

COMMUNITY BANK SYSTEM, INC.
Form 10-Q
May 10, 2017
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 March 31, 2017

OR

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

For the transition period from _____ to _____ .

Commission File Number: 001-13695

(Exact name of registrant as specified in its charter)

Delaware 16 1213679
(State or other jurisdiction of incorporation or organization) (I.R.S. Employer Identification No.)

5790 Widewaters Parkway, DeWitt, New York 13214-1883
(Address of principal executive offices) (Zip Code)

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

NONE

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

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, 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

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

(Do not check if a smaller reporting 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.

45,983,193 shares of Common Stock, \$1.00 par value per share, were outstanding on April 30, 2017.

TABLE OF CONTENTS

Part	Financial Information	Page
I.		
Item	Financial Statements (Unaudited)	
1.		
	Consolidated Statements of Condition March 31, 2017 and December 31, 2016_____	3
	Consolidated Statements of Income Three months ended March 31, 2017 and 2016_____	4
	Consolidated Statements of Comprehensive Income Three months ended March 31, 2017 and 2016_____	5
	Consolidated Statement of Changes in Shareholders' Equity Three months ended March 31, 2017_____	6
	Consolidated Statements of Cash Flows Three months ended March 31, 2017 and 2016_____	7
	Notes to the Consolidated Financial Statements March 31, 2017_____	8
Item	Management's Discussion and Analysis of Financial Condition and Results of 2. Operations_____	28
Item	Quantitative and Qualitative Disclosures about Market 3. Risk_____	44
Item	4. Controls and Procedures_____	45
Part	Other Information	
II.		
Item	1. Legal Proceedings_____	45
Item	1A. Risk Factors_____	45
Item	2. Unregistered Sales of Equity Securities and Use of Proceeds_____	46

Item 3.	Defaults Upon Senior Securities	46
Item 4.	Mine Safety Disclosures	46
Item 5.	Other Information	46
Item 6.	Exhibits	47

Part I. Financial Information

Item 1. Financial Statements

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

	March 31, 2017	December 31, 2016
Assets:		
Cash and cash equivalents	\$291,186	\$173,857
Available-for-sale investment securities (cost of \$2,695,204 and \$2,706,863, respectively)	2,740,890	2,748,656
Other securities, at cost	47,828	35,736
Loans held for sale, at fair value	673	2,416
Loans	4,932,213	4,948,562
Allowance for loan losses	(47,096)	(47,233)
Net loans	4,885,117	4,901,329
Goodwill, net	542,986	465,142
Core deposit intangibles, net	6,553	7,107
Other intangibles, net	69,438	8,595
Intangible assets, net	618,977	480,844
Premises and equipment, net	111,154	112,318
Accrued interest and fees receivable	28,466	31,093
Other assets	189,569	180,188
Total assets	\$8,913,860	\$8,666,437
Liabilities:		
Noninterest-bearing deposits	\$1,642,158	\$1,646,039
Interest-bearing deposits	5,694,719	5,429,915
Total deposits	7,336,877	7,075,954
Borrowings	0	146,200
Subordinated debt held by unconsolidated subsidiary trusts	102,177	102,170
Accrued interest and other liabilities	178,776	144,013
Total liabilities	7,617,830	7,468,337
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; 46,430,517 and 44,950,352 shares issued, respectively	46,431	44,950
Additional paid-in capital	627,015	545,775
Retained earnings	626,258	614,692

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

Accumulated other comprehensive income	10,354	7,843
Treasury stock, at cost (474,635 and 512,937 shares, respectively)	(14,028)	(15,160)
Total shareholders' equity	1,296,030	1,198,100
Total liabilities and shareholders' equity	\$8,913,860	\$8,666,437

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

3

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

	Three Months Ended March 31,	
	2017	2016
Interest income:		
Interest and fees on loans	\$52,384	\$51,650
Interest and dividends on taxable investments	13,566	13,596
Interest on nontaxable investments	4,008	4,510
Total interest income	69,958	69,756
Interest expense:		
Interest on deposits	1,730	1,894
Interest on borrowings	149	287
Interest on subordinated debt held by unconsolidated subsidiary trusts	805	694
Total interest expense	2,684	2,875
Net interest income	67,274	66,881
Provision for loan losses	1,828	1,341
Net interest income after provision for loan losses	65,446	65,540
Noninterest revenues:		
Deposit service fees	14,707	13,734
Other banking services	1,159	1,579
Employee benefit services	17,189	12,011
Insurance revenues	6,400	5,841
Wealth management services	4,861	5,116
Gain on investment securities	2	0
Total noninterest revenues	44,318	38,281
Noninterest expenses:		
Salaries and employee benefits	41,400	39,138
Occupancy and equipment	8,196	7,663
Data processing and communications	8,521	8,412
Amortization of intangible assets	2,768	1,442
Legal and professional fees	2,414	2,516
Office supplies and postage	1,674	1,778
Business development and marketing	2,081	2,013
FDIC insurance premiums	753	1,101
Acquisition expenses	1,716	77
Other expenses	4,052	3,529
Total noninterest expenses	73,575	67,669
Income before income taxes	36,189	36,152
Income taxes	9,932	11,749
Net income	\$26,257	\$24,403

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

Basic earnings per share	\$0.58	\$0.55
Diluted earnings per share	\$0.57	\$0.55
Cash dividends declared per share	\$0.32	\$0.31

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

4

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

	Three Months Ended March 31,	
	2017	2016
<u>Pension and other post-retirement obligations:</u>		
Amortization of actuarial losses included in net periodic pension cost, gross	\$265	\$375
Tax effect	(102)	(144)
Amortization of actuarial losses included in net periodic pension cost, net	163	231
Amortization of prior service cost included in net periodic pension cost, gross	(31)	(34)
Tax effect	12	13
Amortization of prior service cost included in net periodic pension cost, net	(19)	(21)
Other comprehensive income related to pension and other post-retirement obligations, net of taxes	144	210
<u>Unrealized gains on available-for-sale securities:</u>		
Net unrealized holding gains arising during period, gross	3,893	67,257
Tax effect	(1,526)	(25,415)
Net unrealized holding gains arising during period, net	2,367	41,842
Other comprehensive income related to unrealized gains on available-for-sale securities, net of taxes	2,367	41,842
Other comprehensive income, net of tax	2,511	42,052
Net income	26,257	24,403
Comprehensive income	\$28,768	\$66,455

	As of	
	March 31, 2017	December 31, 2016
<u>Accumulated Other Comprehensive Income By Component:</u>		
Unrealized loss for pension and other post-retirement obligations	\$ (28,735)	\$ (28,969)
Tax effect	10,918	11,008
Net unrealized loss for pension and other post-retirement obligations	(17,817)	(17,961)
Unrealized gain on available-for-sale securities	45,686	41,793
Tax effect	(17,515)	(15,989)
Net unrealized gain on available-for-sale securities	28,171	25,804
Accumulated other comprehensive income	\$ 10,354	\$ 7,843

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

5

COMMUNITY BANK SYSTEM, INC.
CONSOLIDATED STATEMENT OF CHANGES IN SHAREHOLDERS' EQUITY (Unaudited)
Three months ended March 31, 2017
(In Thousands, Except Share Data)

	Common Stock Shares Outstanding	Amount Issued	Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income	Treasury Stock	Total
Balance at December 31, 2016	44,437,415	\$44,950	\$545,775	\$614,692	\$ 7,843	\$ (15,160)	\$1,198,100
Net income				26,257			26,257
Other comprehensive income, net of tax					2,511		2,511
Cash dividends declared: Common, \$0.32 per share				(14,691)			(14,691)
Common stock issued under employee stock plan	157,801	158	1,651				1,809
Stock-based compensation			1,410				1,410
Stock issued for acquisition	1,322,364	1,323	77,160				78,483
Treasury stock issued to benefit plan	38,302		1,019			1,132	2,151
Balance at March 31, 2017	45,955,882	\$46,431	\$627,015	\$626,258	\$ 10,354	\$ (14,028)	\$1,296,030

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

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

	Three Months Ended March 31,	
	2017	2016
Operating activities:		
Net income	\$26,257	\$24,403
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	3,669	3,556
Amortization of intangible assets	2,768	1,442
Net accretion on securities, loans and borrowings	(406)	(911)
Stock-based compensation	1,410	1,219
Provision for loan losses	1,828	1,341
Amortization of mortgage servicing rights	126	131
Income from bank-owned life insurance policies	(368)	(355)
Net gain on sale of loans and other assets	(53)	(68)
Change in other assets and liabilities	7,430	(3,454)
Net cash provided by operating activities	42,661	27,304
Investing activities:		
Proceeds from maturities of available-for-sale investment securities	33,479	18,894
Proceeds from maturities of other investment securities	8,709	12,297
Purchases of available-for-sale investment securities	(16,784)	(12,255)
Purchases of other securities	(505)	(4,612)
Net change in loans	12,197	(22,031)
Cash paid for acquisition, net of cash acquired of \$11,063 and \$0, respectively	(63,517)	(575)
Purchases of premises and equipment, net	(2,088)	(2,639)
Net cash used in investing activities	(28,509)	(10,921)
Financing activities:		
Net change in deposits	260,923	245,588
Net change in borrowings	(146,200)	(267,600)
Issuance of common stock	1,809	932
Sales of treasury stock	2,151	5,022
Cash dividends paid	(14,186)	(13,605)
Withholding taxes paid on share-based compensation	(1,320)	(1,417)
Net cash provided by/(used in) financing activities	103,177	(31,080)
Change in cash and cash equivalents	117,329	(14,697)
Cash and cash equivalents at beginning of period	173,857	153,210
Cash and cash equivalents at end of period	\$291,186	\$138,513
Supplemental disclosures of cash flow information:		
Cash paid for interest	\$2,707	\$2,863
Cash paid for income taxes	9,044	7,065
Supplemental disclosures of noncash financing and investing activities:		
Dividends declared and unpaid	14,773	13,610
Transfers from loans to other real estate	920	390
Acquisitions:		

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

Common stock issued	78,483	0
Fair value of assets acquired, excluding acquired cash and intangibles	31,599	0
Fair value of liabilities assumed	30,500	0

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

7

COMMUNITY BANK SYSTEM, INC.
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)
MARCH 31, 2017

NOTE A: BASIS OF PRESENTATION

The interim financial data as of and for the three months ended March 31, 2017 is unaudited; however, in the opinion of Community Bank System, Inc. (the "Company"), the interim data includes all adjustments, consisting only of normal recurring adjustments, necessary for a fair statement of the results for the interim periods in conformity with generally accepted accounting principles ("GAAP"). The results of operations for the interim periods are not necessarily indicative of the results that may be expected for the full year or any other interim period.

NOTE B: ACQUISITIONS

Pending Acquisition – Merchants Bancshares, Inc.

On October 24, 2016, the Company announced that it had entered into a definitive agreement to acquire Merchants Bancshares, Inc. ("Merchants"), parent company of Merchants Bank headquartered in South Burlington, Vermont, for approximately \$335 million in Company stock and cash. The acquisition will extend the Company's footprint into the Vermont and Western Massachusetts markets. Upon the completion of the merger, Community Bank will add 31 branch locations in Vermont and one location in Massachusetts with approximately \$2.0 billion of assets, and deposits of \$1.5 billion. The Company and Merchants have received regulatory approvals from the Board of Governors of the Federal Reserve System and the Office of the Comptroller of the Currency ("OCC") for the announced merger and the acquisition is expected to close on May 12, 2017, subject to the satisfaction of customary closing conditions. The Company expects to incur certain one-time, transaction-related costs in 2017.

On March 1, 2017, the Company, through its subsidiary, OneGroup NY, Inc. ("OneGroup"), completed its acquisition of certain assets of Dryfoos Insurance Agency, Inc. ("Dryfoos"), an insurance agency headquartered in Hazleton, Pennsylvania. The Company paid \$3.3 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 approximately \$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 in 2008 as a non-depository trust company which provides fiduciary services for collective investment trusts and other products. The acquisition of NRS and GTC, hereafter referred to collectively as NRS, will strengthen and complement the Company's existing employee benefit services businesses. Upon the completion of the merger, NRS is a wholly-owned subsidiary of Benefit Plans Administrative Services, Inc. ("BPAS") and will operate as Northeast Retirement Services, LLC, a Delaware limited liability company. This transaction resulted in the acquisition of \$36.4 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 \$24.2 million deferred tax liability associated with the customer list intangible, and approximately \$76.2 million in goodwill. The effects of the acquired assets and liabilities have been included in the consolidated financial statements since that date. Revenues of \$5.1 million and expenses of \$3.6 million from NRS were included in the consolidated income statement for the three months ended March 31, 2017.

On January 4, 2017, the Company, through its subsidiary, OneGroup, completed its acquisition of 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 BAS and recorded intangible assets of \$1.2 million in conjunction with

the acquisition. The effects of the acquired assets and liabilities have been included in the consolidated financial statements since that date.

