DEUTSCHE BANK AKTIENGESELLSCHAFT
Form FWP
September 24, 2014

Term Sheet W38
To underlying supplement No. 1 dated October 1, 2012,
prospectus supplement dated September 28, 2012 and
prospectus dated September 28, 2012
Deutsche Bank

Registration Statement No. 333-184193
Dated September 23, 2014; Rule 433

Structured Investments

Deutsche Bank AG
Call Warrants Linked to the S&P 500® Index Expiring September 29*, 2017

General

- The call warrants (the “warrants”) are designed for investors who seek a leveraged return at expiration based on the increase, if any, in the S&P 500® Index (the “Index”). If the Final Level of the Index is less than or equal to the Strike Level, which is 100% of the Initial Level, the warrants will expire worthless and investors will lose their entire investment in the warrants. If the Final Level is greater than the Strike Level, investors will receive a cash payment upon expiration based on the performance of the Index. In this circumstance, investors will still lose some or a significant portion of their initial investment if the level of the Index does not increase sufficiently to offset the Warrant Premium. Any payment on the warrants is subject to the credit of the Issuer.
- The warrants are risky investments. The warrants will be exercised automatically on the Expiration Date, and you do not have the right to exercise your warrants prior to the Expiration Date. You will not be able to purchase the warrants unless you have an options-approved brokerage account. The warrants involve a high degree of risk and are not appropriate for investors who cannot sustain a total loss of their investment. You must be able to understand and bear the risk of an investment in the warrants, and you should be experienced with respect to options and option transactions.
- Unsecured contractual obligations of Deutsche Bank AG expiring September 29*, 2017
- Minimum initial investment of $9,910.40 or 76 warrants, each with a Notional Amount of $1,000 (and then in increments of one warrant thereafter), resulting in an aggregate minimum Notional Amount of $76,000.
- The warrants are expected to price on or about September 26*, 2014 (the “Trade Date”) and are expected to settle on or about October 1*, 2014 (the “Settlement Date”).

Key Terms

Issuer:	Deutsche Bank AG, London Branch
Index:	The S&P 500® Index (Ticker: SPX)
Issue Price per Warrant:	Equal to the Warrant Premium
Warrant Premium:	$130.40 per warrant (equal to 13.04% of the Notional Amount)
Notional Amount:	$1,000 per warrant
Warrant Premium Percentage:	13.04%, equal to the Warrant Premium divided by the Notional Amount
Payment at Expiration:	On the Expiration Date, the warrants will be automatically exercised and you will be entitled to receive a cash payment per warrant equal to the Cash Settlement Amount, which could be zero.
Cash Settlement Amount:	With respect to each warrant, the Cash Settlement Amount will be calculated as follows: If the Final Level is greater than the Strike Level, $1,000 x Index Strike Return If the Final Level is less than or equal to the Strike Level, $0. If the Final Level is less than or equal to the Strike Level, the Index Strike Return will be negative or zero and the warrants will expire worthless. If the level of the Index does not increase, you will lose your entire investment in the warrants. In addition, if the Final Level is not sufficiently greater than the Strike Level to offset the Warrant Premium, you will lose a portion of your initial investment. In order to receive a positive return on your investment,

	the Final Level must be greater than the Strike Level by a percentage greater than the Warrant Premium Percentage.
Index Strike Return:	Calculated as follows: $$\frac{\text{Final Level} - \text{Strike Level}}{\text{Initial Level}}$$
Initial Level:	The closing level of the Index on the Trade Date
Final Level:	The closing level of the Index on the Final Valuation Date
Strike Level:	100% of the Initial Level
Trade Date:	September 26*, 2014
Settlement Date:	October 1*, 2014
Final Valuation Date†:	September 26*, 2017
Expiration Date†:	September 29*, 2017
Listing:	The warrants will not be listed on any securities exchange.
CUSIP/ISIN:	25157U598 / US25157U5983

* Expected. In the event that we make any change to the expected Trade Date or Settlement Date, the Final Valuation Date and Expiration Date may be changed so that the stated term of the warrants remains the same.

† Subject to postponement as described under "General Terms of the Warrants — Market Disruption Events" in this term sheet.

Investing in the warrants involves a number of risks, including the risk that the warrants expire worthless and you lose your entire investment. See "Selected Risk Considerations" beginning on page 6 of this term sheet.

The Issuer's estimated value of the warrants on the Trade Date is approximately $107.40 to $112.40 per warrant, which is less than the Issue Price. Please see "Issuer's Estimated Value of the Warrants" on the following page of this term sheet for additional information.

Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of the warrants or passed upon the accuracy or the adequacy of this term sheet or the accompanying underlying supplement, prospectus supplement or prospectus. Any representation to the contrary is a criminal offense.

	Price to Public	Fees(1)	Proceeds to Issuer
Per warrant	$130.40	$6.50	$123.90
Total	$	$	$

(1) J.P. Morgan Securities LLC, which we refer to as JPMS LLC, and JPMorgan Chase Bank, N.A. will act as agents for the warrants. The agents will forego fees for sales to fiduciary accounts. The total fees represent the amount that the agents receive from sales to accounts other than such fiduciary accounts. The agents will receive a fee from us that will not exceed $6.50 per warrant. For more information see "Underwriting" in this term sheet.

The warrants are not bank deposits and are not insured or guaranteed by the Federal Deposit Insurance Corporation or any other governmental agency.

JPMorgan
Placement Agent

September 23, 2014

Issuer's Estimated Value of the Warrants

The Issuer's estimated value of the warrants is our valuation of the warrants calculated based on our internal pricing models using relevant parameter inputs such as expected interest rates and mid-market levels of price and volatility of the assets underlying the warrants or any futures, options or swaps related to such underlying assets. Our internal pricing models are proprietary and rely in part on certain assumptions about future events, which may prove to be incorrect.

The Issuer's estimated value of the warrants on the Trade Date (as disclosed on the cover of this term sheet) is less than the Issue Price of the warrants. The difference between the Issue Price and the Issuer's estimated value of the warrants on the Trade Date is due to the inclusion in the Issue Price of the agent's commissions, if any, and the cost of hedging our obligations under the warrants through one or more of our affiliates. Such hedging cost includes our or our affiliates' expected cost of providing such hedge, as well as the profit we or our affiliates expect to realize in consideration for assuming the risks inherent in providing such hedge.

The Issuer's estimated value of the warrants on the Trade Date does not represent the price at which we or any of our affiliates would be willing to purchase your warrants in the secondary market at any time. Assuming no changes in market conditions or our creditworthiness and other relevant factors, the price, if any, at which we or our affiliates would be willing to purchase the warrants from you in secondary market transactions, if at all, would generally be lower than both the Issue Price and the Issuer's estimated value of the warrants on the Trade Date. Our purchase price, if any, in secondary market transactions will be based on the estimated value of the warrants determined by reference to our pricing models at that time, less a bid spread determined after taking into account the size of the repurchase, the nature of the assets underlying the warrants and then-prevailing market conditions. The price we report to financial reporting services and to distributors of our warrants for use on customer account statements would generally be determined on the same basis. However, during the period of approximately three months beginning from the Trade Date, we or our affiliates may, in our sole discretion, increase the purchase price determined as described above by an amount equal to the declining differential between the Issue Price and the Issuer's estimated value of the warrants on the Trade Date, prorated over such period on a straight-line basis, for transactions that are individually and in the aggregate of the expected size for ordinary secondary market repurchases.

Additional Terms Specific to the Warrants

You should read this term sheet together with the prospectus dated September 28, 2012, as supplemented by the prospectus supplement dated September 28, 2012, relating to our warrants and the underlying supplement No. 1 dated October 1, 2012. You may access these documents on the website of the Securities and Exchange Commission (the "SEC") at.www.sec.gov as follows (or if such address has changed, by reviewing our filings for the relevant date on the SEC website):

Underlying supplement No. 1 dated October 1, 2012:
http://www.sec.gov/Archives/edgar/data/1159508/000095010312005120/crt_dp33209-424b2.pdf

Prospectus supplement dated September 28, 2012:
http://www.sec.gov/Archives/edgar/data/1159508/000119312512409460/d415003d424b21.pdf

Prospectus dated September 28, 2012:
http://www.sec.gov/Archives/edgar/data/1159508/000119312512409372/d413728d424b21.pdf

Our Central Index Key, or CIK, on the SEC website is 0001159508. As used in this term sheet, "we," "us" or "our" refers to Deutsche Bank AG, including, as the context requires, acting through one of its branches.

This term sheet, together with the documents listed above, contains the terms of the warrants and supersedes all other prior or contemporaneous oral statements as well as any other written materials including preliminary or indicative pricing terms, correspondence, trade ideas, structures for implementation, sample structures, brochures or other educational materials of ours. You should carefully consider, among other things, the matters set forth in "Selected Risk Considerations" in this term sheet, as the warrants involve risks not associated with conventional debt securities. We urge you to consult your investment, legal, tax, accounting and other advisers before deciding to invest in the warrants.

Deutsche Bank AG has filed a registration statement (including a prospectus) with the Securities and Exchange Commission for the offering to which this term sheet relates. Before you invest, you should read the prospectus in that registration statement and the other documents relating to this offering that Deutsche Bank AG has filed with the SEC for more complete information about Deutsche Bank AG and this offering. You may obtain these documents without cost by visiting EDGAR on the SEC website at.www.sec.gov. Alternatively, Deutsche Bank AG, any agent or any dealer participating in this offering will arrange to send you the underlying supplement, prospectus supplement, prospectus and this term sheet if you so request by calling toll-free 1-800-311-4409.

You may revoke your offer to purchase the warrants at any time prior to the time at which we accept such offer by notifying the applicable agent. We reserve the right to change the terms of, or reject any offer to purchase, the warrants prior to their issuance. We will notify you in the event of any changes to the terms of the warrants, and you will be asked to accept such changes in connection with your purchase of any warrants. You may choose to reject such changes, in which case we may reject your offer to purchase the warrants.

What Is the Cash Settlement Amount, Assuming a Range of Performances for the Index?

The table and examples below illustrate the potential Cash Settlement Amounts per warrant on the Expiration Date for a hypothetical range of performances of the Index from -100.00% to 100.00%. The hypothetical Cash Settlement Amounts set forth below reflect the Strike Level of 100% of the Initial Level, the Warrant Premium Percentage of 13.04% and the Warrant Premium of $130.40 per warrant and assume a hypothetical Initial Level of 2,000.00. The actual Initial Level and Strike Level will be determined on the Trade Date. The hypothetical returns set forth below are for illustrative purposes only and may not be the actual returns applicable to an investor in the warrants. The numbers appearing in the following table and examples may have been rounded for ease of analysis.

Hypothetical Final Level	Percentage Change from Initial Level	Hypothetical Index Strike Return	Cash Settlement Amount	Cash Settlement Amount minus Warrant Premium	Cash Settlement Amount minus Warrant Premium as Percentage Return on Warrant Premium
4,000.00	100.00%	100.00%	$1,000.00	$869.60	666.87%
3,800.00	90.00%	90.00%	$900.00	$769.60	590.18%
3,600.00	80.00%	80.00%	$800.00	$669.60	513.50%
3,400.00	70.00%	70.00%	$700.00	$569.60	436.81%
3,200.00	60.00%	60.00%	$600.00	$469.60	360.12%
3,000.00	50.00%	50.00%	$500.00	$369.60	283.44%
2,800.00	40.00%	40.00%	$400.00	$269.60	206.75%
2,600.00	30.00%	30.00%	$300.00	$169.60	130.06%
2,400.00	20.00%	20.00%	$200.00	$69.60	53.37%
2,300.00	15.00%	15.00%	$150.00	$19.60	15.03%
2,260.80	13.04%	13.04%	$130.40	$0.00	0.00%
2,200.00	10.00%	10.00%	$100.00	-$30.40	-23.31%
2,100.00	5.00%	5.00%	$50.00	-$80.40	-61.66%
2,050.00	2.50%	2.50%	$25.00	-$105.40	-80.83%
2,000.00	0.00%	0.00%	$0.00	-$130.40	-100.00%
1,800.00	-10.00%	-10.00%	$0.00	-$130.40	-100.00%
1,600.00	-20.00%	-20.00%	$0.00	-$130.40	-100.00%
1,400.00	-30.00%	-30.00%	$0.00	-$130.40	-100.00%
1,200.00	-40.00%	-40.00%	$0.00	-$130.40	-100.00%
1,000.00	-50.00%	-50.00%	$0.00	-$130.40	-100.00%
800.00	-60.00%	-60.00%	$0.00	-$130.40	-100.00%
600.00	-70.00%	-70.00%	$0.00	-$130.40	-100.00%
400.00	-80.00%	-80.00%	$0.00	-$130.40	-100.00%
200.00	-90.00%	-90.00%	$0.00	-$130.40	-100.00%
0.00	-100.00%	-100.00%	$0.00	-$130.40	-100.00%

Hypothetical Examples of Amounts Payable at Expiration

The following hypothetical examples illustrate how the Cash Settlement Amounts set forth above are calculated.

Example 1: The level of the Index increases 30.00% from the Initial Level of 2,000.00 to a Final Level of 2,600.00. Because the Final Level of 2,600.00 is greater than the Strike Level of 2,000.00, the Index Strike Return is 30.00% and the investor will be entitled to receive a Cash Settlement Amount of $300.00 per warrant, calculated as follows:

$1,000 x Index Strike Return
$1,000 x 30.00% = $300.00

Taking into account the investor's payment of the Warrant Premium of $130.40, the payment of the Cash Settlement Amount of $300.00 represents a gain of $169.60 per warrant, or 130.06% of the initial investment of $130.40.

Example 2: The level of the Index increases 5.00% from the Initial Level of 2,000.00 to a Final Level of 2,100.00. Because the Final Level of 2,100.00 is greater than the Strike Level of 2,000.00, the Index Strike Return is 5.00% and the investor will be entitled to receive a Cash Settlement Amount of $50.00 per warrant, calculated as follows:

$1,000 x Index Strike Return
$1,000 x 5.00% = $50.00

In this example, because the Final Level is greater than the Strike Level by only 5.00%, which is less than the Warrant Premium Percentage of 13.04%, the investor's Cash Settlement Amount of $50.00 per warrant will result in a 61.66% loss of its initial investment of $130.40.

Example 3: The Final Level of 2,000.00 is the same as the Initial Level. Because the Final Level of 2,000.00 is equal to the Strike Level, the Index Strike Return is 0.00% and the warrants expire worthless. As a result, the investor will lose its entire investment in the warrants.

Example 4: The level of the Index decreases 30.00% from the Initial Level of 2,000.00 to a Final Level of 1,400.00. Because the Final Level of 1,400.00 is less than the Strike Level of 2,000.00, the Index Strike Return is -30.00% and the warrants expire worthless. As a result, the investor will lose its entire investment in the warrants.

Selected Purchase Considerations

- UNCAPPED APPRECIATION POTENTIAL; LOSS OF ENTIRE INITIAL INVESTMENT IF THE LEVEL OF THE INDEX DOES NOT INCREASE — The warrants provide exposure to the performance of the Index if the Final Level is greater than the Strike Level by a percentage greater than the Warrant Premium Percentage of 13.04%. For example, if the closing level of the Index increases 30.00% from the Initial Level to the Final Level, investors will receive a Cash Settlement Amount of $300.00 at expiration, representing a gain of 130.06% of the initial investment of $130.40. If the Final Level is greater than the Strike Level but by a percentage less than the Warrant Premium Percentage, you will lose some or a significant portion of your initial investment. If the Final Level is less than or equal to the Strike Level, the warrants will expire worthless and you will lose your entire investment in the warrants. Any payment on the warrants at expiration is subject to our ability to satisfy our obligations as they become due. You should read this term sheet carefully and understand the terms of the warrants and the manner in which the Cash Settlement Amount is determined before deciding that an investment in the warrants is suitable for you.

- THE WARRANTS ARE SUITABLE ONLY FOR INVESTORS WITH OPTIONS-APPROVED ACCOUNTS — You will not be able to purchase the warrants unless you have an options-approved brokerage account. The warrants involve a high degree of risk and are not appropriate for every investor. You must be able to understand and bear the risk of an investment in the warrants, and you should be experienced with respect to options and option transactions.

- RETURN LINKED TO THE PERFORMANCE OF THE S&P 500® INDEX — The return on the warrants, which may be positive, zero or negative, is linked to the performance of the S&P 500® Index as described herein. The S&P 500® Index is intended to provide a performance benchmark for the U.S. equity markets. The calculation of the level of the S&P 500® Index is based on the relative value of the aggregate market value of the shares of 500 companies as of a particular time as compared to the aggregate average market value of the shares of 500 similar companies during the base period of the years 1941 through 1943. On March 11, 2014, the sponsor of the S&P 500® Index announced that the sponsor will start including, on a case by case basis, multiple share class lines in the S&P 500® Index. This will result in the S&P 500® Index including more than 500 component shares while continuing to include only 500 component companies. The sponsor expects to revise the S&P 500® Index's methodology to fully reflect a multiple share class structure by September 2015. This is only a summary of the S&P 500® Index. For more information on the S&P 500® Index, including information concerning its composition, calculation methodology and adjustment policy, please see the section entitled "The S&P Indices – The S&P 500® Index" in the accompanying underlying supplement No. 1 dated October 1, 2012.

- MINIMUM INITIAL INVESTMENT — The minimum initial investment is $9,910.40 or 76 warrants, each with a Notional Amount of $1,000 (and then in increments of one warrant thereafter), resulting in an aggregate minimum Notional Amount of $76,000.

- TAX CONSEQUENCES — In the opinion of our special tax counsel, Davis Polk & Wardwell LLP, the warrants will be treated for U.S. federal income tax purposes as cash-settled options. Generally, (i) you will not recognize taxable income or loss with respect to a warrant prior to its exercise or lapse, other than pursuant to a taxable disposition, and (ii) the gain or loss on your warrant will be capital gain or loss and will be long-term capital gain or loss if you have held the warrant for more than one year.

You should review carefully the section of the accompanying prospectus supplement entitled "United States Federal Income Taxation." The preceding discussion, when read in combination with that section, constitutes the full opinion of our special tax counsel regarding the material U.S. federal income tax consequences of owning and disposing of the warrants.

Under current law, the United Kingdom will not impose withholding tax on payments made with respect to the warrants.

For a discussion of certain German tax considerations relating to the warrants, you should refer to the section in the accompanying prospectus supplement entitled "Taxation by Germany of Non-Resident Holders."

You should consult your tax adviser regarding the U.S. federal tax consequences of an investment in the warrants, as well as tax consequences arising under the laws of any state, local or non-U.S. taxing jurisdiction.

Selected Risk Considerations

An investment in the warrants involves significant risks. Investing in the warrants is not equivalent to investing directly in the stocks composing the Index.

- THE WARRANTS ARE A RISKY INVESTMENT AND THE WARRANTS WILL EXPIRE WORTHLESS IF THE FINAL LEVEL IS LESS THAN OR EQUAL TO THE STRIKE LEVEL — The warrants are highly speculative and highly leveraged. If the Final Level is less than or equal to the Strike Level, the warrants will expire worthless and you will lose your entire investment in the warrants. The warrants are not suitable for investors who cannot sustain a total loss of their investment. You should be willing and able to sustain a total loss of your investment in the warrants.

- YOU MAY LOSE SOME OR A SIGNIFICANT PORTION OF YOUR INITIAL INVESTMENT EVEN IF THE FINAL LEVEL IS GREATER THAN THE STRIKE LEVEL — Even if the Final Level is greater than the Strike Level, you will lose some or a significant portion of your initial investment if the Final Level is greater than the Strike Level but by a percentage less than the Warrant Premium Percentage of 13.04%. In order for you to receive a Cash Settlement Amount greater than your initial investment, the Final Level must be greater than the Strike Level by a percentage greater than the Warrant Premium Percentage.

- THE WARRANTS ARE SUITABLE ONLY FOR INVESTORS WITH OPTIONS-APPROVED ACCOUNTS — You will not be able to purchase the warrants unless you have an options-approved brokerage account. The warrants involve a high degree of risk and are not appropriate for every investor. You must be able to understand and bear the risk of an investment in the warrants, and you should be experienced with respect to options and option transactions.

- THE WARRANTS DO NOT PROVIDE FOR ANY COUPON PAYMENTS OR VOTING RIGHTS — As a holder of the warrants, you will not receive any coupon payments, and you will not have any voting rights or rights to receive cash dividends or other distributions or other rights that holders of the stocks composing the Index would have.

	•	NY	39,520	6.72%	1	1	1	1
Carbon	PA	45,560	4.96%	2	2	2	1	
Chenango	NY	31,761	4.75%	2	2	1	1	
Cayuga	NY	42,417	4.22%	2	2	2	1	
Bradford	PA	46,006	4.20%	2	2	2	1	
Washington	NY	17,905	2.72%	1	0	1	1	
Warren	NY	32,788	2.22%	1	1	1	1	
Oneida	NY	55,944	1.81%	1	1	1	1	
Broome	NY	26,217	1.15%	1	1	1	0	
Ulster	NY	26,438	0.78%	1	1	1	1	
Erie	NY	106,225	0.35%	4	4	3	2	
Onondaga	NY	30,279	0.35%	2	3	2	0	
Saratoga	NY	12,068	0.33%	1	1	1	0	
Tompkins	NY	4,732	0.26%	1	0	1	0	
		$6,051,593	6.75%	183	192	147	112	

(1) Deposits and Market Share data as of June 30, 2013, the most recent information available from SNL Financial LLC,

adjusted for deposits acquired with the Bank of America branch acquisition and branch consolidations occurring after June 30, 2013.

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Employees

As of December 31, 2013, the Company employed 1,940 full-time employees, 122 part-time employees and 153 temporary employees. None of the Company's employees are represented by a collective bargaining agreement. The Company offers a variety of employment benefits and considers its relationship with its employees to be good.

Supervision and Regulation

General

The banking industry is highly regulated with numerous statutory and regulatory requirements that are designed primarily for the protection of depositors and the financial system, and not for the purpose of protecting shareholders. Set forth below is a description of the material information governing the laws and regulations applicable to the Company and the Bank. This summary is not complete and the reader should refer to these laws and regulation for more detailed information. The Company's and the Bank's failure to comply with applicable laws and regulations could result in a range of sanctions and administrative actions imposed upon the Company and/or the Bank, including the imposition of civil money penalties, formal agreements and cease and desist orders. Changes in applicable law or regulations, and in their interpretation and application by regulatory agencies, cannot be predicted, and may have a material effect on the Company's business and results.

The Company and its subsidiaries are subject to the laws and regulations of the federal government and the states in which they conduct business. The Company, as a bank holding company, is subject to extensive regulation, supervision and examination by the Board of Governors of the Federal Reserve System ("FRB") as its primary federal regulator. The Bank is a nationally-chartered bank and is subject to extensive regulation, supervision and examination by the Office of the Comptroller of the Currency ("OCC") as its primary federal regulator, and as to certain matters, the FRB, the Bureau of Consumer Financial Protection ("CFPB"), and the FDIC.

The Company is also subject to the jurisdiction of the SEC and is subject to disclosure and regulatory requirement under the Securities Act of 1933, as amended, and the Securities Exchange Act of 1934, as amended. The Company's common stock is listed on the New York Stock Exchange ("NYSE") and it is subject to NYSE's rules for listed companies. Affiliated entities, including BPAS, HB&T, Nottingham, CISI, his and CBNA Insurance are subject to the jurisdiction of certain state and federal regulators and self-regulatory organizations including, but not limited to, the SEC, the Texas Department of Banking, the Financial Industry Regulatory Authority ("FINRA"), and state securities and insurance regulators.

Federal Bank Holding Company Regulation

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

Federal Reserve System Regulation

Because the Company is a bank holding company it is subject to regulatory capital requirements and required by the FRB to, among other things, maintain cash reserves against its deposits. The Bank is under similar capital requirements administered by the OCC as discussed below. FRB policy has historically required a bank holding company to act as a source of financial and managerial strength to its subsidiary banks. The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act") codifies this historical policy as a statutory requirement. To the extent the Bank is in need of capital, the Company could be expected to provide additional capital, including borrowings from the FRB for such purpose. Both the Company and the Bank are subject to extensive supervision and regulation, which focus on, among other things, the protection of depositors' funds.

The FRB has established minimum capital requirements for the Company and the Bank. The FRB capital adequacy guidelines apply on a consolidated basis and require bank holding companies to maintain a minimum ratio of Tier 1 capital to total average assets (or "leverage ratio") of 4%. The FRB capital adequacy guidelines also require bank holding companies to maintain a minimum ratio of Tier 1 capital to risk-weighted assets of 4% and a minimum ratio of qualifying total capital to risk-weighted assets of 8%. As of December 31, 2013, the Company's leverage ratio was 9.29%, its ratio of Tier 1 capital to risk-weighted assets was 16.42%, and its ratio of qualifying total capital to risk-weighted assets was 17.57%. For additional information on the Company's capital requirements see "Management's Discussion and Analysis of Financial Condition and Results of Operations - Capital" and Note P to the Financial Statements. The FRB may set higher minimum capital requirements for bank holding companies whose circumstances warrant it, such as companies anticipating significant growth or facing unusual risks. Any holding company whose capital does not meet the minimum capital adequacy guidelines is considered to be undercapitalized and is required to submit an acceptable plan to the FRB for achieving capital adequacy. Such a company's ability to pay dividends to its shareholders and expand its lines of business through the acquisition of new banking or nonbanking subsidiaries also could be restricted.

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

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

The Office of Comptroller of the Currency Regulation

The Bank is supervised and regularly examined by the OCC. The various laws and regulations administered by the OCC affect the Company's practices such as payment of dividends, incurring debt, and acquisition of financial institutions and other companies. It also affects the Bank's business practices, such as payment of interest on deposits, the charging of interest on loans, types of business conducted and the location of its offices. The OCC generally prohibits a depository institution from making any capital distributions, including the payment of a dividend, or paying any management fee to its parent holding company if the depository institution would become undercapitalized due to the payment. Undercapitalized institutions are subject to growth limitations and are required to submit a capital restoration plan to the OCC. The Bank is well capitalized under regulatory standards administered by the OCC. For additional information on our capital requirements see "Management's Discussion and Analysis of Financial Condition and Results of Operations - Capital" and Note P to the Financial Statements.

Federal Home Loan Bank

The Bank is a member of the FHLB, which provides a central credit facility primarily for member institutions for home mortgage and neighborhood lending. The Bank is subject to the rules and requirements of the FHLB, including the purchase of shares of FHLB activity-based stock in the amount of 4.5% of the dollar amount of outstanding advances and FHLB capital stock in an amount equal to the greater of $1,000 or the sum of .20% of the mortgage-related assets held by the Bank based upon the previous year-end financial information. The Bank was in compliance with the rules and requirements of the FHLB at December 31, 2013.

