NBT BANCORP INC
Form 10-K
March 01, 2019

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549
FORM 10-K
ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE
SECURITIES EXCHANGE ACT OF 1934
FOR THE FISCAL YEAR ENDED DECEMBER 31, 2018
COMMISSION FILE NUMBER: 0-14703

NBT BANCORP INC.
(Exact name of registrant as specified in its charter)

| Delaware | 16-1268674 |
|---|---|
| (State or other jurisdiction of incorporation or organization) | (IRS Employer Identification No.) |

52 SOUTH BROAD STREET
NORWICH, NEW YORK 13815
(Address of principal executive office) (Zip Code)
(607) 337-2265 (Registrant's telephone number, including area code)

Securities registered pursuant to section 12(b) of the Act:

| Title of each class: | Name of each exchange on which registered: |
|---|---|
| Common Stock, par value $0.01 per share | The NASDAQ Stock Market LLC |

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 No

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 No

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

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

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 to this Form 10-K.

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

| Large accelerated filer | Accelerated filer | Non-accelerated filer | Smaller reporting company | Emerging growth Company |
| --- | --- | --- | --- | --- |

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

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

Based on the closing price of the registrant’s common stock as of June 30, 2018, the aggregate market value of the voting stock, common stock, par value, $0.01 per share, held by non-affiliates of the registrant is $1,616,972,258.

The number of shares of common stock outstanding as of February 11, 2019, was 43,731,476.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant's definitive Proxy Statement for its Annual Meeting of Stockholders to be held on May 21, 2019 are incorporated by reference into Part III, Items 10, 11, 12, 13 and 14 of this Form 10-K.

NBT BANCORP INC.
FORM 10-K – Year Ended December 31, 2018

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PART I

ITEM 1. Business

NBT Bancorp Inc. (the "Registrant" or the "Company") is a registered financial holding company incorporated in the state of Delaware in 1986, with its principal headquarters located in Norwich, New York. The Company, on a consolidated basis, at December 31, 2018 had assets of $9.6 billion and stockholders' equity of $1.0 billion.

The principal assets of the Registrant consist of all of the outstanding shares of common stock of its subsidiaries, including NBT Bank, National Association (the "Bank"), NBT Financial Services, Inc. ("NBT Financial"), NBT Holdings, Inc. ("NBT Holdings"), CNBF Capital Trust I, NBT Statutory Trust I, NBT Statutory Trust II, Alliance Financial Capital Trust I and Alliance Financial Capital Trust II (collectively, the "Trusts"). The Company's principal sources of revenue are the management fees and dividends it receives from the Bank, NBT Financial and NBT Holdings.

The Company's business, primarily conducted through the Bank, consists of providing commercial banking, retail banking and wealth management services primarily to customers in its market area, which includes central and upstate New York, northeastern Pennsylvania, southern New Hampshire, western Massachusetts, Vermont and the southern coastal Maine area. The Company has been, and intends to continue to be, a community-oriented financial institution offering a variety of financial services. The Company's business philosophy is to operate as a community bank with local decision-making, providing a broad array of banking and financial services to retail, commercial and municipal customers. The financial condition and operating results of the Company are dependent on its net interest income, which is the difference between the interest and dividend income earned on its earning assets, primarily loans and investments and the interest expense paid on its interest bearing liabilities, primarily consisting of deposits and borrowings. Among other factors, net income is also affected by provisions for loan losses and noninterest income, such as service charges on deposit accounts, insurance and other financial services revenue, trust revenue and gains/losses on securities sales, bank owned life insurance income, ATM and debit card fees and retirement plan administration fees, as well as noninterest expense, such as salaries and employee benefits, occupancy, equipment, data processing and communications, professional fees and outside services, office supplies and postage, amortization of intangible assets, loan collection and other real estate owned ("OREO") expenses, advertising, FDIC expenses and other expenses.

Some of the market areas that the Company serves are experiencing economic challenges and volatility. A variety of factors (e.g., any substantial rise in inflation or rise in unemployment rates, decrease in consumer confidence, adverse international economic conditions, natural disasters, war or political instability) may adversely affect both the Company's markets and the national market. The Company will continue to emphasize effectively managing its funding costs and lending and investment rates to maintain profitability. In addition, the Company will continue to seek and maintain relationships that can generate noninterest income. We anticipate that this approach should help mitigate profit fluctuations that are caused by movements in interest rates, business and consumer loan cycles and local economic factors.

NBT Bank, N.A.

The Bank is a full service commercial bank formed in 1856, which provides a broad range of financial products to individuals, corporations and municipalities throughout the central and upstate New York, northeastern Pennsylvania, western Massachusetts, southern New Hampshire, Vermont and southern coastal Maine market areas.

Through its network of branch locations, the Bank offers a wide range of products and services tailored to individuals, businesses and municipalities. Deposit products offered by the Bank include demand deposit accounts, savings accounts, negotiable order of withdrawal ("NOW") accounts, money market deposit accounts ("MMDA") and certificate

of deposit ("CD") accounts. The Bank offers various types of each deposit account to accommodate the needs of its customers with varying rates, terms and features. Loan products offered by the Bank include indirect and direct consumer loans, home equity loans, mortgages, business banking loans and commercial loans, with varying rates, terms and features to accommodate the needs of its customers. The Bank also offers various other products and services through its branch network such as trust and investment services and financial planning and life insurance services. In addition to its branch network, the Bank also offers access to certain products and services electronically through 24-hour online, mobile and telephone channels that enable customers to check balances, make deposits, transfer funds, pay bills, access statements, apply for loans and access various other products and services.

NBT Financial Services, Inc.

Through NBT Financial Services, the Company operates EPIC Advisors, Inc. ("EPIC"), a retirement plan administrator. Through EPIC, the Company offers services including retirement plan consulting and recordkeeping services. EPIC's headquarters are located in Rochester, New York.



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NBT Holdings, Inc.

Through NBT Holdings, the Company operates NBT Insurance Agency, LLC ("NBT Insurance"), a full-service insurance agency acquired by the Company on September 1, 2008. NBT Insurance's headquarters are located in Norwich, New York. Through NBT Insurance, the Company offers a full array of insurance products, including personal property and casualty, business liability and commercial insurance, tailored to serve the specific insurance needs of individuals as well as businesses in a range of industries operating in the markets served by the Company.

The Trusts

The Trusts were organized to raise additional regulatory capital and to provide funding for certain acquisitions. CNBF Capital Trust I and NBT Statutory Trust I are Delaware statutory business trusts formed in 1999 and 2005, respectively, for the purpose of issuing trust preferred securities and lending the proceeds to the Company. In connection with the acquisition of CNB Bancorp, Inc., the Company formed NBT Statutory Trust II in February 2006 to fund the cash portion of the acquisition as well as to provide regulatory capital. In connection with the acquisition of Alliance Financial Corporation ("Alliance"), the Company acquired two statutory trusts, Alliance Financial Capital Trust I and Alliance Financial Capital Trust II, which were formed in 2003 and 2006, respectively. The Company guarantees, on a limited basis, payments of distributions on the trust preferred securities and payments on redemption of the trust preferred securities. The Trusts are variable interest entities for which the Company is not the primary beneficiary, as defined by Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC"). In accordance with ASC, the accounts of the Trusts are not included in the Company's consolidated financial statements.

Operating Subsidiaries of the Bank

The Bank has seven operating subsidiaries, NBT Capital Corp., Broad Street Property Associates, Inc., NBT Services, Inc., CNB Realty Trust, Alliance Preferred Funding Corp., Alliance Leasing, Inc. and Columbia Ridge Capital Management, Inc. NBT Capital Corp., formed in 1998, is a venture capital corporation formed to assist young businesses in developing and growing primarily in the markets these businesses serve. Broad Street Property Associates, Inc., formed in 2004, is a property management company. CNB Realty Trust, formed in 1998, is a real estate investment trust. Alliance Preferred Funding Corp., formed in 1999, is a real estate investment trust. Alliance Leasing, Inc. was formed in 2002 to provide equipment leasing services. Columbia Ridge Capital Management, Inc. was acquired in 2016 and is a registered investment advisor that provides investment management and financial consulting services.

Competition

The financial services industry, including commercial banking, is highly competitive and we encounter strong competition for deposits, loans and other financial products and services in our market area. The increasingly competitive environment is the result of the continued low rate environment, changes in regulation, changes in technology and product delivery systems, additional financial service providers and the accelerating pace of consolidation among financial services providers. The Company competes for loans, deposits and customers with other commercial banks, savings and loan associations, securities and brokerage companies, mortgage companies, insurance companies, finance companies, money market funds, credit unions and other nonbank financial service providers.

The financial services industry could become even more competitive as a result of legislative, regulatory and technological changes and continued consolidation. Banks, securities firms and insurance companies can merge under the umbrella of a financial holding company, which can offer virtually any type of financial service, including banking, securities underwriting, insurance (both agency and underwriting) and merchant banking. In addition,

technology has lowered barriers to entry and made it possible for non-banks to offer products and services traditionally provided by banks, such as automatic transfer and automatic payment systems.

Some of the Company’s nonbanking competitors have fewer regulatory constraints and may have lower cost structures. In addition, some of the Company’s competitors have assets, capital and lending limits greater than that of the Company, have greater access to capital markets and offer a broader range of products and services than the Company. These institutions may have the ability to finance wide-ranging advertising campaigns and may be able to offer lower rates on loans and higher rates on deposits than the Company can offer. Some of these institutions offer services, such as credit cards and international banking, which the Company does not directly offer.

Various in-state market competitors and out-of-state banks continue to enter or have announced plans to enter or expand their presence in the market areas in which the Company currently operates. With the addition of new banking presences within our market, the Company expects increased competition for loans, deposits and other financial products and services.

In order to compete with other financial services providers, the Company stresses the community nature of its banking operations and principally relies upon local promotional activities, personal relationships established by officers, directors and employees with the Company's customers and specialized services tailored to meet the needs of the communities served. We also offer certain customer services, such as agricultural lending, that many of our larger competitors do not offer. While the Company’s position varies by market, the Company’s management believes that it can compete effectively as a result of local market knowledge, local decision making and awareness of customer needs.

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The table below summarizes the Bank's deposits and market share as June 30, 2018 by the thirty-eight counties of New York, Pennsylvania, New Hampshire, Massachusetts, Vermont and Maine. Market share is based on deposits of all commercial banks, credit unions, savings and loans associations and savings banks.

| County | State | Deposits in Thousands | Market Share | | Market Rank | Number of Branches* | Number of ATMs* |
|---|---|---|---|---|---|---|---|
| Chenango | NY | $ 836,819 | 94.51 | % | 1 | 11 | 12 |
| Fulton | NY | 507,651 | 64.84 | % | 1 | 5 | 6 |
| Schoharie | NY | 219,139 | 47.47 | % | 1 | 4 | 4 |
| Hamilton | NY | 45,801 | 43.48 | % | 2 | 1 | 1 |
| Cortland | NY | 291,036 | 40.84 | % | 1 | 5 | 7 |
| Montgomery | NY | 266,070 | 35.71 | % | 2 | 5 | 4 |
| Delaware | NY | 368,041 | 35.70 | % | 1 | 5 | 5 |
| Otsego | NY | 380,455 | 34.31 | % | 1 | 8 | 11 |
| Essex | NY | 208,694 | 28.47 | % | 2 | 3 | 5 |
| Madison | NY | 231,978 | 25.34 | % | 2 | 4 | 8 |
| Susquehanna | PA | 178,324 | 20.11 | % | 2 | 5 | 7 |
| Broome | NY | 391,519 | 14.15 | % | 2 | 7 | 9 |
| Oneida | NY | 498,371 | 14.00 | % | 4 | 7 | 9 |
| St. Lawrence | NY | 165,322 | 13.72 | % | 4 | 4 | 5 |
| Pike | PA | 83,699 | 11.66 | % | 5 | 2 | 2 |
| Oswego | NY | 144,549 | 10.91 | % | 4 | 4 | 6 |
| Wayne | PA | 124,450 | 9.54 | % | 4 | 3 | 4 |
| Herkimer | NY | 56,982 | 8.45 | % | 4 | 2 | 1 |
| Tioga | NY | 35,521 | 7.90 | % | 5 | 1 | 1 |
| Clinton | NY | 106,166 | 7.64 | % | 5 | 3 | 3 |
| Lackawanna | PA | 416,818 | 6.98 | % | 6 | 12 | 17 |
| Schenectady | NY | 177,724 | 6.41 | % | 5 | 2 | 2 |
| Franklin | NY | 34,042 | 6.33 | % | 4 | 1 | 1 |
| Onondaga | NY | 487,142 | 4.74 | % | 6 | 11 | 13 |
| Warren | NY | 78,519 | 4.14 | % | 5 | 2 | 3 |
| Saratoga | NY | 174,077 | 3.68 | % | 8 | 4 | 4 |
| Monroe | PA | 73,469 | 2.70 | % | 8 | 4 | 4 |
| Berkshire | MA | 117,200 | 2.63 | % | 7 | 6 | 6 |
| Chittenden | VT | 102,142 | 2.31 | % | 7 | 3 | 3 |
| Greene | NY | 37,089 | 2.30 | % | 5 | 2 | 2 |
| Cheshire | NH | 32,815 | 2.06 | % | 7 | 1 | - |
| Luzerne | PA | 97,177 | 1.56 | % | 13 | 4 | 6 |
| Albany | NY | 265,509 | 1.37 | % | 9 | 4 | 5 |
| Rensselaer | NY | 27,233 | 1.29 | % | 10 | 1 | 1 |
| Hillsborough | NH | 90,806 | 0.78 | % | 12 | 2 | 2 |
| Rutland | VT | 4,813 | 0.49 | % | 10 | 1 | 1 |
| Cumberland | ME | 17,176 | 0.18 | % | 16 | 1 | - |
| Rockingham | NH | 8,765 | 0.11 | % | 23 | 1 | 2 |
| | | $ 7,383,103 | | | | 151 | 182 |

Source: SNL Financial LLC

* Branch and ATM data is as of December 31, 2018.

Data Privacy and Security Practices

The Company's enterprise security strategy revolves around people, processes and technology. The Company employs a defense in depth strategy, which combines physical control measures with logical control measures and uses a layered security model to provide end-to-end security of Company and client information. The high-level objective of the information security program is to protect the confidentiality, integrity and availability of all information assets in our environment. We accomplish this by building our program around six foundational control areas: program oversight and governance, safeguards and controls, security awareness training, service provider oversight, incident response and business continuity. The Company's data security and privacy practices are in compliance with all applicable laws and regulations including the Gramm-Leach Bliley Act of 2001 and applicable privacy laws described under the heading Supervision and Regulation in this Item 1. Business section.



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The controls identified in our enterprise security program are managed by various stakeholders throughout the Company and monitored by the information security team. All employees are required to complete information security and privacy training when they join the Company and then complete annual online training certification and ad hoc face to face trainings. The Company engages outside consultants to perform periodic audits of our information and data security controls and processes including penetration testing of the Company's public facing websites and corporate networks. The Board of Directors requires the Company's Information Security Officer to report to them the status of the overall information security and data privacy program on a recurring basis.More information can be located on the Company's website https://www.nbtbank.com/Personal/Customer-Support/Fraud-Information-Center.

Investment in Human Capital

The Company's strategic initiative regarding investing in human capital includes key initiatives to attract, develop and retain our valued employees. Talent management continues to be a top priority as specific competencies are predicted to be in short-supply with the transition of retirement age skill sets.

To aid in retention and attract talent, the Company took advantage of the additional funds resulting from the lower corporate tax rate provided by the 2017 Tax Cuts and Jobs Act to increase the Company's minimum hiring pay rate to $15 per hour and provided a 5% pay increase to the remaining employees earning $50,000 and under annually. As a result, we have experienced even higher levels of employee retention rates, which results in greater customer satisfaction and continuity. The Company's incentive programs recognize all full-time employees at all levels and are designed to motivate employees to support achievement of company success, with appropriate risk assessment and prevention measures designed to prevent fraud.

Learning and Development

The Company focuses on the future by encouraging and promoting internal development. We have four distinct training and development programs that address and encourage development and foster retention. Our high-potential program is in its sixth cycle of leader development. Our emerging leaders program develops our up-and-coming next generation of leaders. Our management development program aims at attracting key external talent, particularly through benefit programs such as financial education, tuition repayment, graduate school tuition assistance and flexible work arrangements. The management development program has placed many graduates in key positions where they have made significant contributions. Our professional development program provides an entry point for early career professionals. This program provides an overview of banking functions over a 12-18 month period, ultimately placing employees with working knowledge in positions of responsibility around the Company. In addition, employees have access to career paths throughout the Company's business areas, supported by individual development plans and internal learning management system resources. To support this process, we named an internal career counselor to work as a liaison with employees and managers to direct their personal career aspirations.

