COMMUNITY BANK SYSTEM INC
Form 10-K
March 01, 2013

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

FORM 10-K

X ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended December 31, 2012

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHAN 1934
For the transition period from to .
Commission file number 001-13695

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

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

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

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

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

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

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

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

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

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

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

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

Large accelerated filer x	Accelerated filer o	Non-accelerated filer o	Smaller reporting company o.
		(Do not check if a smaller reporting company)	

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

The aggregate market value of the common stock, $1.00 par value, held by non-affiliates of the registrant computed by reference to the closing price as of the close of business on June 30, 2012 (the registrant's most recently completed second fiscal quarter): $1,008,194,666.

The number of shares of the common stock, $1.00 par value, outstanding as of the close of business on January 31, 2013: 39,644,985 shares

DOCUMENTS INCORPORATED BY REFERENCE.

Portions of the Definitive Proxy Statement for the Annual Meeting of the Shareholders to be held on May 8, 2013 (the "Proxy Statement") is incorporated by reference in Part III of this Annual Report on Form 10-K.

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Part I

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

Item 1. Business

Community Bank System, Inc. ("the Company") was incorporated on April 15, 1983, under the Delaware General Corporation Law. Its principal office is located at 5790 Widewaters Parkway, DeWitt, New York 13214. The Company is a single bank holding company which wholly-owns five subsidiaries: Community Bank, N.A. ("the Bank" or "CBNA"), Benefit Plans Administrative Services, Inc. ("BPAS"), CFSI Closeout Corp. ("CFSICC"), First of Jermyn Realty Company, Inc. ("FJRC") and Town & Country Agency LLC ("T&C"). BPAS owns three subsidiaries, Benefit Plans Administrative Services LLC ("BPA"), a provider of defined contribution plan administration services; Harbridge Consulting Group LLC ("Harbridge"), a provider of actuarial and benefit consulting services; and Hand Benefits & Trust Company ("HB&T"), a provider of Collective Investment Fund administration and institutional trust services. HB&T owns two subsidiaries, Flex Corp. ("Flex"), a provider of administration, servicing and marketing of various flexible employee benefit programs and Hand Securities, Inc. ("HSI"), an introducing broker dealer. CFSICC, FJRC and T&C are inactive companies. The Company also wholly-owns two unconsolidated subsidiary business trusts formed for the purpose of issuing mandatorily-redeemable preferred securities which are considered Tier I capital under regulatory capital adequacy guidelines.

The Bank's business philosophy is to operate as a community bank with local decision-making, principally in non-metropolitan markets, providing a broad array of banking and financial services to retail, commercial, and municipal customers. As of December 31, 2012 the Bank operates 179 full-service branches throughout 35 counties of Upstate New York, where it operates as Community Bank, N.A. and five counties of Northeastern Pennsylvania, where it is known as First Liberty Bank & Trust, offering a range of commercial and retail banking services. The Bank owns the following subsidiaries: 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.

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

Acquisition History (2008-2012)

HSBC and First Niagara Branches

On July 20, 2012, Community Bank, N.A. (the" Bank"), the wholly-owned banking subsidiary of the Company, 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 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 Bank, N.A. ("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.

CAI Benefits, Inc.
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 enhances distribution prospects in support of the Company's broader-based employee benefits business, including daily valuation plan and collective investment fund administration.

The Wilber Corporation
On April 8, 2011, the Company acquired The Wilber Corporation, parent company of Wilber National Bank, and its 22 branch-banking centers in the Central, Greater Capital District and Catskill regions of New York for $103 million of stock and cash. The Company acquired approximately $462 million in loans, $297 million of investment securities and $772 million in deposits.

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

Alliance Benefit Group MidAtlantic
On July 7, 2008, BPAS acquired the Philadelphia division of Alliance Benefit Group MidAtlantic ("ABG") from BenefitStreet, Inc. in an all-cash transaction. ABG was a provider of retirement plan consulting, daily valuation administration, actuarial and ancillary support services.

Services

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

Competition

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

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

				Number of			
County	State	Deposits as of 6/30/2012(1) (000's omitted)	Market Share (1)	Branches	ATM's	Towns/ Cities	Towns Where Company Has 1st or 2nd Market Position
Lewis	NY	$145,984	65.34%	4	4	3	3
Franklin	NY	265,148	58.31%	9	7	6	6
Hamilton	NY	38,629	53.12%	2	2	2	2
Allegany	NY	212,633	47.78%	9	10	8	8
Cattaraugus	NY	392,553	46.46%	10	11	7	6
Otsego	NY	408,127	41.30%	10	10	6	5
Seneca	NY	195,465	36.80%	4	3	4	3
St. Lawrence	NY	393,575	35.11%	12	8	11	10
Schuyler	NY	54,166	31.82%	1	1	1	1
Jefferson	NY	394,200	28.98%	8	8	6	6
Wyoming	PA	120,618	27.85%	4	4	3	3
Clinton	NY	325,666	27.12%	6	9	2	2
Yates	NY	81,023	27.03%	3	2	2	1
Livingston	NY	176,362	22.19%	5	6	5	5
Essex	NY	119,748	21.16%	5	6	5	5
Steuben	NY	177,926	20.39%	8	7	7	4
Chautauqua	NY	290,105	20.24%	13	13	11	8
Delaware	NY	171,778	18.57%	5	5	5	5
Wayne	NY	132,259	18.26%	4	4	2	2
Ontario	NY	248,045	14.17%	8	13	5	5
Oswego	NY	123,674	10.28%	4	5	4	2
Schoharie	NY	33,331	8.58%	1	1	1	0
Lackawanna	PA	405,052	8.39%	11	11	8	4
Tioga	NY	33,251	8.19%	2	2	2	1
Chemung	NY	78,703	7.71%	2	2	1	0
Herkimer	NY	41,893	7.15%	1	1	1	1
Susquehanna	PA	44,109	6.31%	3	1	3	2
Chenango	NY	37,366	6.29%	2	2	1	1
Cayuga	NY	41,020	4.39%	2	2	2	1
Luzerne	PA	240,922	4.20%	6	7	6	3
Bradford	PA	39,211	3.59%	2	2	2	1
Washington	NY	18,328	2.76%	1	0	1	1
Warren	NY	32,795	2.30%	1	1	1	1
Oneida	NY	56,299	1.86%	1	1	1	1
Broome	NY	34,532	1.53%	1	1	1	1
Ulster	NY	25,586	0.80%	1	1	1	1
Saratoga	NY	15,195	0.43%	1	1	1	0

Erie	NY	116,855	0.39%	4	4	3	2
Onondaga	NY	28,824	0.34%	2	3	2	0
Tompkins	NY	5,590	0.32%	1	0	1	0
		$5,796,546	6.68%	179	181	144	113

(1) Deposits and Market Share data as of June 30, 2012, the most recent information available from SNL Financial LLC, adjusted for deposits acquired with the HSBC and First Niagara Branch Acquisitions.

Employees

As of December 31, 2012, the Company employed 1,908 full-time employees, 157 part-time employees and 123 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. Statutory and regulatory controls are designed primarily for the protection of depositors and the financial system, and not for the purpose of protecting shareholders. The following discussion is not intended to be a complete list of all the activities regulated by the banking laws or of the impact of such laws and regulations on the Company and the Bank. Changes in applicable law or regulations, and in their interpretation and application by regulatory agencies, cannot be predicted, but may have a material effect on our 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. The Bank is also subject to the regulations and supervision of the FRB and the FDIC.

The Company is subject to the jurisdiction of the Securities and Exchange Commission ("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. Affiliated entities, including BPAS, HB&T, Nottingham, CISI, and HSI are subject to the jurisdiction of the SEC, the New York Stock Exchange, the Texas Department of Banking, the Financial Industry Regulatory Authority ("FINRA") and state securities regulators, among others.

Set forth below is a description of the material information governing the laws and regulations applicable to the Company:

Federal Bank Holding Company Regulation

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

Federal Reserve System Regulation

The Company, as a bank holding company, is subject to regulatory capital requirements and is 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. 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 Act (as defined below) codifies this policy as a statutory requirement. After exhausting other sources of funds, the Company may seek borrowings from the FRB for such purposes. Bank holding companies registered with the FRB are, among other things, restricted from making direct investments in real estate. Both the Company and the Bank are subject to extensive supervision and regulation, which focus on, among other things, the protection of depositors' funds.

The 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 their strategies for such changes, the level of earnings can be materially affected by economic circumstances beyond their control.

The Company and the Bank are subject to minimum capital requirements established by the FRB, the OCC and the FDIC. For information on these capital requirements and the Company's and the Bank's capital ratios see "Management's Discussion and Analysis of Financial Condition and Results of Operations - Capital" and Note P to the Financial Statements.

Office of Comptroller of the Currency Regulation

The Bank is supervised and regularly examined by the OCC. The various laws and regulations administered by the OCC affect corporate practices such as payment of dividends, incurring debt, and acquisition of financial institutions and other companies. It also affects business practices, such as payment of interest on deposits, the charging of interest on loans, types of business conducted and location of offices. The OCC generally prohibits a depository institution from making any capital distributions (including payment of a dividend) or paying any management fee to its parent holding company if the depository institution would thereafter be undercapitalized. 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.