Deposit Insurance

Substantially all of the deposits of the Bank are insured up to applicable limits by the Deposit Insurance Fund ("DIF") and are subject to deposit insurance assessments to maintain the DIF. The Dodd-Frank Act permanently increased the maximum amount of deposit insurance to $250,000 per deposit category, per depositor, per institution retroactive to January 1, 2008. On April 1, 2011, the deposit insurance assessment base changed from total domestic deposits to the average consolidated total assets minus the average tangible equity of the depository institution, pursuant to a rule issued by the FDIC as required by the Dodd-Frank Act. Additionally, the deposit insurance assessment system was revised to create a two scorecard system, one for most large institutions that have more than $10 billion in assets and another for “highly complex” institutions that have over $50 billion in assets and are fully owned by a parent with over $500 billion in assets. The Bank is not affected by the two scorecard system as total assets are below the minimum threshold.

In October 2010, the FDIC adopted a DIF restoration plan to ensure that the fund reserve ratio reaches 1.35% by September 30, 2020, as required by the Dodd-Frank Act. At least semi-annually, the FDIC will update its loss and income projections for the fund and, if needed, will increase or decrease assessment rates, following notice-and-comment rulemaking if required. FDIC insurance expense totaled $3.8 million, $3.8 million and $3.9 million in 2013, 2012 and 2011, respectively.

Under the Federal Deposit Insurance Act, if the FDIC finds that an institution has engaged in unsafe and unsound practices, is in an unsafe or unsound condition to continue operations, or has violated any applicable law, regulation, rule, order or condition imposed by the FDIC, the FDIC may determine that such violation or unsafe or unsound practice or condition require the termination of deposit insurance.

Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010

On July 21, 2010, the Dodd-Frank Actwas signed into law, which resulted in significant changes to the banking industry. The provisions that have received the most public attention have been those that apply to financial institutions larger than the Company; however, the Dodd-Frank Act does contain numerous other provisions that will affect all banks and bank holding companies and impacts how the Company and the Bank handle their operations. The Dodd-Frank Act requires various federal agencies, including those that regulate the Company and the Bank, to promulgate new rules and regulations and to conduct various studies and reports for Congress. The federal agencies are in the process of promulgating these rules and regulations and have been given significant discretion in drafting such rules and regulations. Several of the provisions of the Dodd-Frank Act may have the consequence of increasing the Bank's expenses, decreasing its revenues, and changing the activities in which it chooses to engage. The specific impact of the Dodd-Frank Act on the Company's current activities or new financial activities the Company may consider in the future, the Company's financial performance, and the markets in which the Company operates depends on the manner in which the relevant agencies continue to develop and implement the required rules and regulations and the reaction of market participants to these regulatory developments.

The Dodd-Frank Act includes provisions that, among other things:

- Changes the assessment base for federal deposit insurance from the amount of insured deposits to consolidated assets less tangible capital, eliminate the ceiling on the size of the DIF, and increase the floor applicable to the size of the DIF.
- Makes permanent the $250,000 limit on deposits for federal deposit insurance, retroactive to January 1, 2008.
- Repeals the federal prohibitions on the payment of interest on demand deposits, thereby permitting depository institutions to pay interest on business transaction and other accounts.
- Centralizes responsibility for consumer financial protection by creating the CFPB, a new agency that started in July 2011 with responsibility for implementing, examining, and enforcing compliance with federal consumer laws.
- Restricts the preemption of certain state consumer financial protection laws by federal law and disallow subsidiaries and affiliates of national banks from availing themselves of such preemption.
- Applies the same leverage and risk-based capital requirements that apply to insured depository institutions to most bank holding companies, which, among other things as applied to the Company, going forward will preclude the Company from including in Tier 1 Capital trust preferred securities or cumulative preferred stock, if any, issued on or after May 19, 2010. The Company has not issued any trust preferred securities since May 19, 2010.
- Requires the OCC to seek to make its capital requirements for national banks countercyclical.
- Imposes comprehensive regulation of the over-the-counter derivatives market, which would include certain provisions that would effectively prohibit insured depository institutions from conducting certain derivatives businesses in the institution itself.
- Amends the Electronic Fund Transfer Act to, among several changes, give the FRB the authority to establish rules regarding interchange fees charged for electronic debit transactions by payment card issuers having assets over $10 billion and to enforce a new statutory requirement that such fees be reasonable and proportional to the actual cost of a transaction to the issuer.
- Increases the authority of the FRB to examine the Company and any of its non-bank subsidiaries.

Further, pursuant to FRB regulations mandated by the Dodd-Frank Act, effective October 1, 2011, interchange fees on debit card are limited to a maximum of $.21 per transaction plus 5 basis points of the transaction amount. A debit card issuer may recover an additional one cent per transaction for fraud prevention purposes if the issuer complies with certain fraud-related requirements prescribed by the FRB. Issuers that, together with their affiliates, have less than $10 billion in assets, such as the Company, are exempt from the debit card interchange fee standards. The FRB also adopted requirements in the final rule that issuers include two unaffiliated networks for routing debit transactions that are applicable to the Company and the Bank.

On December 10, 2013, the FRB, SEC, OCC, FDIC and Commodity Futures Trading Commission issued the final rules implementing Section 619 of the Dodd-Frank Act (commonly known as the Volcker Rule) which become effective on April 1, 2014. The final rules prohibit insured depository institutions and companies affiliated with insured depository institutions from engaging in short-term proprietary trading of certain securities, derivatives, commodity futures and options on these instruments, for their own account. The final rules also impose limits on banking entities' investments in, and other relationships with, hedge funds or private equity funds. Banking entities with less than $10 billion in total consolidated assets, which generally have very little or no involvement in prohibited proprietary trading or investment activities in covered funds, do not have any compliance obligations under the final rule if they do not engage in any covered activities other than trading in certain government, agency, State or municipal obligations.

On February 7, 2012, the CFPB issued the final rules implementing Section 1073 of the Dodd-Frank Act to create a comprehensive new system of consumer protections for remittance transfers sent by consumers in the United States to individuals and businesses in foreign countries. The final rules became effective on October 28, 2013. The amendments provide new protections, including disclosure requirements, and error resolution and cancellation rights, to consumers who send remittance transfers to other consumers or businesses in a foreign country. The Bank has adopted policies and procedures to comply with the final foreign remittance transfer rules.

The scope and impact of many of the Dodd-Frank Act's provisions will continue to be determined over time as final regulations are issued and become effective. As a result, the Company cannot predict the ultimate impact of the Dodd-Frank Act on the Company or the Bank at this time, including the extent to which it could increase costs or limit the Company's ability to pursue business opportunities in an efficient manner, or otherwise adversely affect its business, financial condition and results of operations. Nor can the Company predict the impact or substance of other future legislation or regulation. However, it is expected that they at a minimum will increase the Company's and the Bank's operating and compliance costs. As continued rules and regulations are issued, the Company may need to dedicate additional resources to ensure compliance, which may increase its costs of operations and adversely impact its earnings.

Basel III

In December 2010, the Basel Committee, a group of bank regulatory supervisors from around the world, released its final framework for strengthening international capital and liquidity regulation, now officially identified by the Basel Committee as "Basel III." In July 2013, the FRB, FDIC and OCC released the final rules implementing Basel III in the United States. For community banks with less than $15 billion in assets, the new minimum capital requirements are effective on January 1, 2015 and the capital conservation buffer and deductions from CET1 capital (defined below) phase in over time.

The Basel III final capital framework, among other things: introduces as a new capital measure "Common Equity Tier 1," or "CET1," specifies that Tier 1 capital consists of CET1 and "Additional Tier 1 capital" instruments meeting specified requirements, defines CET1 narrowly by requiring that most adjustments to regulatory capital measures be made to CET1 and not to the other components of capital, and expands the scope of the adjustments as compared to existing regulations. When fully phased in on January 1, 2019, Basel III requires banks to maintain:

- a minimum ratio of CET1 to risk-weighted assets of at least 4.5 percent, plus a 2.5 percent "capital conservation buffer" (which is added to the 4.5 percent CET1 ratio as that buffer is phased in, effectively resulting in a minimum ratio of CET1 to risk-weighted assets of at least 7 percent),
- a minimum ratio of Tier 1 capital to risk-weighted assets of at least 6.0 percent, plus the capital conservation buffer (which is added to the 6.0 percent Tier 1 capital ratio as that buffer is phased in, effectively resulting in a minimum Tier 1 capital ratio of 8.5 percent upon full implementation),
- a minimum ratio of Total (that is, Tier 1 plus Tier 2) capital to risk-weighted assets of at least 8.0 percent, plus the capital conservation buffer (which is added to the 8.0 percent total capital ratio as that buffer is phased in, effectively resulting in a minimum total capital ratio of 10.5 percent upon full implementation),
- as a newly adopted international standard, a minimum leverage ratio of 3.0 percent, calculated as the ratio of Tier 1 capital to balance sheet exposures plus certain off-balance sheet exposures (as the average for each quarter of the month-end ratios for the quarter), and
- provides for a "countercyclical capital buffer," generally to be imposed when national regulators determine that excess aggregate credit growth becomes associated with a buildup of systemic risk, that would be a CET1 add-on to the capital conservation buffer in the range of 0 percent to 2.5 percent when fully implemented (potentially resulting in total buffers of between 2.5 percent and 5 percent).

The capital conservation buffer is designed to absorb losses during periods of economic stress. Banking institutions with a ratio of CET1 to risk-weighted assets above the minimum but below the conservation buffer (or below the combined capital conservation buffer and countercyclical capital buffer, when the latter is applied) will face constraints on dividends, equity repurchases and compensation based on the amount of the shortfall. Banking institutions will be required to meet the following minimum capital ratios based upon the final Basel III rules:

- 4.5 percent CET1 to risk-weighted assets;
- 6.0 percent Tier 1 capital to risk-weighted assets; and

- 8.0 percent Total capital to risk-weighted assets.

The Basel III final framework provides for a number of new deductions from and adjustments to CET1. These include, for example, the requirement that mortgage servicing rights, deferred tax assets and significant investments in non-consolidated financial entities be deducted from CET1 to the extent that any one such category exceeds 10 percent of CET1 or all such categories in the aggregate exceed 15 percent of CET1. Implementation of the deductions and other adjustments to CET1 will begin on January 1, 2015 and will be phased-in over a five-year period (20 percent per year). The implementation of the capital conservation buffer will begin on January 1, 2016 at 0.625 percent and be phased in over a four-year period (increasing by that amount on each subsequent January 1, until it reaches 2.5 percent on January 1, 2019). The Company fully expects to be in compliance with the higher Basel III capital standards as they become effective.

Consumer Protection Laws

In connection with its lending activities, the Bank is subject to a number of federal and state laws designed to protect borrowers and promote lending to various sectors of the economy. These laws include the Equal Credit Opportunity Act, GLB Act, the Fair Credit Reporting Act ("FCRA"), the Fair and Accurate Credit Transactions Act of 2003 ("FACT Act"), Electronic Funds Transfer Act, the Truth in Lending Act, the Home Mortgage Disclosure Act, the Dodd-Frank Act, the Real Estate Settlement Procedures Act, the Secure and Fair Enforcement for Mortgage Licensing Act ("SAFE"), and various state law counterparts.

The Dodd-Frank Act created the CFPB with broad powers to supervise and enforce consumer protection laws, including laws that apply to banks in order to prohibit unfair, deceptive or abusive practices. The CFPB has examination authority over all banks and savings institutions with more than $10 billion in assets. Because the Company is below this threshold, the OCC continues to exercise primary examination authority over the Bank with regard to compliance with federal consumer protection laws and regulations. The Dodd-Frank Act weakens the federal preemption rules that have been applicable to national banks and gives attorney generals for the states certain powers to enforce federal consumer protection laws.

In addition, the GLB Act requires all financial institutions to adopt privacy policies, restrict the sharing of nonpublic customer data with nonaffiliated parties and establishes procedures and practices to protect customer data from unauthorized access. In addition, the FCRA, as amended by the FACT Act, includes provisions affecting the Company, the Bank, and their affiliates, including provisions concerning obtaining consumer reports, furnishing information to consumer reporting agencies, maintaining a program to prevent identity theft, sharing of certain information among affiliated companies, and other provisions. The FACT Act requires persons subject to FCRA to notify their customers if they report negative information about them to a credit bureau or if they are granted credit on terms less favorable than those generally available. The FRB and the Federal Trade Commission have extensive rulemaking authority under the FACT Act, and the Company and the Bank are subject to the rules that have been created under the FACT Act, including rules regarding limitations on affiliate marketing and implementation of programs to identify, detect and mitigate certain identity theft red flags. The Bank is also subject to data security standards and data breach notice requirements issued by the OCC and other regulatory agencies. The Bank has created policies and procedures to comply with these consumer protection requirements.

On January 10, 2013, the CFPB issued the final rules implementing the ability-to-repay and qualified mortgage (QM) provisions of the Truth in Lending Act, as amended by the Dodd-Frank Act (the "QM Rule"). The ability-to-repay provision requires creditors to make reasonable, good faith determinations that borrowers are able to repay their mortgages before extending the credit based on a number of factors and consideration of financial information about the borrower derived from reasonably reliable third-party documents. Under the Dodd-Frank Act and the QM Rule, loans meeting the definition of "qualified mortgage" are entitled to a presumption that the lender satisfied the ability-to-repay requirements. The presumption is a conclusive presumption/safe harbor for loans meeting the QM requirements, and a rebuttable presumption for higher-priced loans meeting the QM requirements. The definition of a "qualified mortgage" incorporates the statutory requirements, such as not allowing negative amortization or terms longer than 30 years. The QM Rule also adds an explicit maximum 43% debt-to-income ratio for borrowers if the loan is to meet the QM definition, though some mortgages that meet government-sponsored enterprises, Federal Housing Administration, and Veterans Administration underwriting guidelines may, for a period not to exceed seven years, meet the QM definition without being subject to the 43% debt-to-income limits. The QM Rule became effective on January 10, 2014 and the Bank has created policies and procedures to comply with these consumer protection requirements.

USA Patriot Act

The Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 ("USA Patriot Act") imposes obligations on U.S. financial institutions, including banks and broker-dealer subsidiaries, to implement policies, procedures and controls which are reasonably designed to detect and report instances of money laundering and the financing of terrorism. In addition, provisions of the USA Patriot Act require the federal financial institution regulatory agencies to consider the effectiveness of a financial institution's anti-money laundering activities when reviewing bank mergers and bank holding company acquisitions. The USA Patriot Act also encourages information-sharing among financial institutions, regulators, and law enforcement authorities by providing an exemption from the privacy provisions of the GLB Act for financial institutions that comply with the provision of the Act. Failure of a financial institution to maintain and implement adequate programs to combat money laundering and terrorist financing, or to comply with all of the relevant laws or regulations, could have serious legal, financial and reputational consequences for the institution. The Company has approved policies and procedures that are designed to comply with the USA Patriot Act.

Office of Foreign Assets Control Regulation

The United States has imposed economic sanctions that affect transactions with designated foreign countries, nationals and others administrated by the Treasury's Office of Foreign Assets Control ("OFAC"). The OFAC administered sanctions can take many different forms depending upon the country; however, they contain one or more of the following elements: (i) restrictions on trade with or investment in a sanctioned country, including prohibitions against direct or indirect imports from and exports to a sanctioned country and prohibitions on "U.S. persons" engaging in financial transactions relating to making investments in, or providing investment related advice or assistance to, a sanctioned country; and (ii) a blocking of assets in which the government or specially designated nationals of the sanctioned country have an interest, by prohibiting transfers of property subject to U.S. jurisdiction (including property in the possession or control of U.S. persons). Blocked assets (e.g., property and bank deposits) cannot be paid out, withdrawn, set off or transferred in any manner without a license from OFAC. Failure to comply with these sanctions could have serious legal, financial, and reputational consequences.

Sarbanes-Oxley Act of 2002

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

Electronic Fund Transfer Act

Effective July 1, 2010, a federal banking rule under the Electronic Fund Transfer Act prohibits financial institutions from charging consumers fees for paying overdrafts on automated teller machines and one-time debit card transactions, unless a consumer consents, or opts in, to the overdraft service for those types of transactions. The new rule does not govern overdraft fees on the payment of checks and regular electronic bill payments. The adoption of this regulation lowered fee income immediately after its effective date.

Community Reinvestment Act of 1977

Under the Community Reinvestment Act of 1977 ("CRA"), the Bank is required to help meet the credit needs of its communities, including low- and moderate-income neighborhoods. Although the Bank must follow the requirements of CRA, it does not limit the Bank's discretion to develop products and services that are suitable for a particular community or establish lending requirements or programs. In addition, the Equal Credit Opportunity Act and the Fair Housing Act prohibits discrimination in lending practices. The Bank's failure to comply with the provisions of the CRA could, at a minimum, result in regulatory restrictions on its activities and the activities of the Company. The Bank's failure to comply with the Equal Credit Opportunity Act and the Fair Housing Act could result in enforcement actions against it by its regulators as well as other federal regulatory agencies and the Department of Justice. The Bank's latest CRA rating was "Satisfactory".

The Bank Secrecy Act

The Bank Secrecy Act ("BSA") requires all financial institutions, including banks and securities broker-dealers, to, among other things, establish a risk-based system of internal controls reasonably designed to prevent money laundering and the financing of terrorism. The BSA includes a variety of recordkeeping and reporting requirements (such as cash and suspicious activity reporting), as well as due diligence/know-your-customer documentation requirements. The Company has established an anti-money laundering program and taken other appropriate measures in order to comply with BSA requirements.

Item 1A. Risk Factors

There are risks inherent in the Company's business. The material risks and uncertainties that management believes affect the Company are described below. Adverse experience with these could have a material impact on the Company's financial condition and results of operations.

Changes in interest rates affect our profitability, assets and liabilities.

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

Current levels of market volatility remain higher than historical norms.

From December 2007 through June 2009, the U.S. economy was in recession. During the last five years, the U.S. economy has experienced modest improvements, however, the capital, credit and financial markets have experienced significant volatility and disruption during the last five years. These conditions have had significant adverse effects on our national and local economies, including declining real estate values, a widespread tightening of the availability of credit, illiquidity in certain securities markets, increasing loan delinquencies, historically unfavorable consumer confidence and spending, and a slow recovery of manufacturing and service business activity. The U.S. economy continued to experience turmoil (i.e. the uncertainty caused by the "fiscal cliff", the adoption of The American Taxpayer Relief Act of 2012, and the extension of the debt ceiling) and management does not expect these market conditions to change meaningfully over the short term, and a continuation of these conditions could result in:

- A decrease in the demand for loans and other products and services offered
- A decrease in the value of loans held for sale or other assets secured by consumer or commercial real estate; and
- An increase in the number of customers who may become delinquent or default on their loans

The Company operates in a highly regulated environment and may be adversely affected by changes in laws and regulations.

The Company and its subsidiaries are subject to extensive state and federal regulation, supervision and legislation that govern nearly every aspect of its operations. The Company, as a bank holding company, is subject to regulation by the FRB and its banking subsidiary is subject to regulation by the OCC. These regulations affect deposit and lending practices, capital levels and structure, investment practices, dividend policy and growth. In addition, the non-bank subsidiaries are engaged in providing investment management and insurance brokerage service, which industries are also heavily regulated on both a state and federal level. Such regulators govern the activities in which the Company and its subsidiaries may engage. These regulatory authorities have extensive discretion in connection with their supervisory and enforcement activities, including the imposition of restrictions on the operation of a bank, the classification of assets by a bank and the adequacy of a bank's allowance for loan losses. Any change in such regulation and oversight, whether in the form of regulatory policy, regulations, or legislation, could have a material impact on the Company and its operations. Changes to the regulatory laws governing these businesses could affect the Company's ability to deliver or expand its services and adversely impact its operations and financial condition.

In July 2010, the Dodd-Frank Act was signed into law. The Dodd-Frank Act is sweeping legislation intended to overhaul regulation of the financial services industry. Its goals are to establish a new council of "systemic risk" regulators, create a new consumer protection division, empower the Federal Reserve to supervise the largest, most complex financial companies, allow the government to seize and liquidate failing financial companies, and give regulators new powers to oversee the derivatives market. The provisions of the Dodd-Frank Act are so extensive that full implementation may require several years, and an assessment of its full effect on the Company is not possible at this time.

The Dodd-Frank Act also established the CFPB and authorizes it to supervise certain consumer financial services companies and large depository institutions and their affiliates for consumer protection purposes. Subject to the provisions of the Act, the CFPB has responsibility to implement, examine for compliance with, and enforce "Federal consumer financial law." As a depository institution, the Company will be subject to the regulations promulgated by the CFPB, which will focus on the Company's ability to detect, prevent, and correct practices that present a significant risk of violating the law and causing consumer harm.

The CFPB's new QM Rule became effective on January 10, 2014. The QM Rule is designed to clarify how lenders can manage the potential legal liability under the Dodd-Frank Act which would hold lenders accountable for insuring a borrower's ability to repay a mortgage. Loans that meet this definition of "qualified mortgage" will be presumed to have complied with the new ability-to-repay standard. The QM Rule on qualified mortgages and similar rules could limit the Bank's ability to make certain types of loans or loans to certain borrowers, or could make it more expensive and time-consuming to make these loans, which could limit the Bank's growth or profitability

Compliance with new laws and regulations will likely result in additional costs and/or decreases in revenue, which could adversely impact the Company's results of operations, financial condition or liquidity.

The provisions of the Dodd-Frank Act restricting bank interchange fees, and any rules promulgated thereunder, may negatively impact our revenues and earnings.

Pursuant to the Dodd-Frank Act, the Federal Reserve adopted a rule, effective as of October 1, 2011, addressing interchange fees for debit card transactions that is expected to lower fee income generated from this source. This rule limits interchange fees on debit card transactions to a maximum of 21 cents per transaction plus 5 basis points of the transaction amount. A debit card issuer may recover an additional one cent per transaction for fraud prevention purposes if the issuer complies with certain fraud-related requirements prescribed by the Federal Reserve. Although technically the fee caps rule only applies to institutions with assets in excess of $10 billion, it is expected that smaller institutions, such as the Company, may also be impacted due to market reaction. The Company contracts with large debit card processors and clearing networks with which it could have weaker bargaining power due to the interchange fee limitations. As a result of the Dodd-Frank Act, the Company expects to earn lower revenues on these types of transactions.

The Company may be subject to more stringent capital requirements.

As discussed above, Basel III and the Dodd-Frank Act require the federal banking agencies to establish stricter risk-based capital requirements and leverage limits for banks and bank holding companies. Under the legislation, the federal banking agencies are required to develop capital requirements that address systemically-risky activities. The capital rules must address, at a minimum, risks arising from significant volumes of activity in derivatives, securities products, financial guarantees, securities borrowing and lending and repurchase agreements; concentrations in assets for which reported values are based on models; and concentrations in market share for any activity that would substantially disrupt financial markets if the institutions were forced to unexpectedly cease the activity. These requirements, and any other new regulations, could adversely affect the Company's ability to pay dividends, or could require it to reduce business levels or to raise capital, including in ways that may adversely affect its results of operations or financial condition.

Regional economic factors may have an adverse impact on the Company's business.

The Company's main markets are located in the states of New York and Pennsylvania. Most of the Company's customers are individuals and small and medium-sized businesses which are dependent upon the regional economy. Accordingly, the local economic conditions in these areas have a significant impact on the demand for the Company's products and services as well as the ability of the Company's customers to repay loans, the value of the collateral securing loans and the stability of the Company's deposit funding sources. A prolonged economic downturn in these markets could negatively impact the Company.

The Company faces strong competition from other banks and financial institutions, which can negatively impact its business.

The Company conducts its banking operations in a number of competitive local markets. In those markets, it competes against commercial banks, savings banks, savings and loans associations, credit unions, mortgage banks, brokerage firms, and other financial institutions. Many of these entities are larger organizations with significantly greater financial, management and other resources than the Company has, and they offer the same or similar banking or financial services that it offers in its markets. Moreover, new and existing competitors may expand their business in or into the Company's markets. Increased competition in its markets may result in a reduction in loans, deposits and other sources of its revenues. Ultimately, the Company may not be able to compete successfully against current and future competitors.

The allowance for loan losses may be insufficient.

The Company's business depends on the creditworthiness of its customers. The Company reviews the allowance for loan losses quarterly for adequacy considering economic conditions and trends, collateral values and credit quality indicators, including past charge-off experience and levels of past due loans and nonperforming assets. If the Company's assumptions prove to be incorrect, the Company's allowance for loan losses may not be sufficient to cover losses inherent in the Company's loan portfolio, resulting in additions to the allowance. Material additions to the allowance would materially decrease its net income. It is possible that over time the allowance for loan losses will be inadequate to cover credit losses in the portfolio because of unanticipated adverse changes in the economy, market conditions or events adversely affecting specific customers, industries or markets.

Changes in the equity markets could materially affect the level of assets under management and the demand for other fee-based services.

Economic downturns could affect the volume of income from and demand for fee-based services. Revenue from the wealth management and benefit plan administration businesses depends in large part on the level of assets under management and administration. Market volatility that can lead customers to liquidate investment, as well as lower asset values, can reduce our level of assets under management and administration and thereby decrease the Company's investment management and administration revenues.

Mortgage banking income may experience significant volatility.

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

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

The ability of the Company to satisfy its obligations and pay cash dividends to its shareholders is primarily dependent on the earnings of and dividends from the subsidiary bank. However, payment of dividends by the bank subsidiary is limited by dividend restrictions and capital requirements imposed by bank regulations. The ability to pay dividends is also subject to the continued payment of interest that the Company owes on its subordinated junior debentures. As of December 31, 2013, the Company had $102 million of subordinated junior debentures outstanding. The Company has the right to defer payment of interest on the subordinated junior debentures for a period not exceeding 20 quarters, although the Company has not done so to date. If the Company defers interest payments on the subordinated junior debentures, it will be prohibited, subject to certain exceptions, from paying cash dividends on the common stock until all deferred interest has been paid and interest payments on the subordinated junior debentures resumes.

The risks presented by acquisitions could adversely affect the Company's financial condition and result of operations.

The business strategy of the Company includes growth through acquisition. Any other future acquisitions will be accompanied by the risks commonly encountered in acquisitions. These risks include among other things: the difficulty of integrating operations and personnel, the potential disruption of our ongoing business, the inability of the Company's management to maximize its financial and strategic position, the inability to maintain uniform standards, controls, procedures and policies, and the impairment of relationships with employees and customers as a result of changes in ownership and management. Further, the asset quality or other financial characteristics of a company may deteriorate after the acquisition agreement is signed or after the acquisition closes.

