CHEMUNG FINANCIAL CORP
Form 10-Q
August 01, 2018

UNITED STATES
SECURITIES AND
EXCHANGE COMMISSION
WASHINGTON D.C. 20549

FORM 10-Q

| | |
|---|---|
| [X] | QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 |

For Quarterly period ended June 30, 2018
Or

| | |
|---|---|
| [ ] | TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 |

Commission File No.
000-13888
CHEMUNG FINANCIAL CORPORATION
(Exact name of registrant as specified in its charter)

| | |
|---|---|
| New York | 16-1237038 |
| (State or other jurisdiction of incorporation or organization) | I.R.S. Employer Identification No. |
| | |
| One Chemung Canal Plaza, Elmira, NY | 14901 |
| (Address of principal executive offices) | (Zip Code) |

(607) 737-3711 or (800) 836-3711
(Registrant's telephone number, including area code)

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

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: X NO:____

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 | [ ] | Non-accelerated filer | [ ] |
| Accelerated filer | [X] | Smaller reporting company | [ ] |
| | | Emerging growth company | [ ] |

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act):
YES: NO: X

The number of shares of the registrant's common stock, $.01 par value, outstanding on July 31, 2018 was 4,803,888.

CHEMUNG FINANCIAL CORPORATION AND SUBSIDIARIES

INDEX

## GLOSSARY OF ABBREVIATIONS AND TERMS

To assist the reader the Corporation has provided the following list of commonly used abbreviations and terms included in the Notes to the Unaudited Consolidated Financial Statements and Management's Discussion and Analysis of Financial Condition and Results of Operations.

| Abbreviations | |
|---|---|
| ALCO | Asset-Liability Committee |
| ASU | Accounting Standards Update |
| Bank | Chemung Canal Trust Company |
| Basel III | The Third Basel Accord of the Basel Committee on Banking Supervision |
| Board of Directors | Board of Directors of Chemung Financial Corporation |
| CDARS | Certificate of Deposit Account Registry Service |
| CDO | Collateralized Debt Obligation |
| CECL | Current expected credit loss |
| CFS | CFS Group, Inc. |
| Corporation | Chemung Financial Corporation |
| CRM | Chemung Risk Management, Inc. |
| Dodd-Frank Act | The Dodd-Frank Wall Street Reform and Consumer Protection Act |
| EPS | Earnings per share |
| Exchange Act | Securities Exchange Act of 1934 |
| FASB | Financial Accounting Standards Board |
| FDIC | Federal Deposit Insurance Corporation |
| FHLBNY | Federal Home Loan Bank of New York |
| FRB | Board of Governors of the Federal Reserve System |
| FRBNY | Federal Reserve Bank of New York |
| Freddie Mac | Federal Home Loan Mortgage Corporation |
| GAAP | U.S. Generally Accepted Accounting Principles |
| ICS | Insured Cash Sweep Service |
| IFRS | International Financial Reporting Standards |
| MD&A | Management's Discussion and Analysis of Financial Condition and Results of Operations |
| NAICS | North American Industry Classification System |
| N/M | Not meaningful |
| OPEB | Other postemployment benefits |
| OREO | Other real estate owned |
| OTTI | Other-than-temporary impairment |
| PCI | Purchased credit impaired |
| ROA | Return on average assets |
| Regulatory Relief Act | Economic Growth, Regulatory Relief, and Consumer Protection Act |
| ROE | Return on average equity |
| RWA | Risk-weighted assets |
| SBA | Small Business Administration |
| SEC | Securities and Exchange Commission |
| Securities Act | Securities Act of 1933 |
| Tax Act | Tax Cuts and Jobs Act of 2017 |
| TDRs | Troubled debt restructurings |
| WMG | Wealth Management Group |

3

| Terms | |
|---|---|
| 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 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. |
| 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. |
| Captive insurance company | A company that provides risk-mitigation services for its parent company. |
| 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. |
| | A type of asset-backed security that is secured by a collection of mortgages. |

| | |
|---|---|
| Mortgage-backed securities | |
| 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 | Not meaningful. |
| 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. |
| 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. |
| Regulatory Relief Act | The Regulatory Relief Act was enacted on May 22, 2018 provides certain limited amendments to the Dodd-Frank Act, as well as certain targeted modifications to other post-financial crisis regulatory requirements. In addition, the legislation establishes new consumer protections and amends various securities- and investment company-related requirements. |
| RWA | Risk-weighted assets 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. |
| Tax Act | The Tax Act was enacted on December 22, 2017 and amended the Internal Revenue Code of 1986. The legislation reduced the U.S. federal corporate income tax rate from 35 percent to 21 percent, with some related business deductions and credits being either reduced or eliminated. |
| 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.

CHEMUNG FINANCIAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(UNAUDITED)

| (in thousands, except share and per share data) | June 30, 2018 | December 31, 2017 |
|---|---|---|
| ASSETS | | |
| Cash and due from financial institutions | $30,837 | $27,966 |
| Interest-earning deposits in other financial institutions | 3,978 | 2,763 |
| Total cash and cash equivalents | 34,815 | 30,729 |
| | | |
| Equity investments, at estimated fair value | 2,112 | 2,337 |
| Securities available for sale, at estimated fair value | 265,157 | 293,091 |
| Securities held to maturity, estimated fair value of $3,790 at June 30, 2018 and $3,776 at December 31, 2017 | 3,806 | 3,781 |
| FHLBNY and FRBNY Stock, at cost | 5,816 | 5,784 |
| | | |
| Loans, net of deferred loan fees | 1,334,444 | 1,311,824 |
| Allowance for loan losses | (19,645) | (21,161) |
| Loans, net | 1,314,799 | 1,290,663 |
| | | |
| Loans held for sale | 684 | 542 |
| Premises and equipment, net | 26,049 | 26,657 |
| Goodwill | 21,824 | 21,824 |
| Other intangible assets, net | 1,709 | 2,085 |
| Bank-owned life insurance | 3,014 | 2,982 |
| Accrued interest receivable and other assets | 30,381 | 27,145 |
| | | |
| Total assets | $1,710,166 | $1,707,620 |
| | | |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | |
| Deposits: | | |
| Non-interest-bearing | $462,233 | $467,610 |
| Interest-bearing | 1,016,676 | 999,836 |
| Total deposits | 1,478,909 | 1,467,446 |
| | | |
| FHLBNY overnight advances | 58,950 | 57,700 |
| Securities sold under agreements to repurchase | — | 10,000 |
| FHLBNY term advances | — | 2,000 |
| Long term capital lease obligation | 4,411 | 4,517 |
| Dividends payable | 1,249 | 1,232 |
| Accrued interest payable and other liabilities | 14,867 | 14,912 |
| Total liabilities | 1,558,386 | 1,557,807 |
| | | |
| Shareholders' equity: | | |
| Common stock, $0.01 par value per share, 10,000,000 shares authorized; 5,310,076 issued at June 30, 2018 and December 31, 2017 | 53 | 53 |
| Additional paid-in capital | 45,873 | 45,967 |
| Retained earnings | 132,973 | 128,453 |

| | | |
|---|---|---|
| Treasury stock, at cost; 507,471 shares at June 30, 2018 and 559,094 shares at December 31, 2017 | (12,998) | (14,320) |
| Accumulated other comprehensive loss | (14,121) | (10,340) |
| Total shareholders' equity | 151,780 | 149,813 |
| Total liabilities and shareholders' equity | $ 1,710,166 | $ 1,707,620 |

See accompanying notes to unaudited consolidated financial statements.

