2018 and 2017:

	Three Months Ended September 30,		Nine Months Ended September 30,	
(000's omitted, except per share data)	2018	2017	2018	2017
Net income	$ 43,106	$ 35,243	$ 127,818	$ 78,691
Income attributable to unvested stock-based compensation awards	(191)	(164)	(563)	(387)
Income available to common shareholders	$ 42,915	$ 35,079	$ 127,255	$ 78,304
Weighted-average common shares outstanding – basic	51,250	50,703	51,108	48,189
Basic earnings per share	$ 0.84	$ 0.69	$ 2.49	$ 1.62
Net income	$ 43,106	$ 35,243	$ 127,818	$ 78,691
Income attributable to unvested stock-based compensation awards	(191)	(164)	(563)	(387)
Income available to common shareholders	$ 42,915	$ 35,079	$ 127,255	$ 78,304
Weighted-average common shares outstanding – basic	51,250	50,703	51,108	48,189
Assumed exercise of stock options	608	585	590	640
Weighted-average common shares outstanding – diluted	51,858	51,288	51,698	48,829
Diluted earnings per share	$ 0.83	$ 0.68	$ 2.46	$ 1.60

Stock Repurchase Program

At its December 2017 meeting, the Company's Board of Directors (the "Board") approved a stock repurchase program authorizing the repurchase of up to 2.5 million shares of the Company's common stock in accordance with securities laws and regulations, through December 31, 2018. 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 Company did not repurchase any shares under the authorized plan during the first nine months of 2018.

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 amounts of commitments and contingencies are as follows:

(000's omitted)	September 30, 2018	December 31, 2017
Commitments to extend credit	$ 1,097,509	$ 1,080,004
Standby letters of credit	32,160	23,782
Total	$ 1,129,669	$ 1,103,786

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

NOTE K: FAIR VALUE

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.

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, 2018			
(000's omitted)	Level 1	Level 2	Level 3	Total Fair Value
Available-for-sale investment securities:				
U.S. Treasury and agency securities	$1,867,144	$130,951	$ 0	$1,998,095
Obligations of state and political subdivisions	0	475,365	0	475,365
Government agency mortgage-backed securities	0	358,063	0	358,063
Corporate debt securities	0	2,550	0	2,550
Government agency collateralized mortgage obligations	0	70,706	0	70,706
Total available-for-sale investment securities	1,867,144	1,037,635	0	2,904,779
Equity securities	498	0	0	498
Mortgage loans held for sale	0	0	0	0
Commitments to originate real estate loans for sale	0	0	9	9
Forward sales commitments	0	9	0	9
Interest rate swap agreements asset	0	1,306	0	1,306
Interest rate swap agreements liability	0	(1,360)	0	(1,360)
Total	$1,867,642	$1,037,590	$ 9	$2,905,241

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

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

- Available-for-sale investment securities and equity securities – The fair values of available-for-sale investment securities and equity securities are 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 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 – 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 statements of income. All mortgage loans held for sale are current and in performing status. The fair value of mortgage loans held for sale is determined using quoted secondary-market prices of loans with similar characteristics and, as such, has been classified as a Level 2 valuation. There were no mortgage loans held for sale at September 30, 2018. The unrealized gain on mortgage loans held for sale was recognized in other banking services revenues in the consolidated statements of income and is immaterial.

- Forward sales commitments – The Company enters into forward sales commitments to sell certain residential real estate loans. Such commitments are considered to be derivative financial instruments and, therefore, are carried at estimated fair value in the other asset or other liability section of the consolidated statement of condition. The fair value of these forward sales commitments is primarily measured by obtaining pricing from certain government-sponsored entities and reflects the underlying price the entity would pay the Company for an immediate sale on these mortgages. As such, these instruments are classified as Level 2 in the fair value hierarchy.

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

- Interest rate swaps – The interest rate swaps are reported at their fair value utilizing Level 2 inputs from third parties. The fair value of the interest rate swaps are determined using prices obtained from a third party advisor. The fair value measurement of the interest rate swap is determined by netting the discounted future fixed cash payments and the discounted expected variable cash receipts. The variable cash receipts are based on the expectation of future interest rates derived from observed market interest rate curves.

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

The fair value information of assets and liabilities measured on a non-recurring basis presented below is not as of the period-end, but rather as of the date the fair value adjustment was recorded closest to the date presented.

	September 30, 2018				December 31, 2017			
(000's omitted)	Level 1	Level 2	Level 3	Total Fair Value	Level 1	Level 2	Level 3	Total Fair Value
Other real estate owned	$0	$ 0	$ 1,142	$ 1,142	$0	$ 0	$ 1,915	$ 1,915

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

Other real estate owned ("OREO") is valued at the time the loan is foreclosed upon and the asset is transferred to OREO. The value is based primarily on third party appraisals, less costs to sell. The appraisals are sometimes further discounted based on management's historical knowledge, changes in market conditions from the time of valuation, and/or management's expertise and knowledge of the customer and customer's business. Such discounts are significant, ranging from 9% to 76.3% at September 30, 2018 and result in a Level 3 classification of the inputs for determining fair value. OREO is reviewed and evaluated on at least a quarterly basis for additional impairment and adjusted accordingly, based on the same factors identified above. The Company recovers the carrying value of OREO through the sale of the property. The ability to affect future sales prices is subject to market conditions and factors beyond the Company's control and may impact the estimated fair value of a property.