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

The assets and liabilities assumed in the acquisitions were recorded at their estimated fair values based on management's best estimates using information available at the dates of the acquisition, and were subject to adjustment based on updated information not available at the time of acquisition.

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

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

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

(000s omitted)	2017			2016	
	BAS	NRS	Dryfoos	Total	WJL
Consideration paid :					
Cash	\$ 1,200	\$ 70,073	\$ 3,307	\$ 74,580	\$ 575
Community Bank System, Inc. common stock	0	78,483	0	78,483	0
Total net consideration paid	1,200	148,556	3,307	153,063	575
Recognized amounts of identifiable assets acquired and liabilities assumed:					
Cash and cash equivalents	0	11,063	0	11,063	0
Investment securities	0	20,294	0	20,294	0
Premises and equipment	0	411	0	411	0
Accrued interest receivable	0	75	0	75	0
Other assets	0	10,819	0	10,819	0
Other intangibles	1,200	60,200	1,657	63,057	288
Other liabilities	0	(30,500)	0	(30,500)	0
Total identifiable assets, net	1,200	72,362	1,657	75,219	288
Goodwill	\$ 0	\$ 76,194	\$ 1,650	\$ 77,844	\$ 287

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

Direct costs related to the acquisitions were expensed as incurred. Merger and acquisition integration-related expenses amount to \$1.7 million and \$0.1 million during the three months ended March 31, 2017 and 2016, respectively, and have been separately stated in the Consolidated Statements of Income.

Supplemental Pro Forma Financial Information

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

The pro forma information set forth below reflects the historical results of NRS combined with the Company's consolidated statement of income with adjustments related to amortization of customer lists intangibles.

(000's omitted)

Pro Forma
(Unaudited)

	Three Months Ended March 31, 2016
Total revenue, net of interest expense	\$ 112,694
Net income	24,358

NOTE C: ACCOUNTING POLICIES

The accounting policies of the Company, as applied in the consolidated interim financial statements presented herein, are substantially the same as those followed on an annual basis as presented on pages 56 through 61 of the Annual Report on Form 10-K for the year ended December 31, 2016 filed with the Securities and Exchange Commission ("SEC") on March 1, 2017.

Critical Accounting Policies

Acquired Loans

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

Acquired Impaired Loans

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

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

Acquired Non-impaired Loans

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

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

loss is recognized.

Allowance for Loan Losses

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

10

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

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

Investment Securities

The Company can classify its investments in debt and equity securities as held-to-maturity, available-for-sale, or trading. Held-to-maturity securities are those for which the Company has the positive intent and ability to hold until maturity, and are reported at cost, which is adjusted for amortization of premiums and accretion of discounts. Securities classified as available-for-sale are reported at fair value with net unrealized gains and losses reflected as a separate component of shareholders' equity, net of applicable income taxes. None of the Company's investment securities have been classified as trading securities at March 31, 2017. Certain equity securities are stated at cost and include restricted stock of the Federal Reserve Bank of New York ("Federal Reserve") and Federal Home Loan Bank of New York ("FHLB").

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

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

An OTTI loss must be recognized for a debt security in an unrealized loss position if there is intent to sell the security or it is more likely than not the Company will be required to sell the security prior to recovery of its amortized cost basis. In this situation, the amount of loss recognized in income is equal to the difference between the fair value and the amortized cost basis of the security. Even if management does not have the intent, and it is not more likely than

not that the Company will be required to sell the securities, an evaluation of the expected cash flows to be received is performed to determine if a credit loss has occurred. For debt securities, a critical component of the evaluation for OTTI is the identification of credit-impaired securities, where the Company does not expect to receive cash flows sufficient to recover the entire amortized cost basis of the security. In the event of a credit loss, only the amount of impairment associated with the credit loss would be recognized in income. The portion of the unrealized loss relating to other factors, such as liquidity conditions in the market or changes in market interest rates, is recorded in accumulated other comprehensive loss.

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

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

Intangible Assets

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

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

Retirement Benefits

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

Recently Adopted Accounting Pronouncement

In March 2016, the FASB issued ASU 2016-09, Compensation – Stock Compensation (Topic 718). The amendments simplify several aspects of the accounting for share-based payment transactions, including the income tax consequences, classification of awards as either equity or liabilities, accounting for award forfeitures, and classification on the statement of cash flows. The amendments were effective for public business entities for the first interim and annual reporting periods beginning after December 15, 2016 and the Company adopted the amendments as of January 1, 2017. The new guidance requires entities to prospectively recognize all excess tax benefits and tax deficiencies related to share-based payment awards as income tax benefit or expense in the statement of income when the awards vest or are settled. Previously, income tax benefits (or deficiencies) were reported as increases (or decreases) to additional paid-in capital to the extent that those benefits were greater than (or less than) the income tax benefits recognized in earnings during the awards' vesting periods. In addition, excess tax benefits and deficiencies are to be classified as an operating activity in the statement of cash flows, rather than a financing activity as required under prior accounting guidance. The new guidance also requires employee taxes paid when an employer withholds shares for withholding tax purposes to be classified as a financing activity in the statement of cash flows. The Company has elected to apply the changes in presentation on the statement of cash flows for excess tax benefits and deficiencies and employee taxes paid when an employer withholds shares on a retrospective basis. The Company has also elected to continue to incorporate estimated forfeitures in the accrual of compensation expense, and this election had no impact on the Company's consolidated financial statements. For the three months ended March 31, 2017, the effect on net income from excess tax benefits was \$2.2 million, or approximately \$0.05 per diluted common share.

New Accounting Pronouncements

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

beginning after December 15, 2017, and should be applied either retrospectively to each prior reporting period presented or retrospectively with the cumulative effect of initially applying this guidance recognized at the date of initial application. The Company's implementation efforts include the identification of revenue within the scope of the guidance, as well as evaluation of revenue contracts. The Company's review is ongoing, and the Company will continue to evaluate any impact as additional guidance is issued and as our internal assessment progresses.

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

In February 2016, the FASB issued ASU 2016-02, Leases (Topic 842). This new guidance supersedes the lease requirements in Topic 840, Leases and is based on the principle that a lessee should recognize in the statement of financial position a liability to make lease payments (the lease liability) and a right-of-use asset representing its right to use the underlying asset for the lease term. The accounting applied by a lessor is largely unchanged from that applied under the previous guidance. In addition, the guidance requires an entity to separate the lease components from the nonlease components in a contract. The ASU requires disclosures about the amount, timing, and judgments related to a reporting entity's accounting for leases and related cash flows. The standard is required to be applied to all leases in existence as of the date of adoption using a modified retrospective transition approach. This guidance is effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Early adoption is permitted for all companies in any interim or annual period. The Company 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.

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 an increase in the allowance for credit losses resulting from the change to expected losses for the estimated life of the financial asset, including an allowance for debt securities. The amount of the increase in the allowance for credit 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.

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

In January 2017, the FASB issued ASU No. 2017-04, Intangibles-Goodwill and Other (Topic 350). The amendments simplify how an entity is required to test goodwill for impairment by eliminating the requirement to measure a goodwill impairment loss by comparing the implied fair value of a reporting unit's goodwill with the carrying amount of that goodwill. Instead, an entity will perform its goodwill impairment test by comparing the fair value of a reporting unit with its carrying amount, and recognize an impairment charge for the amount by which the carrying amount of the reporting unit exceeds its fair value. Impairment loss recognized under this new guidance will be limited to the goodwill allocated to the reporting unit. This ASU is effective prospectively for the Company for

annual or interim goodwill impairment tests in fiscal years beginning after December 15, 2019. Early adoption is permitted for interim or annual goodwill impairment tests performed on testing dates after January 1, 2017. This ASU is not expected to have a material impact on the Company's consolidated financial statements.

In March 2017, the FASB issued ASU No. 2017-07, Compensation – Retirement Benefits (Topic 715): Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost. This new guidance requires the service cost component of net periodic pension and postretirement benefit costs to be presented separately from other components of net benefit cost in the statement of income. This ASU is effective for the Company for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. This ASU is not expected to have a material impact on the Company's consolidated financial statements.

13

NOTE D: INVESTMENT SECURITIES

The amortized cost and estimated fair value of investment securities as of March 31, 2017 and December 31, 2016 are as follows:

(000's omitted)	March 31, 2017				December 31, 2016			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available-for-Sale Portfolio:								
U.S. Treasury and agency securities	\$1,878,982	\$30,358	\$1,106	\$1,908,234	\$1,876,358	\$28,522	\$2,118	\$1,902,762
Obligations of state and political subdivisions	564,501	14,603	446	578,658	582,655	13,389	1,054	594,990
Government agency mortgage-backed securities	237,257	4,526	2,729	239,054	232,657	5,040	2,467	235,230
Corporate debt securities	5,697	0	16	5,681	5,716	2	31	5,687
Government agency collateralized mortgage obligations	8,516	293	0	8,809	9,225	310	0	9,535
Marketable equity securities	251	203	0	454	252	200	0	452
Total available-for-sale portfolio	\$2,695,204	\$49,983	\$4,297	\$2,740,890	\$2,706,863	\$47,463	\$5,670	\$2,748,656
Other Securities:								
Federal Home Loan Bank common stock	\$5,590			\$5,590	\$12,191			\$12,191
Federal Reserve Bank common stock	19,781			19,781	19,781			19,781
Certificates of deposit	18,758			18,758	0			0
Other equity securities	3,699			3,699	3,764			3,764
Total other securities	\$47,828			\$47,828	\$35,736			\$35,736

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

As of March 31, 2017

(000's omitted)	Less than 12 Months			12 Months or Longer			Total	
	#	Fair Value	Gross Unrealized Losses	#	Fair Value	Gross Unrealized Losses	#	Fair Value
								Gross Unrealized Losses

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

Available-for-Sale Portfolio:

U.S. Treasury and agency securities	7	\$258,008	\$ 1,106	0	\$0	\$ 0	7	\$258,008	\$ 1,106
Obligations of state and political subdivisions	75	40,177	446	0	0	0	75	40,177	446
Government agency mortgage-backed securities	67	95,749	1,866	14	21,228	863	81	116,977	2,729
Corporate debt securities	1	2,677	16	0	0	0	1	2,677	16
Government agency collateralized mortgage obligations	0	0	0	2	2	0	2	2	0
Total available-for-sale investment portfolio	150	\$396,611	\$ 3,434	16	\$21,230	\$ 863	166	\$417,841	\$ 4,297

As of December 31, 2016

(000's omitted)	Less than 12 Months			12 Months or Longer			Total		
	#	Fair Value	Gross Unrealized Losses	#	Fair Value	Gross Unrealized Losses	#	Fair Value	Gross Unrealized Losses

Available-for-Sale Portfolio:

U.S. Treasury and agency securities	13	\$449,242	\$ 2,118	0	\$0	\$ 0	13	\$449,242	\$ 2,118
Obligations of state and political subdivisions	197	102,106	1,054	0	0	0	197	102,106	1,054
Government agency mortgage-backed securities	57	83,862	1,637	15	21,788	830	72	105,650	2,467
Corporate debt securities	1	2,677	31	0	0	0	1	2,677	31
Government agency collateralized mortgage obligations	0	0	0	2	2	0	2	2	0
Total available-for-sale investment portfolio	268	\$637,887	\$ 4,840	17	\$21,790	\$ 830	285	\$659,677	\$ 5,670

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 the Ginnie Mae, Fannie Mae, and the Federal Home Loan Mortgage Corporation ("FHLMC"), which are currently rated AAA by Moody's Investor Services, AA+ by Standard & Poor's and are guaranteed by the U.S. government. The majority of the obligations of state and political subdivisions and corporations carry a credit rating of A or better. Additionally, a majority of the obligations of state and political subdivisions carry a secondary level of credit enhancement. The Company does not intend to sell these securities, nor is it more likely than not that the Company will be required to sell these securities prior to recovery of the amortized cost. The unrealized losses in the portfolios are primarily attributable to changes in interest rates. As such, management does not believe any individual unrealized loss as of March 31, 2017 represents OTTI.

The amortized cost and estimated fair value of debt securities at March 31, 2017, by contractual maturity, are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties. Securities not due at a single maturity date are shown separately.

(000's omitted)	Available-for-Sale	
	Amortized Cost	Fair Value
Due in one year or less	\$38,222	\$38,447
Due after one through five years	1,199,564	1,221,056
Due after five years through ten years	1,041,199	1,058,066
Due after ten years	170,195	175,004
Subtotal	2,449,180	2,492,573
Government agency mortgage-backed securities	237,257	239,054
Government agency collateralized mortgage obligations	8,516	8,809
Total	\$2,694,953	\$2,740,436

NOTE E: LOANS

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

Consumer mortgages consist primarily of fixed rate residential instruments, typically 10 – 30 years in contractual term, secured by first liens on real property.