CHEMUNG FINANCIAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME
(UNAUDITED)

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| (in thousands, except per share data) | 2018 | 2017 | 2018 | 2017 |
| Interest and dividend income: | | | | |
| Loans, including fees | $14,300 | $12,817 | $28,350 | $25,316 |
| Taxable securities | 1,264 | 1,398 | 2,553 | 2,820 |
| Tax exempt securities | 295 | 276 | 603 | 514 |
| Interest-earning deposits | 10 | 193 | 32 | 348 |
| Total interest and dividend income | 15,869 | 14,684 | 31,538 | 28,998 |
| Interest expense: | | | | |
| Deposits | 608 | 549 | 1,109 | 1,087 |
| Securities sold under agreements to repurchase | 44 | 95 | 137 | 288 |
| Borrowed funds | 200 | 90 | 375 | 179 |
| Total interest expense | 852 | 734 | 1,621 | 1,554 |
| Net interest income | 15,017 | 13,950 | 29,917 | 27,444 |
| Provision for loan losses | 2,362 | 421 | 3,071 | 1,461 |
| Net interest income after provision for loan losses | 12,655 | 13,529 | 26,846 | 25,983 |
| | | | | |
| Non-interest income: | | | | |
| WMG fee income | 2,373 | 2,269 | 4,689 | 4,378 |
| Service charges on deposit accounts | 1,144 | 1,225 | 2,308 | 2,409 |
| Interchange revenue from debit card transactions | 996 | 964 | 2,031 | 1,884 |
| Net gains (losses) on security transactions | — | 12 | — | 12 |
| Net gains on sales of loans held for sale | 59 | 53 | 105 | 122 |
| Net gains (losses) on sales of other real estate owned | (48) | (9) | (4) | 8 |
| Income from bank-owned life insurance | 17 | 18 | 33 | 35 |
| Other | 784 | 490 | 1,638 | 1,021 |
| Total non-interest income | 5,325 | 5,022 | 10,800 | 9,869 |
| | | | | |
| Non-interest expenses: | | | | |
| Salaries and wages | 5,564 | 5,422 | 11,278 | 10,697 |
| Pension and other employee benefits | 1,518 | 1,540 | 3,176 | 3,091 |
| Other components of net periodic pension and postretirement benefits | (408) | (333) | (816) | (666) |
| Net occupancy expenses | 1,643 | 1,702 | 3,251 | 3,308 |
| Furniture and equipment expenses | 702 | 781 | 1,360 | 1,462 |
| Data processing expense | 1,764 | 1,587 | 3,506 | 3,191 |
| Professional services | 508 | 417 | 1,048 | 717 |
| Legal accruals and settlements | 989 | 850 | 989 | 850 |
| Amortization of intangible assets | 182 | 213 | 376 | 439 |
| Marketing and advertising expenses | 255 | 118 | 604 | 367 |
| Other real estate owned expenses | 100 | 11 | 238 | 31 |
| FDIC insurance | 301 | 309 | 618 | 634 |
| Loan expense | 184 | 166 | 353 | 282 |
| Other | 1,665 | 1,549 | 3,152 | 2,974 |
| Total non-interest expenses | 14,967 | 14,332 | 29,133 | 27,377 |

| | | | | |
|---|---|---|---|---|
| Income before income tax expense | 3,013 | 4,219 | 8,513 | 8,475 |
| Income tax expense | 486 | 1,263 | 1,547 | 2,540 |
| Net income | $2,527 | $2,956 | 6,966 | $5,935 |
| | | | | |
| Weighted average shares outstanding | 4,828 | 4,797 | 4,825 | 4,793 |
| Basic and diluted earnings per share | $0.52 | $0.62 | $1.44 | $1.24 |

See accompanying notes to unaudited consolidated financial statements.

CHEMUNG FINANCIAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(UNAUDITED)

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| (in thousands) | 2018 | 2017 | 2018 | 2017 |
| Net income | $2,527 | $2,956 | $6,966 | $5,935 |
| Other comprehensive income (loss): | | | | |
| Unrealized holding gains (losses) on securities available for sale | (400) | 2,854 | (4,839) | 6,020 |
| Reclassification adjustment for gains realized in net income | — | (12) | — | (12) |
| Net unrealized gains (losses) | (400) | 2,842 | (4,839) | 6,008 |
| Tax effect | (101) | 1,078 | (1,233) | 2,267 |
| Net of tax amount | (299) | 1,764 | (3,606) | 3,741 |
| | | | | |
| Change in funded status of defined benefit pension plan and other benefit plans: | | | | |
| Net gain (loss) arising during the period | — | — | — | — |
| Reclassification adjustment for amortization of prior service costs | (55) | (55) | (110) | (110) |
| Reclassification adjustment for amortization of net actuarial loss | 73 | 88 | 146 | 176 |
| Total before tax effect | 18 | 33 | 36 | 66 |
| Tax effect | 4 | 13 | 9 | 25 |
| Net of tax amount | 14 | 20 | 27 | 41 |
| | | | | |
| Total other comprehensive income (loss) | (285) | 1,784 | (3,579) | 3,782 |
| | | | | |
| Comprehensive income | $2,242 | $4,740 | $3,387 | $9,717 |

See accompanying notes to unaudited consolidated financial statements.

CHEMUNG FINANCIAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY
(UNAUDITED)

| (in thousands, except share and per share data) | Common Stock | Additional Paid-in Capital | Retained Earnings | Treasury Stock | Accumulated Other Comprehensive Loss | Total |
|---|---|---|---|---|---|---|
| Balances at January 1, 2017 | $ 53 | $ 45,603 | $ 124,111 | $ (15,265) | $ (10,754) | $ 143,748 |
| Net income | — | — | 5,935 | — | — | 5,935 |
| Other comprehensive income | — | — | — | — | 3,782 | 3,782 |
| Restricted stock awards | — | 107 | — | — | — | 107 |
| Restricted stock units for directors' deferred compensation plan | — | 49 | — | — | — | 49 |
| Cash dividends declared ($0.52 per share) | — | — | (2,461) | — | — | (2,461) |
| Distribution of 7,880 shares of treasury stock for directors' compensation | — | 68 | — | 201 | — | 269 |
| Distribution of 5,861 shares of treasury stock for employee compensation | — | 50 | — | 150 | — | 200 |
| Distribution of 2,438 shares of treasury stock for deferred directors' compensation | — | (51) | — | 62 | — | 11 |
| Sale of 8,788 shares of treasury stock (a) | — | 97 | — | 225 | — | 322 |
| Forfeiture of 1,139 shares of restricted stock awards | — | 43 | — | (43) | — | — |
| Balances at June 30, 2017 | $ 53 | $ 45,966 | $ 127,585 | $ (14,670) | $ (6,972) | $ 151,962 |
| | | | | | | |
| Balances at December 31, 2017, as reported | $ 53 | $ 45,967 | $ 128,453 | $ (14,320) | $ (10,340) | $ 149,813 |
| Cumulative effect of accounting change (b) | — | — | 40 | — | (202) | (162) |
| Balances at January 1, 2018, as adjusted | 53 | 45,967 | 128,493 | (14,320) | (10,542) | 149,651 |
| Net income | — | — | 6,966 | — | — | 6,966 |
| Other comprehensive loss | — | — | — | — | (3,579) | (3,579) |
| Restricted stock awards | — | 232 | — | — | — | 232 |
| Restricted stock units for directors' deferred compensation plan | — | 47 | — | — | — | 47 |
| Cash dividends declared ($0.52 per share) | — | — | (2,486) | — | — | (2,486) |
| Distribution of 6,015 shares of treasury stock for directors' compensation | — | 147 | — | 154 | — | 301 |
| Distribution of 1,784 shares of treasury stock for employee compensation | — | 44 | — | 45 | — | 89 |
| Distribution of 36,681 shares of treasury stock for deferred directors' compensation | — | (722) | — | 940 | — | 218 |
| Sale of 7,143 shares of treasury stock (a) | — | 158 | — | 183 | — | 341 |
| Balances at June 30, 2018 | $ 53 | $ 45,873 | $ 132,973 | $ (12,998) | $ (14,121) | $ 151,780 |