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

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

During 2011, certain securities were downgraded, none of which resulted in an impairment charge to the Company. These downgrades were primarily the result of Standard & Poor's downgrade of the U.S. government from AAA to AA+. However, any additional downgrades and credit watches may contribute to further declines in the fair value of these securities. In addition, the measurement of the fair value of these securities involves significant judgment due to the complexity of the factors contributing to the measurement. Market volatility makes measurement of the fair value even more difficult and subjective. To the extent that any portion of the unrealized losses in the investment portfolio is determined to be other than temporary, and the loss is related to credit factors, the Company could be required to recognize a charge to earnings in the quarter during which such determination is made.

The Company's financial statements are based in part on assumptions and estimates which, if incorrect, could cause unexpected losses in the future.

Pursuant to accounting principles generally accepted in the United States, the Company is required to use certain assumptions and estimates in preparing its financial statements, including in determining credit loss reserves, mortgage repurchase liability and reserves related to litigation, among other items. Certain of the Company's financial instruments, including available-for-sale securities and certain loans, among other items, require a determination of their fair value in order to prepare the Company's financial statements. Where quoted market prices are not available, the Company may make fair value determinations based on internally developed models or other means which ultimately rely to some degree on management judgment. Some of these and other assets and liabilities may have no direct observable price levels, making their valuation particularly subjective, as they are based on significant estimation and judgment. In addition, sudden illiquidity in markets or declines in prices of certain loans and securities may make it more difficult to value certain balance sheet items, which may lead to the possibility that such valuations will be subject to further change or adjustment. If assumptions or estimates underlying the Company's financial statements are incorrect, it may experience material losses.

The Company's information systems may experience an interruption or security breach.

The Company relies heavily on communications and information systems to conduct its business. The Company may be the subject of sophisticated and targeted attacks intended to obtain unauthorized access to assets or confidential information, destroy data, disable or degrade service, or sabotage systems, often through the introduction of computer viruses or malware, cyberattacks and other means. Any failure, interruption or breach in security of these systems could result in failures or disruptions in the Company's online banking system, its general ledger, and its deposit and loan servicing and origination systems. Furthermore, if personal, confidential or proprietary information of customers or clients in the Company's possession were to be mishandled or misused, the Company could suffer significant regulatory consequences, reputational damage and financial loss. Such mishandling or misuse could include circumstances where, for example, such information was erroneously provided to parties who are not permitted to have the information, either by fault of the Company's systems, employees, or counterparties, or where such information was intercepted or otherwise inappropriately taken by third parties. The Company has policies and procedures designed to prevent or limit the effect of the possible failure, interruption or security breach of its information systems; however, any such failure, interruption or security breach could adversely affect the Company's business and results of operations through loss of assets or by requiring it to expend significant resources to correct the defect, as well as exposing the Company to customer dissatisfaction and civil litigation, regulatory fines or penalties or losses not covered by insurance.

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

The Company owns common stock of FHLB in order to qualify for membership in the Federal Home Loan Bank system, which enables it to borrow funds under the FHLB advance program. The carrying value of the Company's FHLB common stock was $12.1 million as of December 31, 2013. There are 12 branches of the Federal

Home Loan Bank system, including New York. Several branches have warned that they have either breached risk-based capital requirement or that they are close to breaching those requirements. To conserve capital, some Federal Home Loan Bank branches have suspended dividends, cut dividend payments, and have not redeemed excess Federal Home Loan Bank stock that members hold. The FHLB has stated that they expect to be able to continue to pay dividends, redeem excess capital stock, and provide competitively priced advances currently and in the future. Although most of the severe problems in the Federal Home Loan Bank system have been at the other Federal Home Loan Bank branches, nonetheless, the 12 Federal Home Loan Bank branches are jointly liable for the consolidated obligations of the Federal Home Loan Bank system. To the extent that one Federal Home Loan Bank branch cannot meet its obligations to pay its share of the system's debt, other Federal Home Loan Bank branches can be called upon to make any required payments. Any such adverse effects on the FHLBNY could adversely affect the value of the Company's investment in its common stock and negatively impact the Company's results of operations.

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

The financial services industry is continually undergoing rapid technological change with frequent introductions of new technology-driven products and services. The effective use of technology increases efficiency and enables financial institutions to better serve customers and to reduce costs. The Company's future success depends, in part, upon its ability to address the needs of its customers by using technology to provide products and services that will satisfy customer demands as well as to create additional efficiencies in the Company's operations.

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

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

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

The Company's ability to attract and retain qualified employees is critical to the success of its business, and failure to do so may have a materially adverse affect on the Company's performance.

The Company's employees are its most important resource, and in many areas of the financial services industry, competition for qualified personnel is intense. The imposition on the Company or its employees of certain existing and proposed restrictions or taxes on executive compensation may adversely affect the Company's ability to attract and retain qualified senior management and employees. If the Company is unable to continue to retain and attract qualified employees, the Company's performance, including its competitive position, could have a materially adverse affect.

Item 1B. Unresolved Staff Comments
None

Item 2. Properties

The Company's primary headquarters are located at 5790 Widewaters Parkway, Dewitt, New York, which is leased. In addition, the Company has 213 properties located in the counties identified in the table on page 5, of which 134 are owned and 79 are under lease arrangements. In total, the Company operates 183 full-service branches, 15 are other customer service facilities for our financial service subsidiaries and six are utilized for back office operations. Some properties contain tenant leases or subleases.

Real property and related banking facilities owned by the Company at December 31, 2013 had a net book value of $57.7 million and none of the properties were subject to any material encumbrances. For the year ended December 31, 2013, rental fees of $5.1 million were paid on facilities leased by the Company for its operations. The Company believes that its facilities are suitable and adequate for the Company’s current operations.

Item 3. Legal Proceedings

The Company and its subsidiaries are subject in the normal course of business to various pending and threatened legal proceedings in which claims for monetary damages are asserted. As of December 31, 2013, 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. Although not considered probable, the range of reasonably possible losses for such matters in the aggregate, beyond the existing recorded liability, was between $0 and $5 million. Although the Company does not believe that the outcome of pending litigation will be material to the Company’s consolidated financial position, it cannot rule out the possibility that such outcomes will be material to the consolidated results of operations for a particular reporting period in the future.

The Bank was named a defendant in an action commenced October 30, 2013 which is pending in the United States District Court for the Middle District of Pennsylvania. The plaintiff alleges that the notices provided to her in connection with the repossession of her automobile failed to comply with certain requirements of the applicable Uniform Commercial Code (UCC). Plaintiff seeks to pursue the action as a class action on behalf of herself and other similarly situated plaintiffs who had their automobiles repossessed and seeks to recover statutory damages under the UCC. The Bank has filed a motion to dismiss the action on the basis of mootness and contests the allegation that the repossession notices were deficient. The Bank also maintains that the case should not proceed as a class action and will oppose class certification. At this time it is difficult to estimate when the action will be resolved. As set forth in the preceding paragraph, all current litigation matters, including this action, are within a range of reasonably possible losses for such matters in the aggregate, beyond the existing recorded liability, and are included in the range of reasonably possible losses set forth above.

Item 4. Mine Safety Disclosures

Not Applicable

Item 4A. Executive Officers of the Registrant

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

Name	Age	Position
Mark E. Tryniski	53	Director, President and Chief Executive Officer of the Company and the Bank. Mr. Tryniski assumed his current position in August 2006. He served as Executive Vice President and Chief Operating Officer from March 2004 to July 2006 and as the Treasurer and Chief Financial Officer from June 2003 to March 2004. He previously served as a partner in the Syracuse office of PricewaterhouseCoopers LLP.
Scott Kingsley	49	Executive Vice President and Chief Financial Officer of the Company. Mr. Kingsley joined the Company in August 2004 in his current position. He served as Vice President and Chief Financial Officer of Carlisle Engineered Products, Inc., a subsidiary of the Carlisle Companies, Inc., from 1997 until joining the Company.
Brian D. Donahue	57	Executive Vice President and Chief Banking Officer. Mr. Donahue assumed his current position in August 2004. He served as the Bank’s Chief Credit Officer from February 2000 to July 2004 and as the Senior Lending Officer for the Southern Region of the Bank from 1992 until June 2004.
George J. Getman	57	Executive Vice President and General Counsel. Mr. Getman assumed his current position in January 2008. Prior to joining the Company, he was a partner with Bond, Schoeneck & King, PLLC and served as corporate counsel to the Company.

Part II

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

The Company’s common stock has been trading on the New York Stock Exchange under the symbol “CBU” since December 31, 1997. Prior to that, the common stock traded over-the-counter on the NASDAQ National Market under the symbol “CBSI” beginning on September 16, 1986. There were 40,431,318 shares of common stock outstanding on January 31, 2014, held by approximately 3,571 registered shareholders of record. The following table sets forth the high and low closing prices for the common stock, and the cash dividends declared with respect thereto, for the periods indicated. The prices do not include retail mark-ups, mark-downs or commissions.

Year / Qtr	High Price	Low Price	Quarterly Dividend
2013			
4th	$40.27	$33.23	$0.28
3rd	$34.71	$31.12	$0.28
2nd	$30.85	$27.64	$0.27
1st	$29.92	$27.60	$0.27
2012			
4th	$28.44	$25.66	$0.27
3rd	$29.30	$26.54	$0.27
2nd	$29.38	$25.55	$0.26
1st	$29.13	$26.36	$0.26

The Company has historically paid regular quarterly cash dividends on its common stock, and declared a cash dividend of $0.28 per share for the first quarter of 2014. The Board of Directors of the Company presently intends to continue the payment of regular quarterly cash dividends on the common stock, as well as to make payment of regularly scheduled dividends on the trust preferred stock when due, subject to the Company's need for those funds. However, because substantially all of the funds available for the payment of dividends by the Company are derived from the subsidiary Bank, future dividends will depend upon the earnings of the Bank, its financial condition, its need for funds and applicable governmental policies and regulations.

The following graph compares cumulative total shareholders returns on the Company's common stock over the last five fiscal years to the S&P 600 Commercial Banks Index, the NASDAQ Bank Index, the S&P 500 Index, and the KBW Regional Banking Index. Total return values were calculated as of December 31 of each indicated year assuming a $100 investment on December 31, 2008 and reinvestment of dividends.

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Equity Compensation Plan Information

The following table provides information as of December 31, 2013 with respect to shares of common stock that may be issued under the Company's existing equity compensation plans.

Plan Category	Number of Securities to be Issued upon Exercise of Outstanding Options, Warrants and Rights (1)	Weighted-average Exercise Price of Outstanding Options, Warrants and Rights	Number of Securities Remaining Available For Future Issuance Under Equity Compensation Plans (excluding securities reflected in column (a))
Equity compensation plans approved by security holders:			
1994 Long-term Incentive Plan	140,936	$19.45	3,689
2004 Long-term Incentive Plan	2,394,920	$21.68	1,004,545
Equity compensation plans not approved by security holders	0	0	0
Total	2,535,856	$21.56	1,008,234

(1) The number of securities includes unvested restricted stock issued of 260,965.

At its December 2012 meeting, the Board approved a new stock repurchase program authorizing the repurchase, at the discretion of senior management, of up to 2,000,000 shares of the Company's common stock, in accordance with securities laws and regulations, during a twelve-month period starting January 1, 2013. There were no treasury stock purchases in 2013. At its December 2013 meeting, the Board approved a new stock repurchase program authorizing the repurchase, at the discretion of senior management, of up to 2,000,000 shares of the Company's common stock, in accordance with securities laws and regulations, during a twelve-month period starting January 1, 2014. Any repurchased shares will be used for general corporate purposes, including those related to stock plan activities. The timing and extent of repurchases will depend on market conditions and other corporate considerations as determined at the Company's discretion.

The following table presents stock purchases made during the fourth quarter of 2013:

Issuer Purchases of Equity Securities

Total Number of	Average	Total Number of Shares Purchased as Part of	Maximum Number of

Period	Shares Purchased	Price Paid Per share	Publicly Announced Plans or Programs	Shares That May Yet be Purchased Under the Plans or Programs
October 1-31, 2013	0	$ 0.00	0	2,000,000
November 1-30, 2013	0	0.00	0	2,000,000
December 1-31, 2013 (1)	56	34.08	0	2,000,000
Total	56	$34.08		

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

Item 6. Selected Financial Data

The following table sets forth selected consolidated historical financial data of the Company as of and for each of the years in the five-year period ended December 31, 2013. The historical information set forth under the captions "Income Statement Data" and "Balance Sheet Data" is derived from the audited financial statements while the information under the captions "Capital and Related Ratios", "Selected Performance Ratios" and "Asset Quality Ratios" for all periods is unaudited. All financial information in this table should be read in conjunction with the information contained in "Management's Discussion and Analysis of Financial Condition and Results of Operations" and with the Consolidated Financial Statements and the related notes thereto included elsewhere in this Annual Report on Form 10-K.

SELECTED CONSOLIDATED FINANCIAL INFORMATION

	Years Ended December 31,				
(In thousands except per share data and ratios)	2013	2012	2011	2010	2009
Income Statement Data:					
Loan interest income	$188,197	$192,710	$192,981	$178,703	$185,119
Investment interest income	75,962	88,690	77,988	69,578	63,663
Interest expense	26,065	50,976	61,556	66,597	83,282
Net interest income	238,094	230,424	209,413	181,684	165,500
Provision for loan losses	7,992	9,108	4,736	7,205	9,790
Noninterest income	108,748	98,955	89,283	88,792	83,528
Gain (loss) on investment securities & early retirement of long-term borrowings, net	(6,568)	291	(61)	0	7
Acquisition expenses, litigation settlement, and contract termination charges	2,181	8,247	4,831	1,365	1,621
Other noninterest expenses	219,074	203,510	185,541	175,521	184,557
Income before income taxes	111,027	108,805	103,527	86,385	53,067
Net income	78,829	77,068	73,142	63,320	41,445
Diluted earnings per share (1)	1.94	1.93	2.01	1.89	1.26
Balance Sheet Data:					
Cash equivalents	$11,288	$84,415	$203,082	$114,996	$257,812
Investment securities	2,218,725	2,818,527	2,151,370	1,742,324	1,487,127
Loans, net of unearned discount	4,109,083	3,865,576	3,471,025	3,026,363	3,099,485
Allowance for loan losses	(44,319)	(42,888)	(42,213)	(42,510)	(41,910)
Intangible assets	390,499	387,134	360,564	311,714	317,671
Total assets	7,095,864	7,496,800	6,488,275	5,444,506	5,402,813
Deposits	5,896,044	5,628,039	4,795,245	3,934,045	3,924,486
Borrowings	244,010	830,134	830,329	830,484	856,778
Shareholders' equity	875,812	902,778	774,583	607,258	565,697
Capital and Related Ratios:					
Cash dividends declared per share	$1.10	$1.06	$1.00	$0.94	$0.88
Book value per share	21.66	22.78	20.94	18.23	17.25
Tangible book value per share (2)	12.80	13.72	11.85	9.49	8.09
Market capitalization (in millions)	1,604	1,084	1,028	925	633
Tier 1 leverage ratio	9.29%	8.40%	8.38%	8.23%	7.39%
Total risk-based capital to risk-adjusted assets	17.57%	16.20%	15.51%	14.74%	13.03%
Tangible equity to tangible assets (2)	7.68%	7.62%	7.12%	6.14%	5.20%
Dividend payout ratio	56.0%	54.3%	49.3%	49.2%	69.5%
Period end common shares outstanding	40,431	39,626	36,986	33,319	32,800
Diluted weighted-average shares outstanding	40,726	39,927	36,454	33,553	32,992

Selected Performance Ratios:					
Return on average assets	1.09%	1.08%	1.18%	1.16%	0.78%
Return on average equity	9.04%	8.82%	10.36%	10.66%	7.46%
Net interest margin	3.91%	3.88%	4.07%	4.04%	3.80%
Noninterest income/operating income (FTE)	30.0%	28.6%	28.4%	31.1%	31.6%
Efficiency ratio (3)	59.3%	57.4%	57.6%	59.4%	65.5%
Asset Quality Ratios:					
Allowance for loan losses/total loans	1.08%	1.11%	1.22%	1.40%	1.35%
Nonperforming loans/total loans	0.54%	0.75%	0.85%	0.61%	0.61%
Allowance for loan losses/nonperforming loans	201%	147%	144%	230%	222%
Loan loss provision/net charge-offs	122%	108%	94%	109%	131%
Net charge-offs/average loans	0.17%	0.23%	0.15%	0.21%	0.24%

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

(2) The tangible book value per share and the tangible equity to tangible asset ratio excludes goodwill and identifiable intangible assets, adjusted for deferred tax liabilities generated from tax deductible goodwill. The ratio is not a financial measurement required by accounting principles generally accepted in the United States of America. However, management believes such information is useful to analyze the relative strength of the Company's capital position and is useful to investors in evaluating Company performance.

(3) Efficiency ratio provides a ratio of operating expenses to operating income. It excludes intangible amortization, goodwill impairment, acquisition expenses, litigation settlement and contract termination charges from expenses and gains and losses on investment securities & early retirement of long-term borrowings from income while adding a fully-taxable equivalent adjustment. The efficiency ratio is not a financial measurement required by accounting principles generally accepted in the United States of America. However, the efficiency ratio is used by management in its assessment of financial performance specifically as it relates to noninterest expense control. Management also believes such information is useful to investors in evaluating Company performance.

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

This Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") primarily reviews the financial condition and results of operations of the Company for the past two years, although in some circumstances a period longer than two years is covered in order to comply with SEC disclosure requirements or to more fully explain long-term trends. The following discussion and analysis should be read in conjunction with the Selected Consolidated Financial Information on page 21 and the Company's Consolidated Financial Statements and related notes that appear on pages 51 through 92. All references in the discussion to the financial condition and results of operations are to the consolidated position and results of the Company and its subsidiaries taken as a whole.

Unless otherwise noted, all earnings per share ("EPS") figures disclosed in the MD&A refer to diluted EPS; interest income, net interest income and net interest margin are presented on a fully tax-equivalent ("FTE") basis. The term "this year" and equivalent terms refer to results in calendar year 2013, "last year" and equivalent terms refer to calendar year 2012, and all references to income statement results correspond to full-year activity unless otherwise noted.

This MD&A contains certain forward-looking statements with respect to the financial condition, results of operations and business of the Company. These forward-looking statements involve certain risks and uncertainties. Factors that may cause actual results to differ materially from those contemplated by such forward-looking statements are set herein under the caption "Forward-Looking Statements" on page 48.

Critical Accounting Policies

As a result of the complex and dynamic nature of the Company's business, management must exercise judgment in selecting and applying the most appropriate accounting policies for its various areas of operations. The policy decision process not only ensures compliance with the latest generally accepted accounting principles ("GAAP"), but also reflects management's discretion with regard to choosing the most suitable methodology for reporting the Company's financial performance. It is management's opinion that the accounting estimates covering certain aspects of the business have more significance than others due to the relative importance of those areas to overall performance, or the level of subjectivity in the selection process. These estimates affect the reported amounts of assets and liabilities and 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 credit losses resulting in an increase in the allowance for loan losses. Subsequent improvements in expected cash flows result in a recovery of previously recorded allowance for loan losses or a reversal of a corresponding amount of the non-accretable discount, which the Company then reclassifies as an accretable discount that is recognized into interest income over the remaining life of the loans using the interest method.

For acquired loans that are not deemed impaired at acquisition, the difference between the acquisition date fair value and the outstanding balance represents the fair value adjustment for a loan and includes both credit and interest rate considerations. Subsequent to the purchase date, the methods used to estimate the allowance for loan losses for the acquired non-impaired loans is consistent with the policy described below. However, the Company compares the net realizable value of the loans to the carrying value, for loans collectively evaluated for impairment. The carrying value represents the net of the loan's unpaid principal balance and the remaining purchase discount (or premium) that has yet to be accreted into interest income. When the carrying value exceeds the net realizable value, an allowance for loan losses is recognized. For loans individually evaluated for impairment, a provision is recorded when the required allowance exceeds any remaining discount on the loan.

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

- Investment securities – Investment securities are classified as held-to-maturity, available-for-sale, or trading. The appropriate classification is based partially on the Company's ability to hold the securities to maturity and largely on management's intentions with respect to either holding or selling the securities. The classification of investment securities is significant since it directly impacts the accounting for unrealized gains and losses on securities. Unrealized gains and losses on available-for-sale securities are recorded in accumulated other comprehensive income or loss, as a separate component of shareholders' equity and do not affect earnings until realized. The fair values of investment securities are generally determined by reference to quoted market prices, where available. If quoted market prices are not available, fair values are based on quoted market prices of comparable instruments, or a discounted cash flow model using market estimates of interest rates and volatility. Investment securities with significant declines in fair value are evaluated to determine whether they should be considered other-than-temporarily impaired. An unrealized loss is generally deemed to be other-than-temporary and a credit loss is deemed to exist if the present value of the expected future cash flows is less than the amortized cost basis of the debt security. The credit loss component of an other-than-temporary impairment write-down is recorded in earnings, while the remaining portion of the impairment loss is recognized in other comprehensive income (loss), provided the Company does not intend to sell the underlying debt security, and it is not more likely than not that the Company will be required to sell the debt security prior to recovery of the full value of its amortized cost basis. During 2013, the Company sold certain held-to-maturity securities. As a result of the transaction, the Company will not be able to use the held-to-maturity classification for the foreseeable future.

  - Retirement benefits - The Company provides defined benefit pension benefits to eligible employees and post-retirement health and life insurance benefits to certain eligible retirees. The Company also provides deferred compensation and supplemental executive retirement plans for selected current and former employees and officers. Expense under these plans is charged to current operations and consists of several components of net periodic benefit cost based on various actuarial assumptions regarding future experience under the plans, including, but not limited to, discount rate, rate of future compensation increases, mortality rates, future health care costs and the expected return on plan assets.

- Provision for income taxes – The Company is subject to examinations from various taxing authorities. Such examinations may result in challenges to the tax return treatment applied by the Company to specific transactions. Management believes that the assumptions and judgments used to record tax-related assets or liabilities have been appropriate. Should tax laws change or the taxing authorities determine that management's assumptions were inappropriate, an adjustment may be required which could have a material effect on the Company's results of operations.

- Intangible assets – As a result of acquisitions, the Company has acquired goodwill and identifiable intangible assets. Goodwill represents the cost of acquired companies in excess of the fair value of net assets at the acquisition date. Goodwill is evaluated at least annually, or when business conditions suggest impairment may have occurred and will be reduced to its carrying value through a charge to earnings if impairment exists. Core deposits and other identifiable intangible assets are amortized to expense over their estimated useful lives. The determination of whether or not impairment exists is based upon discounted cash flow modeling techniques that require management to make estimates regarding the amount and timing of expected future cash flows. It also requires them to select a discount rate that reflects the current return requirements of the market in relation to present risk-free interest rates, required equity market premiums and company-specific risk indicators, all of which are susceptible to change based on changes in economic 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", starting on page 56.

Executive Summary

The Company’s business philosophy is to operate as a community bank with local decision-making, principally in non-metropolitan markets, providing a broad array of banking and financial services to retail, commercial and municipal customers.

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

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

On April 8, 2011, the Company acquired The Wilber Corporation, the parent company of Wilber National Bank ("Wilber"), for $103 million in stock and cash, comprised of $20.4 million in cash and the issuance of 3.35 million additional shares of the Company's common stock. Based in Oneonta, New York, Wilber operated 22 branches in the Central, Greater Capital District and Catskills regions of Upstate New York. The acquisition added approximately $462 million of loans, $297 million of investment securities and $772 million of deposits.

On November 30, 2011, the Company, through its BPAS subsidiary, acquired certain assets and liabilities of CAI, a provider of actuarial, consulting and retirement plan administration services, with offices in New York City and Northern New Jersey. The transaction adds valuable service capacity and enhances distribution prospects in support of the Company's broader-based employee benefits business, including daily valuation plan and collective investment fund administration.

On July 20, 2012, the Bank completed its acquisition of 16 retail branches in central, northern and western New York from HSBC, acquiring approximately $106 million in loans and $697 million of deposits. The assumed deposits consist primarily of core deposits (checking, savings and money market accounts) and the purchased loans consist of in-market performing loans primarily residential real estate loans. Under the terms of the purchase agreement, the Bank paid First Niagara (who acquired HSBC's Upstate New York banking business and assigned its right to purchase the 16 branches to the Bank) a blended deposit premium of 3.4%, or approximately $24 million.

On September 7, 2012, the Bank completed its acquisition of three branches in central New York from First Niagara, acquiring approximately $54 million of loans and $101 million of deposits. The assumed deposits consist primarily of core deposits (checking, savings and money market accounts) and the purchased loans consist of in-market performing loans, primarily residential real estate loans. Under the terms of the purchase agreement, the Bank paid a blended deposit premium of 3.1%, or approximately $3 million.

In support of the HSBC and First Niagara branch acquisitions, the Company completed a public common stock offering in late January 2012 and raised $57.5 million through the issuance of 2.13 million shares. The net proceeds of the offering were approximately $54.9 million.

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

The Company reported net income for the year ended December 31, 2013 of $78.8 million or 2.3% above 2012's reported net income of $77.1 million. Earnings per share of $1.94 for the full year 2013 were $0.01 above the prior year level. The increase in net income was due to higher revenue from both increased net interest income and higher non-interest income, a lower provision for loan losses, and lower acquisition and litigation settlement expenses. Offsetting higher revenue was increased operating expenses and a net loss on the sale of investment securities and debt extinguishments. The 2013 results included $2.2 million or $0.4 per share of acquisition expenses related to the B of A branch acquisition and $6.6 million or $0.12 per share net loss on the sale of investment securities and debt extinguishments. This compares to the 2012 results which included $5.7 million or $0.10 per share of acquisition expenses related to the HSBC and First Niagara branch acquisitions and a $2.5 million or $0.05 per share litigation settlement charge. The loss in 2013 on the sale of investment securities and debt extinguishments resulted from the sale of the Company's portfolio of bank and insurance trust preferred collateralized debt obligation (CDO) securities in response to the uncertainties created by the initial announcement of the final rules implementing Section 619 of the Dodd-Frank Act, commonly known as the "Volcker Rule." The litigation settlement charge in 2012 pertains to the settlement of a class action lawsuit related to the processing of retail debit card transactions and its impact on overdraft fees.

Asset quality remained favorable in 2013, with lower year-end net loan charge-off ratios, non-performing loan ratios and loan delinquency ratios as compared to 2012. The Company experienced year-over-year growth in average interest-earning assets, reflective of strong organic loan growth and the HSBC and First Niagara branch acquisitions, completed in the third quarter of 2012, partially offset by a balance sheet restructuring in the first half of 2013 whereby certain longer duration investment securities were sold and a portion of the Company existing FHLB borrowings were retired. Average deposits increased in 2013 as compared to 2012, reflective of the HSBC and First Niagara branch acquisitions and organic growth in core deposits, offset by a reduction in time deposit balances. Average external borrowings in 2013 decreased from 2012 reflective of the Company's balance sheet restructuring program during the first half of the year.