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, 2018.

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. 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:

(000's omitted)	Fair Value at	Valuation Technique	Significant Unobservable Inputs	Significant

	September 30, 2018			Unobservable Input Range (Weighted Average)	
Other real estate owned	$ 1,142	Fair Value of Collateral	Estimated cost of disposal/market adjustment	9.0% - 76.3% (32.3	%)
Commitments to originate real estate loans for sale	9	Discounted cash flow	Embedded servicing value	1	%

(000's omitted)	Fair Value at December 31, 2017	Valuation Technique	Significant Unobservable Inputs	Significant Unobservable Input Range (Weighted Average)	
Other real estate owned	$ 1,915	Fair value of collateral	Estimated cost of disposal/market adjustment	9.0% - 99.0% (38.5	%)
Commitments to originate real estate loans for sale	89	Discounted cash flow	Embedded servicing value	1	%

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, 2018 and December 31, 2017 are as follows:

	September 30, 2018		December 31, 2017	
(000's omitted)	Carrying Value	Fair Value	Carrying Value	Fair Value
Financial assets:				
Net loans	$6,250,755	$6,171,599	$6,209,174	$6,244,941
Financial liabilities:				
Deposits	8,463,821	8,441,535	8,444,420	8,431,481
Short-term borrowings	0	0	24,000	24,000
Securities sold under agreement to repurchase, short-term	274,561	274,561	337,011	337,011
Other long-term debt	1,998	1,915	2,071	2,021
Subordinated debt held by unconsolidated subsidiary trusts	97,939	97,939	122,814	122,814

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

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

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

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

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

NOTE 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 interest rate swap agreements, commitments to originate real estate loans held for sale and forward sales commitments. The Company does not hold or issue derivative financial instruments for trading or other speculative purposes.

The Company enters into forward sales commitments for the future delivery of residential mortgage loans, and interest rate lock commitments to fund loans at a specified interest rate. The forward sales commitments are utilized to reduce interest rate risk associated with interest rate lock commitments and loans held for sale. Changes in the estimated fair value of the forward sales commitments and interest rate lock commitments subsequent to inception are based on changes in the fair value of the underlying loan resulting from the fulfillment of the commitment and changes in the probability that the loan will fund within the terms of the commitment, which is affected primarily by changes in interest rates and the passage of time. At inception and during the life of the interest rate lock commitment, the Company includes the expected net future cash flows related to the associated servicing of the loan as part of the fair value measurement of the interest rate lock commitments. These derivatives are recorded at fair value, which were immaterial at September 30, 2018. The effect of the changes to these derivatives for the three and nine months then ended was also immaterial.

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The Company acquired interest rate swaps in the Merchants acquisition with notional amounts with certain commercial customers which totaled $37.5 million at September 30, 2018. In order to minimize the Company's risk, these customer derivatives (pay floating/receive fixed swaps) have been offset with essentially matching interest rate swaps (pay fixed/receive floating swaps) with the Company's counterparty totaling $37.5 million. The weighted average receive rate of these interest rate swaps was 4.06%, the weighted average pay rate was 3.84% and the weighted average maturity was 5.7 years. The fair values of $1.3 million and $1.3 million were reflected in other assets and other liabilities, respectively, in the accompanying consolidated statement of condition at September 30, 2018. Hedge accounting has not been applied for these derivatives. Since the terms of the swaps with the customer and the other financial institution offset each other, with the only difference being counterparty credit risk, changes in the fair value of the underlying derivative contracts are not materially different and do not significantly impact our results of operations.

The Company also acquired interest rate swaps in the Merchants acquisition with notional amounts totaling $6.6 million at September 30, 2018 that were designated as fair value hedges of certain fixed rate loans with municipalities. At September 30, 2018, the weighted average receive rate of these interest rate swaps was 2.74%, the weighted average pay rate was 3.11% and the weighted average maturity was 14.8 years. The fair value of $0.05 million at September 30, 2018, was reflected as an increase to loans and an increase to other liabilities. The ineffective portion of the interest swaps was immaterial and is not recorded in earnings.

The Company assessed its counterparty risk at September 30, 2018 and determined any credit risk inherent in our derivative contracts was not material. Information about the fair value of derivative financial instruments can be found in Note K to these consolidated financial statements.