(a) All treasury stock sales were completed at the prevailing market price with the Chemung Canal Trust Company Profit Sharing, Savings, and Investment Plan which is a defined contribution plan sponsored by the Bank.
(b) Due to implementation of ASC 2016-01. See "Adoption of New Accounting Standards" discussion in Note 1.

See accompanying notes to unaudited consolidated financial statements.

CHEMUNG FINANCIAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(UNAUDITED)

| (in thousands) | Six Months Ended June 30, | |
|---|---|---|
| CASH FLOWS FROM OPERATING ACTIVITIES: | 2018 | 2017 |
| Net income | $6,966 | $5,935 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Amortization of intangible assets | 376 | 439 |
| Provision for loan losses | 3,071 | 1,461 |
| Net losses on disposal of fixed assets | 10 | 31 |
| Depreciation and amortization of fixed assets | 1,816 | 1,946 |
| Amortization of premiums on securities, net | 608 | 736 |
| Gains on sales of loans held for sale, net | (105 ) | (122 ) |
| Proceeds from sales of loans held for sale | 5,308 | 6,204 |
| Loans originated and held for sale | (5,345 ) | (6,056 ) |
| Net gains on equity investments | (36 ) | (64 ) |
| Net gains on securities transactions | — | (12 ) |
| Net (gains) losses on sales of other real estate owned | 4 | (8 ) |
| Purchase of equity investments | (50 ) | (39 ) |
| Expense related to restricted stock units for directors' deferred compensation plan | 47 | 49 |
| Expense related to employee stock compensation | 89 | 200 |
| Expense related to employee restricted stock awards | 232 | 107 |
| Income from bank-owned life insurance | (33 ) | (35 ) |
| Increase in other assets and accrued interest receivable | (4,197 ) | (132 ) |
| Decrease in accrued interest payable | (33 ) | (47 ) |
| Increase (decrease) in other liabilities | 1,825 | (1,594 ) |
| Net cash provided by operating activities | 10,553 | 8,999 |
| | | |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Proceeds from sales and calls of securities available for sale | 820 | 1,075 |
| Proceeds from maturities and principal collected on securities available for sale | 21,666 | 24,624 |
| Proceeds from maturities and principal collected on securities held to maturity | 585 | 1,544 |
| Purchases of securities available for sale | — | (41,306 ) |
| Purchases of securities held to maturity | (610 ) | (1,767 ) |
| Purchase of FHLBNY and FRBNY stock | (17,123 ) | (173 ) |
| Redemption of FHLBNY and FRBNY stock | 17,091 | 450 |
| Purchases of premises and equipment | (1,218 ) | (890 ) |
| Proceeds from sales of other real estate owned | 1,295 | 176 |
| Net increase in loans | (27,451 ) | (53,083 ) |
| Net cash used in investing activities | (4,945 ) | (69,350 ) |
| | | |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | |
| Net increase (decrease) in demand deposits, interest-bearing demand accounts, savings accounts, and insured money market accounts | (16,269 ) | 79,997 |
| Net increase (decrease) in time deposits | 27,732 | (11,303 ) |
| Net decrease in securities sold under agreements to repurchase | (10,000 ) | (15,669 ) |
| Net increase in FHLBNY overnight advances | 1,250 | — |
| Repayments of FHLBNY long term advances | (2,000 ) | (55 ) |

| | | |
|---|---|---|
| Payments made on capital leases | (106 ) | (102 ) |
| Sale of treasury stock | 341 | 322 |
| Cash dividends paid | (2,470 ) | (2,455 ) |
| Net cash (used in) provided by financing activities | (1,522 ) | 50,735 |
| Net increase (decrease) in cash and cash equivalents | 4,086 | (9,616 ) |
| Cash and cash equivalents, beginning of period | 30,729 | 74,162 |
| Cash and cash equivalents, end of period | $34,815 | $64,546 |

(continued)

See accompanying notes to unaudited consolidated financial statements.

10

CHEMUNG FINANCIAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS, CONTINUED
(UNAUDITED)

| (in thousands) | Six Months Ended June 30, | |
|---|---|---|
| Supplemental disclosure of cash flow information: | 2018 | 2017 |
| Cash paid (received) for: | | |
| Interest | $1,654 | $1,601 |
| Income taxes | $1,355 | $4,050 |
| Supplemental disclosure of non-cash activity: | | |
| Transfer of loans to other real estate owned | $244 | $116 |
| Dividends declared, not yet paid | $1,249 | $1,231 |
| Distribution of treasury stock for directors' compensation | $301 | $269 |
| Distribution of treasury stock for deferred directors' compensation | $218 | $11 |

See accompanying notes to unaudited consolidated financial statements.
11

CHEMUNG FINANCIAL CORPORATION AND SUBSIDIARIES
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

## NOTE 1 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

### Organization

The Corporation, through its wholly-owned subsidiaries, the Bank and CFS, provides a wide range of banking, financing, fiduciary and other financial services to its clients. The Corporation and the Bank are subject to the regulations of certain federal and state agencies and undergo periodic examinations by those regulatory authorities.

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.

### Basis of Presentation

The accompanying unaudited consolidated financial statements have been prepared in conformity with GAAP for interim financial information and pursuant to the requirements for reporting on Form 10-Q and Article 10 of Regulation S-X of the Exchange Act. These financial statements include the accounts of the Corporation and its subsidiaries, and all significant intercompany balances and transactions are eliminated in consolidation. Amounts in the prior periods' consolidated financial statements are reclassified whenever necessary to conform to the current period's presentation.

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions based on available information. These estimates and assumptions affect the amounts reported in the financial statements and disclosures provided, and actual results could differ. In the opinion of management, all adjustments (consisting of normal recurring adjustments) and disclosures necessary for the fair presentation of the accompanying consolidated financial statements have been included. The unconsolidated financial statements should be read in conjunction with the Corporation's 2017 Annual Report on Form 10-K for the year ended December 31, 2017. The results of operations for any interim periods are not necessarily indicative of the results which may be expected for the entire year or any other period.

### Reclassifications

Some items in the prior year financial statements were reclassified to conform to the current presentation. Reclassifications had no effect on prior year net income or shareholders' equity.

