CHEMUNG FINANCIAL CORP
Form 10-K
March 08, 2018

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 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, 2017 OR
TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from _______________ to _____________
Commission File Number 0-13888
CHEMUNG FINANCIAL CORPORATION
(Exact name of registrant as specified in its charter)

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| NEW YORK | 16-123703-8 |
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification No.) |
| One Chemung Canal Plaza, Elmira, New York | 14901 |
| (Address of principal executive offices) | (Zip Code) |

Registrant's telephone number, including area code: (607) 737-3711
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 | 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 and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). YES NO
Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of 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, smaller reporting company, or an emerging growth company. See 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 |
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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 upon the closing price of the registrant's Common Stock as of June 30, 2017, the aggregate market value of the voting stock held by non-affiliates of the registrant was $149,907,174.

As of March 7, 2018, there were 4,760,984 shares of Common Stock, $0.01 par value, outstanding.

DOCUMENTS INCORPORATED BY REFERENCE
Portions of the Proxy Statement for the Annual Meeting of Shareholders to be held on May 10, 2018 are incorporated by reference into Part III, Items 10, 11, 12, 13, and 14 of this Form 10-K.

CHEMUNG FINANCIAL CORPORATION

ANNUAL REPORT ON FORM 10-K FOR THE FISCAL YEAR ENDED DECEMBER 31, 2017

Some of the information contained in this report concerning the markets and industry in which we operate is derived from publicly available information and from industry sources. Although we believe that this publicly available information and information provided by these industry sources are reliable, we have not independently verified the accuracy of any of this information.

To assist the reader, the Corporation has provided the following list of commonly used abbreviations and terms included in Parts I through IV.

| Abbreviations | |
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| ALCO | Asset-Liability Committee |
| AOCI | Accumulated Other Comprehensive Income |
| ASC | Accounting Standards Codification |
| ASU | Accounting Standards Update |
| Bank | Chemung Canal Trust Company |
| Basel I | The First Basel Accord of the Basel Committee on Banking Supervision |
| Basel III | The Third Basel Accord of the Basel Committee on Banking Supervision |
| BHCA | Bank Holding Company Act of 1956 |
| Board of Directors | Board of Directors of Chemung Financial Corporation |
| BOLI | Bank Owned Life Insurance |
| CAPM | Capital Asset Pricing Model |
| CDARS | Certificate of Deposit Account Registry Service |
| CDO | Collateralized Debt Obligation |
| CFPB | Consumer Financial Protection Bureau |
| CFS | CFS Group, Inc. |
| Corporation | Chemung Financial Corporation |
| CRA | Community Reinvestment Act |
| CRM | Chemung Risk Management, Inc. |
| DIF | Deposit Insurance Fund |
| Dodd-Frank Act | The Dodd-Frank Wall Street Reform and Consumer Protection Act |
| ECOA | Equal Credit Opportunity Act |
| EPS | Earnings per share |
| Exchange Act | Securities Exchange Act of 1934 |
| FACT Act | Fair and Accurate Credit Transactions Act of 2003 |
| FASB | Financial Accounting Standards Board |
| FCRA | Fair Credit Reporting Act |
| FDIA | Federal Deposit Insurance Act |
| FDIC | Federal Deposit Insurance Corporation |
| FFIEC | Federal Financial Institution Examination Council |
| FHLBNY | Federal Home Loan Bank of New York |
| FICO | Financing Corporation |
| FINRA | Financial Industry Regulatory Authority |
| FOFC | Fort Orange Financial Corporation |
| FRB | Board of Governors of the Federal Reserve System |
| FRBNY | Federal Reserve Bank of New York |
| Freddie Mac | Federal Home Loan Mortgage Corporation |
| FTC | Federal Trade Commission |
| GAAP | U.S. Generally Accepted Accounting Principles |
| GLB Act | Gramm-Leach-Bliley Act |
| ICS | Insured Cash Sweep Service |

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| IPS | Investment Policy Statement |
| LIBOR | London Interbank Offered Rate |

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| MD&A | Management's Discussion and Analysis of Financial Condition and Results of Operations |
| NAICS | North American Industry Classification System |
| N/M | Not meaningful |
| NYSDFS | New York State Department of Financial Services |
| OCC | Office of the Comptroller of the Currency |
| OPEB | Other postemployment benefits |
| OREO | Other real estate owned |
| OTTI | Other-than-temporary impairment |
| PCI | Purchased credit impaired |
| Riegle-Neal Act | Riegle-Neal Interstate Banking and Branching Efficiency Act |
| RESPA | Real Estate Settlement Procedures Act |
| ROA | Return on average assets |
| ROE | Return on average equity |
| RWA | Risk-weighted assets |
| SBA | Small Business Administration |
| SEC | Securities and Exchange Commission |
| Security Guidelines | Interagency Guidelines Establishing Information Security Standards |
| Securities Act | Securities Act of 1933 |
| Sarbanes-Oxley | Sarbanes-Oxley Act of 2002 |
| Tax Act | Tax Cuts and Jobs Act of 2017 |
| TDRs | Troubled debt restructurings |
| TILA | Truth in Lending Act |
| TRID Rule | TILA-RESPA Integrated Disclosure Rule |
| USA PATRIOT Act | Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 |
| WMG | Wealth Management Group |

Terms

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| Accumulated benefit obligation | An approximate measure of the pension plan liability, which is based on the assumption that the pension plan is to be terminated immediately and does not consider any future salary increases. |
| Allowance for loan losses to total loans | Represents period-end allowance for loan losses divided by retained loans. |
| Assets under administration | Represents assets that are beneficially owned by clients and all investment decisions pertaining to these assets are also made by clients. |
| Assets under management | Represents assets that are managed on behalf of clients. |
| Basel I | A set of international banking regulations, which set out the minimum capital requirements of financial institutions with the goal of minimizing credit risk. The main focus was mainly on credit risk by creating a bank asset classification system. |
| Basel III | A comprehensive set of reform measures designed to improve the regulation, supervision, and risk management within the banking sector. The reforms require banks to maintain proper leverage ratios and meet certain capital requirements. |
| Benefit obligation | Refers to the projected benefit obligation for pension plans and the accumulated postretirement benefit obligation for OPEB plans. |
| Capital Bank | Division of Chemung Canal Trust Company located in the "Capital Region" of New York State and includes the counties of Albany and Saratoga. |
| | A company that provides risk-mitigation services for its parent company. |

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| Captive insurance company | |
| CDARS | Product involving a network of financial institutions that exchange certificates of deposits among members in order to ensure FDIC insurance coverage on customer deposits above the single institution limit. Using a sophisticated matching system, funds are exchanged on a dollar-for-dollar basis, so that the equivalent of an original deposit comes back to the originating institution. |

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| Collateralized debt obligation | A structured financial product that pools together cash flow-generating assets, such as mortgages, bonds, and loans. |
| Collateralized mortgage obligations | A type of mortgage-backed security with principal repayments organized according to their maturities and into different classes based on risk. The mortgages serve as collateral and are organized into classes based on their risk profile. |
| Dodd-Frank Act | The Dodd-Frank Act was enacted on July 21, 2010 and significantly changed the bank regulatory landscape and has impacted and will continue to impact the lending, deposit, investment, trading and operating activities of financial institutions and their holding companies. The Dodd-Frank Act requires various federal agencies to adopt a broad range of new rules and regulations, and to prepare various studies and reports for Congress. |
| Fully taxable equivalent basis | Income from tax-exempt loans and investment securities that have been increased by an amount equivalent to the taxes that would have been paid if this income were taxable at statutory rates; the corresponding income tax impact related to tax-exempt items is recorded within income tax expense. |
| GAAP | Accounting principles generally accepted in the United States of America. |
| Holding company | Consists of the operations for Chemung Financial Corporation (parent only). |
| ICS | Product involving a network of financial institutions that exchange interest-bearing money market deposits among members in order to ensure FDIC insurance coverage on customer deposits above the single institution limit. Using a sophisticated matching system, funds are exchanged on a dollar-for-dollar basis, so that the equivalent of an original deposit comes back to the originating institution. |
| Loans held for sale | Residential real estate loans originated for sale on the secondary market with maturities from 15-30 years. |
| Long term lease obligation | An obligation extending beyond the current year, which is related to a long term capital lease that is considered to have the economic characteristics of asset ownership. |
| Mortgage-backed securities | A type of asset-backed security that is secured by a collection of mortgages. |
| Municipal clients | A political unit, such as a city, town, or village, incorporated for local self-government. |
| N/A | Data is not applicable or available for the period presented. |
| N/M | Data is not meaningful in context presented. |
| Non-GAAP | A calculation not made according to GAAP. |
| Obligations of state and political subdivisions | An obligation that is guaranteed by the full faith and credit of a state or political subdivision that has the power to tax. |
| Obligations of U.S. Government | A federally guaranteed obligation backed by the full power of the U.S. government, including Treasury bills, Treasury notes and Treasury bonds. |
| Obligations of U.S. Government sponsored enterprise obligations | Obligations of agencies originally established or chartered by the U.S. government to serve public purposes as specified by the U.S. Congress; these obligations are not explicitly guaranteed as to the timely payment of principal and interest by the full faith and credit of the U.S. government. |
| OREO | Represents real property owned by the Corporation, which is not directly related to its business and is most frequently the result of a foreclosure on real property. |
| OTTI | Impairment charge taken on a security whose fair value has fallen below the carrying value on the balance sheet and whose value is not expected to recover through the holding period of the security. |
| PCI loans | Represents loans that were acquired in the Fort Orange Financial Corp. transaction and deemed to be credit-impaired on the acquisition date in accordance with the guidance of FASB. |
| Political subdivision | A county, city, town, or other municipal corporation, a public authority, or a publicly-owned entity that is an instrumentality of a state or a municipal corporation. |

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| Pre-provision profit/(loss) | Represents total net revenue less noninterest expense, before income tax expense (benefit). The Corporation believes that this financial measure is useful in assessing the ability of a bank to generate income in excess of its provision for credit losses. |
| Projected benefit obligation | An approximate measure of the pension plan liability, which is based on the assumption that the plan will not terminate in the near future and that employees will continue to work and receive future salary increases. |

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| RWA | Risk-weighted assets, which is used to calculate regulatory capital ratios, consist of on- and off-balance sheet assets that are assigned to one of several broad risk categories and weighted by factors representing their risk and potential for default. On-balance sheet assets are risk-weighted based on the perceived credit risk associated with the obligor or counterparty, the nature of any collateral, and the guarantor, if any. Off-balance sheet assets such as lending-related commitments, guarantees, derivatives and other applicable off-balance sheet positions are risk-weighted by multiplying the contractual amount by the appropriate credit conversion factor to determine the on-balance sheet credit equivalent amount, which is then risk-weighted based on the same factors used for on-balance sheet assets. Risk-weighted assets also incorporate a measure for market risk related to applicable trading assets-debt and equity instruments. The resulting risk-weighted values for each of the risk categories are then aggregated to determine total risk-weighted assets. |
| SBA loan pools | Business loans partially guaranteed by the SBA. |
| Securities sold under agreements to repurchase | Sale of securities together with an agreement for the seller to buy back the securities at a later date. |
| TDR | A TDR is deemed to occur when the Corporation modifies the original terms of a loan agreement by granting a concession to a borrower that is experiencing financial difficulty. |
| Trust preferred securities | A hybrid security with characteristics of both subordinated debt and preferred stock which allows for early redemption by the issuer, makes fixed or variable payments, and matures at face value. |
| Unaudited | Financial statements and information that have not been subjected to auditing procedures sufficient to permit an independent certified public accountant to express an opinion. |
| WMG | Provides services as executor and trustee under wills and agreements, and guardian, custodian, trustee and agent for pension, profit-sharing and other employee benefit trusts, as well as various investment, financial planning, pension, estate planning and employee benefit administration services. |

# PART I

## ITEM 1. BUSINESS

### General

The Corporation was incorporated on January 2, 1985 under the laws of the State of New York and is headquartered in Elmira, NY. The Corporation was organized for the purpose of acquiring the Bank. The Bank was established in 1833 under the name Chemung Canal Bank, and was subsequently granted a New York State bank charter in 1895. In 1902, the Bank was reorganized as a New York State trust company under the name Elmira Trust Company, and its name was changed to Chemung Canal Trust Company in 1903.

The Corporation became a financial holding company in June 2000. Financial holding company status provided the Corporation with the flexibility to offer an array of financial services, such as insurance products, mutual funds, and brokerage services, which provide additional sources of fee based income and allow the Corporation to better serve its customers. The Corporation established a financial services subsidiary, CFS, in September 2001 which offers non-banking financial services such as mutual funds, annuities, brokerage services, insurance and tax preparation services. The Corporation established a captive insurance subsidiary, CRM, based in the State of Nevada in May 2016, which insures gaps in commercial coverage and uninsured exposures in the Corporation's current insurance coverages and allows the Corporation to strengthen its overall risk management program.

The Corporation's Board of Directors has concluded that the expansion of the franchise's geographic footprint, an increase in the Bank's earning assets, and the generation of new sources of non-interest income are important components of its strategic plan. Towards that end, in recent years it has completed the following transactions:

- On May 3, 2007, the Bank acquired the trust business of Partners Trust Bank, Utica, New York. At the time of the acquisition, the Bank acquired $351.0 million in trust assets.

- On March 14, 2008, the Bank acquired three branches from Manufacturers and Traders Trust Company in the New York counties of Broome and Tioga. At the time of the acquisition, the Bank assumed $64.4 million in deposits and acquired $12.6 million in loans.
- On May 29, 2009, the Corporation acquired Canton Bancorp, Inc., the holding company of Bank of Canton based in Canton, Pennsylvania. At the time of the merger, Canton Bancorp, Inc. had $81.1 million in assets, $58.8 million in loans and $72.9 million in deposits.
- On April 8, 2011, the Corporation acquired FOFC, the holding company of Capital Bank & Trust Company based in Albany, New York. At the time of the merger, Capital Bank had $254.4 million in assets, $170.7 million in loans and $199.2 million in deposits.
- On November 23, 2013, the Bank completed the acquisition of six branch offices from Bank of America located in Cayuga, Cortland, Seneca, and Tompkins counties in New York. As part of the transaction, the Corporation acquired $177.7 million in deposits and $1.2 million in loans.

As a result of these transactions and organic growth, the Corporation had $1.708 billion in consolidated assets, $1.312 billion in loans, $1.467 billion in deposits and $149.8 million in shareholders' equity at December 31, 2017.

Growth Strategy

The Corporation's growth strategy is to leverage its expanding branch network in current or new markets to build client relationships and grow loans and deposits. Consistent with the Corporation's community banking model, emphasis is placed on acquiring stable, low-cost deposits, primarily checking account deposits and other low interest-bearing deposits to fund high-quality loans. Expanding the branch network involves branch purchases or opening de novo branches in contiguous markets and acquiring other financial institutions in the Northeast. The Corporation evaluates acquisition targets based on the economic viability of the markets they are in, the degree to which they can be effectively integrated into the Corporation's current operations and the degree to which they are accretive to capital and earnings.

Description of Business

The Corporation, through the Bank and CFS, provides a wide range of financial services, including demand, savings and time deposits, commercial, residential and consumer loans, interest rate swaps, letters of credit, wealth management services, employee benefit plans, insurance products, mutual funds and brokerage services. The Bank derives its income primarily from interest and fees on loans, interest on investment securities, WMG fee income, and fees received in connection with deposit and other services. The Bank's operating expenses are interest expense paid on deposits and borrowings, salaries and employee benefit plans and general operating expenses.

CRM, a wholly-owned subsidiary of the Corporation which was formed and began operations on May 31, 2016, is a Nevada-based captive insurance company which insures against certain risks unique to the operations of the Corporation and its subsidiaries and for which insurance may not be currently available or economically feasible in today's insurance marketplace. CRM pools resources with several other similar insurance company subsidiaries of financial institutions to spread a limited amount of risk among themselves. CRM is subject to regulations of the State of Nevada and undergoes periodic examinations by the Nevada Division of Insurance.

In order to compete with other financial services companies, the Corporation relies upon personal relationships established with clients by its officers, employees, and directors. The Corporation has maintained a strong community orientation by supporting the active participation of officers and employees in local charitable, civic, school, religious, and community development activities. The Corporation believes that its emphasis on local relationship banking together with a prudent approach to lending are important factors in its success and growth.

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Lending Activities

Lending Strategy

The Corporation’s objective is to channel deposits gathered locally into high-quality, market-yielding loans without taking unacceptable credit and/or interest rate risk.  The Corporation seeks to have a diversified loan portfolio consisting of commercial and agricultural loans, commercial mortgages, residential mortgages, home equity lines of credit and home equity term loans, consumer and indirect auto loans.  The Bank operates with a traditional community bank model where the relationship manager possesses credit skills and has significant influence over credit decisions.  This creates value since clients and prospects know they are dealing with a decision maker.

Lending Authority

The Board of Directors establishes the lending policies, underwriting standards, and loan approval limits of the Bank.  In accordance with those policies, the Board of Directors has designated certain officers to consider and approve loans within their designated authority.  These officers exercise substantial authority over credit and pricing decisions, subject to loan committee approval for larger credits.  The Bank recognizes that exceptions to the lending policies may occasionally occur and has established procedures for approving exceptions to these policies.

In underwriting loans, primary emphasis is placed on the borrower’s financial condition, including ability to generate cash flow to support the debt and other cash expenses.  In addition, substantial consideration is given to collateral value and marketability as well as the borrower’s character, reputation and other relevant factors.  Interest rates charged by the Bank vary with degree of risk, type, size, complexity, repricing frequency, and other relevant factors associated with the loans.  Competition from other financial services companies also impacts interest rates charged on loans.

The Corporation has also implemented reporting systems to monitor loan originations, loan quality, concentration of credit, loan delinquencies, non-performing loans and potential problem loans.

Lending Segments

The Corporation segments its loan portfolio into the following major lending categories: (i) commercial and agricultural, (ii) commercial mortgages, (iii) residential mortgages, and (iv) consumer loans.