During the fourth quarter, the Company announced that its subsidiary, Harbridge, reached an agreement to acquire a professional services practice from EBS-RMSCO, Inc., a subsidiary of The Lifetime Healthcare Companies. This professional services practice, which provides actuarial valuation and consulting services to clients who sponsor pension and post-retirement medical and welfare plans, enhances the Company's participation in the Western New York marketplace and is expected to add incremental revenue of approximately $1.2 million annually. The transaction was completed as planned on January 1, 2014.

Net Income and Profitability

Net income for 2013 was $78.8 million, an increase of $1.8 million, or 2.3%, from 2012's earnings of $77.1 million. Earnings per share for 2013 were $1.94, up $0.01 from 2012's earnings per share of $1.93. The 2013 results included $6.6 million or $0.12 per share net loss on the sale of certain investment securities and debt extinguishments resulting from the sale of the Company's portfolio of CDO securities in response to the uncertainties created by the December 2013 announcement of the final rules implementing the Volker Rule as well as $2.2 million or $0.04 per share of acquisition expenses related to the B of A branch acquisition in December 2013. The 2012 results included $5.7 million, or $0.10 per share, of acquisition expenses related principally to the HSBC and First Niagara branch acquisitions, which were completed in the third quarter of 2012, as well as a $2.5 million or $0.05 per share litigation settlement charge.

Net income for 2012 was $77.1 million, up $3.9 million or 5.4% from 2011's earnings of $73.1 million. Earnings per share for 2012 were $1.93, down 4.0% from 2011's earnings per share of $2.01. The 2012 results included $5.7 million, or $0.10 per share of acquisition expenses principally related to the Company's acquisition of the HSBC and First Niagara branch acquisitions, as well as a $2.5 million or $0.05 per share litigation settlement charge. The 2011 results included $4.8 million or $0.09 per share of acquisition expenses, associated with the Wilber acquisition completed in April 2011. Fully diluted shares outstanding increased 9.5% in 2012 over 2011, due principally to the full-year impact of the shares issued in the Wilber acquisition in early 2011 and the additional shares issued in early 2012 in support of the HSBC and First Niagara branch acquisitions.

Table 1: Condensed Income Statements

	Years Ended December 31,				
(000's omitted, except per share data)	2013	2012	2011	2010	2009
Net interest income	$238,094	$230,424	$209,413	$181,684	$165,500
Provision for loan losses	7,992	9,108	4,736	7,205	9,790
Gain on sales of investment securities, net	80,768	291	30	0	7
Loss on debt extinguishments	87,336	0	91	0	0
Noninterest income	108,748	98,955	89,283	88,792	83,528
Acquisition expenses, litigation settlement, and contract termination charges	2,181	8,247	4,831	1,365	1,621
Other noninterest expenses	219,074	203,510	185,541	175,521	184,557
Income before taxes	111,027	108,805	103,527	86,385	53,067
Income taxes	32,198	31,737	30,385	23,065	11,622
Net income	$78,829	$77,068	$73,142	$63,320	$41,445
	40,726	39,927	36,454	33,553	32,992

Diluted weighted average common shares outstanding					
Diluted earnings per share	$1.94	$1.93	$2.01	$1.89	$1.26

The Company operates in three business segments: banking, employee benefit services and wealth management services. Employee benefit services, which includes BPAS, Harbridge and HB&T provides employee benefit trust, collective investment fund, retirement plan administration, actuarial, VEBA/HRA and health and welfare consulting services. Employee benefit services provides services to 3,600 plan sponsors and 350,000 participants, holds $16 billion in assets under custody or administration, employs 235 professionals and operates out of nine offices located throughout the U.S. and Puerto Rico. Wealth management services activities include trust services provided by the personal trust unit within CBNA, investment and insurance products and services provided by CISI and CBNA Insurance and asset advisory services provided by Nottingham. The banking segment provides a wide array of lending and depository-related products and services to individuals, businesses, and municipal enterprises. In addition to general liquidity and intermediation services, the Banking segment provides treasury management solutions, capital financing products, and payment processing services. For additional financial information on the Company's segments, refer to Note T: Segment Information in the Notes to Consolidated Financial Statements.

The primary factors explaining 2013 earnings performance are discussed in the remaining sections of this document and are summarized as follows:

Banking

- As shown in Table 1 above, net interest income increased $7.7 million, or 3.3%, due to a $94.9 million increase in average earning assets and a three-basis point increase in the net interest margin. Average loans grew $326.5 million due to strong organic growth in the consumer mortgage, consumer indirect, direct and business lending portfolios, as well as loans acquired in the HSBC and First Niagara branch transactions. Partially offsetting the strong loan growth was a decrease in the average book value of investments, including cash equivalents of $231.6 million or 8.4% due to the balance sheet restructuring in the first half of 2013 and the sale of the CDO portfolio in December in response to the final rules implementing the Volcker Rule. Average interest-bearing deposits increased $322.9 million or 7.6% due to the HSBC, First Niagara, and B of A branch acquisitions and organic core deposit growth. Average borrowings decreased $380.4 million or 40% as compared to the prior year, primarily due to the balance sheet restructuring in the first half of 2013.

- The loan loss provision of $8.0 million decreased $1.1 million or 12%, from the prior year level. Net charge-offs of $6.6 million decreased by $1.9 million or 22% from 2012, lowering the net charge-off ratio (net charge-offs / total average loans) six basis points to 0.17% for the year. Nonperforming loans as a percentage of total loans and nonperforming assets as a percentage of loans and other real estate owned, decreased 21 and 22 basis points, respectively, as of December 31, 2013 as compared to December 31, 2012 and remain well below averages for the Company's peers. Additional information on trends and policy related to asset quality is provided in the asset quality section on pages 39 through 43.

- Excluding gain on sale of investment securities and loss on debt extinguishments, banking noninterest income for 2013 of $54.6 million increased by $4.5 million, or 8.9%, from 2012's level due to both organic and acquired growth. Fees from banking services were $3.2 million or 7.3%, higher primarily due to higher debit card related revenue and the banking acquisitions completed over the last two years. Additionally, mortgage banking revenue increased $0.8 million in 2013 and included the recovery of $0.4 million of previously recorded valuation allowances related to mortgage servicing rights.

- Total banking noninterest expenses, including acquisition expenses, litigation settlement, and contract termination charges increased $7.8 million, or 4.6%, in 2013 to $178.7 million, reflective of acquired and organic growth initiatives and investments in technology infrastructure over the past two years. Excluding acquisition expenses, litigation settlement, and contract termination charges, banking noninterest expenses increased $13.9 million or 8.5% due in most part to the three acquisitions completed over the last two years.

Employee Benefit Services

- Employee benefit services revenue for 2013 of $39.5 million increased $2.8 million or 7.5% from the prior year level benefiting from new and expanded customer relationships, along with positive equity market influences.

- The growth in employee benefit services noninterest expenses for 2013, which totaled $31.7 million, was limited to $0.3 million or 0.9% from the prior year level due to the successful integration of the CAI business acquired in late 2011 and the full year effect of certain operating efficiencies implemented during 2012.

Wealth Management Services

- Wealth management services revenue for 2013 of $16.3 million increased $2.7 million or 20% from the prior year level due to positive market conditions, as well as additional resources and customers from both organic and acquired growth initiatives.

- Wealth management services noninterest expenses of $12.5 million increased $1.5 million or 14% from the prior year level to support the acquired and organic revenue growth.

Selected Profitability and Other Measures

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

Table 2: Selected Ratios

	2013	2012	2011
Return on average assets	1.09%	1.08%	1.18%
Return on average equity	9.04%	8.82%	10.36%
Dividend payout ratio	56.0%	54.3%	49.3%
Average equity to average assets	12.11%	12.22%	11.42%

As displayed in Table 2 above, both the return on average assets and the return on average equity increased in 2013 as compared to 2012 and remained below the 2011 ratios. The increase in return on average assets was the result of net income increasing at a faster pace than average assets due in large part to noninterest income growth and a lower provision for loan losses. The increase in return on average equity was due to increased net income while average equity declined primarily due to the balance sheet restructure in the first half of the year and market-related changes in the unrealized gains and losses on the available-for-sale portfolio during the year. The decrease in return on average assets and return on average equity in 2012 as compared to 2011 was a result of net income growing at a slower pace than average assets and average equity, both of which grew significantly as a result of acquisitions, capital raised to support the transactions, organic growth, higher retained earnings and a significant increase in the unrealized gains on available-for-sale investment securities. The corresponding net income was negatively impacted by a declining net interest margin and non-recurring costs associated with the acquisitions and the litigation settlement charge in 2012.

The dividend payout ratio for 2013 increased 1.7 percentage points from 2012 as dividends declared increased 5.4% primarily as a result of a 3.8% increase in the dividends declared per share as well as the additional 0.8 million shares issued in conjunction with the employee stock plan, while net income increased at a smaller 2.2% rate from 2012. The five percentage point increase in the dividend payout ratio in 2012 as compared to 2011 was the result of a 16% increase in dividends declared while net income increased at a slower 5.4% pace. The increase in the dividends declared was a result of a 6.0% increase in the dividends declared per share as well as the additional 2.1 million shares issued in conjunction with the public stock offering in January 2012 and the 3.4 million shares issued in conjunction with the Wilber acquisition in the second quarter of 2011.

Net Interest Income

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

As disclosed in Table 3, net interest income (with nontaxable income converted to a fully tax-equivalent basis) totaled $253.2 million in 2013, up $5.8 million, or 2.4%, from the prior year a result of a $94.9 million increase in average interest-earning assets, a three-basis point increase in net interest margin and a $57.5 million decrease in average interest-bearing liabilities. As reflected in Table 4, the increase in interest-earning assets, the decrease in interest bearing liabilities and the lower rate on interest-bearing liabilities had a $29.3 million favorable impact that was partially offset by a $23.5 million unfavorable impact from the decrease in the yield on interest-bearing assets.

The net interest margin increased three basis points from 3.88% in 2012 to 3.91% in 2013. This increase was attributable to a 47-basis point decrease in the cost of interest-bearing liabilities having a greater impact than a 36-basis point decrease in earning-asset yields. The yield on loans decreased 56 basis points in 2013 to 4.78% from 5.34% in 2012, due to new loan volume carrying lower yields in the current low-rate environment than the loans maturing or being prepaid, as well as certain adjustable rate loans repricing downward. The yield on investments, including cash equivalents, decreased from 3.80% in 2012 to 3.58% in 2013. During the first six months of 2013, the Company sold $648.7 million of U.S. Treasury and agency securities, with an average yield of 2.78%, realizing $63.8 million of gains. The proceeds were utilized to retire $501.6 million of FHLB borrowings with an average cost of 4.15% that had $63.5 million of associated early extinguishments costs. These actions enhanced the Company’s regulatory capital position, while positively impacting expected future net interest income generation. During the first nine months of the year, the Company purchased $650 million of U.S. Treasury securities with an average yield of 2.49% in anticipation of the excess funding expected from the pending branch acquisition and certain other expected contractual cash flows. The cost of funding, including the impact of non-interest checking deposits, decreased 41 basis points during 2013 to 0.42% as compared to 0.83% for 2012. The decreased cost of funds was reflective of the extinguishment of the higher rate FHLB borrowings previously discussed, as well as continued disciplined deposit pricing, whereby interest rates on essentially all deposit account categories were lowered throughout 2013 and 2012 in response to market conditions. Additionally, the proportion of customer deposits in higher cost time deposits declined 2.9 percentage points in 2013, while the percentage of deposits in non-interest bearing and lower cost checking accounts correspondingly increased.

The net interest margin in 2012 was 3.88%, compared to 4.07% in 2011. This 19-basis point decrease was primarily attributable to a 51-basis point decrease in the earning-asset yields having a greater impact than a 37-basis point decrease in the cost of interest-bearing liabilities. The yield on loans decreased 44 basis points in 2012 to 5.34% from 5.78% in 2011, mostly as a result of the low interest rate environment. The yield on investments, including cash equivalents, decreased from 4.27% in 2011 to 3.80% in 2012, largely a result of the purchase during 2012 of $899 million of U.S. Treasury, obligations of state and political subdivisions and other securities with an average yield of 2.7%. The decreased cost of funds was reflective of disciplined deposit pricing, whereby interest rates on selected categories of deposit accounts were lowered throughout 2011 and 2012 in response to market conditions. The cost of funding, including the impact of non-interest checking deposits, decreased 31 basis points during 2012 to 0.83% from 1.14% for 2011.

As shown in Table 3, total interest income decreased by $19.1 million, or 6.4% in 2013 in comparison to 2012. Table 4 indicates that higher average earning assets created $4.4 million of incremental interest income, offset by lower yields with a negative impact of $23.5 million. Average loans increased a total of $326.5 million in 2013, primarily as result of strong organic growth in the consumer mortgage and consumer indirect portfolios, as well as the full year impact of the loans added in the HSBC and First Niagara branch acquisitions in the third quarter of 2012. Loan interest income and fees decreased $4.7 million or 2.4% in 2013 as compared to 2012, attributable to the 56-basis point decrease in loan yields, partially offset by higher average loan balances. On an FTE basis, investment interest income, including interest on average cash equivalents of $90.0 million in 2013, was $14.4 million or 13.8% lower than the prior year as a result of a smaller portfolio and a 22-basis point decrease in the investment yield. Average investments for 2013, including cash equivalents, were $231.6 million lower than 2012, reflective of the balance sheet restructure in the first half of 2013, partially offset by the purchase of U.S. Treasury securities in anticipation of the excess funding expected from the branch acquisition completed in the fourth quarter of 2013.

Total interest income increased by $11.7 million, or 4.1%, in 2012 from 2011's level. Table 4 indicates that higher average earning assets contributed a positive $41.4 million variance, offset by lower yields with a negative impact of $29.7 million. Average loans increased a total of $272.7 million in 2012, primarily as result of strong organic growth in the consumer mortgage and consumer indirect portfolios, as well as loans added in the HSBC and First Niagara branch acquisitions. Loan interest income and fees decreased slightly in 2012 as compared to 2011, attributable to the 44-basis point decrease in loan yields, partially offset by higher average loan balances. Investment interest income, including cash equivalents, on an FTE basis of $104.5 million in 2012 was $11.8 million or 12.7% higher than the prior year as a result of a larger portfolio, partially offset by a 47-basis point decrease in the investment yield. Average investments, including cash equivalents, for 2012 were $576.2 million higher than 2011, reflective of the deployment of excess funding supplied by the HSBC and First Niagara branch acquisitions and organic deposit growth.

Total average funding (deposits and borrowings) in 2013 increased $72.8 million or 1.2%. Average deposits increased $453.2 million, of which approximately $359.3 million was attributable to the HSBC and First Niagara branch acquisitions, $14.8 million was attributable to the B of A acquisition and the remaining $79.1 million was attributable to organic deposit growth. Consistent with the Company's funding mix objective and customers unwillingness to commit to less liquid instruments in the low rate environment, average core deposit balances increased $575.4 million, while time deposits declined $122.2 million year-over-year. Average external borrowings decreased $380.4 million in 2013 as compared to the prior year, reflective of the restructuring program in the first half of 2013 which retired $501.6 million of FHLB borrowings, partially offset by the initiative in the second and third quarter of 2013 to use short-term borrowings to pre-invest a portion of the liquidity expected from the branch acquisition in the fourth quarter of 2013. In 2012, total average funding increased $769.4 million or 14%. Deposits increased $655.1 million, $345 million due to the HSBC and First Niagara acquisitions, $209 million attributable to the Wilber acquisition and $101 million due to organic growth. Consistent with the Company's funding mix objective, average core deposit balances increased $693.8 million, while time deposits were managed downward $38.7 million over the year. Average external borrowings increased $114.4 million in 2012 as compared to the prior year as the Company pre-invested (and borrowed) during the first half of 2012 a portion of the liquidity ultimately received from the branch acquisitions in the third quarter.

Total interest expense decreased by $24.9 million to $26.1 million in 2013. As shown in Table 4, lower interest rates on deposits and external borrowings resulted in $24.4 million of this decrease, while lower external borrowing balances, partially offset by higher deposit balances accounted for a decrease of $0.6 million in interest expense. Interest expense as a percentage of earning assets decreased by 40 basis points to 0.40%. The rate on interest-bearing deposits decreased 19 basis points to 0.24% due to the reduction of rates in all interest-bearing categories throughout 2012 and 2013 and the previously discussed decline of higher rate time deposit balances. The rate on external borrowings decreased 76 basis points to 2.70% in 2013 primarily due to the balance sheet restructuring in the first half of 2013 which retired $501.6 million of FHLB borrowings and by the initiative in the second and third quarter of 2013 to use short-term borrowings to pre-invest a portion of the liquidity expected from the branch acquisition in the fourth quarter of 2013. Total interest expense decreased by $10.6 million to $51.0 million in 2012 as compared to 2011. Lower interest rates on interest-bearing liabilities accounted for $18.0 million of this decrease, while the higher interest-bearing liability balances accounted for an increase of $7.4 million in interest expense. In 2012, the rate on interest-bearing deposits decreased 27 basis points to 0.43% and the rate on external borrowings decreased 79 basis points from 2011 to 3.46%.

The following table sets forth information related to average interest-earning assets and interest-bearing liabilities and their associated yields and rates for the years ended December 31, 2013, 2012 and 2011. Interest income and yields are on a fully tax-equivalent basis using marginal income tax rates of 39.1% in 2013 and 38.8% in 2012 and 2011. Average balances are computed by totaling the daily ending balances in a period and dividing by the number of days in that period. Loan yields and amounts earned include loan fees. Average loan balances include nonaccrual loans and loans held for sale.

Table 3: Average Balance Sheet

	Year Ended December 31, 2013			Year Ended December 31, 2012			Year Ended December 31, 2011		
(000's omitted except yields and rates)	Average Balance	Interest	Avg. Yield/Rate Paid	Average Balance	Interest	Avg. Yield/Rate Paid	Average Balance	Interest	Avg. Yield/Rate Paid
Interest-earning assets:									
Cash equivalents	$62,584	$159	0.25%	$126,714	$330	0.26%	$202,885	$503	0.25%
Taxable investment securities (1)	1,806,137	56,646	3.14%	1,939,998	66,857	3.45%	1,398,437	56,982	4.07%
Nontaxable investment securities (1)	645,464	33,242	5.15%	679,119	37,278	5.49%	568,295	35,207	6.20%
Loans (net of unearned discount)(2)	3,954,515	189,172	4.78%	3,628,006	193,841	5.34%	3,355,286	193,951	5.78%
Total interest-earning assets	6,468,700	279,219	4.32%	6,373,837	298,306	4.68%	5,524,903	286,643	5.19%
Noninterest-earning assets	732,347			780,497			659,267		
Total assets	$7,201,047			$7,154,334			$6,184,170		
Interest-bearing liabilities:									
Interest checking, savings and money market deposits	$3,614,722	3,773	0.10%	$3,169,651	6,895	0.22%	$2,640,239	10,103	0.38%
Time deposits	940,095	6,959	0.74%	1,062,307	11,267	1.06%	1,101,013	16,053	1.46%
Borrowings	567,079	15,333	2.70%	947,454	32,814	3.46%	833,075	35,400	4.25%
Total interest-bearing liabilities	5,121,896	26,065	0.51%	5,179,412	50,976	0.98%	4,574,327	61,556	1.35%
Noninterest-bearing liabilities:									

Noninterest checking deposits	1,119,935			989,631			825,277		
Other liabilities	86,920			111,051			78,221		
Shareholders' equity	872,296			874,240			706,345		
Total liabilities and shareholders' equity	$7,201,047			$7,154,334			$6,184,170		
Net interest earnings		$253,154			$247,330			$225,087	
Net interest spread			3.81%			3.70%			3.84%
Net interest margin on interest-earning assets			3.91%			3.88%			4.07%
Fully tax-equivalent adjustment		$15,060			$16,906			$15,674	

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

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

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

Table 4: Rate/Volume

	2013 Compared to 2012 Increase (Decrease) Due to Change in (1)			2012 Compared to 2011 Increase (Decrease) Due to Change in (1)		
(000's omitted)	Volume	Rate	Net Change	Volume	Rate	Net Change
Interest earned on:						
Cash equivalents	($164)	($7)	($171)	($198)	$25	($173)
Taxable investment securities	(4,433)	(5,778)	(10,211)	19,633	(9,758)	9,875
Nontaxable investment securities	(1,796)	(2,240)	(4,036)	6,372	(4,301)	2,071
Loans (net of unearned discount)	16,600	(21,269)	(4,669)	15,146	(15,256)	(110)
Total interest-earning assets (2)	4,385	(23,472)	(19,087)	41,411	(29,748)	11,663
Interest paid on:						
Interest checking, savings and money market deposits	861	(3,983)	(3,122)	1,749	(4,957)	(3,208)
Time deposits	(1,188)	(3,120)	(4,308)	(546)	(4,240)	(4,786)
Borrowings	(11,306)	(6,175)	(17,481)	4,477	(7,063)	(2,586)
Total interest-bearing liabilities (2)	(560)	(24,351)	(24,911)	7,421	(18,001)	(10,580)
Net interest earnings (2)	3,701	2,123	5,824	33,331	(11,088)	22,243

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

Noninterest Income

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

Table 5: Noninterest Income

(000's omitted except ratios)	Years Ended December 31, 2013	2012	2011
Employee benefit services	$38,596	$35,946	$31,601
Deposit service charges and fees	28,595	26,840	25,658
Electronic banking	18,480	17,025	14,784
Wealth management services	15,550	12,876	10,697
Other banking revenues	5,854	5,425	4,808
Mortgage banking	1,673	843	1,735
Subtotal	108,748	98,955	89,283
Gain on sales of investment securities, net	80,768	291	30
Loss on debt extinguishments	(87,336)	0	(91)
Total noninterest income	$102,180	$99,246	$89,222
Noninterest income/operating income (FTE basis) (1)	30.0%	28.6%	28.4%

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

As displayed in Table 5, noninterest income, excluding security gains and losses and debt extinguishments costs, of $108.7 million for 2013 increased by $9.8 million, comprised of growth in revenue from the Company's financial services businesses, increased debit card related income, higher banking fees due to the HSBC and First Niagara branch acquisitions and higher mortgage banking income. Total noninterest income, excluding security gains and losses and debt extinguishments costs, increased by 10.8% to $99.0 million in 2012 as compared to 2011, largely as a result of growth in revenue from the Company's financial services businesses, primarily from the CAI acquisition completed in December 2011, increased debit card related income, incremental revenue produced by the acquired Wilber trust operations, higher banking fees due to the HSBC, First Niagara and Wilber acquisitions, partially offset by lower mortgage banking income.

Noninterest income as a percent of operating income (FTE basis) was 30.0% in 2013, up 1.4 percentage points from the prior year and up 1.6 percentage points from 2011. The current year increase was due to a 9.9% increase in noninterest income, primarily the result of solid organic growth in the financial services businesses, the HSBC and First Niagara branch acquisitions and strong growth in debit card related income while net interest income increased at a smaller rate of 4.5%. The increase from 2011 to 2012 was primarily driven by a 10.8% increase in noninterest income, primarily the result of the HSBC, First Niagara, Wilber and CAI acquisitions and strong growth in debit card related income while net interest income increased at a smaller rate of 9.9%, primarily due to the contracting net interest margin.

The largest portion of the Company's recurring noninterest income is the wide variety of fees earned from general banking services, which was $52.9 million in 2013, up $3.6 million or 7.4% from the prior year. The increase was due to the addition of new deposit relationships from both acquired and organic growth, as well as solid growth in debit card-related revenue. Electronic banking revenue grew $1.5 million due in large part to a continued concerted effort to increase the penetration and utilization of consumer debit cards. Fees from general banking services were $49.3 million in 2012, up $4.0 million or 8.9% from 2011. The expansion of core deposit relationships through acquisition and marketing efforts, as well as solid growth in debit card-related revenue more than offset the continuing trend of lower utilization of overdraft protection programs.

In 2013, mortgage banking revenue increased $0.8 million from the income generated in 2012, which was down $0.9 million from 2011, reflective of the decision to hold a majority of secondary market eligible mortgages in portfolio from mid-2011 through the first quarter of 2013. Beginning in the second quarter of 2013, the Company began selling conforming 30 year mortgages in the secondary market. Residential mortgage banking income consists of realized gains or losses from the sale of residential mortgage loans and the origination of mortgage loan servicing rights, unrealized gains and losses on residential mortgage loans held for sale and related commitments, mortgage loan servicing fees and other mortgage loan-related fee income. Included in mortgage banking income is a net recovery of $0.4 million in 2013 for the fair value of the mortgage servicing rights due primarily to a decrease in the expected prepayment speed of the Company's sold loan portfolio with servicing retained. Residential mortgage loans sold to investors in 2013, primarily Fannie Mae, totaled $25.2 million as compared to $3.6 million and $43.1 million during 2012 and 2011, respectively. Residential mortgage loans held for sale and recorded at fair value at December 31, 2013 totaled $0.7 million. The continuation of the level of mortgage noninterest income produced in 2013 will be dependent on market conditions and the trend in long-term interest rates.

As disclosed in Table 5, noninterest income from financial services (revenues from employee benefit services and wealth management services) rose $5.3 million, or 11%, in 2013 to $54.1 million. Financial services revenue accounted for 50% of total noninterest income in 2013, excluding net gains (losses) on the sale of investment securities and debt extinguishments. Employee benefit services generated revenue growth of $2.7 million, or 7.4%, in 2013, driven by a combination of new client generation, expanded service offerings and increased asset-based revenue. Employee benefit services, which includes BPAS, Harbridge and HB&T, provides employee benefit trust, collective investment fund, retirement plan administration, actuarial, VEBA/HRA and health and welfare consulting services on a national basis from offices in New Jersey, New York, Pennsylvania, Texas and Puerto Rico. Employee benefit services revenue of $35.9 million in 2012 was $4.3 million higher than 2011's results, primarily driven by the CAI acquisition completed in December 2011.

On November 30, 2011, BPAS acquired, in an all-cash transaction, certain assets and liabilities of CAI, a provider of actuarial, consulting and retirement plan administration services, with offices in New York City and Northern New Jersey. The transaction added valuable service capacity and enhanced distribution prospects in support of the Company's broader-based employee benefits business, including daily valuation plan and collective investment fund administration. While not immediately additive to GAAP earnings, the acquisition added approximately $4.2 million in revenue for the 2012 year in the strategically important metropolitan New York marketplace.

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Wealth management services revenue increased $2.7 million or 21% in 2013. Personal trust revenue increased $0.3 million, CISI revenue increased $2.0 million, Nottingham revenue increased $0.3 million and CBNA Insurance revenue increased $0.1 million. The improved revenue generation of the wealth management services was reflective of positive market conditions and additional resources and customers from both organic and acquired growth initiatives. Wealth management services revenue in 2012 increased $2.2 million or 20% as compared to 2011. Personal trust revenues increased $1.0 million, in large part due to incremental revenue produced by the acquired Wilber trust operations. CISI revenues increased $0.8 million, Nottingham revenue increased $0.3 million and CBNA Insurance revenue increased $0.1 million. The improved revenue generation of the wealth management services in 2012 was reflective of the Wilber acquisition and solid organic growth in trust, and asset management services and investment product sales.