Business lending is comprised of general purpose commercial and industrial loans including, but not limited to, agricultural-related and dealer floor plans, as well as mortgages on commercial properties.

Consumer indirect consists primarily of installment loans originated through selected dealerships and are secured by automobiles, marine and other recreational vehicles.

Consumer direct consists of all other loans to consumers such as personal installment loans and lines of credit.

Home equity products are consumer purpose installment loans or lines of credit most often secured by a first or second lien position on residential real estate with terms up to 30 years.

The balances of these classes are summarized as follows:

(000's omitted)	March 31, 2017	December 31, 2016
Consumer mortgage	\$1,830,800	\$1,819,701
Business lending	1,468,465	1,490,076
Consumer indirect	1,055,112	1,044,972
Consumer direct	184,067	191,815
Home equity	393,769	401,998

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

Gross loans, including deferred origination costs	4,932,213	4,948,562
Allowance for loan losses	(47,096)	(47,233)
Loans, net of allowance for loan losses	\$4,885,117	\$4,901,329

The outstanding balance related to credit impaired acquired loans was \$6.5 million and \$6.6 million at March 31, 2017 and December 31, 2016, respectively. The changes in the accretable discount related to the credit impaired acquired loans are as follows:

(000's omitted)	
Balance at December 31, 2016	\$498
Accretion recognized, year-to-date	(72)
Net reclassification to accretable from non-accretable	100
Balance at March 31, 2017	\$526

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 March 31, 2017:

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

(000's omitted)	Past Due	90+ Days Past Due and Still	Nonaccrual	Total		Total Loans
	30 – 89 Days	Accruing		Past Due	Current	
Consumer mortgage	\$7,717	\$ 742	\$ 10,999	\$19,458	\$1,657,788	\$1,677,246
Business lending	2,776	569	2,970	6,315	1,266,627	1,272,942
Consumer indirect	8,941	123	0	9,064	1,019,069	1,028,133
Consumer direct	1,047	79	0	1,126	174,413	175,539
Home equity	967	194	1,299	2,460	312,915	315,375
Total	\$21,448	\$ 1,707	\$ 15,268	\$38,423	\$4,430,812	\$4,469,235

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

(000's omitted)	Past Due	90+ Days Past Due and Still	Nonaccrual	Total		Total Loans
	30 – 89 Days	Accruing		Past Due	Acquired Impaired ⁽¹⁾	
Consumer mortgage	\$907	\$ 111	\$ 2,574	\$3,592	\$ 0	\$149,962
Business lending	332	0	1,718	2,050	5,440	188,033
Consumer indirect	147	3	0	150	0	26,829
Consumer direct	100	0	0	100	0	8,428
Home equity	415	988	506	1,909	0	76,485
Total	\$1,901	\$ 1,102	\$ 4,798	\$7,801	\$ 5,440	\$449,737

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

The following is an aged analysis of the Company's past due loans by class as of December 31, 2016:

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

(000's omitted)	Past Due 30 – 89 Days	90+ Days Past Due and Still Accruing	Nonaccrual	Total Past Due	Current	Total Loans
Consumer mortgage	\$11,379	\$ 1,180	\$ 11,352	\$23,911	\$1,635,849	\$1,659,760
Business lending	3,921	145	3,811	7,877	1,269,789	1,277,666
Consumer indirect	13,883	166	0	14,049	1,000,776	1,014,825
Consumer direct	1,549	58	0	1,607	180,315	181,922
Home equity	1,250	414	1,437	3,101	315,928	319,029
Total	\$31,982	\$ 1,963	\$ 16,600	\$50,545	\$4,402,657	\$4,453,202

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

(000's omitted)	Past Due	90+ Days Past Due and Still Accruing	Nonaccrual	Total Past Due	Acquired Impaired ⁽¹⁾	Current	Total Loans
	30 – 89 Days						
Consumer mortgage	\$ 1,539	\$ 205	\$ 2,332	\$ 4,076	\$ 0	\$ 155,865	\$ 159,941
Business lending	528	0	1,252	1,780	5,553	205,077	212,410
Consumer indirect	231	3	0	234	0	29,913	30,147
Consumer direct	231	0	0	231	0	9,662	9,893
Home equity	778	905	435	2,118	0	80,851	82,969
Total	\$ 3,307	\$ 1,113	\$ 4,019	\$ 8,439	\$ 5,553	\$ 481,368	\$ 495,360

Acquired impaired loans were not classified as nonperforming assets as the loans are considered to be performing (1) 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:

(000's omitted)	March 31, 2017			December 31, 2016		
	Legacy	Acquired	Total	Legacy	Acquired	Total
Pass	\$ 1,040,398	\$ 147,347	\$ 1,187,745	\$ 1,051,005	\$ 162,165	\$ 1,213,170
Special mention	141,807	24,122	165,929	135,602	29,690	165,292
Classified	90,691	18,614	109,305	90,585	15,002	105,587
Doubtful	46	0	46	474	0	474
Acquired impaired	0	5,440	5,440	0	5,553	5,553
Total	\$ 1,272,942	\$ 195,523	\$ 1,468,465	\$ 1,277,666	\$ 212,410	\$ 1,490,076

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 March 31, 2017:

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

(000's omitted)	Consumer Mortgage	Consumer Indirect	Consumer Direct	Home Equity	Total
Performing	\$1,665,505	\$1,028,010	\$175,460	\$313,882	\$3,182,857
Nonperforming	11,741	123	79	1,493	13,436
Total	\$1,677,246	\$1,028,133	\$175,539	\$315,375	\$3,196,293

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

(000's omitted)	Consumer Mortgage	Consumer Indirect	Consumer Direct	Home Equity	Total
Performing	\$ 150,869	\$ 26,976	\$ 8,528	\$ 76,900	\$ 263,273
Nonperforming	2,685	3	0	1,494	4,182
Total	\$ 153,554	\$ 26,979	\$ 8,528	\$ 78,394	\$ 267,455

The following table details the balances in all other loan categories at December 31, 2016:

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

(000's omitted)	Consumer Mortgage	Consumer Indirect	Consumer Direct	Home Equity	Total
Performing	\$ 1,647,228	\$ 1,014,659	\$ 181,864	\$ 317,178	\$ 3,160,929
Nonperforming	12,532	166	58	1,851	14,607
Total	\$ 1,659,760	\$ 1,014,825	\$ 181,922	\$ 319,029	\$ 3,175,536

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

(000's omitted)	Consumer Mortgage	Consumer Indirect	Consumer Direct	Home Equity	Total
Performing	\$ 157,404	\$ 30,144	\$ 9,893	\$ 81,629	\$ 279,070
Nonperforming	2,537	3	0	1,340	3,880
Total	\$ 159,941	\$ 30,147	\$ 9,893	\$ 82,969	\$ 282,950

All loan classes are collectively evaluated for impairment except business lending, as described in Note C. A summary of individually evaluated impaired loans as of March 31, 2017 and December 31, 2016 follows:

(000's omitted)	March 31, 2017	December 31, 2016
Loans with allowance allocation	\$ 580	\$ 1,109
Loans without allowance allocation	0	556
Carrying balance	580	1,665
Contractual balance	2,229	3,340
Specifically allocated allowance	46	477

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 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 months ended March 31, 2017 and 2016 was immaterial.

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.

18

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

Information regarding TDRs as of March 31, 2017 and December 31, 2016 is as follows:

(000's omitted)	March 31, 2017						December 31, 2016					
	Nonaccrual		Accruing		Total		Nonaccrual		Accruing		Total	
	#	Amount	#	Amount	#	Amount	#	Amount	#	Amount	#	Amount
Consumer mortgage	44	\$ 2,082	43	\$ 1,812	87	\$ 3,894	36	\$ 1,520	45	\$ 1,956	81	\$ 3,476
Business lending	6	76	4	323	10	399	6	91	5	690	11	781
Consumer indirect	0	0	79	776	79	776	0	0	78	771	78	771
Consumer direct	0	0	13	76	13	76	0	0	23	65	23	65
Home equity	14	267	7	213	21	480	14	221	7	216	21	437
Total	64	\$ 2,425	146	\$ 3,200	210	\$ 5,625	56	\$ 1,832	158	\$ 3,698	214	\$ 5,530

The following table presents information related to loans modified in a TDR during the three months ended March 31, 2017 and 2016. Of the loans noted in the table below, all loans for the three months ended March 31, 2017 and 2016 were modified due to a Chapter 7 bankruptcy as described previously. The financial effects of these restructurings were immaterial.

(000's omitted)	Three Months Ended March 31, 2017		Three Months Ended March 31, 2016	
	Number of loans Outstanding		Number of loans Outstanding	
	modified	Balance	modified	Balance
Consumer mortgage	7	\$ 502	4	\$ 266
Business lending	0	0	0	0
Consumer indirect	8	106	12	238
Consumer direct	4	15	0	0
Home equity	2	98	1	0
Total	21	\$ 721	17	\$ 504

Allowance for Loan Losses

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

(000's omitted)	Three Months Ended March 31, 2017							
	Consumer Mortgage	Business Lending	Consumer Indirect	Consumer Direct	Home Equity	Unallocated	Acquired Impaired	Total
Beginning balance	\$ 10,094	\$ 17,220	\$ 13,782	\$ 2,979	\$ 2,399	\$ 651	\$ 108	\$ 47,233
Charge-offs	(85)	(695)	(1,947)	(417)	(38)	0	0	(3,182)
Recoveries	7	71	869	245	25	0	0	1,217
Provision	133	261	1,292	45	(27)	122	2	1,828
Ending balance	\$ 10,149	\$ 16,857	\$ 13,996	\$ 2,852	\$ 2,359	\$ 773	\$ 110	\$ 47,096

(000's omitted)	Three Months Ended March 31, 2016							
	Consumer Mortgage	Business Lending	Consumer Indirect	Consumer Direct	Home Equity	Unallocated	Acquired Impaired	Total
Beginning balance	\$ 10,198	\$ 15,749	\$ 12,422	\$ 2,997	\$ 2,666	\$ 1,201	\$ 168	\$ 45,401
Charge-offs	(88)	(210)	(1,854)	(462)	(57)	0	0	(2,671)

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

Recoveries	45	136	1,114	221	9	0	0	1,525
Provision	(7)	1,020	652	119	(38)	(322)	(83)	1,341
Ending balance	\$10,148	\$16,695	\$12,334	\$2,875	\$2,580	\$879	\$85	\$45,596

19

NOTE F: GOODWILL AND IDENTIFIABLE INTANGIBLE ASSETS

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

(000's omitted)	March 31, 2017			December 31, 2016		
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Amortizing intangible assets:						
Core deposit intangibles	\$39,688	\$ (33,135)	\$6,553	\$39,688	\$ (32,581)	\$7,107
Other intangibles	80,910	(11,472)	69,438	17,853	(9,258)	8,595
Total amortizing intangibles	\$120,598	\$ (44,607)	\$75,991	\$57,541	\$ (41,839)	\$15,702

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

(000's omitted)	
Apr - Dec 2017	\$10,496
2018	11,918
2019	9,886
2020	8,150
2021	7,119
Thereafter	28,422
Total	\$75,991

Shown below are the components of the Company's goodwill at December 31, 2016 and March 31, 2017:

(000's omitted)	December 31, 2016		March 31, 2017	
	Goodwill	Activity	Goodwill	Activity
Goodwill	\$469,966	\$77,844	\$547,810	
Accumulated impairment	(4,824)	0	(4,824)	
Goodwill, net	\$465,142	\$77,844	\$542,986	

NOTE G: MANDATORILY REDEEMABLE PREFERRED SECURITIES

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

Trust	Issuance Date	Par Amount	Interest Rate	Maturity Date	Call Price
III	7/31/2001	\$24.5 million	3 month LIBOR plus 3.58% (4.62%)	7/31/2031	Par
IV	12/8/2006	\$75 million	3 month LIBOR plus 1.65% (2.78%)	12/15/2036	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. The Company made a \$2.9 million contribution to its defined benefit pension plan in the first quarter of 2017.

The net periodic (benefit) cost for the three months ended March 31, 2017 and 2016 is as follows:

	Pension Benefits		Post-retirement Benefits	
	Three Months Ended		Three Months Ended	
(000's omitted)	March 31, 2017	March 31, 2016	March 31, 2017	March 31, 2016
Service cost	\$ 1,039	\$ 1,026	\$ 0	\$ 0
Interest cost	1,361	1,406	19	20
Expected return on plan assets	(3,121)	(2,960)	0	0
Amortization of unrecognized net loss	263	377	2	(1)
Amortization of prior service cost	14	11	(45)	(45)
Net periodic (benefit) cost	\$ (444)	\$ (140)	\$ (24)	\$ (26)

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 March 31, 2017.

