COMMUNITY BANK SYSTEM INC
Form 10-K
February 29, 2012

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, 2011

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, 2011 (the registrant's most recently completed second fiscal quarter): $858,986,069.

The number of shares of the common stock, $1.00 par value, outstanding as of the close of business on January 31, 2012: 39,196,328 shares

DOCUMENTS INCORPORATED BY REFERENCE.

Portions of the Definitive Proxy Statement for the Annual Meeting of the Shareholders to be held on May 9, 2012 (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. 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. The Bank operates 168 customer facilities 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: Community Investment Services, Inc. ("CISI"), CBNA Treasury Management Corporation ("TMC"), CBNA Preferred Funding Corporation ("PFC"), Nottingham Advisors, Inc. ("Nottingham"), First Liberty Service Corp. ("FLSC"), Brilie Corporation ("Brilie"), CBNA Insurance Agency, Inc. ("CBNA Insurance") and Western Catskill Realty, LLC ("WCR"). CISI provides broker-dealer and investment advisory services. TMC provides cash management, investment, and treasury services to the Bank. PFC primarily acts as an investor in residential real estate loans. Nottingham provides asset management services to individuals, corporate pension and profit sharing plans, and foundations. FLSC provides banking-related services to the Pennsylvania branches of the Bank. Brilie and WCR are inactive companies. CBNA Insurance is a full-service insurance agency offering primarily property and casualty products.

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.

On January 19, 2012, the Bank, the wholly-owned banking subsidiary of the Company, entered into an Assignment, Purchase and Assumption Agreement (the "HSBC Branch Agreement") and a Purchase and Assumption Agreement (the "First Niagara Branch Agreement") (collectively, the "Agreements") with First Niagara Bank, N.A. ("First Niagara"). Under the Agreements, the Bank will acquire 19 branches in Central, Northern, and Western New York consisting of three branches purchased directly from First Niagara and 16 branches which are currently owned by HSBC Bank USA, National Association ("HSBC"). First Niagara is assigning its rights to the HSBC branches in connection with its pending acquisition of HSBC's Upstate New York banking franchise. Upon its completion, the branch acquisitions will strengthen and extend the Company's Upstate New York presence. Under the terms of the Agreements, Community Bank will acquire approximately $218 million in loans and $955 million in deposits at a blended deposit premium of 3.22%. The branch acquisitions are expected to close during the third quarter of 2012 subject to regulatory review and approval and customary closing conditions. The Company expects to incur certain one-time, transaction-related costs in 2012.

The Company completed a public stock offering in late January 2012. The offering 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 intends to use the net proceeds from this offering to support the HSBC and First Niagara branch acquisitions.

Acquisition History (2007-2011)

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 is expected to add approximately $4 million of revenue to this business line in 2012.

The Wilber Corporation Acquisition
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 Acquisition
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.

TLNB Financial Corporation
On June 1, 2007, the Company acquired TLNB Financial Corporation, parent company of Tupper Lake National Bank ("TLNB"), in an all-cash transaction valued at approximately $17.8 million. Based in Tupper Lake, New York, TLNB operated five branches in the northeastern New York State cities of Tupper Lake, Plattsburgh and Saranac Lake, as well as an insurance subsidiary, TLNB Insurance Agency, Inc.