Diversity and Inclusion

We have enhanced the visibility and structure of our long-standing commitment to diversity and inclusion ("D&I"). Our Chief Diversity Officer has placed a high level of focus on relevant and impactful D&I initiatives by building upon our strong cultural foundation. In its second year of a three-year strategic roadmap, the Company has implemented a variety of initiatives from being transparent by posting our diversity values on our website to providing forums to listen more closely to what our employees want to say. The Company has a D&I steering committee comprised of members of the executive team, including the Chief Executive Officer. The plan is shared with our board of directors, management and employees, who are often included in implementing specific action items.

The Company developed a purpose statement to support the D&I initiative, which states that the Company strives to create an environment that is open and welcoming to all, leading to high employee engagement and job performance.

We believe this will enable the Company to outperform its peers, ensure high levels of shareholder return and provide for financial independence. We strive to ensure our executives are demonstrating the highest ethical leadership, are approachable and inspire trust. More information can be located on the Company's website at https://www.nbtbank.com/Personal/About-Us/Our-Bank/Diversity-and-Inclusion.

Conduct and Ethics

It is critical that the board of directors and senior management vigorously endorse a no-tolerance stance for workplace harassment, biases and unethical behavior. The Company's values-based Code of Business Conduct and Ethics is extensively communicated on our website, intranet, company newsletter and internally socialized through a blog entitled "Respectfully Yours." Frequent training specific to managers and employees, regular publication of our whistleblower policy and reporting mechanisms provide framework to the Company's motto of: "The right people. Doing the right things. In the right way."

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Engaging Employees

The Company seeks to further refine its workforce programs through its employee engagement survey, which had a 90% participation rate in 2018. Based on the most recent survey, high impact strengths included leadership, alignment to company goals and individual work, sense of team and identity, autonomy to get things done, access to learning and development and social responsibility. The executive team owns several initiatives directly tied to the survey feedback, including the employee forums mentioned above. With technology and the implementation of Office 365, we have increased interactions among team members across our geography. The Company believes that engaged employees will drive retention and effort, ultimately correlating to a better experience for our customers.

Supervision and Regulation

The Company, the Bank and certain of its non-banking subsidiaries are subject to extensive regulation under federal and state laws. The regulatory framework applicable to bank holding companies and their subsidiary banks is intended to protect depositors, federal deposit insurance funds and the stability of the U.S. banking system. This system is not designed to protect equity investors in bank holding companies, such as the Company.

Set forth below is a summary of the significant laws and regulations applicable to the Company and its subsidiaries. The description that follows is qualified in its entirety by reference to the full text of the statutes, regulations and policies that are described. Such statutes, regulations and policies are subject to ongoing review by Congress and state legislatures and federal and state regulatory agencies. A change in any of the statutes, regulations or regulatory policies applicable to the Company and its subsidiaries could have a material effect on the results of the Company.

Environmental

The Company is focused on the environment and committed to business practices and activities that encourage sustainability and minimize our environmental impact. In larger facilities, the Company conserves energy through the use of building energy management systems and motion sensor lighting controls. In new construction and renovations, the Company incorporates high-efficiency mechanical equipment, LED lighting, and modern building techniques to reduce our carbon footprint wherever possible. The Company has an ongoing initiative to replace existing lighting with LED lighting to reduce energy consumption.

Through our solar financing partnership, the Company offers homeowners across the country the opportunity to power their homes with a sustainable energy source. Services like mobile and online banking, remote deposit capture, eStatements and combined statements enable us to support all customers in their efforts to consume less fuel and paper. We continue to digitize loan origination processes, reducing trips to the bank and paper documents for our customers. Across our footprint, we host community shred days with multiple confidential document destruction companies to promote safe document disposal and recycling.

Overview

The Company is a registered bank holding company and financial holding company under the Bank Holding Company Act of 1956, as amended (the “BHC Act”) and is subject to the supervision of and regular examination by the Board of Governors of the Federal Reserve System (the “Federal Reserve Board” or “FRB”) as its primary federal regulator. The Company is also subject to the jurisdiction of the Securities and Exchange Commission (“SEC”) and is subject to the disclosure and other regulatory requirements of the Securities Act of 1933, as amended, and the Securities Exchange Act of 1934, as amended (the "Exchange Act"), as administered by the SEC. The Company's common stock is listed on the NASDAQ Global Select market under the ticker symbol, “NBTB,” and the Company is subject to the NASDAQ stock market rules.

The Bank is chartered as a national banking association under the National Bank Act. The Bank is subject to the supervision of, and to regular examination by, the Office of the Comptroller of the Currency (“OCC”) as its chartering authority and primary federal regulator. The Bank is also subject to the supervision and regulation, to a limited extent, of the Federal Deposit Insurance Corporation (“FDIC”) as its deposit insurer. Financial products and services offered by the Company and the Bank are subject to federal consumer protection laws and implementing regulations promulgated by the Consumer Financial Protection Bureau (“CFPB”). The Company and the Bank are also subject to oversight by state attorneys general for compliance with state consumer protection laws. The Bank's deposits are insured by the FDIC up to the applicable deposit insurance limits in accordance with FDIC laws and regulations. The non-bank subsidiaries of the Company and the Bank are subject to federal and state laws and regulations, including regulations of the FRB and the OCC, respectively.

Since the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the “Dodd-Frank Act”), U.S. banks and financial services firms have been subject to enhanced regulation and oversight. Over the past year, the current administration and its appointees to the federal banking agencies have enacted legislation and taken other steps to modify and scale back portions of the Dodd-Frank Act and certain of its implementing regulations. It is not clear whether any additional such legislation or regulatory changes will be enacted or implemented or, if enacted or implemented, what the effect on the Company would be, though major changes are not expected in the near term.

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Federal Bank Holding Company Regulation

The Company is a bank holding company as defined by the BHC Act. The BHC Act generally limits the business of the Company to banking, managing or controlling banks and other activities that the FRB has determined to be so closely related to banking "as to be a proper incident thereto." The Company has also qualified for and elected to be a financial holding company. Financial holding companies may engage in any activity, or acquire and retain the shares of a company engaged in any activity that is either (i) financial in nature or incidental to such financial activity (as determined by the FRB in consultation with the Secretary of the Treasury), or (ii) complementary to a financial activity and that does not pose a substantial risk to the safety and soundness of depository institutions or the financial system (as solely determined by the FRB). If a bank holding company seeks to engage in the broader range of activities permitted under the BHC Act for financial holding companies, (i) the bank holding company and all of its depository institution subsidiaries must be "well-capitalized" and "well-managed," as defined in the FRB's Regulation Y and (ii) it must file a declaration with the FRB that it elects to be a "financial holding company." In order for a financial holding company to commence any activity that is financial in nature, incidental thereto, or complementary to a financial activity, or to acquire a company engaged in any such activity permitted by the BHC Act, each insured depository institution subsidiary of the financial holding company must have received a rating of at least "satisfactory" in its most recent examination under the Community Reinvestment Act of 1977 (the "CRA"). See the section titled "Community Reinvestment Act of 1977" for further information relating to the CRA.

Regulation of Mergers and Acquisitions

The BHC Act, the Bank Merger Act and other federal and state statutes regulate acquisitions of depository institutions and their holding companies. The BHC Act requires prior FRB approval for a bank holding company to acquire, directly or indirectly, 5% or more of any class of voting securities of a commercial bank or its parent holding company and for a company, other than a bank holding company, to acquire 25% or more of any class of voting securities of a bank or bank holding company (and sometimes a lower percentage if there are other indications of control). Under the Change in Bank Control Act, any person, including a company, may not acquire, directly or indirectly, control of a bank without providing 60 days' prior notice and receiving a non-objection from the appropriate federal banking agency.

Under the Bank Merger Act, prior approval of the OCC is required for a national bank to merge with another bank where the national bank is the surviving bank or to purchase the assets or assume the deposits of another bank. In reviewing applications seeking approval of merger and acquisition transactions, the federal banking agencies will consider, among other criteria, the competitive effect and public benefits of the transactions, the capital position of the combined banking organization, the applicant's performance record under the CRA and the effectiveness of the subject organizations in combating money laundering activities.

As a financial holding company, the Company is permitted to acquire control of non-depository institutions engaged in activities that are financial in nature and in activities that are incidental to financial activities without prior FRB approval. However, the BHC Act, as amended by the Dodd-Frank Act, requires prior written approval from the FRB or prior written notice to the FRB before a financial holding company may acquire control of a company with consolidated assets of $10 billion or more.

Capital Distributions

The principal source of the Company's liquidity is dividends from the Bank. The OCC oversees the ability of the Bank to make capital distributions, including dividends. 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 bank would thereafter be undercapitalized. The OCC's prior approval is required if the total of all dividends declared by a national bank in any calendar year would exceed the sum of the bank's net income for that

year and its undistributed net income for the preceding two calendar years, less any required transfers to surplus. The National Bank Act also prohibits national banks from paying dividends that would be greater than the bank's undivided profits after deducting statutory bad debt in excess of the bank's allowance for loan losses.

The federal banking agencies have indicated that paying dividends that deplete a bank's capital base to an inadequate level would be an unsafe and unsound banking practice and that banking organizations should generally pay dividends only out of current operating earnings. The appropriate federal regulatory authority is authorized to determine, based on the financial condition of a bank holding company or a bank, that the payment of dividends would be an unsafe or unsound practice and to prohibit such payment.

Affiliate and Insider Transactions

Transactions between the Bank and its affiliates, including the Company, are governed by Sections 23A and 23B of the Federal Reserve Act (the "FRA") and the FRB's implementing Regulation W. An "affiliate" of a bank includes any company or entity that controls, is controlled by or is under common control with such bank. In a bank holding company context, at a minimum, the parent holding company of a bank and companies that are controlled by such parent holding company, are affiliates of the bank. Generally, Sections 23A and 23B of the FRA are intended to protect insured depository institutions from losses in transactions with affiliates. These sections place quantitative and qualitative limitations on covered transactions between the Bank and its affiliates and require that all transactions between a bank and its affiliates occur on market terms that are consistent with safe and sound banking practices.

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Section 22(h) of the FRA and its implementing Regulation O restricts loans to the Bank's and its affiliates' directors, executive officers and principal stockholders (“Insiders”). Under Section 22(h), loans to Insiders and their related interests may not exceed, together with all other outstanding loans to such persons and affiliated entities, the Bank's total capital and surplus. Loans to Insiders above specified amounts must receive the prior approval of the Bank’s board of directors. Further, under Section 22(h) of the FRA, loans to directors, executive officers and principal stockholders must be made on terms substantially the same as offered in comparable transactions to other persons, except that such Insiders may receive preferential loans made under a benefit or compensation program that is widely available to the Bank’s employees and does not give preference to the Insider over the employees. Section 22(g) of the FRA places additional limitations on loans to the Bank's and its affiliates' executive officers.

Federal Deposit Insurance and Brokered Deposits

The FDIC’s deposit insurance limit is $250,000 per depositor, per insured bank, for each account ownership category, in accordance with applicable FDIC regulations. The Bank’s deposit accounts are fully insured by the FDIC Deposit Insurance Fund (the “DIF”) up to the deposit insurance limits in accordance with applicable laws and regulations.

The FDIC uses a risk-based assessment system that imposes insurance premiums based upon a risk matrix that takes into account a bank's capital level and supervisory rating (“CAMELS rating”). The risk matrix uses different risk categories distinguished by capital levels and supervisory ratings. As a result of the Dodd-Frank Act, the base for deposit insurance assessments is the consolidated average assets less average tangible equity. Assessment rates are calculated using formulas that take into account the risk of the institution being assessed. In addition to deposit insurance assessments, the Federal Deposit Insurance Act (“FDIA”) provides for additional assessments related to outstanding bonds issued by The Financing Corporation ("FICO"). The FICO is a mixed-ownership government corporation established by the Competitive Equality Banking Act of 1987 whose sole purpose was to function as a financing vehicle for the now defunct Federal Savings & Loan Insurance Company. The FICO assessments are adjusted quarterly to reflect changes in the assessment base of the DIF and do not vary depending upon a depository institution’s capitalization or supervisory evaluation. Outstanding FICO bonds mature through 2019.

Under FDIC laws and regulations, no FDIC-insured depository institution can accept brokered deposits unless it is well-capitalized or unless it is adequately capitalized and receives a waiver from the FDIC. Applicable laws and regulations also prohibit any depository institution that is not well-capitalized from paying an interest rate on brokered deposits in excess of three-quarters of one percentage point over certain prevailing market rates.

Under the FDIA, the FDIC may terminate deposit insurance upon a finding that the institution has engaged in unsafe and unsound practices, is in an unsafe or unsound condition to continue operations or has violated any applicable law, regulation, rule, order or condition imposed by the FDIC. The Bank's management is not aware of any practice, condition or violation that might lead to the termination of its deposit insurance.

Federal Home Loan Bank System

The Bank is also a member of the Federal Home Loan Bank (“FHLB”) of New York, which provides a central credit facility primarily for member institutions for home mortgage and neighborhood lending. The Bank is subject to the rules and requirements of the FHLB, including the requirement to acquire and hold shares of capital stock in the FHLB in an amount at least equal to the sum of 0.125% of mortgage related assets loans at the beginning of each year. The Bank was in compliance with FHLB rules and requirements as of December 31, 2018.

Debit Card Interchange Fees

The Dodd-Frank Act requires that any interchange transaction fee charged for a debit transaction be reasonable and proportional to the cost incurred by the issuer for the transaction. FRB regulations mandated by the Dodd-Frank Act

limit interchange fees on debit cards to a maximum of 21 cents per transaction plus 5 basis points of the transaction amount. The rule also permits a fraud-prevention adjustment of 1 cent per transaction conditioned upon an issuer developing, implementing and updating reasonably designed fraud-prevention policies and procedures. Issuers that, together with their affiliates, have less than $10 billion of assets, such as the Company, are exempt from the debit card interchange fee standards. However, FRB regulations prohibit all issuers, including the Company and the Bank, from restricting the number of networks over which electronic debit transactions may be processed to less than two unaffiliated networks.

Source of Strength Doctrine

FRB policy requires bank holding companies to act as a source of financial and managerial strength to their subsidiary banks. Section 616 of the Dodd-Frank Act codifies the requirement that bank holding companies serve as a source of financial strength to their subsidiary depository institutions. A bank holding company’s failure to meet its obligations to serve as a source of strength to its subsidiary banks will generally be considered by the FRB to be an unsafe and unsound banking practice or a violation of FRB regulations or both. As a result, the Company is expected to commit resources to support the Bank, including at times when the Company may not be in a financial position to provide such resources. Any capital loan by the Company to the Bank is subordinate in right of payment to deposits and to certain other indebtedness of such subsidiary banks. The U.S. Bankruptcy Code provides that, in the event of a bank holding company’s bankruptcy, any commitment by the bank holding company to a federal bank regulatory agency to maintain the capital of a subsidiary bank will be assumed by the bankruptcy trustee and entitled to priority of payment.

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In addition, under the National Bank Act, if the Bank's capital stock is impaired by losses or otherwise, the OCC is authorized to require payment of the deficiency by assessment upon the Company. If the assessment is not paid within three months, the OCC could order a sale of Bank stock held by the Company to cover any deficiency.

Capital Adequacy and Prompt Corrective Action

In July 2013, the FRB, the OCC and the FDIC approved final rules (the "Capital Rules") that established a new capital framework for U.S. banking organizations. The Capital Rules generally implement the Basel Committee on Banking Supervision's (the "Basel Committee") December 2010 final capital framework referred to as "Basel III" for strengthening international capital standards. The Capital Rules revise the definitions and the components of regulatory capital, as well as address other issues affecting the numerator in banking institutions' regulatory capital ratios. The Capital Rules also address asset risk weights and other matters affecting the denominator in banking institutions' regulatory capital ratios and replace the existing general risk-weighting approach with a more risk-sensitive approach.

The Capital Rules: (i) require a capital measure called "Common Equity Tier 1" ("CET1") and related regulatory capital ratio of CET1 to risk-weighted assets; (ii) specify that Tier 1 capital consists of CET1 and "Additional Tier 1 capital" instruments meeting certain revised requirements; (iii) mandate that most deductions/adjustments to regulatory capital measures be made to CET1 and not to the other components of capital; and (iv) expand the scope of the deductions from and adjustments to capital as compared to existing regulations. Under the Capital Rules, for most banking organizations, including the Company, the most common form of Additional Tier 1 capital is non-cumulative perpetual preferred stock and the most common forms of Tier 2 capital are subordinated notes and a portion of the allocation for loan losses, in each case, subject to the Capital Rules' specific requirements.

Pursuant to the Capital Rules, the minimum capital ratios as of January 1, 2015 are:

4.5% CET1 to risk-weighted assets;

6.0% Tier 1 capital (CET1 plus Additional Tier 1 capital) to risk-weighted assets;

8.0% Total capital (Tier 1 capital plus Tier 2 capital) to risk-weighted assets; and

4.0% Tier 1 capital to average consolidated assets as reported on consolidated financial statements (known as the "leverage ratio").