Basic earnings per share are computed based on the weighted-average of the common shares outstanding for the period. Diluted earnings per share are based on the weighted-average of the shares outstanding adjusted for the dilutive effect of restricted stock and the assumed exercise of stock options during the year. The dilutive effect of options is calculated using the treasury stock method of accounting. The treasury stock method determines the number of common shares that would be outstanding if all the dilutive options (those where the average market price is greater than the exercise price) were exercised and the proceeds were used to repurchase common shares in the open market at the average market price for the applicable time period. There were approximately 0.2 million weighted-average anti-dilutive stock options outstanding for the three months ended March 31, 2017, compared to approximately 0.6 million weighted-average anti-dilutive stock options outstanding for the three months ended March 31, 2016 that were not included in the computation below.

The following is a reconciliation of basic to diluted earnings per share for the three months ended March 31, 2017 and 2016:

(000's omitted, except per share data)	Three Months Ended	
	March 31, 2017	March 31, 2016
Net income	\$26,257	\$24,403

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

Income attributable to unvested stock-based compensation awards	(138)	(89)
Income available to common shareholders	\$26,119	\$24,314
Weighted-average common shares outstanding – basic	45,284	43,863
Basic earnings per share	\$0.58	\$0.55
Net income	\$26,257	\$24,403
Income attributable to unvested stock-based compensation awards	(138)	(89)
Income available to common shareholders	\$26,119	\$24,314
Weighted-average common shares outstanding – basic	45,284	43,863
Assumed exercise of stock options	703	333
Weighted-average common shares outstanding – diluted	45,987	44,196
Diluted earnings per share	\$0.57	\$0.55

Stock Repurchase Program

At its December 2016 meeting, the Company's Board of Directors approved a stock repurchase program authorizing the repurchase of up to 2.2 million shares of the Company's common stock in accordance with securities laws and regulations, through December 31, 2017. 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 three months of 2017.

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:

	March 31, 2017	December 31, 2016
(000's omitted)		
Commitments to extend credit	\$770,666	\$773,442
Standby letters of credit	23,004	22,656
Total	\$793,670	\$796,098

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 March 31, 2017, 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:

- 1 - Level 1 Quoted prices in active markets for identical assets or liabilities.
- 2 - 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.
- 3 - 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.

22

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

March 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	\$1,908,234	\$0	\$0	\$1,908,234
Obligations of state and political subdivisions	0	578,658	0	578,658
Government agency mortgage-backed securities	0	239,054	0	239,054
Corporate debt securities	0	5,681	0	5,681
Government agency collateralized mortgage obligations	0	8,809	0	8,809
Marketable equity securities	454	0	0	454
Total available-for-sale investment securities	1,908,688	832,202	0	2,740,890
Mortgage loans held for sale	0	673	0	673
Commitments to originate real estate loans for sale	0	0	114	114
Forward sales commitments	0	(19)	0	(19)
Total	\$1,908,688	\$832,856	\$114	\$2,741,658
December 31, 2016				
(000's omitted)	Level 1	Level 2	Level 3	Total Fair Value
Available-for-sale investment securities:				
U.S. Treasury and agency securities	\$1,902,762	\$0	\$0	\$1,902,762
Obligations of state and political subdivisions	0	594,990	0	594,990
Government agency mortgage-backed securities	0	235,230	0	235,230
Corporate debt securities	0	5,687	0	5,687
Government agency collateralized mortgage obligations	0	9,535	0	9,535
Marketable equity securities	452	0	0	452
Total available-for-sale investment securities	1,903,214	845,442	0	2,748,656
Mortgage loans held for sale	0	2,416	0	2,416
Commitments to originate real estate loans for sale	0	0	54	54
Forward sales commitments	0	3	0	3
Total	\$1,903,214	\$847,861	\$54	\$2,751,129

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

Available-for-sale investment securities – The fair values of available-for-sale investment 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 marketable equity securities that are traded by dealers or brokers in active over-the-counter markets. Level 2 securities include U.S. agency securities, mortgage-backed securities issued by government-sponsored entities, municipal securities and corporate debt securities that are valued by reference to prices for similar securities or through model-based techniques in which all significant inputs, such as reported trades, trade execution data, LIBOR swap yield curve, market prepayment speeds, credit information, market spreads, and security's terms and conditions, are observable. See Note D for further disclosure of the fair value of investment securities.

Mortgage loans held for sale –The Company has elected to value loans held for sale at fair value in order to more closely match the gains and losses associated with loans held for sale with the gains and losses on forward sales contracts. Accordingly, the impact on the valuation will be recognized in the Company's consolidated statement of income. All mortgage loans held for sale are current and in performing status. 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. The unpaid principal value of mortgage loans held for sale at March 31, 2017 was approximately \$0.7 million. The unrealized gain on mortgage loans held for sale was recognized in mortgage banking and other income in the consolidated statement 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 balance sheet. The fair value of these forward sales commitments is primarily measured by obtaining pricing from certain government-sponsored entities and reflects the underlying price the entity would pay the Company for an immediate sale on these mortgages. As such, these instruments are classified as Level 2 in the fair value hierarchy.

23

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

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

	Three Months Ended	
	March 31, 2017	March 31, 2016
(000's omitted)		
Beginning balance	\$ 54	\$ 117
Total losses included in earnings ⁽¹⁾	(54)	(117)
Commitments to originate real estate loans held for sale, net	114	282
Ending balance	\$ 114	\$ 282

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

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.

	March 31, 2017				December 31, 2016			
	Level 1	Level 2	Level 3	Total Fair Value	Level 1	Level 2	Level 3	Total Fair Value
(000's omitted)								
Impaired loans	\$ 0	\$ 0	\$ 535	\$ 535	\$ 0	\$ 0	\$ 633	\$ 633
Other real estate owned	0	0	2,486	2,486	0	0	1,966	1,966
Total	\$ 0	\$ 0	\$ 3,021	\$ 3,021	\$ 0	\$ 0	\$ 2,599	\$ 2,599

Loans are generally not recorded at fair value on a recurring basis. Periodically, the Company records nonrecurring adjustments to the carrying value of loans based on fair value measurements for partial charge-offs of the uncollectible portions of those loans. Nonrecurring adjustments also include certain impairment amounts for collateral-dependent loans calculated when establishing the allowance for credit losses. Such amounts are generally based on the fair value

of the underlying collateral supporting the loan and, as a result, the carrying value of the loan less the calculated valuation amount does not necessarily represent the fair value of the loan. Real estate collateral is typically valued using independent appraisals or other indications of value based on recent comparable sales of similar properties or assumptions generally observable in the marketplace, adjusted for non-observable inputs. Thus, the resulting nonrecurring fair value measurements are generally classified as Level 3. Estimates of fair value used for other collateral supporting commercial loans generally are based on assumptions not observable in the marketplace and, therefore, such valuations classify as Level 3.

Other real estate owned ("OREO") is valued at the time the loan is foreclosed upon and the asset is transferred to OREO. The value is based primarily on third party appraisals, less 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 2% to 96% at March 31, 2017 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.

24

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 March 31, 2017.

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 March 31, 2017	Valuation Technique	Significant Unobservable Inputs	Significant Unobservable Input Range (Weighted Average)	
Other real estate owned	\$2,486	Fair Value of Collateral	Estimated cost of disposal/market adjustment	2.3% - 96.0%	(35.4 %)
Impaired loans	535	Fair Value of Collateral	Estimated cost of disposal/market adjustment	9% - 43%	(26.0 %)
Commitments to originate real estate loans for sale	114	Discounted cash flow	Embedded servicing value	1	%

(000's omitted)	Fair Value at December 31, 2016	Valuation Technique	Significant Unobservable Inputs	Significant Unobservable Input Range (Weighted Average)	
Other real estate owned	\$ 1,966	Fair value of collateral	Estimated cost of disposal/market adjustment	9.0% - 97.0%	(29.6 %)
Impaired loans	633	Fair value of collateral	Estimated cost of disposal/market adjustment	15.0% - 50.0%	(36.5 %)
Commitments to originate real estate loans for sale	54	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 March 31, 2017 and December 31, 2016 are as follows:

	March 31, 2017		December 31, 2016	
	Carrying Value	Fair Value	Carrying Value	Fair Value
(000's omitted)				
Financial assets:				
Net loans	\$4,885,117	\$4,918,453	\$4,901,329	\$4,935,140
Financial liabilities:				
Deposits	7,336,877	7,331,201	7,075,954	7,071,191
Borrowings	0	0	146,200	146,200
Subordinated debt held by unconsolidated subsidiary trusts	102,177	91,164	102,170	90,144

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.

25

Borrowings have been classified as a Level 2 valuation. The fair value of FHLB overnight advances is the amount payable on demand at the reporting date.

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

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

NOTE L: DERIVATIVE INSTRUMENTS

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

The Company enters into forward sales commitments for the future delivery of residential mortgage loans, and interest rate lock commitments to fund loans at a specified interest rate. The forward sales commitments are utilized to reduce interest rate risk associated with interest rate lock commitments and loans held for sale. Changes in the estimated fair value of the forward sales commitments and interest rate lock commitments subsequent to inception are based on changes in the fair value of the underlying loan resulting from the fulfillment of the commitment and changes in the probability that the loan will fund within the terms of the commitment, which is affected primarily by changes in interest rates and the passage of time. At inception and during the life of the interest rate lock commitment, the Company includes the expected net future cash flows related to the associated servicing of the loan as part of the fair value measurement of the interest rate lock commitments. These derivatives are recorded at fair value, which were immaterial at March 31, 2017. The effect of the changes to these derivatives for the three months then ended was also immaterial.

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 northern, central, and western New York as well as northeastern Pennsylvania. Employee Benefit Services, which includes the operating subsidiaries Benefit Plans Administrative Services, LLC, BPAS Actuarial and Pension Services, LLC (formerly Harbridge Consulting Group, LLC), BPAS Trust Company of Puerto Rico, Northeast Retirement Services, LLC, and Hand Benefits & Trust Company, provides employee benefit trust, collective investment fund, retirement plan administration, 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 Community Investment Services, Inc. ("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, 2016 filed with the SEC on March 1, 2017).

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 March 31, 2017					
Net interest income	\$67,134	\$78	\$62	\$ 0	\$67,274
Provision for loan losses	1,828	0	0	0	1,828
Noninterest revenues	15,867	17,636	11,479	(664)	44,318
Amortization of intangible assets	554	1,591	623	0	2,768
Acquisition expenses	521	1,062	133	0	1,716
Other operating expenses	49,493	11,370	8,892	(664)	69,091
Income before income taxes	\$30,605	\$3,691	\$1,893	\$ 0	\$36,189
Assets	\$8,663,042	\$221,437	\$72,526	\$ (43,145)	\$8,913,860
Goodwill	\$440,870	\$84,213	\$17,903	\$ 0	\$542,986
Three Months Ended March 31, 2016					
Net interest income	\$66,798	\$40	\$43	\$ 0	\$66,881
Provision for loan losses	1,341	0	0	0	1,341
Noninterest revenues	15,313	12,390	11,144	(566)	38,281
Amortization of intangible assets	719	116	607	0	1,442
Acquisition expenses	70	0	7	0	77
Other operating expenses	48,460	9,447	8,809	(566)	66,150
Income before income taxes	\$31,521	\$2,867	\$1,764	\$ 0	\$36,152
Assets	\$8,546,646	\$38,535	\$69,385	\$ (38,665)	\$8,615,901
Goodwill	\$440,870	\$8,019	\$16,253	\$ 0	\$465,142

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 months ended March 31, 2017 and 2016, although in some circumstances the fourth quarter of 2016 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 27. 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 2017, "last year" and equivalent terms refer to calendar year 2016, "first quarter" refers to the three months ended March 31, 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 42.

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.

Investment securities – Investment securities are classified as held-to-maturity, available-for-sale, or trading. The appropriate classification is based partially on the Company's ability to hold the securities to maturity and largely on management's intentions with respect to either holding or selling the securities. The classification of investment securities is significant since it directly impacts the accounting for unrealized gains and losses on securities. Unrealized gains and losses on available-for-sale securities are recorded in accumulated other comprehensive income or loss, as a separate component of shareholders' equity, and do not affect earnings until realized. The fair values of investment securities are generally determined by reference to quoted market prices, where available. If quoted market prices are not available, fair values are based on quoted market prices of comparable instruments, or a discounted cash flow model using market estimates of interest rates and volatility. Investment securities with significant declines in fair value are evaluated to determine whether they should be considered other-than-temporarily impaired ("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 59-65 of the most recent Form 10-K (fiscal year ended December 31, 2016) filed with the Securities and Exchange Commission ("SEC") on March 1, 2017.

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) and expenses associated with acquisitions. 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 community bank with local decision-making, principally in non-metropolitan markets, providing a broad array of banking and financial services to retail, commercial and municipal customers. The Company's banking subsidiary is Community Bank, N.A. (the "Bank" or "CBNA").