Insurance of Deposit Accounts

The Bank is a member of the Deposit Insurance Fund ("DIF"), which is administered by the FDIC. On July 22, 2010, the FDIC amended its insurance regulations to insure deposit accounts up to a maximum of $250,000 (previously $100,000) for each separately insured depositor. Additionally, on November 9, 2010, the FDIC issued a final rule implementing Section 343 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("the Dodd-Frank Act") which provides certain noninterest-bearing transaction accounts with unlimited insurance coverage, regardless of the dollar amount, which terminated on December 31, 2012.

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

In the fourth quarter of 2009, the FDIC adopted a rule that required insured depository institutions to prepay their quarterly risk-based assessments for the fourth quarter of 2009, and for all of 2010, 2011 and 2012, on December 30, 2009. For purposes of calculating the amount to prepay, the FDIC required that institutions use their total base assessment rate in effect on September 30, 2009 and increase that assessment base quarterly at a 5 percent annual growth rate through the end of 2012. The FDIC also increased annual assessment rates uniformly by three basis points beginning in 2011. The Company's prepayment for 2010, 2011 and 2012 amounted to $21.4 million. Effective April 1, 2011, the FDIC changed the basis for premium payments from a percentage of average deposits to a percentage of average consolidated Bank assets less average tangible capital, resulting in lower 2011 and 2012 premiums for the Company.

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

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act"). This law results 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 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:

- Change 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.
- Make permanent the $250,000 limit on deposits for federal deposit insurance, retroactive to January 1, 2008, and provided unlimited federal deposit insurance through December 31, 2012 for non-interest bearing demand transaction accounts at all insured depository institutions.
- Repeal the federal prohibitions on the payment of interest on demand deposits, thereby permitting depository institutions to pay interest on business transaction and other accounts.
- Centralize responsibility for consumer financial protection by creating the Consumer Financial Protection Bureau (“CFPB”), a new agency started in July 2011 with responsibility for implementing, examining, and enforcing compliance with federal consumer laws.

- Restrict the preemption of state law by federal law and disallow subsidiaries and affiliates of national banks from availing themselves of such preemption.
- Apply 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.
- Require the OCC to seek to make its capital requirements for national banks countercyclical.
- Impose 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.
- Amend the Electronic Fund Transfer Act to, among other things, 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.
- Increase the authority of the FRB to examine the Company and any of its non-bank subsidiaries.

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." Basel III, when implemented by the U.S. bank regulatory agencies and fully phased-in, will require bank holding companies and their bank subsidiaries to maintain substantially more capital, with a greater emphasis on common equity. 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.

The Basel III revisions governing liquidity and capital requirements are subject to prolonged observation and transition periods. The transition period for banks to meet the revised Tier 1 common requirement will begin in 2013, with implementation on January 1, 2019. The implementation of the Basel III final framework, scheduled to commence on January 1, 2013 has been deferred. Once the final implementation guidance is approved, banking institutions will be required to meet the following minimum capital ratios:

- 3.5 percent CET1 to risk-weighted assets;
- 4.5 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, 2014 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 Dodd-Frank Act requires the Federal Reserve to adopt regulations imposing a continuing "floor" of the Basel I-based capital requirements in cases where the Basel II-based capital requirements and any changes in capital regulations resulting from Basel III otherwise would permit lower requirements. In November 2012, the Federal Reserve announced the final rule on implementation will not occur until 2013. Given that the Basel III rules are subject to implementation and change and the scope and content of capital regulations that U.S. federal banking agencies may adopt under the Dodd-Frank Act is uncertain, we cannot be certain of the impact new capital regulations will have on our capital ratios. The Company fully expects to be in compliance with the higher Basel III capital standards, as well as any additional Dodd-Frank Act capital requirements, 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, the Gramm-Leach-Bliley 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. 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.

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 new 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 in the fourth quarter of 2010 and all of 2011 and 2012.

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 our mortgage-backed securities portfolio. If the interest rates paid on deposits and other borrowings increase at a faster rate than the interest rates received on loans and other investments, our net interest income could be adversely affected, which in turn could negatively affect our earnings. Earnings could also be adversely affected if the interest rates received on loans and other investments fall more quickly than the interest rates paid on deposit and other borrowings. Although management believes it has implemented effective asset and liability management strategies to reduce the potential effects of changes in interest rates on the 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 three 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 continues 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 difficult market conditions to improve meaningfully over the short term, and a continuation of these conditions could exacerbate their adverse effects:

- 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 within the Federal Reserve, 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. Among other changes, significant amendments and revisions to the laws governing mortgage lending have been slated for 2013.

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 management of the Company could have weaker bargaining power. 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 would require the federal banking agencies to establish stricter risk-based capital requirements and leverage limits to apply to banks and bank holding companies. Under the legislation, the federal banking agencies would be 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 periodically reviews the allowance for loan losses for adequacy considering economic conditions and trends, collateral values and credit quality indicators, including past charge-off experience and levels of past due loans and nonperforming assets. 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.

FDIC deposit insurance premiums have increased and may increase further in the future.

The Company is generally unable to control the amount of premiums that it is required to pay for FDIC insurance. In November 2009, the FDIC adopted a rule requiring banks to prepay their quarterly risk-based assessment for the 13 quarters ended December 31, 2012. In 2010, the FDIC increased the general assessment rate as compared to prior periods. Effective April 1, 2011, the FDIC changed the basis for premium payments from a percentage of average deposits to a percentage of average consolidated Bank assets less average tangible capital, resulting in lower 2011 and 2012 premiums for the Company as compared to 2009 and 2010, but still higher than historical norms. However, if there are additional bank or financial institution failures, the Company may be required to pay higher FDIC premiums than the current levels. These announced increases and any future increases or required prepayments of FDIC insurance premiums may adversely impact the Company’s earnings.

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 leads customers to liquidate investment, as well as lower asset values, can reduce our level of assets under management and administration and thereby decrease our investment management and administration revenues.

Mortgage banking income may experience significant volatility.

Mortgage banking income is highly influenced by the level and direction of mortgage interest rates, and real estate and refinancing activity. In lower interest rate environments, the demand for mortgage loans and refinancing activity will tend to increase. This has the effect of increasing fee income, but could adversely impact the estimated fair value of our mortgage servicing rights as the rate of loan prepayments increase. In higher interest rate environments, the demand for mortgage loans and refinancing activity will generally be lower. This has the effect of decreasing fee income 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, 2012, 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 our management to maximize our financial and strategic position, the inability to maintain uniform standards, controls, procedures and policies, and the impairment of relationships with employees and customers as a result of changes in ownership and management. 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 2010 rating agencies imposed a number of downgrades and credit watches on certain securities in the Company's investment securities portfolio, which contributed to the decline in fair value of such securities. During 2011 additional 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 litigations, 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 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 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 Federal Home Loan Bank of New York ("FHLBNY") in order to qualify for membership in the FHLB system, which enables it to borrow funds under the FHLBNY advance program. The carrying value of the Company's FHLBNY common stock was $38.1 million as of December 31, 2012. There are 12 branches of the FHLB, 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 FHLB branches have suspended dividends, cut dividend payments, and have not redeemed excess FHLB stock that members hold. The FHLBNY 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 FHLB system have been at the other FHLB branches, nonetheless, the 12 FHLB branches are jointly liable for the consolidated obligations of the FHLB system. To the extent that one FHLB branch cannot meet its obligations to pay its share of the system's debt, other FHLB 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.

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 208 properties located in the counties identified in the table on page 5, of which 124 are owned and 84 are under lease arrangements. In total, the Company operates 179 full-service branches, 15 are other customer service facilities for our financial service subsidiaries and 14 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, 2012 had a net book value of $57.6 million and none of the properties were subject to any material encumbrances. For the year ended December 31, 2012, rental fees of $4.9 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, 2012, 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 or results of operations.

The Bank was named a defendant in a class action proceeding filed July 20, 2012 in the United States District Court for the Middle District of Pennsylvania which sought to establish and represent a class of customers allegedly harmed by the Bank's overdraft practices. The complaint alleged that the Bank failed to adequately disclose the processing order of customer transactions from highest dollar value to lowest dollar value which unfairly resulted in increasing the number of overdraft charges. The plaintiffs sought recovery of any overdraft fees wrongfully paid by plaintiffs, damages, expenses of litigation, attorneys' fees, and other relief deemed equitable by the court. This case is substantially similar to cases filed against more than 100 other banks across the United States. On January 14, 2013, the Bank reached an agreement in principle to settle this matter for $2.5 million. This settlement is subject to, among other things, final documentation, notice to the class, and court approval. This $2.5 million litigation settlement charge was recorded in the fourth quarter of 2012.

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	52	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	48	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	56	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	56	Executive Vice President and General Counsel. Mr. Getman assumed his current position in January 2008. Prior to joining the Company, he was a member with Bond, Schoeneck & King, PLLC and served as corporate counsel to the Company.

Part II

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

The Company's common stock has been trading on the New York Stock Exchange under the symbol "CBU" since December 31, 1997. Prior to that, the common stock traded over-the-counter on the NASDAQ National Market under the symbol "CBSI" beginning on September 16, 1986. There were 39,625,933 shares of common stock outstanding on December 31, 2012, held by approximately 3,677 registered shareholders of record. The following table sets forth the high and low prices for the common stock, and the cash dividends declared with respect thereto, for the periods indicated. The prices do not include retail mark-ups, mark-downs or commissions.

Year / Qtr	High Price	Low Price	Quarterly Dividend
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
2011			
4th	$28.26	$21.86	$0.26
3rd	$25.84	$21.67	$0.26
2nd	$25.12	$22.78	$0.24
1st	$28.45	$23.02	$0.24

The Company has historically paid regular quarterly cash dividends on its common stock, and declared a cash dividend of $0.27 per share for the first quarter of 2013. 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, 2007 and reinvestment of dividends.