### Recent Accounting Pronouncements

In February 2016, the FASB issued ASU 2016-02, Leases (Topic 842). ASU 2016-02 requires companies that lease valuable assets to recognize on their balance sheets the assets and liabilities generated by contracts longer than a year. The amendments in this update are effective for annual periods, and interim periods within those annual periods, beginning after December 15, 2018, though early adoption is permitted. The Corporation intends to adopt the new lease guidance as of January 1, 2019 and is currently evaluating the impact that adoption of these updates will have on its consolidated financial statements. Currently, the Corporation believes the implementation of this ASU will create a right of use asset of less than $15.0 million for the Corporation's 16 leased facilities and a related capital obligation of the same amount as of January 1, 2019.

In June 2016, the FASB issued ASU 2016-13, Financial Instruments - Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments. The objective of the ASU is to provide financial statement users with more decision-useful information about the expected credit losses on financial instruments and other commitments to extend credit held by a reporting entity at each reporting date by replacing the incurred loss impairment methodology in current GAAP with a methodology that reflects expected credit losses and requires consideration of a broader range of reasonable and supportable information to form credit loss estimates. 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. The Corporation is currently evaluating the impact of the adoption of this guidance on its consolidated financial statements. The Corporation anticipates that the adoption of the CECL model will result in an increase to the Corporation's allowance for loan losses. The Corporation has established a committee to oversee the implementation of CECL and has selected a vendor to assist in the implementation process. In 2018 the committee plans to begin establishing parameters which will be used in the CECL model with the selected vendor. The Corporation further plans to run its current incurred loss model and a CECL model concurrently for twelve months prior to the adoption of this guidance on January 1, 2020.

In January 2017, the FASB issued ASU 2017-04, Intangibles - Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment. The objective of the ASU is to simplify the manner in which an entity is required to test goodwill for impairment by eliminating Step 2 from the goodwill impairment test. Additionally, the ASU removes the requirement for any reporting unit with a zero or negative carrying amount to perform a qualitative assessment and, if it fails such qualitative test, to perform Step 2 of the goodwill impairment test. The amendments in this ASU are effective for annual, or any interim, goodwill impairment tests in fiscal years beginning after December 15, 2019. The adoption of the ASU is not expected to have a significant impact on the Corporation's consolidated financial statements.

In March 2017, the FASB issued ASU 2017-08, Receivables - Nonrefundable Fees and Other Costs (Subtopic 310-20): Premium Amortization on Purchased Callable Debt Securities. The objective of the ASU is to align the amortization period of premiums and discounts to expectations incorporated in market pricing on the underlying securities. The amendment requires that the premium be amortized to the earliest call date, but does not require an accounting change for securities held at a discount; the discount continues to be amortized to maturity. The amendments in this ASU are effective for fiscal years, and for interim periods within those fiscal years, beginning after December 15, 2018. The adoption of the ASU is not expected to have a significant impact on the Corporation's consolidated financial statements.

## NOTE 2 EARNING PER COMMON SHARE (shares in thousands)

Basic earnings per share is net income divided by the weighted average number of common shares outstanding during the period. Issuable shares, including those related to directors’ restricted stock units and directors’ stock compensation, are considered outstanding and are included in the computation of basic earnings per share. All outstanding unvested share based payment awards that contain rights to non-forfeitable dividends are considered participating securities for this calculation. Restricted stock awards are grants of participating securities and are considered outstanding at grant date. Earnings per share information is adjusted to present comparative results for stock splits and stock dividends that occur. Earnings per share were computed by dividing net income by 4,828 and 4,797 weighted average shares outstanding for the three-month periods ended June 30, 2018 and 2017, respectively. Earnings per share were computed by dividing net income by 4,825 and 4,793 weighted average shares outstanding for the six- month periods ended June 30, 2018 and 2017, respectively. There were no common stock equivalents during the three and six-month periods ended June 30, 2018 or 2017.

NOTE 3 SECURITIES

Amortized cost and estimated fair value of securities available for sale are as follows (in thousands):

| | June 30, 2018 | | | |
|---|---|---|---|---|
| | Amortized Cost | Unrealized Gains | Unrealized Losses | Estimated Fair Value |
| Obligations of U.S. Government and U.S. Government sponsored enterprises | $15,489 | $ 11 | $ 50 | $15,450 |
| Mortgage-backed securities, residential | 207,708 | 69 | 9,137 | 198,640 |
| Obligations of states and political subdivisions | 47,574 | 37 | 582 | 47,029 |
| Corporate bonds and notes | 249 | 1 | — | 250 |
| SBA loan pools | 3,832 | — | 44 | 3,788 |
| Total | $274,852 | $ 118 | $ 9,813 | $265,157 |

| | December 31, 2017 | | | |
|---|---|---|---|---|
| | Amortized Cost | Unrealized Gains | Unrealized Losses | Estimated Fair Value |
| Obligations of U.S. Government and U.S. Government sponsored enterprises | $15,492 | $ 20 | $ 21 | $15,491 |
| Mortgage-backed securities, residential | 224,939 | 136 | 5,166 | 219,909 |
| Obligations of states and political subdivisions | 52,928 | 355 | 151 | 53,132 |
| Corporate bonds and notes | 249 | 2 | — | 251 |
| SBA loan pools | 4,339 | 1 | 32 | 4,308 |
| Total | $297,947 | $ 514 | $ 5,370 | $293,091 |

Amortized cost and estimated fair value of securities held to maturity are as follows (in thousands):

| | June 30, 2018 | | | |
|---|---|---|---|---|
| | Amortized Cost | Unrealized Gains | Unrealized Losses | Estimated Fair Value |
| Obligations of states and political subdivisions | $1,481 | $ — | $ — | $ 1,481 |
| Time deposits with other financial institutions | 2,325 | — | 16 | 2,309 |
| Total | $3,806 | $ — | $ 16 | $ 3,790 |

| | December 31, 2017 | | | |
|---|---|---|---|---|
| | Amortized Cost | Unrealized Gains | Unrealized Losses | Estimated Fair Value |
| Obligations of states and political subdivisions | $1,946 | $ — | $ — | $ 1,946 |
| Time deposits with other financial institutions | 1,835 | — | 5 | 1,830 |
| Total | $3,781 | $ — | $ 5 | $ 3,776 |

The amortized cost and estimated fair value of debt securities are shown below by expected maturity. Expected maturities may differ from contractual maturities if borrowers have the right to call or prepay obligations with or without call or prepayment penalties. Securities not due at a single maturity date are shown separately (in thousands):

| | June 30, 2018 | | | |
|---|---|---|---|---|
| | Available for Sale | | Held to Maturity | |
| | Amortized Cost | Fair Value | Amortized Cost | Fair Value |
| Within one year | $16,875 | $16,873 | $884 | $882 |
| After one, but within five years | 19,459 | 19,347 | 2,689 | 2,675 |
| After five, but within ten years | 26,495 | 26,053 | 233 | 233 |
| After ten years | 483 | 456 | — | — |
| | 63,312 | 62,729 | 3,806 | 3,790 |
| Mortgage-backed securities, residential | 207,708 | 198,640 | — | — |
| SBA loan pools | 3,832 | 3,788 | — | — |
| Total | $274,852 | $265,157 | $3,806 | $3,790 |