Commercial and agricultural loans primarily consist of loans to small to mid-sized businesses in the Corporation's market area in a diverse range of industries.  These loans are of higher risk and typically are made on the basis of the borrower’s ability to make repayment from the cash flow of the borrower’s business.  Further, the collateral securing the loans may depreciate over time, may be difficult to appraise and may fluctuate in value.  The credit risk related to commercial loans is largely influenced by general economic conditions and the resulting impact on a borrower’s operations or on the value of underlying collateral, if any.

Commercial mortgage loans generally have larger balances and involve a greater degree of risk than residential mortgage loans, and they, therefore, pose higher potential losses on an individual customer basis.  Loan repayment is often dependent on the successful operation and management of the properties and/or the businesses occupying the properties, as well as on the collateral securing the loan.  Economic events or conditions in the real estate market could have an adverse impact on the cash flows generated by properties securing the Corporation’s commercial real estate loans and on the value of such properties.

The Corporation offers interest rate swaps to certain larger commercial mortgage borrowers. These swaps allow the Corporation to originate a mortgage based on short-term LIBOR rates and allow the borrower to swap into a longer term fixed rate. The Corporation simultaneously sells an offsetting back-to-back swap to an investment grade national bank so that it does not retain this fixed-rate risk. The swap agreements are free-standing derivatives and are recorded at fair value in the Corporation's consolidated balance sheets, which typically involves a day one gain.

Residential mortgage loans are generally made on the basis of the borrower’s ability to make repayment from his or her employment and other income, but are secured by real property whose value tends to be more easily ascertainable. Credit risk for these types of loans is generally influenced by general economic conditions, the characteristics of individual borrowers and the nature of the loan collateral.

The consumer loan segment includes home equity lines of credit and home equity loans, which exhibit many of the same risk characteristics as residential mortgages. Indirect and other consumer loans may entail greater credit risk than residential mortgage and home equity loans, particularly in the case of other consumer loans which are unsecured or, in the case of indirect consumer loans, secured by depreciable assets, such as automobiles, recreational vehicles, or boats. In such cases, any repossessed collateral for a defaulted consumer loan may not provide an adequate source of repayment of the outstanding loan balance. In addition, consumer loan collections are dependent on the borrower's continuing financial stability, thus are more likely to be affected by adverse personal circumstances such as job loss, illness, or personal bankruptcy. Furthermore, the application of various federal and state laws, including bankruptcy and insolvency laws, may limit the amount which can be recovered on such loans.

Funding Activities

Funding Strategy

The Corporation's deposit strategy is to fund the Bank with stable, low-cost deposits, primarily checking account deposits and low interest-bearing deposit accounts. A checking account is the driver of a banking relationship and consumers consider the bank where they have their checking account as their primary bank. These customers will typically turn to their primary bank first when in need of other financial services. The Corporation also considers brokered deposits to be an element of its deposit strategy and anticipates that it will continue using brokered deposits as a secondary source of funding to support growth. Borrowings may be used on a short-term basis for liquidity purposes or on a long-term basis to fund asset growth.

Funding Sources

The Corporation's primary sources of funds are deposits, principal and interest payments on loans and securities, borrowings and funds generated from operations of the Bank. The Bank also has access to advances from the FHLBNY, other financial institutions, and the FRBNY. Contractual loan payments are a relatively stable source of funds, while deposit inflows and outflows and loan prepayments are significantly influenced by general market interest rates and economic conditions.

The Corporation considers core deposits, consisting of non-interest-bearing and interest-bearing checking accounts, savings accounts, and insured money market accounts, to be a significant component of its deposits. The Corporation monitors the activity on these core deposits and, based on historical experience and pricing strategy, believes it will continue to retain a large portion of such accounts. The Bank is currently not limited with respect to the rates that it may offer on deposit products. The Bank believes it is competitive in the types of accounts and interest rates it has offered on its deposit products. The Bank regularly evaluates the internal cost of funds, surveys rates offered by competitors, reviews cash flow requirements for lending and liquidity, and executes rate changes when necessary as part of its asset/liability management, profitability and growth strategies.

The flow of deposits is influenced significantly by general economic conditions, changes in prevailing interest rates and competition. The Bank's deposits are obtained predominantly from the areas in which its retail offices are located. The Bank relies primarily on customer service, long-standing relationships and other banking services, including loans and wealth management services, to attract and retain these deposits. However, market interest rates and rates offered by competing financial institutions affect the Bank's ability to attract and retain deposits. The Bank utilizes a combination of traditional media, such as print, television, and radio, as well as digital advertising, such as social media and eBlasts, when advertising its deposit products.

Derivative Financial Instruments

The Corporation offers interest rate swaps to commercial loan customers who wish to fix the interest rates on their loans, and the Corporation matches these swaps with offsetting swaps with national bank counterparties. These swaps are considered free standing derivatives and are carried at fair value on the consolidated balance sheet in other assets and other liabilities, with gains and losses recorded through other non-interest income. The swaps are not designated as hedging derivatives. Additionally, the Corporation participates in risk participation agreements with dealer banks on commercial loans in which it participates. The Corporation receives an upfront fee for participating in the credit exposure of the interest rate swap associated with the commercial loan in which it is a participant and the fee received is recognized immediately in other non-interest income. The Corporation is exposed to its share of the credit loss equal to the fair value of the interest rate swap in the event of nonperformance by the counterparty of the interest rate swap.

The Corporation has a policy for managing its derivative financial instruments, and the policy and program activity are overseen by ALCO. Under the policy, derivative financial instruments with counterparties, who are not customers, are limited to a national financial institution. Cash and/or certain qualified securities are required to serve as collateral when exposures exceed $100 thousand, with a minimum collateral coverage of $150 thousand. The credit worthiness of the counterparty is reviewed internally by the Bank's credit department.

Wealth Management Strategy

With $1.952 billion of assets under management or administration at December 31, 2017, including $346.8 million of assets held under management or administration for the Corporation, WMG is responsible for the largest component of non-interest income. Wealth management services provided by the Bank include services as executor and trustee under wills and agreements, and guardian, custodian, trustee, and agent for pension, profit-sharing and other employee benefit trusts, as well as various investment, pension, estate planning, and employee benefit administrative services. The Corporation’s growth strategy also includes the acquisition of trust businesses to generate new sources of fee income.

The Corporation offers an array of financial services including mutual funds, securities and insurance brokerage, tax preparation, and other services through CFS, its wholly owned subsidiary.

For additional information, including information concerning the results of operations of the Corporation and its subsidiaries, see Management's Discussion and Analysis of Financial Condition and Results of Operations in Part II, Item 7.

There were no material changes in the manner of doing business by the Corporation or its subsidiaries during the fiscal year ended December 31, 2017.

Market Area and Competition

The Bank operates 34 branch offices located in 12 counties in New York and Bradford County in Pennsylvania. Bank branch offices are located in the following New York counties: Chemung, where the Bank is headquartered, Broome, Cayuga, Cortland, Schuyler, Seneca, Steuben, Tioga and Tompkins. The Bank also operates under the name “Capital Bank, a division of Chemung Canal Trust Company,” with branch offices located in Albany, Saratoga, and Schenectady counties in New York.

Albany, Saratoga, and Schenectady counties rely heavily on business related to New York State government activities, the nanotechnology industry, and colleges located within these counties. Tompkins County is dominated by the presence of Cornell University and Ithaca College. The world headquarters of Corning Incorporated, the region’s largest employer, is located in Steuben County. The remaining New York counties have a combination of service, small manufacturing and tourism related businesses, with colleges located in Broome, Chemung, and Cortland counties. Bradford County's largest employers are a combination of service and small manufacturing businesses, along with the natural gas industry.

Within all these market areas, the Bank encounters intense competition in the lending and deposit gathering aspects of its business from local, regional and national commercial banks and thrift institutions, credit unions and other providers of financial services, such as brokerage firms, investment companies, insurance companies and internet banking entities. The Bank also competes with non-financial institutions, including retail stores and certain utilities that maintain their own credit programs, as well as governmental agencies that make loans to certain borrowers. Many of these competitors are not subject to regulation as extensive as that affecting the Bank and, as a result, may have a competitive advantage over the Bank in certain respects. This is particularly true of credit unions because their pricing structure is not encumbered by the payment of income taxes.

Similarly, the competition for the Bank's wealth management services is primarily from local offices of national brokerage firms, independent investment advisors, national and regional banks as well as internet based brokerage and advisory firms. The Bank operates full-service wealth management centers in Chemung, Broome, and Albany counties in New York.

Employees

As of December 31, 2017, the Corporation and its subsidiaries employed 371 persons on a full-time equivalent basis. None of the Corporation's employees are covered by collective bargaining agreements. The Corporation provides its employees with a comprehensive benefit program, some of which is contributory. The Corporation believes that its relationship with its employees is good.

Available Information

The SEC maintains a web site at www.sec.gov that contains reports, proxy and information statements, and other information regarding the Corporation. You may also read and copy materials we file with the SEC at the SEC's Public Reference Room at 100 F St., NE, Washington, D.C. 20549. You may obtain information concerning the operation of the Public Reference Room by calling 1-800-SEC-0330. In addition, the Corporation maintains a corporate web site at www.chemungcanal.com. The Corporation makes available free of charge through Bank's web site its annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and any amendments to those reports filed with the SEC pursuant to Section 13(a) or 15(d) of the Exchange Act. These items are available as soon as reasonably practicable after we electronically file or furnish such material with the SEC. These items are also available on the Bank's web site as Interactive Data Files as required pursuant to Rule 405 of Regulation S-T (§232.405). The contents of the Bank's web site are not a part of this report. These materials are also available free of charge by written request to: Kathleen S. McKillip, Corporate Secretary, Chemung Financial Corporation, One Chemung Canal Plaza, Elmira, NY 14901.

Supervision and Regulation

The Corporation and the Bank are subject to comprehensive regulation, supervision and examination by regulatory authorities. Numerous statutes and regulations apply to the Corporation’s and, to a greater extent, the Bank’s operations, including required reserves, investments, loans, deposits, issuances of securities, payments of dividends and establishment of branches. Set forth below is a brief description of some of these laws and regulations. The description does not purport to be complete, and is qualified in its entirety by reference to the text of the applicable laws and regulations.

The Corporation

Bank Holding Company Act

The Corporation is a bank holding company registered with, and subject to regulation and examination by, the FRB pursuant to the BHCA, as amended. The FRB regulates and requires the filing of reports describing the activities of bank holding companies, and conducts periodic examinations to test compliance with applicable regulatory requirements. The FRB has enforcement authority over bank holding companies, including, among other things, the ability to assess civil money penalties, to issue cease and desist or removal orders, and to require a bank holding company to divest subsidiaries.

The Corporation generally may engage in the activities permissible for a bank holding company, which includes banking, managing or controlling banks, performing certain servicing activities for subsidiaries, and engaging in other activities that the FRB has determined to be so closely related to banking as to be a proper incident thereto, as set forth in the FRB's Regulation Y. As the Corporation has elected financial holding company status, it may also engage in a broader range of activities that are determined by the FRB and the Secretary of the Treasury to be financial in nature or incidental to financial activities or, with the prior approval of the FRB, activities that are determined by the FRB to be complementary to a financial activity and that do not pose a substantial risk to the safety and soundness of depository institutions or the financial system generally.

The BHCA prohibits a bank holding company from acquiring direct or indirect ownership or control of more than 5% of the voting shares of any bank, or increasing such ownership or control of any bank, without the prior approval of the FRB.

Interstate Banking and Branching

Under the Riegle-Neal Act, subject to certain concentration limits and other requirements, adequately capitalized bank holding companies, such as the Corporation, are permitted to acquire banks and bank holding companies located in any state. Any bank that is a subsidiary of a bank holding company is permitted to receive deposits, renew time deposits, close loans, service loans, and receive loan payments as an agent for any other bank subsidiary of that bank holding company. Subject to certain conditions, bank are permitted to acquire branch offices outside of their home states by merging with out-of-state banks, purchasing branches in other states, and establishing de novo branch offices in other states.

In April 2008, banking regulators in the states of New Jersey, New York, and Pennsylvania entered into a Memorandum of Understanding (the "Interstate MOU") to clarify their respective roles, as home and host state regulators, regarding interstate branching activity on a regional basis pursuant to the Riegle-Neal Amendments Act of 1997. The Interstate MOU established the regulatory responsibilities of the respective state banking regulators regarding bank regulatory examinations and is intended to reduce the regulatory burden on state-chartered banks branching within the region by elimination duplicative host state compliance exams.

Under the Interstate MOU, the activities of branches the Bank established in Pennsylvania would be governed by New York state law to the same extent that the Federal law governs the activities of the branch of an out-of-state national bank in such host states. Issues regarding whether a particular host state law is preempted are to be determined in the first instance by the NYSDFS. In the event that the NYSDFS and the applicable host state regulator disagree regarding whether a particular host state law is pre-empted, the NYSDFS and the applicable host state regulator would use their reasonable best efforts to consider all points of view to resolve the disagreement.

New York Law

The Corporation is organized under New York law and is subject to the New York Business Corporation Law, which governs the rights and obligations of directors and shareholders and other corporate matters.

The Corporation is also a bank holding company as defined in the New York Banking Law by virtue of its ownership and control of the Bank. Generally, this means that the NYSDFS must approve the Corporation’s acquisition of control of other banking institutions and similar transactions.

Federal Securities Law

The Corporation is subject to the information, reporting, proxy solicitation, insider trading, and other rules contained in the Exchange Act, the disclosure requirements of the Securities Act and the regulations of the SEC thereunder. In addition, the Corporation must comply with the corporate governance and listing standards of the Nasdaq Stock Market to maintain the listing of its common stock on the exchange. These standards include rules relating to a listed company's board of directors, audit committees and independent director oversight of executive compensation, the director nomination process, a code of conduct and shareholder meetings.

The SEC has adopted certain proxy disclosure rules regarding executive compensation and corporate governance, with which the Corporation must comply. They include: (i) disclosure of total compensation of key officers of the Corporation, including disclosure of restricted and unrestricted stock awards compensation; (ii) disclosure regarding any potential conflict of interest of any compensation consultants of the Corporation; (iii) disclosure regarding compensation committee independence and experience, qualifications, skills and diversity of its directors and any director nominees; (iv) “say-on-pay” disclosure; and (v) information relating to the leadership structure of the Corporation’s Board of Directors and the Board of Directors' role in the risk management process. Additionally, these rules require the Corporation to report the voting results of annual meetings in a much more timely manner on Form 8-K, rather than on a quarterly or annual report.

Sarbanes-Oxley

The Corporation is also subject to Sarbanes-Oxley. Sarbanes-Oxley established laws affecting public companies’ corporate governance, accounting obligations, and corporate reporting by: (i) creating a federal accounting oversight body; (ii) revamping auditor independence rules; (iii) enacting new corporate responsibility and governance measures; (iv) enhancing disclosures by public companies, their directors, and their executive officers; (v) strengthening the powers and resources of the SEC; and (vi) imposing new criminal and civil penalties for securities fraud and related wrongful conduct.

The SEC has adopted regulations under Sarbanes-Oxley, including: (i) executive compensation disclosure rules; (ii) standards of independence for directors who serve on the Corporation’s audit committee; (iii) disclosure requirements as to whether at least one member of the Corporation’s audit committee qualifies as a “financial expert” as defined in SEC regulations; (iv) whether the Corporation has adopted a code of ethics applicable to its chief executive officer, chief financial officer, or those persons performing similar functions; (v) and disclosure requirements regarding the operations of Board of Directors' nominating committees and the means, if any, by which security holders may communicate with directors.

Support of Subsidiary Banks

The Dodd-Frank Act, discussed in the section of this document entitled "Additional Important Legislation and Regulation," codifies the FRB's long-standing policy of requiring bank holding companies to act as a source of financial and managerial strength to their subsidiary banks. Accordingly, the Corporation is expected to commit resources to support its banking subsidiaries, including at times when it may not be advantageous for the Corporation to do so.

Capital Distributions

A bank holding company is generally required to give the FRB prior written notice of any purchase or redemption of then outstanding equity securities if the gross consideration for the purchase or redemption, when combined with the net consideration paid for all such purchases or redemptions during the preceding 12 months, is equal to 10% or more of the company's consolidated net worth. The FRB may disapprove such a purchase or redemption if it determines that the proposal would constitute an unsafe and unsound practice, or would violate any law, regulation, FRB order or directive, or any condition imposed by, or written agreement with, the FRB. There is an exception to this approval requirement for well-capitalized bank holding companies that meet certain other conditions.

The FRB has issued a policy statement regarding capital distributions, including dividends, by bank holding companies. In general, the FRB's policies provide that dividends should be paid only out of current earnings and only if the prospective rate of earnings retention by the bank holding company appears consistent with the organization's capital needs, asset quality and overall financial condition. Under applicable laws, the ability of a bank holding company to pay dividends may be restricted if a subsidiary bank becomes undercapitalized. In addition, the FRB has issued guidance which requires consultation with the agency prior to a bank holding company's payment of dividends or repurchase or redemption of its stock under certain circumstances. These regulatory policies could affect the ability of the Corporation to pay dividends, repurchase its stock or otherwise engage in capital distributions.

The Bank

General

The Bank is a commercial bank chartered under the laws of New York State and is supervised by the NYSDFS. The Bank also is a member bank of the FRB and, therefore, the FRB serves as its primary federal regulator. The FDIC insures the Bank's deposit accounts up to applicable limits. The Bank must file reports with the FFIEC, the FRB and the FDIC concerning its activities and financial condition and must obtain regulatory approval before commencing certain activities or engaging in transactions such as mergers and other business combinations or the establishment, closing, purchase or sale of branch offices. This regulatory structure gives the regulatory authorities extensive discretion in the enforcement of laws and regulations and the supervision of the Bank.

Loans to One Borrower

The Bank generally may not make a loan or extend credit to a single or related group of borrowers in excess of 15% of its unimpaired capital and surplus. Up to an additional 10% of unimpaired capital and surplus can be lent if the additional amount is fully secured by certain readily marketable collateral. At December 31, 2017, the Bank's legal lending limit on loans to one borrower was $23.4 million for loans not fully secured by readily marketable collateral and $25.8 million for loans secured by readily marketable collateral. The Bank's internal limit on loans is set at $15.0 million. At December 31, 2017, the Bank did not have any loans or agreements to extend credit to a single or related group of borrowers in excess of its legal lending limit.