The following table provides information as of December 31, 2012 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 Weighted-average 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	350,751	$22.21	0
2004 Long-term Incentive Plan	2,602,055	$21.26	1,374,520
Total	2,952,806	$21.37	1,374,520

(1) The number of securities includes unvested restricted stock issued of 192,083.

On July 22, 2009, the Company announced an authorization to repurchase up to 1,000,000 of its outstanding shares in open market transactions or privately negotiated transactions in accordance with securities laws and regulations through December 31, 2011. The program was extended through December 31, 2012 and increased to 1,500,000 shares. Any repurchased shares will be used for general corporate purposes, including those related to stock plan activities. The timing and extent of repurchases will depend on market conditions and other corporate considerations as determined at the Company's discretion. There were no treasury stock purchases in 2012 or 2011. 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.

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, 2012. 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)	2012	2011	2010	2009	2008
Income Statement Data:					
Loan interest income	$192,710	$192,981	$178,703	$185,119	$186,833
Investment interest income	88,690	77,988	69,578	63,663	64,026
Interest expense	50,976	61,556	66,597	83,282	102,352
Net interest income	230,424	209,413	181,684	165,500	148,507
Provision for loan losses	9,108	4,736	7,205	9,790	6,730
Noninterest income	98,955	89,283	88,792	83,528	73,244
Gain (loss) on investment securities & early retirement of long-term borrowings	291	(61)	0	7	230
Acquisition expenses, litigation settlement, and contract termination charges	8,247	4,831	1,365	1,621	1,399
Other noninterest expenses	203,510	185,541	175,521	184,557	157,163
Income before income taxes	108,805	103,527	86,385	53,067	56,689
Net income	77,068	73,142	63,320	41,445	45,940
Diluted earnings per share (1)	1.93	2.01	1.89	1.26	1.49
Balance Sheet Data:					
Cash equivalents	$84,415	$203,082	$114,996	$257,812	$112,181
Investment securities	2,818,527	2,151,370	1,742,324	1,487,127	1,395,011
Loans, net of unearned discount	3,865,576	3,471,025	3,026,363	3,099,485	3,136,140
Allowance for loan losses	(42,888)	(42,213)	(42,510)	(41,910)	(39,575)
Intangible assets	387,134	360,564	311,714	317,671	328,624
Total assets	7,496,800	6,488,275	5,444,506	5,402,813	5,174,552
Deposits	5,628,039	4,795,245	3,934,045	3,924,486	3,700,812
Borrowings	830,134	830,329	830,484	856,778	862,533
Shareholders' equity	902,778	774,583	607,258	565,697	544,651
Capital and Related Ratios:					
Cash dividends declared per share	$1.06	$1.00	$0.94	$0.88	$0.86
Book value per share	22.78	20.94	18.23	17.25	16.69
Tangible book value per share (2)	13.72	11.85	9.49	8.09	6.62
Market capitalization (in millions)	1,084	1,028	925	633	796
Tier 1 leverage ratio	8.40%	8.38%	8.23%	7.39%	7.22%
Total risk-based capital to risk-adjusted assets	16.20%	15.51%	14.74%	13.03%	12.53%
Tangible equity to tangible assets (2)	7.62%	7.12%	6.14%	5.20%	4.74%
Dividend payout ratio	54.3%	49.3%	49.2%	69.5%	57.3%
Period end common shares outstanding	39,626	36,986	33,319	32,800	32,633
Diluted weighted-average shares outstanding	39,927	36,454	33,553	32,992	30,826

Selected Performance Ratios:					
Return on average assets	1.08%	1.18%	1.16%	0.78%	0.97%
Return on average equity	8.82%	10.36%	10.66%	7.46%	9.23%
Net interest margin	3.88%	4.07%	4.04%	3.80%	3.82%
Noninterest income/operating income (FTE)	28.6%	28.4%	31.1%	31.6%	31.0%
Efficiency ratio (3)	57.4%	57.6%	59.4%	65.5%	62.7%
Asset Quality Ratios:					
Allowance for loan losses/total loans	1.11%	1.22%	1.40%	1.35%	1.26%
Nonperforming loans/total loans	0.75%	0.85%	0.61%	0.61%	0.40%
Allowance for loan losses/nonperforming loans	147%	144%	230%	222%	312%
Net charge-offs/average loans	0.23%	0.15%	0.21%	0.24%	0.20%
Loan loss provision/net charge-offs	108%	94%	109%	131%	117%

(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, gain (loss) on investment securities & debt extinguishments, goodwill impairment, acquisition expenses and contract termination charges from noninterest income 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 Securities and Exchange Commission disclosure requirements or to more fully explain long-term trends. The following discussion and analysis should be read in conjunction with the Selected Consolidated Financial Information on page 20 and the Company's Consolidated Financial Statements and related notes that appear on pages 50 through 89. 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 2012, "last year" and equivalent terms refer to calendar year 2011, 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 Community Bank System, Inc. These forward-looking statements involve certain risks and uncertainties. Factors that may cause actual results to differ materially from those contemplated by such forward-looking statements are set herein under the caption "Forward-Looking Statements" on page 47.

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. 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. Subsequent to the acquisition of acquired impaired loans, GAAP requires the continued estimation of expected cash flows to be received. This estimation requires numerous assumptions, interpretations and judgments using internal and third-party credit quality information. Changes in expected cash flows could result in the recognition of impairment through provision for credit losses.

For acquired loans that are not deemed impaired at acquisition, credit discounts representing the principal losses expected over the life of the loan are a component of the initial fair value. Subsequent to the purchase date, the methods utilized to estimate the required allowance for loan losses for the non-impaired acquired loans is similar to originated loans, however, the Company records a provision for loan losses only when the required allowance exceeds any remaining pooled discounts for loans evaluated collectively for impairment. 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 laons, 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.

  - 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 55.

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, 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, Community Bank, N.A. (the" Bank"), the wholly-owned banking subsidiary of the Company, 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 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 Bank, N.A. ("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.

The Company reported net income for the year ended December 31, 2012 of $77.1 million or 5.4% above 2011's reported net income of $73.1 million. Earnings per share of $1.93 for the full year 2012 were $0.08 or 4.0%, below the prior year level. The increase in net income was due to higher revenue from both increased net interest income, as a result of earning asset growth, and higher non-interest income, partially offset by a 19-basis point decrease in net interest margin. Also offsetting higher income was a higher provision for loan losses and higher operating expenses. The 2012 results 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 as compared to $4.8 million or $0.09 per share of acquisition expenses related to the Company's merger with Wilber in early April 2011. The litigation settlement charge pertains to the settlement of a class action lawsuit related to the processing of retail debit card transactions and its impact on overdraft fees. Full year 2012 earnings per share were adversely impacted by the 2.13 million shares issued in January 2012 in support of the HSBC and First Niagara branch acquisitions that closed in the third quarter of this year.

Asset quality remained favorable in 2012, with lower year-end non-performing loan ratios and loan delinquency ratios as compared to 2011. Net loan charge-off and the provision for loan loss ratios increased, but remained superior to peer company averages. The Company experienced year-over-year growth in interest-earning assets, reflective of strong organic loan growth and the HSBC and First Niagara branch acquisitions, completed in the third quarter of 2012. Average deposits increased in 2012 as compared to 2011, 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 increased from 2011 reflective of the Company's strategy of pre-investing a portion of the liquidity obtained from the HSBC and First Niagara branch acquisitions prior to their closings.

Net Income and Profitability

Net income for 2012 was $77.1 million, an increase of $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 related principally to the Company's acquisition of 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. The 2011 results included $4.8 million, or $0.09 per share of acquisition expenses, principally related to the Wilber acquisition which was completed in the second quarter of 2011. Fully diluted shares outstanding increased 9.5% in 2012 over 2011, due principally to the full-year impact of the Wilber acquisition completed in early 2011 and the additional shares issued in early 2012 in support of the HSBC and First Niagara branch acquisitions.

Net income for 2011 was $73.1 million, up $9.8 million or 16% from 2010's earnings of $63.3 million. Earnings per share for 2011 were $2.01, up 6.3% from 2010's earnings per share. The 2011 results included $4.8 million, or $0.09 per share of acquisition expenses principally related to the Wilber acquisition. The 2010 results included $1.4 million or $0.03 per share of acquisition expenses, associated with the Wilber acquisition and a contract termination charge related to the core banking system conversion.

Table 1: Condensed Income Statements

	Years Ended December 31,				
(000's omitted, except per share data)	2012	2011	2010	2009	2008
Net interest income	$230,424	$209,413	$181,684	$165,500	$148,507
Loan loss provision	9,108	4,736	7,205	9,790	6,730
Noninterest income	99,246	89,222	88,792	83,535	73,474
Acquisition expenses, litigation settlement, and contract termination charges	8,247	4,831	1,365	1,621	1,399
Other noninterest expenses	203,510	185,541	175,521	184,557	157,163
Income before taxes	108,805	103,527	86,385	53,067	56,689
Income taxes	31,737	30,385	23,065	11,622	10,749
Net income	$77,068	$73,142	$63,320	$41,445	$45,940
Diluted earnings per share	$1.93	$2.01	$1.89	$1.26	$1.49

The primary factors explaining 2012 earnings performance are discussed in detail in the remaining sections of this document and are summarized as follows:

- As shown in Table 1 above, net interest income increased $21.0 million, or 10.0%, due to a $848.9 million increase in average earning assets partially offset by a 19-basis point decrease in the net interest margin. Average loans grew $272.7 million due to the HSBC and First Niagara branch acquisitions and strong growth in the consumer mortgage portfolio, aided by long-term interest rates remaining low, and growth in the indirect consumer installment portfolio. The average book value of investments, including cash equivalents, increased $576.2 million or 27% in 2012 due to the net liquidity acquired from the HSBC and First Niagara branch acquisitions and organic deposit growth. Average interest-bearing deposits increased $490.7 million or 13% due to the HSBC and First Niagara branch acquisitions and organic growth. Average borrowings increased $114.4 million or 14% as compared to the prior year, as the Company pre-invested during the first half of the year a portion of the pending net liquidity received from the branch acquisitions in the third quarter.