The Company's core operating objectives are: (i) grow the branch network, primarily through a disciplined acquisition strategy, and certain selective de novo expansions, (ii) build profitable loan and deposit volume using both organic and acquisition strategies, (iii) increase the noninterest component of total revenues through development of banking-related fee income, growth in existing financial services business units, and the acquisition of additional financial services and banking businesses, and (iv) utilize technology to deliver customer-responsive products and services and improve efficiencies.

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.

29

On January 4, 2017, the Company, through its subsidiary, OneGroup NY, Inc. ("OneGroup"), completed its acquisition of 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 BAS and recorded intangible assets of \$1.2 million in conjunction with the acquisition.

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 approximately \$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 in 2008 as a non-depository trust company which provides fiduciary services for collective investment trusts and other products. The acquisition of NRS and GTC, hereafter referred to collectively as NRS, will strengthen and complement the Company's existing employee benefit services businesses. Upon the completion of the merger, NRS is a wholly-owned subsidiary of Benefit Plans Administrative Services, Inc. ("BPAS") and will operate as Northeast Retirement Services, LLC, a Delaware limited liability company. This transaction resulted in the acquisition of \$36.4 million in net tangible assets, principally cash and certificates of deposit, \$60.2 million in customer list intangibles that will be amortized over 10 years, a \$24.2 million deferred tax liability associated with the customer list intangible, and approximately \$76.2 million in goodwill.

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 \$3.3 million in cash to acquire the assets of Dryfoos, and recorded goodwill in the amount of \$1.7 million and other intangible assets of \$1.6 million in conjunction with the acquisition.

Current year first quarter net income increased \$1.9 million compared to the comparable 2016 timeframe. Earnings per share of \$0.57 for the first quarter were \$0.02 above the first quarter of 2016. The higher net income was primarily due to the NRS acquisition and a reduction of income tax expense in the first quarter of 2017 related to new accounting guidance for share-based compensation transactions.

Both average loans and average deposits in the first quarter of 2017 were higher than their respective balances in the prior year first quarter as a result of organic growth. Ending balances for the loan portfolio at March 31, 2017 were down from December 31, 2016, as seasonally expected, but were higher than the end of March 2016. Deposit balances at the end of March 2017 increased from the 2016 year-end level.

The trends of declining yields on interest-earning assets and rates of interest-bearing liabilities continue. Interest rates have increased moderately over the past five months but it continues to be a historically low rate environment that has generally meant that higher rate interest-earning assets continue to be replaced with lower rate assets, although that has moderated over the last year. The continued modest decline in the cost of funds is a result of a larger proportion of deposits coming from lower rate and noninterest-bearing accounts, instead of higher cost time deposits and borrowings.

The first quarter 2017 provision for loan losses was \$0.5 million higher than the first quarter of 2016, reflective of higher levels of net charge-offs and an increase in the loan portfolio balance. Asset quality in the first quarter of 2017 remained stable and favorable. First quarter net charge-off, nonperforming loan, and delinquent loan ratios were comparable to those experienced in the first quarter of 2016.

Pending Acquisition – Merchants Bancshares, Inc.

On October 24, 2016, the Company announced that it had entered into a definitive agreement to acquire Merchants Bancshares, Inc. ("Merchants"), parent company of Merchants Bank headquartered in South Burlington, Vermont, for approximately \$335 million in Company stock and cash. The acquisition will extend the Company's footprint into the Vermont and Western Massachusetts markets. Upon the completion of the merger, Community Bank will add 31 branch locations in Vermont and one location in Massachusetts with approximately \$2.0 billion of assets, and deposits of \$1.5 billion. The Company and Merchants have received regulatory approvals from the Board of Governors of the Federal Reserve System and the Office of the Comptroller of the Currency ("OCC") for the announced merger and the acquisition is expected to close on May 12, 2017, subject to the satisfaction of customary closing conditions. The Company expects to incur certain one-time, transaction-related costs in 2017.

Net Income and Profitability

As shown in Table 1, net income for the first quarter of \$26.3 million was up \$1.9 million, or 7.6%, as compared to the first quarter of 2016. Earnings per share of \$0.57 for the first quarter was two cents greater than was generated in the first quarter of 2016. The increases are primarily due to the effects of the NRS acquisition and a \$2.2 million reduction of income tax expense in the first quarter of 2017 related to new accounting guidance for share-based transactions that requires all excess tax benefits and deficiencies associated with share-based compensation be recognized as income tax expense or benefit.

30

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

As reflected in Table 1, first quarter net interest income of \$67.3 million was up \$0.4 million, or 0.6%, from the comparable prior year period. The quarterly improvement resulted from an increase in interest-earning assets, primarily from solid loan growth in the consumer mortgage and consumer installment loan portfolios, partially offset by a decrease in loan and investment yields.

The provision for loan losses for the current first quarter increased \$0.5 million as compared to the prior year first quarter, reflective of changes in certain asset quality metrics and growth of the loan portfolio.

First quarter noninterest revenues were \$44.3 million, an increase of \$6.0 million, or 15.8%, from the first quarter of 2016. The increase was a result of the NRS, Dryfoos and BAS acquisitions completed in the first quarter of 2017, as well as organic revenue growth generated by the Company's other financial services subsidiaries and a slight increase in banking noninterest income.

Noninterest expenses of \$73.6 million for the first quarter, increased \$5.9 million, or 8.7%, from the prior year first quarter. Excluding acquisition-related expenses, first quarter 2017 operating expenses were \$4.3 million, or 6.3%, higher than one year earlier, primarily resulting from operating a larger franchise, including the impact of the NRS acquisition.

A condensed income statement is as follows:

Table 1: Condensed Income Statements

	Three Months Ended March 31,	
	2017	2016
(000's omitted, except per share data)		
Net interest income	\$67,274	\$66,881
Provision for loan losses	1,828	1,341
Noninterest revenues	44,318	38,281
Noninterest expenses	73,575	67,669
Income before income taxes	36,189	36,152
Income taxes	9,932	11,749
Net income	\$26,257	\$24,403
Diluted weighted average common shares outstanding	46,227	44,356
Diluted earnings per share	\$0.57	\$0.55

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 interest 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 2, net interest income (with nontaxable income converted to a fully tax-equivalent basis) for the first quarter totaled \$69.6 million, an increase of \$0.2 million, or 0.3%, from the same period last year. The increase resulted from an \$111.8 million increase in average interest-earning assets and a \$34.6 million decrease in average interest-bearing liabilities, partially offset by a two basis point decrease in the net interest margin. As reflected in Table 3, the first quarter volume increase in interest-earning assets combined with the decrease in interest-bearing liabilities and decrease in the rate on interest-bearing liabilities had a \$1.2 million favorable impact on net interest income, while the rate decrease on interest-earning assets had a \$1.0 million unfavorable impact on net interest

income.

The lower net interest margin for the first quarter of 2017 as compared to the first quarter of 2016 was the result of the average yield on interest-earning assets decreasing three basis points while the average rate on interest-bearing liabilities decreased one basis point. Declining asset yields outweighed the positive effect of modestly lower funding costs on the net interest margin.

The average yield on earning assets decreased as the average yields for loans and investments continued to decline. For the first quarter the average yield on loans decreased two basis points compared to the prior year period while the average yield on investments, including cash equivalents, declined eight basis points. The decline in the loan yield was due to yields on new loan volume being generally below rates of the overall portfolio in the continued low-rate environment. The lower average yield of investments was the result of maturing higher interest rate investments being replaced with lower rate instruments or being used to pay down external borrowings.

31

The average rate on interest-bearing liabilities decreased one basis point as a slight decline in the average rate for interest-bearing deposits was partially offset by an increase in the average rate on external borrowings. The average rate on interest-bearing deposits decreased one basis point for the first quarter while the average rate on borrowings increased 85 basis points when compared to the prior year first quarter. The increase in the average cost of borrowings was the result of lower-rate overnight FHLB borrowings becoming a smaller proportion of this funding component, as well as increased costs resulting from increases in the Federal Funds rate in December 2016 and March 2017.

The average balance of investments, including cash equivalents, decreased \$14.7 million for the quarter as compared to the corresponding prior year period primarily related to maturities, calls and principal payments on the nontaxable municipal investment portfolio outpacing new purchases. Average loan balances increased \$126.5 million, or 2.6%, as compared to the prior year quarter, due to organic loan growth in the consumer mortgage and indirect loan portfolios.

In comparison to the prior year first quarter, total first quarter average interest-bearing deposits increased \$84.8 million primarily a result of new customers and growth in the balances of existing accounts. The average borrowing balance decreased \$119.4 million for the quarter, and was reflective of the decrease in overnight FHLB borrowings due to additional funding from organic deposit growth.

Table 2 below sets forth information related to average interest-earning assets and interest-bearing liabilities and their associated yields and rates for the periods indicated. Interest income and yields are on a fully tax-equivalent basis ("FTE") using marginal income tax rates of 38.1% and 38.2% in 2017 and 2016, 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 fees and costs as well as accretion of acquired loan marks. Average loan balances include nonaccrual loans and loans held for sale.

Table 2: Quarterly Average Balance Sheet

	Three Months Ended March 31, 2017			Three Months Ended March 31, 2016			
	Average Balance	Interest	Avg. Yield/Rate Paid	Average Balance	Interest	Avg. Yield/Rate Paid	
(000's omitted except yields and rates)							
Interest-earning assets:							
Cash equivalents	\$40,209	\$79	0.79 %	\$22,355	\$26	0.47 %	
Taxable investment securities ⁽¹⁾	2,203,175	13,487	2.48 %	2,172,983	13,570	2.51 %	
Nontaxable investment securities ⁽¹⁾	540,518	6,161	4.62 %	603,297	6,931	4.62 %	
Loans (net of unearned discount) ⁽²⁾	4,939,092	52,541	4.31 %	4,812,575	51,753	4.33 %	
Total interest-earning assets	7,722,994	72,268	3.80 %	7,611,210	72,280	3.82 %	
Noninterest-earning assets	1,024,272			993,054			
Total assets	\$8,747,266			\$8,604,264			
Interest-bearing liabilities:							
Interest checking, savings, and money market deposits	\$4,847,582	1,028	0.09 %	\$4,666,174	1,029	0.09 %	
Time deposits	695,464	702	0.41 %	792,099	865	0.44 %	
FHLB borrowings	75,414	149	0.80 %	194,815	287	0.59 %	
Subordinated debt held by unconsolidated subsidiary trusts	102,173	805	3.20 %	102,149	694	2.73 %	
Total interest-bearing liabilities	5,720,633	2,684	0.19 %	5,755,237	2,875	0.20 %	

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

Noninterest-bearing liabilities:

Noninterest checking deposits	1,620,473	1,527,585
Other liabilities	149,272	144,196
Shareholders' equity	1,256,888	1,177,246
Total liabilities and shareholders' equity	\$8,747,266	\$8,604,264

Net interest earnings	\$69,584	\$69,405
-----------------------	----------	----------

Net interest spread	3.61	%	3.62	%
---------------------	------	---	------	---

Net interest margin on interest-earning assets	3.65	%	3.67	%
--	------	---	------	---

Fully tax-equivalent adjustment	\$2,310	\$2,524
---------------------------------	---------	---------

Averages for investment securities are based on historical cost and the yields do not give effect to changes in fair (1) value that are 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.

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

(000's omitted)	Three months ended March 31, 2017 versus March 31, 2016 Increase (Decrease) Due to Change in ⁽¹⁾		
	Volume	Rate	Net Change
Interest earned on:			
Cash equivalents	\$29	\$24	\$ 53
Taxable investment securities	187	(270)	(83)
Nontaxable investment securities	(716)	(54)	(770)
Loans	1,350	(562)	788
Total interest-earning assets ⁽²⁾	1,054	(1,066)	(12)
Interest paid on:			
Interest checking, savings and money market deposits	39	(40)	(1)
Time deposits	(101)	(62)	(163)
Borrowings	(214)	76	(138)
Subordinated debt held by unconsolidated subsidiary trusts	0	111	111
Total interest-bearing liabilities ⁽²⁾	(17)	(174)	(191)
Net interest earnings ⁽²⁾	1,012	(833)	179

(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 Community Investment Services, Inc. ("CISI")) and asset management services (performed by Nottingham Advisors, Inc.); and 4) insurance products and services (performed by OneGroup). Additionally, the Company has periodic transactions, most often net gains or losses from the sale of investment securities and prepayment of debt instruments.