Branching

Subject to the approval of the NYSDFS and FRB, New York-chartered member commercial banks may establish branch offices anywhere within New York State, except in communities having populations of less than 50,000 inhabitants in which another New York-chartered commercial bank or a national bank has its principal office. Additionally, under the Dodd-Frank Act, state-chartered banks may generally branch into other states to the same extent as commercial banks chartered under the laws of that state may branch.

Payment of Dividends

The Bank is subject to substantial regulatory restrictions affecting its ability to pay dividends to the Corporation. Under FRB and NYSDFS regulations, the Bank may not pay a dividend without prior approval of the FRB and the NYSDFS if the total amount of all dividends declared during such calendar year, including the proposed dividend, exceeds the sum of its retained net income to date during the calendar year and its retained net income over the preceding two calendar years. As of December 31, 2017, approximately $13.8 million was available for the payment of dividends by the Bank to the Corporation without prior approval. The Bank's ability to pay dividends also is subject to the Bank being in compliance with regulatory capital requirements. The Bank is currently in compliance with these requirements.

Federal Reserve System

FRB member banks must maintain, with a Federal Reserve bank, reserves against their transaction accounts (primarily checking, NOW, and Super NOW accounts) and non-personal time accounts. As of December 31, 2017, the Bank was in compliance with applicable reserve requirements. In all years preceding 2008, these reserves were maintained as vault cash or noninterest-bearing accounts, thereby reducing the Bank’s earnings potential. In the fourth quarter of 2008, the FRB announced that they would begin to pay interest on member banks’ required reserve balances, as well as excess reserve balances.

Standards for Safety and Soundness

The FRB has adopted guidelines prescribing safety and soundness standards. These guidelines establish general standards relating to capital adequacy, asset quality, management, earnings performance, liquidity and sensitivity to market risk. In evaluating these safety and soundness standards, the FRB considers internal controls and information systems, internal audit systems, loan documentation, credit underwriting, exposure to changes in interest rates, asset growth, compensation, fees, and benefits. In general, the guidelines require appropriate systems and practices to identify and manage the risks and exposures specified in the guidelines. The FRB may order an institution that has been given notice that it is not satisfying these safety and soundness standards to submit a compliance plan, and if an institution fails to do so, the FRB must issue an order directing action to correct the deficiency and may issue an order directing other action. If an institution fails to comply with such an order, the FRB may seek to enforce such order in judicial proceedings and to impose civil money penalties.

Real Estate Lending Standards

The FRB has adopted guidelines that generally require each FRB state member bank to establish and maintain written internal real estate lending standards that are consistent with safe and sound banking practices and appropriate to the size of the bank and the nature and scope of its real estate lending activities. The standards also must be consistent with accompanying FRB guidelines, which include loan-to-value ratios for the different types of real estate loans.

Transactions with Related Parties

The Federal Reserve Act governs transactions between the Bank and its affiliates, specifically the Corporation, CFS, and CRM. In general, an affiliate of the Bank is any company that controls, is controlled by, or is under common control with the Bank. Generally, the Federal Reserve Act limits the extent to which the Bank or its subsidiaries may engage in “covered transactions” with any one affiliate to 10% of the Bank’s capital stock and surplus, and contains an aggregate limit of 20% of capital stock and surplus for covered transactions with all affiliates. Covered transactions include loans, asset purchases, the issuance of guarantees, and similar transactions. Certain transactions must be collateralized according to the requirements of the statute. In addition, all covered transactions and other transactions between the Bank and its affiliates must be on terms and conditions that are substantially the same as, or at least as favorable to, the Bank.

Section 22(h) of the Federal Reserve Act and its implementing Regulation O restricts a bank's loans to its directors, executive officers, and principal stockholders ("Insiders"). Loans to Insiders (and their related entities) 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. The loans must be made on terms that are substantially the same as, and follow credit underwriting procedures that are not less stringent than, those prevailing for comparable transactions with unaffiliated persons and that do not involve more than the normal risk of repayment or present other unfavorable features, 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. Loans to executive officers are subject to additional restrictions on the types and amounts of permissible loans.

Deposit Insurance

The FDIC insures the deposits of the Bank up to regulatory limits and the deposits are subject to the deposit insurance premium assessments of the DIF. The FDIC currently maintains a risk-based assessment system under which assessment rates vary based on the level of risk posed by the institution to the DIF. Therefore, the assessment rate may change if any of these measurements change.

Assessments for institutions with less than $10 billion of assets, such as the Bank, are based on financial measures and supervisory ratings derived from statistical modeling estimating the probability of an institution’s failure within three years, with institutions deemed less risky paying lower assessments. That system, effective July 1, 2016, replaced a previous system under which institutions were placed into risk categories.

The Dodd-Frank Act required the FDIC to revise its procedures to base assessments upon each insured institution’s total assets less tangible equity instead of deposits. The FDIC finalized a rule, effective April 1, 2011, that set the risk-based assessment range (inclusive of possible adjustments) at 2.5 to 45 basis points of total assets less tangible equity. In conjunction with the DIF’s reserve ratio achieving 1.15%, the assessment range was reduced for insured institutions of less than $10 billion of total assets to 1.5 basis points to 30 basis points, effective July 1, 2016.

All institutions with deposits insured by the FDIC are required to pay assessments to fund interest payments on bonds issued by FICO, an agency of the federal government established to recapitalize the former Savings Association Insurance Fund. These assessments will continue until the FICO bonds mature through 2019. The FDIC's FICO assessment authority is separate from its authority to assess risk-based premiums for deposit insurance. The FICO assessment rate is adjusted quarterly to reflect changes in the assessment bases of the fund and is not risk-based by institution. The FICO assessment rate for the third quarter of 2017, due December 29, 2017, was 0.115 basis points, or an annual rate of 0.46 basis points, of the Bank's assessment base, or average total assets less average tangible equity and allowable deductions.

The FDIC has authority to increase insurance assessments. Any material increases would likely have an adverse effect on the operating expenses and results of operations of the Bank and the Corporation. Future insurance assessments cannot be predicted.

Insurance of deposits may be terminated by the FDIC upon a finding that an institution has engaged in unsafe or unsound practices, is in an unsafe or unsound condition to continue operations, or has violated any applicable law, regulation, rule, order or condition imposed in writing. Management of the Bank does not know of any practice, condition, or violation that may lead to termination of the Bank’s deposit insurance.

Regulatory Capital Requirements

On October 11, 2013, the FRB approved a final rule that amended the regulatory capital rules for state member banks effective January 1, 2015. The FRB approved the new capital rules in coordination with substantially identical final rules approved by the FDIC and the Office of the Comptroller of the Currency for other types of banking organizations. The revisions make the capital rules consistent with agreements that were reached by Basel III and certain provisions of the Dodd-Frank Act. In general, the new capital rules revise regulatory capital definitions and minimum ratios; redefine Tier 1 Capital as two components (common equity Tier 1 capital and additional Tier 1 capital); create a new “common equity Tier 1 risk-based capital ratio”; implement a capital conservation buffer; revise prompt corrective action thresholds; and change risk weights for certain assets and off-balance sheet exposures.

The new capital rules implemented a revised definition of regulatory capital, a new common equity Tier 1 minimum capital requirement of 4.5%, and a higher minimum Tier 1 capital requirement of 6.0% (which is an increase from 4.0%). Under the new rules, the total capital ratio remains at 8.0%, and the minimum leverage ratio (Tier 1 capital to total assets) for all banking organizations, regardless of supervisory rating, is 4.0%. Additionally, under the new capital rules, in order to avoid limitations on capital distributions, including dividend payments and certain discretionary bonus payments to executive officers, a banking organization must hold a capital conservation buffer composed of common equity Tier 1 capital above its minimum risk-based capital requirements. The buffer is measured relative to risk-weighted assets. The final rules also enhance risk sensitivity and address weaknesses identified by the regulators over recent years with the measure of risk-weighted assets, including through new measures of creditworthiness to replace references to credit ratings, consistent with the requirements of the Dodd-Frank Act. Effective January 1, 2016, the additional capital conservation buffer of 0.625% was added to the minimum requirements for capital adequacy purposes, subject to a multi-year phase-in of an increase of 0.625% each succeeding January 1. The capital conservation buffer will be fully phased-in on January 1, 2019 at 2.5%.

The new capital requirements also include changes in the risk-weights of assets to better reflect credit risk and other risk exposures. These include a 150% risk weight (up from 100%) for certain high volatility commercial real estate acquisition, development and construction loans and the unsecured portion of non-residential mortgage loans that are 90 days past due or otherwise on non-accrual status; a 20% (up from 0%) credit conversion factor for the unused portion of a commitment with an original maturity of one year or less that is not unconditionally cancellable; a 250% risk weight (up from 100%) for mortgage servicing rights and deferred tax assets that are not deducted from capital; and increased risk weights (from 0% to up to 600%) for equity exposures.

The Corporation is subject to FRB consolidated capital requirements applicable to bank holding companies, which are similar to those applicable to the Bank.

In assessing a state member bank's capital adequacy, the FRB takes into consideration not only these numeric factors but also qualitative factors, and has the authority to establish higher capital requirements for individual banks where necessary. Prompt corrective action regulations provide five classifications: well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized, although these terms are not used to represent overall financial condition. The Bank, in accordance with its internal prudential standards, targets as its goal the maintenance of capital ratios which exceed these minimum requirements and that are consistent with its risk profile. As of December 31, 2017, the Bank exceeded all regulatory capital ratios necessary to be considered well capitalized.

Prompt Corrective Action

The FDIA requires the federal banking agencies to resolve the problems of insured banks at the least possible loss to the DIF. The FRB has adopted prompt corrective action regulations to carry out this statutory mandate. The FRB's regulations authorize, and in some situations, require, the FRB to take certain supervisory actions against undercapitalized state member banks, including the imposition of restrictions on asset growth and other forms of expansion. The prompt corrective action regulations place state member banks in one of the following five categories based on the bank's capital:

- well capitalized
- adequately capitalized
- undercapitalized
- significantly undercapitalized
- critically undercapitalized

The capital rules described above under "Regulatory Capital Requirements" maintained the existing general structure of the current prompt corrective action framework and increased some of the thresholds for the prompt corrective action capital categories. For example, an adequately capitalized bank is required to maintain a Tier 1 risk-based capital ratio of 6.0% (increased from the current level of 4.0%). The rule also introduced the common equity Tier 1 capital ratio as a new prompt corrective action capital category threshold.

As an institution's capital decreases within the three undercapitalized categories listed above, the severity of the action that is authorized or required to be taken by the FRB for state member banks under the prompt corrective action regulations increases. All banks are prohibited from paying dividends or other capital distributions or paying management fees to any controlling person if, following such distribution, the bank would be undercapitalized. The FRB is required to monitor closely the condition of an undercapitalized institution and to restrict the growth of its assets.

An undercapitalized state member bank is required to file a capital restoration plan with the FRB within 45 days (or other timeframe prescribed by the FRB) of the date the bank receives notice that it is within any of the three undercapitalized categories, and the plan must be guaranteed by its parent holding company, subject to a cap on the guarantee that is the lesser of: (i) an amount equal to 5.0% of the bank's total assets at the time it was notified that it became undercapitalized; and (ii) the amount that is necessary to restore the bank's capital ratios to the levels required to be classified as "adequately classified," as those ratios and levels are defined as of the time the bank failed to comply with the plan. If the bank fails to submit an acceptable plan, it is treated as if it were "significantly undercapitalized." Banks that are significantly or critically undercapitalized are subject to a wider range of regulatory requirements and restrictions including, with respect to critically undercapitalized status, the appointment of a receiver or conservator within specified periods of time.

The NYSDFS possesses enforcement power over New York State-chartered banks pursuant to New York law. This includes authority to order a New York State bank to, among other things, cease an apparent violation of law, discontinue unauthorized or unsafe banking practices or maintain prescribed books and accounts. Such orders are enforceable by financial penalties. Upon a finding by the NYSDFS that a bank director or officer has violated any law or regulation or continued unauthorized or unsafe practices in conducting its business after having been notified by the NYSDFS to discontinue such violation or practices, such director or officer may be removed from office after notice and an opportunity to be heard. The NYSDFS also has authority to appoint a conservator or receiver (which may be the FDIC) for a bank under certain circumstances.

Under federal law, the FRB possesses authority to bring enforcement actions against member banks and their ‘‘institution-affiliated parties,’’ including directors, officers, employees and, under certain circumstances, a stockholder, attorney, appraiser or accountant. Such enforcement action can occur for matters such as failure to comply with applicable law or regulations or engaging in unsafe or unsound banking practices. Possible enforcement actions range from an informal measure, such as a memorandum of understanding, to formal actions, such as a written agreement, cease and desist order, civil money penalty, capital directive, removal of directors or officers or the appointment of a conservator or receiver. The FRB also possesses authority to bring enforcement actions against bank holding companies, their nonbanking subsidiaries and their “institution-affiliated parties.”

Federal Home Loan Bank

The Bank is also a member of the FHLBNY, 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 FHLBNY, including the requirement to acquire and hold shares of capital stock in the FHLBNY. The Bank was in compliance with the rules and requirements of the FHLBNY at December 31, 2017.

Community Reinvestment Act

Under the federal CRA, the Bank, consistent with its safe and sound operation, must help meet the credit needs of its entire community, including low and moderate income neighborhoods. The FRB periodically assesses the Bank's compliance with CRA requirements. The Bank received a “satisfactory” rating for CRA on its last performance evaluation conducted by the FRB as of June 19, 2017.

Fair Lending and Consumer Protection Laws

The Bank must also comply with the federal Equal Credit Opportunity Act and the New York Executive Law, which prohibit creditors from discrimination in their lending practices on bases specified in these statutes. In addition, the Bank is subject to a number of federal statutes and regulations implementing them, which are designed to protect the general public, borrowers, depositors, and other customers of depository institutions. These include the Bank Secrecy Act, the Truth in Lending Act, the Home Ownership and Equity Protection Act, the Truth in Savings Act, the Home Mortgage Disclosure Act, the Fair Housing Act, the Real Estate Settlement Procedures Act, the Electronic Funds Transfers Act, the FCRA, the Right to Financial Privacy Act, the Expedited Funds Availability Act, the Flood Disaster Protection Act, the Fair Debt Collection Practices Act, Helping Families Save Their Homes Act, and the Consumer Protection for Depository Institutions Sales of Insurance regulation. The FRB and, in some instances, other regulators, including the U.S. Department of Justice, the FTC, the CFPB and state Attorneys General, may take enforcement action against institutions that fail to comply with these laws.

Prohibitions against Tying Arrangements

Subject to some exceptions, regulations under the BHCA and the Federal Reserve Act prohibit banks from extending credit to or offering any other service, or fixing or varying the consideration for such extension of credit or service, on the condition that the customer obtain some additional service from the bank or its affiliates or not obtain services of a competitor of the bank.

Privacy Regulations

Regulations under the Federal Reserve Act generally require the Bank to disclose its privacy policy. The policy must identify with whom the Bank shares its customers’ “nonpublic personal information,” at the time of establishing the customer relationship and annually thereafter. In addition, the Bank must provide its customers with the ability to “opt out” of having their personal information shared with unaffiliated third parties and not to disclose account numbers or access codes to non-affiliated third parties for marketing purposes. The Bank’s privacy policy complies with Federal Reserve Act regulations.

The USA PATRIOT Act

The Bank is subject to the USA PATRIOT Act, which gives the federal government powers to address terrorist threats through enhanced domestic security measures, expanded surveillance powers, increased information sharing, and broadened anti-money laundering requirements. The USA PATRIOT Act imposes affirmative obligations on financial institutions, including the Bank, to establish anti-money laundering programs which require: (i) the establishment of internal policies, procedures, and controls; (ii) the designation of an anti-money laundering compliance officer; (iii) ongoing employee training programs; and (iv) an independent audit function to test the anti-money laundering program. The FRB must consider the Bank's effectiveness in combating money laundering when ruling on merger and other applications.

CFS

CFS is subject to supervision by other regulatory authorities as determined by the activities in which it is engaged. Insurance activities are supervised by the NYSDFS, and brokerage activities are subject to supervision by the SEC and FINRA.

CRM

CRM is subject to regulations of the State of Nevada and undergoes periodic examinations by the Nevada Division of Insurance.

Additional Important Legislation and Regulation

The Dodd-Frank Act

The Dodd-Frank Act, enacted on July 21, 2010, significantly changed the bank regulatory landscape and has impacted and will continue to impact the lending, deposit, investment, trading and operating activities of financial institutions and their holding companies. The Dodd-Frank Act requires various federal agencies to adopt a broad range of new rules and regulations, and to prepare various studies and reports for Congress. We have summarized below significant rules adopted by the federal agencies pursuant to the Dodd-Frank Act.

Consumer Financial Protection Bureau Rules

The Dodd-Frank Act created the CFPB, with wide-ranging powers to supervise and enforce consumer protection laws. The CFPB has broad rule-making authority for a wide range of consumer protection laws that apply to all banks and savings institutions, including the authority to prohibit "unfair, deceptive or abusive" acts and practices. The CFPB has examination and enforcement authority over all banks and savings institutions with more than $10 billion in assets. Smaller institutions continue to be examined by their primary federal regulator as to compliance with consumer protection laws. The Dodd-Frank Act also weakened the federal preemption rules that had been applicable to national banks and federal savings associations, especially with respect to the applicability of state consumer protection laws, and gives state attorneys general certain powers to enforce federal consumer protection regulations.

The CFPB has issued several new rules pursuant to the Dodd-Frank Act concerning the regulation of mortgage markets in the U.S. The rules amend several existing regulations, including Regulation Z, which implements the Truth in Lending Act, Regulation X, which implements the Real Estate Settlement Procedures Act and Regulation B, which implements the Equal Credit Opportunity Act. The CFPB has also issued amendments to Regulation P, which governs information privacy and Regulation E, which implements the Electronic Funds Transfers Act. The CFPB may from time to time issue additional amendments or new rules that will affect the Corporation's business practices.