- The loan loss provision of $9.1 million increased $4.4 million or 92%, from the prior year level and included $0.5 million for certain loans acquired in the HSBC and First Niagara branch acquisitions where the fair value exceeded the estimated net recoverable value. Net charge-offs of $8.4 million increased by $3.4 million from 2011, increasing the net charge-off ratio (net charge-offs / total average loans) eight basis points to 0.23% 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 ten basis points and 5 basis points, respectively, in the fourth quarter as compared to the fourth quarter of the prior year 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 37 through 41.

- Noninterest income for 2012 of $99.2 million increased by $10.0 million, or 11%, from 2011's level due to growth in financial services revenue and fees from banking services, primarily as the result of the Wilber, CAI, HSBC and First Niagara acquisitions. Fees from banking services were $4.0 million or 8.9%, higher primarily due to higher debit card related revenue and the banking acquisitions completed over the last two years. Partially offsetting this growth was a $0.9 million decrease in mortgage banking revenue. Financial services revenue was up $6.5 million, or 15%, due to the CAI acquisition and solid organic growth in almost all lines of business.

- Total noninterest expenses, including acquisition expenses, litigation settlement, and contract termination charges increased $21.4 million, or 11.2%, in 2012 to $211.8 million, primarily due to the additional operating costs associated with the HSBC, First Niagara, Wilber and CAI acquisitions, partially offset by lower FDIC insurance. Excluding acquisition, expenses, litigation settlement, and contract termination charges, other noninterest expenses increased $18.0 million or 9.7%.

- The Company's combined effective federal and state income tax rate decreased slightly in 2012 to 29.2% as compared to 29.4% in 2011, reflective of similar levels of proportional income from both fully taxable and non-taxable sources.

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

	2012	2011	2010
Return on average assets	1.08%	1.18%	1.16%
Return on average equity	8.82%	10.36%	10.66%
Dividend payout ratio	54.3%	49.3%	49.2%
Average equity to average assets	12.22%	11.42%	10.89%

As displayed in Table 2 above, both the return on average assets and the return on average equity decreased in 2012 as compared to 2011 and 2010. The decrease in comparison to both years 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 increase in return on average assets in 2011 as compared to 2010 was a result of net income growing at a faster pace than average assets due to increasing net interest margins, non-interest income growth, lower provision for loan losses and operating expense containment. The return on equity decline in 2011 despite strong earnings growth was due to the equity issued in conjunction with the Wilber acquisition, build up of capital through earnings retention and an increase in the equity components of the investment market value adjustment due mostly to a decrease in intermediate and to long-term interest rates.

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. The dividend payout ratio for 2011 increased slightly from 2010 as dividends declared increased 15.7% primarily as a result of a 6.4% increase in the dividends declared per share as well as the additional 3.4 million shares issued in conjunction with the Wilber acquisition in the second quarter of 2011, while net income increased a slightly smaller 15.5% from 2010.

Net Interest Income

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

As disclosed in Table 3, net interest income (with nontaxable income converted to a fully tax-equivalent basis) totaled $247.3 million in 2012, up $22.2 million, or 9.9%, from the prior year. An $848.9 million increase in average interest-earning assets more than offset a $605.1 million increase in average interest-bearing liabilities and a 19-basis point decrease in the net interest margin. As reflected in Table 4, the volume changes increased net interest income by approximately $33.3 million, while the lower net interest margin had an $11.1 million unfavorable impact.

The net interest margin decreased 19 basis points from 4.07% in 2011 to 3.88% in 2012. This decrease was attributable a 51-basis point decrease in the earning-asset yields having a great 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% in 2012 from 5.78% in 2011, due to new volume coming on at lower yields in the current low-rate environment than the loans maturing or being prepaid, as well as variable and adjustable rate loans repricing downward. The yield on investments, including cash equivalents, decreased from 4.27% in 2011 to 3.80% in 2012, largely a result of the purchase of $899 million of U.S. Treasury, obligations of state and political subdivisions and other securities with an average yield of 2.7%. The cost of funding, including the impact of non-interest checking deposits, decreased 31 basis points during 2012 to 0.83% as compared to 1.14% for 2011. The decreased cost of funds was reflective of disciplined deposit pricing, whereby interest rates on essentially all deposit account categories were lowered throughout 2011 and 2012 in response to market conditions. Additionally, the proportion of customer deposits in higher cost time deposits declined 5.3 percentage points2012, while the percentage of deposits in non-interest bearing and lower cost checking accounts correspondingly increased.

The net interest margin in 2011 was 4.07%, compared to 4.04% in 2010. This three-basis point increase was primarily attributable to a 29-basis point decrease in interest-bearing liability yields having a greater impact than a 22-basis point decrease in earning-asset yields. The decreased cost of funds was reflective of disciplined deposit pricing, whereby interest rates on selected categories of deposit accounts were lowered throughout 2010 and 2011 in response to market conditions. The yield on loans decreased five basis points in 2011, mostly as a result of the low interest rate environment. The yield on investments, including cash equivalents, decreased from 4.70% in 2010 to 4.27% in 2011, with some of the yield decline being mitigated by the effective deployment of cash into higher yielding securities during 2011.

As shown in Table 3, total interest income increased by $11.7 million, or 4.1% in 2012 in comparison to 2011. Table 4 indicates that higher average earning assets created $41.4 million of incremental interest income, 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. On an FTE basis, investment interest income, including cash equivalents 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 interest income increased by $23.2 million, or 8.8%, in 2011 from 2010's level. Table 4 indicates that higher average earning assets contributed a positive $34.4 million variance, offset by lower yields with a negative impact of $11.2 million. Average loans increased a total of $280.3 million in 2011, primarily as result of the Wilber acquisition and organic growth in the consumer mortgage and consumer indirect portfolios. Loan interest income and fees increased $14.7 million in 2011 as compared to 2010, attributable to the higher average loan balances, partially offset by a five-basis point decrease in loan yields. Investment interest income, including cash equivalents, on an FTE basis of $92.7 million in 2011 was $8.4 million or 10.0% higher than the prior year as a result of a larger portfolio, partially offset by a 43-basis point decrease in the investment yield. Average investments, including cash equivalents, for 2011 were $376.1 million higher than 2010, reflective of the acquired Wilber portfolio and deployment of excess funding supplied by organic deposit growth.

Total average funding (deposits and borrowings) in 2012 increased $769.4 million or 14%. Deposits increased $655.1 million, of which approximately $345 million was attributable to the HSBC and First Niagara branch acquisitions, $209 million was attributable to the Wilber acquisition and the remaining $101 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 $693.8 million, while time deposits declined $38.7 million year-over-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 the year a portion of the liquidity ultimately received from the branch acquisitions in the third quarter. In 2011 total average funding increased $607.4 million or 12.7%. Deposits increased $613.6 million, $559.7 million attributable to the Wilber acquisition and $53.9 million due to organic growth. Consistent with the Company's funding mix objective, average core deposit balances increased $207.1 million, while time deposits were managed downward $153.2 million over the year. Average external borrowings decreased $6.2 million in 2011 as compared to the prior year.

Total interest expense decreased by $10.6 million to $51.0 million in 2012. As shown in Table 4, lower interest rates on deposits and external borrowings resulted in $18.0 million of this decrease, while higher deposit and external borrowing balances accounted for an increase of $7.4 million in interest expense. Interest expense as a percentage of earning assets decreased by 31 basis points to 0.80%. The rate on interest-bearing deposits decreased 27 basis points to 0.43%, due to reductions of rates in all interest-bearing categories throughout 2012 and the previously discussed decline of higher rate time deposit balances. The rate on external borrowings decreased 79 basis points to 3.46% in 2012 primarily due to the maturing of the interest rate swap in December 2011, which converted the variable rate trust preferred securities (with an interest rate of 2.20% at December 31, 2011) into a fixed rate obligation at 6.43% for a term of five years, and the utilization of low-rate overnight borrowings to fund acquisition-related investment activity. Total interest expense decreased by $5.0 million to $61.6 million in 2011 as compared to 2010. Lower interest rates on interest-bearing liabilities accounted for $12.8 million of this decrease, while the higher interest-bearing liability balances accounted for an increase of $7.7 million in interest expense. In 2011, the rate on interest-bearing deposits decreased 25 basis points to 0.70% and the rate on external borrowings decreased four basis points to 4.25%.