Assets under administration within the Company's employee benefit services segment increased $10.8 billion to $16.1 billion at year-end 2013 from $5.3 billion at year-end 2012, primarily as a result of additions to the collective investment fund administration business and higher equity market valuations. Assets under management with the Company's wealth management services segment increased $0.5 billion to $3.4 billion at year-end 2013 from $2.8 billion at year-end 2012 due to market-driven gains in equity-based assets and the addition of new client assets. Assets under administration declined $0.2 billion at the employee benefit services segment in 2012 as compared to 2011. Assets under management increased $0.5 billion for the wealth management businesses at year end 2012 as compared to one year earlier.

In the first half of 2013, the company sold $648.7 million of investment securities, realizing $63.8 million of gains, and utilized the proceeds to retire FHLB borrowings of $501.6 million with $63.5 million of early extinguishment costs. In late December 2013, in response to the uncertainties created by the announcement of the final regulations implementing the Volcker Rule, the Company sold its entire portfolio of bank and insurance trust preferred collateralized debt obligation securities (CDOs), recognizing a $15.4 million loss on the sale. In conjunction with the liquidation of the trust preferred CDOs, the Company also extinguished $226 million of FHLB advances with $23.8 million of early extinguishment costs and sold $418 million of U.S. Treasury securities previously classified as held to maturity realizing $32.4 million of gains.

Noninterest Expenses

As shown in Table 6, operating expenses increased $9.5 million, or 4.5%, in 2013 to $221.3 million and include non-recurring acquisition expenses as well as incremental operating expenses from the HSBC, First Niagara and B of A acquisitions. Operating expenses in 2012 were $21.4 million or 11.2% higher than 2011 and include non-recurring acquisition expenses and a litigation settlement charge, as well as incremental operating expenses from the HSBC, First Niagara, CAI and Wilber acquisitions. Operating expenses (excluding acquisitions expenses, litigation settlement charge and amortization of intangible assets) for 2013 as a percent of average assets were 2.98%, up 20 basis points from 2.78% in 2012 and five basis points higher than the 2.93% in 2011. The increase in this ratio was due to a 7.9% increase in operating expenses, primarily due to the acquisitions over the last two years, without a corresponding increase in average assets due to the balance sheet restructuring undertaken in the first half of 2013. The improvement in this ratio in 2012 as compared to 2011 was due to effective management of operating expenses combined with the increase in average assets resulting from the HSBC, First Niagara and Wilber acquisitions.

The efficiency ratio, a performance measurement tool widely used by banks, is defined by the Company as operating expenses (excluding acquisition expenses, litigation settlement charge and intangible amortization) divided by operating income (fully tax-equivalent net interest income plus noninterest income, excluding net securities and debt gains and losses). Lower ratios are often correlated to higher operating efficiency. The efficiency ratio for 2013 was 1.9 percentage points higher than the 57.4% ratio for 2012 due to a 7.9% increase in operating expenses, as defined above, being larger than the 4.5% increase in operating income. The increase in 2013 operating income was comprised of a 2.4% increase in net interest income and a 9.9% increase in noninterest income. In 2012, the efficiency ratio declined 0.2 percentage points as the 9.8% increase in operating expenses, as defined above, grew at a slower pace than the increase in income comprised of a 9.9% increase in net interest income and a 10.8% increase in noninterest income (excluding net securities gains and debt extinguishments costs).

Table 6: Noninterest Expenses

	Years Ended December 31,		
(000's omitted)	2013	2012	2011
Salaries and employee benefits	$121,629	$112,034	$102,278
Occupancy and equipment	27,045	25,799	24,502
Data processing and communications	27,186	23,696	20,525
Amortization of intangible assets	4,469	4,607	4,381
Legal and professional fees	7,008	7,950	5,889
Office supplies and postage	6,122	5,742	5,246
Business development and marketing	6,815	5,919	5,931
FDIC insurance premiums	3,829	3,804	3,920
Acquisition expenses and litigation settlement	2,181	8,247	4,831
Other	14,971	13,959	12,869
Total noninterest expenses	$221,255	$211,757	$190,372
Operating expenses(1) /average assets	2.98%	2.78%	2.93%
Efficiency ratio	59.3%	57.4%	57.6%

(1)Operating expenses are total noninterest expenses excluding acquisition expenses, litigation settlement charge and amortization of intangible assets

Salaries and employee benefits increased $9.6 million or 8.6% in 2013, primarily due to the addition of approximately 145 employees from the HSBC and First Niagara branch acquisitions in the third quarter of 2012, 40 employees as a result of the B of A acquisition in late 2013, as well as the impact of annual merit increases and higher incentive payments in 2013 based on the achievement of the Company’s annual business objectives. Total salaries and employee benefits increased $9.8 million or 9.5% in 2012, primarily due to the HSBC, First Niagara, Wilber and CAI acquisitions and the impact of annual merit increases, partially offset by lower incentive payments in 2012. Total full-time equivalent staff at the end of 2013 was 1,987 compared to 1,996 at December 31, 2012 and 1,831 at the end of 2011.

Employee medical expenses increased $1.7 million or 20% in 2013 due to a general rise in the cost of medical care, administration and insurance, as well as the additional employees added from the HSBC and First Niagara branch acquisitions in 2012. Medical expenses increased $0.6 million in 2012, or 7.4%, due primarily to the additional employees added from the Wilber, HSBC and First Niagara acquisitions. This year's defined benefit retirement plan expense decreased $0.4 million due to the improved funded status of the pension plan, higher returns on plan assets and the increase in the liability discount rate from 4.1% to 5.0%. Defined benefit pension expense in 2012 increased $0.5 million due to the additional employees added with the HSBC and First Niagara acquisitions, and the decrease in the liability discount rate from 4.1% to 3.4%, partially offset by higher returns on plan assets. The 401(k) Plan expense for 2013 increased approximately $0.3 million from 2012 due to additional participants being added as a result of the HSBC and First Niagara acquisitions. The 401(k) Plan expense increased $0.2 million in 2012 as compared to 2011 due to the additional participants being added as a result of the HSBC, First Niagara and Wilber acquisitions. The three assumptions that have the largest impact on the calculation of annual pension expense are the discount rate utilized, the rate applied to future compensation increases and the expected rate of return on plan assets. See Note K to the financial statements for further information about the pension plan.

Total non-personnel noninterest expenses, excluding one-time acquisition expenses, and litigation settlement charges increased $6.0 million, or 6.5%, in 2013, and includes the HSBC and First Niagara branch acquisitions completed in 2012. Data processing and communication expenses increased $3.5 million or 14.7% over 2012 levels, due to the higher level of electronic transaction processing as well as continued investments in Company-wide technology enhancements. Legal and professional fees declined $0.9 million in 2013, or 11.8%, and reflected the absence of certain costs incurred in 2012 for a litigation settlement charge partially offset by additional regulatory compliance related activities.

The Company continually evaluates all aspects of its operating expense structure and is diligent about identifying opportunities to improve operating efficiencies. During 2013, the Company consolidated four of its branch offices. This realignment reduced market overlap and further strengthened its branch network, and reflects management's focus on achieving long-term performance improvements through proactive, strategic decision making.

Total non-personnel noninterest expenses, excluding one-time acquisition expenses, litigation settlement and contract termination charges increased $8.2 million, or 9.9%, in 2012, and included incremental direct expenses related to the retail branches acquired from HSBC, First Niagara and Wilber.

Acquisition expenses and litigation settlement charges totaled $2.2 million in 2013, down $6.1 million from the costs incurred in the prior year. Acquisition expenses for 2013 totaled $2.2 million and related primarily to the acquisition of the B of A branches.
Acquisition expenses for 2012 totaled $5.7 million and were associated with the acquisition of the HSBC and First Niagara branches. Additionally, 2012 included a charge of $2.5 million from the settlement of a class action lawsuit related to the processing of retail debit card transactions and its impact on overdraft fees. The Company had considerable affirmative defenses to the claims, however, the settlement the Company was able to achieve was, in its judgment, a superior outcome for shareholders when measured against the cost and the staff resources required for litigation. Acquisition expenses and litigation settlement charges in 2012 were $3.4 million higher than the costs incurred in the prior year. Acquisition expenses and contract termination charges totaled $4.8 million in 2011 and were primarily associated with the Wilber acquisition which closed in April 2011.

Income Taxes

The Company estimates its income tax expense based on the amount it expects to owe the respective tax authorities, plus the impact of deferred tax items. Taxes are discussed in more detail in Note I of the Consolidated Financial Statements beginning on page 74. Accrued taxes represent the net estimated amount due or to be received from taxing authorities. In estimating accrued taxes, management assesses the relative merits and risks of the appropriate tax treatment of transactions taking into account statutory, judicial and regulatory guidance in the context of the Company's tax position. If the final resolution of taxes payable differs from its estimates due to regulatory determination or legislative or judicial actions, adjustments to tax expense may be required.

The effective tax rate for 2013 was 29.0%, compared to 29.2% in 2012, reflective of generally similar proportional levels of income from both fully taxable and non-taxable sources. The effective tax rate for 2012 was ten basis points lower than the 29.3% rate reported in 2011.

Capital

Shareholders' equity ended 2013 at $875.8 million, down $27.0 million, or 3.0%, from one year earlier. This decrease reflects an $80.9 million decrease in accumulated other comprehensive income, and common stock dividends declared of $44.1 million. These decreases were partially offset by net income of $78.8 million, $15.2 million from the issuance of shares through employee stock plans and $4.0 million from stock-based compensation. The change in other comprehensive income was comprised of a $101.5 million decrease in the market value adjustment ("MVA", represents the after-tax, unrealized change in value of available-for-sale securities in the Company's investment portfolio) due principally to the sale of investment securities during the 2013 and a rise in long-term interest rates, partially offset by a positive $20.6 million adjustment to the funded status of the Company's employee retirement plans. These changes in accumulated other comprehensive income resulted in a net comprehensive loss of $2.1 million in 2013 as compared to net comprehensive income of $102.2 million in 2012. The primary year-over-year driver of the difference is the changes in unrealized gains and losses on the available-for-sale investment portfolio, much of which resulted from realized gains recorded in 2013. Excluding accumulated other comprehensive income in both 2013 and 2012, capital rose by $53.9 million, or 6.4%. Shares outstanding increased by 0.8 million during the year added through employee stock plans.

Shareholders' equity ended 2012 at $902.8 million, up $128.2 million, or 17%, from one year earlier. This increase reflects net income of $77.1 million, $54.9 million from common stock issuance, a $25.2 million increase in other comprehensive income, $9.2 million from the issuance of shares through employee stock plans, and $3.7 million from stock-based compensation. These increases were partially offset by common stock dividends declared of $41.9 million. The change in accumulated other comprehensive income was comprised of a $28.1 million increase in the MVA and a $2.9 million change based on the funded status of the Company's employee retirement plans. Excluding accumulated other comprehensive income in both 2012 and 2011, capital rose by $103.0 million, or 14%. Shares outstanding increased by 2.6 million during the year, comprised of 2.13 million shares added through a public common stock offering in January 2012 in support of the HSBC and First Niagara branch acquisition and 0.5 million added through employee stock plans.

The Company's ratio of ending Tier 1 capital to quarterly average assets (or tier 1 leverage ratio), the basic measure for which regulators have established a 5% minimum for an institution to be considered "well-capitalized," increased 89 basis points to end the year at 9.29%. This was the result of a 9.4% increase in Tier 1 capital primarily from the retention of net income generation while fourth quarter average net assets (excludes investment market value adjustment, intangible assets net of related deferred tax liabilities and disallowed mortgage service rights) declined 1.2%, due mostly to the balance sheet restructuring conducted in the first half of 2013. The tangible equity to tangible assets ratio was 7.68% at the end of 2013 versus 7.62% one year earlier. The increase was due to common shareholders' equity decreasing less than tangible assets, as a result of capital generation through retained earnings and reduction of the level of assets as a result of the balance sheet restructure in the first half of the year, the sale of the investments at the end of the year having a higher impact than the decline in market value adjustment due to the rising rate environment. The Company manages organic and acquired growth in a manner that enables it to continue to build upon its strong capital base and maintain the Company's ability to take advantage of future strategic growth opportunities.

Cash dividends declared on common stock in 2013 of $44.1 million represented an increase of 5.4% over the prior year. This growth was a result of the 0.8 million shares issued through employee stock programs and the $0.04 increase in dividends per share for the year. Dividends per share of $1.10 for 2013 increased from $1.06 in 2012, a result of quarterly dividends per share being raised from $0.27 to $0.28 (a 3.7% increase) in the third quarter of 2013 and from $0.26 to $0.27 (a 3.8% increase) in the third quarter of 2012. The 2013 increase in quarterly dividends marked the 21st consecutive year of dividend increases for the Company. The dividend payout ratio for this year was 56.0% compared to 54.3% in 2012, and 49.3% in 2011. The dividend payout ratio increased during 2013 because dividends declared increased 5.4% while net income increased at a lower 2.3% rate. The payout ratio increased during 2012 because dividends increased 16.1% while net income increased 5.4%.

Liquidity

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

Given the uncertain nature of our customers' demands as well as the Company's desire to take advantage of earnings enhancement opportunities, the Company must have available adequate sources of on and off-balance sheet funds that can be acquired in time of need. Accordingly, in addition to the liquidity provided by balance sheet cash flows, liquidity must be supplemented with additional sources such as credit lines from correspondent banks, borrowings from the FHLB and the Federal Reserve Bank of New York. Other funding alternatives may also be appropriate from time to time, including wholesale and retail repurchase agreements, large certificates of deposit and the brokered CD market. The primary source of non-deposit funds are FHLB advances, of which $142 million were outstanding at December 31, 2013.

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 December 31, 2013, the Bank had $150 million of cash and cash equivalents of which $11 million are interest earning deposits held at the Federal Reserve, FHLB and other correspondent banks. The Bank also had $1.1 billion in unused FHLB borrowing capacity based on the Company's quarter-end collateral levels. Additionally, the Company has $1.3 billion of unencumbered securities that could be pledged at the FHLB or Federal Reserve to obtain additional funding. There is $65 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 December 31, 2013, this ratio was 16.4% for 30-days and 16.3% for 90-days, excluding the Company's capacity to borrow additional funds from the FHLB and other sources. There is a sufficient amount of liquidity given the Company's internal policy requirement of 7.5%.

A sources and uses statement is used by the Company to measure intermediate liquidity risk over the next twelve months. As of December 31, 2013, 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 December 31, 2013 indicate the Bank has sufficient sources of funds for the next year in all stressed scenarios.

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

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

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

Intangible Assets

The changes in intangible assets by reporting segment for the year ended December 31, 2013 are summarized as follows:

Table 7: Intangible Assets

(000's omitted)	Balance at December 31, 2012	Additions	Amortization	Impairment	Balance at December 31, 2013
Banking Segment					
Goodwill	$359,207	$5,288	$0	$0	$364,495
Core deposit intangibles	14,492	2,537	3,569	0	13,460
Total Banking Segment	373,699	7,825	3,569	0	377,955
Employee Benefit Services Segment					
Goodwill	7,836	0	0	0	7,836
Other intangibles	2,168	0	662	0	1,506
Total BPAS Segment	10,004	0	662	0	9,342
Wealth Management Segment					
Goodwill	2,660	0	0	0	2,660
	771	9	238	0	542

Other intangibles					
Total Other Segment	3,431	9	238	0	3,202
Total	$387,134	$7,834	$4,469	$0	$390,499

Intangible assets at the end of 2013 totaled $390.5 million, an increase of $3.4 million from the prior year-end due to $7.8 million of additional intangible assets arising primarily from the acquisitions of the B of A branches, offset by $4.5 million of amortization during the year. Intangible assets consist of goodwill and the value of core deposits and customer relationships that arise from acquisitions. Goodwill represents the excess cost of an acquisition over the fair value of the net assets acquired. Goodwill at December 31, 2013 totaled $375.0 million, comprised of $364.5 million related to banking acquisitions and $10.5 million arising from the acquisition of financial services businesses. Goodwill is subjected to periodic impairment analysis to determine whether the carrying value of the acquired net assets exceeds their fair value, which would necessitate a write-down of goodwill. The Company completed its goodwill impairment analyses during the first quarters of 2013 and 2012 and no adjustments were necessary for the banking or financial services businesses. The impairment analysis was 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 the selection 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 and company-specific performance and risk indicators. Management believes that there is a low probability of future impairment with regard to the goodwill associated with its whole-bank, branch and financial services businesses acquisitions.

Core deposit intangibles represent the value of non-time deposits acquired in excess of funding that could have been obtained in the capital markets. Core deposit intangibles are amortized on either an accelerated or straight-line basis over periods ranging from seven to twenty years. The recognition of customer relationship intangibles arose due to the acquisitions of the trust department of Wilber, CAI, Alliance Benefit Group MidAtlantic, HB&T, Harbridge and the CBNA Insurance Agency. These assets were determined based on a methodology that calculates the present value of the projected future net income derived from the acquired customer base. These assets are being amortized on an accelerated basis over periods ranging from seven to twelve years.

Loans

The Company’s loans outstanding, by type, as of December 31 are as follows:

Table 8: Loans Outstanding

(000's omitted)	2013	2012	2011	2010	2009
Consumer mortgage	$1,582,058	$1,448,415	$1,214,621	$1,057,332	$1,044,589
Business lending	1,260,364	1,233,944	1,226,439	1,023,286	1,066,730
Consumer indirect	740,002	647,518	556,955	494,529	528,791
Consumer direct	180,139	171,474	149,170	146,575	139,757
Home equity	346,520	364,225	323,840	304,641	319,618
Gross loans	4,109,083	3,865,576	3,471,025	3,026,363	3,099,485
Allowance for loan losses	(44,319)	(42,888)	(42,213)	(42,510)	(41,910)
Loans, net of allowance for loan losses	$4,064,764	$3,822,688	$3,428,812	$2,983,853	$3,057,575
Daily average of total loans	$3,954,515	$3,628,006	$3,355,286	$3,075,030	$3,104,808

As disclosed in Table 8 above, gross loans outstanding of $4.1 billion as of year-end 2013 increased $243.5 million or 6.3% compared to December 31, 2012 as a result strong organic growth in the consumer mortgage, consumer indirect,

direct and business lending portfolios. The low interest rate environment and continued business development efforts contributed to strong organic consumer mortgage, business lending and consumer indirect lending activity during 2013. The home equity portfolio decreased due primarily to pay downs associated with the high level of mortgage refinancing being conducted in the low interest rate environment, as well as the continued deleveraging activities being undertaken by consumers in the current economic environment. Gross loans outstanding at December 31, 2012 of $3.9 billion increased $394.6 million or 11.4% compared to December 31, 2011 as a result of the HSBC and First Niagara branch acquisitions in the third quarter of 2012, as well as strong organic growth in the consumer mortgage, consumer indirect and consumer direct portfolios. Excluding loans acquired from HSBC and First Niagara, loans increased $234.4 million or 6.8% as of year-end 2012 as compared to year-end 2011.

The compounded annual growth rate (“CAGR”) for the Company’s total loan portfolio between 2008 and 2013 was 5.6%, comprised of approximately 2.8% of organic growth, with the remainder coming from acquisitions. The greatest overall expansion occurred in the consumer mortgage segment, which grew at a 8.0% CAGR, driven by robust mortgage refinancing volumes over the last five years, as well as the acquisition of consumer-oriented banks and branches. The consumer indirect and direct segment grew at a compounded annual growth rate of 6.3% from 2008 to 2013. Consumer indirect and direct loans consist of personal loans originated both in the branch network and in automobile, marine and recreational vehicle dealerships. The business lending segment grew at a compounded annual growth rate of 3.9% driven by acquisitions during the five year period. The home equity lending segment grew at a compounded annual growth rate of 0.7% from 2008 to 2013, including the impact from acquisitions.

The weighting of the components of the Company's loan portfolio enables it to be highly diversified. Approximately 69% of loans outstanding at the end of 2013 were made to consumers borrowing on an installment, line of credit or residential mortgage loan basis. The business lending portfolio is also broadly diversified by industry type as demonstrated by the following distributions at year-end 2013: commercial real estate (28%), healthcare (11%), restaurant & lodging (11%), general services (8%), agriculture (7%), manufacturing (7%), retail trade (6%), construction (6%), wholesale trade (5%) and motor vehicle and parts dealers (4%). A variety of other industries with less than a 3% share of the total portfolio comprise the remaining 7%.

The consumer mortgage portion of the Company's loan portfolio is comprised of fixed (98%) and adjustable rate (2%) residential lending and includes no exposure to Alt-A or other higher-risk mortgage products. Consumer mortgages increased $133.6 million or 9.2% in 2013. During 2013, the Company originated and sold an additional $25.2 million of longer-term, fixed-rate residential mortgages, principally to Fannie Mae. During 2012, the Company originated and sold $3.6 million of residential mortgages. Beginning in the fourth quarter of 2011 through the first quarter of 2013, the Company chose to retain in portfolio the majority of mortgage production. Consumer mortgage volume has been strong over the last few years due to historically low long-term interest rates and comparatively stable real estate valuations in the Company's primary markets. The Company's solid performance during a tumultuous period in the overall industry is a reflection of the high quality profile of its portfolio and its ability to successfully meet customer needs at a time when some national mortgage lenders have restricted their lending activities in many of the Company's markets. Interest rates, expected duration, and the Company's overall interest rate sensitivity profile continue to be the most significant factors in determining whether the Company chooses to retain versus sell and service portions of its new mortgage generation.

The combined total of general-purpose business lending, including agricultural-related and dealer floor plans, as well as mortgages on commercial property, is characterized as the Company's business lending activity. The business lending portfolio increased $26.4 million or 2.1% in 2013. Generating organic growth in this segment has remained challenging primarily due to a prolonged soft economic environment and highly competitive conditions. Further, the Company proactively managed payout of certain unprofitable loan relationships (principally acquired) during 2012 and to a lesser degree in 2013. 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 has continued to invest in personnel, technology, and business development resources to further strengthen its capabilities and enhance overall operational efficiencies in this important product category.

The following table shows the maturities and type of interest rates for business and construction loans as of December 31, 2013:

Table 9: Maturity Distribution of Business and Construction Loans (1)

(000's omitted)	Maturing in One Year or Less	Maturing After One but Within Five Years	Maturing After Five Years	Total
Commercial, financial and agricultural	$322,523	$496,342	$408,383	$1,227,248
Real estate – construction	45,036	0	0	45,036
Total	$367,559	$496,342	$408,383	$1,272,284

Fixed or predetermined interest rates	$101,239	$206,636	$98,827	$406,702
Floating or adjustable interest rates	266,320	289,706	309,556	865,582
Total	$367,559	$496,342	$408,383	$1,272,284

(1) Scheduled repayments are reported in the maturity category in which the payment is due.

Consumer installment loans, both those originated directly (such as personal installment loans and lines of credit), and indirectly (originated predominantly in automobile, marine and recreational vehicle dealerships), increased $101.1 million or 12% from one year ago. The volume of new and used vehicles sales to upper-tier credit profile customers in the Company's primary markets has improved in recent periods. The Company is focused on maintaining the solid profitability produced by its in-market and contiguous market indirect portfolio, while continuing to pursue its disciplined, long-term approach to expanding its dealer network. A by-product of the still historically low new vehicle sales rates has been an improvement in used car valuations, where the majority of the Company's installment lending is concentrated. Market trends predict moderate vehicle sales increases over the prior year levels and this will create opportunity for the Company to continue to produce solid indirect loan growth.

Home equity loans decreased $17.7 million or 4.9% from one year ago, in part due to home equity loans being paid off or down as part of the high level of mortgage refinancing activity that occurred throughout 2012 and continued in 2013 in the low rate environment. In addition, home equity utilization has been adversely impacted by the heightened level of consumer deleveraging activity that is occurring in response to the continued longer-term slow growth economic conditions.

Asset Quality

The following table presents information concerning nonperforming assets as of December 31:

Table 10: Nonperforming Assets

(000's omitted)	2013	2012	2011	2010	2009
Nonaccrual loans					
Consumer mortgage	$12,560	$11,286	$6,520	$4,737	$4,077
Business lending	4,555	13,691	18,535	9,715	12,103
Consumer indirect	14	0	2	0	54
Consumer direct	4	8	0	0	368
Home equity	2,340	1,375	1,205	926	558
Total nonaccrual loans	19,473	26,360	26,262	15,378	17,160
Accruing loans 90+ days delinquent					
Consumer mortgage	1,338	1,818	2,171	2,308	891
Business lending	164	247	399	247	662
Consumer indirect	755	73	32	131	29
Consumer direct	117	71	95	96	33
Home equity	181	539	393	309	135
Total accruing loans 90+ days delinquent	2,555	2,748	3,090	3,091	1,750
Nonperforming loans					
Consumer mortgage	13,898	13,104	8,691	7,045	4,968
Business lending	4,719	13,938	18,934	9,962	12,765
Consumer indirect	769	73	34	131	83
Consumer direct	121	79	95	96	401
Home equity	2,521	1,914	1,598	1,235	693
Total nonperforming loans	22,028	29,108	29,352	18,469	18,910
Other real estate (OREO)	5,060	4,788	2,682	2,011	1,429
Total nonperforming assets	$27,088	$33,896	$32,034	$20,480	$20,339
Allowance for loan losses / total loans	1.08%	1.11%	1.22%	1.40%	1.35%
Allowance for legacy loan losses / total legacy loans (1)	1.15%	1.21%	1.36%	1.40%	1.35%
Allowance for loan losses / nonperforming loans	201%	147%	144%	230%	222%
Allowance for legacy loans / nonperforming legacy loans (1)	234%	171%	197%	230%	222%

Nonperforming loans / total loans	0.54%	0.75%	0.85%	0.61%	0.61%
Legacy nonperforming loans / legacy total loans	0.49%	0.71%	0.69%	0.61%	0.61%
Nonperforming assets / total loans and other real estate	0.66%	0.88%	0.92%	0.68%	0.66%
Delinquent loans (30 days old to nonaccruing) to total loans	1.49%	1.92%	1.99%	1.91%	1.48%
Loan loss provision to net charge-offs	122%	108%	94%	109%	131%
Legacy loan loss provision to net charge-offs (1)	134%	116%	86%	109%	131%

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

The Company places a loan on nonaccrual status when the loan becomes 90 days past due, or sooner if management concludes collection of interest is doubtful, except when, in the opinion of management, it is well-collateralized and in the process of collection. As shown in Table 10 above, nonperforming loans, defined as nonaccruing loans, accruing loans 90 days or more past due and restructured loans ended 2013 at $22.0 million, down approximately $7.1 million from one year earlier. The ratio of nonperforming loans to total loans at December 31, 2013 decreased 21 basis points from the prior year. Excluding nonperforming acquired loans, the ratio of nonperforming loans to total loans at the end of 2013 was 0.49%, a decrease of 22 basis points from the prior year. The ratio of nonperforming assets (which includes other real estate owned, or "OREO", in addition to nonperforming loans) to total loans plus OREO decreased to 0.66% at year-end 2013, down 22 basis points from one year earlier. The Company's success at keeping these ratios at favorable levels despite soft economic conditions was the result of continued focus on maintaining strict underwriting standards, early problem recognition, and effective collection and recovery efforts. At year-end 2013, the Company was managing 46 OREO properties with a value of $5.1 million, as compared to 26 OREO properties with a value of $4.8 million a year earlier. The increase in OREO balances and the number of properties continue to reflect increases in the time necessary to process residential mortgage foreclosures.