In December 2013, the FRB and the SEC released final rules to implement certain provisions of the Dodd-Frank Act, commonly known as the “Volcker Rule.” The Volcker Rule, among other things, prohibits banking entities from engaging in proprietary trading and from sponsoring, having an ownership interest in or having certain relationships with a hedge fund or private equity fund, subject to certain exemptions. At December 31, 2017, the Corporation was not engaged in any activities and it did not have any ownership interests in any funds that are not permitted under the Volcker Rule.

In 2013, the CFPB issued a final rule amending Regulation Z (which implements TILA) and Regulation X (which implements RESPA). In 2015, the CFPB issued a final rule, effective October 3, 2015, specifying mandatory new procedures for the making of these disclosures. The purpose of the new rule, known as the TRID Rule, is to integrate certain disclosures for closed-end credit extended against real property, the appraisal notice required under the ECOA, and the servicing notice required under RESPA in two new forms: a Loan Estimate that must be provided to a consumer within a specified time after receiving his or her application, and a Closing Disclosure that must be provided at least three days before the loan is closed. The TRID Rule generally applies to all lenders, including the Bank, that extended credit to consumers 25 or more times in the preceding or current year.

Securities and Exchange Commission Rules

As discussed above under “Federal Securities Law,” pursuant to the Dodd-Frank Act, the SEC issued regulations that provide the shareholders of public companies with an advisory vote on: i) executive compensation ("say-on-pay"); ii) the desired frequency of say-on-pay; and iii) compensation arrangements and understandings in connection with merger transactions, known as "golden parachute" arrangements. Additionally, the SEC has issued regulations effective January 1, 2017 requiring companies subject to the reporting rules of the SEC to disclose to shareholders the ratio of compensation of the chief executive officer to the median compensation of employees. The SEC has also adopted corporate governance regulations that provide to shareholders of companies subject to the SEC’s proxy rules: i) the opportunity to nominate directors at a shareholder meeting and to have their nominees included in the company proxy materials sent to all shareholders; and ii) the ability to use the shareholder proposal process to establish procedures for the inclusion of shareholder director nominations in company proxy materials.

Banking Agency Rules

As discussed above under “Regulatory Capital Requirements,” pursuant to the Dodd-Frank Act, the FRB and the other federal banking agencies have established minimum leverage and risk-based capital requirements for insured depository institutions and bank holding companies.

The Dodd-Frank Act directs the federal banking regulators to promulgate rules requiring the reporting of incentive-based compensation and prohibiting excessive incentive-based compensation paid to executives of depository institutions and their holding companies with total assets in excess of $1.0 billion that encourages excessive risk-taking that could lead to a material financial loss.  In April 2011, the FRB, along with other federal banking supervisors, issued a joint notice of proposed rulemaking implementing those requirements.

Many other provisions of the Dodd-Frank Act still require extensive rulemaking, guidance and interpretation by regulatory agencies. Accordingly, in many respects, the ultimate impact of the legislation and its effects on the Corporation and the Bank remain uncertain. The Corporation continues to closely monitor and evaluate regulatory developments. Such developments could adversely affect its financial condition and results of operations through significant increases in its regulatory compliance costs.

Gramm-Leach-Bliley Act

Under the privacy and data security provisions of the Financial Modernization Act of 1999, also known as the GLB Act, and rules promulgated thereunder, all financial institutions, including the Corporation, the Bank and CFS are required to establish policies and procedures to restrict the sharing of nonpublic customer data with nonaffiliated parties at the customer's request and to protect customer data from unauthorized access. In addition, the FCRA, as amended by the FACT Act, includes many provisions affecting the Corporation, Bank, and/or CFS including provisions concerning obtaining consumer reports, furnishing information to consumer reporting agencies, maintaining a program to prevent identity theft, sharing of certain information among affiliated companies, and other provisions.  For instance, the FCRA requires persons subject to the FCRA to notify their customers if they report negative information about them to a credit bureau or if they are granted credit on terms less favorable than those generally available. The FRB and the FTC have extensive rulemaking authority under the FACT Act, and the Corporation and the Bank are subject to the rules that have been promulgated by the FRB and FTC thereunder, including recent rules regarding limitations on affiliate marketing and implementation of programs to identify, detect and mitigate the risk of identity theft through red flags. The Corporation has developed policies and procedures for itself and its subsidiaries to maintain compliance and believes it is in compliance with all privacy, information sharing and notification provisions of the GLB Act and the FCRA.

The GLB Act and the FCRA also impose requirements regarding data security and the safeguarding of customer information. The Bank is subject to the Security Guidelines, which implement section 501(b) of the GLB Act and section 216 of the FACT Act. The Security Guidelines establish standards relating to administrative, technical, and physical safeguards to ensure the security, confidentiality, integrity and the proper disposal of customer information. The Bank believes it is in compliance with all such standards.

ITEM 1A.  RISK FACTORS

The Corporation’s business is subject to many risks and uncertainties.  Although the Corporation seeks ways to manage these risks and develop programs to control those that management can control, the Corporation ultimately cannot predict the extent to which these risks and uncertainties could affect the Corporation's results.  Actual results may differ materially from management's expectations.  The following discussion sets forth what the Corporation currently believes could be the most significant factors of which it is currently aware that could affect the

Corporation's business, results of operations or financial condition. You should consider all of the following risks together with all of the other information in this Annual Report on Form 10-K.

Economic conditions may adversely affect the Corporation’s financial performance.

The Corporation's businesses and results of operation are affected by the financial markets and general economic conditions in the United States, and particularly to adverse conditions in New York and Pennsylvania. Key economic factors affecting the Corporation include the level and volatility of short-term and long-term interest rates, inflation, home prices, unemployment and under-employment levels, bankruptcies, household income, consumer spending, fluctuations in both debt and equity capital markets and currencies, liquidity of the financial markets, the availability and the cost of capital and credit, investor sentiment, confidence in the financial markets, and the sustainability of economic growth. The deterioration of any of these conditions could adversely affect the Corporation's consumer and commercial businesses, its securities and derivatives portfolios, its level of charge-offs and provision for credit losses, the carrying value of the Corporation's deferred tax assets, its capital levels and liquidity, and the Corporation's results of operations.

A decline or prolonged weakness in business and economic conditions generally or specifically in the principal markets in which the Corporation does business could have one or more of the following adverse effects on the Corporation’s business:

i. a decrease in the demand for loans and other products and services;
ii. a decrease in the value of the Corporation’s loans or other assets secured by consumer or commercial real estate;
iii. an impairment of certain of the Corporation’s intangible assets, such as goodwill; and
iv. an increase in the number of borrowers and counter-parties who become delinquent, file for protection under bankruptcy laws or default on their loans or other obligations to the Corporation.

For example, in 2018, S&P Global Rating lowered the long-term bond rating of Elmira, New York, the location of the Corporation's headquarters, to junk status due to the city's growing revenue challenges and current weak economy.

Additionally, in light of economic conditions, the Corporation’s ability to assess the creditworthiness of its customers may be impaired if the models and approaches that it uses to select, manage and underwrite loans become less predictive of future behaviors. Further, competition in the Corporation’s industry may intensify as a result of consolidation of financial services companies in response to adverse market conditions and the Corporation may face increased regulatory scrutiny, which may increase its costs and limit its ability to pursue business opportunities.

Commercial real estate and business loans increase the Corporation’s exposure to credit risks.

At December 31, 2017, the Corporation’s portfolio of commercial real estate and business loans totaled $843.3 million or 64.3% of total loans. The Corporation plans to continue to emphasize the origination of these types of loans, which generally expose the Corporation to a greater risk of nonpayment and loss than residential real estate or consumer loans because repayment of commercial real estate and business loans often depends on the successful operation and income stream of the borrower’s business. Additionally, such loans typically involve larger loan balances to single borrowers or groups of related borrowers compared to residential real estate and consumer loans. Also, some of the Corporation’s borrowers have more than one commercial loan outstanding. Consequently, an adverse development with respect to one loan or one credit relationship can expose the Corporation to a significantly greater risk of loss compared to an adverse development with respect to residential real estate and consumer loans. In some instances, the Corporation has originated unsecured commercial loans with certain high net worth individuals who have personally guaranteed such loans. This type of commercial loan has an increased risk of loss if the Corporation is unable to collect repayment through legal action due to personal bankruptcy or other financial limitations of the borrower. The Corporation targets its business lending and marketing strategy towards small to medium-sized businesses. These small to medium-sized businesses generally have fewer financial resources in terms of capital or borrowing capacity than larger entities. If general economic conditions negatively impact these businesses, the Corporation’s results of operations and financial condition may be adversely affected.

The Corporation's portfolio of indirect automobile lending exposes it to increased credit risks.

At December 31, 2017, $153.1 million, or 11.7% of our total loan portfolio, consisted of automobile loans, primarily originated through automobile dealers for the purchase of new or used automobiles. The Corporation serves customers that cover a range of creditworthiness and the required terms and rates are reflective of those risk profiles. Automobile loans are inherently risky as they are often secured by assets that may be difficult to locate and can depreciate rapidly. In some cases, repossessed collateral for a defaulted automobile loan may not provide an adequate source of repayment for the outstanding loan and the remaining deficiency may not warrant further substantial collection efforts against the borrower. Automobile loan collections depend on the borrower's continuing financial stability, and therefore, are more likely to be adversely affected by job loss, divorce, illness, or personal bankruptcy. Additional risk elements associated with indirect lending include the limited personal contact with the borrower as a result of indirect lending through non-bank channels, namely automobile dealers.

The allowance for loan losses may prove to be insufficient to absorb losses in the loan portfolio.

The Corporation’s customers may not repay their loans according to the original terms, and the collateral securing the payment of those loans may be insufficient to pay any remaining loan balance.  Hence, the Corporation may experience significant loan losses, which could have a material adverse effect on the Corporation's operating results. Management makes various assumptions and judgments about the collectability of its loan portfolio, including the creditworthiness of its borrowers and the value of the real estate and other assets serving as collateral for the repayment of loans.  In determining the amount of the allowance for loan losses, management relies on loan quality reviews, past loss experience, and an evaluation of economic conditions, among other factors.  If these assumptions prove to be incorrect, the allowance for loan losses may not be sufficient to cover losses inherent in the Corporation’s loan portfolio, resulting in additions to the allowance.  Material additions to the allowance would materially decrease net income.

The Corporation’s emphasis on the origination of commercial loans is one of the more significant factors in evaluating its allowance for loan losses.  As the Corporation continues to increase the amount of these loans, additional or increased provisions for loan losses may be necessary, which could result in a decrease in earnings.

Bank regulators periodically review the Corporation’s allowance for loan losses and may require the Corporation to increase its provision for loan losses or loan charge-offs. Any increase in the allowance for loan losses or loan charge-offs as required by these regulatory authorities could have a material adverse effect on the Corporation's results of operations and/or financial condition.

Changes in interest rates could adversely affect the Corporation’s results of operations and financial condition.

The Corporation’s results of operations and financial condition are significantly affected by changes in interest rates. The Corporation's financial results depend substantially on net interest income, which is the difference between the interest income that it earns on interest-earning assets and the interest expense paid on interest-bearing liabilities.  If the Corporation’s interest-bearing liabilities mature or reprice more quickly than its interest-earning assets in a given period as a result of increasing interest rates, net interest income may decrease.  Likewise, net interest income may decrease if interest-earning assets mature or reprice more quickly than interest-bearing liabilities in a given period as a result of decreasing interest rates.  The Corporation has taken steps to mitigate this risk, such as holding fewer longer-term residential mortgages, as well as investing excess funds in shorter-term investments.

Changes in interest rates also affect the fair value of the Corporation’s interest-earning assets and, in particular, its investment securities available for sale.  Generally, the fair value of investment securities fluctuates inversely with changes in interest rates.  Decreases in the fair value of investment securities available for sale, therefore, could have an adverse effect on its shareholders’ equity or earnings if the decrease in fair value is deemed to be other than temporary.

Changes in interest rates may also affect the average life of loans and mortgage-related securities.  Increases in interest rates may decrease loan demand and make it more difficult for borrowers to repay adjustable rate loans. Additionally, decreases in interest rates can result in increased prepayments of loans and mortgage-related securities, as borrowers refinance to reduce borrowing costs.  Under these circumstances, the Corporation is subject to reinvestment risk to the extent that it is unable to reinvest the cash received from such prepayments at rates that are comparable to the rates on its existing loans and securities.

Municipal deposits are generally more sensitive to interest rates and may require competitive rates at placement and subsequent rollover dates, which may make it more difficult for the Bank to attract and retain public and municipal deposits. Additionally, when municipal deposits exceed FDIC coverage, any amounts not insured under the FDIC must be properly secured through a pledge of eligible securities. The requirement that the Bank collateralize municipal deposits above FDIC insurance may have an adverse effect on the Corporation's liquidity.

Strong competition within the Corporation's industry and market area could limit its growth and profitability.

The Corporation faces substantial competition in all phases of its operations from a variety of different competitors. Future growth and success will depend on the ability to compete effectively in this highly competitive environment. The Corporation competes for deposits, loans and other financial services with a variety of banks, thrifts, credit unions and other financial institutions as well as other entities, which provide financial services. Some of the financial institutions and financial services organizations with which the Corporation competes with are not subject to the same degree of regulation as the Corporation. Many competitors have been in business for many years, have established customer bases, are larger, and have substantially higher lending limits. The financial services industry is also likely to become more competitive as further technological advances enable more companies to provide financial services. These technological advances may diminish the importance of depository institutions and other financial intermediaries in the transfer of funds between parties.

The Corporation’s growth strategy may not prove to be successful and its market value and profitability may suffer.

As part of the Corporation's strategy for continued growth, it may open additional branches. New branches do not initially contribute to operating profits due to the impact of overhead expenses and the start-up phase of generating loans and deposits. To the extent that additional branches are opened, the Corporation may experience the effects of higher operating expenses relative to operating income from the new operations, which may have an adverse effect on the Corporation's levels of net income, return on average equity and return on average assets.

In addition, the Corporation may acquire banks and related businesses that it believes provide a strategic fit with its business, such as the 2011 acquisition of FOFC and the 2013 acquisition of six branches from Bank of America. To the extent that the Corporation grows through acquisitions, it cannot provide assurance that such strategic decisions will be accretive to earnings.

Compliance with the Dodd-Frank Act has increased the Corporation’s costs of operations and may adversely affect the Corporation’s earnings and financial condition.

The Dodd-Frank Act significantly changed the then-existing bank regulatory structure and affected the lending, deposit, investment, trading, and operating activities of financial institutions and their holding companies. The Dodd-Frank Act changed the regulatory structure to which the Corporation and the Bank are subject in numerous ways, including, but not limited to, the following:

- the base for FDIC insurance assessments has been changed to a bank's average consolidated total assets minus average tangible equity, rather than upon its deposit base, while the FDIC's authority to raise insurance premiums has been expanded;
- the current standard deposit insurance limit has been permanently raised to $250,000;
- the FDIC must raise the ratio of reserves to deposits from 1.15% to 1.35% for deposit insurance purposes by September 30, 2020 and to "offset the effect" of increased assessments on insured depository institutions with assets of less than $10.0 billion;
- the interchange fees payable on debit card transactions have been limited;
- there are multiple new provisions affecting corporate governance and executive compensation at all publicly traded companies; and
- all federal prohibitions on the ability of financial institutions to pay interest on commercial demand deposit accounts have been repealed.

In addition to the foregoing, the Dodd-Frank Act established the CFPB as an independent entity within the FRB. The CFPB has broad rulemaking, supervisory and enforcement authority over consumer financial products and services, including deposit products, residential mortgages, home-equity loans and credit cards, as well as with respect to certain mortgage-related matters, such as steering incentives, determinations as to a borrower's ability to repay and prepayment penalties.

As a result of the Dodd-Frank Act, operating and compliance costs have increased and may continue to increase in the future.

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

Currently, the Corporation and its subsidiaries are subject to extensive regulation, supervision, and examination by regulatory authorities. For example, the FRB regulates the Corporation, the FRB, the FDIC and the NYSDFS regulate the Bank, and CRM is regulated by the Nevada Division of Insurance. Such regulators govern the activities in which the Corporation and its subsidiaries may engage. These regulatory authorities have extensive discretion in connection with their supervisory and enforcement activities, including the imposition of restrictions on the operation of a bank, the classification of assets by a bank, and the adequacy of a bank's allowance for loan losses. Any change in such regulation and oversight, whether in the form of regulatory policy, regulations, or legislation, could have a material impact on the Corporation and its operations. The Corporation believes that it is in substantial compliance with applicable federal, state and local laws, rules and regulations. As the Corporation's business is highly regulated, the laws, rules and applicable regulations are subject to regular modification and change. There can be no assurance that proposed laws, rules and regulations, or any other law, rule or regulation, will not be adopted in the future, which could make compliance more difficult or expensive or otherwise adversely affect the Corporation's business, financial condition or prospects.

The Corporation and Bank have become subject to more stringent capital requirements, which may adversely impact the Corporation's return on equity, require it to raise additional capital, or constrain it from paying dividends or repurchasing shares.

In July 2013, the Federal Reserve Board approved a new rule that substantially amended the regulatory risk-based capital rules applicable to the Corporation, on a consolidated basis, and the Bank, on a stand-alone basis. The final rule implements the "Basel III" regulatory capital reforms and changes required by the Dodd-Frank Act.