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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 All Other as its reportable operating business segments. Community Bank, N.A. (the “Bank” or “CBNA”) operates the Banking segment that provides full-service banking to consumers, businesses, and governmental units in Upstate New York as well as Northeastern Pennsylvania, Vermont and Western Massachusetts. Employee Benefit Services, which includes the operating subsidiaries Benefit Plans Administrative Services, LLC, BPAS Actuarial and Pension Services, LLC, BPAS Trust Company of Puerto Rico, NRS, GTC, and Hand Benefits & Trust Company, provides employee benefit trust, collective investment fund, retirement plan administration, fund administration, transfer agency, actuarial, VEBA/HRA, and health and welfare consulting services. The All Other segment is comprised of: (a) wealth management services including trust services provided by the personal trust unit within the Bank, broker-dealer and investment advisory services provided by CISI and The Carta Group, Inc., as well as asset management provided by Nottingham Advisors, Inc., and (b) full-service insurance, risk management and employee benefit services provided by OneGroup. The accounting policies used in the disclosure of business segments are the same as those described in the summary of significant accounting policies (See Note A: Summary of Significant Accounting Policies of the most recent Form 10-K for the year ended December 31, 2017 filed with the SEC on March 1, 2018).

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

(000's omitted)	Banking	Employee Benefit Services	All Other	Eliminations	Consolidated Total
Three Months Ended September 30, 2018					
Net interest income	$86,060	$ 102	$ 36	$ 0	$86,198
Provision for loan losses	2,215	0	0	0	2,215
Noninterest revenues	18,002	23,815	14,737	(763)	55,791
Amortization of intangible assets	1,535	1,970	922	0	4,427
Acquisition expenses	(832)	0	0	0	(832)
Other operating expenses	57,863	14,025	10,513	(763)	81,638
Income before income taxes	$43,281	$ 7,922	$ 3,338	$ 0	$54,541
Assets	$10,440,732	$ 205,565	$ 66,470	$ (53,200)	$10,659,567
Goodwill	$629,916	$ 83,275	$ 20,288	$ 0	$733,479
Three Months Ended September 30, 2017					
Net interest income	$84,227	$ 104	$ 64	$ 0	$84,395
Provision for loan losses	2,314	0	0	0	2,314
Noninterest revenues	20,120	21,207	12,298	(684)	52,941
Amortization of intangible assets	1,796	2,323	830	0	4,949
Acquisition expenses	534	11	35	0	580
Other operating expenses	56,926	12,788	9,217	(684)	78,247
Income before income taxes	$42,777	$ 6,189	$ 2,280	$ 0	$51,246
Assets	$10,613,065	$ 226,812	$ 77,802	$ (67,461)	$10,850,218
Goodwill	$629,153	$ 84,448	$ 17,904	$ 0	$731,505

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(000's omitted)	Banking	Employee Benefit Services	All Other	Eliminations	Consolidated Total
Nine Months Ended September 30, 2018					
Net interest income	$257,313	$ 264	$ 91	$ 0	$ 257,668
Provision for loan losses	8,342	0	0	0	8,342
Noninterest revenues	58,399	70,316	43,285	(2,159)	169,841
Amortization of intangible assets	4,914	6,047	2,819	0	13,780
Acquisition expenses	(782)	7	6	0	(769)
Other operating expenses	172,283	41,938	32,603	(2,159)	244,665
Income before income taxes	$130,955	$ 22,588	$ 7,948	$ 0	$ 161,491
Nine Months Ended September 30, 2017					
Net interest income	$229,233	$ 276	$ 189	$ 0	$ 229,698
Provision for loan losses	5,603	0	0	0	5,603
Noninterest revenues	54,049	59,961	36,510	(2,035)	148,485
Amortization of intangible assets	3,520	6,256	2,204	0	11,980
Acquisition expenses	23,784	1,190	218	0	25,192
Other operating expenses	160,311	37,225	27,557	(2,035)	223,058
Income before income taxes	$90,064	$ 15,566	$ 6,720	$ 0	$ 112,350

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

This Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") primarily reviews the financial condition and results of operations of Community Bank System, Inc. (the "Company" or "CBSI") as of and for the three and nine months ended September 30, 2018 and 2017, although in some circumstances the second quarter of 2018 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 30. All references in the discussion of the financial condition and results of operations refer to the consolidated position and results of the Company and its subsidiaries taken as a whole. Unless otherwise noted, the term "this year" and equivalent terms refers to results in calendar year 2018, "third quarter" refers to the three months ended September 30, 2018, "YTD" refers to the nine months ended September 30, 2018, 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 contemplated by such forward-looking statements are set herein under the caption, "Forward-Looking Statements," on page 48.

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 and liabilities as well as disclosures of revenues and expenses during the reporting period. Actual results could differ from these estimates. Management believes that the 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 loan losses resulting in an increase in the allowance for loan losses. Subsequent improvements in expected cash flows result in a recovery of previously recorded allowance for loan losses or a reversal of a corresponding amount of the non-accretable discount, which the Company then reclassifies as an accretable discount that is recognized into interest income over the remaining life of the loans using the interest method.