The proceeds from sales and calls of securities resulting in gains or losses for the three months ended June 30, 2018 and 2017 are listed below (in thousands):

| | 2018 | 2017 |
|---|---|---|
| Proceeds | $ — | $540 |
| Gross gains | — | 12 |
| Tax expense | — | 4 |

The proceeds from sales and calls of securities resulting in gains or losses for the six months ended June 30, 2018 and 2017 are listed below (in thousands):

| | 2018 | 2017 |
|---|---|---|
| Proceeds | $ — | $540 |
| Gross gains | — | 12 |
| Tax expense | — | 4 |

The following tables summarize the investment securities available for sale with unrealized losses at June 30, 2018 and December 31, 2017 by aggregated major security type and length of time in a continuous unrealized loss position (in thousands):

| | Less than 12 months | | 12 months or longer | | Total | |
|---|---|---|---|---|---|---|
| June 30, 2018 | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| Obligations of U.S. Government and U.S. Government sponsored enterprises | $14,948 | $ 50 | $— | $ — | $14,948 | $ 50 |
| Mortgage-backed securities, residential | 65,746 | 2,193 | 130,586 | 6,944 | 196,332 | 9,137 |
| Obligations of states and political subdivisions | 36,819 | 488 | 1,709 | 94 | 38,528 | 582 |
| SBA loan pools | 243 | 1 | 3,545 | 43 | 3,788 | 44 |
| Total temporarily impaired securities | $117,756 | $ 2,732 | $135,840 | $ 7,081 | $253,596 | $ 9,813 |

| December 31, 2017 | Less than 12 months Fair Value | Less than 12 months Unrealized Losses | 12 months or longer Fair Value | 12 months or longer Unrealized Losses | Total Fair Value | Total Unrealized Losses |
|---|---|---|---|---|---|---|
| Obligations of U.S. Government and U.S. Government sponsored enterprises | $14,982 | $ 21 | $— | $ — | $14,982 | $ 21 |
| Mortgage-backed securities, residential | 83,562 | 1,013 | 131,165 | 4,153 | 214,727 | 5,166 |
| Obligations of states and political subdivisions | 20,526 | 133 | 271 | 18 | 20,797 | 151 |
| SBA loan pools | 3,937 | 32 | — | — | 3,937 | 32 |
| Total temporarily impaired securities | $123,007 | $ 1,199 | $131,436 | $ 4,171 | $254,443 | $ 5,370 |

Other-Than-Temporary Impairment

As of June 30, 2018, the majority of the Corporation’s unrealized losses in the investment securities portfolio related to mortgage-backed securities. At June 30, 2018, all of the unrealized losses related to mortgage-backed securities were issued by U.S. government sponsored entities, Fannie Mae and Freddie Mac. Because the decline in fair value is attributable to changes in interest rates and not credit quality, and because it is not likely that the Corporation will be required to sell these securities before their anticipated recovery, the Corporation does not consider these securities to be other-than-temporarily impaired at June 30, 2018.

NOTE 4 LOANS AND ALLOWANCE FOR LOAN LOSSES

The composition of the loan portfolio, net of deferred origination fees and costs, is summarized as follows (in thousands):

| | June 30, 2018 | December 31, 2017 |
|---|---|---|
| Commercial and agricultural: | | |
| Commercial and industrial | $193,092 | $198,463 |
| Agricultural | 424 | 544 |
| Commercial mortgages: | | |
| Construction | 45,543 | 45,558 |
| Commercial mortgages, other | 621,150 | 598,772 |
| Residential mortgages | 193,423 | 194,440 |
| Consumer loans: | | |
| Credit cards | 1,367 | 1,517 |
| Home equity lines and loans | 99,052 | 100,591 |
| Indirect consumer loans | 162,813 | 153,060 |
| Direct consumer loans | 17,580 | 18,879 |
| Total loans, net of deferred origination fees and costs | $1,334,444 | $1,311,824 |
| Interest receivable on loans | 3,666 | 3,758 |
| Total recorded investment in loans | $1,338,110 | $1,315,582 |

The Corporation's concentrations of credit risk by loan type are reflected in the preceding table. The concentrations of credit risk with standby letters of credit, committed lines of credit and commitments to originate new loans generally follow the loan classifications in the table above.

The following tables present the activity in the allowance for loan losses by portfolio segment for the three and six-month periods ended June 30, 2018 and 2017 (in thousands):

| | Three Months Ended June 30, 2018 | | | | |
|---|---|---|---|---|---|
| Allowance for loan losses | Commercial and Agricultural | Commercial Mortgages | Residential Mortgages | Consumer Loans | Total |
| Beginning balance | $7,003 | $ 8,640 | $ 1,407 | $ 4,340 | $21,390 |
| Charge-offs | (3,624 ) | (145 ) | (71 ) | (463 ) | (4,303 ) |
| Recoveries | 11 | 1 | — | 184 | 196 |
| Net recoveries (charge-offs) | (3,613 ) | (144 ) | (71 ) | (279 ) | (4,107 ) |
| Provision | 1,579 | 244 | 109 | 430 | 2,362 |
| Ending balance | $4,969 | $ 8,740 | $ 1,445 | $ 4,491 | $19,645 |

| | Three Months Ended June 30, 2017 | | | | |
|---|---|---|---|---|---|
| Allowance for loan losses | Commercial and Agricultural | Commercial Mortgages | Residential Mortgages | Consumer Loans | Total |
| Beginning balance | $1,650 | $ 7,749 | $ 1,512 | $ 4,049 | $14,960 |
| Charge-offs | (2 ) | — | (48 ) | (397 ) | (447 ) |
| Recoveries | 36 | 2 | 13 | 119 | 170 |
| Net recoveries (charge-offs) | 34 | 2 | (35 ) | (278 ) | (277 ) |
| Provision | 199 | 27 | 40 | 155 | 421 |
| Ending balance | $1,883 | $ 7,778 | $ 1,517 | $ 3,926 | $15,104 |

| | Six Months Ended June 30, 2018 | | | | |
|---|---|---|---|---|---|
| Allowance for loan losses | Commercial and Agricultural | Commercial Mortgages | Residential Mortgages | Consumer Loans | Total |
| Beginning balance: | $6,976 | $ 8,514 | $ 1,316 | $ 4,355 | $21,161 |
| Charge-offs: | (3,644 ) | (145 ) | (165 ) | (921 ) | (4,875 ) |
| Recoveries: | 21 | 2 | 5 | 260 | 288 |
| Net recoveries (charge-offs) | (3,623 ) | (143 ) | (160 ) | (661 ) | (4,587 ) |
| Provision | 1,616 | 369 | 289 | 797 | 3,071 |
| Ending balance | $4,969 | $ 8,740 | $ 1,445 | $ 4,491 | $19,645 |

| | Six Months Ended June 30, 2017 | | | | |
|---|---|---|---|---|---|
| Allowance for loan losses | Commercial and Agricultural | Commercial Mortgages | Residential Mortgages | Consumer Loans | Total |
| Beginning balance: | $1,589 | $ 7,270 | $ 1,523 | $ 3,871 | $14,253 |
| Charge-offs: | (7 ) | — | (60 ) | (825 ) | (892 ) |
| Recoveries: | 61 | 3 | 30 | 188 | 282 |
| Net recoveries (charge-offs) | 54 | 3 | (30 ) | (637 ) | (610 ) |
| Provision | 240 | 505 | 24 | 692 | 1,461 |
| Ending balance | $1,883 | $ 7,778 | $ 1,517 | $ 3,926 | $15,104 |