The Capital Rules also require a "capital conservation buffer," composed entirely of CET1, on top of these minimum risk-weighted asset ratios. The capital conservation buffer is designed to absorb losses during periods of economic stress. Banking institutions with a ratio of CET1 to risk-weighted assets above the minimum but below the capital conservation buffer will face constraints on dividends, equity and other capital instrument repurchases and compensation based on the amount of the shortfall. The capital conservation buffer was phased in incrementally until when, on January 1, 2019, the capital conservation buffer was fully phased in, resulting in the capital standards applicable to the Company and the Bank including an additional capital conservation buffer of 2.5% of CET1, and effectively resulting in minimum ratios inclusive of the capital conservation buffer of (i) CET1 to risk-weighted assets of at least 7%, (ii) Tier 1 capital to risk-weighted assets of at least 8.5% and (iii) Total capital to risk-weighted assets of at least 10.5%. The risk-weighting categories in the Capital Rules are standardized and include a risk-sensitive number of categories, depending on the nature of the assets, generally ranging from 0% for U.S. government and agency securities, to 600% for certain equity exposures and resulting in higher risk weights for a variety of asset classes.

The Capital Rules provide for a number of deductions from and adjustments to CET1. These include, for example, the requirement that mortgage servicing rights, deferred tax assets arising from temporary differences that could not be realized through net operating loss carrybacks and significant investments in non-consolidated financial entities be deducted from CET1 to the extent that any one such category exceeds 10% of CET1 or all such items, in the aggregate, exceed 15% of CET1. The deductions and adjustments will be incrementally phased in between January 1, 2015 and January 1, 2019.

In addition, under the prior general risk-based capital rules, the effects of accumulated other comprehensive income or loss ("AOCI") items included in stockholders' equity (for example, marks-to-market of securities held in the available for sale ("AFS") portfolio) under GAAP were excluded for the purposes of determining regulatory capital ratios. Under the Capital Rules, the effects of certain AOCI items are not excluded; however, banking organizations not using the advanced approaches, including the Company and the Bank, were permitted to make a one-time permanent election to continue to exclude these items in January 2015. The Capital Rules also preclude certain hybrid securities, such as trust preferred securities issued after May 19, 2010, from inclusion in bank holding companies' Tier 1 capital.

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Implementation of the deductions and other adjustments to CET1 began on January 1, 2015 and were phased in over a 4-year period (beginning at 40% on January 1, 2015 and an additional 20% per year thereafter). The implementation of the capital conservation buffer began on January 1, 2016 at the 0.625% level and increased by 0.625% on each subsequent January 1, until it reached 2.5% on January 1, 2019.

In September 2017, the federal banking agencies proposed simplifying the Capital Rules. The proposal would apply primarily to non-advanced approaches institutions, such as the Company. The proposal would simplify and clarify a number of the more complex aspects of the Capital Rules, including the treatment for certain acquisition, development and construction loans, mortgage servicing assets, certain deferred tax assets, investments in the capital instruments of unconsolidated financial institutions and minority interest. In November 2017, the FRB finalized a rule extending the currently applicable capital rules for mortgage servicing assets and certain other items for non-advanced approaches institutions. That rule is in effect pending the comment period and review of the general proposal to simplify the Capital Rules for non-advanced approaches institutions.

In addition, the Economic Growth, Regulatory Reform and Consumer Protection Act (“EGRRCPA”), which was enacted in May 2018, required the federal banking agencies to promulgate rules establishing a new “community bank leverage ratio” for depository institutions and their holding companies with less than $10 billion in total consolidated assets, such as us. This change is intended to simplify regulatory capital requirements for institutions like us with less than $10 billion in total consolidated assets, which will have an option to calculate this leverage ratio, rather than multiple existing measures of capital adequacy. Such an institution would be considered to have met the capital ratio requirements to be well-capitalized if it has a community bank leverage ratio greater than 9%. The federal banking agencies issues proposed rules to implement this section of the EGRRCPA in November 2018. If we remain under the $10 billion threshold when these rules are finalized, we will evaluate whether to elect the option to calculate the community bank leverage ratio instead of multiple existing measures of capital adequacy.

Management believes that the Company is in compliance, with the targeted capital ratios.

Prompt Corrective Action and Safety and Soundness

Pursuant to Section 38 of the FDIA, federal banking agencies are required to take “prompt corrective action” (“PCA”) should an insured depository institution fail to meet certain capital adequacy standards. At each successive lower capital category, an insured depository institution is subject to more restrictions and prohibitions, including restrictions on growth, restrictions on interest rates paid on deposits, restrictions or prohibitions on payment of dividends and restrictions on the acceptance of brokered deposits. Furthermore, if an insured depository institution is classified in one of the undercapitalized categories, it is required to submit a capital restoration plan to the appropriate federal banking agency and the holding company must guarantee the performance of that plan. Based upon its capital levels, a bank that is classified as well-capitalized, adequately capitalized or undercapitalized, may be treated as though it were in the next lower capital category if the appropriate federal banking agency, after notice and opportunity for hearing, determines that an unsafe or unsound condition or an unsafe or unsound practice, warrants such treatment.

For purposes of PCA, to be: (i) well-capitalized, an insured depository institution must have a total risk based capital ratio of at least 10%, a Tier 1 risk based capital ratio of at least 8%, a CET1 risk based capital ratio of at least 6.5%, and a Tier 1 leverage ratio of at least 5%; (ii) adequately capitalized, an insured depository institution must have a total risk based capital ratio of at least 8%, a Tier 1 risk based capital ratio of at least 6%, a CET1 risk based capital ratio of at least 4.5%, and a Tier 1 leverage ratio of at least 4%; (iii) undercapitalized, an insured depository institution would have a total risk based capital ratio of less than 8%, a Tier 1 risk based capital ratio of less than 6%, a CET1 risk based capital ratio of less than 4.5%, and a Tier 1 leverage ratio of less than 4%; (iv) significantly undercapitalized, an insured depository institution would have a total risk based capital ratio of less than 6%, a Tier 1 risk based capital ratio of less than 4%, a CET1 risk based capital ratio of less than 3%, and a Tier 1 leverage ratio of

less than 3%.; (v) critically undercapitalized, an insured depository institution would have a ratio of tangible equity to total assets that is less than or equal to 2%. At December 31, 2018, the Bank qualified as “well capitalized” under applicable regulatory capital standards.

Bank holding companies and insured depository institutions may also be subject to potential enforcement actions of varying levels of severity by the federal banking agencies for unsafe or unsound practices in conducting their business or for violation of any law, rule, regulation, condition imposed in writing by the agency or term of a written agreement with the agency. In more serious cases, enforcement actions may include the issuance of directives to increase capital; the issuance of formal and informal agreements; the imposition of civil monetary penalties; the issuance of a cease and desist order that can be judicially enforced; the issuance of removal and prohibition orders against officers, directors and other institution–affiliated parties; the termination of the insured depository institution’s deposit insurance; the appointment of a conservator or receiver for the insured depository institution; and the enforcement of such actions through injunctions or restraining orders based upon a judicial determination that the FDIC, as receiver, would be harmed if such equitable relief was not granted.

Volcker Rule

Section 619 of the Dodd-Frank Act, commonly known as the Volcker Rule, restricts the ability of banking entities from: (i) engaging in “proprietary trading” and (ii) investing in or sponsoring certain covered funds, subject to certain limited exceptions. Under the EGRRCPA, depository institutions and their holding companies with less than $10 billion in assets, like us, are excluded from the prohibitions of the Volcker Rule. Accordingly, we are no longer subject to the Volcker Rule, although if we grow to have more than $10 billion in assets, we will become subject to the Volcker Rule again. Given the Company's size and the scope of its activities, the implementation of the Volcker Rule did not have a significant effect on its consolidated financial statements, and we expect this will remain true if the Company becomes subject to the Volcker Rule again in the future.

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Depositor Preference

The FDIA provides that, in the event of the "liquidation or other resolution" of an insured depository institution, the claims of depositors of the institution, including the claims of the FDIC as subrogee of insured depositors and certain claims for administrative expenses of the FDIC as a receiver, will have priority over other general unsecured claims against the institution. If an insured depository institution fails, insured and uninsured depositors, along with the FDIC, will have priority in payment ahead of unsecured, non-deposit creditors, including the parent bank holding company, with respect to any extensions of credit they have made to such insured depository institution.

Consumer Protection and CFPB Supervision

The Dodd-Frank Act centralized responsibility for consumer financial protection by creating the CFPB, an independent agency charged with responsibility for implementing, enforcing and examining compliance with federal consumer financial laws. The CFPB has examination authority over all banks and savings institutions with more than $10 billion in assets. As the Company is below this threshold, the OCC continues to exercise primary examination authority over the Bank with regard to compliance with federal consumer financial laws and regulations. Under the Dodd-Frank Act, state attorneys general are empowered to enforce rules issued by the CFPB.

The Company is subject to federal consumer financial statutes and the regulations promulgated thereunder including, but not limited to:

the Truth-In-Lending Act, governing disclosures of credit terms to consumer borrowers;

the Equal Credit Opportunity Act ("ECOA"), prohibiting discrimination in connection with the extension of credit;

the Home Mortgage Disclosure Act ("HMDA"), requiring home mortgage lenders, including the Bank, to make available to the public expanded information regarding the pricing of home mortgage loans, including the "rate spread" between the annual percentage rate and the average prime offer rate for mortgage loans of a comparable type;

the Fair Credit Reporting Act ("FCRA"), governing the provision of consumer information to credit reporting agencies and the use of consumer information; and

the Fair Debt Collection Practices Act, governing the manner in which consumer debts may be collected by collection agencies.

The Bank's failure to comply with any of the consumer financial laws can result in civil actions, regulatory enforcement action by the federal banking agencies and the U.S. Department of Justice.

USA PATRIOT Act

The Bank Secrecy Act ("BSA"), as amended by 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. Financial institutions also are required to respond to requests for information from federal banking agencies and law enforcement agencies. Information sharing among financial institutions for the above purposes is encouraged by an exemption granted to complying financial institutions from the privacy provisions of the Gramm-Leach-Bliley Act ("GLBA") and other privacy laws. Financial institutions that hold correspondent accounts for foreign banks or provide private banking services to foreign individuals are required to take measures to avoid dealing with certain foreign individuals or entities, including foreign banks with profiles that raise money laundering concerns and are

prohibited from dealing with foreign "shell banks" and persons from jurisdictions of particular concern. The primary federal banking agencies and the Secretary of the Treasury have adopted regulations to implement several of these provisions. Beginning on May 11, 2018, the Bank is required to comply with the Customer Due Diligence Rule, which clarified and strengthened the existing obligations for identifying new and existing customers and explicitly included risk-based procedures for conducting ongoing customer due diligence. All financial institutions also are required to establish internal anti-money laundering programs. The effectiveness of a financial institution in combating money laundering activities is a factor to be considered in any application submitted by the financial institution under the Bank Merger Act. The Company has a Bank Secrecy Act and USA PATRIOT Act board-approved compliance program commensurate with its risk profile.

Identity Theft Prevention

The Fair Credit Reporting Act's ("FCRA") Red Flags Rule requires financial institutions with covered accounts (e.g., consumer bank accounts and loans) to develop, implement and administer an identity theft prevention program. This program must include reasonable policies and procedures to detect suspicious patterns or practices that indicate the possibility of identity theft, such as inconsistencies in personal information or changes in account activity.

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Office of Foreign Assets Control Regulation

The United States government has imposed economic sanctions that affect transactions with designated foreign countries, nationals and others. These are typically known as the "OFAC" rules based on their administration by the U.S. Treasury Department Office of Foreign Assets Control ("OFAC"). The OFAC-administered sanctions targeting countries take many different forms. Generally, 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 (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 and reputational consequences.

Financial Privacy and Data Security

The Company and the Bank are subject to federal laws, including the GLBA and certain state laws containing consumer privacy protection provisions. These provisions limit the ability of banks and other financial institutions to disclose nonpublic information about consumers to affiliated and non-affiliated third parties and limit the reuse of certain consumer information received from nonaffiliated financial institutions. These provisions require notice of privacy policies to clients and, in some circumstances, allow consumers to prevent disclosure of certain nonpublic personal information to affiliates or non-affiliated third parties by means of "opt out" or "opt in" authorizations.

The GLBA requires that financial institutions implement comprehensive written information security programs that include administrative, technical and physical safeguards to protect consumer information. Further, pursuant to interpretive guidance issued under the GLBA and certain state laws, financial institutions are required to notify clients of security breaches resulting in unauthorized access to their personal information. The Bank believes it is in compliance with all GLBA obligations.

The Bank is also subject to data security standards, privacy and data breach notice requirements, primarily those issued by the OCC. The federal banking agencies, through the Federal Financial Institutions Examination Council, have adopted guidelines to encourage financial institutions to address cyber security risks and identify, assess and mitigate these risks, both internally and at critical third party services providers.

Community Reinvestment Act of 1977

The Bank has a responsibility under the CRA, as implemented by OCC regulations, to help meet the credit needs of the communities it serves, including low- and moderate-income neighborhoods. The CRA does not establish specific lending requirements or programs for financial institutions nor does it limit an institution's discretion to develop the types of products and services that it believes are best suited to its particular community, consistent with the CRA. Regulators periodically assess the Bank's record of compliance with the CRA. The Bank's failure to comply with the CRA could, at a minimum, result in regulatory restrictions on its activities and the activities of the Company. The Bank's latest CRA rating was "Satisfactory."

Future Legislative Initiatives

Congress, state legislatures and financial regulatory agencies may introduce various legislative and regulatory initiatives that could affect the financial services industry, generally. Such initiatives may include proposals to expand or contract the powers of bank holding companies and/or depository institutions or proposals to substantially change

the financial institution regulatory system. Such legislation could change banking statutes and the operating environment of the Company in substantial and unpredictable ways. If enacted, such legislation could increase or decrease the cost of doing business, limit or expand permissible activities or affect the competitive balance among banks, savings associations, credit unions and other financial institutions. The Company cannot predict whether any such legislation will be enacted, and, if enacted, the effect that it or any implementing regulations would have on the financial condition or results of operations of the Company. A change in statutes, regulations or regulatory policies applicable to the Company or any of its subsidiaries could have a material effect on the business of the Company.

Employees

At December 31, 2018, the Company had 1,791 full-time equivalent employees. The Company’s employees are not presently represented by any collective bargaining group.

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Available Information

The Company's website is http://www.nbtbancorp.com. The Company makes available free of charge through its website its Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K and any amendments to those reports as soon as reasonably practicable after such material is electronically filed with or furnished to the SEC pursuant to Section 13(a) or 15(d) of the Exchange Act. We also make available through our website other reports filed with or furnished to the SEC under the Exchange Act, including our proxy statements and reports filed by officers and directors under Section 16(a) of that Act, as well as our Code of Business Conduct and Ethics and other codes/committee charters. The references to our website do not constitute incorporation by reference of the information contained in the website and such information should not be considered part of this document.

This Annual Report on Form 10-K and other reports filed with the SEC are available on the SEC's website, which contains reports, proxy and information statements and other information regarding issuers that file electronically with the SEC. The SEC's website address is www.sec.gov.

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ITEM 1A. Risk Factors

There are risks inherent to the Company's business. The material risks and uncertainties that management believes affect the Company are described below. Any of the following risks could affect the Company's financial condition and results of operations and could be material and/or adverse in nature. You should consider all of the following risks together with all of the other information in this Annual Report on Form 10-K.

Deterioration in local economic conditions may negatively impact our financial performance.

The Company's success depends primarily on the general economic conditions in central and upstate New York, northeastern Pennsylvania, southern New Hampshire, western Massachusetts, Vermont, southern coastal Maine and the specific local markets in which the Company operates. Unlike larger national or other regional banks that are more geographically diversified, the Company provides banking and financial services to customers primarily in the upstate New York areas of Norwich, Syracuse, Oneonta, Amsterdam-Gloversville, Albany, Binghamton, Utica-Rome, Plattsburgh, Glens Falls and Ogdensburg-Massena, the northeastern Pennsylvania areas of Scranton, Wilkes-Barre and East Stroudsburg, Berkshire County, Massachusetts, southern New Hampshire, Vermont and the southern coastal Maine area. 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.

As a lender with the majority of our loans secured by real estate or made to businesses in New York, Pennsylvania, New Hampshire, Massachusetts, Vermont and Maine, a downturn in these local economies could cause significant increases in nonperforming loans, which could negatively impact our earnings. Declines in real estate values in our market areas could cause any of our loans to become inadequately collateralized, which would expose us to greater risk of loss. Additionally, a decline in real estate values could result in the decline of originations of such loans, as most of our loans and the collateral securing our loans, are located in those areas.

Variations in interest rates could adversely affect our results of operations and financial condition.