Hand Benefits & Trust, Company
On May 18, 2007, BPAS acquired HB&T in an all-cash transaction. HB&T was a Houston, Texas based provider of employee benefit plan administration and trust 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 6/30/2011 (000's omitted)	Market Share (1)	Facilities	ATM's	Towns/ Cities	Towns Where Company Has 1st or 2nd Market Position
Hamilton	NY	$35,739	52.50%	2	1	2	2
Lewis	NY	113,165	46.57%	4	4	3	3
Franklin	NY	244,835	46.07%	8	8	7	6
Allegany	NY	205,771	44.42%	9	10	8	8
Otsego	NY	427,769	40.69%	10	9	6	5
Yates	NY	89,144	30.32%	2	2	1	0
Cattaraugus	NY	313,215	29.24%	10	9	6	7
Wyoming	PA	121,304	24.23%	4	3	3	3
Seneca	NY	96,158	23.97%	4	3	4	2
St. Lawrence	NY	372,524	22.66%	14	8	11	10
Essex	NY	117,357	19.93%	6	5	5	5
Clinton	NY	240,334	16.52%	5	7	2	2
Chautauqua	NY	257,785	15.02%	12	12	10	7
Delaware	NY	161,538	13.68%	5	4	5	5
Schuyler	NY	19,625	12.36%	1	1	1	0
Jefferson	NY	201,103	11.56%	5	5	4	2
Livingston	NY	86,018	10.25%	3	4	3	3
Ontario	NY	151,205	8.73%	7	12	6	4
Schoharie	NY	32,763	8.48%	1	1	1	0
Steuben	NY	171,285	7.90%	8	7	7	4
Lackawanna	PA	404,132	7.76%	11	11	8	4
Tioga	NY	31,465	7.63%	2	2	2	1
Chenango	NY	42,282	7.19%	2	2	1	1
Chemung	NY	80,554	7.08%	2	2	1	0
Herkimer	NY	40,003	6.67%	1	1	1	1
Susquehanna	PA	37,363	5.51%	3	1	3	2
Wayne	NY	55,181	5.12%	2	4	2	1
Cayuga	NY	42,963	4.28%	2	2	2	1
Luzerne	PA	232,719	3.67%	6	7	6	3
Oswego	NY	49,051	3.59%	2	2	2	2
Washington	NY	19,238	3.05%	1	0	1	1
Bradford	PA	29,293	2.55%	2	2	2	1
Warren	NY	34,311	2.44%	1	1	1	1
Oneida	NY	53,878	1.17%	2	1	1	1
Broome	NY	39,611	0.83%	1	1	1	1
Ulster	NY	24,981	0.65%	1	1	1	1

Saratoga	NY	15,126	0.41%	1	1	1	0
Onondaga	NY	25,064	0.26%	2	3	2	0
Tompkins	NY	4,946	0.21%	1	0	1	0
Erie	NY	46,426	0.19%	3	3	3	1
		$4,767,224	5.09%	168	162	137	101

(1) Deposit market share data as of June 30, 2011 the most recent information available.
Source: SNL Financial LLC

Employees

As of December 31, 2011, the Company employed 1,784 full-time employees, 144 part-time employees and 102 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 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 Federal Deposit Insurance Corporation ("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. Nottingham Advisors, Inc., Community Investment Services, Inc. and Hand Securities, Inc. are subject to the jurisdiction of the SEC, the New York Stock Exchange, 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, through 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 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 larger financial institutions; 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 provide 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 a new agency responsible for implementing, examining, and enforcing compliance with federal consumer financial laws under the newly created Consumer Financial Protection Bureau ("CFPB").
- 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.

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, and various state law counterparts.

The Dodd-Frank Act creates 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.

The Emergency Economic Stabilization Act of 2008

The Emergency Economic Stabilization Act of 2008 ("EESA") provides the U.S. Secretary of the Treasury with broad authority to implement certain actions to help restore stability and liquidity to U.S. markets. The EESA authorizes the U.S. Treasury to, among other things, purchase up to $700 billion of mortgages, mortgage-backed securities and certain other financial instruments from financial institutions for the purpose of stabilizing and providing liquidity to the U.S. financial markets. The Company did not originate or invest in sub-prime assets and, therefore, does not expect to participate in the sale of any of our assets into these programs. One of the provisions resulting from the legislation is the Troubled Asset Relief Program Capital Purchase Program ("TARP Capital Purchase Program"), which provides direct equity investment in perpetual preferred stock by the U.S. Treasury Department in qualified financial institutions. The program is voluntary and requires an institution to comply with a number of restrictions and provisions, including limits on executive compensation, stock redemptions, and declaration of dividends. The Company chose not to participate in the TARP Capital Purchase Program.

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.

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 are unprecedented.

From December 2007 through June 2009, the U.S. economy was in recession. Although 2010 and 2011 have experienced modest improvements, 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. 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 Wall Street Reform and Consumer Protection Act (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 Consumer Financial Protection Bureau (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 examinations 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.

Dodd-Frank provided that debit card interchange fees must be reasonable and proportional to the cost incurred by the issuer with respect to the transaction. This provision is known as the Durbin Amendment. In June 2011, the Federal Reserve Board adopted regulations setting the maximum permissible interchange fee as the sum of 21 cents per transaction and 5 basis points multiplied by the value of the transaction, with an additional adjustment of up to one cent per transaction if the issuer implements certain fraud-prevention standards. While the restrictions on interchange fees do not apply to banks that, together with their affiliates, have assets of less than $10 billion, the rule could affect the competitiveness of debit cards issued by smaller banks.