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, 2012, 2011 and 2010. Interest income and yields are on a fully tax-equivalent basis using marginal income tax rates of 38.8% in 2012 and 2011 and 38.5% in 2010. 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, 2012			Year Ended December 31, 2011			Year Ended December 31, 2010		
(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	$126,714	$330	0.26%	$202,885	$503	0.25%	$101,507	$255	0.25%
Taxable investment securities (1)	1,939,998	66,857	3.45%	1,398,437	56,982	4.07%	1,154,780	48,388	4.19%
Nontaxable investment securities (1)	679,119	37,278	5.49%	568,295	35,207	6.20%	537,216	35,624	6.63%
Loans (net of unearned discount)(2)	3,628,006	193,841	5.34%	3,355,286	193,951	5.78%	3,075,030	179,215	5.83%
Total interest-earning assets	6,373,837	298,306	4.68%	5,524,903	286,643	5.19%	4,868,533	263,482	5.41%
Noninterest-earning assets	780,497			659,267			590,464		
Total assets	$7,154,334			$6,184,170			$5,458,997		
Interest-bearing liabilities:									
Interest checking, savings and money market deposits	$3,169,651	6,895	0.22%	$2,640,239	10,103	0.38%	$2,193,512	11,399	0.52%
Time deposits	1,062,307	11,267	1.06%	1,101,013	16,053	1.46%	1,030,995	19,160	1.86%
Borrowings	947,454	32,814	3.46%	833,075	35,400	4.25%	839,314	36,038	4.29%
Total interest-bearing liabilities	5,179,412	50,976	0.98%	4,574,327	61,556	1.35%	4,063,821	66,597	1.64%
Noninterest-bearing liabilities:									

Noninterest checking deposits	989,631			825,277			728,408		
Other liabilities	111,051			78,221			72,520		
Shareholders' equity	874,240			706,345			594,248		
Total liabilities and shareholders' equity	$7,154,334			$6,184,170			$5,458,997		
Net interest earnings		$247,330			$225,087			$196,885	
Net interest spread			3.70%			3.84%			3.77%
Net interest margin on interest-earning assets			3.88%			4.07%			4.04%
Fully tax-equivalent adjustment		$16,906			$15,674			$15,201	

(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.

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

	2012 Compared to 2011 Increase (Decrease) Due to Change in (1)			2011 Compared to 2010 Increase (Decrease) Due to Change in (1)		
(000's omitted)	Volume	Rate	Net Change	Volume	Rate	Net Change
Interest earned on:						
Cash equivalents	($198)	$25	($173)	$252	($4)	$248
Taxable investment securities	19,633	(9,758)	9,875	9,961	(1,367)	8,594
Nontaxable investment securities	6,372	(4,301)	2,071	1,998	(2,415)	(417)
Loans (net of unearned discount)	15,146	(15,256)	(110)	16,211	(1,475)	14,736
Total interest-earning assets (2)	41,411	(29,748)	11,663	34,399	(11,238)	23,161
Interest paid on:						
Interest checking, savings and money market deposits	1,749	(4,957)	(3,208)	2,054	(3,350)	(1,296)
Time deposits	(546)	(4,240)	(4,786)	1,234	(4,341)	(3,107)
Borrowings	4,477	(7,063)	(2,586)	(267)	(371)	(638)
Total interest-bearing liabilities (2)	7,421	(18,001)	(10,580)	7,749	(12,790)	(5,041)
Net interest earnings (2)	33,331	(11,088)	22,243	26,732	1,470	28,202

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

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

Noninterest Income

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

Table 5: Noninterest Income

	Years Ended December 31,		
(000's omitted except ratios)	2012	2011	2010
Benefit trust, administration, consulting and actuarial fees	$35,946	$31,601	$29,616
Deposit service charges and fees	26,840	25,658	29,485
Electronic banking	17,025	14,784	11,646
Wealth management services	12,876	10,697	9,833
Other banking revenues	5,425	4,808	4,514
Mortgage banking	843	1,735	3,698
Subtotal	98,955	89,283	88,792
Gain (loss) on investment securities & debt extinguishments, net	291	(61)	0
Total noninterest income	$99,246	$89,222	$88,792
Noninterest income/operating income (FTE basis) (1)	28.6%	28.4%	31.1%

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

As displayed in Table 5, noninterest income, excluding security gains and losses and debt extinguishments costs, of $99.0 million for 2012 increased by $9.7 million, comprised of growth in revenue from the Company's financial services businesses, primarily from the CAI Benefits 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. Total noninterest income, excluding security gains and losses and debt extinguishments costs, increased by 0.6% to $89.3 million in 2011 as compared to 2010, largely as a result of increased debit card related income, growth in revenue from the Company's financial services businesses and incremental revenue produced by the acquired Wilber trust operations, partially offset by lower banking fees due to reduced utilization of certain services by the Bank's customers, as well as lower mortgage banking income.

Noninterest income as a percent of operating income (FTE basis) was 28.6% in 2012, up 0.2 percentage points from the prior year and down 2.5 percentage points from 2010. The current year increase was due to 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 decrease from 2010 to 2011 was primarily driven by a 14.3% increase in net interest income, primarily the result of the Wilber acquisition, while noninterest income increased at a much smaller rate of 0.6% as discussed below.

The largest portion of the Company's recurring noninterest income is the wide variety of fees earned from general banking services, which was $49.3 million in 2012, up $4.0 million or 8.9% from the prior year. The addition of new deposit relationships from both acquired and organic growth, as well as solid growth in debit card-related revenue more than offset the continuing trend of lower utilization of overdraft protection programs. Effective July 1, 2010, modifications to Regulation E (a Federal Reserve Board Regulation) prohibited financial institutions from charging consumers fees for paying overdrafts on ATM and debit card transactions, unless the customer consents. The majority of the Company's customers have consented to protecting their accounts from electronic transaction rejection. Electronic banking revenue grew $2.2 million due in large part to a concerted effort to increase the penetration and utilization of consumer debit cards.

Fees from general banking services were $45.3 million in 2011, down $0.4 million or 0.9% from 2010. A large part of the decline was due to lower overdraft and deposit fees reflective of lower service utilization due to economic conditions and regulatory and policy changes. Partially offsetting these declines was $3.1 million of income growth from electronic banking fees due in large part to a concerted effort to increase the penetration and utilization of consumer debit cards.

In 2012, mortgage banking revenue declined $0.9 million from the income generated in 2011, which was down $2.0 million from 2010, reflective of the decision to hold a majority of secondary market eligible mortgages in portfolio since the second half of 2011. 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 impairment charge of $0.1 million in 2011 for the fair value of the mortgage servicing rights due primarily to an increase in the expected prepayment speed of the Company's sold loan portfolio with servicing retained. Residential mortgage loans sold to investors in 2012 totaled $3.6 million. During 2011 and 2010 $43.1 million and $119.0 million of residential mortgage loans were sold, primarily to Fannie Mae. There were no residential mortgage loans held for sale at December 31, 2012. The continuation of the level of mortgage noninterest income produced in 2012 will be dependent on market conditions and the trend in long-term interest rates.

As disclosed in Table 5, noninterest income from financial services (including revenues from benefit trust, administration, consulting and actuarial fees and wealth management services) rose $6.5 million, or 15%, in 2012 to $48.8 million. Financial services revenue now comprises 49% of total noninterest income, excluding net gains (losses) on the sale of investment securities and debt extinguishments. BPAS generated revenue growth of $4.3 million, or 14%, for the 2012 year, primarily driven by the CAI Benefits acquisition completed in December 2011. BPAS offers their clients daily valuation, actuarial and employee benefit consulting services on a national basis from offices in New Jersey, New York, Pennsylvania and Texas. BPAS revenue of $31.6 million in 2011 was $2.0 million higher than 2010's results, driven by a combination of new client generation, expanded service offerings, increased asset-based revenue and one month of revenue from its CAI acquisition.

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 earnings, the acquisition added approximately $4.2 million in revenue for the 2012 year in the strategically important metropolitan New York marketplace.

Wealth management services revenue increased $2.2 million or 20% in 2012. 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 was reflective of the Wilber acquisition and solid organic growth in trust, and asset management services and investment product sales. Organic performance benefited from favorable market conditions and the generation of new client relationships. Wealth management services revenue in 2011 increased $0.9 million or 8.9% as compared to 2010. Personal trust revenues increased $1.6 million, principally due to incremental revenue produced by the acquired Wilber trust operations. Nottingham revenue increased $0.2 million and CBNA Insurance revenue increased $0.3 million. These increases were partially offset by $1.2 million decrease in revenue at CISI due to lower production levels for broker advisory services.

Assets under management and administration at the Company's financial services businesses increased $0.3 billion to $8.0 billion at year-end 2012 from $7.7 billion at year-end 2011, primarily as a result of the HSBC and First Niagara branch acquisitions and the addition of new client assets. Assets under management and administration increased $0.5 billion for the wealth management businesses and declined $0.2 billion at BPA in 2012. Assets under management and administration increased $1.0 billion during 2011 from $6.7 billion at year-end 2010. The increase was due to market-driven gains in equity-based assets and the addition of new client assets. BPA, in particular, was successful at growing assets in its customer base, as demonstrated by the approximately $0.5 billion increase in its assets under administration during 2011. Additionally, the acquired Wilber trust operation added $0.4 billion of assets under management in the second quarter of 2011.

Noninterest Expenses

As shown in Table 6, operating expenses increased $21.4 million, or 11.2%, in 2012 to $211.8 million and include non-recurring acquisition expenses and a litigation settlement charge as well as incremental operating expenses from the HSBC, First Niagara and CAI acquisitions. Operating expenses in 2011 were $13.5 million or 7.6% higher than 2010 primarily due primarily due to the acquisition of Wilber in April 2011, partially offset by lower FDIC premiums and lower amortization of intangibles. Operating expenses for 2012 as a percent of average assets were 2.78%, down 15 basis points from 2.93% in 2011 and 33 basis points lower than the 3.11% in 2010. The improvement in this ratio was due to effective management of operating expenses combined with the increase in average assets resulting from the HSBC, First Niagara and Wilber acquisitions. This ratio was down 18 basis points in 2011 as compared to 2010 as a result of a slower rate of increase of operating expenses in comparison to higher average assets as the Company gained operating leverage from its acquisitions.