The Company's earnings and financial condition, like that of most financial institutions, are largely dependent upon net interest income, which is the difference between interest earned from loans and investments and interest paid on deposits and borrowings. The narrowing of interest rate spreads could adversely affect the Company's earnings and financial condition. The Company cannot predict with certainty, or control, changes in interest rates. Regional and local economic conditions and the policies of regulatory authorities, including monetary policies of the FRB, affect rates and, therefore, interest income and interest expense. High interest rates could also affect the amount of loans that the Company can originate because higher rates could cause customers to apply for fewer mortgages or cause depositors to shift funds from accounts that have a comparatively lower cost to accounts with a higher cost. The Company may also experience customer attrition due to competitor pricing. If the cost of interest-bearing deposits increases at a rate greater than the yields on interest-earning assets increase, net interest income will be negatively affected. Changes in the asset and liability mix may also affect net interest income. Similarly, lower interest rates cause higher yielding assets to prepay and floating or adjustable rate assets to reset to lower rates. If the Company is not able to reduce its funding costs sufficiently, due to either competitive factors or the maturity schedule of existing liabilities, then the Company's net interest margin will decline.

Any substantial or unexpected change in, or prolonged change in market interest rates could have a material adverse effect on the Company's financial condition and results of operations. See the section captioned "Net Interest Income" in Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations and Item 7A. Quantitative and Qualitative Disclosure About Market Risk located elsewhere in this report for further discussion related to the Company's management of interest rate risk.

Our lending, and particularly our emphasis on commercial lending, exposes us to the risk of losses upon borrower default.

As of December 31, 2018, approximately 47% of the Company's loan portfolio consisted of commercial and industrial, agricultural, commercial construction and commercial real estate loans. These types of loans generally expose a lender to greater risk of non-payment and loss than residential real estate loans because repayment of the loans often depends on the successful operation of the property, the income stream of the borrowers and, for construction loans, the accuracy of the estimate of the property's value at completion of construction and the estimated cost of construction. Such loans typically involve larger loan balances to single borrowers or groups of related borrowers compared to residential real estate loans. Because the Company's loan portfolio contains a significant number of commercial and industrial, agricultural, construction and commercial real estate loans with relatively large balances, the deterioration of one or a few of these loans could cause a significant increase in nonperforming loans. An increase in nonperforming loans could result in a net loss of earnings from these loans, an increase in the provision for loan losses and/or an increase in loan charge-offs, all of which could have a material adverse effect on the Company's financial condition and results of operations. See the section captioned "Loans" in Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations located elsewhere in this report for further discussion related to our commercial and industrial, agricultural, construction and commercial real estate loans.

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Our allowance for loan losses may not be sufficient to cover actual loan losses, which could have a material adverse effect on our business, financial condition and results of operations.

The Company maintains an allowance for loan losses, which is an allowance established through a provision for loan losses charged to expense, that represents management's best estimate of incurred losses within the existing portfolio of loans. The allowance, in the judgment of management, is necessary to reserve for estimated loan losses and risks inherent in the loan portfolio. The level of the allowance reflects management's continuing evaluation of industry concentrations; specific credit risks; loan loss experience; current loan portfolio quality; present economic, political, environmental and regulatory conditions and unidentified losses inherent in the current loan portfolio. The determination of the appropriate level of the allowance for loan losses inherently involves a high degree of subjectivity and requires the Company to make significant estimates of current credit risks and future trends, all of which may undergo material changes. Changes in economic conditions affecting borrowers, new information regarding existing loans, identification of additional problem loans and other factors, both within and outside of the Company's control, may require an increase in the allowance for loan losses. Bank regulatory agencies periodically review the Company's allowance for loan losses and may require an increase in the provision for loan losses or the recognition of further loan charge-offs, based on judgments different from those of management. In addition, if charge-offs in future periods exceed the allowance for loan losses, the Company may need additional provisions to increase the allowance for loan losses. These potential increases in the allowance for loan losses would result in a decrease in net income and, possibly, capital and may have a material adverse effect on the Company's financial condition and results of operations. See the section captioned "Risk Management – Credit Risk" in Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations located elsewhere in this report for further discussion related to the Company's process for determining the appropriate level of the allowance for loan losses.

Strong competition within our industry and market area could adversely affect our performance and slow our growth.

The Company faces substantial competition in all areas of its operations from a variety of different competitors, many of which are larger and may have more financial resources. Such competitors primarily include national, regional and community banks within the various markets in which the Company operates. Additionally, various banks continue to enter or have announced plans to enter the market areas in which the Company currently operates. The Company also faces competition from many other types of financial institutions, including, without limitation, savings and loans, credit unions, finance companies, brokerage firms, insurance companies and other financial intermediaries. The financial services industry could become even more competitive as a result of legislative, regulatory and technological changes and continued consolidation. Technology has lowered barriers to entry and made it possible for non-banks to offer products and services traditionally provided by banks, such as automatic transfer and automatic payment systems. Many of the Company's competitors have fewer regulatory constraints and may have lower cost structures. Additionally, due to their size, many competitors may be able to achieve economies of scale and, as a result, may offer a broader range of products and services as well as better pricing for those products and services than the Company can.

The Company's ability to compete successfully depends on a number of factors, including, among other things:

the ability to develop, maintain and build upon long-term customer relationships based on top quality service, high ethical standards and safe, sound assets;

the ability to expand the Company's market position;

the scope, relevance and pricing of products and services offered to meet customer needs and demands;

the rate at which the Company introduces new products, services and technologies relative to its competitors;

customer satisfaction with the Company’s level of service;

industry and general economic trends; and

the ability to attract and retain talented employees.

Failure to perform in any of these areas could significantly weaken the Company’s competitive position, which could adversely affect the Company’s growth and profitability, which, in turn, could have a material adverse effect on the Company’s financial condition and results of operations.



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We are subject to extensive government regulation and supervision, which may interfere with our ability to conduct our business and may negatively impact our financial results.

We are subject to extensive federal and state regulation and supervision. Banking regulations are primarily intended to protect depositors' funds, the DIF and the safety and soundness of the banking system as a whole, not stockholders. These regulations affect the Company's lending practices, capital structure, investment practices, dividend policy and growth, among other things. Congress and federal regulatory agencies continually review banking laws, regulations and policies for possible changes. Changes to statutes, regulations or regulatory policies, including changes in interpretation or implementation of statutes, regulations or policies, could affect the Company in substantial and unpredictable ways. Such changes could subject the Company to additional costs, limit the types of financial services and products the Company may offer and/or limit the pricing the Company may charge on certain banking services, among other things. Compliance personnel and resources may increase our costs of operations and adversely impact our earnings.

Failure to comply with laws, regulations or policies could result in sanctions by regulatory agencies, civil money penalties and/or reputation damage, which could have a material adverse effect on our business, financial condition and results of operations. While the Company has policies and procedures designed to prevent any such violations, there can be no assurance that such violations will not occur. See the section captioned "Supervision and Regulation" in Item 1. Business of this report for further information.

We will be subject to heightened regulatory requirements if we exceed $10 billion in total consolidated assets.

As of December 31, 2018, we had total assets of approximately $9.6 billion and, based on our historical growth rates and current size, it is possible that our total assets could exceed $10 billion dollars in the near future. The Dodd-Frank Act and its implementing regulations impose enhanced supervisory requirements on bank holding companies with more than $10 billion in total consolidated assets. For bank holding companies with more than $10 billion in total consolidated assets, such requirements include, among other things:

increased Volcker Rule requirements and restrictions;

increased capital, leverage, liquidity and risk management standards;

examinations by the CFPB for compliance with federal consumer financial protection laws and regulations; and

limits on interchange fees on debit cards.

The EGRRCPA, which was enacted in 2018, amended Dodd-Frank Act to raise the $10 billion stress testing threshold to $250 billion, among other things; however, the proposed rules to implement the EGRRCPA have not yet been finalized. Under current regulations, once our total assets exceed $10 billion, we will be required to comply with the FRB's annual stress testing requirements. However, the federal financial regulators have proposed rules to increase the threshold for these stress testing requirements from $10 billion to $250 billion, consistent with the EGRRCPA.

Federal financial regulators may require us to take actions to prepare for compliance with the foregoing requirements before we exceed $10 billion in total consolidated assets. Our regulators may consider our preparation for compliance with these regulatory requirements when examining our operations or considering any request for regulatory approval. We may, therefore, incur compliance costs before we reach $10 billion in total consolidated assets and may be required to maintain the additional compliance procedures even if we do not grow at the anticipated rate or at all.

Failure to comply with these new requirements may negatively impact the results of our operations and financial condition. To ensure compliance, we will be required to investment significant resources, which may necessitate

hiring additional personnel and implementing additional internal controls. These additional compliance costs may have a material adverse effect on our business, results of operations and financial condition.

The Company is subject to liquidity risk, which could adversely affect net interest income and earnings.

The purpose of the Company's liquidity management is to meet the cash flow obligations of its customers for both deposits and loans. The primary liquidity measurement the Company utilizes is called basic surplus, which captures the adequacy of the Company's access to reliable sources of cash relative to the stability of its funding mix of average liabilities. This approach recognizes the importance of balancing levels of cash flow liquidity from short and long-term securities with the availability of dependable borrowing sources, which can be accessed when necessary. However, competitive pressure on deposit pricing could result in a decrease in the Company's deposit base or an increase in funding costs. In addition, liquidity will come under additional pressure if loan growth exceeds deposit growth. These scenarios could lead to a decrease in the Company's basic surplus measure to an amount below the minimum policy level of 5%. To manage this risk, the Company has the ability to purchase brokered time deposits, borrow against established borrowing facilities with other banks (Federal funds) and enter into repurchase agreements with investment companies. Depending on the level of interest rates applicable to these alternatives, the Company's net interest income, and therefore earnings, could be adversely affected. See the section captioned "Liquidity Risk" in Item 7.

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Our ability to service our debt, pay dividends and otherwise pay our obligations as they come due is substantially dependent on capital distributions from our subsidiaries.

The Company is a separate and distinct legal entity from its subsidiaries. It receives substantially all of its revenue from dividends from its subsidiaries. These dividends are the principal source of funds to pay dividends on the Company's common stock and interest and principal on the Company's debt. Various federal and/or state laws and regulations limit the amount of dividends that the Bank may pay to the Company. In addition, the Company's right to participate in a distribution of assets upon a subsidiary's liquidation or reorganization is subject to the prior claims of the subsidiary's creditors. In the event the Bank is unable to pay dividends to the Company, the Company may not be able to service debt, pay obligations or pay dividends on the Company's common stock. The inability to receive dividends from the Bank could have a material adverse effect on the Company's business, financial condition and results of operations.

We face cybersecurity risks and risks associated with security breaches which have the potential to disrupt our operations, cause material harm to our financial condition, result in misappropriation of assets, compromise confidential information and/or damage our business relationships and can provide no assurance that the steps we and our service providers take in response to these risks will be effective.

We depend upon data processing, communication and information exchange on a variety of computing platforms and networks and over the internet. In addition, we rely on the services of a variety of vendors to meet our data processing and communication needs. We face cybersecurity risks and risks associated with security breaches or disruptions such as those through cyber-attacks or cyber intrusions over the internet, malware, computer viruses, attachments to emails, social engineering and phishing schemes or persons inside our organization. The risk of a security breach or disruption, particularly through cyber-attacks or cyber intrusions, including by computer hackers, nation-state affiliated actors, and cyber terrorists, has generally increased as the number, intensity and sophistication of attempted attacks and intrusions from around the world have increased. These incidents may result in disruption of our operations, material harm to our financial condition, cash flows and the market price of our common stock, misappropriation of assets, compromise or corruption of confidential information collected in the course of conducting our business, liability for stolen information or assets, increased cybersecurity protection and insurance costs, regulatory enforcement, litigation and damage to our stakeholder relationships. These risks require continuous and likely increasing attention and other resources from us to, among other actions, identify and quantify these risks, upgrade and expand our technologies, systems and processes to adequately address them and provide periodic training for our employees to assist them in detecting phishing, malware and other schemes. Such attention diverts time and other resources from other activities and there is no assurance that our efforts will be effective.

In the normal course of business, we collect and retain certain personal information provided by our customers, employees and vendors. We also rely extensively on computer systems to process transactions and manage our business. We can provide no assurance that the data security measures designed to protect confidential information on our systems established by us will be able to prevent unauthorized access to this personal information. There can be no assurance that our efforts to maintain the security and integrity of the information we and our service providers collect on our and their computer systems will be effective or that attempted security breaches or disruptions would not be successful or damaging. Even the most well protected information, networks, systems and facilities remain potentially vulnerable because the techniques used in such attempted security breaches evolve and generally are not recognized until launched against a target, and in some cases are designed not be detected and, in fact, may not be detected. Accordingly, we may be unable to anticipate these techniques or to implement adequate security barriers or other preventative measures, and thus it is impossible for us to entirely mitigate this risk.

The Company may be adversely affected by fraud.

As a financial institution, the Company is inherently exposed to operational risk in the form of theft and other fraudulent activity by employees, customers and other third parties targeting the Company and/or the Company's customers or data. Such activity may take many forms, including check fraud, electronic fraud, wire fraud, phishing, social engineering and other dishonest acts. Although the Company devotes substantial resources to maintaining effective policies and internal controls to identify and prevent such incidents, given the increasing sophistication of possible perpetrators, the Company may experience financial losses or reputational harm as a result of fraud.

We continually encounter technological change and the failure to understand and adapt to these changes could have a material adverse impact our business.

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 serve customers better 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. Many of the Company's competitors have substantially greater resources to invest in technological improvements. The Company may not be able to effectively implement new technology-driven products and services or be successful in marketing these products and services to its customers. Failure to successfully keep pace with technological changes affecting the financial services industry could have a material adverse impact on the Company's business and, in turn, the Company's financial condition and results of operations.

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The Company relies on third parties to provide key components of its business infrastructure.

The Company relies on third parties to provide key components for its business operations, such as data processing and storage, recording and monitoring transactions, online banking interfaces and services, internet connections and network access. While the Company selects these third-party vendors carefully, it does not control their actions. Any problems caused by these third parties, including those resulting from breakdowns or other disruptions in communication services provided by a vendor, failure of a vendor to handle current or higher volumes, cyber-attacks and security breaches at a vendor, failure of a vendor to provide services for any reason or poor performance of services by a vendor, could adversely affect the Company's ability to deliver products and services to its customers and otherwise conduct its business. Financial or operational difficulties of a third-party vendor could also hurt the Company's operations if those difficulties interfere with the vendor's ability to serve the Company. Replacing these third party vendors also could create significant delays and expense that adversely affect the Company's business and performance.

The possibility of the economy's return to recessionary conditions and the possibility of further turmoil or volatility in the financial markets would likely have an adverse effect on our business, financial position and results of operations.

The economy in the United States and globally has experienced volatility in recent years and may continue to do so for the foreseeable future. There can be no assurance that economic conditions will not worsen. Unfavorable or uncertain economic conditions can be caused by declines in economic growth, business activity or investor or business confidence, limitations on the availability or increases in the cost of credit and capital, increases in inflation or interest rates, the timing and impact of changing governmental policies, natural disasters, terrorist attacks, acts of war or a combination of these or other factors. A worsening of business and economic conditions recovery could have adverse effects on our business, including the following:

investors may have less confidence in the equity markets in general and in financial services industry stocks in particular, which could place downward pressure on the Company's stock price and resulting market valuation;

consumer and business confidence levels could be lowered and cause declines in credit usage and adverse changes in payment patterns, causing increases in delinquencies and default rates;

the Company's ability to assess the creditworthiness of its customers may be impaired if the models and approaches the Company uses to select, manage and underwrite its customers become less predictive of future behaviors;

the Company could suffer decreases in demand for loans or other financial products and services or decreased deposits or other investments in accounts with the Company;

demand for and income received from the Company's fee-based services could decline;

customers of the Company's trust and benefit plan administration business may liquidate investments, which together with lower asset values, may reduce the level of assets under management and administration and thereby decrease the Company's investment management and administration revenues;

competition in the financial services industry could intensify as a result of the increasing consolidation of financial services companies in connection with current market conditions or otherwise; and;

the value of loans and other assets or collateral securing loans may decrease.

We are subject to other-than-temporary impairment risk, which could negatively impact our financial performance.

The Company recognizes an impairment charge when the decline in the fair value of equity, debt securities and cost-method investments below their cost basis are judged to be other-than-temporary. Significant judgment is used to identify events or circumstances that would likely have a significant adverse effect on the future use of the investment. The Company considers various factors in determining whether an impairment is other-than-temporary, including the severity and duration of the impairment, forecasted recovery, the financial condition and near-term prospects of the investee, whether the Company has the intent to sell and whether it is more likely than not it will be forced to sell the security in question. Information about unrealized gains and losses is subject to changing conditions. The values of securities with unrealized gains and losses will fluctuate, as will the values of securities that we identify as potentially distressed. Our current evaluation of other-than-temporary impairments reflects our intent to hold securities for a reasonable period of time sufficient for a forecasted recovery of fair value. However, our intent to hold certain of these securities may change in future periods as a result of facts and circumstances impacting a specific security. If our intent to hold a security with an unrealized loss changes and we do not expect the security to fully recover prior to the expected time of disposition, we will write down the security to its fair value in the period that our intent to hold the security changes.