The final rule includes new minimum risk-based capital and leverage ratios, which became effective for the Corporation and the Bank on January 1, 2015, and refines the definition of what constitutes "capital" for purposes of calculating these ratios. The new minimum capital requirements are: (i) a new common equity Tier 1 capital ratio of 4.5%; (ii) a Tier 1 to risk-based assets capital ratio of 6% (increased from 4%); (iii) a total capital ratio of 8% (unchanged from former rules); and (iv) a Tier 1 leverage ratio of 4%. The final rule also establishes a "capital conservation buffer" of 2.5%, and will result in the following minimum ratios: (i) a common equity Tier 1 capital ratio of 7.0%, (ii) a Tier 1 to risk-based assets capital ratio of 8.5%, and (iii) a total capital ratio of 10.5%. The new capital conservation buffer requirement is being phased in beginning in January 2016 at 0.625% of risk-weighted assets and will increase each year until fully implemented in January 2019. For 2018, the capital conservation buffer will be 1.875% of risk-weighted assets. An institution will be subject to limitations on paying dividends, engaging in share repurchases, and paying discretionary bonuses if its capital level falls below the buffer amount. These limitations will establish a maximum percentage of eligible retained income that can be utilized for such actions.

The application of more stringent capital requirements for the Bank and the Corporation could, among other things, result in lower returns on equity, require the raising of additional capital, and result in regulatory actions constraining them from paying dividends or repurchasing shares if they are unable to comply with such requirements.

Changes in tax rates could adversely affect the Corporation's results of operations and financial condition.

The Corporation is subject to the income tax laws of the United States, its states, and municipalities. The income tax laws of the jurisdictions in which the Corporation operates are complex and subject to different interpretations by the taxpayer and the relevant government taxing authorities. In establishing a provision for income tax expense, the Corporation must make judgments and interpretations about the application of these inherently complex tax laws to its business activities, as well as the timing of when certain items may affect taxable income.

The provision for income taxes is composed of current and deferred taxes. Deferred taxes arise from differences between assets and liabilities measured for financial reporting versus income tax return purposes. Deferred tax assets are recognized if, in the Corporation's judgment, their realizability is determined to be more likely than not. The Corporation performs regular reviews to ascertain the realizability of its deferred tax assets. These reviews include the Corporation's estimates and assumptions regarding future taxable income, which incorporates various tax planning strategies.

The Corporation may be adversely affected by recent changes in U.S. tax laws and regulations.
Changes in tax laws contained in the Tax Act, which was enacted in December 2017, include a number of provisions that will have an impact on the banking industry, borrowers and the market for single-family residential real estate. Included in this legislation is a reduction of the corporate income tax rate from 35% to 21%. In addition, other changes include (i) a lower limit on the deductibility of mortgage interest on single-family residential mortgage loans, (ii) the elimination of interest deductions for home equity loans, (iii) a limitation on the deductibility of business interest expense and (iv) a limitation on the deductibility of property taxes and state and local income taxes. These recent changes in the tax laws may have an adverse effect on the market for, and valuation of, residential properties, and on the demand for such loans in the future, and could make it harder for borrowers to make their loan payments.

In addition, these recent changes may also have a disproportionate effect on taxpayers in states with high residential home prices and high state and local taxes, such as New York. If home ownership becomes less attractive, demand for mortgage loans could decrease. The value of the properties securing loans in the Corporation's loan portfolio may be adversely impacted as a result of the changing economics of home ownership, which could require an increase in the Corporation's provision for loan losses, which would reduce its profitability and could materially adversely affect the Corporation's business, financial condition and results of operations.

The Corporation is a holding company and depends on its subsidiaries for dividends, distributions and other payments.

The Corporation is a legal entity separate and distinct from the Bank and other subsidiaries. Its principal source of cash flow, including cash flow to pay dividends to its shareholders, is dividends from the Bank. There are statutory and regulatory limitations on the payment of dividends by the Bank to the Corporation, as well as by the Corporation to its shareholders. FRB regulations affect the ability of the Bank to pay dividends and other distributions and to make loans to the Corporation. If the Bank is unable to make dividend payments to the Corporation and sufficient capital is not otherwise available, the Corporation may not be able to make dividend payments to its common shareholders.

The Corporation holds certain intangible assets that could be classified as impaired in the future. If these assets are considered to be either partially or fully impaired in the future, its earnings and the book values of these assets would decrease.

The Corporation is required to test its goodwill and core deposit intangible assets for impairment on a periodic basis. The impairment testing process considers a variety of factors, including the current market price of its common stock, the estimated net present value of its assets and liabilities, and information concerning the terminal valuation of similarly situated insured depository institutions. If an impairment determination is made in a future reporting period, its earnings and the book value of these intangible assets would be reduced by the amount of the impairment. If an impairment loss is recorded, it will have little or no impact on the tangible book value of the Corporation's common shares or its regulatory capital levels, but such an impairment loss could significantly restrict the Bank from paying a dividend to the Corporation.

Financial counterparties expose the Corporation to risks.

The Corporation has increased its use of derivative financial instruments, primarily interest rate swaps, which exposes it to financial and contractual risks with counterparty banks. The Corporation maintains correspondent bank relationships, manages certain loan participations, engages in securities transactions, and engages in other activities with financial counterparties that are customary to its industry. Financial risks are inherent in these counterparty relationships.

The Corporation may not be able to attract and retain skilled people.

The Corporation's success depends, in large part, on its ability to attract and retain key people. Competition for the best people in most activities in which the Corporation engages can be intense and it may not be able to hire people or to retain them. A key component of employee retention is providing a fair compensation base combined with the opportunity for additional compensation for above average performance. In this regard, the Corporation uses a stock-based compensation program that aligns the interest of the Corporation's executives and senior managers with the interests of the Corporation, and its shareholders.

The Corporation's compensation practices are designed to be competitive and comparable to those of its peers, however, the unexpected loss of services of one or more of the Corporation's key personnel could have a material adverse impact on the business because it would lose the employees’ skills, knowledge of the market, and years of industry experience and may have difficulty promptly finding qualified replacement personnel.

The Corporation's controls and procedures may fail or be circumvented, which may result in a material adverse effect on its business.

Management regularly reviews and updates its 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.

The Corporation continually encounters technological change and the failure to understand and adapt to these changes could adversely affect its business.

The banking industry is undergoing rapid technological changes with frequent introductions of new technology-driven products and services. Technology has lowered barriers to entry and made it possible for "non-banks" to offer traditional bank products and services using innovative technological platforms such as Fintech and Blockchain. These "digital banks" may be able to achieve economies of scale and offer better pricing for banking products and services than the Corporation can. The Corporation's future success will depend, in part, on the ability to address the needs of customers by using technology to provide products and services that will satisfy customer demands for convenience as well as to create additional efficiencies in operations. Many competitors have substantially greater resources to invest in technological improvements. There can be no assurance that the Corporation will be able to effectively implement new technology-driven products and services or be successful in marketing such products and services to customers. Failure to successfully keep pace with technological change affecting the financial services industry could have a material adverse impact on the Corporation's business and, in turn, its financial condition and results of operations.

The Corporation is subject to security and operational risks relating to its use of technology.

Despite instituted safeguards, the Corporation cannot be certain that all of its systems are entirely free from vulnerability to attack or other technological difficulties or failures, such as cyber-attacks. The Corporation relies on the services of a variety of vendors to meet its data processing and communication needs. If information security is breached or other technology difficulties or failures occur, information may be lost or misappropriated, services and operations may be interrupted and the Corporation could be exposed to claims from customers. Any of these results could have a material adverse effect on the Corporation's business, financial condition, results of operations or liquidity.

Provisions of the Corporation's certificate of incorporation, bylaws, as well as New York law and certain banking laws, could delay or prevent a takeover of the Corporation by a third party.

Provisions of the Corporation’s certificate of incorporation and bylaws, New York law, and state and federal banking laws, including regulatory approval requirements, could delay, defer or prevent a third party from acquiring the Corporation, despite the possible benefit to the Corporation’s shareholders, or otherwise adversely affect the market price of the Corporation’s common stock. These provisions include: a two-thirds affirmative vote of all outstanding shares of Corporation stock for certain business combinations; a supermajority shareholder vote of 75% of outstanding stock for business combinations involving 10% shareholders; the election of directors to staggered terms of three years; and advance notice requirements for nominations for election to the Corporation’s Board of Directors and for proposing matters that shareholders may act on at a shareholder meeting. In addition, the Corporation is subject to New York law, which among other things prohibits the Corporation from engaging in a business combination with any interested stockholder for a period of five years from the date the person became an interested stockholder unless certain conditions are met. These provisions may discourage potential takeover attempts, discouraging bids for the Corporation’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 Corporation’s common stock. These provisions could also discourage proxy contests and make it more difficult for shareholders to elect directors other than candidates nominated by the Board of Directors.

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

The business strategy of the Corporation has included and may continue to include growth through acquisition from time to time. Any future acquisitions will be accompanied by the risks commonly encountered in acquisitions. These risks may include, among other things: its ability to realize anticipated cost savings, the difficulty of integrating operations and personnel, the loss of key employees, the potential disruption of its or the acquired company's ongoing business in such a way that could result in decreased revenues, the inability of its management to maximize its 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.

Severe weather and other natural disasters can affect the Corporation's business.

The Corporation's main office and its branch offices can be affected by natural disasters such as severe storms and flooding. These kinds of events could interrupt the Corporation's operations, particularly its ability to deliver deposit and other retail banking services to its customers and as a result, the Corporation's business could suffer serious harm. While the Corporation maintains adequate insurance against property and casualty losses arising from most natural disasters, and it has successfully overcome the challenges caused by past flooding in Central New York, there can be no assurance that it will be as successful if and when disasters occur.

The Corporation's accounting policies and estimates are critical to how the Corporation reports its financial condition and results of operations, and any changes to such accounting policies and estimates could materially affect how the Corporation reports its financial condition and results of operations.

Management has identified certain accounting policies as being critical because they require management’s judgment to ascertain the valuations of assets, liabilities, commitments and contingencies. A variety of factors could affect the ultimate value that is obtained either when earning income, recognizing an expense, recovering an asset, valuing an asset or liability or reducing a liability. The Corporation has established detailed policies and control procedures that are intended to ensure that these critical accounting estimates and judgments are well controlled and applied consistently. In addition, these policies and procedures are intended to ensure that the process for changing methodologies occurs in an appropriate manner. Because of the uncertainty surrounding its judgments and the estimates pertaining to these matters, actual outcomes may be materially different from amounts previously estimated. For example, because of the inherent uncertainty of estimates, management cannot provide any assurance that the Bank will not significantly increase its allowance for loan losses if actual losses are more than the amount reserved. Any increase in its allowance for loan losses or loan charge-offs could have a material adverse effect on the Corporation's financial condition and results of operations. In addition, the Corporation cannot guarantee that it will not be required to adjust accounting policies or restate prior financial statements.

Further, from time to time, the FASB and SEC change the financial accounting and reporting standards that govern the preparation of the Corporation's financial statements. These changes can be hard to predict and can materially impact how the Corporation records and reports its financial condition and results of operations. In some cases, the Corporation could be required to apply a new or revised standard retroactively, resulting in its restating prior period financial statements or otherwise adversely affecting its financial condition or results of operations.

Specifically, in June of 2016, FASB issued a new accounting standard, ASU 2016-13, Financial Instruments - Credit Losses (Topic 326) that will substantially change the accounting for credit losses under GAAP. Under GAAP's current standards, credit losses are not reflected in the Corporation's financial statements until it is probable that the credit losses has been incurred. This methodology has the effect of delaying the recognition of credit losses on loans. Under the new credit loss standard, the allowance for credit losses will be an estimate of the "expected" credit losses on loans. The new credit loss standard may have a negative impact on the reporting of results of operations and financial condition of the Corporation. The amendments in this ASU are effective for public companies for fiscal years beginning after December 15, 2019, though entities may adopt the amendments earlier for fiscal years beginning after December 15, 2018.

There may be claims and litigation pertaining to fiduciary responsibility.

From time to time as part of the Corporation’s normal course of business, customers make claims and take legal action against the Corporation based on its actions or inactions related to the fiduciary responsibilities of the Wealth Management Group segment. If such claims and legal actions are not resolved in a manner favorable to the Corporation, they may result in financial liability and/or adversely affect the market perception of the Corporation and its products and services. This may also impact customer demand for the Corporation’s products and services. Any financial liability or reputation damage could have a material adverse effect on the Corporation’s business, which, in turn, could have a material adverse effect on its financial condition and results of operations.

ITEM 1B. UNRESOLVED STAFF COMMENTS

None.

## ITEM 2.  PROPERTIES

All properties owned or leased by the Bank are considered to be in good condition.  For additional information about the Corporation's facilities, including rental expenses, see "Note 5 Premises and Equipment" in Notes to Consolidated Financial Statements in Part IV, Item  15. Exhibits and Financial Statement Schedules of this report.  The Corporation holds no real estate in its own name.

Corporate Headquarters
Executive and Administrative Offices
One Chemung Canal Plaza, Elmira, NY 14901

New York

Albany County
*132 State St., Albany, NY 12207
*65 Wolf Rd., Albany, NY 12205
*581 Loudon Rd., Latham, NY 12110
*1365 New Scotland Rd., Slingerlands, NY 12159

Broome County
*127 Court St., Binghamton, NY 13901
*601-635 Harry L. Dr., Johnson City, NY 13790 (Oakdale Mall)
*100 Rano Blvd., Vestal, NY 13850

Cayuga County
*110 Genesee St., Auburn, NY 13021
185 Grant Ave., Auburn, NY 13021

Chemung County
One Chemung Canal Plaza, Elmira, NY 14901
628 W. Church St., Elmira, NY 14905
437 Maple St., Big Flats, NY 14814
951 Pennsylvania Ave., Elmira, NY 14904
100 W. McCann's Blvd., Elmira Heights, NY 14903
29 Arnot Rd., Horseheads, NY 14845
602 S. Main St., Horseheads, NY 14845

Cortland County
*1094 State Rte. 222, Cortland, NY 13045

Saratoga County
*25 Park Ave., Clifton Park, NY 12065

Schenectady County
*2 Rush St., Schenectady, NY 12305

Schuyler County
318 N. Franklin St., Watkins Glen, NY 14891
303 W. Main St., Montour Falls, NY 14865

Seneca County
54 Fall St., Seneca Falls, NY 13148

Steuben County
*410 West Morris St., Bath, NY 14810
149 West Market St., Corning, NY 14830
243 North Hamilton St., Painted Post, NY 14870

Tioga County
203 Main St., Owego, NY 13827
*1054 State Route 17C, Owego, NY 13827
405 Chemung St., Waverly, NY 14892

Tompkins County
806 W. Buffalo St., Ithaca, NY 14850
304 Elmira Rd., Ithaca, NY 14850
*909 Hanshaw Rd., Ithaca, NY 14850

Pennsylvania

Bradford County
5 West Main St., Canton, PA 17724
304 Main St., Towanda, PA 18848
159 Canton St., Troy, PA 16947

CFS Group
One Chemung Canal Plaza, Elmira, NY 14901

* Leased facilities and/or property

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| Leased Off-Site ATM Locations | |
|---|---|
| Albany Capital Center | Albany, NY |
| Times Union Center | Albany, NY |
| Elmira-Corning Regional Airport | Big Flats, NY |
| Corning Community College | Corning, NY |
| Elmira College | Elmira, NY |
| E-Z Food Mart | Elmira, NY |
| Hardinge Inc. (employees only) | Elmira, NY |
| Quality Beverage | Elmira, NY |
| Collegetown Bagels | Ithaca, NY |
| Ithaca College | Ithaca, NY |
| Lansing Market | Lansing, NY |
| Schuyler Hospital | Montour Falls, NY |

ITEM 3. LEGAL PROCEEDINGS

In the normal course of business, there are various outstanding claims and legal proceedings involving the Corporation or its subsidiaries. Except for the legal matter discussed in Footnote 15 of the Corporation's consolidated financial statements, the Corporation believes that it is not a party to any pending legal, arbitration, or regulatory proceedings that could have a material adverse impact on its financial results or liquidity as of December 31, 2017.

ITEM 4. MINE SAFETY DISCLOSURES

None.

PART II

ITEM 5. MARKET FOR THE REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

The Corporation's common stock is traded on the Nasdaq Global Market under the symbol "CHMG."

The table below shows the price ranges for the Corporation’s common stock during each of the indicated quarters. The information is based upon the high and low closing sales prices reported by the Nasdaq Global Market.

Common Stock Market Prices and Dividends Paid
During the Past Two Years

| December 31, 2017 | High | Low | Dividends |
|---|---|---|---|
| 4th Quarter | $54.30 | $44.06 | $ 0.26 |
| 3rd Quarter | 47.10 | 39.00 | 0.26 |
| 2nd Quarter | 41.43 | 37.05 | 0.26 |
| 1st Quarter | 39.50 | 32.72 | 0.26 |

| December 31, 2016 | High | Low | Dividends |
|---|---|---|---|
| 4th Quarter | $36.74 | $28.29 | $ 0.26 |
| 3rd Quarter | 32.19 | 27.47 | 0.26 |
| 2nd Quarter | 32.95 | 26.20 | 0.26 |
| 1st Quarter | 28.03 | 26.25 | 0.26 |

Under New York law, the Corporation may pay dividends on its common stock either: (i) out of surplus, so that the Corporation’s net assets remaining after such payment equal the amount of its stated capital, or (ii) if there is no surplus, out of its net profits for the fiscal year in which the dividend is declared and/or the preceding fiscal year. The payment of dividends on the Corporation's common stock is dependent, in large part, upon receipt of dividends from the Bank, which is subject to certain restrictions which may limit its ability to pay the Corporation dividends. See Item 1, “Business – Supervision and Regulation-The Bank-Payment of Dividends” for an explanation of legal limitations on the Bank’s ability to pay dividends.

As of February 28, 2018, there were 512 registered holders of record of the Corporation's stock.

The table below sets forth the information with respect to purchases made by the Corporation of our common stock during the quarter ended December 31, 2017:

| Period | Total number of shares purchased | Average price paid per share | Total number of shares purchased as part of publicly announced plans or programs | Maximum number of shares that may yet be purchased under the plans or programs |
|---|---|---|---|---|
| 10/1/17-10/31/17 | — | $ — | — | 121,906 |
| 11/1/17-11/30/17 | — | $ — | — | 121,906 |
| 12/1/17-12/31/17 | 1,159 | $ 52.92 | — | 121,906 |
| Quarter ended 12/31/17 | 1,159 | $ 52.92 | — | 121,906 |

On December 19, 2012, the Corporation’s Board of Directors approved a stock repurchase plan authorizing the purchase of up to 125,000 shares of the Corporation's outstanding common stock. Purchases may be made from time to time on the open market or in private negotiated transactions and will be at the discretion of management. For the year ended December 31, 2017, no shares had been purchased under this plan. Since inception of the plan, a total of 3,094 shares have been purchased under the plan.