The efficiency ratio, a performance measurement tool widely used by banks, is defined by the Company as operating expenses (excluding acquisition expenses, contract termination charges, 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 2012 was 0.2 percentage points lower than the 57.6% ratio for 2011 due to a 9.8% increase in operating expenses, as defined above, being smaller than the 10.2% increase in operating income. The increase in operating income was comprised of a 9.9% increase in net interest income and a 10.8% increase in noninterest income. In 2011 the efficiency ratio declined 1.8 percentage points as the 6.8% increase in operating expenses, as defined above, grew at a slower pace than the increase in income comprised of a 14.3% increase in net interest income and a 0.6% increase in noninterest income (excluding net securities gains and debt extinguishments costs).

Table 6: Noninterest Expenses

	Years Ended December 31,		
(000's omitted)	2012	2011	2010
Salaries and employee benefits	$112,034	$102,278	$91,399
Occupancy and equipment	25,799	24,502	22,933
Data processing and communications	23,696	20,525	20,720
Amortization of intangible assets	4,607	4,381	5,957
Legal and professional fees	7,950	5,889	5,532
Office supplies and postage	5,742	5,246	5,469
Business development and marketing	5,919	5,931	5,237
FDIC insurance premiums	3,804	3,920	5,838
Acquisition expenses, litigation settlement and contract termination charges	8,247	4,831	1,365
Other	13,959	12,869	12,436
Total noninterest expenses	$211,757	$190,372	$176,886
Operating expenses(1) /average assets	2.78%	2.93%	3.11%
Efficiency ratio	57.4%	57.6%	59.4%

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

Salaries and employee benefits increased $9.8 million or 9.5% in 2012, primarily due to the addition of approximately 145 employees from the HSBC and First Niagara branch acquisitions, 200 employees as a result of the Wilber acquisition and 30 employees from the CAI acquisition, as well as the impact of annual merit increases, partially offset by lower incentive payments in 2012 based on the achievement of the Company's annual business objectives. Total salaries and employee benefits increased $10.9 million or 11.9% in 2011, primarily due to the Wilber acquisition and the impact of annual merit increases. Total full-time equivalent staff at the end of 2012 was 1,996 compared to 1,831 at December 31, 2011 and 1,624 at the end of 2010.

Medical expenses increased $0.6 million or 7.4% in 2012 due primarily to the additional employees added from the HSBC and First Niagara branch acquisitions in 2012 and a full year of expense from the employees added with the Wilber acquisition in 2011. Medical expenses increased $0.9 million in 2011, or 12.4%, due primarily to the additional employees added from the Wilber acquisition. This year's qualified and nonqualified retirement plan expense increased $0.5 million due to the additional employees added with the Wilber acquisition, and the decrease in the liability discount rate from 4.1% to 3.4%, partially offset by higher returns on plan assets. Qualified and nonqualified pension expense in 2011 was consistent with 2010. Qualified pension plan expense decreased approximately $0.2 million due primarily to higher returns on plan assets, partially offset by a lower discount rate. The 401(k) Plan expense for 2012 increased approximately $0.2 million from 2011 due to additional participants being added as a result of the HSBC, First Niagara and Wilber acquisitions. The 401(k) Plan expense increased $0.2 million in 2011 as compared to 2010 due to the additional participants as a result of the Wilber acquisition. 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, litigation settlement and contract termination charges increased $8.2 million, or 9.9%, in 2012. Excluding incremental direct expenses related to the retail branches acquired from HSBC, First Niagara and Wilber, non-personnel noninterest expenses as defined above increased $3.8 million or 4.6%. As displayed in Table 6, this was largely caused by higher data processing and communications (up $3.2 million in total and up $2.2 million excluding incremental acquired branch expenses), legal and professional fees (up $2.1 million in total and up $1.9 million excluding the incremental acquired branch expense), occupancy & equipment (up $1.3 million in total and down $0.8 million excluding incremental acquired branch expense), property and other writedowns (up $1.3 million in total and up $0.9 million excluding incremental acquired branch expense), office supplies and postage (up $0.5 million in total and up $0.4 million excluding the incremental acquired branch expense), and amortization of intangible assets (up $0.2 million due to acquisitions), partially offset by lower FDIC insurance premiums (down $0.1 million in total and down $0.4 million excluding incremental acquired branch expense). The higher data processing and communication cost is due to increased level of company-wide technology enhancements, expenses related to the higher level of residential mortgage originations and an increased level of electronic transactions. The increase in legal and professional fees includes costs related to the litigation settlement charge, additional compliance related activities and processing costs related to the higher level of residential mortgage originations in 2012.

The Company continually evaluates all aspects of its operating expense structure and is diligent about identifying opportunities to improve operating efficiencies. During the third quarter of 2012, the Company consolidated five 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.

The FDIC imposes an assessment against all depository institutions for deposit insurance based on the risk category of the institution and the institution's deposits. Effective in April 1, 2011, the FDIC changed the calculation of the assessment to be based upon a percentage of average consolidated Bank assets less average tangible capital as opposed to a percentage of average deposits which has been used in the past. The result for Company was a savings of approximately $0.4 million and $2.0 million for 2012 and 2011, respectively, in deposit insurance assessments.

Total non-personnel noninterest expenses, excluding one-time acquisition expenses and contract termination charges decreased $0.9 million or 1.0% in 2011 versus 2010. Excluding expenses related to the retail branches acquired from Wilber, non-personnel noninterest expenses as defined above declined $6.2 million or 7.3%. As displayed in Table 6, this was largely caused by lower FDIC insurance premiums (down $1.9 million in total and down $2.3 million excluding acquired Wilber branches), amortization of intangible assets (down $1.6 million in total and down $2.2 million excluding acquired Wilber branches), data processing and communications (down $0.2 million in total and down $1.1 million excluding acquired Wilber branches), occupancy & equipment (up $1.6 million in total and down $0.1 million excluding acquired Wilber branches), partially offset by higher business development and marketing costs (up $0.7 million in total and up $0.4 million excluding the acquired Wilber branches), higher legal and professional fees (up $0.4 million in total and up $0.2 million excluding the acquired Wilber branches). Amortization of intangibles decreased in 2011, a result of accelerated amortization methodologies employed and the core deposit intangible from a 2001 acquisition became fully amortized in 2010. The lower data processing and communications costs are a result of the conversion of the Company's core banking system in the second half of 2010.

Acquisition expenses, litigation settlement and contract termination charges totaled $8.2 million in 2012 up $3.4 million from the costs incurred for acquisition and contract termination charges in the prior year. Acquisition expenses for 2012 totaled $5.7 million and were associated with the acquisition of the HSBC and First Niagara branches. Additionally, 2012 included an accrual of $2.5 million pertaining to 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 contract termination charges totaled $4.8 million in 2011, primarily associated with the Wilber acquisition which closed in April 2011, up $3.5 million from the cost incurred for acquisition and contract termination charges in the prior year. Acquisition expenses and contract termination charges totaled $1.4 million in 2010 comprised of $0.9 million of acquisition expenses related to the Wilber acquisition and $0.5 million of contract termination fees related to the core banking system conversion in the third quarter of 2010.

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 73. 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 2012 was 29.2% as compared to 29.3% in 2011, reflective of similar proportional levels of income from both fully taxable and non-taxable sources. The effective tax rate for 2011 increased 2.6 percentage points from the prior year to 29.3%, principally a result of a higher proportion of income being generated from fully taxable sources. The effective tax rate for 2010 was 26.7%, reflecting the higher level of income from fully taxable sources.

Capital

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 market value adjustment ("MVA", represents the after-tax, unrealized change in value of available-for-sale securities in the Company's investment portfolio) and a $2.9 million charge 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.

Shareholders' equity ended 2011 at $774.6 million, up $167.3 million, or 28%, from one year earlier. This increase reflects $82.6 million from shares issued in conjunction with the Wilber acquisition, net income of $73.1 million, a $38.5 million increase in accumulated other comprehensive income, $5.6 million from the issuance of shares through employee stock plans and $3.5 million from stock-based compensation. These increases were partially offset by common stock dividends declared of $36.0 million. The change in other comprehensive income was comprised of a $47.1 million increase in the MVA, a $10.6 million charge based on the funded status of the Company's employee retirement plans and a $2.0 million increase in the fair value of interest rate swaps designated as a cash flow hedge. Excluding accumulated other comprehensive income in both 2011 and 2010, capital rose by $128.8 million, or 21%. Shares outstanding increased by 3.7 million during the year comprised of 3.35 million shares added through common stock issued from treasury shares in the Wilber acquisition in the second quarter and 0.3 million added through employee stock plans.