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 Company may be subject to more stringent capital requirements.

As discussed above, 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 loss 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 fourth quarter of 2009 and for all of 2010, 2011 and 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 premiums for the Company. 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, 2011, 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. The Company has announced that it has entered into a definitive agreement to acquire 19 branch-banking centers from First Niagara and HSBC. The acquisition is expected to close during the third quarter of 2012. This acquisition and 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, 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. 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 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 $37.3 million as of December 31, 2011. 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. During the third quarter of 2010, the Company converted its core loan, deposit and financial reporting information technology platform from an outsourced, third-party provided system to an in-house, integrated solution. Although the Company expects to benefit from the enhanced functionality and process efficiencies of the new system, the conversion has created certain processing difficulties and continues to include the risk of integrating newly acquired banks and branches into the existing platform.

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 194 properties located in the counties identified in the table on page 5, of which 122 are owned and 72 are under lease arrangements. In total, the Company operates 168 full-service branches, 14 are other customer service facilities for our financial service subsidiaries and 12 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, 2011 had a net book value of $60.3 million and none of the properties were subject to any material encumbrances. For the year ended December 31, 2011, rental fees of $4.2 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. Management, after consultation with legal counsel, does not anticipate that the aggregate liability, if any, arising out of litigation pending against the Company or its subsidiaries will have a material effect on the Company's consolidated financial position or results of operations.

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	51	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	47	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	55	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	55	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 36,986,409 shares of common stock outstanding on December 31, 2011, held by approximately 3,716 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
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
2010			
4th	$28.95	$22.12	$0.24
3rd	$25.93	$21.52	$0.24
2nd	$26.49	$21.33	$0.24
1st	$24.25	$17.81	$0.22

The Company has historically paid regular quarterly cash dividends on its common stock, and declared a cash dividend of $0.26 per share for the first quarter of 2012. 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 Company completed a public stock offering in late January 2012. The offering 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 intends to use the net proceeds from this offering to support the HSBC and First Niagara branch acquisitions.

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, 2006 and reinvestment of dividends.

The following table provides information as of December 31, 2011 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	600,420	$20.11	0
2004 Long-term Incentive Plan	2,616,436	$19.52	1,741,682
Total	3,216,856	$19.63	1,741,682

(1) The number of securities includes unvested restricted stock issued of 269,641.

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. 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 2011 or 2010. At its December 2011 meeting, the Board approved extending the stock repurchase program authorizing the repurchase, at the discretion of senior management, of up to 1,500,000 shares through December 31, 2012.

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, 2011. 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)	2011	2010	2009	2008	2007
Income Statement Data:					
Loan interest income	$192,981	$178,703	$185,119	$186,833	$186,784
Investment interest income	77,988	69,578	63,663	64,026	69,453
Interest expense	61,556	66,597	83,282	102,352	120,263
Net interest income	209,413	181,684	165,500	148,507	135,974
Provision for loan losses	4,736	7,205	9,790	6,730	2,004
Noninterest income	89,283	88,792	83,528	73,244	63,260
Gain (loss) on investment securities & early retirement of long-term borrowings	(61)	0	7	230	(9,974)
Acquisition expenses & contract termination charges	4,831	1,365	1,621	1,399	382
Other noninterest expenses	185,541	175,521	184,557	157,163	141,692
Income before income taxes	103,527	86,385	53,067	56,689	45,182
Net income	73,142	63,320	41,445	45,940	42,891
Diluted earnings per share (1)	2.01	1.89	1.26	1.49	1.42
Balance Sheet Data:					
Cash equivalents	$203,082	$114,996	$257,812	$112,181	$4,533
Investment securities	2,151,370	1,742,324	1,487,127	1,395,011	1,391,872
Loans, net of unearned discount	3,471,025	3,026,363	3,099,485	3,136,140	2,821,055
Allowance for loan losses	(42,213)	(42,510)	(41,910)	(39,575)	(36,427)
Intangible assets	360,564	311,714	317,671	328,624	256,216
Total assets	6,488,275	5,444,506	5,402,813	5,174,552	4,697,502
Deposits	4,795,245	3,934,045	3,924,486	3,700,812	3,228,464
Borrowings	830,329	830,484	856,778	862,533	929,328
Shareholders’ equity	774,583	607,258	565,697	544,651	478,784
Capital and Related Ratios:					
Cash dividends declared per share	$1.00	$0.94	$0.88	$0.86	$0.82
Book value per share	20.94	18.23	17.25	16.69	16.16
Tangible book value per share (2)	11.85	9.49	8.09	6.62	7.51
Market capitalization (in millions)	1,028	925	633	796	589
Tier 1 leverage ratio	8.38%	8.23%	7.39%	7.22%	7.77%
Total risk-based capital to risk-adjusted assets	15.51%	14.74%	13.03%	12.53%	14.05%
Tangible equity to tangible assets (2)	7.12%	6.14%	5.20%	4.74%	5.01%
Dividend payout ratio	49.3%	49.2%	69.5%	57.3%	57.1%
	36,986	33,319	32,800	32,633	29,635