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The process of evaluating the potential impairment of goodwill and other intangibles is highly subjective and requires significant judgment. The Company estimates the expected future cash flows of its various businesses and determines the carrying value of these businesses. The Company exercises judgment in assigning and allocating certain assets and liabilities to these businesses. The Company then compares the carrying value, including goodwill and other intangibles, to the discounted future cash flows. If the total of future cash flows is less than the carrying amount of the assets, an impairment loss is recognized based on the excess of the carrying amount over the fair value of the assets. Estimates of the future cash flows associated with the assets are critical to these assessments. Changes in these estimates based on changed economic conditions or business strategies could result in material impairment charges and therefore have a material adverse impact on the Company’s financial condition and performance.

The risks presented by acquisitions could adversely affect our financial condition and results of operations.

The business strategy of the Company has included and may continue to include growth through acquisition. Any future acquisitions will be accompanied by the risks commonly encountered in acquisitions. These risks may include, among other things:

our ability to realize anticipated cost savings;

the difficulty of integrating operations and personnel and the potential loss of key employees;

the potential disruption of our or the acquired company’s ongoing business in such a way that could result in decreased revenues or 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 the acquired company’s employees and customers as a result of changes in ownership and management.

We cannot provide any assurance that we will be successful in overcoming these risks or any other problems encountered in connection with acquisitions. Our inability to overcome these risks could have an adverse effect on the achievement of our business strategy and results of operations.

There are substantial risks and uncertainties associated with the introduction or expansion of lines of business or new products and services within existing lines of business.

From time to time, the Company may implement new lines of business or offer new products and services within existing lines of business. There are substantial risks and uncertainties associated with these efforts, particularly in instances where the markets are not fully developed. In developing and marketing new lines of business and/or new products and services, the Company may invest significant time and resources. Initial timetables for the introduction and development of new lines of business and/or new products or services may not be achieved and price and profitability targets may not prove attainable. External factors, such as compliance with regulations, competitive alternatives and shifting market preferences, may also impact the successful implementation of a new line of business or a new product or service. Furthermore, any new line of business and/or new product or service could have a significant impact on the effectiveness of the Company’s system of internal controls. Failure to successfully manage these risks in the development and implementation of new lines of business or new products or services could have a material adverse effect on the Company’s business, results of operations and financial condition.

Our controls and procedures may fail or be circumvented, which may result in a material adverse effect on our business.

Management regularly reviews and updates our internal controls, disclosure controls and procedures and corporate governance policies and procedures. Any system of controls, however well designed and operated, is based in part on certain assumptions and can provide only reasonable, not absolute, assurances that the objectives of the system are met. Any failure or circumvention of the controls and procedures or failure to comply with regulations related to controls and procedures could have a material adverse effect on our business, results of operations and financial condition.

We may be held responsible for environmental liabilities with respect to properties to which we obtain title, resulting in significant financial loss.

A significant portion of our loan portfolio at December 31, 2018 was secured by real estate. In the course of our business, we may foreclose and take title to real estate and could be subject to environmental liabilities with respect to these properties. We may be held liable to a government entity or to third parties for property damage, personal injury, investigation and clean-up costs incurred by these parties in connection with environmental contamination or may be required to clean up hazardous or toxic substances, or chemical releases at a property. The costs associated with investigation and remediation activities could be substantial. In addition, if we are the owner or former owner of a contaminated site, we may be subject to common law claims by third parties based on damages and costs resulting from environmental contamination emanating from the property. These costs and claims could adversely affect our business, results of operations, financial condition and liquidity.

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We may be adversely affected by the soundness of other financial institutions including the FHLB of New York.

Our ability to engage in routine funding transactions could be adversely affected by the actions and commercial soundness of other financial institutions. Financial services companies are interrelated as a result of trading, clearing, counterparty or other relationships. We have exposure to many different industries and counterparties and we routinely execute transactions with counterparties in the financial services industry, including brokers and dealers, commercial banks, investment banks, mutual and hedge funds and other institutional clients. As a result, defaults by, or even rumors or questions about, one or more financial services companies, or the financial services industry generally, have led to market-wide liquidity problems and could lead to losses or defaults by us or by other institutions. Many of these transactions expose us to credit risk in the event of default of our counterparty or client. In addition, our credit risk may be exacerbated if the collateral held by us cannot be realized or is liquidated at prices not sufficient to recover the full amount of the loan or derivative exposure due us. There is no assurance that any such losses would not materially and adversely affect our business, financial condition or results of operations.

The Company owns common stock of FHLB of New York in order to qualify for membership in the FHLB system, which enables it to borrow funds under the FHLB of New York's advance program. The carrying value and fair market value of our FHLB of New York common stock was $38.0 million as of December 31, 2018. There are 11 branches of the FHLB, including New York, which 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 the payment. Any adverse effects on the FHLB of New York could adversely affect the value of our investment in its common stock and negatively impact our results of operations.

Replacement of the LIBOR benchmark interest rate could adversely affect our business, financial condition, and results of operations.

In 2017, the United Kingdom's Financial Conduct Authority ("FCA"), which regulates the London Interbank Offered Rate ("LIBOR"), announced that the FCA intends to stop persuading or compelling banks to submit the rates required to calculate LIBOR after 2021. This announcement indicates that the continuation of LIBOR on the current basis cannot and will not be guaranteed after 2021. Consequently, at this time, it is not possible to predict whether and to what extent banks will continue to provide submissions for the calculation of LIBOR. Similarly, it is not possible to predict whether LIBOR will continue to be viewed as an acceptable market benchmark, what rate or rates may become accepted alternatives to LIBOR or what the effect of any such changes in views or alternatives may be on the markets for LIBOR-indexed financial instruments. The Alternative Reference Rates Committee ("ARRC") has proposed that the Secured Overnight Financing Rate ("SOFR") is the rate that represents best practice as the alternative to LIBOR for use in derivatives and other financial contracts that are currently indexed to LIBOR. ARRC has proposed a paced market transition plan to SOFR from LIBOR and organizations are currently working on industry wide and company specific transition plans as it relates to derivatives and cash markets exposed to LIBOR.

We have a significant number of loans, derivative contracts, borrowings and other financial instruments with attributes that are either directly or indirectly dependent on LIBOR. The transition from LIBOR, or any changes or reforms to the determination or supervision of LIBOR, could have an adverse impact on the market for or value of any LIBOR-linked securities, loans, and other financial obligations or extensions of credit held by or due to us, could create considerable costs and additional risk and could have an adverse impact on our overall financial condition or results of operations. Since proposed alternative rates are calculated differently, payments under contracts referencing new rates will differ from those referencing LIBOR. The transition will change our market risk profiles, requiring changes to risk and pricing models, valuation tools, product design and hedging strategies. Furthermore, failure to adequately manage this transition process with our customers could adversely impact our reputation.

We rely on our management and other key personnel, and the loss of any of them may adversely affect our operations.

We are and will continue to be dependent upon the services of our executive management team. In addition, we will continue to depend on our ability to retain and recruit key client relationship managers. The unexpected loss of services of any key management personnel, or the inability to recruit and retain qualified personnel in the future, could have an adverse effect on our business and financial condition.

Provisions of our certificate of incorporation and bylaws, as well as Delaware law and certain banking laws, could delay or prevent a takeover of us by a third party.

Provisions of the Company’s certificate of incorporation and bylaws, the corporate law of the State of Delaware and state and federal banking laws, including regulatory approval requirements, could delay, defer or prevent a third party from acquiring the Company, despite the possible benefit to the Company’s stockholders, or otherwise adversely affect the market price of the Company’s common stock. These provisions include supermajority voting requirements for certain business combinations and advance notice requirements for nominations for election to the Company’s board of directors and for proposing matters that stockholders may act on at stockholder meetings. In addition, the Company is subject to Delaware law, which among other things prohibits the Company from engaging in a business combination with any interested stockholder for a period of three years from the date the person became an interested stockholder unless certain conditions are met. These provisions may discourage potential takeover attempts, discourage bids for the Company’s common stock at a premium over market price or adversely affect the market price of and the voting and other rights of the holders of the Company’s common stock. These provisions could also discourage proxy contests and make it more difficult for you and other stockholders to elect directors other than candidates nominated by the Board.

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The Company’s common stock price may fluctuate significantly.

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

- the political climate and whether the proposed policies of the current Presidential administration in the U.S. that have affected market prices for financial institution stocks are successfully implemented;
- changes in securities analysts’ recommendations or 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;
- 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; and
- severe weather, natural disasters, acts of war or terrorism and other external events.

There may be future sales or other dilution of the Company's equity, which may adversely affect the market price of the Company's stock.

The Company is not restricted from issuing additional common stock, including any securities that are convertible into or exchangeable for, or that represent the right to receive, common stock. The Company also grants a significant number of shares of common stock to employees and directors under the Company's incentive plan each year. The issuance of any additional shares of the Company's common stock or preferred stock or securities convertible into, exchangeable for or that represent the right to receive common stock or the exercise of such securities could be substantially dilutive to stockholders of the Company's common stock. Holders of the Company's common stock have no preemptive rights that entitle such holders to purchase their pro rata share of any offering of shares or any class or series. Because the Company's decision to issue securities in any future offering will depend on market conditions, its acquisition activity and other factors, the Company cannot predict or estimate the amount, timing or nature of its future offerings. Thus, the Company's stockholders bear the risk of the Company's future offerings reducing the market price of the Company's common stock and diluting their stock holdings in the Company.

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## ITEM 1B. Unresolved Staff Comments

None.

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ITEM 2. Properties

The Company owns its headquarters located at 52 South Broad Street, Norwich, New York 13815. The Company operated the following community banking branches and ATMs as of December 31, 2018:

| County | Branches | ATMs | County | Branches | ATMs |
|---|---|---|---|---|---|
| New York | | | Pennsylvania | | |
| Albany | 4 | 5 | Lackawanna | 12 | 17 |
| Broome | 7 | 9 | Luzerne | 4 | 6 |
| Chenango | 11 | 12 | Monroe | 4 | 4 |
| Clinton | 3 | 3 | Pike | 2 | 2 |
| Cortland | 5 | 7 | Susquehanna | 5 | 7 |
| Delaware | 5 | 5 | Wayne | 3 | 4 |
| Essex | 3 | 5 | | | |
| Franklin | 1 | 1 | New Hampshire | | |
| Fulton | 5 | 6 | Cheshire | 1 | - |
| Greene | 2 | 2 | Hillsborough | 2 | 2 |
| Hamilton | 1 | 1 | Rockingham | 1 | 2 |
| Herkimer | 2 | 1 | | | |
| Madison | 4 | 8 | Vermont | | |
| Montgomery | 5 | 4 | Chittenden | 3 | 3 |
| Oneida | 7 | 9 | Rutland | 1 | 1 |
| Onondaga | 11 | 13 | | | |
| Oswego | 4 | 6 | Massachusetts | | |
| Otsego | 8 | 11 | Berkshire | 6 | 6 |
| Rensselaer | 1 | 1 | | | |
| St. Lawrence | 4 | 5 | Maine | | |
| Saratoga | 4 | 4 | Cumberland | 1 | - |
| Schenectady | 2 | 2 | | | |
| Schoharie | 4 | 4 | | | |
| Tioga | 1 | 1 | | | |
| Warren | 2 | 3 | | | |
| | | | Total | 151 | 182 |

The Company leases 65 of the above listed branches from third parties. The Company owns all other banking premises. The Company believes that its offices are sufficient for its present operations and that all properties are adequately covered by insurance. All of the above ATMs are owned by the Company.

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ITEM 3. Legal Proceedings

There are no material legal proceedings, other than ordinary routine litigation incidental to the business, to which the Company or any of its subsidiaries is a party or of which any of their property is subject.

ITEM 4. Mine Safety Disclosures

None.

PART II

ITEM 5. Market for Registrant's Common Equity, Related Stockholder matters and Issuer Purchases of Equity Securities

Market Information

The common stock of the Company, par value $0.01 per share (the "Common Stock"), is quoted on the NASDAQ Global Select Market under the symbol "NBTB." The closing price of the Common Stock on February 11, 2019 was $37.47. As of February 11, 2019, there were 5,985 stockholders of record of Common Stock. No unregistered securities were sold by the Company during the year ended December 31, 2018.

Stock Performance Graph

The following stock performance graph compares the cumulative total stockholder return (i.e., price change, reinvestment of cash dividends and stock dividends received) on our Common Stock against the cumulative total return of the NASDAQ Stock Market (U.S. Companies) Index and the KBW Regional Bank Index (Peer Group). The stock performance graph assumes that $100 was invested on December 31, 2013. The graph further assumes the reinvestment of dividends into additional shares of the same class of equity securities at the frequency with which dividends are paid on such securities during the relevant fiscal year. The yearly points marked on the horizontal axis correspond to December 31 of that year. We calculate each of the referenced indices in the same manner. All are market-capitalization-weighted indices, so companies judged by the market to be more important (i.e., more valuable) count for more in all indices.

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| | Period Ending | | | | | |
|---|---|---|---|---|---|---|
| Index | 12/31/13 | 12/31/14 | 12/31/15 | 12/31/16 | 12/31/17 | 12/31/18 |
| NBT Bancorp | $100.00 | $105.07 | $115.29 | $178.26 | $160.59 | $154.95 |
| KBW Regional Bank Index | $100.00 | $102.43 | $108.56 | $151.40 | $153.77 | $126.88 |
| NASDAQ Composite Index | $100.00 | $114.83 | $122.99 | $134.02 | $173.86 | $168.98 |

Source: Bloomberg, L.P.

Dividends

The Company depends primarily upon dividends from subsidiaries for a substantial part of the Company's revenue. Accordingly, the ability to pay dividends to stockholders depends primarily upon the receipt of dividends or other capital distributions from the subsidiaries. Payment of dividends to the Company from the Bank is subject to certain regulatory and other restrictions. Under OCC regulations, the Bank may pay dividends to the Company without prior regulatory approval so long as it meets its applicable regulatory capital requirements before and after payment of such dividends and its total dividends do not exceed its net income to date over the calendar year plus retained net income over the preceding two years. At December 31, 2018, the Bank was in compliance with all applicable minimum capital requirements and had the ability to pay dividends of $174.1 million to the Company without the prior approval of the OCC.

If the capital of the Company is diminished by depreciation in the value of its property or by losses, or otherwise, to an amount less than the aggregate amount of the capital represented by the issued and outstanding stock of all classes having a preference upon the distribution of assets, no dividends may be paid out of net profits until the deficiency in

the amount of capital represented by the issued and outstanding stock of all classes having a preference upon the distribution of assets has been repaired. See the section captioned "Supervision and Regulation" in Item 1. Business and Note 16 to the consolidated financial statements is included in Item 8. Financial Statements and Supplementary Data, which are located elsewhere in this report.

Stock Repurchase

The Company did not purchase shares of its common stock during year ended December 31, 2018. On October 23, 2017, the NBT Board of Directors authorized a repurchase program for NBT to repurchase up to 1,000,000 shares of its outstanding stock. This plan expires on December 31, 2019.