Approximately 63% of nonperforming loans at December 31, 2013 are related to the consumer mortgage portfolio. Collateral values of residential properties within the Company's market area did not experience the significant declines in values that other parts of the country encountered in the 2009 to 2011 period. However, the slow economic recovery conditions and still high unemployment levels have adversely impacted consumers and and have resulted in higher than historically normal nonperforming levels. Approximately 21% of the nonperforming loans at December 31, 2013 are related to the business lending portfolio, which is comprised of business loans broadly diversified by industry type. The decrease in nonperforming loans in the business lending portfolio is primarily related to two large relationships, one of which was foreclosed and currently is included in OREO. The remaining 16% percent of nonperforming loans relate to consumer installment and home equity loans. The allowance for loan losses to nonperforming loans ratio, a general measure of coverage adequacy, was 201% at the end of 2013 compared to 147% at year-end 2012 and 144% at December 31, 2011, reflective of the lower level of nonperforming loans. Excluding acquired loans, the ratio of allowance for legacy loans to nonperforming legacy loans was 234% at the end of 2013, compared to 171% at year-end 2012 and 197% at December 31, 2011.

Members of senior management, special asset officers, and commercial bankers 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 the loans, issuing demand letters or other actions. The Company's larger criticized credits are also reviewed on at least a quarterly basis by senior credit administration, special assets and commercial lending management to monitor their status and discuss relationship management plans. Commercial lending management reviews the entire criticized loan portfolio on a monthly basis.

Total delinquencies, defined as loans 30 days or more past due or in nonaccrual status, finished the current year at 1.49% of total loans outstanding, versus 1.92% at the end of 2012. As of year-end 2013, total delinquency ratios for commercial loans, consumer installment loans, real estate mortgages and home equity loans were 0.65%, 1.62%, 2.04% and 1.66%, respectively. These measures were 1.91%, 1.52%, 2.15% and 1.92%, respectively, as of December 31, 2012. Delinquency levels, particularly in the 30 to 89 days category, tend to be somewhat volatile due to their measurement at a point in time, and therefore management believes that it is useful to evaluate this ratio over a longer period. The average quarter-end delinquency ratio for total loans in 2013 was 1.50%, as compared to an average of 1.80% in 2012 and 1.64% in 2011, reflective of the underlying economic conditions and the typical delayed impact they have on loan performance characteristics.

Loans are considered modified in a troubled debt restructuring (“TDR”) when, due to a borrower’s financial difficulties, the Company makes a concession(s) to the borrower that it would not otherwise consider. These modifications primarily include, among others, an extension of the term of the loan or granting a period with reduced or no principal and/or interest payments that can be caught up with payments made over the remaining term of the loan or at maturity. Historically, the Company has had very few TDRs. During 2012, new regulatory guidance was issued by the OCC addressing the accounting of certain loans that have been discharged in Chapter 7 bankruptcy. In accordance with this new guidance, loans that have been discharged in Chapter 7 bankruptcy but not reaffirmed by the borrower are classified as TDRs, irrespective of payment history or delinquency status, even if the repayment terms for the loan have not been otherwise modified and the Company’s lien position against the underlying collateral remains unchanged. Pursuant to that guidance, the Company records a charge-off equal to any portion of the carrying value that exceeds the net realizable value of the collateral. The amount of loss incurred in 2012 was immaterial. With this new interpretation, at December 31, 2013 the Company had 47 loans totaling $2.0 million considered to be nonaccruing TDRs and 213 loans totaling $3.4 million considered to be accruing TDRs as compared to 18 loans totaling $3.3 million considered to be nonaccruing TDRs and 189 loans totaling $3.2 million considered to be accruing TDRs at December 31, 2012.

The changes in the allowance for loan losses for the last five years are as follows:

Table 11: Allowance for Loan Losses Activity

(000's omitted except for ratios)	Years Ended December 31, 2013	2012	2011	2010	2009
Allowance for loan losses at beginning of period	$42,888	$42,213	$42,510	$41,910	$39,575
Charge-offs:					
Consumer mortgage	1,012	1,004	748	583	498
Business lending	3,671	5,654	2,964	3,950	3,324
Consumer indirect	4,544	5,407	4,464	4,279	5,374
Consumer direct	1,954	1,694	1,273	1,719	1,928
Home equity	650	423	265	181	36
Total charge-offs	11,831	14,182	9,714	10,712	11,160
Recoveries:					
Consumer mortgage	36	59	30	71	28
Business lending	692	1,295	692	730	374
Consumer indirect	3,488	3,551	3,200	2,569	2,517
Consumer direct	1,034	821	674	730	732
Home equity	20	23	85	7	54
Total recoveries	5,270	5,749	4,681	4,107	3,705
Net charge-offs	6,561	8,433	5,033	6,605	7,455
Provision for loan losses	7,358	8,715	4,350	7,205	9,790
Provision for acquired impaired loans	634	393	386	0	0
Allowance for loan losses at end of period	$44,319	$42,888	$42,213	$42,510	$41,910
Net charge-offs to average loans outstanding:					
Consumer mortgage	0.06%	0.07%	0.06%	0.05%	0.04%
Business lending	0.24%	0.36%	0.19%	0.31%	0.28%
Consumer indirect	0.16%	0.31%	0.24%	0.34%	0.54%
Consumer direct	0.52%	0.54%	0.39%	0.68%	0.82%
Home equity	0.18%	0.12%	0.06%	0.06%	-0.01%
Total loans	0.17%	0.23%	0.15%	0.21%	0.24%

As displayed in Table 11 above, total net charge-offs in 2013 were $6.6 million, down $1.9 million from the prior year due to lower charge-offs in the business lending and consumer indirect portfolios, partially offset by higher levels of net charge-offs in the consumer mortgage, consumer direct and home equity portfolios. Net charge-offs in 2012 were $3.4 million higher than 2011’s level, due to higher levels of net charge-offs in all portfolios.

Due to the significant increases in average loan balances over time due to acquisition and organic growth, management believes that net charge-offs as a percent of average loans (“net charge-off ratio”) offers a more meaningful representation of asset quality trends. The net charge-off ratio for 2013 was down six basis points from 2012 and was two basis points higher than 2011. Gross charge-offs as a percentage of average loans was 0.30% in 2013 as compared to 0.39% in 2012 and 0.29% in 2011. Continued strong recovery efforts were evidenced by recoveries of $5.3 million in 2013, representing 41% of average gross charge-offs for the latest two years, compared to 48% in 2012 and 46% in 2011.

Business loan net charge-offs decreased in 2013, totaling $3.0 million or 0.24% of average business loans outstanding versus $4.4 million or 0.36% in 2012, reflective of the Company's disciplined risk management and underwriting standards. Consumer installment loan net charge-offs decreased to $2.0 million this year from $2.7 million in 2012, with a net charge-off ratio of 0.23% in 2013 and 0.36% in 2012. Higher used automobile valuations benefited consumer installment recovery efforts, which were 67% of average gross charge-offs in 2013, compared to 68% in 2012, and 66% in 2011. The dollar amount of consumer mortgage net charge-offs increased slightly in 2013, but the net charge-off ratio decreased one basis point to 0.06%. Home equity net charges offs increased by $0.2 million to $0.6 million in 2013 and the net charge-off ratio increased six basis points to 0.18%.

Management continually evaluates the credit quality of the Company's loan portfolio and conducts a formal review of the allowance for loan losses adequacy on a quarterly basis. The two primary components of the loan review process that are used to determine proper allowance levels are specific and general loan loss allocations. Measurement of specific loan loss allocations is typically based on expected future cash flows, collateral values and other factors that may impact the borrower's ability to repay. Impaired loans greater than $0.5 million are evaluated for specific loan loss allocations. Consumer mortgages, consumer installment and home equity loans are considered smaller balance homogeneous loans and are evaluated collectively. The Company considers a loan to be impaired when, based on current information and events, it is probable that the Company will be unable to collect all amounts according to the contractual terms of the loan agreement or the loan is delinquent 90 days or more.

The second component of the allowance establishment process, general loan loss allocations, is composed of two calculations that are computed on the five main loan segments: business lending, consumer direct, consumer indirect, consumer mortgage and home equity. The first calculation determines an allowance level based on the latest 36 months of historical net charge-off data for each loan category (business loans exclude balances with specific loan loss allocations). The second calculation is qualitative and takes into consideration eight qualitative environmental factors: levels and trends in delinquencies and impaired loans; levels of and trends in charge-offs and recoveries; trends in volume and terms of loans; effects of any changes in risk selection and underwriting standards, and other changes in lending policies, procedure, 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. The allowance levels computed from the specific and general loan loss allocation methods are combined with unallocated allowances, if any, to derive the required allowance for loan losses to be reflected on the Consolidated Statement of Condition. As it has in prior periods, the Company strives to refine and enhance its loss evaluation and estimation processes continually.

The loan loss provision is calculated by subtracting the previous period allowance for loan losses, net of the interim period net charge-offs, from the current required allowance level. This provision is then recorded in the income statement for that period. Members of senior management and the Audit/Compliance/Risk Management Committee of the Board of Directors review the adequacy of the allowance for loan losses quarterly. Management is committed to continually improving the credit assessment and risk management capabilities of the Company and has dedicated the resources necessary to ensure advancement in this critical area of operations.

Acquired loans are recorded at acquisition date at their acquisition date fair values, and therefore, are excluded from the calculation of loan loss reserves as of the acquisition date. To the extent there is a decrease in the present value of cash from the acquired impaired loans after the date of acquisition, the Company records a provision for potential losses. During the year ended December 31, 2011, the Company established an allowance for loan losses for acquired impaired loans of $0.4 million for estimated additional losses on certain acquired impaired loans. In 2013 and 2012, an additional $0.6 million and $0.4 million, respectively, of provision for loan losses related to the acquired impaired loans was recorded.

For acquired loans that are not deemed impaired at acquisition, a fair value adjustment is recorded that includes both credit and interest rate considerations. Subsequent to the purchase date, the methods utilized to estimate the required allowance for loan losses for these loans is similar to originated loans, however, the Company records a provision for loan losses only when the required allowance exceeds any remaining purchased discounts. During 2013, the Company recorded a provision for loan losses on acquired non-impaired loans of $0.3 million. During 2012, the Company recorded a provision for loan losses on acquired non-impaired loans of $0.7 million, of which $0.5 million was recorded in the third quarter for loan pools acquired in the third quarter where the net fair value of the pool was deemed greater than its par value at acquisition.

The allowance for loan losses increased to $44.3 million at year-end 2013 from $42.9 million at the end of 2012. The $1.4 million increase was primarily due to organic loan growth. The allowance for legacy loan losses increased $1.8 million as growth in the loan portfolio was partially offset by changes in the composition of the loan portfolio from higher risk business loans to lower risk consumer mortgage and consumer indirect loans. The ratio of the allowance for loan losses to total loans decreased three basis points to 1.08% for year-end 2013 as compared to 1.11% for 2012 and 1.22% for 2011. The ratio of allowance for loan losses to total legacy loans decreased six basis points to 1.15% for 2013 as compared to 2012. Management believes the year-end 2013 allowance for loan losses to be adequate in light of the probable losses inherent in the Company's loan portfolio.

The loan loss provision for legacy loans of $7.0 million in 2013 increased by $0.6 million as a result of management's assessment of the probable losses in the loan portfolio, as discussed above. The loan loss provision as a percentage of average loans was 0.20% in 2013 as compared to 0.25% in 2012 and 0.14% in 2011. The loan loss provision was 122% of net charge-offs this year versus 108% in 2012 and 94% in 2011, reflective of the assessed risk in the portfolio.

The following table sets forth the allocation of the allowance for loan losses by loan category as of the dates indicated, as well as the percentage of loans in each category to total loans. This allocation is based on management's assessment, as of a given point in time, of the risk characteristics of each of the component parts of the total loan portfolio and is subject to changes when the risk factors of each component part change. The allocation is not indicative of either the specific amounts of the loan categories in which future charge-offs may be taken, nor should it be taken as an indicator of future loss trends. The allocation of the allowance to each category does not restrict the use of the allowance to absorb losses in any category.

Table 12: Allowance for Loan Losses by Loan Type

	2013		2012		2011		2010		2009	
		Loan		Loan		Loan		Loan		Loan
(000's omitted except for ratios)	Allowance	Mix	Allowance	Mix	Allowance	Mix	Allowance	Mix	Allowance	Mix
Consumer mortgage	$8,994	38.5%	$7,070	37.5%	$4,651	35.0%	$2,451	34.9%	$1,127	33.7%
Business lending	17,507	30.5%	18,013	31.6%	20,574	34.8%	22,326	33.8%	23,577	34.4%
Consumer indirect	10,248	18.0%	9,606	16.7%	8,960	16.1%	9,922	16.4%	10,004	17.1%
Consumer direct	3,181	4.4%	3,303	4.4%	3,290	4.3%	3,977	4.8%	3,660	4.5%
Home equity	1,830	8.4%	1,451	9.4%	1,130	9.3%	689	10.1%	374	10.3%
Acquired impaired loans	530	0.2%	779	0.4%	386	0.5%	0		0	
Unallocated	2,029		2,666		3,222		3,145		3,168	
Total	$44,319	100.0%	$42,888	100.0%	$42,213	100.0%	$42,510	100.0%	$41,910	100.0%

As demonstrated in Table 12 above and discussed previously, business lending and consumer installment by their nature carries higher credit risk than residential real estate, and as a result these loans carry allowance for loan losses that cover a higher percentage of their total portfolio balances. As in prior years, the unallocated allowance is maintained for inherent losses in the portfolio that is not reflected in the historical loss ratios, model imprecision, and for acquired loan portfolios in the process of being fully integrated at year-end. The unallocated allowance decreased from $3.2 million at year-end 2011 to $2.7 million at year-end 2012 to $2.0 million at December 31, 2013. The general declines in the unallocated portion of the allowance, as well as changes in year-over-year allowance allocations reflect management's continued refinement of its loss estimation techniques. However, given the inherent imprecision in the many estimates used in the determination of the allocated portion of the allowance, management deliberately remained cautious and conservative in establishing the overall allowance for loan losses. Management considers the allocated and unallocated portions of the allowance for loan losses to be prudent and reasonable. Furthermore, the Company's allowance is general in nature and is available to absorb losses from any loan category.

Funding Sources

The Company utilizes a variety of funding sources to support the earning asset base as well as to achieve targeted growth objectives. Overall funding is comprised of three primary sources that possess a variety of maturity, stability, and price characteristics: deposits of individuals, partnerships and corporations (IPC deposits), municipal deposits that are collateralized for amounts not covered by FDIC insurance (public funds) and external borrowings. The average daily amount of deposits and the average rate paid on each of the following deposit categories are summarized below for the years indicated:

Table 13: Average Deposits

(000's omitted, except rates)	2013 Average Balance	2013 Average Rate Paid	2012 Average Balance	2012 Average Rate Paid	2011 Average Balance	2011 Average Rate Paid
Noninterest checking deposits	$1,119,935	0.00%	$989,631	0.00%	$825,277	0.00%
Interest checking deposits	1,206,242	0.03%	1,036,249	0.06%	855,693	0.16%
Regular savings deposits	982,519	0.10%	806,310	0.16%	628,394	0.23%
Money market deposits	1,425,961	0.17%	1,327,092	0.38%	1,156,152	0.63%
Time deposits	940,095	0.74%	1,062,307	1.06%	1,101,013	1.46%
Total deposits	$5,674,752	0.19%	$5,221,589	0.35%	$4,566,529	0.57%

As displayed in Table 13 above, total average deposits for 2013 equaled $5.67 billion, up $453.2 million or 8.7% from the prior year. Excluding the impact of the B of A, HSBC and First Niagara acquisitions, average deposits increased $79.1 million or 1.6% as compared to 2012. Consistent with the Company's focus on expanding core account relationships and reduced customer demand for time deposits, average non-acquired, non-time ("core") deposit balances grew $262.7 million or 6.8% as compared to 2012 while time deposits balances declined $183.6 million or 18%. This shift in mix also reflects the diminished rate differential between core and time deposits in the low interest rate environment. Average deposits in 2012 were up $655.1 million or 14% from 2011, comprised of a $693.8 million or 20% increase in core deposits, and a $38.7 million or 3.5% decrease in time deposits. Excluding the impact of the HSBC, First Niagara and Wilber acquisitions, average deposits increased $222.9 million or 4.9% as compared to 2011.

The Company's funding composition continues to benefit from a high level of non-public deposits, which reached an all-time high in 2013 with an average balance of $5.1 billion, an increase of $424.5 million or 9.0% over the comparable 2012 period. Excluding the impact of the B of A, HSBC and First Niagara acquisitions, average non-public deposits increased $66.9 million or 1.5% during 2013. Non-public, core deposits are frequently considered to be a bank's most attractive source of funding because they are generally stable, do not need to be collateralized, have a relatively low cost, and provide a strong customer base for which a variety of loan, deposit and other financial service-related products can be sold.

Full-year average deposits of local municipalities increased $28.7 million or 5.6% during 2013 to $541.7 million. Excluding the impact of the B of A, HSBC, and First Niagara acquisitions, average public deposits increased $12.2 million or 2.4% during 2013. Municipal deposit balances tend to be more volatile than non-public deposits because they are heavily impacted by the seasonality of tax collection and fiscal spending patterns, as well as the longer-term financial position of the local government entities, which can change from year to year. However, the Company has many strong, long-standing relationships with municipal entities throughout its markets and the diversified core deposits held by these customers have provided an attractive and comparatively stable funding source over an extended time period. The Company is required to collateralize all local government deposits in excess of FDIC coverage with marketable securities from its investment portfolio. Because of this stipulation, as well as the competitive bidding nature of municipal time deposits, management considers this funding source to be similar to external borrowings and thus prices these products on a consistent basis.

The mix of average deposits has been changing throughout the last several years. The weighting of core (interest checking, noninterest checking, savings and money market accounts) has increased, while time deposits' weighting decreased. This change in deposit mix reflects the Company's focus on expanding core account relationships and customers preference for unrestricted accounts in the current low rate environment. The average balance for time deposit accounts decreased from 23.7% of total average deposits for the fourth quarter of 2011 to 15.5% of total average deposits for the fourth quarter of 2013. Correspondingly, average core deposit balances have increased from 76.3% for the fourth quarter of 2011 to 84.5% in the fourth quarter of 2013. This shift in mix, combined with lower average interest rates in all interest-bearing deposit product categories caused the cost of interest bearing deposits to decline to 0.24% in 2013, as compared to 0.43% in 2012 and 0.70% in 2011. The total cost of deposit funding including demand deposits also declined significantly in 2013 to 0.19%, versus 0.35% in 2012, benefiting from the 13% increase in non-interest bearing checking average balances.

The remaining maturities of time deposits in amounts of $100,000 or more outstanding as of December 31 are as follows:

Table 14: Time Deposit > $100,000 Maturities

(000's omitted)	2013	2012
Less than three months	$50,233	$44,379
Three months to six months	43,880	48,637
Six months	48,578	62,064

to one year		
Over one year	63,724	89,845
Total	$206,415	$244,925

External borrowings are defined as funding sources available on a national market basis, generally requiring some form of collateralization. Borrowing sources for the Company include the FHLB and Federal Reserve Bank of New York, as well as access to the brokered CD and repurchase markets through established relationships with primary market security dealers. The Company also had approximately $102 million in floating-rate subordinated debt outstanding at the end of 2013 that is held by unconsolidated subsidiary trusts. In December 2006, the Company completed a sale of $75 million of trust preferred securities. The securities mature on December 15, 2036 and carry an annual rate equal to the three-month LIBOR rate plus 1.65%. The Company used the net proceeds of the offering for general corporate purposes including the early call of the $30 million of fixed-rate trust preferred securities. At the time of the offering, the Company also entered into an interest rate swap agreement to convert the variable rate trust preferred securities into a fixed rate obligation for a term of five years at a fixed rate of 6.43%. The interest rate swap matured in the fourth quarter of 2011.

As shown in Table 15, year-end 2013 external borrowings totaled $244.0 million, a decrease of $586.1 million from 2012. As part of the ongoing asset liability management process, the Company had been evaluating the opportunity to restructure certain portions of the balance sheet. During the first half of 2013, the Company initiated a balance sheet restructuring program through the sale of certain longer duration investment securities and retired $501.6 million of the company's existing FHLB borrowings with $63.5 million of early extinguishment costs. These actions enhanced the Company's regulatory capital position while positively impacting expected future net interest income generation. During the second and third quarter of 2013, the Company used $300 million of short-term borrowing to purchase U.S. Treasury securities in anticipation of the excess funding expected from the pending branch acquisition in the fourth quarter of 2013. In December, in conjunction with the liquidation of the trust preferred CDOs, the Company extinguished an additional $226 million of FHLB advances with $23.8 million of early extinguishment costs.

External borrowings averaged $567.1 million or 9.1% of total funding sources for all of 2013 as compared to $947.5 million or 15.4% of total funding sources for 2012. This ratio decreased as the Company early extinguished FHLB advances, partially offset by the use of short term borrowings from the FHLB to fund the purchase of investment securities during the second half of 2013 as part of the pre-investment of the anticipated liquidity coming from the branch acquisitions. As shown in Table 16 at year-end 2013, the Company had $141.9 million or 58% of external borrowings with remaining terms of one year or less as compared to virtually no external borrowings maturing within one year at December 31, 2012. The Company had no FHLB borrowings maturing in more than one year as of December 31, 2013.

As displayed in Table 3 on page 29, the overall mix of funding in 2013 has shifted in 2013. The percentage of funding derived from deposits increased to 90.9% in 2013 from 84.6% in 2012 and 2011. During 2013 average borrowings decreased 40% while average deposits increased 8.7%.

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

Table 15: Borrowings

(000's omitted, except rates)	2013	2012	2011
FHLB overnight advance	$141,900	$0	$0
FHLB term advances	0	728,034	728,235
Capital lease obligation	13	27	46
Subordinated debt held by unconsolidated subsidiary trusts	102,097	102,073	102,048
Balance at end of period	$244,010	$830,134	$830,329
Daily average during the year	$567,079	$947,454	$833,075
Maximum month-end balance	830,099	1,259,932	849,815
Weighted-average rate during the year	2.70%	3.46%	4.25%
Weighted-average year-end rate	1.22%	3.81%	3.84%

The following table shows the contractual maturities of various obligations as of December 31, 2013:

Table 16: Maturities of Contractual Obligations

	Maturing Within One Year	Maturing After One Year but Within	Maturing After Three Years but Within	Maturing After

(000's omitted)	Or Less	Three Years	Five Years	Five Years	Total
FHLB overnight advance	$141,900	$0	$0	$0	$141,900
Subordinated debt held by unconsolidated subsidiary trusts	0	0	0	102,527	102,527
Capital lease obligation	13	0	0	0	13
Interest on borrowings	2,429	4,852	4,852	38,387	50,520
Operating leases	5,342	9,104	6,941	5,138	26,525
Total	$149,684	$13,956	$11,793	$146,052	$321,485

Financial Instruments with Off-Balance Sheet Risk

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

The contract amount of these off-balance sheet financial instruments as of December 31 is as follows:

Table 17: Off-Balance Sheet Financial Instruments

(000's omitted)	2013	2012
Commitments to extend credit	$704,904	$750,178
Standby letters of credit	24,449	24,168
Total	$729,353	$774,346

Investments

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

The book value of the Company's investment portfolio decreased $437.3 million to $2.250 billion at year-end 2013. As part of the ongoing asset liability management process, the Company had been evaluating the opportunity to restructure certain portions of the balance sheet. During the first quarter of 2013, the Company initiated a balance sheet restructuring program through the sale of certain longer duration investment securities and retired a portion of the Company's existing FHLB borrowings. During the first half of 2013, the Company sold $648.7 million of U.S. Treasury and Agency securities, realizing $63.8 million of gains that supported the retirement of $501.6 million of FHLB borrowings. These actions enhanced the Company's regulatory capital position and reduced the expected duration of the investment portfolio, while positively impacting expected future net interest income generation. During the second and third quarters of 2013, the Company purchased $525 million of U.S. Treasury securities in anticipation of the excess funding expected from the pending branch acquisition and certain other expected cash flows.

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

During 2012, the Company purchased approximately $675 million of U.S. Treasury securities and $224 million of obligations of state and political subdivisions and other securities utilizing cash flows from deposit growth, maturing loans and investments and short-term borrowings that were replaced with liquidity provided by the branch acquisitions in the third quarter. In April 2011, investments increased $297 million from the Wilber acquisition, primarily in government agency mortgage-backed securities, government agency collateralized mortgage obligations ("CMOs") and U.S. Treasury and Agency securities.

Average investment balances including cash equivalents (book value basis) for 2013 decreased $231.6 million or 8.4% versus the prior year driven by the balance sheet restructure in the first half of the year, partially offset by the third quarter pre-investment strategy of expected liquidity from the B of A branch acquisition, completed in December 2013. Investment interest income (FTE basis) in 2013 was $14.4 million or 14% lower than the prior year as a result of the lower average balances in the portfolio and because of a 22-basis point decrease in the average investment yield from 3.80% to 3.58%. During 2013, market interest rates continued to be low, and as a result, cash flows from sales and maturing investments were reinvested at lower interest rates. The investments sold during the year had a weighted average yield of 2.87% and were partially replaced with investments carrying an average yield of 2.66%.

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

The net pre-tax market value loss as compared to the book value for the available-for-sale portfolio as of December 31, 2013 was $31.0 million, as compared to a pre-tax market value gain of $131.5 million one year earlier. This decrease is indicative of the interest rate movements and changing spreads during the respective time periods and the changes in the size and composition of the portfolio.