Period end common shares outstanding					
Diluted weighted-average shares outstanding	36,454	33,553	32,992	30,826	30,232
Selected Performance Ratios:					
Return on average assets	1.18%	1.16%	0.78%	0.97%	0.93%
Return on average equity	10.36%	10.66%	7.46%	9.23%	9.20%
Net interest margin	4.07%	4.04%	3.80%	3.82%	3.64%
Noninterest income/operating income (FTE)	28.4%	31.1%	31.6%	31.0%	26.1%
Efficiency ratio (3)	57.6%	59.4%	65.5%	62.7%	63.3%
Asset Quality Ratios:					
Allowance for loan losses/total loans	1.22%	1.40%	1.35%	1.26%	1.29%
Nonperforming loans/total loans	0.85%	0.61%	0.61%	0.40%	0.32%
Allowance for loan losses/nonperforming loans	144%	230%	222%	312%	410%
Net charge-offs/average loans	0.15%	0.21%	0.24%	0.20%	0.10%
Loan loss provision/net charge-offs	94%	109%	131%	117%	76%

(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 19 and the Company's Consolidated Financial Statements and related notes that appear on pages 49 through 88. 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 2011, "last year" and equivalent terms refer to calendar year 2010, 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 46.

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.

- 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 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 54.

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 Wilber, 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. The transaction is expected to add approximately $4 million of revenue to this business line in 2012.

The Company reported net income for the year ended December 31, 2011 of $73.1 million or 16% above 2010's reported net income of $63.3 million. Earnings per share of $2.01 for the full year 2011 were $0.12 or 6.3% above the prior year level. The increase was due to higher revenue from both increased net interest income, as a result of earning asset growth, a higher net interest margin, and non-interest income. Also contributing to higher net income was a lower provision for loan losses. These were partially offset by higher operating expenses and a higher effective income tax rate due to a higher proportional level of fully taxable income. The 2011 results included $4.8 million or $0.09 per share of acquisition expenses related to the Company's merger with Wilber in early April 2011, as compared to $1.4 million or $0.03 per share of acquisition expenses in 2010.

Asset quality remained favorable in 2011, with lower loan net charge-offs and a lower provision for loan losses. Year-end non-performing loan ratios and loan delinquency ratios increased, but remained much better than peer company averages. The Company experienced year-over-year growth in interest-earning assets, reflective of the Wilber acquisition which added approximately $462 million of loans and $297 million of investments in the second quarter of 2011. Average deposits increased in 2011 as compared to 2010, reflective of the Wilber acquisition and organic growth in core deposits, offset by a reduction in time deposit balances. Average external borrowings were down slightly from 2010.

On January 19, 2012, the Bank, entered into the HSBC Branch Agreement and the First Niagara Branch Agreement with First Niagara. Under the Agreements, the Bank will acquire 19 branches in Central, Northern, and Western New York consisting of three branches purchased directly from First Niagara and 16 branches which are currently owned by HSBC. First Niagara is assigning its rights to the HSBC branches in connection with its pending acquisition of HSBC's Upstate New York banking franchise. The branch acquisitions will strengthen and extend the Company's Upstate New York presence. Under the terms of the Agreements, the Bank will acquire approximately $218 million in loans and $955 million in deposits at a blended deposit premium of 3.22%. The branch acquisitions are expected to close during the third quarter of 2012 subject to regulatory review and approval and customary closing conditions. The Company expects to incur certain one-time, transaction-related costs in 2012.