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, for loans collectively evaluated for impairment, the Company compares the net realizable value of the loans to the carrying value. 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 on impaired loans, appraisal values of underlying collateral for collateralized 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.

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- 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 debt securities are recorded in accumulated other comprehensive income or loss, as a separate component of shareholders' equity, and do not affect earnings until realized. Unrealized gains and losses on equity securities with a readily determinable fair value are recognized in the consolidated statements of income. The fair values of investment securities are generally determined by reference to quoted market prices, where available. If quoted market prices are not available, fair values are based on quoted market prices of comparable instruments, or a discounted cash flow model using market estimates of interest rates and volatility. Investment securities with significant declines in fair value are evaluated to determine whether they should be considered other-than-temporarily impaired ("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. 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 the expected return on plan assets.

- Intangible assets – As a result of acquisitions, the Company carries 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. Should impairment occur, goodwill will be reduced to its carrying value through a charge to earnings. 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 current credit risk-free interest rates, required equity market premiums, and company-specific performance and risk metrics, all of which are susceptible to change based on changes in economic and market 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 63-71 of the most recent Form 10-K (fiscal year ended December 31, 2017) filed with the Securities and Exchange Commission ("SEC") on March 1, 2018.

Supplemental Reporting of Non-GAAP Results of Operations

The Company also provides supplemental reporting of its results on a "net adjusted" or "tangible" basis, from which it excludes the after-tax effect of amortization of core deposit and other intangible assets (and the related goodwill, core deposit intangible and other intangible asset balances, net of applicable deferred tax amounts), accretion on non-impaired purchased loans, acquisition expenses, the unrealized gain(loss) on equity securities, loss on debt extinguishment and the one-time benefit from the revaluation of net deferred tax liabilities. Although "adjusted net income” as defined by the Company is a non-GAAP measure, the Company’s management believes this information helps investors understand the effect of acquisition activity in its reported results. Reconciliations of GAAP amounts with corresponding non-GAAP amounts are presented in Table 11.

Executive Summary

The Company’s business philosophy is to operate as a diversified financial services enterprise 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 also provides employee benefit related services via its Benefit Plans Administrative Services, Inc. (“BPAS”) subsidiary, and wealth management and insurance-related services.

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) manage an investment securities portfolio to complement the Company’s loan and deposit strategies and optimize interest rate risk, yield and liquidity, (iv) increase the noninterest 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 (v) utilize technology to deliver customer-responsive products and services and improve efficiencies.

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Significant factors reviewed by management 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 revenues, noninterest expenses, asset quality, loan and deposit growth, capital management, performance of individual banking and financial services units, performance of specific product lines and customers, 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 recently acquired businesses.

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

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

On April 2, 2018, the Company, through its subsidiary, Benefit Plans Administrative Services, Inc. ("BPAS"), acquired certain assets of HR Consultants (SA), LLC ("HR Consultants"), a benefits consulting group headquartered in Puerto Rico. The Company paid $0.3 million in cash to acquire the assets of HR Consultants and recorded intangible assets of $0.3 million in conjunction with the acquisition. The effects of the acquired assets have been included in the consolidated financial statements since that date.

Third quarter net income increased $7.9 million, or 22.3%, compared to the third quarter of 2017. Earnings per share of $0.83 for the third quarter of 2018 increased $0.15 from the third quarter of 2017. The increase in net income and earnings per share for the quarter are primarily the result of higher net interest income, a slightly lower provision for loan losses, higher noninterest revenues, lower acquisition expenses and a lower effective tax rate, partially offset by higher noninterest expenses, and an increase in diluted shares outstanding. Third quarter net income and earnings per share were also impacted by debit interchange fee limitations established by the Durbin amendment of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act") that were effective for the Company beginning in the third quarter of 2018. Third quarter net income adjusted to exclude acquisition expenses, unrealized gain on equity securities, loss on debt extinguishment, amortization of intangibles and acquired non-impaired loan accretion, increased $6.3 million, or 16.7%, as compared to the third quarter of 2017. Earnings per share adjusted to exclude acquisition expenses, unrealized gain on equity securities, loss on debt extinguishment, amortization of intangibles and acquired non-impaired loan accretion of $0.84 for the third quarter increased $0.11, or 15.1%, compared to the third quarter of 2017.