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

Table 18: Investment Securities

	2013		2012		2011	
(000's omitted)	Amortized Cost/Book Value	Fair Value	Amortized Cost/Book Value	Fair Value	Amortized Cost/Book Value	Fair Value
Held-to-Maturity Portfolio:						
U.S. Treasury and agency securities	$0	$0	$548,634	$607,715	$448,260	$505,060
Obligations of state and political subdivisions	0	0	65,742	71,592	69,623	74,711
Government agency mortgage-backed securities	0	0	20,578	21,657	35,576	38,028
Corporate debt securities	0	0	2,924	2,977	0	0
Other securities	0	0	16	16	36	36
Total held-to-maturity portfolio	0	0	637,894	703,957	553,495	617,835
Available-for-Sale Portfolio:						
U.S. Treasury and agency securities	1,252,332	1,212,147	988,217	1,079,257	463,922	520,548
	665,441	668,982	629,883	662,892	543,527	573,012

Obligations of state and political subdivisions						
Government agency mortgage-backed securities	250,431	254,978	253,013	269,951	310,541	331,379
Pooled trust preferred securities	0	0	61,979	49,600	68,115	43,846
Corporate debt securities	26,932	27,587	24,136	25,357	21,495	22,855
Government agency collateralized mortgage obligations	21,779	22,048	32,359	33,935	45,481	46,943
Marketable equity securities	250	421	351	402	380	390
Total available-for-sale portfolio	2,217,165	2,186,163	1,989,938	2,121,394	1,453,461	1,538,973
Other Securities:						
Federal Reserve Bank common stock	16,050	16,050	16,050	16,050	15,451	15,451
FHLB common stock	12,053	12,053	38,111	38,111	38,343	38,343
Other equity securities	4,459	4,459	5,078	5,078	5,108	5,108
Total other securities	32,562	32,562	59,239	59,239	58,902	58,902
Total	$2,249,727	$2,218,725	$2,687,071	$2,884,590	$2,065,858	$2,215,710

The following table sets forth as of December 31, 2013, the maturities of investment securities and the weighted-average yields of such securities, which have been calculated on the cost basis, weighted for scheduled maturity of each security:

Table 19: Maturities of Investment Securities

(000's omitted, except rates)	Maturing Within One Year or Less	Maturing After One Year But Within Five Years	Maturing After Five Years But Within Ten Years	Maturing After Ten Years	Total Amortized Cost/Book Value
Available-for-Sale Portfolio:					
U.S. Treasury and agency securities	$7,489	$22,325	$1,222,518	$0	$1,252,332
Obligations of state and political subdivisions	33,313	131,457	227,066	273,605	665,441
Government agency mortgage-backed securities (2)	0	1,520	1,873	247,038	250,431
Corporate debt securities	0	24,043	2,889	0	26,932
Government agency collateralized mortgage obligations (2)	0	0	52	21,727	21,779
Available-for-sale portfolio	$40,802	$179,345	$1,454,398	$542,370	$2,216,915
Weighted-average yield (1)	3.42%	3.01%	2.52%	3.73%	2.87%

(1) Weighted-average yields are an arithmetic computation of income (not fully tax-equivalent adjusted) divided by book balance;
they may differ from the yield to maturity, which considers the time value of money.
(2) Mortgage-backed securities and collateralized mortgage obligations are listed based on the contractual maturity. Actual
maturities will differ from contractual maturities because borrowers may have the right to call or prepay certain obligations with
or without penalties.

Impact of Inflation and Changing Prices

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

New Accounting Pronouncements

See “New Accounting Pronouncements” Section of Note A of the notes to the consolidated financial statements on page 61 for additional accounting pronouncements.

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. Actual results may differ materially from the results discussed in the forward-looking statements. Moreover, the Company’s plans, objectives and intentions are subject to change based on various factors (some of which are beyond the Company’s control). Factors that could cause actual results to differ from those discussed in the forward-looking statements include: (1) risks related to credit quality, interest rate sensitivity and liquidity; (2) the strength of the U.S. economy in general and the strength of the local economies where the Company conducts its business; (3) the effect of, and changes in, monetary and fiscal policies and laws, including interest rate policies of the Board of Governors of the Federal Reserve System; (4) inflation, interest rate, market and monetary fluctuations; (5) the timely development of new products and services and customer perception of the overall value thereof (including features, pricing and quality) compared to competing products and services; (6) changes in consumer spending, borrowing and savings habits; (7) technological changes; (8) any acquisitions or mergers that might be considered or consummated by the Company and the costs and factors associated therewith; (9) the ability to maintain and increase market share and control expenses; (10) the effect of changes in laws and regulations (including laws and regulations concerning taxes, banking, securities and insurance) and accounting principles generally accepted in the United States; (11) changes in the Company’s organization, compensation and benefit plans and in the availability of, and compensation levels for, employees in its geographic markets; (12) the costs and effects of litigation and of any adverse outcome in such litigation; (13) other risk factors outlined in the Company’s filings with the Securities and Exchange Commission from time to time; (14) changes imposed by regulatory agencies to increase the Company’s capital requirements; and (15) the success of the Company at managing the risks of the foregoing.

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

Item 7A. Quantitative and Qualitative Disclosures about Market Risk

Market risk is the risk of loss in a financial instrument arising from adverse changes in market rates, prices or credit risk. Credit risk associated with the Company's loan portfolio has been previously discussed in the asset quality section of the MD&A. Management believes that the tax risk of the Company's municipal investments associated with potential future changes in statutory, judicial and regulatory actions is minimal. Treasury, agency, mortgage-backed and CMO securities issued by government agencies comprise 69% 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 31% of the total portfolio, of which, 98% carry a minimum rating of A. The remaining 2% of the portfolio is comprised of other investment grade securities. The Company does not have material foreign currency exchange rate risk exposure. Therefore, almost all the market risk in the investment portfolio is related to interest rates.

The ongoing monitoring and management of both interest rate risk and liquidity, in the short and long term time horizons is an important component of the Company's asset/liability management process, which is governed by limits established in the policies reviewed and approved annually by the Company’s Board of Directors. The Board of Directors delegates responsibility for carrying out the policies to the ALCO Committee, which typically 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 December 31, 2013 as a starting point.

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

- The prime rate and federal funds rates are assumed to move up 200 basis points over a 12-month period while moving the long end of the treasury curve to spreads over federal funds that are more consistent with historical norms (normalized yield curve). In the 0 basis point model, the prime and federal funds rates remain at current levels while moving the long end of the curve to levels over federal funds using spreads at a time when the yield curve was flat. Deposit rates are assumed to move in a manner that reflects the historical relationship between deposit rate movement and changes in the federal funds rate.

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

Net Interest Income Sensitivity Model

Change in interest rates	Calculated annualized increase (decrease) in

	projected net interest income at December 31, 2013
+200 basis points	($4,478,000)
0 basis points	($899,000)

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

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

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

Item 8. Financial Statements and Supplementary Data

The following consolidated financial statements and independent registered public accounting firm's report of Community Bank System, Inc. are contained on pages 51 through 92 of this item.

- Consolidated Statements of Condition,
December 31, 2013 and 2012

- Consolidated Statements of Income,
Years ended December 31, 2013, 2012, and 2011

- Consolidated Statements of Comprehensive Income,
Years ended December 31, 2013, 2012, and 2011

- Consolidated Statements of Changes in Shareholders' Equity,
Years ended December 31, 2013, 2012, and 2011

- Consolidated Statements of Cash Flows,
Years ended December 31, 2013, 2012, and 2011

- Notes to Consolidated Financial Statements,
December 31, 2013

- Management's Report on Internal Control Over Financial Reporting

- Report of Independent Registered Public Accounting Firm

Quarterly Selected Data (Unaudited) for 2013 and 2012 are contained on page 95.

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

	December 31, 2013	2012
Assets:		
Cash and cash equivalents	$149,647	$228,558
Available-for-sale investment securities (cost of $2,217,165 and $1,989,938, respectively)	2,186,163	2,121,394
Held-to-maturity investment securities (fair value of $0 and $703,957, respectively)	0	637,894
Other securities, at cost	32,562	59,239
Loans held for sale, at fair value	728	0
Loans	4,109,083	3,865,576
Allowance for loan losses	(44,319)	(42,888)
Net loans	4,064,764	3,822,688
Goodwill	374,991	369,703
Core deposit intangibles, net	13,460	14,492
Other intangibles, net	2,048	2,939
Intangible assets, net	390,499	387,134
Premises and equipment, net	93,636	89,938
Accrued interest and fees receivable	25,475	32,305
Other assets	152,390	117,650
Total assets	$7,095,864	$7,496,800
Liabilities:		
Noninterest-bearing deposits	$1,203,346	$1,110,994
Interest-bearing deposits	4,692,698	4,517,045
Total deposits	5,896,044	5,628,039
Borrowings	141,913	728,061
Subordinated debt held by unconsolidated subsidiary trusts	102,097	102,073
Accrued interest and other liabilities	79,998	135,849
Total liabilities	6,220,052	6,594,022
Commitments and contingencies (See Note N)		

Shareholders' equity:		
Preferred stock $1.00 par value, 500,000 shares authorized, 0 shares issued	0	0
Common stock, $1.00 par value, 75,000,000 shares authorized; 41,213,491 and		
40,421,493 shares issued, respectively	41,213	40,421
Additional paid-in capital	396,528	378,413
Retained earnings	481,732	447,018
Accumulated other comprehensive (loss) income	(26,546)	54,334
Treasury stock, at cost (782,173 and 795,560 shares, respectively)	(17,115)	(17,408)
Total shareholders' equity	875,812	902,778
Total liabilities and shareholders' equity	$7,095,864	$7,496,800

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

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

	Years Ended December 31, 2013	2012	2011
Interest income:			
Interest and fees on loans	$188,197	$192,710	$192,981
Interest and dividends on taxable investments	54,995	65,165	55,634
Interest and dividends on nontaxable investments	20,967	23,525	22,354
Total interest income	264,159	281,400	270,969
Interest expense:			
Interest on deposits	10,732	18,162	26,156
Interest on borrowings	12,813	30,098	29,599
Interest on subordinated debt held by unconsolidated subsidiary trusts	2,520	2,716	5,801
Total interest expense	26,065	50,976	61,556
Net interest income	238,094	230,424	209,413
Provision for loan losses	7,992	9,108	4,736
Net interest income after provision for loan losses	230,102	221,316	204,677
Noninterest income:			
Deposit service fees	49,357	46,064	42,334
Other banking services	5,245	4,069	4,651
Employee benefit services	38,596	35,946	31,601
Wealth management services	15,550	12,876	10,697
Gain on sales of investment securities, net	80,768	291	30
Loss on debt extinguishments	(87,336)	0	(91)
Total noninterest income	102,180	99,246	89,222
Noninterest expenses:			
Salaries and employee benefits	121,629	112,034	102,278
Occupancy and equipment	27,045	25,799	24,502
Data processing and communications	27,186	23,696	20,525
Amortization of intangible assets	4,469	4,607	4,381
Legal and professional fees	7,008	7,950	5,889
Office supplies and postage	6,122	5,742	5,246
Business development and marketing	6,815	5,919	5,931
FDIC insurance premiums	3,829	3,804	3,920
Acquisition expenses	2,181	5,747	4,831
Other	14,971	16,459	12,869

Total noninterest expenses	221,255	211,757	190,372
Income before income taxes	111,027	108,805	103,527
Income taxes	32,198	31,737	30,385
Net income	$78,829	$77,068	$73,142
Basic earnings per share	$1.96	$1.95	$2.03
Diluted earnings per share	$1.94	$1.93	$2.01

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

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

	Years Ended December 31,		
	2013	2012	2011
Pension and other post retirement obligations:			
Amortization of actuarial gains/(losses) included in net periodic pension cost, gross	$35,395	($3,786)	($16,006)
Tax effect	(13,841)	1,469	6,167
Amortization of actuarial gains/(losses) included in net periodic pension cost, net	21,554	(2,317)	(9,839)
Amortization of prior service cost included in net periodic pension cost, gross	(1,502)	(970)	(1,207)
Tax effect	588	376	465
Amortization of prior service cost included in net periodic pension cost, net	(914)	(594)	(742)
Other comprehensive income/(loss) related to pension and other post retirement obligations, net of taxes	20,640	(2,911)	(10,581)
Derivative instruments used in cash flow hedging relationships:			
Unrealized losses on derivative instruments used in cash flow hedging relationships, gross	$0	$0	3,232
Tax effect	0	0	(1,252)
Unrealized losses on derivative instruments, net	0	0	1,980
Unrealized gains on securities:			
Net unrealized holding (losses)/gains arising during period, gross	(79,899)	46,236	75,609
Tax effect	30,385	(17,978)	(28,485)
Net unrealized holding (losses)/gains arising during period, net	(49,514)	28,258	47,124
Reclassification adjustment for net gains included in net income, gross	(80,768)	(291)	(30)
Tax effect	29,756	113	12
Reclassification adjustment for net loss included in net income, net	(51,012)	(178)	(18)
Unrealized holding loss, net related to securities transferred from held-to-maturity to available-for-sale, gross	(1,791)	0	0
Tax effect	797	0	0
	(994)	0	0

Reclassification adjustment for net loss transferred from held-to-maturity to available-for-sale, gross			
Other comprehensive (loss)/income related to unrealized (loss)/gain on available-for-sale securities, net of taxes	(101,520)	28,080	47,106
Other comprehensive (loss)/income, net of tax	(80,880)	25,169	38,505
Net income	78,829	77,068	73,142
Comprehensive (loss)/income	($2,051)	$102,237	$111,647
	As of December 31,		
	2013	2012	2011
Accumulated Other Comprehensive Income By Component:			
Unrealized loss for pension and other postretirement obligations	($11,339)	($45,232)	($40,477)
Tax effect	4,194	17,447	15,603
Net unrealized loss for pension and other postretirement obligations	(7,145)	(27,785)	(24,874)
Unrealized (loss)/gain on available-for-sale securities	(31,002)	131,456	85,512
Tax effect	11,601	(49,337)	(31,473)
Net unrealized (loss)/gain on available-for-sale securities	(19,401)	82,119	54,039
Accumulated other comprehensive (loss)/income	($26,546)	$54,334	$29,165

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

COMMUNITY BANK SYSTEM, INC.
CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY
Years ended December 31, 2011, 2012 and 2013
(In Thousands, Except Share Data)

	Common Stock Shares Outstanding	Common Stock Amount Issued	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive (Loss)/Income	Treasury Stock	Total
Balance at December 31, 2010	33,318,943	$34,131	$225,543	$374,700	($9,340)	($17,776)	$607,258
Net income				73,142			73,142
Other comprehensive income, net of tax					38,505		38,505
Dividends declared:							
Common, $1.00 per share				(36,037)			(36,037)
Common stock issued under employee stock plan, including tax benefits of $703	314,665	311	4,947			93	5,351
Stock-based compensation			3,784				3,784
Stock issued for acquisition	3,352,801	3,353	79,227				82,580
Balance at December 31, 2011	36,986,409	37,795	313,501	411,805	29,165	(17,683)	774,583
Net income				77,068			77,068
Other comprehensive income, net of tax					25,169		25,169
Dividends declared:							
Common, $1.06 per share				(41,855)			(41,855)
Common stock issued under							

employee stock plan,							
including tax benefits of $1,524	509,724	496	8,457			275	9,228
Stock-based compensation			3,668				3,668
Common stock issuance	2,129,800	2,130	52,787				54,917
Balance at December 31, 2012	39,625,933	40,421	378,413	447,018	54,334	(17,408)	902,778
Net income				78,829			78,829
Other comprehensive income							
(loss), net of tax					(80,880)		(80,880)
Dividends declared:							
Common, $1.10 per share				(44,115)			(44,115)
Common stock issued under							
employee stock plan,							
including tax benefits of $1,825	805,385	792	14,154			293	15,239
Stock-based compensation			3,961				3,961
Balance at December 31, 2013	40,431,318	$41,213	$396,528	$481,732	($26,546)	($17,115)	$875,812

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

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

	Years Ended December 31,		
	2013	2012	2011
Operating activities:			
Net income	$78,829	$77,068	$73,142
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation	12,236	11,482	11,374
Amortization of intangible assets	4,469	4,607	4,381
Net accretion of premiums & discounts on securities, loans and borrowings	(5,959)	(9,379)	(5,373)
Stock-based compensation	3,961	3,668	3,784
Provision for loan losses	7,992	9,108	4,736
Provision for deferred income taxes	7,130	12,032	12,942
Amortization of mortgage servicing rights	529	687	868
Income from bank-owned life insurance policies	(1,066)	(1,121)	(894)
Gain on sales of investment securities, net	(80,768)	(291)	(30)
Loss on debt extinguishments	87,336	0	91
Net loss (gain) on sale of loans and other assets	257	247	(422)
Net change in loans originated for sale	(515)	608	4,047
Change in other assets and liabilities	(11,247)	(292)	(14,268)
Net cash provided by operating activities	103,184	108,424	94,378
Investing activities:			
Proceeds from sales of available-for-sale investment securities	713,694	5,378	15,330
Proceeds from sales of held-to-maturity investment securities	450,032	0	0
Proceeds from sales of other securities	26,649	278	1,032
Proceeds from maturities of held-to-maturity investment securities	31,595	28,340	65,062
Proceeds from maturities of available-for-sale investment securities	234,021	215,223	254,368
Purchases of held-to-maturity investment securities	(8,308)	(110,925)	(13,292)
Purchases of available-for-sale investment securities	(923,588)	(752,891)	(353,498)
Purchases of other securities	0	(615)	(2,908)
Net change in loans	(248,962)	(239,174)	16,078
Cash received for acquisitions, net of cash acquired of $291,990, $5,510, and $26,901, respectively	291,980	600,972	4,746
Purchases of premises and equipment	(13,855)	(10,846)	(9,613)
Net cash provided by/(used in) investing activities	553,258	(264,260)	(22,695)
Financing activities:			
Net change in deposits	(35,451)	34,832	89,646
Net change in borrowings, net of payments of $815,384, $220 and $25,938	(673,484)	(220)	(19,938)
Issuance of common stock	15,239	64,145	5,351

Cash dividends paid	(43,482)	(40,765)	(34,404)
Tax benefits from share-based payment arrangements	1,825	1,524	703
Net cash (used in)/provided by financing activities	(735,353)	59,516	41,358
Change in cash and cash equivalents	(78,911)	(96,320)	113,041
Cash and cash equivalents at beginning of year	228,558	324,878	211,837
Cash and cash equivalents at end of year	$149,647	$228,558	$324,878
Supplemental disclosures of cash flow information:			
Cash paid for interest	$30,141	$51,541	$61,564
Cash paid for income taxes	23,648	16,462	20,810
Supplemental disclosures of noncash financing and investing activities:			
Dividends declared and unpaid	11,332	10,699	9,609
Transfers from loans to other real estate	8,325	5,059	5,186
Transfer of investment securities from held-to-maturity to available-for-sale	198,890	0	0
Acquisitions:			
Fair value of assets acquired, excluding acquired cash and intangibles	3,678	165,885	815,824
Fair value of liabilities assumed	303,494	798,031	791,222

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

COMMUNITY BANK SYSTEM, INC.

NOTE A: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Nature of Operations
Community Bank System, Inc. (the "Company") is a single bank holding company which wholly-owns five consolidated subsidiaries: Community Bank, N.A. (the "Bank"), Benefit Plans Administrative Services, Inc. ("BPAS"), CFSI Closeout Corp. ("CFSICC"), First of Jermyn Realty Co. ("FJRC"), and Town & Country Agency LLC ("T&C"). BPAS owns four subsidiaries, Benefit Plans Administrative Services, LLC ("BPA"), Harbridge Consulting Group, LLC ("Harbrdge"), BPAS Trust Company of Puerto Rico; and Hand Benefits & Trust, Inc. ("HB&T"), which, as of December 31, 2013 owned two subsidiaries Hand Securities Inc. ("HSI"), and Flex Corporation ("Flex"), which was merged with BPA on January 1, 2014. BPAS provides administration, consulting and actuarial services to sponsors of employee benefit plans. CFSICC, FJRC and T&C are inactive companies. The Company also wholly-owns two unconsolidated subsidiary business trusts formed for the purpose of issuing mandatorily-redeemable preferred securities which are considered Tier I capital under regulatory capital adequacy guidelines (see Note P).

As of December 31, 2013, the Bank operated 183 full service branches under the Community Bank, N.A. name throughout 35 counties of Upstate New York and six counties of Northeastern Pennsylvania offering a range of commercial and retail banking services. The Bank owns the following subsidiaries: CBNA Insurance Agency, Inc. ("CBNA Insurance"), CBNA Preferred Funding Corporation ("PFC"), CBNA Treasury Management Corporation ("TMC"), Community Investment Services, Inc. ("CISI"), First Liberty Service Corp. ("FLSC"), Nottingham Advisors, Inc. ("Nottingham"), Brilie Corporation ("Brilie"), and Western Catskill Realty, LLC ("WCR"). CBNA Insurance is a full-service insurance agency offering primarily property and casualty products. PFC primarily acts as an investor in residential real estate loans. TMC provides cash management, investment, and treasury services to the Bank. CISI provides broker-dealer and investment advisory services. FLSC provides banking-related services to the Pennsylvania branches of the Bank. Nottingham provides asset management services to individuals, corporate pension and profit sharing plans, and foundations. Brilie and WCR are inactive companies.

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

Variable Interest Entities ("VIE") are required to be consolidated by a company if it is determined the company is the primary beneficiary of a VIE. The primary beneficiary of a VIE is the enterprise that has: (1) the power to direct the activities of the VIE that most significantly impact the VIE's economic performance, and (2) the obligation to absorb losses of the VIE that could potentially be significant to the VIE or the right to receive benefits of the VIE that could potentially be significant to the VIE. The Company's wholly-owned subsidiaries, Community Statutory Trust III and Community Capital Trust IV, are VIEs for which the Company is not the primary beneficiary. Accordingly, the accounts of these entities are not included in the Company's consolidated financial statements.

Critical Accounting Estimates in the Preparation of Financial Statements
The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Critical accounting estimates include the allowance for loan losses, actuarial assumptions associated with the pension, post-retirement and other employee benefit plans, the provision for income taxes, investment valuation and other-than-temporary impairment, the carrying value of goodwill and other intangible assets, and acquired loan

valuations.

Risk and Uncertainties

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

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

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Revenue Recognition
The Company recognizes income on an accrual basis. CISI recognizes fee income when investment and insurance products are sold to customers. Nottingham provides asset management services to brokerage firms and clients and recognizes income ratably over the contract period during which service is performed. Revenue from BPA's administration and recordkeeping services is recognized ratably over the service contract period. Revenue from consulting and actuarial services is recognized when services are rendered. CBNA Insurance recognizes commission revenue at the later of the effective date of the insurance policy, or the date on which the policy premium is billed to the customer. At that date, the earnings process has been completed and the impact of refunds for policy cancellations can be reasonably estimated to establish reserves. The reserve for policy cancellations is based upon historical cancellation experience adjusted for known circumstances. All intercompany revenue and expense among related entities are eliminated in consolidation.

Cash and Cash Equivalents
For purposes of reporting cash flows, cash and cash equivalents include cash on hand, amounts due from banks and highly liquid investments with original maturities of less than 90 days. The carrying amounts reported in the balance sheet for cash and cash equivalents approximate those assets' fair values.

Investment Securities
The Company has classified its investments in debt and equity securities as held-to-maturity or available-for-sale. Held-to-maturity securities are those for which the Company has the positive intent and ability to hold until maturity, and are reported at cost, which is adjusted for amortization of premiums and accretion of discounts. As discussed further in Note D, the Company reclassified its held-to-maturity portfolio to available-for-sale and the Company will not be able to use the held-to-maturity classification for the foreseeable future. Securities classified as available-for-sale and are reported at fair value with net unrealized gains and losses reflected as a separate component of shareholders' equity, net of applicable income taxes. None of the Company's investment securities have been classified as trading securities at December 31, 2013. 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"). During 2013 the Company sold certain held-to-maturity securities. As a result of the transaction, the Company will not be able to use the held-to-maturity classification for the foreseeable future.

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.

Derivative Financial Instruments
The Company has utilized interest rate swap agreements, considered to be cash flow hedges, as part of the management of interest rate risk to modify the repricing characteristics of certain portions of its portfolios of interest-bearing liabilities. These derivative instruments, when used, are required to be carried at fair value on the balance sheet.

Cash flow hedges are accounted for by recording the fair value of the derivative instrument on the balance sheet as either a freestanding asset or liability, with a corresponding offset recorded in other comprehensive income within shareholders' equity, net of income tax effect. Amounts are reclassified from other comprehensive income to the income statement in the period or periods the hedged transaction affects earnings. Derivative gains and losses not effective in hedging the expected cash flows of the hedged item are recognized immediately in the income statement. At the hedge's inception and at least quarterly thereafter, a formal assessment is performed to determine the effectiveness of the cash flow hedge. If it is determined that a derivative instrument has not been or will not continue to be highly effective as a hedge, hedge accounting is discontinued.

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

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

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

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

method.

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

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

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

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

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

During 2012, new regulatory guidance was issued by the OCC addressing the accounting of certain loans that have been discharged in Chapter 7 bankruptcy. In accordance with this new guidance, loans that have been discharged in Chapter 7 bankruptcy but not reaffirmed by the borrower are classified as TDRs, irrespective of payment history or delinquency status, even if the repayment terms for the loan have not been otherwise modified. The Company's lien position against the underlying collateral remains unchanged. Pursuant to that guidance, the Company records a charge-off equal to any portion of the carrying value that exceeds the net realizable value of the collateral.

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

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

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

specific loan loss allocations.

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

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

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.

Premises and Equipment

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

Other Real Estate

Other real estate owned is comprised of properties acquired through foreclosure, or by deed in lieu of foreclosure. These assets are carried at fair value less estimated costs of disposal. At foreclosure, if the fair value, less estimated costs to sell, of the real estate acquired is less than the Company's recorded investment in the related loan, a write-down is recognized through a charge to the allowance for loan losses. Any subsequent reduction in value is recognized by a charge to income. Operating costs associated with the properties are charged to expense as incurred. At December 31, 2013 and 2012, other real estate amounted to $5.1 million and $4.8 million, respectively, and is included in other assets.

Mortgage Servicing Rights

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

Treasury Stock

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

Income Taxes

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

Benefits from tax positions should be recognized in the financial statements only when it is more likely than not that the tax position will be sustained upon examination by the appropriate taxing authority having full knowledge of all relevant information. A tax position meeting the more-likely-than-not recognition threshold should be measured at the largest amount of benefit for which the likelihood of realization upon ultimate settlement exceeds 50 percent.

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.

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

Advertising
Advertising costs amounting to approximately $3.0 million, $2.6 million and $2.5 million for the years ending December 31, 2013, 2012 and 2011, respectively, are nondirect response in nature and expensed as incurred.