The Company's ratio of Tier 1 capital to assets (or tier 1 leverage ratio), the basic measure for which regulators have established a 5% minimum for an institution to be considered "well-capitalized," increased two basis points to end the year at 8.40%. This was the result of a 15.7% increase in Tier 1 capital primarily, from net income generation and the public stock offering in conjunction with the HSBC and First Niagara branch acquisitions, being greater than the 15.5% year-over-year increase in fourth quarter average net assets (excludes investment market value adjustment, intangible assets net of related deferred tax liabilities and disallowed mortgage service rights) due mostly to the HSBC and First Niagara branch acquisitions. The tangible equity to tangible assets ratio was 7.62% at the end of 2012 versus 7.12% one year earlier. The increase was due to common shareholders' equity growing at a greater pace than tangible assets and includes the positive impact of the $28 million increase in the equity component of the investment market value adjustment. 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 2012 of $41.9 million represented an increase of 16.1% over the prior year. This growth was a result of the 2.13 million shares issued in January in support of the HSBC and First Niagara branch acquisitions and 0.5 million shares issued through employee stock programs. In addition, dividends per share of $1.06 for 2012 increased from $1.00 in 2011, a result of quarterly dividends per share being raised from $0.26 to $0.27 (a 3.8% increase) in the third quarter of 2012 and from $0.24 to $0.26 in the third quarter of 2011. The 2012 increase in quarterly dividends marked the twentieth consecutive year of dividend increases for the Company. The dividend payout ratio for this year was 54.3% compared to 49.3% in 2011, and 49.2% in 2010. The dividend payout ratio increased during 2012 because dividends increased 16.1% while net income increased at a slower rate of 5.4%. The payout ratio in 2011 was consistent with 2010 because dividends paid increased 15.7% while net income increased 15.5%.

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' liquidity 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 Federal Home Loan Bank of New York ("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 $728 million were outstanding at December 31, 2012.

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, 2012, the Bank had $229 million of cash and cash equivalents of which $83 million are interest-earning deposits held at the Federal Reserve. The Bank also had $597 million in unused Federal Home Loan Bank borrowing capacity based on the Company's year-end collateral levels. Additionally, the Company has $1.6 billion of unencumbered securities that could be pledged at the Federal Home Loan Bank 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, 2012, the ratios were 21.6% for 30-days and 21.8% for 90-days, excluding the Company's capacity to borrow additional funds from the Federal Home Loan Bank and other sources. There is a sufficient amount of liquidity available 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, 2012, 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, 2012 indicate the Bank has sufficient sources of funds for the next year in all stressed scenarios.

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

Though remote, the possibility of a funding crisis exists at all financial institutions. Accordingly, management has addressed this issue by formulating a Liquidity Contingency Plan, which has been reviewed and approved by both the Company's Board of Directors and the Asset Liability Management 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, 2012 are summarized as follows:

Table 7: Intangible Assets

(000's omitted)	Balance at December 31, 2011	Additions	Amortization	Impairment	Balance at December 31, 2012
Banking Segment					
Goodwill	$334,554	$24,653	$0	$0	$359,207
Core deposit intangibles	11,519	6,521	3,548	0	14,492
Total Banking Segment	346,073	31,174	3,548	0	373,699
Other Segment					
Goodwill	10,496	0	0	0	10,496
Other intangibles	3,995	3	1,059	0	2,939
Total Other Segment	14,491	3	1,059	0	13,435
Total	$360,564	$31,177	$4,607	$0	$387,134

Intangible assets at the end of 2012 totaled $387.1 million, an increase of $26.6 million from the prior year-end due to $31.2 million of additional intangible assets arising from the acquisitions of HSBC and First Niagara branches, offset by $4.6 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, 2012 totaled $369.7 million, comprised of $359.2 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 2012 and 2011 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, ABG, 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)	2012	2011	2010	2009	2008
Consumer mortgage	$1,448,415	$1,214,621	$1,057,332	$1,044,589	$1,078,545
Business lending	1,233,944	1,226,439	1,023,286	1,066,730	1,042,999
Consumer indirect	647,518	556,955	494,529	528,791	530,196
Consumer direct	171,474	149,170	146,575	139,757	149,089
Home equity	364,225	323,840	304,641	319,618	335,311
Gross loans	3,865,576	3,471,025	3,026,363	3,099,485	3,136,140
Allowance for loan losses	(42,888)	(42,213)	(42,510)	(41,910)	(39,575)
Loans, net of allowance for loan losses	$3,822,688	$3,428,812	$2,983,853	$3,057,575	$3,096,565
	$3,628,006	$3,355,286	$3,075,030	$3,104,808	$2,934,790

Daily average of total loans

As disclosed in Table 8 above, gross loans outstanding of $3.9 billion as of year-end 2012 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 and consumer indirect and direct portfolios. Excluding loans acquired from HSBC and First Niagara, loans increased $234.4 million or 6.8%. The low interest rate environment and business development efforts contributed to strong organic consumer mortgage and consumer indirect lending activity during 2012. Excluding loans acquired from HSBC and First Niagara, the business lending and home equity portfolios declined as compared to year-end 2011. The home equity portfolio, excluding loans acquired from HSBC and First Niagara 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.

The compounded annual growth rate ("CAGR") for the Company's total loan portfolio between 2008 and 2012 was 5.4%, comprised of approximately 1.1% of organic growth, with the remainder coming from acquisitions. The greatest overall expansion occurred in the consumer mortgage segment, which grew at a 7.6% 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 4.8% from 2008 to 2012. 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 4.3% driven by acquisitions during the five year period. The home equity lending segment grew at a compounded annual growth rate of 2.1% from 2008 to 2012, including the impact from acquisitions.

The weighting of the components of the Company's loan portfolio enables it to be highly diversified. Approximately 68% of loans outstanding at the end of 2012 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 2012: commercial real estate (29%), healthcare (11%), restaurant & lodging (10%), general services (8%), agriculture (7%), manufacturing (7%), retail trade (6%), construction (5%), 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 8%.

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 subprime, Alt-A or other higher-risk mortgage products. Consumer mortgages increased $233.8 million or 19% in 2012. Excluding mortgage loans acquired from HSBC and First Niagara, mortgage lending increased $189.0 million or 16%. During the year ended December 31, 2012, the Company originated and sold an additional $3.6 million of longer-term, fixed-rate residential mortgages. During the year ended December 31, 2011, the Company originated and sold $43.1 million of residential mortgages, principally to Fannie Mae. Beginning in the fourth quarter of 2011, 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 $7.5 million or 0.6% in 2012. Excluding loans acquired from HSBC and First Niagara, business lending balances declined $26.6 million from one year ago. Generating growth in this segment has remained challenging primarily due to a prolonged soft economic environment and highly competitive conditions. In addition, the Company proactively managed payout of certain unprofitable loan relationships (principally acquired) during 2012. 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 additional personnel, technology, and business development resources to further strengthen its capabilities in this important product category. During 2012 the small business lending platform was expanded to further develop efficiencies in the delivery of the loan product in this sector.

The following table shows the maturities and type of interest rates for business and construction loans as of December 31, 2012:

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	$303,636	$496,485	$426,276	$1,226,397

Real estate – construction	26,238	-	-	26,238
Total	$329,874	$496,485	$426,276	$1,252,635
Fixed or predetermined interest rates	$97,705	$222,032	$132,969	$452,706
Floating or adjustable interest rates	232,169	274,453	293,307	799,929
Total	$329,874	$496,485	$426,276	$1,252,635

(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 $112.9 million or 16% from one year ago. Excluding the impact of consumer installment loans acquired from HSBC and First Niagara, the consumer installment indirect lending portfolio had organic growth of $89.9 million or 16%, while the consumer installment direct lending portfolio increased $9.0 million or 6.0%. 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 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 increased $40.4 million or 12.5% from one year ago. Excluding the home equity loans acquired from HSBC and First Niagara, the home equity portfolio decreased $26.8 million or 8.3% 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 2011 and continued in 2012 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)	2012	2011	2010	2009	2008
Nonaccrual loans					
Consumer mortgage	$11,286	$6,520	$4,737	$4,077	$3,500
Business lending	13,691	18,535	9,715	12,103	7,734
Consumer indirect	0	2	0	54	28
Consumer direct	8	0	0	368	436
Home equity	1,375	1,205	926	558	428
Total nonaccrual loans	26,360	26,262	15,378	17,160	12,126
Accruing loans 90+ days delinquent					
Consumer mortgage	1,818	2,171	2,308	891	392
Business lending	247	399	247	662	71
Consumer indirect	73	32	131	29	34
Consumer direct	71	95	96	33	45
Home equity	539	393	309	135	11
Total accruing loans 90+ days delinquent	2,748	3,090	3,091	1,750	553
Nonperforming loans					
Consumer mortgage	13,104	8,691	7,045	4,968	3,892
Business lending	13,938	18,934	9,962	12,765	7,805
Consumer indirect	73	34	131	83	62
Consumer direct	79	95	96	401	481
Home equity	1,914	1,598	1,235	693	439
Total nonperforming loans	29,108	29,352	18,469	18,910	12,679
Other real estate (OREO)	4,788	2,682	2,011	1,429	1,059
Total nonperforming assets	$33,896	$32,034	$20,480	$20,339	$13,738
Allowance for loan losses / total loans	1.11%	1.22%	1.40%	1.35%	1.26%
Allowance for legacy loan losses / total legacy	1.21%	1.36%	1.40%	1.35%	1.26%

loans (1)					
Allowance for loan losses / nonperforming loans	147%	144%	230%	222%	312%
Allowance for legacy loans / nonperforming legacy loans (1)	171%	197%	230%	222%	312%
Nonperforming loans / total loans	0.75%	0.85%	0.61%	0.61%	0.40%
Legacy nonperforming loans / legacy total loans	0.71%	0.69%	0.61%	0.61%	0.40%
Nonperforming assets / total loans and other real estate	0.88%	0.92%	0.68%	0.66%	0.44%
Delinquent loans (30 days old to nonaccruing) to total loans	1.92%	1.99%	1.91%	1.48%	1.43%
Loan loss provision to net charge-offs	108%	94%	109%	131%	117%
Legacy loan loss provision to net charge-offs (1)	116%	86%	109%	131%	117%

(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 ninety 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 2012 at $29.1 million, down approximately $0.2 million from one year earlier. The ratio of nonperforming loans to total loans decreased 10 basis points from the prior year. Excluding nonperforming acquired loans, the ratio of nonperforming loans to total loans was 0.71%, an increase of two 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 0.88% at year-end 2012, down four basis points from one year earlier. The Company's success at keeping these ratios at favorable levels despite weak 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 2012, the Company was managing 26 OREO properties with a value of $4.8 million, as compared to 28 OREO properties with a value of $2.7 million a year earlier. The 2012 OREO balance includes two large commercial properties totaling $2.5 million. Despite the increase in OREO balances, the current level still reflects the low level of foreclosure activity in the Company's markets and its specific portfolio in comparison to national markets.