September 2018 YTD net income increased $49.1 million, or 62.4%, compared to the first nine months of 2017. Earnings per share 2018 YTD of $2.46 was $0.86 higher than 2017 YTD earnings per share. The increase in net income and earnings per share for the YTD period are primarily the result of higher net interest income, higher noninterest revenues, lower acquisition expenses attributable to the Merchants Bancshares, Inc. ("Merchants") and Northeast Retirement Services, Inc. ("NRS") acquisitions in 2017, partially offset by higher noninterest expenses, an increase in the provision for loan losses and an increase in diluted shares outstanding. YTD net income and earnings per share were also impacted by debit interchange fee limitations mandated by the Durbin amendment of the Dodd-Frank Act. YTD net income adjusted to exclude acquisition expenses, unrealized gain on equity securities, loss on debt extinguishment, amortization of intangibles and acquired non-impaired loan accretion, increased $31.2 million, or 30.7%, compared to September YTD 2017. Earnings per share adjusted for acquisition expenses, unrealized gain on equity securities, loss on debt extinguishment, amortization of intangibles and acquired non-impaired loan accretion of $2.55 for the first nine months of 2018 increased $0.48, or 23.2%, compared to the first nine months of 2017.

Average loans and deposits were down for the quarter, but increased on YTD in comparison to the equivalent prior year period, due primarily to the Merchants acquisition completed in May 2017. On an ending basis, both loans and deposits decreased compared to the prior year.

U.S. market interest rates have increased over the past year. In connection with these rising interest rates, the Company's total cost of funds increased slightly from the prior year period. However, the increase in the rate paid on interest-bearing deposits was moderated by the change in mix of the Company's funding base with a shift toward lower cost core funding sources. Due to the Merchants acquisition, the majority of the Company's borrowings are customer repurchase agreements, rather than wholesale borrowings obtained through capital markets and correspondent banks. Customer repurchase agreements have deposit like features and typically bear lower rates of interest than other types of wholesale borrowings.

The third quarter 2018 provision for loan losses was $0.1 million lower than the third quarter of 2017, while the September YTD provision for loan losses was $2.7 million higher than the prior YTD period. The increase in the September YTD provision is primarily due to growth in certain non-acquired loan portfolios. Third quarter 2018 nonperforming loans were up $1.6 million compared to the third quarter of 2017. Net charge-offs were $1.7 million for the third quarter of 2018, compared to $1.8 million of net charge-offs for the third quarter of 2017.

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Net Income and Profitability

As shown in Table 1, net income for the third quarter of $43.1 million increased $7.9 million, or 22.3%, as compared to the third quarter of 2017. September YTD net income of $127.8 million increased $49.1 million, or 62.4%, compared to September YTD 2017. Earnings per share of $0.83 for the third quarter increased $0.15 compared to the third quarter of 2017, while earnings per share for the first nine months of 2018 of $2.46 was $0.86 higher than the first nine months of 2017. The increase in net income and earnings per share for the quarter are primarily the result of higher net interest income, a slightly lower provision for loan losses, higher noninterest revenues, lower acquisition expenses and a lower effective tax rate, partially offset by higher noninterest expenses, and an increase in diluted shares outstanding. The increase in net income and earnings per share for the YTD period are primarily the result of higher net interest income, higher noninterest revenues, lower acquisition expenses and a lower effective tax rate, partially offset by higher noninterest expenses, an increase in the provision for loan losses and an increase in diluted shares outstanding. Net income adjusted to exclude acquisition expenses, unrealized gain on equity securities, loss on debt extinguishment, amortization of intangibles and acquired non-impaired loan accretion was $44.0 million for the third quarter of 2018. This represents an increase of $6.3 million, or 16.7%, as compared to the third quarter of 2017. Net income adjusted to exclude acquisition expenses, unrealized gain on equity securities, loss on debt extinguishment, amortization of intangibles and acquired non-impaired loan accretion of $133.0 million for the September YTD period increased $31.2 million, or 30.7%, compared to September YTD 2017. Earnings per share adjusted to exclude acquisition expenses, unrealized gain on equity securities, loss on debt extinguishment, amortization of intangibles and acquired non-impaired loan accretion of $0.84 for the third quarter and $2.55 for the YTD period, was up $0.11 compared to the third quarter of 2017, and up $0.48 compared to the first nine months of 2017. See Table 11 for Reconciliation of GAAP to Non-GAAP Measures.

As reflected in Table 1, third quarter net interest income of $86.2 million was up $1.8 million, or 2.1%, from the comparable prior year period. Net interest income for the first nine months of 2018 increased $28.0 million, or 12.2%, versus the first nine months of 2017. The quarterly improvement in net interest income resulted from an increase in the yield on interest-earning assets and a decrease in interest-bearing liability balances, partially offset by a decrease in interest-earning assets and an increase in the average rate paid on interest-bearing liabilities. The year-over-year improvement was due to an increase in interest-earning assets and an increase in the yield on interest-earning assets, primarily due to the impact of the Merchants acquisition, partially offset by an increase in interest-bearing liabilities and the average rate paid on interest-bearing liabilities.