Earnings Per Share
Using the two-class method, basic earnings per common share is computed based upon net income available to common shareholders divided by the weighted average number of common shares outstanding during each period, which excludes the outstanding unvested restricted stock as they contain nonforfeitable rights to dividends. Diluted earnings per share is computed using the weighted average number of common shares determined for the basic earnings per common share computation plus the dilutive effect of stock options using the treasury stock method. Stock options where the exercise price is greater than the average market price of common shares were not included in the computation of earnings per diluted share as they would have been anti-dilutive.

Stock-based Compensation
Companies are required to measure and record compensation expense for stock options and other share-based payments on the instruments' fair value on the date of grant. The Company uses the modified prospective method. Under this method, expense is recognized for awards that are granted, modified, or settled after December 31, 2005, as well as for unvested awards that were granted prior to January 1, 2006. Stock-based compensation expense is recognized ratably over the requisite service period for all awards (see Note L).

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

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

New Accounting Pronouncements
In January 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2014-04, Receivables – Troubled Debt Restructurings by Creditors (Subtopic 310-40): Reclassification of Residential

Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure. This new guidance clarifies when an in substance repossession or foreclosure occurs, and requires all creditors who obtain physical possession (resulting from an in substance repossession or foreclosure) of residential real estate property collateralizing a consumer mortgage loan in satisfaction of a receivable to reclassify the collateralized mortgage loan such that the loan should be derecognized and the collateral asset recognized. This guidance is effective prospectively for the Company for annual and interim periods beginning after December 15, 2014. The adoption of this guidance is not expected to have a material impact on the Company’s consolidated financial statements.

NOTE B: ACQUISITIONS

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

On September 7, 2012, the Bank completed its acquisition of three branches in Western New York from First Niagara Bank, N.A. (“First Niagara”), acquiring approximately $54 million of loans and $101 million of deposits. The assumed deposits consist primarily of core deposits (checking, savings and money market accounts) and the purchased loans consist of in-market performing loans, primarily residential real estate loans. Under the terms of the purchase agreement, the Bank paid a blended deposit premium of 3.1%, or approximately $3 million. The effects of the acquired assets and liabilities have been included in the consolidated financial statements since that date.

On July 20, 2012, the Bank completed its acquisition of 16 retail branches in Central, Northern and Western New York from HSBC Bank USA, N.A. (“HSBC”), acquiring approximately $106 million in loans and $697 million of deposits. The assumed deposits consist primarily of core deposits (checking, savings and money markets accounts) and the purchased loans consist of in-market performing loans, primarily residential real estate loans. Under the terms of the purchase agreement, the Bank paid First Niagara (who acquired HSBC’s Upstate New York banking business and assigned its right to purchase the 16 branches to the Bank) a blended deposit premium of 3.4%, or approximately $24 million. The effects of the acquired assets and liabilities have been included in the consolidated financial statements since that date.

On November 30, 2011, the Company, through its BPAS subsidiary, acquired certain assets and liabilities of CAI Benefits, Inc. (“CAI”), a provider of actuarial, consulting and retirement plan administration services, with offices in New York City and Northern New Jersey. The Company acquired $1.4 million of assets and $0.2 million of liabilities. The results of CAI’s operations have been included in the consolidated financial statements since that date. The transaction adds valuable service capacity and enhances distribution prospects in support of the Company’s broader-based employee benefits business, including daily valuation plan and collective investment fund administration.

On April 8, 2011, the Company acquired The Wilber Corporation (“Wilber”), parent company of Wilber National Bank, for approximately $103 million in stock and cash, comprised of $20.4 million in cash and the issuance of 3.35 million additional shares of the Company’s common stock. Based in Oneonta, New York, Wilber operated 22 branches in the Central, Greater Capital District, and Catskill regions of Upstate New York. Wilber was merged into the Company and Wilber National Bank was merged into the Bank. The Company acquired $462.3 million of loans, $297.6 million of investments, $771.6 million of deposits, and $19.7 million of borrowings. The results of Wilber’s operations have been included in the Company’s financial statements since that date.

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

(000s omitted)	2013	2012	2011
Consideration paid (received):			
Community Bank System, Inc. common stock	$0	$0	$82,580
Cash	(291,980)	(595,462)	22,155
Total net consideration paid (received)	(291,980)	(595,462)	104,735
Recognized amounts of			

identifiable assets acquired and liabilities assumed:			
Cash and cash equivalents	0	5,510	26,901
Investment securities	0	0	297,573
Loans	1,106	160,116	462,334
Premises and equipment	2,549	4,941	6,360
Accrued interest receivable	5	588	2,615
Other assets/(liabilities), net	(18)	171	46,942
Core deposit intangibles	2,537	6,521	4,016
Other intangibles	9	0	1,858
Deposits	(303,456)	(797,962)	(771,554)
Borrowings	0	0	(19,668)
Total identifiable assets (liabilities), net	(297,268)	(620,115)	57,377
Goodwill	$5,288	$24,653	$ 47,358

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

The following is a summary of the loans acquired in the Wilber acquisition at the date of acquisition:

(000's omitted)	Acquired Impaired Loans	Acquired Non-Impaired Loans	Total Acquired Loans
Contractually required principal and interest at acquisition	$41,730	$680,516	$722,246
Contractual cash flows not expected to be collected	(20,061)	(31,115)	(51,176)
Expected cash flows at acquisition	21,669	649,401	671,070
Interest component of expected cash flows	(2,509)	(206,227)	(208,736)
Fair value of acquired loans	$19,160	$443,174	$462,334

The following is a summary of the loans acquired from HSBC and First Niagara at the date of acquisition:

(000's omitted)	Acquired Impaired Loans	Acquired Non-Impaired Loans	Total Acquired Loans
Contractually required principal and interest at acquisition	$0	$201,745	$201,745
Contractual cash flows not expected to be collected	0	(3,555)	(3,555)
Expected cash flows at acquisition	0	198,190	198,190
Interest component of expected cash flows	0	(38,074)	(38,074)
Fair value of acquired loans	$0	$160,116	$160,116

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

The core deposit intangibles and other intangibles related to the B of A, HSBC, Wilber, and CAI acquisitions are being amortized using an accelerated method over their estimated useful life of approximately eight to ten years. The goodwill, which is not amortized for book purposes, was assigned to the Banking segment for the B of A, First Niagara, HSBC and Wilber acquisitions and to the Employee Benefit Services segment for the CAI acquisition. The goodwill arising from the Wilber acquisition is not deductible for tax purposes while the goodwill arising from the CAI, B of A branch, HSBC branch and First Niagara branch acquisitions is deductible for tax purposes.

Direct costs related to the acquisitions were expensed as incurred. Merger and acquisition integration-related expenses amount to $2.2 million, $5.7 million and $4.8 million during 2013, 2012 and 2011, respectively, and have been separately stated in the Consolidated Statements of Income.

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

During the fourth quarter, the Company announced that its subsidiary, Harbridge, reached an agreement to acquire a professional services practice from EBS-RMSCO, Inc., a subsidiary of The Lifetime Healthcare Companies. This professional services practice, which provides actuarial valuation and consulting services to clients who sponsor pension and post-retirement medical and welfare plans, enhances the Company's participation in the Western New York. The transaction was completed as planned on January 1, 2014.

NOTE C: INVESTMENT SECURITIES

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

	2013				2012			
(000's omitted)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Held-to-Maturity Portfolio:								
U.S. Treasury and agency securities	$0	$0	$0	$0	$548,634	$59,081	$0	$607,715
Obligations of state and political subdivisions	0	0	0	0	65,742	5,850	0	71,592
Government agency mortgage-backed securities	0	0	0	0	20,578	1,079	0	21,657
Corporate debt securities	0	0	0	0	2,924	53	0	2,977
Other securities	0	0	0	0	16	0	0	16
Total held-to-maturity portfolio	$0	$0	$0	$0	$637,894	$66,063	$0	$703,957
Available-for-Sale Portfolio:								
U.S. Treasury and agency securities	$1,252,332	$1,119	$41,304	$1,212,147	$988,217	$91,040	$0	$1,079,257
Obligations of state and political subdivisions	665,441	15,919	12,378	668,982	629,883	33,070	61	662,892
Government agency mortgage-backed securities	250,431	8,660	4,113	254,978	253,013	16,989	51	269,951
Pooled trust preferred securities	0	0	0	0	61,979	0	12,379	49,600
Corporate debt securities	26,932	873	218	27,587	24,136	1,265	44	25,357
Government agency collateralized mortgage obligations	21,779	362	93	22,048	32,359	1,579	3	33,935
	250	171	0	421	351	94	43	402

Marketable equity securities								
Total available-for-sale portfolio	$2,217,165	$27,104	$58,106	$2,186,163	$1,989,938	$144,037	$12,581	$2,121,394
Other Securities:								
Federal Reserve Bank common stock	$16,050			$16,050	$16,050			$16,050
Federal Home Loan Bank common stock	12,053			12,053	38,111			38,111
Other equity securities	4,459			4,459	5,078			5,078
Total other securities	$32,562			$32,562	$59,239			$59,239

The Company undertook a balance sheet restructuring program during the first half of 2013 through the sale of certain longer duration investment securities and retirement of the Company's existing FHLB term borrowings. During the first half of 2013, the Company sold $648.7 million of U.S. Treasury and agency securities classified as available-for-sale, realizing $63.8 million of gains. The proceeds from those sales were utilized to retire FHLB term borrowings.

In December 2013, in response to the issuance of the "Volcker Rule", the Company sold its entire portfolio of pooled trust preferred securities, realizing a loss of $15.5 million, as well as U.S. Treasury securities with a book value of $417.6 million that were previously classified as held-to-maturity, realizing $32.4 million of gains. The proceeds from these sales were utilized to retire the remaining FHLB term borrowings. As a result of the securities sold from the held-to-maturity classification, the remaining unsold securities within the held-to-maturity classification, with a book value of $198.9 million, were transferred to the available-for-sale classification prior to December 31, 2013. An unrealized loss of $1.8 million was recorded in accumulated other comprehensive income. In addition, as a result of the sale of securities classified as held-to-maturity, the Company will not be able to use the held-to-maturity classification for the foreseeable future.

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

As of December 31, 2013

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

As of December 31, 2012

(000's omitted)	Less than 12 Months #	Fair Value	Gross Unrealized Losses	12 Months or Longer #	Fair Value	Gross Unrealized Losses	Total #	Fair Value	Gross Unrealized Losses
Available-for-Sale Portfolio:									
Obligations of state and political subdivisions	19	$11,503	$61	0	$0	$0	19	$11,503	$61
Pooled trust preferred securities	0	0	0	3	49,600	12,379	3	49,600	12,379
Government agency mortgage-backed securities	8	14,354	51	0	0	0	8	14,354	51
Corporate debt securities	1	2,905	44	0	0	0	1	2,905	44
Government agency collateralized mortgage obligations	4	426	2	2	1,041	1	6	1,467	3
Marketable equity securities	0	0	0	1	158	43	1	158	43
Total available-for-sale/investment	32	$29,188	$158	6	$50,799	$12,423	38	$79,987	$12,581

portfolio

The unrealized losses reported pertaining to securities issued by the U.S. government and its' sponsored entities, include treasuries, agencies, and mortgage-backed securities issued by GNMA, FNMA and FHLMC which are currently rated AAA by Moody's Investor Services, AA+ by Standard & Poor's and are guaranteed by the U.S. government. The majority of the obligations of state and political subdivisions and corporations carry a credit rating of A or better. Additionally, a majority of the obligations of state and political subdivisions carry a secondary level of credit enhancement. The Company does not intend to sell these securities, nor is it more likely than not that the Company will be required to sell these securities prior to recovery of the amortized cost. The unrealized losses in the portfolios are primarily attributable to changes in interest rates. As such, management does not believe any individual unrealized loss as of December 31, 2013 represents OTTI.

The amortized cost and estimated fair value of debt securities at December 31, 2013, by contractual maturity, are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties. Securities not due at a single maturity date are shown separately.

	Available-for-Sale	
(000's omitted)	Amortized Cost	Fair Value
Due in one year or less	$40,802	$41,307
Due after one through five years	177,826	184,053
Due after five years through ten years	1,452,472	1,414,410
Due after ten years	273,605	268,946
Subtotal	1,944,705	1,908,716
Government agency mortgage-backed securities	250,431	254,978
Government agency collateralized mortgage obligations	21,779	22,048
Total	$2,216,915	$2,185,742

Cash flow information on investment securities for the years ended December 31 is as follows:

(000's omitted)	2013	2012	2011
Gross gains on sales of investment securities	$96,258	$350	$349
Gross losses on sales of investment securities	15,490	59	319
Proceeds from the maturities of mortgage-backed securities and CMO's	83,232	109,843	97,224
Purchases of mortgage-backed securities and CMO's	51,194	26,292	253,378

Investment securities with a carrying value of $0.978 billion and $1.176 billion at December 31, 2013 and 2012, respectively, were pledged to collateralize certain deposits and borrowings.

NOTE D: LOANS

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

- Consumer mortgages - consist primarily of fixed rate residential instruments, typically 15 – 30 years in contractual term, secured by first liens on real property.
- Business lending - is comprised of general purpose commercial and industrial loans including, but not limited to agricultural-related and dealer floor plans, as well as mortgages on commercial property.
  - Consumer indirect - consists primarily of installment loans originated through selected dealerships and are secured by automobiles, marine and other recreational vehicles.
  - Consumer direct - 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 of up to 30 years.

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

(000's omitted)	2013	2012
Consumer mortgage	$1,582,058	$1,448,415
Business lending	1,260,364	1,233,944
Consumer indirect	740,002	647,518
Consumer direct	180,139	171,474
Home equity	346,520	364,225
Gross loans, including net deferred origination costs	4,109,083	3,865,576
Allowance for loan losses	(44,319)	(42,888)
Loans, net of allowance for loan losses	$4,064,764	$3,822,688

The Company had approximately $18.5 million and $16.5 million of net deferred loan origination costs included in gross loans as of December 31, 2013 and 2012, respectively.

Certain directors and executive officers of the Company, as well as associates of such persons, are loan customers. Loans to these individuals were made in the ordinary course of business under normal credit terms and do not have more than a normal risk of collection. Following is a summary of the aggregate amount of such loans during 2013 and 2012.

(000's omitted)	2013	2012
Balance at beginning of year	$8,292	$11,550
New loans	3,643	2,259
Payments	(2,487)	(5,517)
Balance at end of year	$9,448	$8,292

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Acquired loans

Acquired loans are recorded at fair value as of the date of purchase with no allowance for loan loss. As discussed in Note B (Acquisitions), the company acquired loans of $1 million on December 13, 2013 in its Bank of America branch acquisition, $54 million on September 7, 2012 in its acquisition of First Niagara branches, $106 million on July 20, 2012 in its HSBC branch acquisition, and $462 million on April 8, 2011 in its acquisition of Wilber. The outstanding principal balance and the related carrying amount of acquired loans included in the Consolidated Statement of Condition at December 31 are as follows:

(000's omitted)	2013	2012
Credit impaired acquired loans:		
Outstanding principal balance	$13,052	$19,940
Carrying amount	7,090	13,761
Non-impaired acquired loans:		
Outstanding principal balance	342,542	449,739
Carrying amount	330,118	433,594
Total acquired loans:		
Outstanding principal balance	355,594	469,679
Carrying amount	337,208	447,355

The outstanding balance related to credit impaired acquired loans was $15.5 million and $22.4 million at December 31, 2013 and 2012, respectively. The changes in the accretable discount related to the credit impaired acquired loans are as follows:

(000's omitted)	2013	2012
Balance at beginning of year	$ 1,770	$2,610
Accretion recognized	(1,025)	(1,418)
	252	578

Net reclassification to accretable from nonaccretable		
Balance at end of year	$997	$1,770

Credit Quality

Management monitors the credit quality of its loan portfolio on an ongoing basis. Measurement of delinquency and past due status are based on the contractual terms of each loan. Past due loans are reviewed on a monthly basis to identify loans for non-accrual status. The following is an aged analysis of the Company's past due loans by class as of December 31, 2013:

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

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

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

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

(1)

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

The following is an aged analysis of the Company's past due loans by class as of December 31, 2012:

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	$16,334	$1,553	$8,866	$26,753	$1,318,534	$1,345,287
Business lending	6,012	167	12,010	18,189	984,665	1,002,854
Consumer indirect	9,743	73	0	9,816	627,541	637,357
Consumer direct	1,725	71	8	1,804	154,462	156,266
Home equity	4,124	491	1,044	5,659	270,798	276,457
Total	$37,938	$2,355	$21,928	$62,221	$3,356,000	$3,418,221

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

(000's omitted)	Past Due 30 - 89 days	90+ Days Past Due and Still Accruing	Nonaccrual	Total Past Due	Acquired Impaired(1)	Current	Total Loans
Consumer mortgage	$1,726	$265	$2,420	$4,411	$0	$98,717	$103,128
Business lending	3,665	80	1,681	5,426	13,761	211,903	231,090
Consumer indirect	434	0	0	434	0	9,727	10,161
Consumer direct	470	0	0	470	0	14,738	15,208
Home equity	959	48	331	1,338	0	86,430	87,768
Total	$7,254	$393	$4,432	$12,079	$13,761	$421,515	$447,355

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

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

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

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

	December 31, 2013			December 31, 2012		
(000's omitted)	Legacy	Acquired	Total	Legacy	Acquired	Total
Pass	$908,885	$116,271	$1,025,156	$818,469	$144,869	$963,338
Special mention	93,600	24,264	117,864	92,739	32,328	125,067
Classified	83,379	26,714	110,093	90,035	40,132	130,167
Doubtful	161	0	161	1,611	0	1,611
Acquired impaired	0	7,090	7,090	0	13,761	13,761
Total	$1,086,025	$174,339	$1,260,364	$1,002,854	$231,090	$1,233,944

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

The following tables detail the balances in all loan categories except for business lending at December 31, 2013:

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

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

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

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

The following table details the balances in all other loan categories at December 31, 2012:

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

(000's omitted)	Consumer Mortgage	Consumer Indirect	Consumer Direct	Home Equity	Total
Performing	$1,334,868	$637,284	$156,187	$274,922	$2,403,261
Nonperforming	10,419	73	79	1,535	12,106
Total	$1,345,287	$637,357	$156,266	$276,457	$2,415,367

Acquired loans (includes loans acquired after January 1, 2009

(000's omitted)	Consumer Mortgage	Consumer Indirect	Consumer Direct	Home Equity	Total
Performing	$100,443	$10,161	$15,208	$87,389	$213,201
Nonperforming	2,685	0	0	379	3,064
Total	$103,128	$10,161	$15,208	$87,768	$216,265

All loan classes are collectively evaluated for impairment except business lending, as described in Note A. A summary of impaired loans, excluding purchased impaired, as of December 31, 2013 and 2012 are summarized as follows:

(000's omitted)	2013	2012
Loans with reserve	$945	$1,611
Loans without reserve	600	7,798
Carrying balance	1,545	9,409

Contractual balance	1,852	12,804
Specifically allocated allowance	50	800
Average impaired loans	10,729	19,787
Interest income recognized	18	185

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

During 2012, clarified guidance was issued by the OCC addressing the accounting for certain loans that have been discharged in Chapter 7 bankruptcy. In accordance with this clarified guidance, loans that have been discharged in Chapter 7 bankruptcy, but not reaffirmed by the borrower, are classified as TDRs, irrespective of payment history or delinquency status, even if the repayment terms for the loan have not been otherwise modified. 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 2012 and 2013 was immaterial.

TDRs less than $0.5 million are collectively included in the general loan loss allocation and the qualitative review, if necessary. Commercial loans greater than $0.5 million are individually evaluated for impairment, and if necessary, a specific allocation of the allowance for loan losses is provided. At December 31, 2013 there were no impaired loans that were considered a TDR.

Information regarding troubled debt restructurings as of December 31, 2013 and December 31, 2012 is as follows

	December 31, 2013						December 31, 2012					
(000's omitted)	Nonaccrual		Accruing		Total		Nonaccrual		Accruing		Total	
	#	Amount	#	Amount	#	Amount	#	Amount	#	Amount	#	Amount
Consumer mortgage	31	$1,682	48	$2,171	79	$3,853	3	$160	45	$2,074	48	$2,234
Business lending	4	162	1	47	5	209	10	3,046	0	0	10	3,046
Consumer indirect	0	0	98	692	98	692	0	0	106	718	106	718
Consumer direct	0	0	46	116	46	116	0	0	19	116	19	116
Home equity	12	202	20	363	32	565	5	70	19	266	24	336
Total	47	$2,046	213	$3,389	260	$5,435	18	$3,276	189	$3,174	207	$6,450

The following table presents information related to loans modified in a TDR during the years ended December 31, 2013 and 2012. Of the loans noted in the table below, all loans for the year ended December 31, 2012 and all but two loans for the year ended December 31, 2013, were modified due to a Chapter 7 bankruptcy as described previously. The others were a business loan restructured via an extension of term and a consumer mortgage restructured via an extension of term and a rate concession. The financial effects of these restructurings were immaterial.

	December 31, 2013		December 31, 2012	
(000's omitted)	#	Amount	#	Amount
Consumer mortgage	31	$1,758	23	$1,176
Business lending	3	183	9	2,709
Consumer indirect	36	327	47	281
Consumer direct	22	75	13	95

Home equity	14	298	12	126
Total	106	$2,641	104	$4,387

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)	Consumer Mortgage	Business Lending	Home Equity	Consumer Indirect	Consumer Direct	Unallocated	Acquired Impaired	Total
Balance at December 31, 2011	$4,651	$20,574	$1,130	$8,960	$3,290	$3,222	$386	$42,213
Charge-offs	(1,004)	(5,654)	(423)	(5,407)	(1,694)	0	0	(14,182)
Recoveries	59	1,295	23	3,551	821	0	0	5,749
Provision	3,364	1,798	721	2,502	886	(556)	393	9,108
Balance at December 31, 2012	7,070	18,013	1,451	9,606	3,303	2,666	779	42,888
Charge-offs	(1,012)	(2,788)	(650)	(4,544)	(1,954)	0	(883)	(11,831)
Recoveries	36	692	20	3,488	1,034	0	0	5,270
Provision	2,900	1,590	1,009	1,698	798	(637)	634	7,992
Balance at December 31, 2013	$8,994	$17,507	$1,830	$10,248	$3,181	$2,029	$530	$44,319

NOTE E: PREMISES AND EQUIPMENT

Premises and equipment consist of the following at December 31:

(000's omitted)	2013	2012
Land and land improvements	$15,714	$15,480
Bank premises	95,275	90,899
Equipment and construction in progress	75,523	73,404
Premises and equipment, gross	186,512	179,783
Accumulated depreciation	(92,876)	(89,845)
Premises and equipment, net	$93,636	$89,938

NOTE F: GOODWILL AND IDENTIFIABLE INTANGIBLE ASSETS

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

	December 31, 2013			December 31, 2012		
(000's omitted)	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Amortizing intangible assets:						
Core deposit intangibles	$40,722	($27,262)	$13,460	$38,185	($23,693)	$14,492
Other intangibles	9,441	(7,393)	2,048	9,432	(6,493)	2,939
Total amortizing intangibles	$50,163	($34,655)	$15,508	$47,617	($30,186)	$17,431

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

2014	$4,160
2015	3,296
2016	2,515
2017	1,828
2018	1,359

Thereafter	2,350
Total	$15,508

Shown below are the components of the Company's goodwill at December 31, 2013 and 2012:

(000's omitted)	Year Ended December 31, 2011	Activity	Year Ended December 31, 2012	Activity	Year Ended December 31, 2013
Goodwill	$349,874	$24,653	$374,527	$5,288	$379,815
Accumulated impairment	(4,824)	0	(4,824)	0	(4,824)
Goodwill, net	$345,050	$24,653	$369,703	$5,288	$374,991

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

Mortgage Servicing Rights

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

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

(000's omitted)	2013	2012
Carrying value before valuation allowance at beginning of period	$1,458	$2,145
Additions	289	0
Amortization	(529)	(687)
Carrying value before valuation allowance at end of period	1,218	1,458
Valuation allowance balance at beginning of period	(430)	(397)
Impairment charges	(111)	(279)
Impairment recoveries	541	246
Valuation allowance balance at end of period	0	(430)
Net carrying value at end of period	$1,218	$1,028
Fair value of MSRs at end of period	$1,495	$1,028
Principal balance of loans sold during the year	$25,179	$3,554
Principal balance of loans serviced for others	$322,030	$367,241
Custodial escrow balances maintained in connection with loans serviced for others	$4,519	$5,011

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

	2013	2012
Weighted-average contractual life (in years)	19.2	18.8
Weighted-average constant prepayment rate (CPR)	18.0%	34.4%
Weighted-average discount rate	4.5%	3.1%

NOTE G: DEPOSITS

Deposits consist of the following at December 31:

(000's omitted)	2013	2012
Noninterest checking	$1,203,346	$1,110,994
Interest checking	1,289,676	1,151,522

Savings	1,010,196	940,985
Money market	1,466,273	1,409,123
Time	926,553	1,015,415
Total deposits	$5,896,044	$5,628,039

At December 31, 2013 and 2012, time deposits in denominations of $100,000 and greater totaled $206.4 million and $244.9 million, respectively. The approximate maturities of these time deposits at December 31, 2013 are as follows:

(000's omitted)	Amount
2014	$142,691
2015	20,938
2016	17,880
2017	14,347
2018	8,213
Thereafter	2,346
Total	$206,415

NOTE H: BORROWINGS

Outstanding borrowings at December 31 are as follows:

(000's omitted)	2013	2012
FHLB overnight advance	$141,900	$0
FHLB term advances	0	728,034
Capital lease obligations	13	27
Subordinated debt held by unconsolidated subsidiary trusts,		
net of discount of $430 and $454, respectively	102,097	102,073
Total borrowings	$244,010	$830,134

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

The Company undertook a balance sheet restructuring program during the first half of 2013 through the sale of certain longer duration investment securities and retirement of the Company’s existing FHLB term advances. During the first half of 2013, the Company sold securities and utilized the proceeds to retire $501.6 million of FHLB term borrowings with $63.5 million of associated early extinguishments costs.

During December 2013, in response to the issuance of the “Volker Rule”, the Company sold certain investment securities and utilized the proceeds to retire the remaining $226.4 million FHLB term advances with $23.8 million of associated early extinguishment costs.

Borrowings at December 31, 2013 have contractual maturity dates as follows:

(000's omitted, except rate)	Carrying Value	Weighted-average Rate at December 31, 2013
January 2, 2014	$141,900	0.40%
February 1, 2015	13	3.25%
July 31, 2031	24,777	3.82%
December 15, 2036	77,320	1.89%
Total	$244,010	1.22%

The weighted-average interest rate on borrowings for the years ended December 31, 2013 and 2012 was 2.70% and 3.46%, respectively.

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% (3.82%)	7/31/2031	Par
IV	12/8/2006	$75 million	3 month LIBOR plus 1.65% (1.89%)	12/15/2036	Par

On December 8, 2006,