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ITEM 6. Selected Financial Data

The following summary of financial and other information about the Company is derived from the Company's audited consolidated financial statements for each of the last five fiscal years ended December 31 and should be read in conjunction with Item 7 and the Company's consolidated financial statements and accompanying notes, included elsewhere in this report:

| | Year ended December 31, | | | | |
|---|---|---|---|---|---|
| (In thousands, except per share data) | 2018 | 2017 | 2016 | 2015 | 2014 |
| Interest, fee and dividend income | $344,255 | $309,407 | $286,947 | $273,224 | $275,081 |
| Interest expense | 38,626 | 25,914 | 22,506 | 20,616 | 23,203 |
| Net interest income | 305,629 | 283,493 | 264,441 | 252,608 | 251,878 |
| Provision for loan losses | 28,828 | 30,988 | 25,431 | 18,285 | 19,539 |
| Noninterest income excluding net securities (losses) gains | 131,103 | 119,437 | 116,357 | 115,394 | 125,935 |
| Net securities (losses) gains | (6,341) | 1,867 | (644) | 3,087 | 92 |
| Noninterest expense | 264,561 | 245,648 | 235,922 | 236,176 | 246,063 |
| Income before income taxes | 137,002 | 128,161 | 118,801 | 116,628 | 112,303 |
| Net income | 112,566 | 82,151 | 78,409 | 76,425 | 75,074 |
| | | | | | |
| Per common share | | | | | |
| Basic earnings | $2.58 | $1.89 | $1.81 | $1.74 | $1.71 |
| Diluted earnings | 2.56 | 1.87 | 1.80 | 1.72 | 1.69 |
| Cash dividends paid | 0.99 | 0.92 | 0.90 | 0.87 | 0.84 |
| Book value at year-end | 23.31 | 22.01 | 21.11 | 20.31 | 19.69 |
| Tangible book value at year-end [(1)] | 16.66 | 15.54 | 14.61 | 13.79 | 13.22 |
| Average diluted common shares outstanding | 44,020 | 43,905 | 43,622 | 44,389 | 44,395 |
| | | | | | |
| Securities available for sale, at fair value | $998,496 | $1,255,925 | $1,338,290 | $1,174,544 | $1,013,171 |
| Securities held to maturity, at amortized cost | 783,599 | 484,073 | 527,948 | 471,031 | 454,361 |
| Loans | 6,887,709 | 6,583,639 | 6,196,978 | 5,882,642 | 5,591,959 |
| Allowance for loan losses | 72,505 | 69,500 | 65,200 | 63,018 | 66,359 |
| Assets | 9,556,363 | 9,136,812 | 8,867,268 | 8,262,646 | 7,807,340 |
| Deposits | 7,368,211 | 7,170,636 | 6,973,688 | 6,604,843 | 6,299,605 |
| Borrowings | 1,046,616 | 909,188 | 886,986 | 674,124 | 548,943 |
| Stockholders' equity | 1,017,909 | 958,177 | 913,316 | 882,004 | 864,181 |
| | | | | | |
| Key ratios | | | | | |
| Return on average assets | 1.20 % | 0.91 % | 0.92 % | 0.96 % | 0.97 % |
| Return on average equity | 11.49 % | 8.71 % | 8.74 % | 8.70 % | 8.84 % |
| Average equity to average assets | 10.47 % | 10.45 % | 10.49 % | 10.98 % | 10.95 % |
| Net interest margin | 3.58 % | 3.47 % | 3.43 % | 3.50 % | 3.61 % |
| Dividend payout ratio | 38.67 % | 49.20 % | 50.00 % | 49.92 % | 49.16 % |
| Tier 1 leverage | 9.52 % | 9.14 % | 9.11 % | 9.44 % | 9.39 % |
| Common equity tier 1 capital ratio | 10.49 % | 10.06 % | 9.98 % | 10.20 % | N/A |
| Tier 1 risk-based capital | 11.79 % | 11.42 % | 11.42 % | 11.73 % | 12.32 % |
| Total risk-based capital | 12.78 % | 12.42 % | 12.39 % | 12.74 % | 13.50 % |

(1) Tangible book value calculation (non-GAAP):

| | Year ended December 31, | | | | |
|---|---|---|---|---|---|
| (In thousands, except per share data) | 2018 | 2017 | 2016 | 2015 | 2014 |
| Stockholders' equity | $1,017,909 | $958,177 | $913,316 | $882,004 | $864,181 |
| Intangibles | 290,368 | 281,463 | 281,254 | 283,222 | 283,951 |
| Tangible equity | 727,541 | 676,714 | 632,062 | 598,782 | 580,230 |
| Diluted common shares outstanding | 43,673 | 43,543 | 43,258 | 43,431 | 43,896 |
| Tangible book value | $16.66 | $15.54 | $14.61 | $13.79 | $13.22 |

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Selected Quarterly Financial Data

| | 2018 | | | | 2017 | | | |
|---|---|---|---|---|---|---|---|---|
| (In thousands, except per share data) | Fourth | Third | Second | First | Fourth | Third | Second | First |
| Interest, fee and dividend income | $90,524 | $88,204 | $84,767 | $80,760 | $80,230 | $78,847 | $75,894 | $74,436 |
| Interest expense | 11,649 | 10,677 | 9,026 | 7,274 | 6,779 | 6,917 | 6,273 | 5,945 |
| Net interest income | 78,875 | 77,527 | 75,741 | 73,486 | 73,451 | 71,930 | 69,621 | 68,491 |
| Provision for loan losses | 6,528 | 6,026 | 8,778 | 7,496 | 8,153 | 7,889 | 7,567 | 7,379 |
| Noninterest income excluding net securities (losses) gains | 32,862 | 32,969 | 34,067 | 31,205 | 29,603 | 30,782 | 30,302 | 28,750 |
| Net securities (losses) gains | (6,916 ) | 412 | 91 | 72 | 1,869 | (4 ) | 2 | - |
| Noninterest expense | 68,904 | 66,497 | 64,888 | 64,272 | 63,444 | 60,601 | 60,321 | 61,282 |
| Net income | 28,652 | 29,807 | 28,121 | 25,986 | 17,637 | 22,876 | 21,359 | 20,279 |
| Basic earnings per share | $0.66 | $0.68 | $0.64 | $0.60 | $0.40 | $0.52 | $0.49 | $0.47 |
| Diluted earnings per share | $0.65 | $0.68 | $0.64 | $0.59 | $0.40 | $0.52 | $0.49 | $0.46 |
| Annualized net interest margin | 3.61 % | 3.57 % | 3.57 % | 3.57 % | 3.52 % | 3.47 % | 3.44 % | 3.46 % |
| Annualized return on average assets | 1.20 % | 1.25 % | 1.21 % | 1.15 % | 0.77 % | 1.00 % | 0.95 % | 0.92 % |
| Annualized return on average equity | 11.34 % | 11.96 % | 11.64 % | 10.99 % | 7.27 % | 9.55 % | 9.11 % | 8.94 % |
| Weighted average diluted common shares outstanding | 44,060 | 44,051 | 44,017 | 43,975 | 43,958 | 43,915 | 43,901 | 43,883 |

Forward-Looking Statements

Certain statements in this filing and future filings by the Company with the SEC, in the Company’s press releases or other public or stockholder communications or in oral statements made with the approval of an authorized executive officer, contain forward-looking statements, as defined in the Private Securities Litigation Reform Act. These statements may be identified by the use of phrases such as “anticipate,” “believe,” “expect,” “forecasts,” “projects,” “will,” “ca “would,” “should,” “could,” “may,” or other similar terms. There are a number of factors, many of which are beyond the Company’s control that could cause actual results to differ materially from those contemplated by the forward-looking statements. Factors that may cause actual results to differ materially from those contemplated by such forward-looking statements include, among others, the following possibilities: (1) local, regional, national and international economic conditions and the impact they may have on the Company and its customers and the Company’s assessment of that impact; (2) changes in the level of nonperforming assets and charge-offs; (3) changes in estimates of future reserve requirements based upon the periodic review thereof under relevant regulatory and accounting requirements; (4) the effects of and changes in trade and monetary and fiscal policies and laws, including the interest rate policies of the Federal Reserve Board ("FRB"); (5) inflation, interest rate, securities market and monetary fluctuations; (6) political instability; (7) acts of war or terrorism; (8) the timely development and acceptance of new products and services and perceived overall value of these products and services by users; (9) changes in consumer spending, borrowings and savings habits; (10) changes in the financial performance and/or condition of the Company’s borrowers; (11) technological changes; (12) acquisitions and integration of acquired businesses; (13) the ability to increase market share and control expenses; (14) changes in the competitive environment among financial holding companies; (15) the effect of changes in laws and regulations (including laws and regulations concerning taxes, banking, securities and insurance) with which the Company and its subsidiaries must comply, including those under the Dodd-Frank Act; (16) the effect of changes in accounting policies and practices, as may be adopted by the regulatory agencies, as well as the Public Company Accounting Oversight Board, the Financial Accounting Standards Board ("FASB") and other accounting standard setters; (17) changes in the Company’s organization, compensation and benefit plans; (18) the costs and effects of legal and regulatory developments including the resolution of legal proceedings or regulatory or other governmental inquiries and the results of regulatory examinations or reviews; (19) greater than expected costs or difficulties related to the integration of new products and lines of business; and (20) the Company’s success at managing the risks involved in the foregoing items.

The Company cautions readers not to place undue reliance on any forward-looking statements, which speak only as of the date made, and advises readers that various factors, including, but not limited to, those described above and other factors discussed in the Company's annual and quarterly reports previously filed with the Securities and Exchange Commission, could affect the Company’s financial performance and could cause the Company’s actual results or circumstances for future periods to differ materially from those anticipated or projected.

Unless required by law, the Company does not undertake, and specifically disclaims any obligations to, publicly release any revisions that may be made to any forward-looking statements to reflect the occurrence of anticipated or unanticipated events or circumstances after the date of such statements.

General

The financial review that follows focuses on the factors affecting the consolidated financial condition and results of operations of the Company and its wholly-owned subsidiaries, the Bank, NBT Financial Services and NBT Holdings during 2018 and, in summary form, the preceding two years. Collectively, the Registrant and its subsidiaries are referred to herein as “the Company.” Net interest margin is presented in this discussion on a fully taxable equivalent ("FTE") basis. Average balances discussed are daily averages unless otherwise described. The audited consolidated

financial statements and related notes as of December 31, 2018 and 2017 and for each of the years in the three-year period ended December 31, 2018 should be read in conjunction with this review. Amounts in prior period consolidated financial statements are reclassified whenever necessary to conform to the 2018 presentation.

Critical Accounting Policies

The Company has identified policies as being critical because they require management to make particularly difficult, subjective and/or complex judgments about matters that are inherently uncertain and because of the likelihood that materially different amounts would be reported under different conditions or using different assumptions. These policies relate to the allowance for loan losses, pension accounting and provision for income taxes.

Management of the Company considers the accounting policy relating to the allowance for loan losses to be a critical accounting policy given the uncertainty in evaluating the level of the allowance required to cover credit losses inherent in the loan portfolio and the material effect that such judgments can have on the results of operations. While management's current evaluation of the allowance for loan losses indicates that the allowance is appropriate, the allowance may need to be increased under adversely different conditions or assumptions. For example, if historical loan loss experience significantly worsened or if current economic conditions significantly deteriorated, additional provision for loan losses would be required to increase the allowance. In addition, the assumptions and estimates used in the internal reviews of the Company's nonperforming loans and potential problem loans have a significant impact on the overall analysis of the adequacy of the allowance for loan losses. While management has concluded that the current evaluation of collateral values is reasonable, if collateral values were significantly lower, the Company's allowance for loan loss policy would also require additional provision for loan losses.

Management is required to make various assumptions in valuing the Company's pension assets and liabilities. These assumptions include the expected rate of return on plan assets, the discount rate and the rate of increase in future compensation levels. Changes to these assumptions could impact earnings in future periods. The Company takes into account the plan asset mix, funding obligations and expert opinions in determining the various rates used to estimate pension expense. The Company also considers the Citigroup Pension Liability Index, market interest rates and discounted cash flows in setting the appropriate discount rate. In addition, the Company reviews expected inflationary and merit increases to compensation in determining the rate of increase in future compensation levels.

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.

The Company's policies on the allowance for loan losses, pension accounting and provision for income taxes are disclosed in Note 1 to the consolidated financial statements. A more detailed description of the allowance for loan losses is included in the section captioned "Risk Management – Credit Risk" in Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations of this Form 10-K. All significant pension accounting assumptions and income tax assumptions are disclosed in Notes 13 and 12 to the consolidated financial statements, respectively. All accounting policies are important and as such, the Company encourages the reader to review each of the policies included in Note 1 to obtain a better understanding of how the Company's financial performance is reported.

Non-GAAP Measures

This Annual Report on Form 10-K contains financial information determined by methods other than in accordance with accounting principles generally accepted in the United States of America ("GAAP"). These measures adjust GAAP measures to exclude the effects of acquisition-related intangible amortization expense on earnings and equity as well as providing a FTE yield on securities and loans. Where non-GAAP disclosures are used in this Annual Report on Form 10-K, the comparable GAAP measure, as well as a reconciliation to the comparable GAAP measure, is provided in the accompanying tables. Management believes that these non-GAAP measures provide useful information that is important to an understanding of the results of the Company's core business as well as provide information standard in the financial institution industry. Non-GAAP measures should not be considered a substitute for financial measures determined in accordance with GAAP and investors should consider the Company's performance and financial condition as reported under GAAP and all other relevant information when assessing the performance or financial condition of the Company.

Overview

Significant factors management reviews to evaluate the Company's operating results and financial condition include, but are not limited to: net income and earnings per share, return on average assets and equity, net interest margin, noninterest income, operating expenses, asset quality indicators, loan and deposit growth, capital management, liquidity and interest rate sensitivity, enhancements to customer products and services, technology advancements, market share and peer comparisons. The following information should be considered in connection with the Company's results for the fiscal year ended December 31, 2018:

diluted earnings per share up 37% from prior year

earnings in excess of $100 million for the first time in the 163 year history of the Company

loan growth for the year ended December 31, 2018 of 4.6%

average demand deposits for the year ended December 31, 2018 up 4.7% over 2017

FTE net interest margin of 3.58% for year ended December 31, 2018 up 11 bps from 2017

full cycle deposit beta of 6.9% through the quarter ended December 31, 2018[1]

(1) The change in the Company's quarterly deposit costs from December 31, 2015 to December 31, 2018 of 0.15% divided by the change in FRB's target fed funds rate from December 31, 2015 to December 31, 2018 of 2.25%.

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The Company reported net income of $112.6 million or $2.56 per diluted share for 2018, up 37.0% from net income of $82.2 million or $1.87 per diluted share for 2017. Net interest income was $305.6 million for the year ended December 31, 2018, up $22.1 million, or 7.8%, from 2017. FTE net interest margin of 3.58% for the year ended December 31, 2018, was up from 3.47% for the year ended December 31, 2017. Average interest earning assets were up $320.1 million, or 3.9%, for the year ended December 31, 2018 as compared to 2017. The provision for loan losses totaled $28.8 million for the year ended December 31, 2018, as compared with $31.0 million for the year ended December 31, 2017. Significant non-recurring transactions occurring in the fourth quarter 2018 included a one-time tax benefit of $5.5 million related to tax return accounting method changes and $6.6 million in losses on securities sold due to the restructuring of a portion of the investment securities portfolio.

2019 Outlook

The Company’s 2018 earnings reflected the Company’s continued ability to manage through the existing economic conditions and challenges in the financial services industry, while investing in the Company’s future. During 2018, the Company, along with other financial services companies, benefitted from rising asset yields with limited increases in deposit costs. Significant items that may have an impact on 2019 results include:

continued strong economic conditions may lead to further increases in interest rates. This would result in principal and interest payments on currently outstanding loans and investments being reinvested at higher rates. In addition, rising market rates would likely increase deposit and borrowing costs from current low levels. This could potentially offset, or more than offset, the benefits of higher rates on our earning assets. The magnitude and timing of interest rate increases, if any, along with the shape of the yield curve, will impact net interest income in 2019.

slower economic growth could reduce demand for credit, slowing loan growth.

the Company's continued focus on long-term strategies including growth in the New England markets, diversification of revenue, improving operating efficiencies and investing in technology.

the Company’s 2019 outlook is subject to factors in addition to those identified above and those risks and uncertainties that could impact the Company’s future results are explained in ITEM 1A. RISK FACTORS.

Asset/Liability Management

The Company attempts to maximize net interest income and net income, while actively managing its liquidity and interest rate sensitivity through the mix of various core deposit products and other sources of funds, which in turn fund an appropriate mix of earning assets. The changes in the Company’s asset mix and sources of funds, and the resulting impact on net interest income, on a FTE basis, are discussed below. The following table includes the condensed consolidated average balance sheet, an analysis of interest income/expense and average yield/rate for each major category of earning assets and interest bearing liabilities on a taxable equivalent basis. Interest income for tax-exempt securities and loans has been adjusted to a taxable-equivalent basis using the statutory Federal income tax rate of 21% for 2018 and 35% for 2017 and 2016.