Included above are 1,159 shares purchased in December 2017, at an average cost of $52.92, from employees who participate in the Corporation's restricted stock plan to cover related employee payroll taxes associated with those participants' vesting in shares granted under the plan.

STOCK PERFORMANCE GRAPH

The following graph compares the yearly change in the cumulative total shareholder return on the Corporation's common stock against the cumulative total return of the NASDAQ Stock Market (U.S. Companies), NASDAQ Bank Stocks Index, SNL U.S. Bank NASDAQ, and SNL $1B - $5B Bank Index for the period of five years commencing December 31, 2012.

| | Period Ending | | | | | |
|---|---|---|---|---|---|---|
| Index | 12/31/2012 | 12/31/2013 | 12/31/2014 | 12/31/2015 | 12/31/2016 | 12/31/2017 |
| Chemung Financial Corporation | 100.00 | 118.03 | 99.10 | 102.36 | 140.04 | 190.86 |
| NASDAQ Composite | 100.00 | 140.12 | 160.78 | 171.97 | 187.22 | 242.71 |
| SNL U.S. Bank NASDAQ | 100.00 | 143.73 | 148.86 | 160.70 | 222.81 | 234.58 |
| SNL Bank $1B-$5B | 100.00 | 145.41 | 152.04 | 170.20 | 244.85 | 261.04 |

The cumulative total return includes (1) dividends paid and (2) changes in the share price of the Corporation's common stock and assumes that all dividends were reinvested. The above graph assumes that the value of the investment in Chemung Financial Corporation and each index was $100 on December 31, 2012.

The Total Returns Index for NASDAQ Composite and SNL bank stocks indices were obtained from S&P Global Market Intelligence, New York, NY.

## ITEM 6. SELECTED FINANCIAL DATA

The following tables present selected financial data as of and for the years ended December 31, 2017, 2016, 2015, 2014 and 2013. The selected financial data at December 31, 2017, and 2016 and for the three year period ended December 31, 2017 is derived from our audited consolidated financial statements that appear in this annual report on Form 10-K. The other years presented in these tables are derived from audited consolidated financial statements that do not appear in this annual report on Form 10-K. The selected financial data should be read in conjunction with "Management's Discussion and Analysis of Financial Condition and Results of Operations" and our audited consolidated financial statements and related notes.

| | SUMMARIZED BALANCE SHEET DATA AT DECEMBER 31, | | | | |
|---|---|---|---|---|---|
| (in thousands) | 2017 | 2016 | 2015 | 2014 | 2013 |
| Total assets | $1,707,620 | $1,657,179 | $1,619,964 | $1,524,539 | $1,476,143 |
| Loans, net of deferred fees | 1,311,824 | 1,200,290 | 1,168,633 | 1,121,574 | 995,866 |
| Investment securities | 297,408 | 308,107 | 349,386 | 286,338 | 352,511 |
| FHLBNY and FRBNY stock | 5,784 | 4,041 | 4,797 | 5,535 | 4,482 |
| Deposits | 1,467,446 | 1,456,343 | 1,400,295 | 1,280,014 | 1,266,256 |
| Securities sold under agreements to repurchase | 10,000 | 27,606 | 28,453 | 29,652 | 32,701 |
| FHLBNY advances | 59,700 | 9,093 | 33,103 | 50,140 | 25,243 |
| Long term capital lease obligation | 4,517 | 4,722 | 2,873 | 2,976 | — |
| Shareholders' equity | 149,813 | 143,748 | 137,242 | 133,628 | 138,578 |

| | SUMMARIZED EARNINGS DATA FOR THE YEARS ENDED DECEMBER 31, | | | | |
|---|---|---|---|---|---|
| (in thousands) | 2017 | 2016 | 2015 | 2014 | 2013 |
| Net interest income | $56,987 | $52,329 | $50,642 | $49,568 | $46,631 |
| Provision for loan losses | 9,022 | 2,437 | 1,571 | 3,981 | 2,755 |
| Net interest income after provision for loan losses | 47,965 | 49,892 | 49,071 | 45,587 | 43,876 |
| | | | | | |
| Wealth management group fee income | 8,804 | 8,316 | 8,522 | 7,747 | 7,344 |
| Service charges on deposit accounts | 4,961 | 5,089 | 4,886 | 5,281 | 4,706 |
| Interchange revenue from debit card transactions | 3,761 | 4,027 | 3,307 | 3,360 | 2,562 |
| Securities gains, net | 109 | 987 | 372 | 6,869 | 16 |
| Other non-interest income | 2,856 | 2,730 | 3,360 | 3,499 | 3,449 |
| Total non-interest income | 20,491 | 21,149 | 20,447 | 26,756 | 18,077 |
| | | | | | |
| Legal accruals and settlements | 850 | 1,200 | — | 4,250 | — |
| Merger and acquisition related expenses | — | — | — | 115 | 1,387 |
| Other non-interest expenses | 52,914 | 55,410 | 55,427 | 56,112 | 48,013 |
| Total non-interest expenses | 53,764 | 56,610 | 55,427 | 60,477 | 49,400 |
| Income before income tax expense | 14,692 | 14,431 | 14,091 | 11,866 | 12,553 |
| Income tax expense | 7,262 | 4,404 | 4,658 | 3,709 | 3,822 |
| Net income | $7,430 | $10,027 | $9,433 | $8,157 | $8,731 |

| | SELECTED PER SHARE DATA ON SHARES OF COMMON STOCK AT OR FOR THE YEARS ENDED DECEMBER 31, | | | | | | |
|---|---|---|---|---|---|---|---|
| | 2017 | 2016 | 2015 | 2014 | 2013 | % Change 2016 To 2017 | Compounded Annual Growth 5 Years |
| Earnings per share (1) | $1.55 | $2.11 | $2.00 | $1.74 | $1.87 | (26.5)% | (6.9)% |
| Dividends declared | 1.04 | 1.04 | 1.04 | 1.04 | 1.04 | — % | 0.7 % |
| Tangible book value (2) (4) | 26.14 | 24.89 | 23.53 | 22.71 | 23.63 | 5.0 % | 2.6 % |
| Book Value | 31.10 | 30.07 | 28.96 | 28.44 | 29.67 | 3.4 % | 1.6 % |
| Market price at December 31, | 48.10 | 36.35 | 27.50 | 27.66 | 34.17 | 32.3 % | 8.3 % |
| Common shares outstanding at year end (in thousands) (3) | 4,817 | 4,781 | 4,739 | 4,699 | 4,671 | 0.8 % | 0.6 % |
| Weighted average shares outstanding (in thousands) | 4,800 | 4,762 | 4,719 | 4,683 | 4,660 | 0.8 % | 0.6 % |

(1) Earnings per share is computed by dividing net income by the weighted average number of common shares outstanding. There is no difference between basic and diluted earnings per share.
(2) Tangible book value is total shareholders' equity less goodwill and other intangible assets divided by common shares outstanding.
(3) All issuable shares including those related to directors' restricted stock units and directors' stock compensation.
(4) See the GAAP to Non-GAAP reconciliations starting at pages 64-67.

| | SELECTED RATIOS AT OR FOR THE YEARS ENDED DECEMBER 31, | | | | |
|---|---|---|---|---|---|
| | 2017 | 2016 | 2015 | 2014 | 2013 |
| Return on average assets | 0.43 % | 0.60 % | 0.60 % | 0.54 % | 0.67 % |
| Return on average equity | 4.91 % | 7.02 % | 6.84 % | 5.74 % | 6.50 % |
| Dividend yield at year end | 2.16 % | 2.86 % | 3.78 % | 3.76 % | 3.08 % |
| Dividend payout | 66.30 % | 48.76 % | 51.34 % | 58.80 % | 41.04 % |
| Total capital to risk adjusted assets | 11.82 % | 12.14 % | 12.26 % | 11.84 % | 12.10 % |
| Tier I capital to risk adjusted assets | 10.56 % | 10.94 % | 11.01 % | 10.59 % | 10.57 % |
| Tier I leverage ratio | 8.02 % | 7.81 % | 7.83 % | 7.78 % | 8.08 % |
| Average equity to average assets | 8.83 % | 8.57 % | 8.74 % | 9.43 % | 10.28 % |
| Year-end equity to year-end assets ratio | 8.77 % | 8.67 % | 8.47 % | 8.77 % | 9.39 % |
| Loans to deposits | 89.40 % | 82.42 % | 83.46 % | 87.62 % | 78.65 % |
| Allowance for loan losses to total loans | 1.61 % | 1.19 % | 1.22 % | 1.22 % | 1.28 % |
| Allowance for loan losses to non-performing loans | 122.14 % | 118.35 % | 116.58 % | 175.96 % | 150.11 % |
| Non-performing loans to total loans | 1.32 % | 1.00 % | 1.05 % | 0.69 % | 0.86 % |
| Non-performing assets to total assets | 1.13 % | 0.75 % | 0.85 % | 0.71 % | 0.61 % |
| Net interest rate spread | 3.47 % | 3.26 % | 3.36 % | 3.48 % | 3.78 % |
| Net interest margin | 3.56 % | 3.37 % | 3.46 % | 3.59 % | 3.91 % |
| Efficiency ratio (1) (2) | 66.60 % | 74.43 % | 76.18 % | 78.75 % | 72.52 % |

(1) Efficiency ratio is non-interest expense less merger and acquisition related expenses less amortization of intangible assets less legal settlement divided by the total of fully taxable equivalent net interest income plus non-interest income less net gain on securities transactions.
(2) See the GAAP to Non-GAAP reconciliations starting at pages 64-67.

The following tables summarize the Corporation's unaudited net income and basic earnings per share at each quarter end for the years 2017 and 2016:

| (in thousands, except per share data) | 2017 | | | |
|---|---|---|---|---|
| | Quarter Ended | | | |
| UNAUDITED QUARTERLY DATA | Mar. 31 | June 30 | Sept. 30 | Dec. 31 |
| Interest and dividend income | $14,314 | $14,684 | $15,497 | $15,560 |
| Interest expense | 820 | 734 | 734 | 780 |
| Net interest income | 13,494 | 13,950 | 14,763 | 14,780 |
| Provision for loan losses (3) | 1,040 | 421 | 1,289 | 6,272 |
| Net interest income after provision for loan losses | 12,454 | 13,529 | 13,474 | 8,508 |
| Total other non-interest income | 4,847 | 5,022 | 5,166 | 5,456 |
| Total other non-interest expenses (1) | 13,045 | 14,332 | 13,276 | 13,111 |
| Income before income tax expense | 4,256 | 4,219 | 5,364 | 853 |
| Income tax expense (2) | 1,277 | 1,263 | 1,710 | 3,012 |
| Net income (loss) | $2,979 | $2,956 | $3,654 | $(2,159 ) |
| Basic and diluted earnings per share | $0.62 | $0.62 | $0.76 | $(0.45 ) |

(1) The quarter ended June 30, 2017 included a $0.9 million legal reserve. Please refer to Footnote 15 of the audited consolidated financial statements for further discussion.
(2) The quarter ended December 31, 2017 included a $2.9 million net deferred tax remeasurement. Please refer to Footnote 11 of the audited consolidated financial statements for further discussion.
(3) The quarter ended December 31, 2017 included $4.9 million in specific reserves for eight commercial loans to two long-standing relationships in the Southern Tier of New York.

| (in thousands, except per share data) | 2016 | | | |
|---|---|---|---|---|
| | Quarter Ended | | | |
| UNAUDITED QUARTERLY DATA | Mar. 31 | June 30 | Sept. 30 | Dec. 31 |
| Interest and dividend income | $13,949 | $13,925 | $14,025 | $14,269 |
| Interest expense | 924 | 957 | 985 | 973 |
| Net interest income | 13,025 | 12,968 | 13,040 | 13,296 |
| Provision for loan losses | 595 | 388 | 1,050 | 404 |
| Net interest income after provision for loan losses | 12,430 | 12,580 | 11,990 | 12,892 |
| Total other non-interest income | 5,601 | 5,216 | 5,435 | 4,897 |
| Total other non-interest expenses (3) | 14,008 | 15,570 | 13,471 | 13,561 |
| Income before income tax expense | 4,023 | 2,226 | 3,954 | 4,228 |
| Income tax expense | 1,316 | 605 | 1,209 | 1,274 |
| Net income | $2,707 | $1,621 | $2,745 | $2,954 |
| Basic and diluted earnings per share | $0.57 | $0.34 | $0.58 | $0.62 |

(3) The quarter ended June 30, 2016 included a $1.2 million legal reserve. Please refer to Footnote 15 of the audited consolidated financial statements for further discussion.

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATION

The following is the MD&A of the Corporation in this Form 10-K at December 31, 2017 and 2016, and for the years ended December 31, 2017, 2016, and 2015. The purpose of this discussion is to focus on information about the financial condition and results of operations of the Corporation. Reference should be made to the accompanying audited consolidated financial statements and footnotes for an understanding of the following discussion and analysis. See the list of commonly used abbreviations and terms on pages 1-4.

The MD&A included in this Form 10-K contains statements that are forward-looking within the meaning of the Private Securities Litigation Reform Act of 1995. These statements are based on the current beliefs and expectations of the Corporation's management and are subject to significant risks and uncertainties. Actual results may differ from those set forth in the forward-looking statements. For a discussion of those risks and uncertainties and the factors that could cause the Corporation’s actual results to differ materially from those risks and uncertainties, see Forward-looking Statements below.

The Corporation has been a financial holding company since 2000, and the Bank was established in 1833, CFS in 2001, and CRM in 2016. Through the Bank and CFS, the Corporation provides a wide range of financial services, including demand, savings and time deposits, commercial, residential and consumer loans, interest rate swaps, letters of credit, wealth management services, employee benefit plans, insurance products, mutual funds and brokerage services. The Bank relies substantially on a foundation of locally generated deposits. The Corporation, on a stand-alone basis, has minimal results of operations. The Bank derives its income primarily from interest and fees on loans, interest on investment securities, WMG fee income and fees received in connection with deposit and other services. The Bank’s operating expenses are interest expense paid on deposits and borrowings, salaries and employee benefit plans and general operating expenses.

CRM, a wholly-owned subsidiary of the Corporation which was formed and began operations on May 31, 2016, is a Nevada-based captive insurance company that insures against certain risks unique to the operations of the Corporation and its subsidiaries and for which insurance may not be currently available or economically feasible in today's insurance marketplace. CRM pools resources with several other similar insurance company subsidiaries of financial institutions to spread a limited amount of risk among themselves. CRM is subject to regulations of the State of Nevada and undergoes periodic examinations by the Nevada Division of Insurance.

Forward-looking Statements

This discussion contains forward-looking statements within the meaning of Section 27A of the Securities Act, Section 21E of the Exchange Act, and the Private Securities Litigation Reform Act of 1995. The Corporation intends its forward-looking statements to be covered by the safe harbor provisions for forward-looking statements in these sections. All statements regarding the Corporation's expected financial position and operating results, the Corporation's business strategy, the Corporation's financial plans, forecasted demographic and economic trends relating to the Corporation's industry and similar matters are forward-looking statements. These statements can sometimes be identified by the Corporation's use of forward-looking words such as "may," "will," "anticipate," "estimate," "expect," or "intend." The Corporation cannot promise that its expectations in such forward-looking statements will turn out to be correct. The Corporation's actual results could be materially different from expectations because of various factors, including changes in economic conditions or interest rates, credit risk, difficulties in managing the Corporation’s growth, competition, changes in law or the regulatory environment, including the Dodd-Frank Act, and changes in general business and economic trends. Information concerning these and other factors can be found in the Corporation’s periodic filings with the SEC, including the discussion under the heading “Item 1A. Risk Factors” of this Form 10-K. The Corporation's quarterly filings are available publicly on the SEC’s web site at http://www.sec.gov, on the Corporation's web site at http://www.chemungcanal.com or by written request to:

Kathleen S. McKillip, Corporate Secretary, Chemung Financial Corporation, One Chemung Canal Plaza, Elmira, NY 14901. Except as otherwise required by law, the Corporation undertakes no obligation to publicly update or revise its forward-looking statements, whether as a result of new information, future events or otherwise.