Table 4: Noninterest Revenues

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

	Three Months	
	Ended	
	March 31,	
(000's omitted)	2017	2016
Deposit service fees	\$ 14,707	\$ 13,734
Employee benefit services	17,189	12,011
Wealth management services	4,861	5,116
Insurance revenues	6,400	5,841
Other banking services	787	1,121
Mortgage banking	372	458
Subtotal	44,316	38,281
Gain on sales of investment securities, net	2	0
Total noninterest revenues	\$ 44,318	\$ 38,281

Noninterest revenues/operating revenues (FTE basis)⁽¹⁾ 38.9 % 35.5 %

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

As displayed in Table 4, noninterest revenues, excluding gain on sales of securities, were \$44.3 million in the first quarter of 2017. This represents an increase of \$6.0 million, or 15.8%, for the quarter in comparison to the same 2016 timeframe, with the increase primarily related to incremental financial services revenues from the NRS acquisition.

General recurring banking noninterest revenue of \$15.5 million for the first quarter of 2017 was up \$0.6 million, or 4.3%, as compared to the corresponding prior year period. This increase was primarily driven by growth in debit card-related revenue and an increase in revenue from overdraft protection programs.

Mortgage banking income, which totaled \$0.4 million for the first quarter of 2017, was down slightly as compared to the first quarter of 2016. Mortgage banking income consists of realized gains or losses from the sale of residential mortgage loans and the origination of mortgage loan servicing rights, unrealized gains and losses on residential mortgage loans held for sale and related commitments, mortgage loan servicing fees and other residential mortgage loan-related fee income. Residential mortgage loans sold to investors, primarily Fannie Mae, totaled \$7.9 million in the first quarter of 2017 compared to \$5.6 million in the first quarter of 2016. Residential mortgage loans held for sale at March 31, 2017 totaled \$0.7 million. Realization of the unrealized gains or losses on mortgage loans held for sale and the related commitments, as well as future revenue generation from mortgage banking activities, are dependent on market conditions and long-term interest rate trends.

Employee benefit services revenue increased \$5.2 million, or 43.1%, for the three months ended March 31, 2017 as compared to the prior year, primarily related to the NRS acquisition completed in February 2017. Wealth management and insurance services revenues for the first quarter of 2017 were up \$0.3 million as compared to the prior year first quarter primarily due to revenue growth from OneGroup.

The ratio of noninterest revenues to total revenues (FTE basis) was 38.9% for the quarter versus 35.5% for the equivalent period of 2016. The increase is a function of a 15.8% increase in non-interest income while net interest income (FTE basis) increased at a lesser 0.26% rate.

Noninterest Expenses

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

Table 5: Noninterest Expenses

	Three Months Ended March 31,	
(000's omitted)	2017	2016
Salaries and employee benefits	\$41,400	\$39,138
Occupancy and equipment	8,196	7,663
Data processing and communications	8,521	8,412
Amortization of intangible assets	2,768	1,442
Legal and professional fees	2,414	2,516
Office supplies and postage	1,674	1,778
Business development and marketing	2,081	2,013
FDIC insurance premiums	753	1,101
Acquisition expenses	1,716	77
Other	4,052	3,529
Total noninterest expenses	\$73,575	\$67,669

Operating expenses ⁽¹⁾ /average assets	3.20	%	3.09	%
Efficiency ratio ⁽²⁾	60.7	%	61.4	%

Operating expenses, a non-GAAP measure, is calculated as total noninterest expenses less acquisition expenses and ⁽¹⁾amortization of intangibles. See Table 11 for Reconciliation of Quarterly GAAP to Non-GAAP Measures.

Efficiency ratio, a non-GAAP measure, is calculated as operating expenses as defined in ⁽¹⁾ divided by net interest ⁽²⁾income on a fully tax-equivalent basis plus noninterest revenues. See Table 11 for Reconciliation of Quarterly GAAP to Non-GAAP Measures.

As shown in Table 5, noninterest expenses were \$73.6 million for the first quarter, an increase of \$5.9 million, or 8.7%, from the prior year period. Included in first quarter 2017 operating expenses are \$1.6 million more acquisition expenses than the corresponding 2016 period. Salaries and employee benefits increased \$2.3 million, or 5.8%, for the first quarter period as compared to the comparable period of 2016. The main drivers of the increase were more average full-time equivalent employees due to the NRS acquisition and annual merit-based personnel cost increases. The remaining change to quarterly operating expenses can be attributed to higher occupancy and equipment (up \$0.5 million), other expenses (up \$0.5 million), amortization of intangible assets (up \$1.3 million), data processing and communications (up \$0.1 million), and business development and marketing (up \$0.1 million); all primarily a result of additional costs associated with acquired NRS business activities, offset by lower legal and professional (\$0.1 million less), office supplies and postage (\$0.1 million less) and FDIC insurance premiums (\$0.3 million less).

The Company's efficiency ratio (total operating expenses excluding intangible amortization and acquisition expenses divided by FTE net interest income and non-interest income) was 60.7% for the first quarter, 0.7% favorable to the comparable quarter of 2016. This resulted in an increase in operating income of 5.8% from higher FTE-adjusted net interest income and growth in noninterest revenues, while operating expenses (as described above) increased by a smaller 4.4%. Current year operating expenses, excluding intangible amortization and acquisition expenses, as a percentage of average assets increased 11 basis points versus the prior year quarter. First quarter operating expenses (as defined above) increased 4.4% year-over-year while average assets increased at a slower 1.7% rate.

Income Taxes

The first quarter 2017 effective income tax rate was 27.4% as compared to 32.5% for the first quarter of 2016, reflective of a \$2.2 million reduction of income tax expense in the first quarter of 2017 as a result of new accounting guidance for share-based transactions that requires all excess tax benefits and deficiencies associated with share-based compensation be recognized as income tax expense or benefit, partially offset by a higher proportion of income being generated from fully-taxable sources. Excluding the \$2.2 million reduction in income tax expense associated with the change in accounting for share-based transactions, the adjusted effective tax rate for the first quarter would have been 33.5%.

Investments

The carrying value of investments (including unrealized gains and losses on available-for-sale securities) was \$2.79 billion at the end of the first quarter, an increase of \$4.3 million from December 31, 2016 and \$114.2 million lower than March 31, 2016. The book value (excluding unrealized gains and losses) of investments increased \$0.4 million from December 31, 2016 and decreased \$26.8 million from March 31, 2016. During the first three months of 2017, the Company purchased \$1.8 million of obligations of state and political subdivisions with an average yield of 4.52%, and \$15.0 million of government agency mortgage-backed securities with an average yield of 2.59%. The Company also had \$33.5 million of investment maturities, calls and principal payments received during the first three months of 2017. Additionally, \$20.3 million of certificates of deposit were acquired as part of the NRS acquisition, of which \$1.5 million were subsequently redeemed. During the final nine months of 2016, the Company purchased \$6.0 million of obligations of state and political subdivisions and \$47.7 million of government agency mortgage-backed securities. These purchases were more than offset by calls, maturities, and principal payments received of \$90.5 million during the same time period.

The change in the carrying value of investments is also impacted by the amount of net unrealized gains in the available-for-sale portfolio. At March 31, 2017, the portfolio had a \$45.7 million net unrealized gain, an increase of \$3.9 million from the unrealized gain at December 31, 2016 and a \$87.4 million decrease from the unrealized gain at March 31, 2016. These changes in the net unrealized gain were principally driven by the movement in longer-term interest rates over the past year.

Table 6: Investment Securities

(000's omitted)	March 31, 2017		December 31, 2016		March 31, 2016	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Available-for-Sale Portfolio:						
U.S. Treasury and agency securities	\$1,878,982	\$1,908,234	\$1,876,358	\$1,902,762	\$1,868,429	\$1,963,543
Obligations of state and political subdivisions	564,501	578,658	582,655	594,990	632,114	662,392
Government agency mortgage-backed securities	237,257	239,054	232,657	235,230	208,300	215,271
Corporate debt securities	5,697	5,681	5,716	5,687	16,639	16,684
Government agency collateralized mortgage obligations	8,516	8,809	9,225	9,535	11,911	12,436
Marketable equity securities	251	454	252	452	251	410
Total available-for-sale portfolio	2,695,204	2,740,890	2,706,863	2,748,656	2,737,644	2,870,736
Other Securities:						
Federal Home Loan Bank common stock	5,590	5,590	12,191	12,191	7,258	7,258
Federal Reserve Bank common stock	19,781	19,781	19,781	19,781	20,663	20,663
Certificates of deposit	18,758	18,758	0	0	0	0
Other equity securities	3,699	3,699	3,764	3,764	4,221	4,221
Total other securities	47,828	47,828	35,736	35,736	32,142	32,142
Total investments	\$2,743,032	\$2,788,718	\$2,742,599	\$2,784,392	\$2,769,786	\$2,902,878

Loans

As shown in Table 7, loans ended the first quarter at \$4.93 billion, up \$111.0 million, or 2.3%, from one year earlier and down \$16.3 million, or 0.3%, from the end of 2016. The growth during the last twelve months was primarily attributable to organic growth in the consumer mortgage and consumer installment portfolios, partially offset by decreases in the business lending and home equity portfolios. The decrease during the first three months of 2017 occurred primarily in the business lending and home equity portfolios, while the consumer mortgage and consumer installment portfolios increased.

Table 7: Loans

(000's omitted)	March 31, 2017		December 31, 2016		March 31, 2016	
Consumer mortgage	\$1,830,800	37.1 %	\$1,819,701	36.8 %	\$1,777,792	36.9 %
Business lending	1,468,465	29.8 %	1,490,076	30.1 %	1,509,421	31.3 %
Consumer indirect	1,055,112	21.4 %	1,044,972	21.1 %	941,151	19.5 %
Consumer direct	184,067	3.7 %	191,815	3.9 %	189,535	3.9 %
Home equity	393,769	8.0 %	401,998	8.1 %	403,273	8.4 %
Total loans	\$4,932,213	100.0 %	\$4,948,562	100.0 %	\$4,821,172	100.0 %

Consumer mortgages increased \$53.0 million, or 3.0%, from one year ago and increased \$11.1 million, or 0.6%, from December 31, 2016. Consumer mortgage volume has been relatively strong over the last several years due to

historically low long-term rates and comparatively stable real estate valuations in the Company's primary markets. Interest rate levels and expected duration continue to be the most significant factors in determining whether the Company chooses to retain, versus sell and service, portions of its new mortgage production.

The combined total of general-purpose business lending to commercial and industrial customers, mortgages on commercial property, and dealer floor plan financing is characterized as the Company's business lending activity. The business lending portfolio decreased \$41.0 million, or 2.7%, from March 31, 2016 as contractual and unscheduled principal reductions outpaced new loan volume. Additionally, the portfolio decreased \$21.6 million, or 1.5%, from December 31, 2016 as a result of unusually large unscheduled payoffs. Highly competitive conditions continue to prevail in the small and middle market segments in which the Company operates. The Company maintains its commitment to generating growth in its business portfolio in a manner that adheres to its twin goals of maintaining strong asset quality and producing profitable margins. The Company continues to invest in additional personnel, technology and business development resources to further strengthen its capabilities in this important product category.

36

Consumer installment loans, both those originated directly (such as personal installment and lines of credit), and indirectly (originated predominantly in automobile, marine, and recreational vehicle dealerships), increased \$108.5 million, or 9.6%, on a year-over-year basis, due to strong organic growth in the indirect portfolio, partially offset by a modest decrease in the direct portfolio. The volume of new and used vehicle sales to upper tier credit profile customers in the Company's primary markets has increased in recent years. The Company is focused on maintaining the solid profitability produced by its in-market and contiguous market indirect portfolio, while continuing to pursue its disciplined, long-term approach to expanding its dealer network. However, the increasingly competitive nature of this market has resulted in aggressive pricing and incentives that have caused some compression of indirect loan spreads, particularly in the automobile segment. Consumer installment loans increased \$2.4 million, or 0.2%, as compared to December 31, 2016, as seasonally expected.

Home equity loans decreased \$9.5 million, or 2.4%, from one year ago due in part to home equity loans being paid off or down as part of the heightened level of consumer mortgage refinancing that in some cases are used to pay down or pay off home equity balances in the continued low rate environment. The portfolio decreased \$8.2 million, or 2.0%, from December 31, 2016, in part due to lower seasonal demand.

Asset Quality

Table 8 below exhibits the major components of nonperforming loans and assets and key asset quality metrics for the periods ending March 31, 2017 and 2016 and December 31, 2016.