The following tables present the balance in the allowance for loan losses and the recorded investment in loans by portfolio segment and based on impairment method as of June 30, 2018 and December 31, 2017 (in thousands):

| | June 30, 2018 | | | | |
|---|---|---|---|---|---|
| Allowance for loan losses: | Commercial and Agricultural | Commercial Mortgages | Residential Mortgages | Consumer Loans | Total |
| Ending allowance balance attributable to loans: | | | | | |
| Individually evaluated for impairment | $1,285 | $ 453 | $ — | $ — | $1,738 |
| Collectively evaluated for impairment | 3,684 | 8,287 | 1,445 | 4,491 | 17,907 |
| Total ending allowance balance | $4,969 | $ 8,740 | $ 1,445 | $ 4,491 | $19,645 |

| | December 31, 2017 | | | | |
|---|---|---|---|---|---|
| Allowance for loan losses: | Commercial and Agricultural | Commercial Mortgages | Residential Mortgages | Consumer Loans | Total |
| Ending allowance balance attributable to loans: | | | | | |
| Individually evaluated for impairment | $5,135 | $ 802 | $ — | $ — | $5,937 |
| Collectively evaluated for impairment | 1,841 | 7,683 | 1,316 | 4,355 | 15,195 |
| Loans acquired with deteriorated credit quality | — | 29 | — | — | 29 |
| Total ending allowance balance | $6,976 | $ 8,514 | $ 1,316 | $ 4,355 | $21,161 |

| | June 30, 2018 | | | | |
|---|---|---|---|---|---|
| Loans: | Commercial and Agricultural | Commercial Mortgages | Residential Mortgages | Consumer Loans | Total |
| Loans individually evaluated for impairment | $2,017 | $ 6,847 | $ 417 | $ 61 | $9,342 |
| Loans collectively evaluated for impairment | 192,040 | 661,711 | 193,514 | 281,503 | 1,328,768 |
| Total ending loans balance | $194,057 | $ 668,558 | $ 193,931 | $281,564 | $1,338,110 |

| | December 31, 2017 | | | | |
|---|---|---|---|---|---|
| Loans: | Commercial and Agricultural | Commercial Mortgages | Residential Mortgages | Consumer Loans | Total |
| Loans individually evaluated for impairment | $6,133 | $ 7,302 | $ 427 | $ 64 | $13,926 |
| Loans collectively evaluated for impairment | 193,443 | 638,080 | 194,510 | 274,831 | 1,300,864 |
| Loans acquired with deteriorated credit quality | — | 792 | — | — | 792 |
| Total ending loans balance | $199,576 | $ 646,174 | $ 194,937 | $274,895 | $1,315,582 |

The following table presents loans individually evaluated for impairment recognized by class of loans as of June 30, 2018 and December 31, 2017 (in thousands):

| | June 30, 2018 | | | December 31, 2017 | | |
|---|---|---|---|---|---|---|
| With no related allowance recorded: | Unpaid Principal Balance | Recorded Investment | Allowance for Loan Losses Allocated | Unpaid Principal Balance | Recorded Investment | Allowance for Loan Losses Allocated |
| Commercial and agricultural: | | | | | | |
| Commercial and industrial | $643 | $ 647 | $ — | $861 | $ 867 | $ — |
| Commercial mortgages: | | | | | | |
| Construction | 336 | 338 | — | 364 | 365 | — |
| Commercial mortgages, other | 4,366 | 4,370 | — | 4,135 | 4,138 | — |
| Residential mortgages | 439 | 417 | — | 450 | 427 | — |
| Consumer loans: | | | | | | |
| Home equity lines and loans | 60 | 61 | — | 64 | 64 | — |
| With an allowance recorded: | | | | | | |
| Commercial and agricultural: | | | | | | |
| Commercial and industrial | 1,370 | 1,370 | 1,285 | 5,231 | 5,266 | 5,135 |
| Commercial mortgages: | | | | | | |
| Commercial mortgages, other | 2,173 | 2,139 | 453 | 2,989 | 2,799 | 802 |
| Total | $9,387 | $ 9,342 | $ 1,738 | $14,094 | $ 13,926 | $ 5,937 |

The following table presents the average recorded investment and interest income of loans individually evaluated for impairment recognized by class of loans as of the three and six-month periods ended June 30, 2018 and 2017 (in thousands):

| | Three Months Ended June 30, 2018 | | Three Months Ended June 30, 2017 | | Six Months Ended June 30, 2018 | | Six Months Ended June 30, 2017 | |
|---|---|---|---|---|---|---|---|---|
| With no related allowance recorded: | Average Recorded Investment | Interest Income Recognized (1) | Average Recorded Investment | Interest Income Recognized (1) | Average Recorded Investment | Interest Income Recognized (1) | Average Recorded Investment | Interest Income Recognized (1) |
| Commercial and agricultural: | | | | | | | | |
| Commercial and industrial | $710 | $ 7 | $626 | $ 8 | $762 | $ 15 | $649 | $ 17 |
| Commercial mortgages: | | | | | | | | |
| Construction | 345 | 3 | 1,555 | 3 | 352 | 6 | 1,130 | 6 |
| Commercial mortgages, other | 4,290 | 5 | 5,879 | 32 | 4,240 | 10 | 6,538 | 90 |
| Residential mortgages | 421 | 2 | 417 | 2 | 423 | 4 | 410 | 4 |
| Consumer loans: | | | | | | | | |
| Home equity lines & loans | 61 | 1 | 71 | 1 | 62 | 2 | 79 | 1 |
| With an allowance recorded: | | | | | | | | |
| Commercial and agricultural: | | | | | | | | |
| Commercial and industrial | 3,196 | — | 84 | 1 | 3,886 | — | 56 | 1 |
| Commercial mortgages: | | | | | | | | |
| Commercial mortgages, other | 2,467 | 1 | 4,461 | 4 | 2,578 | 3 | 3,723 | 7 |
| Consumer loans: | | | | | | | | |
| Home equity lines and loans | — | — | 180 | — | — | — | 240 | — |
| Total | $11,490 | $ 19 | $13,273 | $ 51 | $12,303 | $ 40 | $12,825 | $ 126 |

(1)Cash basis interest income approximates interest income recognized.