Consolidated Financial Highlights

| (in thousands, except per share data) | As of or for the Years Ended December 31, 2017 | December 31, 2016 | December 31, 2015 |
|---|---|---|---|
| RESULTS OF OPERATIONS | | | |
| Interest and dividend income | $60,055 | $56,168 | $54,244 |
| Interest expense | 3,068 | 3,839 | 3,602 |
| Net interest income | 56,987 | 52,329 | 50,642 |
| Provision for loan losses | 9,022 | 2,437 | 1,571 |
| Net interest income after provision for loan losses | 47,965 | 49,892 | 49,071 |
| Non-interest income | 20,491 | 21,149 | 20,447 |
| Non-interest expenses | 53,764 | 56,610 | 55,427 |
| Income before income tax expense | 14,692 | 14,431 | 14,091 |
| Income tax expense | 7,262 | 4,404 | 4,658 |
| Net income | $7,430 | $10,027 | $9,433 |
| | | | |
| Basic and diluted earnings per share | $1.55 | $2.11 | $2.00 |
| Average basic and diluted shares outstanding | 4,800 | 4,762 | 4,719 |
| | | | |
| PERFORMANCE RATIOS | | | |
| Return on average assets | 0.43 % | 0.60 % | 0.60 % |
| Return on average equity | 4.91 % | 7.02 % | 6.84 % |
| Return on average tangible equity (a) | 5.85 % | 8.52 % | 8.45 % |
| Efficiency ratio (a) (b) | 66.60 % | 74.43 % | 76.18 % |
| Non-interest expense to average assets (a) (c) | 3.14 % | 3.32 % | 3.51 % |
| Loans to deposits | 89.40 % | 82.42 % | 83.46 % |
| | | | |
| AVERAGE YIELDS / RATES - Fully Taxable Equivalent | | | |
| Yield on loans | 4.24 % | 4.18 % | 4.24 % |
| Yield on investments | 2.08 % | 1.83 % | 1.91 % |
| Yield on interest-earning assets | 3.75 % | 3.61 % | 3.71 % |
| Cost of interest-bearing deposits | 0.20 % | 0.21 % | 0.20 % |
| Cost of borrowings | 2.78 % | 3.01 % | 2.85 % |
| Cost of interest-bearing liabilities | 0.28 % | 0.35 % | 0.35 % |
| Interest rate spread | 3.47 % | 3.26 % | 3.36 % |
| Net interest margin, fully taxable equivalent | 3.56 % | 3.37 % | 3.46 % |
| | | | |
| CAPITAL | | | |
| Total equity to total assets at end of year | 8.77 % | 8.67 % | 8.47 % |
| Tangible equity to tangible assets at end of year (a) | 7.48 % | 7.29 % | 6.99 % |
| | | | |
| Book value per share | $31.10 | $30.07 | $28.96 |
| Tangible book value per share (a) | 26.14 | 24.89 | 23.53 |
| Year-end market value per share | 48.10 | 36.35 | 27.50 |
| Dividends declared per share | 1.04 | 1.04 | 1.04 |

| | | | |
|---|---|---|---|
| AVERAGE BALANCES | | | |
| Loans (d) | $1,251,225 | $1,194,589 | $1,141,992 |
| Interest-earning assets | 1,623,948 | 1,571,513 | 1,477,529 |
| Total assets | 1,713,233 | 1,667,184 | 1,577,831 |
| Deposits | 1,514,457 | 1,450,520 | 1,367,717 |
| Total equity | 151,229 | 142,906 | 137,891 |
| Tangible equity (a) | 126,902 | 117,656 | 111,583 |
| | | | |
| ASSET QUALITY | | | |
| Net charge-offs | $2,114 | $2,444 | $997 |
| Non-performing loans (e) | 17,324 | 12,043 | 12,232 |
| Non-performing assets (f) | 19,264 | 12,431 | 13,762 |
| Allowance for loan losses | 21,160 | 14,253 | 14,260 |
| | | | |
| Annualized net charge-offs to average loans | 0.17 % | 0.20 % | 0.09 % |
| Non-performing loans to total loans | 1.32 % | 1.00 % | 1.05 % |
| Non-performing assets to total assets | 1.13 % | 0.75 % | 0.85 % |
| Allowance for loan losses to total loans | 1.61 % | 1.19 % | 1.22 % |
| Allowance for loan losses to non-performing loans | 122.14 % | 118.35 % | 116.58 % |

(a) See the GAAP to Non-GAAP reconciliations on pages 64-67.
(b) Efficiency ratio is non-interest expense less merger and acquisition expenses less amortization of intangible assets less legal accruals and settlements divided by the total of fully taxable equivalent net interest income plus non-interest income less net gains on securities transactions.
(c) For the non-interest expense to average assets ratio, non-interest expense does not include legal accruals and settlements. See footnote 15 of the audited consolidated financial statements for further discussion.
(d) Loans include loans held for sale. Loans do not reflect the allowance for loan losses.
(e) Non-performing loans include non-accrual loans only.
(f) Non-performing assets include non-performing loans plus other real estate owned.

Executive Summary

This executive summary of the MD&A includes selected information and may not contain all of the information that is important to readers of this Form 10-K. For a complete description of the trends and uncertainties, as well as the risks and critical accounting estimates affecting the Corporation, this Form 10-K should be read in its entirety.

The following table presents selected financial information for the years indicated, and the dollar and percent change (in thousands, except per share and ratio data):

| | Years Ended December 31, | | | |
|---|---|---|---|---|
| | 2017 | 2016 | Change | Percentage Change |
| Net interest income | $56,987 | $52,329 | $4,658 | 8.9 % |
| Non-interest income | 20,491 | 21,149 | (658 ) | (3.1 )% |
| Non-interest expenses | 53,764 | 56,610 | (2,846 ) | (5.0 )% |
| Pre-provision income | 23,714 | 16,868 | 6,846 | 40.6 % |
| Provision for loan losses | 9,022 | 2,437 | 6,585 | 270.2 % |
| Income tax expense | 7,262 | 4,404 | 2,858 | 64.9 % |
| Net income | $7,430 | $10,027 | $(2,597) | (25.9 )% |
| | | | | |
| Basic and diluted earnings per share | $1.55 | $2.11 | $(0.56 ) | (26.5 )% |
| | | | | |
| Selected financial ratios | | | | |
| Return on average assets | 0.43 % | 0.60 % | | |
| Return on average equity | 4.91 % | 7.02 % | | |
| Net interest margin, fully taxable equivalent | 3.56 % | 3.37 % | | |
| Efficiency ratio (a) | 66.60 % | 74.43 % | | |
| Non-interest expense to average assets (a) | 3.14 % | 3.32 % | | |

(a) See the GAAP to Non-GAAP reconciliations on pages 64-67.

Net income for the year ended December 31, 2017 was $7.4 million, or $1.55 per share, compared with net income of $10.0 million, or $2.11 per share, for the prior year. Return on equity for the year was 4.91%, compared with 7.02% for the prior year. The decrease in net income for the year ended December 31, 2017, compared to the prior year, was driven by increases in the provision for loan losses and income tax expenses, partially offset by an increase in net interest income and a reduction in non-interest expenses. Net income in 2017 was impacted by a one-time $2.9 million reduction of the net deferred tax asset as a result of a revaluation required under GAAP due to the reduction in the corporation Federal income tax rate from 35% to 21% due to the Tax Act.

Net interest income

Net interest income increased $4.7 million, or 8.9% in 2017, compared with the prior year. The increase was due primarily to an increase of $52.4 million in average interest-earning assets and a 19 basis points increase in net interest margin.

Non-interest income

Non-interest income decreased $0.7 million, or 3.1% in 2017, compared to the prior year. The decrease was due primarily to decreases in service charges on deposit accounts, interchange revenue from debit card transactions, and net gains on securities transactions, partially offset by increases in WMG fee income and other non-interest income.

Non-interest expenses

Non-interest expense decreased $2.8 million, or 5.0% in 2017, compared to the prior year. The decrease was due primarily to the decreases in pension and other employee benefits, net occupancy, furniture and equipment, professional services, and legal accruals and settlements, partially offset by increases in salaries and wages and other non-interest expense. For the years ended December 31, 2017 and 2016, non-interest expense to average assets was 3.14% and 3.32%, respectively.

Provision for loan losses
The provision for loan losses increased $6.6 million, or 270.2% in 2017, compared to the prior year. The increase was the result of specific impairments in loans identified as impaired, including $4.9 million in specific reserves for eight commercial loans to two long-standing relationships in the Southern Tier of New York, volume increases in the commercial and indirect consumer loan portfolios, and an increase in loss factors relating to the indirect and consumer portfolios. Net charge-offs were $2.1 million in 2017, compared with $2.4 million for the prior year.

Income tax expense
Income tax expense increased $2.9 million, or 64.9% in 2017, compared to the prior year. The increase was the the result of a $2.9 million one-time reduction in the Corporation's net deferred asset. GAAP required a tax remeasurement of the Corporation's net deferred tax asset in the period of enactment of the Tax Act. The Tax Act was enacted on December 22, 2017, reducing the corporate Federal income tax rate from 35% to 21% and making other changes to the Federal corporate income tax laws. The additional expense was attributable to the reduction in the carrying value of net deferred tax assets reflecting lower future tax benefits resulting from the lower enacted corporate tax rate.

The following table presents selected financial information for the periods indicated, and the dollar and percent change (in thousands, except per share and ratio data):

| | Years Ended December 31, | | | |
|---|---|---|---|---|
| | 2016 | 2015 | Change | Percentage Change |
| Net interest income | $52,329 | $50,642 | $1,687 | 3.3 % |
| Non-interest income | 21,149 | 20,447 | 702 | 3.4 % |
| Non-interest expenses | 56,610 | 55,427 | 1,183 | 2.1 % |
| Pre-provision income | 16,868 | 15,662 | 1,206 | 7.7 % |
| Provision for loan losses | 2,437 | 1,571 | 866 | 55.1 % |
| Income tax expense | 4,404 | 4,658 | (254 ) | (5.5 )% |
| Net income | $10,027 | $9,433 | $594 | 6.3 % |
| | | | | |
| Basic and diluted earnings per share | $2.11 | $2.00 | $0.11 | 5.5 % |
| | | | | |
| Selected financial ratios | | | | |
| Return on average assets | 0.60 % | 0.60 % | | |
| Return on average equity | 7.02 % | 6.84 % | | |
| Net interest margin, fully taxable equivalent | 3.37 % | 3.46 % | | |
| Efficiency ratio (a) | 74.43 % | 76.18 % | | |
| Non-interest expense to average assets (a) | 3.32 % | 3.51 % | | |

(a) See the GAAP to Non-GAAP reconciliations on pages 64-67.

Net income for the year ended December 31, 2016 was $10.0 million, or $2.11 per share, compared with $9.4 million, or $2.00 per share, for the prior year. Return on equity for the year ended December 31, 2016 was 7.02%, compared with 6.84% for the prior year. The increase in net income for the year ended December 31, 2016, compared to the prior year, was driven by increases in net interest income and non-interest income and a reduction in income tax expense, partially offset by increases in non-interest expense and the provision for loan losses.

Net interest income

Net interest income increased $1.7 million, or 3.3% in 2016, compared with the prior year. The increase was due primarily to an increase of $94.0 million in average interest-earning assets, offset by a nine basis points decline in net interest margin.

Non-interest income

Non-interest income increased $0.7 million, or 3.4% in 2016, compared to the prior year. The increase was due primarily to increases in service charges on deposit accounts, interchange revenue from debit card transactions, and net gains on securities transactions, offset by decreases in WMG fee income and other non-interest income.

Non-interest expense
Non-interest expense increased $1.2 million, or 2.1% in 2016, compared to the same period in the prior year. The increase was due primarily to the establishment of a $1.2 million legal reserve associated with the Fane v. Chemung Canal Trust Company case, along with increases in pension and other employee benefits and professional services, offset by decreases in salaries and wages, net occupancy expenses, amortization of intangible assets, and other real estate owned expenses. Please refer to Footnote 15 of the audited consolidated financial statements for further discussion of the Fane v. Chemung Canal case. For the years ended December 31, 2016 and 2015, non-interest expense to average assets was 3.32% and 3.51%, respectively.

Provision for loan losses
The provision for loan losses increased $0.9 million, or 55.1% in 2016, compared to the prior year. The increase was the result of an increase in net charge-offs and growth in the commercial loan portfolio, compared to the prior year. Net charge-offs were $2.4 million in 2016, compared with $1.0 million for the prior year.

Income tax expense
Income tax expense decreased $0.3 million, or 5.5% in 2016, compared to the prior year. The decrease in income tax expense can be attributed to the formation of CRM and increasing the utilization of the Bank's real estate investment trust in 2016.

Consolidated Results of Operations

The following section of the MD&A provides a comparative discussion of the Corporation’s Consolidated Results of Operations on a reported basis for the years ended December 31, 2017 and 2016 and for the years ended December 31, 2016 and 2015. For a discussion of the Critical Accounting Policies, Estimates and Risks and Uncertainties that affect the Consolidated Results of Operations, see page 64.

Net Interest Income

The following table presents net interest income for the years indicated, and the dollar and percent change (in thousands):

| | Years Ended December 31, | | | |
|---|---|---|---|---|
| | 2017 | 2016 | Change | Percentage Change |
| Interest and dividend income | $60,055 | $56,168 | $3,887 | 6.9 % |
| Interest expense | 3,068 | 3,839 | (771 ) | (20.1 )% |
| Net interest income | $56,987 | $52,329 | $4,658 | 8.9 % |

Net interest income, which is the difference between the interest income earned on interest-earning assets, such as loans and securities and the interest expense accrued on interest-bearing liabilities, such as deposits and borrowings, is the largest contributor to the Corporation’s earnings.

Net interest income for the year ended December 31, 2017 totaled $57.0 million, an increase of $4.7 million, or 8.9%, compared with $52.3 million for the prior year. Fully taxable equivalent net interest margin was 3.56% for the year ended December 31, 2017 compared with 3.37% for the prior year. The increase in net interest income was due primarily to an increase in interest income from the loan portfolio, primarily from the commercial loan portfolio, as average loan balances increased $56.6 million in 2017 when compared to the prior year. The increase in net interest margin was a result of the loan and securities portfolios repricing to current market rates as interest rates increased in 2017. The average yield on average interest-earning assets increased 14 basis points, while the average cost of interest-bearing liabilities decreased seven basis points. The increase in the average yield of interest-earning assets can be mostly attributed to increases of six and 20 basis points in the average yields of commercial loans and consumer loans, respectively, 13 and 18 basis points in the average yields of taxable and tax-exempt securities, respectively, and 59 basis points in the average yield of interest-earning deposits, partially offset by an 11 basis points decrease in mortgage loans. The decline in the average cost of interest-bearing liabilities can be attributed to a 23 basis points decline in the average cost of borrowings due to the maturity of one $10.0 million FHLB term advance (4.60% rate) in December 2016 and one $10.0 million repurchase agreement (4.54% rate) in March 2017.

The following table presents net interest income for the years indicated, and the dollar and percent change (in thousands):

| | Years Ended December 31, | | | |
|---|---|---|---|---|
| | 2016 | 2015 | Change | Percentage Change |
| Interest and dividend income | $56,168 | $54,244 | $1,924 | 3.5 % |
| Interest expense | 3,839 | 3,602 | 237 | 6.6 % |
| Net interest income | $52,329 | $50,642 | $1,687 | 3.3 % |

Net interest income for the year ended December 31, 2016 totaled $52.3 million, an increase of $1.7 million, or 3.3%, compared with $50.6 million for the prior year. Fully taxable equivalent net interest margin was 3.37% for the year ended December 31, 2016 compared with 3.46% for the prior year. The increase in net interest income was due primarily to interest income from the loan portfolio, as the average commercial loan balance increased $77.6 million in 2016 when compared to the prior year. The decline in interest margin was a result of the commercial loan portfolio repricing to current market rates. The average yield on average interest-earning assets decreased 10 basis points, while the average cost of interest-bearing liabilities remained flat. The decline in the average yield of interest-earning assets can be mostly attributed to declines of 23 basis points in the average yield of commercial loans and 17 basis points in the average yield of mortgage loans, due to new production at lower competitive rates, offset by a 33 basis points increase in consumer loans, due to the indirect loan portfolio and increasing the portfolio toward higher yielding used automobile loans. Average interest-earning assets increased $94.0 million in 2016 compared to the prior year, primarily in commercial loans.

Average Consolidated Balance Sheet and Interest Analysis

The following table presents certain information related to the Corporation's average consolidated balance sheets and its consolidated statements of income for the years ended December 31, 2017, 2016 and 2015. It also reflects the average yield on interest-earning assets and average cost of interest-bearing liabilities for the years ended December 31, 2017, 2016 and 2015. For the purpose of the table below, non-accruing loans are included in the daily average loan amounts outstanding. Daily balances were used for average balance computations. Investment securities are stated at amortized cost. Tax equivalent adjustments have been made in calculating yields on obligations of states and political subdivisions, tax-free commercial loans and dividends on equity investments. With the new 21% statutory federal tax rate effective January 1, 2018, the conversion factor to a fully taxable equivalent basis will decrease in 2018. The decline will have no impact on net income, but will cause the net interest margin on a fully taxable equivalent basis to decrease.

AVERAGE CONSOLIDATED BALANCE SHEETS AND NET INTEREST INCOME ANALYSIS

| | Year Ended December 31, | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | 2017 | | | 2016 | | | 2015 | | |
| (in thousands) | Average Balance | Interest | Yield/ Rate | Average Balance | Interest | Yield/ Rate | Average Balance | Interest | Yield/ Rate |
| Interest-earning assets: | | | | | | | | | |
| Commercial loans | $791,627 | $34,596 | 4.37% | $734,628 | $31,682 | 4.31% | $657,038 | $29,824 | 4.54% |
| Mortgage loans | 198,783 | 7,541 | 3.79% | 197,132 | 7,689 | 3.90% | 198,332 | 8,063 | 4.07% |
| Consumer loans | 260,815 | 10,964 | 4.20% | 262,829 | 10,512 | 4.00% | 286,622 | 10,516 | 3.67% |
| Taxable securities | 270,168 | 5,510 | 2.04% | 274,401 | 5,245 | 1.91% | 262,181 | 4,963 | 1.89% |
| Tax-exempt securities | 52,227 | 1,669 | 3.20% | 45,127 | 1,364 | 3.02% | 43,081 | 1,356 | 3.15% |
| Interest-earning deposits | 50,328 | 563 | 1.12% | 57,396 | 307 | 0.53% | 30,275 | 76 | 0.25% |
| Total interest-earning assets | 1,623,948 | 60,843 | 3.75% | 1,571,513 | 56,799 | 3.61% | 1,477,529 | 54,798 | 3.71% |
| | | | | | | | | | |
| Non-interest earning assets: | | | | | | | | | |
| Cash and due from banks | 25,663 | | | 26,708 | | | 26,959 | | |
| Premises and equipment, net | 27,936 | | | 29,525 | | | 30,953 | | |
| Other assets | 53,883 | | | 51,590 | | | 53,153 | | |
| Allowance for loan losses | (15,066) | | | (14,771) | | | (14,103) | | |
| AFS valuation allowance | (3,131) | | | 2,619 | | | 3,340 | | |
| Total assets | $1,713,233 | | | $1,667,184 | | | $1,577,831 | | |
| | | | | | | | | | |
| Interest-bearing liabilities: | | | | | | | | | |
| Interest-bearing demand deposits | $146,999 | 135 | 0.09% | $135,874 | 136 | 0.10% | $129,442 | 113 | 0.09% |
| Savings and insured money market deposits | 800,070 | 1,566 | 0.20% | 752,489 | 1,457 | 0.19% | 671,829 | 1,214 | 0.18% |
| Time deposits | 132,607 | 467 | 0.35% | 156,737 | 577 | 0.37% | 182,177 | 676 | 0.37% |
| FHLBNY advances, securities sold under agreements to repurchase, and other debt | 32,350 | 900 | 2.78% | 55,472 | 1,669 | 3.01% | 56,202 | 1,599 | 2.85% |
| Total interest-bearing liabilities | 1,112,026 | 3,068 | 0.28% | 1,100,572 | 3,839 | 0.35% | 1,039,650 | 3,602 | 0.35% |
| | | | | | | | | | |
| Non-interest bearing liabilities: | | | | | | | | | |
| Demand deposits | 434,781 | | | 405,420 | | | 384,268 | | |
| Other liabilities | 15,197 | | | 18,286 | | | 16,022 | | |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Total liabilities | 1,562,004 | | | 1,524,278 | | | 1,439,940 | | |
| Shareholders' equity | 151,229 | | | 142,906 | | | 137,891 | | |
| Total liabilities and shareholders’ equity | $1,713,233 | | | $1,667,184 | | | $1,577,831 | | |
| Fully taxable equivalent net interest income | | 57,775 | | | 52,960 | | | 51,196 | |
| Net interest rate spread (1) | | | 3.47% | | | 3.26% | | | 3.36% |
| Net interest margin, fully taxable equivalent (2) | | | 3.56% | | | 3.37% | | | 3.46% |
| Taxable equivalent adjustment | | (788) | | | (631) | | | (554) | |
| Net interest income | | $56,987 | | | $52,329 | | | $50,642 | |

(1) Net interest rate spread is the difference in the average yield on interest-earning assets less the average rate on interest-bearing liabilities.