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Average Balances and Net Interest Income

| (Dollars in thousands) | 2018 Average Balance | Interest | Yield/ Rate | 2017 Average Balance | Interest | Yield/ Rate | 2016 Average Balance | Interest | Yield/ Rate |
|---|---|---|---|---|---|---|---|---|---|
| Assets: | | | | | | | | | |
| Short-term interest bearing accounts | $3,377 | $183 | 5.42 % | $9,636 | $179 | 1.86 % | $16,301 | $95 | 0.58 % |
| Securities available for sale (1)(3) | 1,210,013 | 27,081 | 2.24 % | 1,350,995 | 28,969 | 2.14 % | 1,237,930 | 24,450 | 1.98 % |
| Securities held to maturity (1) | 567,117 | 14,657 | 2.58 % | 507,583 | 13,490 | 2.66 % | 487,837 | 12,255 | 2.51 % |
| Federal Reserve Bank and FHLB stock | 48,214 | 3,083 | 6.39 % | 46,673 | 2,634 | 5.64 % | 38,867 | 1,973 | 5.08 % |
| Loans (2) | 6,765,748 | 301,258 | 4.45 % | 6,359,447 | 267,934 | 4.21 % | 6,035,513 | 251,723 | 4.17 % |
| Total interest earning assets | $8,594,469 | $346,262 | 4.03 % | $8,274,334 | $313,206 | 3.79 % | $7,816,448 | $290,496 | 3.72 % |
| Other assets (3) | 764,670 | | | 752,258 | | | 740,506 | | |
| Total assets | $9,359,139 | | | $9,026,592 | | | $8,556,954 | | |
| | | | | | | | | | |
| Liabilities and Stockholders' Equity: | | | | | | | | | |
| Money market deposit accounts | $1,706,823 | $8,314 | 0.49 % | $1,697,386 | $3,864 | 0.23 % | $1,668,555 | $3,599 | 0.22 % |
| NOW deposit accounts | 1,191,008 | 1,894 | 0.16 % | 1,153,361 | 1,051 | 0.09 % | 1,077,581 | 546 | 0.05 % |
| Savings deposits | 1,266,970 | 725 | 0.06 % | 1,214,480 | 683 | 0.06 % | 1,135,182 | 652 | 0.06 % |
| Time deposits | 866,388 | 11,211 | 1.29 % | 817,370 | 8,877 | 1.09 % | 905,126 | 9,569 | 1.06 % |
| Total interest bearing deposits | $5,031,189 | $22,144 | 0.44 % | $4,882,597 | $14,475 | 0.30 % | $4,786,444 | $14,366 | 0.30 % |
| Short-term borrowings | 727,635 | 10,552 | 1.45 % | 690,036 | 5,996 | 0.87 % | 497,654 | 2,309 | 0.46 % |
| Long-term debt | 80,195 | 1,790 | 2.23 % | 93,389 | 2,299 | 2.46 % | 118,860 | 3,204 | 2.70 % |
| Junior subordinated debt | 101,196 | 4,140 | 4.09 % | 101,196 | 3,144 | 3.11 % | 101,196 | 2,627 | 2.60 % |
| Total interest bearing liabilities | $5,940,215 | $38,626 | 0.65 % | $5,767,218 | $25,914 | 0.45 % | $5,504,154 | $22,506 | 0.41 % |
| Demand deposits | 2,321,264 | | | 2,217,785 | | | 2,045,465 | | |
| Other liabilities | 117,655 | | | 97,913 | | | 110,105 | | |
| Stockholders' equity | 980,005 | | | 943,676 | | | 897,230 | | |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Total liabilities and stockholders' equity | $9,359,139 | | | $9,026,592 | | | $8,556,954 | | |
| Net interest income (FTE) | | $307,636 | | | $287,292 | | | $267,990 | |
| Interest rate spread | | | 3.38 % | | | 3.34 % | | | 3.31 % |
| Net interest margin (FTE) | | | 3.58 % | | | 3.47 % | | | 3.43 % |
| Taxable equivalent adjustment | | $2,007 | | | $3,799 | | | $3,549 | |
| Net interest income | | $305,629 | | | $283,493 | | | $264,441 | |

(1) Securities are shown at average amortized cost.
(2) For purposes of these computations, nonaccrual loans and loans held for sale are included in the average loan balances outstanding.
(3) For purposes of the average balance sheet presentation, equity securities amounts reclassified for the current period from securities available for sale to other assets, related to the adoption of Accounting Standard Update No. 2016-01, Financial Instruments - Overall (Subtopic 825-10) – Recognition and Measurement of Financial Assets and Financial Liabilities, in the first quarter of 2018.

2018 OPERATING RESULTS AS COMPARED TO 2017 OPERATING RESULTS

Net Interest Income

Net interest income for the year ended 2018 was $305.6 million, up $22.1 million, or 7.8%, from 2017. FTE net interest margin of 3.58% for the year ended December 31, 2018, was up from 3.47% for the year ended December 31, 2017 primarily due to asset yields increasing 24 basis points (“bps”), more than offsetting the 20 bp rise in the cost of interest bearing liabilities. Average interest earning assets were up $320.1 million, or 3.9%, for the year ended December 31, 2018, as compared to the year ended December 31, 2017, driven by a $406.3 million increase in loans that was partially offset by a $81.4 million decrease in securities. Interest income increased $34.8 million, or 11.3%, due to the increase in earning assets combined with a 24 bp improvement in loan yields. Interest expense was up $12.7 million, or 49.1%, for the year ended December 31, 2018 as compared to the year ended December 31, 2017 resulting primarily from a 20 bp increase in rates on interest bearing liabilities driven by higher borrowing costs and a 14 bp increase in the cost of interest bearing deposits, combined with an increase in average interest bearing liabilities of $173.0 million. The FRB has raised its target fed funds rate nine times from December 2015 through December 2018 for a total of 225 bps. During this same cycle of increasing rates, the Company’s deposit rates have increased by 15 bps, resulting in a full cycle deposit beta of 6.9%.

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Analysis of Changes in FTE Net Interest Income

| | Increase (Decrease) 2018 over 2017 | | | Increase (Decrease) 2017 over 2016 | | |
|---|---|---|---|---|---|---|
| (In thousands) | Volume | Rate | Total | Volume | Rate | Total |
| Short-term interest-bearing accounts | $(173 ) | $177 | $4 | $(52 ) | $136 | $84 |
| Securities available for sale | (3,115 ) | 1,227 | (1,888 ) | 2,331 | 2,188 | 4,519 |
| Securities held to maturity | 1,547 | (380 ) | 1,167 | 508 | 727 | 1,235 |
| Federal Reserve Bank and FHLB stock | 89 | 360 | 449 | 425 | 236 | 661 |
| Loans | 17,632 | 15,692 | 33,324 | 13,627 | 2,584 | 16,211 |
| Total FTE interest income | $15,980 | $17,076 | $33,056 | $16,839 | $5,871 | $22,710 |
| Money market deposit accounts | 22 | 4,428 | 4,450 | 63 | 202 | 265 |
| NOW deposit accounts | 35 | 808 | 843 | 41 | 464 | 505 |
| Savings deposits | 30 | 12 | 42 | 45 | (14 ) | 31 |
| Time deposits | 557 | 1,777 | 2,334 | (948 ) | 256 | (692 ) |
| Short-term borrowings | 343 | 4,213 | 4,556 | 1,132 | 2,555 | 3,687 |
| Long-term debt | (307 ) | (202 ) | (509 ) | (644 ) | (261 ) | (905 ) |
| Junior subordinated debt | - | 996 | 996 | - | 517 | 517 |
| Total FTE interest expense | $680 | $12,032 | $12,712 | $(311 ) | $3,719 | $3,408 |
| Change in FTE net interest income | $15,300 | $5,044 | $20,344 | $17,150 | $2,152 | $19,302 |

Loans and Corresponding Interest and Fees on Loans

The average balance of loans increased by approximately $406.3 million, or 6.4%, from 2017 to 2018. The yield on average loans increased from 4.21% in 2017 to 4.45% in 2018, as loan rates increased due to the interest rate environment in 2018. FTE interest income from loans increased 12.4%, from $267.9 million in 2017 to $301.3 million in 2018. This increase was due to the increases in yields and the average loan balances.

Total loans increased $304.1 million, or 4.6%, from December 31, 2017 to December 31, 2018. Increases in Commercial Real Estate, Specialty Lending and Residential Real Estate loans were the primary drivers of the increase in total loans from 2017 with New York and New England markets accounting for the majority of the growth.

The following table reflects the loan portfolio by major categories for the years indicated:

Composition of Loan Portfolio

| | December 31, | | | | |
|---|---|---|---|---|---|
| (In thousands) | 2018 | 2017 | 2016 | 2015 | 2014 |
| Commercial | $1,291,568 | $1,258,212 | $1,242,701 | $1,159,089 | $1,144,761 |
| Commercial Real Estate | 1,930,742 | 1,769,620 | 1,543,301 | 1,430,618 | 1,334,984 |
| Residential Real Estate | 1,380,836 | 1,320,370 | 1,262,041 | 1,196,780 | 1,112,530 |
| Dealer Finance | 1,216,144 | 1,227,870 | 1,169,129 | 1,173,729 | 1,104,869 |
| Specialty Lending | 524,928 | 438,866 | 361,152 | 287,096 | 256,542 |
| Home Equity | 474,566 | 498,179 | 507,784 | 528,442 | 569,595 |
| Other Consumer | 68,925 | 70,522 | 110,870 | 106,888 | 68,678 |
| Total loans | $6,887,709 | $6,583,639 | $6,196,978 | $5,882,642 | $5,591,959 |

Residential Real Estate consist primarily of loans secured by first or second deeds of trust on primary residences. Loans in the Commercial and Commercial Real Estate, consist primarily of loans made to small and medium-sized entities. Dealer Finance loans include indirect installment loans to individuals, which are primarily secured by

automobiles. Other Consumer loans also consist of direct installment loans to individuals most secured by automobiles and other personal property. Although automobile loans have generally been originated through dealers, all applications submitted through dealers are subject to the Company’s normal underwriting and loan approval procedures. The Specialty Lending portfolio includes unsecured consumer loans across a national footprint originated through our relationship with national technology-driven consumer lending companies that began 10 years ago as the result of our investment in Springstone Financial LLC ("Springstone"). Advances of credit through this specialty lending business line are to prime borrowers and are subject to the Company's underwriting standards. As of December 31, 2018, there were $145.6 million in construction and development loans included in total loans.

Risks associated with the Commercial Real Estate portfolio include the ability of borrowers to pay interest and principal during the loan’s term, as well as the ability of the borrowers to refinance at the end of the loan term.

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The following table, Maturities and Sensitivities of Certain Loans to Changes in Interest Rates, summarizes the maturities of the commercial and commercial real estate loan portfolios and the sensitivity of those loans to interest rate fluctuations at December 31, 2018. Scheduled repayments are reported in the maturity category in which the contractual payment is due.

Maturities and Sensitivities of Certain Loans to Changes in Interest Rates

| | Remaining maturity at December 31, 2018 | | | |
|---|---|---|---|---|
| (In thousands) | Within One Year | After One Year But Within Five Years | After Five Years | Total |
| Floating/adjustable rate: | | | | |
| Commercial and Commercial Real Estate | $464,923 | $ 490,180 | $1,418,506 | $2,373,609 |
| Fixed rate: | | | | |
| Commercial and Commercial Real Estate | 89,736 | 448,861 | 310,104 | 848,701 |
| Total | $554,659 | $ 939,041 | $1,728,610 | $3,222,310 |

Securities and Corresponding Interest and Dividend Income

The average balance of securities available for sale ("AFS") decreased $141.0 million, or 10.4%, from 2017 to 2018. The FTE yield on average AFS securities was 2.24% for 2018 compared to 2.14% in 2017.

The average balance of securities held to maturity ("HTM") increased from $507.6 million in 2017 to $567.1 million in 2018. At December 31, 2018, HTM securities were comprised primarily of tax-exempt municipal securities and government-sponsored collateralized mortgage obligations("CMOs"). The FTE yield on HTM securities decreased from 2.66% in 2017 to 2.58% in 2018.

The average balance of Federal Reserve Bank and FHLB stock increased to $48.2 million in 2018 from $46.7 million in 2017. The FTE yield from investments in Federal Reserve Bank and FHLB stock increased from 5.64% in 2017 to 6.39% in 2018.

Securities Portfolio

| | As of December 31, | | | | | |
|---|---|---|---|---|---|---|
| | 2018 | | 2017 | | 2016 | |
| (In thousands) | Amortized Cost | Fair Value | Amortized Cost | Fair Value | Amortized Cost | Fair Value |
| AFS securities: | | | | | | |
| Federal agency | $84,982 | $84,299 | $109,862 | $108,899 | $175,135 | $174,408 |
| State & municipal | 30,136 | 29,915 | 42,171 | 41,956 | 47,053 | 46,726 |
| Mortgage-backed | 522,415 | 512,295 | 556,755 | 554,927 | 528,769 | 529,844 |
| Collateralized mortgage obligations | 380,093 | 371,987 | 546,754 | 535,994 | 574,253 | 566,573 |
| Equity securities | - | - | 10,623 | 14,149 | 15,849 | 20,739 |
| Total AFS securities | $1,017,626 | $998,496 | $1,266,165 | $1,255,925 | $1,341,059 | $1,338,290 |
| | | | | | | |
| HTM securities: | | | | | | |
| Federal agency | $19,995 | $20,047 | $- | $- | $- | $- |
| Mortgage-backed | 179,848 | 178,190 | 96,775 | 96,107 | 97,201 | 96,112 |
| Collateralized mortgage obligations | 340,623 | 338,590 | 186,327 | 183,974 | 225,213 | 224,765 |

| | | | | | | |
|---|---|---|---|---|---|---|
| State & municipal | 243,133 | 241,848 | 200,971 | 201,790 | 205,534 | 204,173 |
| Total HTM securities | $783,599 | $778,675 | $484,073 | $481,871 | $527,948 | $525,050 |

The Company's mortgage-backed securities, U.S. agency notes and CMOs are all “prime/conforming” and are guaranteed by Fannie Mae, Freddie Mac, the FHLB, the Federal Farm Credit Banks or Ginnie Mae (“GNMA”). GNMA securities are considered equivalent to U.S. Treasury securities, as they are backed by the full faith and credit of the U.S. government. Currently, there are no subprime mortgages in our investment portfolio.

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The following tables set forth information with regard to contractual maturities of debt securities at December 31, 2018:

| (Dollars in thousands) | Amortized cost | Estimated fair value | Weighted Average Yield | |
|---|---|---|---|---|
| AFS debt securities: | | | | |
| Within one year | $44,262 | $44,218 | 1.54 | % |
| From one to five years | 84,391 | 83,441 | 2.59 | % |
| From five to ten years | 163,400 | 160,898 | 2.73 | % |
| After ten years | 725,573 | 709,939 | 2.74 | % |
| Total AFS debt securities | $1,017,626 | $998,496 | | |
| | | | | |
| HTM debt securities: | | | | |
| Within one year | $85,778 | $85,778 | 2.11 | % |
| From one to five years | 62,441 | 62,558 | 3.14 | % |
| From five to ten years | 213,184 | 210,480 | 2.34 | % |
| After ten years | 422,196 | 419,859 | 3.12 | % |
| Total HTM debt securities | $783,599 | $778,675 | | |

Funding Sources and Corresponding Interest Expense

The Company utilizes traditional deposit products such as time, savings, NOW, money market and demand deposits as its primary source for funding. Other sources, such as short-term FHLB advances, federal funds purchased, securities sold under agreements to repurchase, brokered time deposits and long-term FHLB borrowings are utilized as necessary to support the Company’s growth in assets and to achieve interest rate sensitivity objectives. The average balance of interest-bearing liabilities increased $173.0 million from 2017 and totaled $5.9 billion in 2018. The rate paid on interest-bearing liabilities increased from 0.45% in 2017 to 0.65% in 2018. This increase in rates and increase in average balances caused an increase in interest expense of $12.7 million, or 49.1%, from $25.9 million in 2017 to $38.6 million in 2018.

Deposits

Average interest bearing deposits increased $148.6 million, or 3.0%, from 2017 to 2018, due primarily to organic deposit growth. Average money market deposits increased $9.4 million, or 0.6% during 2018 compared to 2017. Average NOW accounts increased $37.6 million, or 3.3% during 2018 as compared to 2017. The average balance of savings accounts increased $52.5 million, or 4.3% during 2018 compared to 2017. These average balance of time deposits increased $49.0 million, or 6.0%, from 2017 to 2018. The average balance of demand deposits increased $103.5 million, or 4.7%, during 2018 compared to 2017. This growth in demand deposits was driven principally by increases in accounts from retail, municipal and commercial customers.

The rate paid on average interest-bearing deposits was 0.44% for 2018 and 0.30% for 2017. The rate paid for money market deposit accounts increased from 0.23% during 2017 to 0.49% during 2018. The rate paid for NOW deposit accounts increased from 0.09% in 2017 to 0.16% in 2018. The rate paid for savings deposits was 0.06% for 2018 and 2017. The rate paid for time deposits increased from 1.09% during 2017 to 1.29% during 2018.

The following table presents the maturity distribution of time deposits of $250,000 or more:

| (In thousands) | December 31,2018 |
|---|---|
| Within three months | $ 36,943 |

| | |
|---|---|
| After three but within twelve months | 64,334 |
| After one but within three years | 33,322 |
| Over three years | 11,524 |
| Total | $ 146,123 |

Borrowings

Average short-term borrowings increased to $727.6 million in 2018 from $690.0 million in 2017 funding earning asset growth. The average rate paid on short-term borrowings increased from 0.87% in 2017 to 1.45% in 2018. Average long-term debt decreased from $93.4 million in 2017 to $80.2 million in 2018.

The average balance of junior subordinated debt remained at $101.2 million in 2018. The average rate paid for junior subordinated debt in 2018 was 4.09%, up from 3.11% in 2017.

Short-term borrowings consist of federal funds purchased and securities sold under repurchase agreements, which generally represent overnight borrowing transactions and other short-term borrowings, primarily FHLB advances, with original maturities of one year or less. The Company has unused lines of credit with the FHLB and access to brokered deposits available for short-term financing of approximately $1.9 billion and $2.0 billion at December 31, 2018 and 2017, respectively. Securities collateralizing repurchase agreements are held in safekeeping by non-affiliated financial institutions and are under the Company’s control. Long-term debt, which is comprised primarily of FHLB advances, are collateralized by the FHLB stock owned by the Company, certain of its mortgage-backed securities and a blanket lien on its residential real estate mortgage loans.