Approximately 48% of the nonperforming loans at December 31, 2012 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. With the economic downturn, certain businesses' financial performance and position have deteriorated, and consequently the level of nonperforming loans remains higher than historical levels. Approximately 45% of nonperforming loans at December 31, 2012 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 have encountered. However, the continued soft economic conditions and high unemployment levels have adversely impacted consumers and businesses alike and have resulted in higher nonperforming levels. The remaining seven 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 147% at the end of 2012 compared to 144% at year-end 2011 and 230% at December 31, 2010, reflective of the higher level of nonperforming loans. Excluding acquired loans, the ratio of allowance for legacy loans to nonperforming legacy loans was 171% at the end of 2012, compared to 197% at year-end 2011 and 230% at December 31, 2010.

Members of senior management, special asset officers, and lenders review all delinquent and nonaccrual loans and OREO regularly, in order to identify deteriorating situations, monitor known problem credits and discuss any needed changes to collection efforts, if warranted. Based on the group's consensus, a relationship may be assigned a special assets officer or other senior lending officer to review the loan, meet with the borrowers, assess the collateral and recommend an action plan. This plan could include foreclosure, restructuring 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 1.92% of total loans outstanding, versus 1.99% at the end of 2011. As of year-end 2012, total delinquency ratios for commercial loans, consumer installment loans, real estate mortgages and home equity loans were 1.91%, 1.52%, 2.15% and 1.92%, respectively. These measures were 2.38%, 1.65%, 2.12% and 1.34%, respectively, as of December 31, 2011. 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 2012 was 1.80%, as compared to an average of 1.64% in 2011 and 1.61% in 2010, 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. 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, the Company had 18 loans totaling $3.3 million considered to be nonaccruing TDRs and 189 loans totaling $3.2 million considered to be accruing TDRs.

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, 2012	2011	2010	2009	2008
Allowance for loan losses at beginning of period	$42,213	$42,510	$41,910	$39,575	$36,427
Charge-offs:					
Consumer mortgage	1,004	748	583	498	235
Business lending	5,654	2,964	3,950	3,324	2,516
Consumer indirect	5,407	4,464	4,279	5,374	4,517
Consumer direct	1,694	1,273	1,719	1,928	1,779
Home equity	423	265	181	36	29
Total charge-offs	14,182	9,714	10,712	11,160	9,076
Recoveries:					
Consumer mortgage	59	30	71	28	184
Business lending	1,295	692	730	374	478
Consumer indirect	3,551	3,200	2,569	2,517	2,038
Consumer direct	821	674	730	732	630
Home equity	23	85	7	54	7
Total recoveries	5,749	4,681	4,107	3,705	3,337
Net charge-offs	8,433	5,033	6,605	7,455	5,739
Provision for loan losses	8,715	4,350	7,205	9,790	6,730
Provision for acquired impaired loans	393	386	0	0	0
Acquired allowance for loan losses (1)	0	0	0	0	2,157
Allowance for loan losses at end of period	$42,888	$42,213	$42,510	$41,910	$39,575
Net charge-offs to average loans outstanding:					
Consumer mortgage	0.07%	0.06%	0.05%	0.04%	0.00%
Business lending	0.36%	0.19%	0.31%	0.28%	0.20%
Consumer indirect	0.31%	0.24%	0.34%	0.54%	0.53%
Consumer direct	0.54%	0.39%	0.68%	0.82%	0.74%
Home equity	0.12%	0.06%	0.06%	-0.01%	0.01%
Total loans	0.23%	0.15%	0.21%	0.24%	0.20%

(1)This addition is attributable to loans acquired from Citizens in 2008.

As displayed in Table 11 above, total net charge-offs in 2012 were $8.4 million, up $3.4 million from the prior year due to higher charge-offs in all portfolios. Net charge-offs in 2011 were $1.6 million lower than 2010's level, due to lower levels of net charge-offs in the business lending and consumer installment portfolios, partially offset by higher levels of net charge-offs in the consumer mortgage and home equity 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 2012 was up eight and two basis points from 2011 and 2010, respectively, but was one basis point lower than 2009. Gross charge-offs as a percentage of average loans was 0.39% in 2012 as compared to 0.29% in 2011 and 0.35% in 2010. Continued strong recovery efforts were evidenced by recoveries of $5.7 million in 2012, representing 48% of average gross charge-offs for the latest two years, compared to 46% in 2011 and 38% in 2010.

Business loan net charge-offs increased in 2012, totaling $4.4 million or 0.36% of average business loans outstanding versus $2.3 million or 0.19% in 2011, reflective of underlying economic conditions and their lagged effected on loan credit performance. Consumer installment loan net charge-offs increased to $2.7 million this year from $1.9 million in 2011, with a net charge-off ratio of 0.36% in 2012 and 0.27% in 2011. Higher used automobile valuations benefited consumer installment recovery efforts, which increased to 68% of average gross charge-offs for the latest two years, compared to 66% in 2011 and 55% in 2010. Consumer mortgage net charge-offs increased in 2012, and the net charge-off ratio increased one basis point to 0.07%. Home equity net charges offs increased to $0.4 million in 2012 and the net charge-off ratio increased six basis points to 0.12%.

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 (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, 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. In 2009, the Company developed and utilized more granular historical loss factors on a portfolio-specific basis, as well as enhanced its use of both Company-specific and macro-economic qualitative factors. These enhancements did not result in a significant change to the determined reserve levels.

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 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 loans 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 2012, an additional $0.4 million of provision for loan losses related to the acquired impaired loans was recorded.

For acquired loans that are not deemed impaired at acquisition, credit discounts representing the principal losses expected over the life of the loan are a component of the initial fair value. 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 pooled discounts for loans evaluated collectively for impairment. 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 $42.9 million at year-end 2012 from $42.2 million at the end of 2011. The $0.7 million increase was primarily due to the acquired non-impaired loans. The allowance for legacy loan losses remained stable as growth in the loan portfolio was offset by changes in the composition of the loan portfolio from higher risk commercial loans to lower risk consumer mortgage and consumer indirect loans. The ratio of the allowance for loan losses to total loans decreased 11 basis points to 1.11% for year-end 2012 as compared to 1.22% for 2011 and 1.40% for 2010. The ratio of allowance for loan losses to total legacy loans decreased 15 basis points to 1.21% for 2012 as compared to 2011. Management believes the year-end 2012 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 $6.5 million in 2012 increased by $2.1 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 0.25% in 2012 as compared to 0.14% in 2011 and 0.23% in 2010. The loan loss provision was 108% of net charge-offs this year versus 94% in 2011 and 109% in 2010, 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

	2012		2011		2010		2009		2008	
(000's omitted except for ratios)	Allowance	Loan Mix	Allowance	Loan Mix	Allowance	Loan Mix	Allowance	Loan Mix	Allowance	Loan Mix
Consumer mortgage	$7,070	37.5%	$4,651	35.0%	$2,451	34.9%	$1,127	33.7%	$3,298	34.4%
Business lending	18,013	31.6%	20,574	34.8%	22,326	33.8%	23,577	34.4%	18,750	33.3%
Consumer installment - indirect	9,606	16.7%	8,960	16.1%	9,922	16.4%	10,004	17.1%	8,031	16.9%
Consumer installment - direct	3,303	4.4%	3,290	4.3%	3,977	4.8%	3,660	4.5%	2,625	4.7%
Home equity	1,451	9.4%	1,130	9.3%	689	10.1%	374	10.3%	1,570	10.7%
Acquired impaired loans	779	0.4%	386	0.5%	0		0		0	
Unallocated	2,666		3,222		3,145		3,168		5,301	
Total	$42,888	100.0%	$42,213	100.0%	$42,510	100.0%	$41,910	100.0%	$39,575	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 in 2011 to $2.7 million in 2012. 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

	2012		2011		2010	
	Average	Average	Average	Average	Average	Average
(000's omitted, except rates)	Balance	Rate Paid	Balance	Rate Paid	Balance	Rate Paid
Noninterest checking deposits	$989,631	0.00%	$825,277	0.00%	$728,408	0.00%
Interest checking deposits	1,036,249	0.06%	855,693	0.16%	710,464	0.21%
Regular savings deposits	806,310	0.16%	628,394	0.23%	532,475	0.26%
Money market deposits	1,327,092	0.38%	1,156,152	0.63%	950,573	0.90%
Time deposits	1,062,307	1.06%	1,101,013			