(2) Net interest margin is the ratio of fully taxable equivalent net interest income divided by average interest-earning assets.

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Changes Due to Rate and Volume

Net interest income can be analyzed in terms of the impact of changes in rates and volumes. The table belows illustrates the extent to which changes in interest rates and in the volume of average interest-earning assets and interest-bearing liabilities have affected the Corporation’s interest income and interest expense during the years indicated. Information is provided in each category with respect to (i) changes attributable to changes in volume (changes in volume multiplied by prior rate); (ii) changes attributable to changes in rates (changes in rates multiplied by prior volume); and (iii) the net changes. For purposes of this table, changes that are not due solely to volume or rate changes have been allocated to these categories based on the respective percentage changes in average volume and rate. Due to the numerous simultaneous volume and rate changes during the years analyzed, it is not possible to precisely allocate changes between volume and rates. In addition, average interest-earning assets include non-accrual loans and taxable equivalent adjustments were made.

RATE/VOLUME ANALYSIS OF NET INTEREST INCOME

| | 2017 vs. 2016 Increase/(Decrease) | | | 2016 vs. 2015 Increase/(Decrease) | | |
|---|---|---|---|---|---|---|
| (in thousands) | Total Change | Due to Volume | Due to Rate | Total Change | Due to Volume | Due to Rate |
| Interest income | | | | | | |
| Commercial loans | $2,914 | $2,471 | $443 | $1,858 | $3,421 | $(1,563) |
| Mortgage loans | (148) | 65 | (213) | (374) | (47) | (327) |
| Consumer loans | 452 | (80) | 532 | (4) | (913) | 909 |
| Taxable securities | 265 | (83) | 348 | 282 | 230 | 52 |
| Tax-exempt securities | 305 | 221 | 84 | 8 | 64 | (56) |
| Interest-earning deposits | 256 | (42) | 298 | 231 | 103 | 128 |
| Total interest income | 4,044 | 2,552 | 1,492 | 2,001 | 2,858 | (857) |
| Interest expense | | | | | | |
| Interest-bearing demand deposits | (1) | 12 | (13) | 23 | 7 | 16 |
| Savings and insured money market deposits | 109 | 59 | 50 | 243 | 167 | 76 |
| Time deposits | (110) | (82) | (28) | (99) | (99) | — |
| FHLBNY advances, securities sold under agreements to repurchase and other debt | (769) | (650) | (119) | 70 | (21) | 91 |
| Total interest expense | (771) | (661) | (110) | 237 | 54 | 183 |
| Net interest income | $4,815 | $3,213 | $1,602 | $1,764 | $2,804 | $(1,040) |

Provision for loan losses

Management performs an ongoing assessment of the adequacy of the allowance for loan losses based upon a number of factors including an analysis of historical loss factors, collateral evaluations, recent charge-off experience, credit quality of the loan portfolio, current economic conditions and loan growth. Based on this analysis, the provision for loan losses for the years ended December 31, 2017, 2016 and 2015 were $9.0 million, $2.4 million and $1.6 million, respectively. The increase in provision for loan losses in 2017 was due primarily to $4.9 million in specific reserves for eight commercial loans to two long-standing relationships in the Southern Tier of New York. Net charge-offs for the years ended December 31, 2017, 2016 and 2015 were $2.1 million, $2.4 million and $1.0 million, respectively.

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Non-interest income

The following table presents non-interest income for the years indicated, and the dollar and percent change (in thousands):

| | Years Ended December 31, | | | |
|---|---|---|---|---|
| | 2017 | 2016 | Change | Percentage Change |
| WMG fee income | $8,804 | $8,316 | $488 | 5.9 % |
| Service charges on deposit accounts | 4,961 | 5,089 | (128 ) | (2.5 )% |
| Interchange revenue from debit card transactions | 3,761 | 4,027 | (266 ) | (6.6 )% |
| Net gains on securities transactions | 109 | 987 | (878 ) | (89.0 )% |
| Net gains on sales of loans held for sale | 260 | 326 | (66 ) | (20.2 )% |
| Net gains on sales of other real estate owned | 38 | 21 | 17 | 81.0 % |
| Income from bank owned life insurance | 70 | 73 | (3 ) | (4.1 )% |
| CFS fee and commission income | 646 | 544 | 102 | 18.8 % |
| Other | 1,842 | 1,766 | 76 | 4.3 % |
| Total non-interest income | $20,491 | $21,149 | $(658 ) | (3.1 )% |

Total non-interest income for the year ended December 31, 2017 decreased $0.7 million compared to the prior year. The decrease was primarily due to decreases in service charges on deposit accounts, interchange revenue from debit card transactions, and net gains on securities transactions, offset by increases in WMG fee income and CFS fee and commission income.

WMG fee income

WMG fee income increased in 2017 compared to the prior year due to an increase in assets under management or administration.

Service charges on deposit accounts

Service charges on deposit accounts decreased in 2017 compared to the prior year due to an decrease in overdraft fees.

Interchange revenue from debit card transactions

Interchange revenue from debit card transactions decreased in 2017 compared to the prior year due to the recognition of an incremental volume bonus related to the rebranding of the Bank's credit cards recognized in 2016.

Net gains on securities transactions

Net gains on securities transactions decreased in 2017 compared to the prior year due to the sale of $14.5 million in U.S. Treasuries and $25.0 million in obligations of U.S. Government sponsored enterprises in 2016.

CFS fee and commission income

CFS fee and commission income increased in 2017 compared to the prior year due to an increase in fee income.

The following table presents non-interest income for the years indicated, and the dollar and percent change (in thousands):

| | Years Ended December 31, | | | |
|---|---|---|---|---|
| | 2016 | 2015 | Change | Percentage Change |
| WMG fee income | $8,316 | $8,522 | $(206) | (2.4)% |
| Service charges on deposit accounts | 5,089 | 4,886 | 203 | 4.2 % |
| Interchange revenue from debit card transactions | 4,027 | 3,307 | 720 | 21.8 % |
| Net gains on securities transactions | 987 | 372 | 615 | 165.3 % |
| Net gains on sales of loans held for sale | 326 | 294 | 32 | 10.9 % |
| Net gains (losses) on sales of other real estate owned | 21 | 84 | (63) | (75.0)% |
| Income from bank owned life insurance | 73 | 75 | (2) | (2.7)% |
| CFS fee and commission income | 544 | 906 | (362) | (40.0)% |
| Other | 1,766 | 2,001 | (235) | (11.7)% |
| Total non-interest income | $21,149 | $20,447 | $702 | 3.4 % |

Total non-interest income for year ended December 31, 2016 increased $0.7 million compared to the prior year. The increase was primarily due to increases in service charges on deposit accounts, interchange revenue from debit card transactions, and net gains on securities transactions, offset by decreases in WMG fee income, CFS fee and commission income, and other non-interest income.

WMG fee income

WMG fee income decreased in 2016 compared to the prior year due to a decline in assets under management or administration from the loss of one large non-profit customer during 2016.

Service charges on deposit accounts

Service charges on deposit accounts increased in 2016 compared to the prior year due to an increase in overdraft fees.

Interchange revenue from debit card transactions

Interchange revenue from debit card transactions increased in 2016 compared to the prior year due to the recognition of an incremental volume bonus related to the rebranding of the Bank's credit cards recognized in 2016.

Net gains on securities transactions

Net gains on securities transactions increased in 2016 compared to the prior year due to the sale of $14.5 million in U.S. Treasuries and $25.0 million in obligations of U.S. Government sponsored enterprises.

CFS fee and commission income

CFS fee and commission income decreased in 2016 compared to the prior year due to a decrease in commissions from insurance annuity products.

Other

Other non-interest income decreased in 2016 compared to the prior year due to rental income from OREO properties in 2015, which were sold in 2016.

Non-interest expenses

The following table presents non-interest expenses for the years indicated, and the dollar and percent change (in thousands):

| | Years Ended December 31, 2017 | 2016 | Change | Percentage Change |
|---|---|---|---|---|
| Compensation expenses: | | | | |
| Salaries and wages | $21,476 | $20,954 | $522 | 2.5 % |
| Pension and other employee benefits | 4,276 | 6,132 | (1,856 ) | (30.3 )% |
| Total compensation expenses | 25,752 | 27,086 | (1,334 ) | (4.9 )% |
| | | | | |
| Non-compensation expenses: | | | | |
| Net occupancy | 6,263 | 6,837 | (574 ) | (8.4 )% |
| Furniture and equipment | 2,828 | 2,967 | (139 ) | (4.7 )% |
| Data processing | 6,539 | 6,593 | (54 ) | (0.8 )% |
| Professional services | 1,774 | 2,175 | (401 ) | (18.4 )% |
| Legal accruals and settlements | 850 | 1,200 | (350 ) | (29.2 )% |
| Amortization of intangible assets | 860 | 986 | (126 ) | (12.8 )% |
| Marketing and advertising | 794 | 877 | (83 ) | (9.5 )% |
| Other real estate owned expense | 110 | 180 | (70 ) | (38.9 )% |
| FDIC insurance | 1,236 | 1,193 | 43 | 3.6 % |
| Loan expense | 694 | 669 | 25 | 3.7 % |
| Other | 6,064 | 5,847 | 217 | 3.7 % |
| Total non-compensation expenses | 28,012 | 29,524 | (1,512 ) | (5.1 )% |
| Total non-interest expenses | $53,764 | $56,610 | $(2,846) | (5.0 )% |

Total non-interest expenses for the year ended December 31, 2017 decreased $2.8 million compared with the prior year. The decrease was primarily due to decreases in compensation and non-compensation expenses.

Compensation expenses

Compensation expenses decreased in 2017 compared to the prior year due to a decrease in pension and other employee benefits, offset by an increase in salaries and wages. The decrease in pension and other employee benefits can be mostly attributed to the freezing of accruals for the pension and post-retirement healthcare plans, offset by an increase in healthcare and 401(k) plan contributions. The increase in salaries and wages can be attributed to annual merit increases.

Non-compensation expenses

Non-compensation expense decreased in 2017 compared to the prior year primarily due to decreases in net occupancy, furniture and equipment, professional services and legal accruals and settlements, partially offset by an increase in other non-interest expense. The decrease in net occupancy and furniture and equipment expenses can be attributed to the closure of the branch at 202 East State Street in Ithaca, NY during the second quarter of 2016, offset by exit costs for the branch at 120 Genesee Street in Auburn, NY recognized during the second quarter of 2017. The decrease in professional services can be attributed to professional fees incurred during the formation of CRM in 2016 and legal costs associated with the Fane v. Chemung Canal Trust Company case. The decrease in legal accruals and settlements can be attributed to the creation of a $1.2 million legal accrual for the Fane v. Chemung Canal Trust Company case in

2016, compared to a $0.9 million legal accrual for the same case in 2017. Please refer to Footnote 15 of the audited consolidated financial statements for further discussion of the Fane v. Chemung Canal case.

The following table presents non-interest expense for the years indicated, and the dollar and percent change (in thousands):

| | Years Ended December 31, | | | |
|---|---|---|---|---|
| | 2016 | 2015 | Change | Percentage Change |
| Compensation expenses: | | | | |
| Salaries and wages | $20,954 | $21,223 | $(269) | (1.3)% |
| Pension and other employee benefits | 6,132 | 5,908 | 224 | 3.8 % |
| Total compensation expenses | 27,086 | 27,131 | (45) | (0.2)% |
| | | | | |
| Non-compensation expenses: | | | | |
| Net occupancy | 6,837 | 7,006 | (169) | (2.4)% |
| Furniture and equipment | 2,967 | 2,979 | (12) | (0.4)% |
| Data processing | 6,593 | 6,586 | 7 | 0.1 % |
| Professional services | 2,175 | 1,293 | 882 | 68.2 % |
| Legal settlements | 1,200 | — | 1,200 | N/M |
| Amortization of intangible assets | 986 | 1,136 | (150) | (13.2)% |
| Marketing and advertising | 877 | 899 | (22) | (2.4)% |
| Other real estate owned expense | 180 | 812 | (632) | (77.8)% |
| FDIC insurance | 1,193 | 1,075 | 118 | 11.0 % |
| Loan expense | 669 | 693 | (24) | (3.5)% |
| Other | 5,847 | 5,817 | 30 | 0.5 % |
| Total non-compensation expenses | 29,524 | 28,296 | 1,228 | 4.3 % |
| Total non-interest expenses | $56,610 | $55,427 | $1,183 | 2.1 % |

Total non-interest expenses for the year ended December 31, 2016 increased $1.2 million compared with the same period in the prior year. The increase was primarily due to an increase in non-compensation expense related to the establishment of a $1.2 million legal reserve in 2016.

Compensation expenses

Compensation expense decreased in 2016 compared to the prior year due to a decrease in salaries and wages, offset by an increase in pension and other employee benefits. The decrease in salaries and wages was primarily due to a reduction in full-time equivalent employees. The $0.2 million increase in pension and other employee benefits was primarily due to an increase in health insurance costs, offset by a $0.3 million curtailment gain related to the amendment of the defined benefit health care plan during the fourth quarter of 2015.

Non-compensation expenses

Non-compensation expense increased in 2016 compared to the prior year primarily due to increases in professional services and legal accruals and settlements, offset by decreases in net occupancy expenses, amortization of intangible assets, and other real estate owned expenses. The increase in professional services can be mostly attributed to expenses incurred related to the feasibility and implementation of CRM, consulting costs associated with the conversion of the Corporation's debit cards to MasterCard, and legal costs associated with the appeal of the Fane v. Chemung Canal Trust Company decision. The increase in legal accruals and settlements can be attributed to the establishment of a $1.2 million legal reserve associated with the Fane v. Chemung Canal Trust Company case. Please refer to Footnote 15 of the audited consolidated financial statements for further discussion of the Fane v. Chemung Canal case. The decrease in net occupancy expenses can be attributed to the closure of the branch office at 202 East

State Street in Ithaca, NY during the second quarter of 2016. The decrease in other real estate owned expenses can be attributed to the sale of properties in 2016.

Income tax expense

The following table presents income tax expense and the effective tax rate for the years indicated, and the dollar and percent change (in thousands):

| | Years Ended December 31, | | | |
|---|---|---|---|---|
| | 2017 | 2016 | Change | Percentage Change |
| Income before income tax expense | $14,692 | $14,431 | $261 | 1.8 % |
| Income tax expense | $7,262 | $4,404 | $2,858 | 64.9 % |
| Effective tax rate | 49.4 % | 30.5 % | | |

The effective tax rate increased to 49.4% for the year ended December 31, 2017 compared with 30.5% for the same period in the prior year. The increase in the effective tax rate can be attributed to the $2.9 million one-time reduction in the net deferred tax asset as a result of the remeasurement required under GAAP due to the enactment of the Tax Act. The effective tax rate for the year ended December 31, 2017, excluding the one-time net deferred tax asset revaluation, was 29.5%[1].

The following table presents income tax expense and the effective tax rate for the years indicated, and the dollar and percent change (in thousands):

| | Years Ended December 31, | | | |
|---|---|---|---|---|
| | 2016 | 2015 | Change | Percentage Change |
| Income before income tax expense | $14,431 | $14,091 | $340 | 2.4 % |
| Income tax expense | $4,404 | $4,658 | $(254 ) | (5.5 )% |
| Effective tax rate | 30.5 % | 33.1 % | | |

The decrease in the effective tax rate can be attributed to the formation of CRM in 2016 and increasing the utilization of the Bank's real estate investment trust during 2016.

[1] ($7,262 income tax expense - $2,927 revaluation of net deferred tax expense) / $14,692 income before income tax expense.

Financial Condition

The following table presents selected financial information at December 31, 2017 and 2016, and the dollar and percent change (in thousands):

| | December 31, 2017 | December 31, 2016 | Change | Percentage Change |
|---|---|---|---|---|
| Assets | | | | |
| Total cash and cash equivalents | $ 30,729 | $ 74,162 | $ (43,433) | (58.6)% |
| Total investment securities, FHLB, and FRB stock | 303,192 | 312,148 | (8,956) | (2.9)% |
| | | | | |
| Loans, net of deferred loan fees | 1,311,824 | 1,200,290 | 111,534 | 9.3 % |
| Allowance for loan losses | (21,161) | (14,253) | (6,908) | 48.5 % |
| Loans, net | 1,290,663 | 1,186,037 | 104,626 | 8.8 % |
| | | | | |
| Goodwill and other intangible assets, net | 23,909 | 24,769 | | |