Third quarter and YTD noninterest revenues were $55.8 million and $169.8 million, respectively, up $2.9 million, or 5.4%, from the third quarter of 2017 and up $21.4 million, or 14.4%, from the first nine months of 2017. The YTD increase was primarily a result of the Merchants acquisition completed in May 2017 and the NRS acquisition completed in February 2017, offset by the $3.4 million impact of debit interchange fee limitations established by the Durbin amendment of the Dodd-Frank Act that were effective for the Company beginning in the third quarter of 2018. The quarterly results were favorably impacted by acquired and organic growth, offset by the impact of the Durbin amendment. Between the third quarter of 2017 and the third quarter of 2018, the Company acquired four small insurance and wealth management practices contributing to revenue growth. Employee benefit services revenues for the quarter increased primarily due to organic increases in plan asset and participant levels.

Noninterest expenses of $85.2 million for the third quarter reflected an increase of $1.5 million, or 1.7%, from the third quarter of 2017, while noninterest expenses of $257.7 million for the September YTD period reflected a decrease of $2.6 million, or 1.0%, from the first nine months of 2017. Excluding acquisition-related expenses, 2018 operating expenses were $2.9 million, or 3.4%, higher for the third quarter and $23.4 million, or 10.0%, higher for the YTD timeframe. The increases in noninterest expenses were largely the result of operating a larger franchise, including the impact of the Merchants and NRS acquisitions.

The effective income tax rates were 21.0% and 20.9% for the third quarter and YTD 2018, respectively, as compared to 31.2% and 30.0% for the comparable prior year periods. The decrease in effective income tax rates between the periods is primarily attributable to the impact of the Tax Cuts and Jobs Act of 2017 ("Tax Cuts and Jobs Act") signed into law in December 2017. The Tax Cuts and Jobs Act permanently lowered the corporate tax rate from 35% to 21% for tax years including or commencing January 1, 2018. The windfall tax benefit associated with stock-based compensation reduced income taxes by $0.3 million and $2.2 million for the third quarter and YTD 2018, respectively, as compared to a reduction of $0.3 million and $2.9 million for the comparable prior year periods.

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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)	2018	2017	2018	2017
Net interest income	$ 86,198	$ 84,395	$257,668	$229,698
Provision for loan losses	2,215	2,314	8,342	5,603
Noninterest revenues	55,791	52,941	169,841	148,485
Noninterest expenses	85,233	83,776	257,676	260,230
Income before income taxes	54,541	51,246	161,491	112,350
Income taxes	11,435	16,003	33,673	33,659
Net income	$ 43,106	$ 35,243	$127,818	$78,691
Diluted weighted average common shares outstanding	52,086	51,526	51,925	49,067
Diluted earnings per share	$ 0.83	$ 0.68	$2.46	$1.60

Net Interest Income

Net interest income is the amount by which interest and fees on earning assets (loans, investments, and cash equivalents) exceeds the cost of funds, which consists primarily of interest paid to the Company's depositors and on external borrowings. Net interest margin is the difference between the 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 was $87.3 million, a $0.5 million, or 0.6%, increase from the same period last year. A ten basis point increase in the average yield on earning assets and a $300.6 million decrease in average interest-bearing liabilities favorably impacted net interest income. This was partially offset by a decrease in interest-earning assets of $120.6 million and a five basis point increase in the average rate paid on interest-bearing liabilities. As reflected in Table 3, the third quarter increase in the average yield on earning assets and the volume decrease on interest-bearing liabilities had a combined $2.5 million favorable impact on net interest income, while the volume decrease in interest-earning assets and the rate increase on interest-bearing liabilities had a $2.0 million unfavorable impact on net interest income. September YTD net interest income of $261.0 million, as reflected in Table 2b, increased $24.2 million, or 10.2%, from the year-earlier period. The September YTD increase resulted from an increase in interest-earning assets of $762.8 million from the prior year, reflective of the Merchants acquisition, and a seven basis point increase in the earning asset yield, partially offset by a $315.9 million increase in average interest-bearing liabilities and a four basis point increase in the rate paid on interest-bearing liabilities. The volume increase in interest-earning assets and increase in yield had a $26.7 million favorable impact on September YTD net interest income, while the volume increase on interest-bearing liabilities and rate increase on interest-bearing liabilities had a $2.5 million unfavorable impact on net interest income.

The higher net interest margin for the third quarter of 2018 as compared to the third quarter of 2017 was the result of a ten basis point increase in the earning asset yield, partially offset by a five basis point increase in the average rate on interest-bearing liabilities. The net interest margin of 3.72% for the first nine months of 2018 was five basis points higher than the comparable period of 2017. The yield on interest-earning assets increased seven basis points, while the rate on interest-bearing liabilities increased four basis points for the first nine months of 2018 as compared to the prior year period.

The higher average yield on earning assets for the quarter was the result of an increase in the average yield on loans, partially offset by a decrease in the average yield on investments. For the third quarter, the average yield on loans increased by 20 basis points, while the average yield on investments, including cash equivalents, decreased 14 basis points compared to the prior year. The seven basis point increase in the yield on earning assets for the first nine months of 2018 was the result of a 19 basis point increase in the average yield on loans compared to the comparable period of 2017, partially offset by a 22 basis point decrease in the average yield on investments, including cash equivalents. The increase in the loan yield was due primarily to an increase in acquired loan accretion on the acquired Merchants portfolio. The lower average yield of investments was the result of maturing higher interest rate investments being replaced with lower rate instruments.