The Company completed public stock offering in late January 2012. The offering raised $57.5 million through the issuance of 2.13 million shares. The net proceeds of the offering were approximately $54.9. The Company intends to use the net proceeds from this offering to support the HSBC and First Niagara branch acquisitions.

Net Income and Profitability

Net income for 2011 was $73.1 million, an increase of $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 of $1.89. The 2011 results included $4.8 million, or $0.09 per share, of acquisition expenses related principally to the Company's acquisition of

Wilber, which was completed in the second quarter of 2011. The 2010 results included $1.4 million, or $0.03 per share of acquisition expenses, principally related to the Wilber acquisition.

Net income for 2010 was $63.3 million, up $21.9 million, or 53% from 2009's earnings of $41.4 million. Earnings per share for 2010 were $1.89, up 50% from 2009's earnings per share. The 2010 results included $1.4 million, or $0.03 per share of acquisition expenses principally related to the Wilber acquisition. The 2009 results included a $3.1 million or $0.07 per share non-cash charge for impairment of goodwill associated with the Company's wealth management business as well as a $1.4 million or $0.03 per share special charge related to the planned early termination of its core banking system services contract in 2010. Additionally, during 2009, FDIC insurance costs increased $6.9 million or $0.16 per share as compared to 2008 and included a $2.5 million one-time special assessment charge.

Table 1: Condensed Income Statements

(000's omitted, except per share data)	Years Ended December 31, 2011	2010	2009	2008	2007
Net interest income	$209,413	$181,684	$165,500	$148,507	$135,974
Loan loss provision	4,736	7,205	9,790	6,730	2,004
Noninterest income	89,222	88,792	83,535	73,474	53,286
Operating expenses	190,372	176,886	186,178	158,562	142,074
Income before taxes	103,527	86,385	53,067	56,689	45,182
Income taxes	30,385	23,065	11,622	10,749	2,291
Net income	$73,142	$63,320	$41,445	$45,940	$42,891
Diluted earnings per share	$2.01	$1.89	$1.26	$1.49	$1.42

The primary factors explaining 2011 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 $27.7 million, or 15.3%, due to a $656.4 million increase in average earning assets combined with a three-basis point increase in the net interest margin. Average loans grew $280.3 million due to the acquisition of Wilber 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 increased $333.5 million or 19% in 2011 due to the investments acquired from Wilber and organic deposit growth. Short-term cash equivalents increased $101.4 million as compared to 2010. Average interest-bearing deposits increased $516.7 million or 16% due to the Wilber acquisition and organic growth. Average borrowings decreased slightly from the prior year.

- The loan loss provision of $4.7 million decreased $2.5 million, or 34%, from the prior year level. Net charge-offs of $5.0 million declined by $1.6 million from 2010, decreasing the net charge-off ratio (net charge-offs / total average loans) to 0.15% for the year. Nonperforming loans as a percentage of total loans and nonperforming assets as a percentage of loans and other real estate owned, increased in the fourth quarter primarily due to two commercial lending relationships, but 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 36 through 40.

- Noninterest income for 2011 of $89.2 million increased by $0.4 million, or 0.5%, from 2010's level due to growth in financial services revenue, partially offset by lower fees from banking services. Fees from banking services were $2.4 million or 4.8%, lower primarily due to decreased activity in the secondary mortgage banking business and lower deposit service fees due to lower utilization of overdraft protection programs, partially offset by higher debit card related revenues. Financial services revenue was up $2.8 million, or 7.2%, with solid growth in almost all lines of business.

- Total operating expenses increased $13.5 million, or 7.6%, in 2011 to $190.4 million, primarily due to the additional operating costs associated with the Wilber acquisition, partially offset by lower FDIC insurance costs and lower amortization of intangibles.