20

The following table present the recorded investment in non-accrual and loans past due 90 days or more and still accruing by class of loans as of June 30, 2018 and December 31, 2017 (in thousands):

| | Non-accrual | | Loans Past Due 90 Days or More and Still Accruing | |
|---|---|---|---|---|
| | June 30, 2018 | December 31, 2017 | June 30, 2018 | December 31, 2017 |
| Commercial and agricultural: | | | | |
| Commercial and industrial | $1,513 | $ 5,250 | $3 | $ 5 |
| Commercial mortgages: | | | | |
| Construction | 123 | 135 | — | — |
| Commercial mortgages, other | 6,101 | 6,520 | — | — |
| Residential mortgages | 2,981 | 3,160 | — | — |
| Consumer loans: | | | | |
| Credit cards | — | — | 14 | 24 |
| Home equity lines and loans | 1,359 | 1,310 | — | — |
| Indirect consumer loans | 673 | 935 | — | — |
| Direct consumer loans | 40 | 14 | — | — |
| Total | $12,790 | $ 17,324 | $17 | $ 29 |

The following tables present the aging of the recorded investment in loans as of June 30, 2018 and December 31, 2017 (in thousands):

| | June 30, 2018 | | | | | | |
|---|---|---|---|---|---|---|---|
| | 30 - 59 Days Past Due | 60 - 89 Days Past Due | 90 Days or More Past Due | Total Past Due | Loans Acquired with Deteriorated Credit Quality | Loans Not Past Due | Total |
| Commercial and agricultural: | | | | | | | |
| Commercial and industrial | $392 | $— | $17 | $409 | $ — | $193,223 | $193,632 |
| Agricultural | — | — | — | — | — | 425 | 425 |
| Commercial mortgages: | | | | | | | |
| Construction | — | — | — | — | — | 45,671 | 45,671 |
| Commercial mortgages, other | 992 | 93 | 3,339 | 4,424 | — | 618,463 | 622,887 |
| Residential mortgages | 1,117 | 492 | 1,261 | 2,870 | — | 191,061 | 193,931 |
| Consumer loans: | | | | | | | |
| Credit cards | 11 | 11 | 14 | 36 | — | 1,332 | 1,368 |
| Home equity lines and loans | 359 | 196 | 787 | 1,342 | — | 97,995 | 99,337 |
| Indirect consumer loans | 979 | 218 | 231 | 1,428 | — | 161,778 | 163,206 |
| Direct consumer loans | 56 | 24 | 22 | 102 | — | 17,551 | 17,653 |
| Total | $3,906 | $1,034 | $5,671 | $10,611 | $ — | $1,327,499 | $1,338,110 |

| | December 31, 2017 | | | | | | |
|---|---|---|---|---|---|---|---|
| | 30 - 59 Days Past Due | 60 - 89 Days Past Due | 90 Days or More Past Due | Total Past Due | Loans Acquired with Deteriorated Credit Quality | Loans Not Past Due | Total |
| Commercial and agricultural: | | | | | | | |
| Commercial and industrial | $1,689 | $999 | $20 | $2,708 | $ — | $196,322 | $199,030 |
| Agricultural | — | — | — | — | — | 546 | 546 |
| Commercial mortgages: | | | | | | | |
| Construction | — | — | — | — | — | 45,688 | 45,688 |
| Commercial mortgages, other | 2,399 | 115 | 748 | 3,262 | 792 | 596,432 | 600,486 |
| Residential mortgages | 1,399 | 939 | 1,474 | 3,812 | — | 191,125 | 194,937 |
| Consumer loans: | | | | | | | |
| Credit cards | 17 | 9 | 24 | 50 | — | 1,466 | 1,516 |
| Home equity lines and loans | 265 | 31 | 983 | 1,279 | — | 99,599 | 100,878 |
| Indirect consumer loans | 1,822 | 484 | 581 | 2,887 | — | 150,645 | 153,532 |
| Direct consumer loans | 48 | 28 | 2 | 78 | — | 18,891 | 18,969 |
| Total | $7,639 | $2,605 | $3,832 | $14,076 | $ 792 | $1,300,714 | $1,315,582 |

Troubled Debt Restructurings:

A modification of a loan may result in classification as a TDR when a borrower is experiencing financial difficulty and the modification constitutes a concession. The Corporation offers various types of modifications which may involve a change in the schedule of payments, a reduction in the interest rate, an extension of the maturity date, extending the maturity date at an interest rate lower than the current market rate for new debt with similar risk, requesting additional collateral, releasing collateral for consideration, substituting or adding a new borrower or guarantor, a permanent reduction of the recorded investment in the loan or a permanent reduction of the interest on the loan.

As of June 30, 2018 and December 31, 2017, the Corporation has a recorded investment in TDRs of $7.1 million and $7.7 million, respectively. There were specific reserves of $0.5 million and $0.7 million allocated for TDRs at June 30, 2018 and December 31, 2017, respectively. As of June 30, 2018, TDRs totaling $1.4 million were accruing interest under the modified terms and $5.7 million were on non-accrual status. As of December 31, 2017, TDRs totaling $1.7 million were accruing interest under the modified terms and $6.0 million were on non-accrual status. The Corporation had committed no additional amounts as of both June 30, 2018 and December 31, 2017, to customers with outstanding loans that are classified as TDRs.

There were no loans modified as TDRs during the three month period ended June 30, 2018 while the terms of certain loans were modified as TDRs during the three month period ended June 30, 2017. The modification of the terms of two commercial & industrial term loans and one commercial line of credit during the three months ended June 30, 2017 included consolidating the loans into one commercial & industrial loan, extending the maturity date by approximately two years and lowering the monthly payment. An additional piece of equipment was taken as collateral but was not considered to be of greater value than the concessions given. The modification of the terms of a residential mortgage loan during the three months ended June 30, 2017 included an extension of the maturity date by approximately five years and a postponement of the scheduled amortized past due payments to the end of the loan.

22

During the six months ended June 30, 2018 and 2017, the terms of certain loans were modified as TDRs. The modification of the terms of one commercial & industrial term loan during the six months ended June 30, 2018 included an extension of the maturity date at a stated rate of interest lower than the current market rate for new debt with similar risk. In addition to the modifications noted above, the modification of the terms of one commercial mortgage loan during the six months ended June 30, 2017 included a reduction of the scheduled amortized payments of the loan for greater than a three month period.

The following table presents loans by class modified as TDRs that occurred during the three month period ended June 30, 2017 (dollars in thousands):

| June 30, 2017 | Number of Loans | Pre-Modification Outstanding Recorded Investment | Post-Modification Outstanding Recorded Investment |
|---|---|---|---|
| Troubled debt restructurings: | | | |
| Commercial and agricultural: | | | |
| Commercial and industrial | 3 | $ 171 | $ 171 |
| Residential mortgages | 1 | 105 | 105 |
| Total | 4 | $ 276 | $ 276 |

The TDRs described above increased the allowance for loan losses by $0.1 million and resulted in no charge-offs during the three month period ended June 30, 2017.

The following tables presents loans by class modified as TDRs that occurred during the six months ended June 30, 2018 and 2017 (dollars in thousands):

| June 30, 2018 | Number of Loans | Pre-Modification Outstanding Recorded Investment | Post-Modification Outstanding Recorded Investment |
|---|---|---|---|
| Troubled debt restructurings: | | | |
| Commercial and agricultural: | | | |
| Commercial and industrial | 1 | $ 100 | $ 100 |
| Total | 1 | $ 100 | $ 100 |

| June 30, 2017 | Number of Loans | Pre-Modification Outstanding Recorded Investment | Post-Modification Outstanding Recorded Investment |
|---|---|---|---|
| Troubled debt restructurings: | | | |
| Commercial and agricultural: | | | |
| Commercial and industrial | 3 | $ 171 | $ 171 |
| Commercial mortgages: | | | |
| Commercial mortgages | 1 | $ 166 | $ 166 |
| Residential mortgages | 1 | 105 | 105 |
| Total | 5 | $ 442 | $ 442 |

The TDRs described above did not increase the allowance for loan losses and resulted in no charge-offs during the six months ended June 30, 2018. The TDRs described above increased the allowance for loan losses by $0.1 million and resulted in no charge-offs during the six months ended June 30, 2017.