Table 8: Nonperforming Assets

	March 31, 2017	December 31, 2016	March 31, 2016
(000's omitted)			
Nonaccrual loans			
Consumer mortgage	\$13,573	\$13,684	\$13,526
Business lending	4,688	5,063	7,837
Consumer indirect	0	0	0
Consumer direct	0	0	14
Home equity	1,805	1,872	2,388
Total nonaccrual loans	20,066	20,619	23,765
Accruing loans 90+ days delinquent			
Consumer mortgage	853	1,385	1,556
Business lending	569	145	46
Consumer indirect	126	169	183
Consumer direct	79	58	59
Home equity	1,182	1,319	483
Total accruing loans 90+ days delinquent	2,809	3,076	2,327
Nonperforming loans			
Consumer mortgage	14,426	15,069	15,082
Business lending	5,257	5,208	7,883
Consumer indirect	126	169	183
Consumer direct	79	58	73
Home equity	2,987	3,191	2,871
Total nonperforming loans	22,875	23,695	26,092
Other real estate owned (OREO)	2,486	1,966	2,031
Total nonperforming assets	\$25,361	\$25,661	\$28,123
Nonperforming loans / total loans	0.46 %	0.48 %	0.54 %
Nonperforming assets / total loans and other real estate	0.51 %	0.52 %	0.58 %

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

Delinquent loans (30 days past due to nonaccruing) to total loans	0.94	%	1.19	%	1.00	%
Net charge-offs to average loans outstanding (quarterly)	0.16	%	0.18	%	0.10	%
Legacy net charge-offs to average legacy loans outstanding (quarterly)	0.17	%	0.17	%	0.09	%
Provision for loan losses to net charge-offs (quarterly)	93	%	120	%	117	%
Legacy provision for loan losses to net charge-offs (quarterly) ⁽¹⁾	85	%	133	%	112	%

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

As displayed in Table 8, nonperforming assets at March 31, 2017 were \$25.4 million, a \$0.3 million decrease versus the level at the end of 2016 and a \$2.8 million decrease as compared to one year earlier. Nonperforming loans decreased \$0.8 million from year-end 2016 and were down \$3.2 million from March 31, 2016. Other real estate owned ("OREO") at the end of March 2017 of \$2.5 million increased \$0.5 million from the end of 2016 and increased \$0.5 million from March 31, 2016. At March 31, 2017, OREO consisted of six commercial properties with a total value of \$0.8 million and 32 residential properties with a total value of \$1.7 million. This compares to five commercial properties with a total value of \$0.8 million and 24 residential OREO properties with a total value of \$1.2 million at December 31, 2016, and four commercial properties with a total value of \$0.6 million and 28 residential OREO properties with a total value of \$1.4 million at March 31, 2016. Nonperforming loans were 0.46% of total loans outstanding at the end of the first quarter, two basis points lower than the level at December 31, 2016 and eight basis points lower than the level at March 31, 2016.

Approximately 63% of nonperforming loans at March 31, 2017 are related to the consumer mortgage portfolio. Collateral values of residential properties within the Company's market area have remained stable over the past several years. Additionally, improved process efficiency and economic conditions as well as lower unemployment levels have positively impacted consumers and have resulted in generally improving nonperforming mortgage levels. Approximately 23% of the nonperforming loans at March 31, 2017 were related to the business lending portfolio, which is comprised of business loans broadly diversified by industry type. The level of nonperforming business loans has decreased from the prior year and is below the Company's longer-term average results as a proportion of total loans due to general economic improvements, effective problem loan management and maintenance of strict underwriting standards. The remaining 14% of nonperforming loans relate to consumer installment and home equity loans, with home equity non-performing loan levels being driven by the same factors identified for consumer mortgages. The allowance for loan losses to nonperforming loans ratio, a general measure of coverage adequacy, was 206% at the end of the first quarter, as compared to 199% at year-end 2016 and 175% at March 31, 2016.

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

Delinquent loans (30 days past due through nonaccruing) as a percent of total loans was 0.94% at the end of the first quarter, 25 basis points below the 1.19% at year-end 2016 and six basis points lower than the 1.00% at March 31, 2016. The business lending delinquency ratio at the end of the first quarter was eight basis points below the level at December 31, 2016 and 13 basis points lower than the level at March 31, 2016. The delinquency rate for consumer direct and consumer indirect loans also decreased as compared to December 31, 2016, but the delinquency rate for consumer installment loans was up slightly from March 31, 2016. The delinquency ratio for consumer mortgages was lower than the level at December 31, 2016 and the level one year ago. The home equity delinquency ratio at the end of the first quarter was lower than the level at December 31, 2016 but was higher than the level at March 31, 2016. The Company's success at keeping the nonperforming and delinquency ratios at favorable levels has been the result of its continued focus on maintaining strict underwriting standards, as well as the effective utilization of its collection and recovery capabilities.

Table 9: Allowance for Loan Losses Activity

(000's omitted)	Three Months Ended	
	March 31, 2017	2016
Allowance for loan losses at beginning of period	\$47,233	\$45,401
Charge-offs:		
Consumer mortgage	85	88
Business lending	695	210
Consumer indirect	1,947	1,854
Consumer direct	417	462
Home equity	38	57
Total charge-offs	3,182	2,671
Recoveries:		
Consumer mortgage	7	45
Business lending	71	136
Consumer indirect	869	1,114
Consumer direct	245	221
Home equity	25	9
Total recoveries	1,217	1,525
Net charge-offs	1,965	1,146
Provision for loans losses	1,828	1,341
Allowance for loan losses at end of period	\$47,096	\$45,596
Allowance for loan losses / total loans	0.95 %	0.95 %
Allowance for legacy loan losses / total legacy loans ⁽¹⁾	1.01 %	1.04 %
Allowance for loan losses / nonperforming loans	206 %	175 %
Allowance for legacy loan losses / legacy nonperforming loans ⁽¹⁾	266 %	200 %
Net charge-offs (annualized) to average loans outstanding:		
Consumer mortgage	0.02 %	0.01 %
Business lending	0.17 %	0.02 %
Consumer indirect	0.42 %	0.32 %
Consumer direct	0.36 %	0.49 %
Home equity	0.01 %	0.05 %
Total loans	0.16 %	0.10 %

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

As displayed in Table 9, net charge-offs during the first quarter of 2017 were \$2.0 million, or \$0.8 million more than the first quarter of 2016. Net charge-offs for the consumer installment, business lending, and consumer mortgage portfolios experienced higher levels of net charge-offs through the first three months of 2017 as compared to the first three months of 2016, while the home equity portfolio had lower levels of net charge-offs. The net charge-off ratio (net charge-offs as a percentage of average loans outstanding) for the first quarter of 2017 was 0.16%, six basis points higher than the first quarter of 2016. Net charge-off ratios for the first quarter of 2017 were consistent with the Company's average long-term historical levels.

The provision for loan losses was \$1.8 million in the first quarter, with \$1.6 million related to legacy loans and \$0.2 million related to acquired loans. The provision was \$0.5 million higher than the equivalent prior year period, reflective of a larger loan portfolio and changes in certain asset quality metrics. The allowance for loan losses of \$47.1 million as of March 31, 2017 increased \$1.5 million from one year ago, reflective of the increase in the size of the loan portfolio. Stable asset quality metrics have resulted in an allowance for loan losses to total loans ratio of 0.95% at March 31, 2017, equal to the level reported at March 31, 2016 and December 31, 2016.

As of March 31, 2017, the purchase discount related to the \$463.0 million of remaining non-impaired loan balances acquired from Oneida, HSBC Bank USA, N.A., First Niagara Bank, N.A., and Wilber National Bank was approximately \$7.1 million, or 1.5% of that portfolio, with \$1.9 million included in the allowance for loan losses to account for acquired loans where the carrying value exceeded the estimated net recoverable value.

Deposits

As shown in Table 10, average deposits of \$7.2 billion in the first quarter were up \$177.7 million, or 2.5%, compared to the first quarter of 2016, and increased \$87.4 million, or 1.2%, from the fourth quarter of last year. The mix of average deposit balances continues to change as the weightings of core deposits (noninterest checking, interest checking, savings and money markets) have increased from the prior year levels. Conversely, the proportion of time deposits decreased over the past 12 months, consistent with the last several years. This change in deposit mix reflects the Company's goal of expanding core account relationships and reducing higher cost time deposit balances, as well as the preference of certain customers to hold a higher proportion of their funds in liquid accounts in the low interest rate environment. This shift in product mix resulted in the quarterly average cost of deposits declining from 0.11% in the first quarter of 2016 to 0.10% in the most recent quarter. The Company continues to focus heavily on growing its core deposit relationships through its proactive marketing efforts, competitive product offerings and high quality customer service.

Average nonpublic fund deposits for the first quarter of 2017 increased \$36.1 million, or 0.6%, versus the fourth quarter of 2016 and increased \$114.5 million, or 1.9% compared to the year-earlier period. Average public fund deposits for the first quarter increased \$51.3 million, or 5.1%, from the fourth quarter of 2016 and \$63.2 million, or 6.4%, from the first quarter of 2016. Public fund deposits as a percentage of total deposits increased from 14.2% in the first quarter of 2016 to 14.7% in the first quarter of 2017.

Table 10: Quarterly Average Deposits

	March 31,	December	March 31,
(000's omitted)	2017	31,	2016
		2016	2016
Noninterest checking deposits	\$1,620,473	\$1,603,703	\$1,527,585
Interest checking deposits	1,694,645	1,642,761	1,616,731
Regular savings deposits	1,320,691	1,309,273	1,278,134
Money market deposits	1,832,246	1,806,780	1,771,309
Time deposits	695,464	713,606	792,099
Total deposits	\$7,163,519	\$7,076,123	\$6,985,858
Nonpublic fund deposits	\$6,108,961	\$6,072,911	\$5,994,507
Public fund deposits	1,054,558	1,003,212	991,351
Total deposits	\$7,163,519	\$7,076,123	\$6,985,858

Borrowings

External borrowings were \$102.2 million at the end of the first quarter, \$146.2 million, or 58.9%, lower than borrowings at December 31, 2016, and \$33.7 million, or 24.8%, lower than the end of the first quarter of 2016. This was a result of utilizing increased funding from organic deposit growth to reduce overnight borrowings at the FHLB.

Shareholders' Equity

Total shareholders' equity was \$1.30 billion at the end of the first quarter, an increase of \$97.9 million from the balance at December 31, 2016. This increase consisted of \$78.5 million related to stock issued in connection with the NRS acquisition, net income of \$26.3 million, a \$2.5 million increase in other comprehensive income, \$2.1 million from treasury stock issued to the Company's 401(k) plan, \$1.8 million from shares issued under the employee stock plan, and \$1.4 million from employee stock options earned, partially offset by dividends declared of \$14.7 million.

The change in other comprehensive income was comprised of a \$2.4 million increase in the after-tax market value adjustment on the available-for-sale investment portfolio and a positive \$0.1 million adjustment to the funded status of the Company's retirement plans. Over the past 12 months, total shareholders' equity increased by \$95.4 million, as net income and the issuance of common stock in association with the NRS acquisition, the employee stock plan and the Company's 401(k) plan, more than offset a lower market value adjustment on investments, dividends declared and the change in the funded status of the Company's defined benefit pension and other postretirement plans.

40

The Company's Tier 1 leverage ratio, a primary measure of regulatory capital for which 5% is the requirement to be "well-capitalized", was 10.35% at the end of the first quarter, down 20 basis points from year-end 2016 and 40 basis points higher than its level one year earlier. The decrease in the Tier 1 leverage ratio in comparison to December 31, 2016 was primarily due to the impact of intangible assets from the NRS acquisition, partially offset by net earnings retention, resulting in ending shareholders' equity excluding intangibles and other comprehensive income items decreasing 1.6%, while average assets excluding intangibles and the market value adjustment on investments increased 0.3%. The Tier 1 leverage ratio increased as compared to the prior year's first quarter as shareholders' equity, excluding intangibles and other comprehensive income, increased 5.3% due to strong earnings retention, partially offset by the impact of intangible assets from the NRS acquisition, while average assets excluding intangibles and the market value adjustment increased 1.3%, driven by organic loan growth. The net tangible equity-to-assets ratio (a non-GAAP measure) of 8.91% decreased 33 basis points from December 31, 2016 and decreased 34 basis points as compared to March 31, 2016. The decrease in the tangible equity ratio over the past 12 months was due to a decrease in tangible equity primarily attributable the impact of intangibles resulting from the NRS transaction and the decrease in the investment market value adjustment, while tangible assets increased due to organic loan growth.

The dividend payout ratio (dividends declared divided by net income) for the first three months of 2017 was 56.0%, up from 55.8% for the three months ended March 31, 2016. Dividends declared increased 7.9% as the Company's quarterly dividend per share was raised from \$0.31 to \$0.32 in August 2016, while net income for increased 7.6% over the prior year period. Additionally, the number of common shares outstanding increased 4.3% over the last twelve months including the impact of the 1.32 million shares issued in the NRS transaction that accounted for 3.0% of the total increase. The dividend increase marked the Company's 24th consecutive year of increased dividend payouts to common shareholders.