- The Company's combined effective federal and state income tax rate increased 2.7 percentage points in 2011 to 29.4%, reflective of a higher proportion of income from fully 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

	2011	2010	2009
Return on average assets	1.18%	1.16%	0.78%
Return on average equity	10.36%	10.66%	7.46%
Dividend payout ratio	49.3%	49.2%	69.5%
Average equity to average assets	11.42%	10.89%	10.44%

As displayed in Table 2 above, the returns on average assets increased in 2011 as compared to both 2010 and 2009 and the return on equity was down slightly from 2010 and up significantly from 2009. The increase in comparison to both years 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 declined in 2011 despite strong earnings growth because of the equity issued in conjunction with the Wilber acquisition, build up of capital through earnings retention and a substantial increase in the equity components of the investment market value adjustment due mostly to a decrease in medium to long-term interest rates.

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. The dividend payout ratio for 2010 was below 2009 primarily due to the significant increase in net income partially offset by a smaller increase in the dividend declared. In 2010 net income increased 53% while dividends declared increased 8.2% as a result of a 6.8% increase in the dividend per share and a 1.6% increase in the number of shares outstanding.

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 $225.1 million in 2011, up $28.2 million, or 14%, from the prior year. A $656.4 million increase in average interest-earning assets and a three-basis point increase in the net interest margin more than offset a $510.5 million increase in average interest-bearing liabilities. As reflected in Table 4, the volume changes increased net interest income by approximately $26.7 million, while the higher net interest margin had a $1.5 million favorable impact.

The net interest margin increased three basis points from 4.04% in 2010 to 4.07% in 2011. This 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 the earning-asset yields. The yield on loans decreased five basis points in 2011, due to new volume coming on at lower yields in the current low-rate environment than the loans maturing or being prepaid and variable and adjustable rate loans repricing downward. The yield on investments, including cash equivalents, decreased from 4.70% in 2010 to 4.27% in 2011, with the yield decline being muted by the effective deployment of cash into higher yielding securities. 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 net interest margin in 2010 was 4.04%, compared to 3.80% in 2009. This 24-basis point increase was primarily attributable to a 43-basis point decrease in interest-bearing liability yields having a greater impact than a 13-basis point decrease in earning-asset yields. The decreased cost of funds was reflective of deposit rate reductions throughout 2009 and 2010. Additionally, the proportion of customer deposits in higher cost time deposits declined 7.1 percentage points during 2010, while the percentage of deposits in non-interest bearing and lower cost checking and money market accounts increased throughout 2009 and 2010. The yield on loans decreased 15 basis points in 2010, mostly as a result of the low interest rate environment. The yield on investments, including cash equivalents, decreased from 4.73% in 2009 to 4.70% in 2010, with the yield decline being muted by the effective deployment of cash into higher yielding securities during 2010.

As shown in Table 3, total interest income increased by $23.2 million, or 8.8%, in 2011 from 2010. 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 interest income decreased by $1.0 million, or 0.4% in 2010 from 2009's level. Table 4 indicates that higher average earning assets contributed a positive $5.3 million variance offset by lower yields with a negative impact of $6.3 million. Average loans declined a total of $29.8 million in 2010, adversely impacted by economic and demand conditions. Loan interest income and fees declined $6.4 million in 2010 as compared to 2009, attributable to a 15-basis point decrease in loan yields and the lower average loan balances. Investment interest income, including cash equivalents, on an FTE basis in 2010 of $84.3 million was $5.4 million or 6.8% higher than the prior year as a result of a larger portfolio, partially offset by a three-basis point decrease in the investment yield. Average investments for 2010 were $287.7 million higher than 2009, while overnight invested cash equivalents declined $161.0 million from 2009 reflective of the deployment during the first quarter of 2010 of a portion of the Company's excess liquidity into intermediate-term U.S. Treasury securities.

The earning-asset yield declined 22 basis points to 5.19% in 2011 from 5.41% in 2010 because of the previously mentioned decrease in loan and investment yields. The change in the earning-asset yield is primarily a result of variable and adjustable-rate loans repricing downward and lower rates on new loan volume and investment purchases due to the decline in interest rates to levels below those prevalent in prior years, as well as the Company's increased holding of lower-yielding cash instruments, as it maintained a liquid position in anticipation of improved investment opportunities in future periods. The earning-asset yield declined 13 basis points from 2009 to 5.51% in 2010 because of the previously mentioned decreases in loan and investment yields, partially offset by the higher interest rates earned on the redeployment of cash equivalents into U.S. Treasury Securities.