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Noninterest Income

Noninterest income is a significant source of revenue for the Company and an important factor in the Company's results of operations. The following table sets forth information by category of noninterest income for the years indicated:

| | Years ended December 31, | | |
|---|---|---|---|
| (In thousands) | 2018 | 2017 | 2016 |
| Insurance and other financial services revenue | $24,345 | $23,532 | $24,396 |
| Service charges on deposit accounts | 17,224 | 16,750 | 16,729 |
| ATM and debit card fees | 22,699 | 21,372 | 19,448 |
| Retirement plan administration fees | 26,992 | 20,213 | 16,063 |
| Trust | 19,524 | 19,586 | 18,565 |
| Bank owned life insurance income | 5,091 | 5,175 | 5,195 |
| Net securities (losses) gains | (6,341) | 1,867 | (644) |
| Gain on the sale of equity investment | - | 818 | - |
| Other | 15,228 | 11,991 | 15,961 |
| Total noninterest income | $124,762 | $121,304 | $115,713 |

Noninterest income for the year ended December 31, 2018 was $124.8 million, up $3.5 million, or 2.9%, from the year ended December 31, 2017. The increase from the prior year was driven by higher retirement plan administration fees and an increase in other noninterest income that was partially offset by net securities losses in 2018. Retirement plan administration fees increased due to the acquisitions of Retirement Plan Services, LLC ("RPS") in the second quarter of 2018 and of Downeast Pension Services in the second quarter of 2017. In the fourth quarter of 2018, the Company restructured the investment portfolio by selling $109 million lower yielding bonds and reinvesting the proceeds in higher yielding bonds, which resulted in a $6.6 million loss on securities sold. Other noninterest income in 2018 increased compared to 2017 due to non-recurring gains recognized in 2018. Excluding net securities (losses) gains, noninterest income for the year ended December 31, 2018 would have been $131.1 million, up $11.7 million, or 9.8%, from the year ended December 31, 2017.

Noninterest Expense

Noninterest expenses are also an important factor in the Company's results of operations. The following table sets forth the major components of noninterest expense for the years indicated:

| | Years ended December 31, | | |
|---|---|---|---|
| (In thousands) | 2018 | 2017 | 2016 |
| Salaries and employee benefits | $151,685 | $135,222 | $132,060 |
| Occupancy | 22,318 | 21,808 | 20,940 |
| Data processing and communications | 17,652 | 17,068 | 16,495 |
| Professional fees and outside services | 14,376 | 13,499 | 13,617 |
| Equipment | 17,037 | 15,225 | 14,295 |
| Office supplies and postage | 6,204 | 6,284 | 6,168 |
| FDIC expenses | 4,651 | 4,767 | 5,111 |
| Advertising | 2,782 | 2,744 | 2,556 |
| Amortization of intangible assets | 4,042 | 3,960 | 3,928 |
| Loan collection and other real estate owned, net | 4,217 | 4,763 | 3,458 |
| Other | 19,597 | 20,308 | 17,294 |
| Total noninterest expense | $264,561 | $245,648 | $235,922 |

Noninterest expense for the year ended December 31, 2018 was $264.6 million, up $18.9 million, or 7.7%, from the year ended December 31, 2017. The increase from the prior year was driven by higher salaries and employee benefits due to the retirement plan services acquisitions in 2018 and 2017, higher incentive compensation and wage increases for over 60% of our employees from the Company's commitment to invest a portion of the tax reform benefit in our employees.

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Income Taxes

We calculate our current and deferred tax provision based on estimates and assumptions that could differ from the actual results reflected in income tax returns filed during the subsequent year. Adjustments based on filed returns are recorded when identified, which is generally in the fourth quarter of the subsequent year for U.S. federal and state provisions.

The amount of income taxes the Company pays is subject at times to ongoing audits by federal and state tax authorities, which may result in proposed assessments. Future results may include favorable or unfavorable adjustments to the estimated tax liabilities in the period the assessments are proposed or resolved or when statutes of limitation on potential assessments expire. As a result, the Company’s effective tax rate may fluctuate significantly on a quarterly or annual basis.

On December 22, 2017, the U.S. government enacted the Tax Cuts and Jobs Act (“TCJA”). The TCJA includes significant changes to the U.S. corporate income tax system including: a federal corporate rate reduction from 35% to 21% and establishing other tax laws affecting years subsequent to 2017. In connection with the analysis of the impact of the TCJA, the Company recorded a $4.4 million adjustment in the year ended December 31, 2017 for remeasurement of deferred tax assets and liabilities for the corporate rate reduction.

Income tax expense for the year ended December 31, 2018 was $24.4 million, down $21.6 million, or 46.9%, from the year ended December 31, 2017. The effective tax rate of 17.8% in 2018 was down from 35.9% in 2017. The decrease in income tax expense from the prior year was due to the lower effective tax rate resulting from the TCJA, a $5.5 million tax benefit recorded in the fourth quarter of 2018 primarily related to one-time income tax return accounting method changes during the fourth quarter of 2018, combined with the $4.4 million non-cash charge related to the enactment of the TCJA in 2017 for the Company’s deferred tax assets due to the tax rate reduction. This was partially offset by a higher level of taxable income and lower tax benefit from equity-based transactions. Excluding the tax benefit from equity-based transactions, the tax benefit in the fourth quarter of 2018 and the TCJA charge in 2017, the effective tax rate was 22.2% and 33.8% for the years ending December 31, 2018 and 2017, respectively. The adjusted income tax expense on the Company's income was different from the income tax expense at the Federal statutory rate of 21% for 2018 and 35% for 2017 due primarily to tax-exempt income and, to a lesser extent, the effect of state income taxes and Federal low income housing credits.

Risk Management – Credit Risk

Credit risk is managed through a network of loan officers, credit committees, loan policies and oversight from senior credit officers and Board of Directors. Management follows a policy of continually identifying, analyzing and grading credit risk inherent in each loan portfolio. An ongoing independent review of individual credits in the commercial loan portfolio is performed by the independent loan review function. These components of the Company’s underwriting and monitoring functions are critical to the timely identification, classification and resolution of problem credits.

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Nonperforming Assets

| (Dollars in thousands) | As of December 31, 2018 | % | 2017 | % | 2016 | % | 2015 | % | 2014 | % |
|---|---|---|---|---|---|---|---|---|---|---|
| Nonaccrual loans: | | | | | | | | | | |
| Commercial, Agricultural and Real Estate loans | $11,804 | 46 % | $12,485 | 48 % | $19,351 | 54 % | $14,655 | 43 % | $18,226 | 45 % |
| Residential Real Estate | 6,526 | 26 % | 5,919 | 23 % | 8,027 | 23 % | 8,625 | 26 % | 10,867 | 26 % |
| Consumer | 4,068 | 16 % | 4,324 | 17 % | 4,653 | 13 % | 6,009 | 18 % | 8,086 | 20 % |
| Troubled debt restructured loans | 3,089 | 12 % | 2,980 | 12 % | 3,681 | 10 % | 4,455 | 13 % | 3,895 | 9 % |
| Total nonaccrual loans | $25,487 | 100% | $25,708 | 100% | $35,712 | 100% | $33,744 | 100% | $41,074 | 100% |
| | | | | | | | | | | |
| Loans 90 days or more past due and still accruing: | | | | | | | | | | |
| Commercial, Agricultural and Real Estate loans | $588 | 12 % | $- | - | $- | - | $- | - | $84 | 2 % |
| Residential Real Estate | 1,182 | 23 % | 1,402 | 26 % | 1,733 | 36 % | 1,022 | 28 % | 1,927 | 39 % |
| Consumer | 3,315 | 65 % | 4,008 | 74 % | 3,077 | 64 % | 2,640 | 72 % | 2,930 | 59 % |
| Total loans 90 days or more past due and still accruing | $5,085 | 100% | $5,410 | 100% | $4,810 | 100% | $3,662 | 100% | $4,941 | 100% |
| | | | | | | | | | | |
| Total nonperforming loans | $30,572 | | $31,118 | | $40,522 | | $37,406 | | $46,015 | |
| Other real estate owned | 2,441 | | 4,529 | | 5,581 | | 4,666 | | 3,964 | |
| Total nonperforming assets | $33,013 | | $35,647 | | $46,103 | | $42,072 | | $49,979 | |
| | | | | | | | | | | |
| Total nonperforming loans to total loans | 0.44 % | | 0.47 % | | 0.65 % | | 0.64 % | | 0.82 % | |
| Total nonperforming assets to total assets | 0.35 % | | 0.39 % | | 0.52 % | | 0.51 % | | 0.64 % | |
| Total allowance for loan losses to nonperforming loans | 237.16% | | 223.34% | | 160.90% | | 168.47% | | 144.21% | |

Total nonperforming assets were $33.0 million at December 31, 2018, compared to $35.6 million at December 31, 2017. Nonperforming loans at December 31, 2018 were $30.6 million or 0.44% of total loans compared with $31.1 million or 0.47% of total loans at December 31, 2017. Included in nonperforming loans are $2.1 million and $2.4 million of nonaccrual loans in the acquired loan portfolio at December 31, 2018 and 2017, respectively. Excluding nonaccrual acquired loans, originated nonperforming loans to originated loans was 0.43% and 0.46% at December 31, 2018 and 2017, respectively.

The Company recorded a provision for loan losses of $28.8 million for the year ended December 31, 2018 compared with $31.0 million for the year ended December 31, 2017. Net charge-offs to average loans for the year ended December 31, 2018 were 0.38%, compared with 0.42% for the year ended December 31, 2017. The allowance for loan losses was 237.16% of nonperforming loans at December 31, 2018 as compared to 223.34% at December 31, 2017. The allowance for loan losses as a percentage of loans was 1.05% (1.10% excluding acquired loans with no related allowance recorded) at December 31, 2018 compared to 1.06% (1.12% excluding acquired loans with no related allowance recorded) at December 31, 2017.

Impaired loans, which primarily consist of nonaccruing Commercial, Commercial Real Estate and Residential Real Estate loans, as well as loans that have been modified in a troubled debt restructuring (“TDR”), decreased to $20.6 million at December 31, 2018 as compared to $21.1 million at December 31, 2017. At December 31, 2018, $0.2 million of the total impaired loans had a specific reserve allocation of $25 thousand compared to $1.0 million of impaired loans at December 31, 2017, which had a specific reserve allocation of $57 thousand.

The allowance for loan losses is maintained at a level estimated by management to provide adequately for risk of probable incurred losses inherent in the current loan portfolio. The adequacy of the allowance for loan losses is continuously monitored using a methodology designed to ensure the level of the allowance reasonably reflects the loan portfolio’s risk profile. It is evaluated to ensure that it is sufficient to absorb all reasonably estimable incurred credit losses inherent in the current loan portfolio.

Management considers the accounting policy relating to the allowance for loan losses to be a critical accounting policy given the degree of judgement exercised in evaluating the levels of the allowance required to cover credit losses in the portfolio and the material effect that such judgments can have on the consolidated results of operations.

During the quarter ended March 31, 2018, the Company made adjustments to the class segments within the portfolios to better align risk characteristics and reflect the monitoring and assessment of risks. Agricultural and Agricultural Real Estate were consolidated with Commercial and Industrial and Commercial Real Estate, respectively. Agricultural loans are a type of Commercial loan with certain specific underwriting guidelines; however, as of March 31, 2018, the portfolio has decreased to less than 3% of the Commercial portfolio and separate classification was no longer warranted. The Indirect Lending class was further separated into Dealer Finance and Specialty Lending. The growth in our Specialty Lending portfolio to 21% of Consumer Loans as of March 31, 2018 warranted evaluation of this class segment separately due to different risk characteristics from the Dealer Finance segment. The Direct and Home Equity class segments were consolidated into Direct to reflect common management, similar underwriting and in-market focus. The change to the class segments in the allowance methodology did not have a significant impact on the allowance for loan losses.

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For purposes of evaluating the adequacy of the allowance, the Company considers a number of significant factors that affect the collectability of the portfolio. For individually analyzed loans, these factors include estimates of loss exposure, which reflect the facts and circumstances that affect the likelihood of repayment of such loans as of the evaluation date. For homogeneous pools of loans, estimates of the Company's exposure to credit loss reflect a thorough current assessment of a number of factors, which affect collectability. These factors include: past loss experience; the size, trend, composition and nature of the loans; changes in lending policies and procedures, including underwriting standards and collection, charge-off and recovery practices; trends experienced in nonperforming and delinquent loans; current economic conditions in the Company's market; portfolio concentrations that may affect loss experienced across one or more components of the portfolio; the effect of external factors such as competition, legal and regulatory requirements; and the experience, ability and depth of lending management and staff. In addition, various regulatory agencies, as an integral component of their examination process, periodically review the Company's allowance for loan losses. Such agencies may require the Company to recognize additions to the allowance based on their judgement about information available to them at the time of their examination, which may not be currently available to management.

After a thorough consideration and validation of the factors discussed above, required additions to the allowance for loan losses are made periodically by charges or credits to the provision for loan losses. These are necessary to maintain the allowance at a level which management believes is reasonably reflective of overall inherent risk of probable loss in the portfolio. While management uses available information to recognize losses on loans, additions or reductions to the allowance may fluctuate from one reporting period to another. These fluctuations are reflective of changes in risk associated with portfolio content and/or changes in management's assessment of any or all of the determining factors discussed above. Management considers the allowance for loan losses to be appropriate based on evaluation and analysis of the loan portfolio.

Total net charge-offs for 2018 were $25.8 million, down from $26.7 million in 2017. Net charge-offs to average loans was 0.38% for 2018 as compared with 0.42% for 2017. For the originated portfolio, net charge-offs to average loans for the year ended December 31, 2018 was 0.40%, compared to 0.44% for 2017. Gross charge-offs were up to $34.1 million for 2018 from $33.1 million for 2017. Recoveries were up to $8.3 million for 2018 from $6.4 million for 2017.

Allowance for Loan Losses

| (Dollars in thousands) | 2018 | 2017 | 2016 | 2015 | 2014 |
|---|---|---|---|---|---|
| Balance at January 1 | $69,500 | $65,200 | $63,018 | $66,359 | $69,434 |
| Loans charged-off | | | | | |
| Commercial and Agricultural | 3,463 | 4,169 | 4,592 | 5,718 | 9,414 |
| Residential Real Estate | 913 | 1,846 | 1,343 | 2,229 | 1,417 |
| Consumer* | 29,752 | 27,072 | 23,364 | 18,140 | 16,642 |
| Total loans charged-off | $34,128 | $33,087 | $29,299 | $26,087 | $27,473 |
| Recoveries | | | | | |
| Commercial and Agricultural | $1,178 | $1,077 | $1,887 | $1,014 | $1,774 |
| Residential Real Estate | 306 | 180 | 293 | 320 | 285 |
| Consumer* | 6,821 | 5,142 | 3,870 | 3,127 | 2,800 |
| Total recoveries | $8,305 | $6,399 | $6,050 | $4,461 | $4,859 |
| Net loans charged-off | $25,823 | $26,688 | $23,249 | $21,626 | $22,614 |
| Provision for loan losses | $28,828 | $30,988 | $25,431 | $18,285 | $19,539 |
| Balance at December 31 | $72,505 | $69,500 | $65,200 | $63,018 | $66,359 |
| Allowance for loan losses to loans outstanding at end of year | 1.05 % | 1.06 % | 1.05 % | 1.07 % | 1.19 % |
| Net charge-offs to average loans outstanding | 0.38 % | 0.42 % | 0.39 % | 0.38 % | 0.41 % |

* Consumer charge-off and recoveries include consumer and home equity.

In addition to the nonperforming loans discussed above, the Company has also identified approximately $90.0 million in potential problem loans at December 31, 2018 as compared to $57.7 million at December 31, 2017. Potential problem loans are loans that are currently performing, with a possibility of loss if weaknesses are not corrected. Such loans may need to be disclosed as nonperforming at some time in the future. Potential problem loans are classified by the Company's loan rating system as "substandard." At December 31, 2018, there were 21 potential problem loans exceeding $1.0 million, totaling $45.8 million in aggregated compared to 17 potential problem loans exceeding $1.0 million, totaling $33.2 million in aggregate at December 31, 2017. Management cannot predict the extent to which economic conditions may worsen or other factors, which may impact borrowers and the potential problem loans. Accordingly, there can be no assurance that other loans will not become 90 days or more past due, be placed on nonaccrual, become restructured or require increased allowance coverage and provision for loan losses. To mitigate this risk the Company maintains a diversified loan portfolio, has no significant concentration in any particular industry and originates loans primarily within its footprint.

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

Allocation of the Allowance for Loan Losses

| | December 31, 2018 | | 2017 | | 2016 | | 2015 | | 2014 | |
|---|---|---|---|---|---|---|---|---|---|---|
| (Dollars in thousands) | Allowance | Category Percent of Loans | Allowance | Category Percent of Loans | Allowance | Category Percent of Loans | Allowance | Category Percent of Loans | Allowance | Category Percent of Loans |
| Commercial and Agricultural | $32,759 | 47 % | $27,606 | 46 % | $25,444 | 45 % | $25,545 | 44 % | $32,433 | 44 % |
| Residential Real Estate | 2,568 | 20 % | 5,064 | 20 % | 6,381 | 20 % | 7,960 | 20 % | 7,130 | 20 % |
| Consumer | 37,178 | 33 % | 36,830 | 34 % | 33,375 | 35 % | 29,253 | 36 | | |