Liquidity

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

Given the uncertain nature of our customers' demands as well as the Company's desire to take advantage of earnings enhancement opportunities, the Company must have adequate sources of on- and off-balance sheet funds available that can be acquired in time of need. Accordingly, in addition to the liquidity provided by balance sheet cash flows, liquidity must be supplemented with additional sources such as credit lines from correspondent banks and borrowings from the FHLB and the Federal Reserve Bank of New York ("Federal Reserve"). Other funding alternatives may also be appropriate from time to time, including wholesale and retail repurchase agreements, large certificates of deposit and the brokered CD market. The primary source of non-deposit funds is FHLB overnight advances, of which there were no outstanding borrowings at March 31, 2017.

The Bank's primary sources of liquidity are its liquid assets, as well as unencumbered securities that can be used to collateralize additional funding. At March 31, 2017, the Bank had \$291.2 million of cash and cash equivalents of which \$133.1 million are interest-earning deposits held at the Federal Reserve, FHLB and other correspondent banks. The Bank also had \$1.4 billion in unused FHLB borrowing capacity based on the Company's quarter-end collateral levels. Additionally, the Company has \$1.1 billion of unencumbered securities that could be pledged at the FHLB or

Federal Reserve to obtain additional funding. There is \$25 million available in unsecured lines of credit with other correspondent banks.

The Company's primary approach to measuring short-term liquidity is known as the Basic Surplus/Deficit model. It is used to calculate liquidity over two time periods: first, the amount of cash that could be made available within 30 days (calculated as liquid assets less short-term liabilities as a percentage of average assets); and second, a projection of subsequent cash availability over an additional 60 days. As of March 31, 2017, this ratio was 13.1% for 30-days and 13.0% for 90-days, excluding the Company's capacity to borrow additional funds from the FHLB and other sources. There is a sufficient amount of liquidity based on the Company's internal policy requirement of 7.5%.

A sources and uses statement is used by the Company to measure intermediate liquidity risk over the next twelve months. As of March 31, 2017, there is more than enough liquidity available during the next year to cover projected cash outflows. In addition, stress tests on the cash flows are performed in various scenarios ranging from high probability events with a low impact on the liquidity position to low probability events with a high impact on the liquidity position. The results of the stress tests as of March 31, 2017 indicate the Bank has sufficient sources of funds for the next year in all simulated stressed scenarios.

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

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

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

Forward-Looking Statements

This document contains comments or information that constitute forward-looking statements (within the meaning of the Private Securities Litigation Reform Act of 1995), which involve significant risks and uncertainties.

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

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

Reconciliation of Quarterly GAAP to Non-GAAP Measures

Table 11: Quarterly GAAP to Non-GAAP Reconciliations

(000's omitted)	Three Months Ended		
	March 31, 2017	2016	
Income statement data			
Net income			
Net income (GAAP)	\$26,257	\$24,403	
Amortization of intangibles ⁽¹⁾	2,008	973	
Acquisition expenses ⁽¹⁾	1,245	52	
Adjusted net income (non-GAAP)	\$29,510	\$25,428	
Earnings per common share			
Diluted earnings per share (GAAP)	\$0.57	\$0.55	
Amortization of intangibles ⁽¹⁾	0.04	0.02	
Acquisition expenses ⁽¹⁾	0.03	0.00	
Diluted adjusted net earnings per share (non-GAAP)	\$0.64	\$0.57	
Noninterest operating expenses			
Noninterest expenses (GAAP)	\$73,575	\$67,669	
Amortization of intangibles	(2,768)	(1,442)	
Acquisition expenses	(1,716)	(77)	
Total adjusted noninterest expenses (non-GAAP)	\$69,091	\$66,150	
Efficiency ratio			
Adjusted noninterest expenses (non-GAAP) - numerator	\$69,091	\$66,150	
Tax-equivalent net interest income	69,584	69,405	
Noninterest revenues	44,318	38,281	
Gain on sales of investments	(2)	0	
Operating revenues (non-GAAP) - denominator	\$113,900	\$107,686	
Efficiency ratio (non-GAAP)	60.7	% 61.4	%
		December	
(000's omitted)	March 31, 2017	31, 2016	March 31, 2016
Balance sheet data – at end of quarter			
Total assets			
Total assets (GAAP)	\$8,913,860	\$8,666,437	\$8,615,901
Intangible assets	(618,977)	(480,844)	(484,881)
Deferred taxes on intangible assets	68,236	43,504	40,483
Total tangible assets (non-GAAP)	\$8,363,119	\$8,229,097	\$8,171,503
Total common equity			
Common stock, APIC, Retained earnings, and Treasury stock	\$1,285,676	\$1,190,257	\$1,139,378
Accumulated other comprehensive income	10,354	7,843	61,287
Shareholders' Equity (GAAP)	1,296,030	1,198,100	1,200,665
Intangible assets	(618,977)	(480,844)	(484,881)
Deferred taxes on intangible assets	68,236	43,504	40,483

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

Total tangible common equity (non-GAAP)	\$745,289	\$760,760	\$756,267
Net tangible equity-to-assets ratio at quarter end			
Total tangible common equity (non-GAAP) - numerator	\$745,289	\$760,760	\$756,267
Total tangible assets (non-GAAP) - denominator	8,363,119	8,229,097	8,171,503
Net tangible equity-to-assets ratio at quarter end (non-GAAP)	8.91	% 9.24	% 9.25
⁽¹⁾ After tax effect.			

Item 3. Quantitative and Qualitative Disclosures about Market Risk

Market risk is the risk of loss in a financial instrument arising from adverse changes in market rates, prices or credit risk. Credit risk associated with the Company's loan portfolio has been previously discussed in the asset quality section of the MD&A. Management believes that the tax risk of the Company's municipal investments associated with potential future changes in statutory, judicial and regulatory actions is minimal. Treasury, agency, mortgage-backed and CMO securities issued by government agencies comprise 79% of the total portfolio and are currently rated AAA by Moody's Investor Services and AA+ by Standard & Poor's. Municipal and corporate bonds account for 21% of the total portfolio, of which, 97% carry a minimum rating of A-. The Company does not have material foreign currency exchange rate risk exposure. Therefore, almost all the market risk in the investment portfolio is related to interest rates.

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

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

Asset and liability levels using March 31, 2017 as a starting point.

There are assumed to be conservative levels of balance sheet growth, low-to-mid single digit growth in loans and deposits, while using the cash flows from investment contractual maturities and prepayments to repay short-term capital market borrowings or reinvest into securities or cash equivalents.

The prime rate and federal funds rates are assumed to move up over a 12-month period while moving the long end of the treasury curve to spreads over the three month treasury that are more consistent with historical norms (normalized yield curve). In the -75 basis point model, the prime and federal funds rates move lower in the first quarter of year one while moving the long end of the curve to levels over the three month treasury using spreads at a time when the yield curve was flat. Deposit rates are assumed to move in a manner that reflects the historical relationship between deposit rate movement and changes in the federal funds rate.

Cash flows are based on contractual maturity, optionality, and amortization schedules along with applicable prepayments derived from internal historical data and external sources.

Net Interest Income Sensitivity Model

	Calculated annualized increase (decrease) in projected net interest income at March 31, 2017
Change in interest rates	
+200 basis points	(\$1,183,000)
+100 basis points	(\$218,000)

-75 basis points (\$3,069,000)

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

In the falling rate environment scenario, the Bank shows interest rate risk exposure to lower short term rates and also a flatter yield curve. Net interest income declines during the first twelve months largely due to lower assumed rates on adjustable and variable rate assets. Corresponding deposit rates are assumed to remain constant.

44

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

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

The Company maintains disclosure controls and procedures, as defined in Rule 13a -15(e) and 15d – 15(e) under the Securities Exchange Act of 1934 as amended (the "Exchange Act"), designed to ensure information required to be disclosed by the Company in the reports that it files or submits under the Exchange Act is: (i) recorded, processed, summarized, and reported within the time periods specified in the SEC rules and forms, and (ii) accumulated and communicated to management, including the principal executive and principal financial officers, as appropriate, to allow timely decisions regarding required disclosure. Based on management's evaluation of the effectiveness of the Company's disclosure controls and procedures, with the participation of the Chief Executive Officer and the Chief Financial Officer, it has concluded that, as of the end of the period covered by this Quarterly Report on Form 10-Q, these disclosure controls and procedures were effective as of March 31, 2017.

Changes in Internal Control over Financial Reporting

The Company regularly assesses the adequacy of its internal controls over financial reporting. There have been no changes in the Company's internal controls over financial reporting in connection with the evaluation referenced in the paragraph above that occurred during the Company's quarter ended March 31, 2017 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

Part II. Other Information

Item 1. Legal Proceedings

The Company and its subsidiaries are subject in the normal course of business to various pending and threatened legal proceedings in which claims for monetary damages are asserted. As of March 31, 2017, 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.

Item 1A. Risk Factors

There has not been any material change in the risk factors disclosure from that contained in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2016 filed with the SEC on March 1, 2017.

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

a) Not applicable.

b) Not applicable.

c) At its December 2016 meeting, the Board approved a new stock repurchase program authorizing the repurchase, at the discretion of senior management, of up to 2,200,000 shares of the Company's common stock, in accordance with securities laws and regulations, during a twelve-month period starting January 1, 2017. Any repurchased shares will be used for general corporate purposes, including those related to stock plan activities. The timing and extent of repurchases will depend on market conditions and other corporate considerations as determined at the Company's discretion.

The following table presents stock purchases made during the first quarter of 2017:

Issuer Purchases of Equity Securities

Period	Total Number of Shares Purchased	Average Price Paid Per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number of Shares That May Yet Be Purchased Under the Plans or Programs
January 1-31, 2017 ⁽¹⁾	1,714	\$ 59.95	0	2,200,000
February 1-28, 2017	0	0	0	2,200,000
March 1-31, 2017 ⁽¹⁾	20,656	\$ 59.41	0	2,200,000
Total	22,370	\$ 59.45		

⁽¹⁾ Included in the common shares repurchased were shares acquired by the Company in connection with satisfaction of tax withholding obligations on vested restricted stock issued pursuant to the employee benefit plan of 1,714 shares and 20,656 shares in January 2017 and March 2017, respectively. These shares were not repurchased as part of the publicly announced repurchase plan described above.

Item 3. Defaults Upon Senior Securities

Not applicable.

Item 4. Mine Safety Disclosures

Not applicable.

Item 5. Other Information

Not applicable.

Item 6. Exhibits

<u>Exhibit No.</u>	<u>Description</u>
10.1	Employment Agreement, dated as of January 1, 2017, by and among Community Bank System, Inc., Community Bank N.A., and Scott Kingsley. Incorporated by reference to Exhibit No. 10.1 to the Current Report on Form 8-K filed on January 6, 2017 (Registration No. 001-13695). ⁽¹⁾
10.2	Employment Agreement, dated as of January 1, 2017, by and among Community Bank System, Inc., Community Bank N.A., and George J. Getman. Incorporated by reference to Exhibit No. 10.2 to the Current Report on Form 8-K filed on January 6, 2017 (Registration No. 001-13695). ⁽¹⁾
10.3	Registration Rights Agreement. Incorporated by reference to Exhibit 10.1 to the Registration Statement on Form S-3 filed on February 3, 2017 (File No. 333-215894)).
31.1	Certification of Mark E. Tryniski, President and Chief Executive Officer of the Registrant, pursuant to Rule 13a-15(e) or Rule 15d-15(e) under the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. ⁽²⁾
31.2	Certification of Scott Kingsley, Treasurer and Chief Financial Officer of the Registrant, pursuant to Rule 13a-15(e) or Rule 15d-15(e) under the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. ⁽²⁾
32.1	Certification of Mark E. Tryniski, President and Chief Executive Officer of the Registrant, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. ⁽³⁾
32.2	Certification of Scott Kingsley, Treasurer and Chief Financial Officer of the Registrant, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. ⁽³⁾
101	Interactive data files pursuant to Rule 405 of Regulation S-T: (i) the Consolidated Statements of Condition, (ii) the Consolidated Statements of Income, (iii) the Consolidated Statements of Comprehensive Income, (iv) the Consolidated Statements of Changes in Shareholders' Equity, (v) the Consolidated Statements of Cash Flows, and (vi) the Notes to Consolidated Financial Statements tagged as blocks of text and in detail. ⁽⁴⁾

(1) Denotes management contract or compensatory plan or arrangement.

(2) Filed herewith.

(3) Furnished herewith.

(4) XBRL (Extensible Business Reporting Language) information is furnished and not filed or a part of a registration statement or prospectus for purposes of sections 11 or 12 of the Securities Act of 1933, is deemed not filed for purposes of section 18 of the Securities Exchange Act of 1934, and otherwise is not subject to liability under these sections.

Signatures

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

Community Bank System, Inc.

Date: May 10, 2017 /s/ Mark E. Tryniski
Mark E. Tryniski, President and Chief Executive
Officer

Date: May 10, 2017 /s/ Scott Kingsley
Scott Kingsley, Treasurer and Chief
Financial Officer