Total average funding (deposits and borrowings) in 2011 increased $607.4 million or 12.7%. Deposits increased $613.6 million, $559.7 million attributable to the Wilber acquisition and a $53.9 million increase in organic deposits. Consistent with the Company's funding mix objective, organic average core deposit balances increased $207.1 million, while time deposits declined $153.2 million on an organic basis year-over-year. Average external borrowings decreased $6.2 million in 2011 as compared to the prior year. In 2010 total average funding increased $85.6 million or 1.8%. Deposits increased $105.5 million due to organic growth. Consistent with the Company's funding mix objective, average core deposit balances increased $400.1 million, while time deposits were managed downward $294.6 million over the year. Average external borrowings decreased $19.8 million in 2010 as compared to the prior year.

The cost of funding, including the impact of non-interest checking deposits, decreased 25 basis points during 2011 to 1.14% as compared to 1.39% for 2010. 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. Additionally, the Company focused on expanding core account relationships while time deposit balances were allowed to decline. The cost of funding decreased 38 basis points during 2010 to 1.39% as compared to 1.77% for 2009. Interest rates on deposit accounts were lowered throughout 2010, with decreases in all product offerings. Additionally, the proportion of customer deposits in higher cost time deposits in 2010 declined 7.1 percentage points in comparison to the prior year, while the percentage of deposits in non-interest bearing and lower cost checking accounts increased.

Total interest expense decreased by $5.0 million to $61.6 million in 2011. As shown in Table 4, lower interest rates on deposits and external borrowings resulted in $12.8 million of this decrease, while higher deposit balances, partially offset by the lower external borrowings balance, accounted for an increase of $7.7 million in interest expense. Interest expense as a percentage of earning assets decreased by 26 basis points to 1.11%. The rate on interest-bearing deposits decreased 25 basis points to 0.70%, due largely to reductions of time deposit and money market rates throughout 2011 and the previously discussed balance decline of higher rate time deposits. The rate on external borrowings decreased four basis points to 4.25% in 2011. Total interest expense decreased by $16.7 million to $66.6 million in 2010 as compared to 2009. Lower interest rates on interest-bearing liabilities accounted for $17.6 million of this decrease, while the higher interest-bearing liability balances accounted for an increase of $0.9 million in interest expense. In

2010, the rate on interest-bearing deposits decreased 50 basis points to 0.95% and the rate on external borrowings decreased eight basis points to 4.29%.

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, 2011, 2010 and 2009. Interest income and yields are on a fully tax-equivalent basis using marginal income tax rates of 38.8% in 2011 and 38.5% in 2010 and 2009. 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, 2011			Year Ended December 31, 2010			Year Ended December 31, 2009		
(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	$202,885	$503	0.25%	$101,507	$255	0.25%	$262,479	$682	0.26%
Taxable investment securities (1)	1,398,437	56,982	4.07%	1,154,780	48,388	4.19%	848,963	40,481	4.77%
Nontaxable investment securities (1)	568,295	35,207	6.20%	537,216	35,624	6.63%	555,353	37,704	6.79%
Loans (net of unearned discount)(2)	3,355,286	193,951	5.78%	3,075,030	179,215	5.83%	3,104,808	185,587	5.98%
Total interest-earning assets	5,524,903	286,643	5.19%	4,868,533	263,482	5.41%	4,771,603	264,454	5.54%
Noninterest-earning assets	659,267			590,464			546,595		
Total assets	$6,184,170			$5,458,997			$5,318,198		
Interest-bearing liabilities:									
Interest checking, savings and money market deposits	$2,640,239	10,103	0.38%	$2,193,512	11,399	0.52%	$1,835,138	11,448	0.62%
Time deposits	1,101,013	16,053	1.46%	1,030,995	19,160	1.86%	1,325,598	34,328	2.59%
Borrowings	833,075	35,400	4.25%	839,314	36,038	4.29%	859,155	37,506	4.37%
Total interest-bearing liabilities	4,574,327	61,556	1.35%	4,063,821	66,597	1.64%	4,019,891	83,282	2.07%
Noninterest-bearing liabilities:									
Noninterest checking deposits	825,277			728,408			686,692		

Other liabilities	78,221		72,520		56,147	
Shareholders' equity	706,345		594,248		555,468	
Total liabilities and shareholders' equity	$6,184,170		$5,458,997		$5,318,198	
Net interest earnings		$225,087		$196,885		$181,172
Net interest spread		3.84%				