The average rate on interest-bearing liabilities increased by five basis points compared to the prior year quarter as the average rate paid on borrowings increased 52 basis points and the rate paid on interest-bearing deposits increased four basis points from the prior year quarter. For the first nine months of 2018, the average rate on interest-bearing deposits increased three basis points from the comparable prior year period, while the average rate on borrowings increased 14 basis points. The increase in the average cost of borrowings was primarily the result of an increase in the variable rates paid on overnight borrowings and subordinated debt due to increases in market interest rates.

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The third quarter average balance of investments, including cash equivalents, decreased $67.0 million as compared to the corresponding prior year period as maturities, calls and principal payments outpaced investment purchases. The third quarter YTD average balance of investments, including cash equivalents, increased $167.7 million, principally the result of securities acquired in the Merchants transaction. Average loan balances decreased $53.6 million for the quarter and increased $595.1 million YTD as compared to the prior year, with $541.2 million of the YTD increase a result of the Merchants acquisition.

The average balance of interest-bearing deposits for the third quarter decreased $153.0 million compared to the prior year quarter, while the YTD average of interest-bearing deposits increased $258.1 million compared to the prior year period. The Merchants transaction was responsible for a $325.3 million increase in YTD average interest-bearing deposits. The average borrowing balance, including FHLB borrowings, subordinated debt held by unconsolidated subsidiary trusts, and securities sold under agreement to repurchase (customer repurchase agreements), decreased $147.6 million for the quarter and increased $57.8 million for the YTD period. The quarterly decrease in average borrowings was primarily a result of a decrease in overnight borrowings and the redemption of the subordinated debt held by Community Statutory Trust III, an unconsolidated subsidiary trust, and associated preferred securities during the third quarter of 2018 for a total of $25.2 million.

Tables 2a and 2b below set 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 marginal income tax rates of 24.4% and 37.8% in 2018 and 2017, respectively. Average balances are computed by totaling the daily ending balances in a period and dividing by the number of days in that period. Loan interest income and yields include amortization of deferred loan income and costs and the 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, 2018			Three Months Ended September 30, 2017		
(000's omitted except yields and rates)	Average Balance	Interest	Avg. Yield/Rate Paid	Average Balance	Interest	Avg. Yield/Rate Paid
Interest-earning assets:						
Cash equivalents	$26,832	$108	1.60 %	$26,986	$74	1.09 %
Taxable investment securities [1]	2,574,116	15,313	2.36 %	2,571,459	15,155	2.34 %
Nontaxable investment securities [1]	441,719	4,081	3.67 %	511,182	5,758	4.47 %
Loans (net of unearned discount)[2]	6,289,868	72,472	4.57 %	6,343,468	69,881	4.37 %
Total interest-earning assets	9,332,535	91,974	3.91 %	9,453,095	90,868	3.81 %
Noninterest-earning assets	1,287,337			1,409,518		
Total assets	$10,619,872			$10,862,613		
Interest-bearing liabilities:						
Interest checking, savings, and money market deposits	$5,333,657	1,589	0.12 %	$5,411,179	1,262	0.09 %
Time deposits	743,924	1,175	0.63 %	819,412	861	0.42 %
Customer repurchase agreements	216,389	393	0.72 %	241,283	315	0.52 %
FHLB borrowings	71,040	403	2.25 %	176,949	587	1.32 %
Subordinated debt held by unconsolidated subsidiary trusts	106,054	1,145	4.28 %	122,804	1,067	3.45 %
Total interest-bearing liabilities	6,471,064	4,705	0.29 %	6,771,627	4,092	0.24 %
Noninterest-bearing liabilities:						

Noninterest checking deposits	2,336,778				2,307,205		
Other liabilities	147,796				196,502		
Shareholders' equity	1,664,234				1,587,279		
Total liabilities and shareholders' equity	$10,619,872				$10,862,613		
Net interest earnings		$87,269				$86,776	
Net interest spread			3.62	%			3.57 %
Net interest margin on interest-earning assets			3.71	%			3.64 %
Fully tax-equivalent adjustment		$1,071				$2,381	

(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 noninterest-earning assets, shareholders' equity, and deferred taxes.
(2) Includes nonaccrual loans. The impact of interest and fees not recognized on nonaccrual loans was immaterial.

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

(000's omitted except yields and rates)	Nine Months Ended September 30, 2018 Average Balance	Interest	Avg. Yield/Rate Paid		Nine Months Ended September 30, 2017 Average Balance	Interest	Avg. Yield/Rate Paid	
Interest-earning assets:								
Cash equivalents	$95,761	$1,188	1.66	%	$40,002	$283	0.95	%
Taxable investment securities [1]	2,577,807	46,275	2.40	%	2,395,567	43,687	2.44	%
Nontaxable investment securities [1]	455,816	12,651	3.71	%	526,113	17,861	4.54	%
Loans (net of unearned discount)[2]	6,259,668	213,481	4.56	%	5,664,591	185,076	4.37	%
Total interest-earning assets	9,389,052	273,595	3.90	%	8,626,273	246,907	3.83	%
Noninterest-earning assets	1,306,465				1,237,619			
Total assets	$10,695,517				$9,863,892			
Interest-bearing liabilities:								
Interest checking, savings, and money market deposits	$5,438,539	4,353	0.11	%	$5,174,225	3,573	0.09	%
Time deposits	753,853	2,924	0.52	%	760,071	2,345	0.41	%
Customer repurchase agreements	262,999	1,192	0.61	%	124,216	394	0.42	%
FHLB borrowings	34,179	530	2.07	%	119,638	1,049	1.17	%
Subordinated debt held by unconsolidated subsidiary trusts	117,170	3,645	4.16	%	112,677	2,808	3.33	%
Total interest-bearing liabilities	6,606,740	12,644	0.26	%	6,290,827	10,169	0.22	%
Noninterest-bearing liabilities:								
Noninterest checking deposits	2,298,008				1,961,220			
Other liabilities	147,208				177,297			
Shareholders' equity	1,643,561				1,434,548			
Total liabilities and shareholders' equity	$10,695,517				$9,863,892			
Net interest earnings		$260,951				$236,738		
Net interest spread			3.64	%			3.61	%
Net interest margin on interest-earning assets			3.72	%			3.67	%
Fully tax-equivalent adjustment		$3,283				$7,040		

(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 noninterest-earning assets, shareholders’ equity, and deferred taxes.
(2) Includes nonaccrual loans. The impact of interest and fees not recognized on nonaccrual loans was immaterial.

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As discussed above and disclosed in Table 3 below, the change in net interest income (fully tax-equivalent basis) may be analyzed by segregating the volume and rate components of the changes in interest income and interest expense for each underlying category.

Table 3: Rate/Volume

	Three months ended September 30, 2018 versus September 30, 2017 Increase (Decrease) Due to Change in [1]			Nine months ended September 30, 2018 versus September 30, 2017 Increase (Decrease) Due to Change in [1]		
(000's omitted)	Volume	Rate	Net Change	Volume	Rate	Net Change
Interest earned on:						
Cash equivalents	$ 0	$ 34	$ 34	$ 587	$ 318	$ 905
Taxable investment securities	16	142	158	3,280	(692)	2,588
Nontaxable investment securities	(723)	(954)	(1,677)	(2,203)	(3,007)	(5,210)
Loans	(595)	3,186	2,591	20,045	8,360	28,405
Total interest-earning assets [2]	(1,170)	2,276	1,106	22,162	4,526	26,688
Interest paid on:						
Interest checking, savings and money market deposits	(18)	345	327	189	591	780
Time deposits	(85)	399	314	(19)	598	579
Customer repurchase agreements	(29)	107	78	570	228	798
FHLB borrowings	(465)	281	(184)	(1,025)	506	(519)
Subordinated debt held by unconsolidated subsidiary trusts	(159)	237	78	116	721	837
Total interest-bearing liabilities [2]	(188)	801	613	531	1,944	2,475
Net interest earnings [2]	(1,117)	1,610	493	21,169	3,044	24,213

(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 Revenues

The Company’s sources of noninterest revenues are of four 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 BPAS and its subsidiaries); 3) wealth management services, comprised of trust services (performed by the trust unit within CBNA), investment products and services (performed by CISI) and asset management services (performed by Nottingham Advisors, Inc.); and 4) insurance products and services (performed by OneGroup). The Company also periodically records net gains or losses from the sale of investment securities and prepayment of debt instruments.

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Table 4: Noninterest Revenues

	Three Months Ended September 30,		Nine Months Ended September 30,	
(000's omitted)	2018	2017	2018	2017
Deposit service fees	$ 16,127	$ 18,419	$ 54,268	$ 49,781
Employee benefit services	23,265	20,767	68,813	58,618
Insurance services	8,270	6,344	23,044	19,709
Wealth management services	6,168	5,707	19,370	16,105
Other banking services	1,192	1,335	2,794	2,846
Mortgage banking	344	369	1,148	1,424
Subtotal	55,366	52,941	169,437	148,483
Unrealized gain on equity securities	743	0	722	0
Loss on debt extinguishment	(318)	0	(318)	0
Gain on sales of investment securities, net	0	0	0	2
Total noninterest revenues	$ 55,791	$ 52,941	$ 169,841	$ 148,485
Noninterest revenues/operating revenues (FTE basis) [1]	39.4 %	38.4 %		