A loan is considered to be in payment default once it is 90 days contractually past due under the modified terms. There were no payment defaults on any loans previously modified as TDRs within twelve months following the modification during the three and six month periods ended June 30, 2018 and 2017.

Credit Quality Indicators

The Corporation establishes a risk rating at origination for all commercial loans. The main factors considered in assigning risk ratings include, but are not limited to: historic and future debt service coverage, collateral position, operating performance, liquidity, leverage, payment history, management ability, and the customer’s industry. Commercial relationship managers monitor all loans in their respective portfolios for any changes in the borrower’s ability to service its debt and affirm the risk ratings for the loans at least annually.

For the retail loans, which include residential mortgages, indirect and direct consumer loans, home equity lines and loans, and credit cards, once a loan is properly approved and closed, the Corporation evaluates credit quality based upon loan repayment.

The Corporation uses the risk rating system to identify criticized and classified loans. Commercial relationships within the criticized and classified risk ratings are analyzed quarterly. The Corporation uses the following definitions for criticized and classified loans (which are consistent with regulatory guidelines):

Special Mention – Loans classified as special mention have a potential weakness that deserves management’s close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the loan or the institution’s credit position at some future date.

Substandard – Loans classified as substandard are inadequately protected by the current net worth and paying capability of the obligor or of the collateral pledged, if any. Loans so classified have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected.

Doubtful – Loans classified as doubtful have all the weaknesses inherent in those classified as substandard, with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable.

Commercial loans not meeting the criteria above to be considered criticized or classified are considered to be pass rated loans.  Loans listed as not rated are included in groups of homogeneous loans performing under terms of the loan notes.  Based on the analyses performed as of June 30, 2018 and December 31, 2017, the risk category of the recorded investment of loans by class of loans is as follows (in thousands):

| | June 30, 2018 | | | | | | |
|---|---|---|---|---|---|---|---|
| | Not Rated | Pass | Special Mention | Substandard | Doubtful | Loans acquired with deteriorated credit quality | Total |
| Commercial and agricultural: | | | | | | | |
| Commercial and industrial | $— | $179,814 | $9,843 | $ 2,619 | $ 1,356 | $ — | $193,632 |
| Agricultural | — | 425 | — | — | — | — | 425 |
| Commercial mortgages: | | | | | | | |
| Construction | — | 45,548 | — | 123 | — | — | 45,671 |
| Commercial mortgages | — | 598,395 | 10,639 | 12,526 | 1,327 | — | 622,887 |
| Residential mortgages | 190,776 | — | — | 3,155 | — | — | 193,931 |
| Consumer loans: | | | | | | | |
| Credit cards | 1,368 | — | — | — | — | — | 1,368 |
| Home equity lines and loans | 97,978 | — | — | 1,359 | — | — | 99,337 |
| Indirect consumer loans | 162,533 | — | — | 673 | — | — | 163,206 |
| Direct consumer loans | 17,613 | — | — | 40 | — | — | 17,653 |
| Total | $470,268 | $824,182 | $20,482 | $ 20,495 | $ 2,683 | $ — | $1,338,110 |

25

| | December 31, 2017 | | | | | | |
|---|---|---|---|---|---|---|---|
| | Not Rated | Pass | Special Mention | Substandard | Doubtful | Loans acquired with deteriorated credit quality | Total |
| Commercial and agricultural: | | | | | | | |
| Commercial and industrial | $— | $186,556 | $4,447 | $ 6,605 | $ 1,422 | $ — | $199,030 |
| Agricultural | — | 546 | — | — | — | — | 546 |
| Commercial mortgages: | | | | | | | |
| Construction | — | 45,553 | — | 135 | — | — | 45,688 |
| Commercial mortgages | — | 575,321 | 9,665 | 13,331 | 1,377 | 792 | 600,486 |
| Residential mortgages | 191,777 | — | — | 3,160 | — | — | 194,937 |
| Consumer loans: | | | | | | | |
| Credit cards | 1,516 | — | — | — | — | — | 1,516 |
| Home equity lines and loans | 99,568 | — | — | 1,310 | — | — | 100,878 |
| Indirect consumer loans | 152,598 | — | — | 934 | — | — | 153,532 |
| Direct consumer loans | 18,955 | — | — | 14 | — | — | 18,969 |
| Total | $464,414 | $807,976 | $14,112 | $ 25,489 | $ 2,799 | $ 792 | $1,315,582 |

The Corporation considers the performance of the loan portfolio and its impact on the allowance for loan losses. For residential and consumer loan classes, the Corporation also evaluates credit quality based on the aging status of the loan, which was previously presented, and by payment activity. The following table presents the recorded investment in residential and consumer loans based on payment activity as of June 30, 2018 and December 31, 2017 (in thousands):

| | June 30, 2018 | | | | |
|---|---|---|---|---|---|
| | | Consumer Loans | | | |
| | Residential Mortgages | Credit Card | Home Equity Lines and Loans | Indirect Consumer Loans | Other Direct Consumer Loans |
| Performing | $190,950 | $1,368 | $97,978 | $162,533 | $ 17,613 |
| Non-Performing | 2,981 | — | 1,359 | 673 | 40 |
| | $193,931 | $1,368 | $99,337 | $163,206 | $ 17,653 |

| | December 31, 2017 | | | | |
|---|---|---|---|---|---|
| | | Consumer Loans | | | |
| | Residential Mortgages | Credit Card | Home Equity Lines and Loans | Indirect Consumer Loans | Other Direct Consumer Loans |
| Performing | $191,777 | $1,516 | $99,568 | $152,598 | $ 18,955 |
| Non-Performing | 3,160 | — | 1,310 | 934 | 14 |
| | $194,937 | $1,516 | $100,878 | $153,532 | $ 18,969 |

NOTE 5 FAIR VALUE

Fair value is the exchange price that would be received for an asset or paid to transfer a liability in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. There are three levels of inputs that may be used to measure fair value:

Level 1: Quoted prices (unadjusted) for identical assets or liabilities in active markets that the entity has the ability to access as of the measurement date.

Level 2: Significant other observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data.

Level 3: Significant unobservable inputs that reflect a reporting entity's own assumptions about the assumptions that market participants would use in pricing an asset or liability.

The Corporation used the following methods and significant assumptions to estimate fair value on a recurring basis:

Available for Sale Securities: The fair values of securities available for sale are usually determined by obtaining quoted prices on nationally recognized securities exchanges (Level 1 inputs), or matrix pricing, which is a mathematical technique widely used to value debt securities without relying exclusively on quoted prices for the specific securities but rather by relying on the securities' relationship to other benchmark quoted securities (Level 2 inputs). For securities where quoted prices or market prices of similar securities are not available, fair values are calculated using discounted cash flows or other market indicators (Level 3 inputs).

Equity Investments: Securities that are held to fund a deferred compensation plan and securities that have a readily determinable fair market value, are recorded at fair value with changes in fair value included in earnings. The fair values of equity investments are determined by quoted market prices (Level 1 inputs).

Impaired Loans: At the time a loan is considered impaired, it is valued at the lower of cost or fair value. Impaired loans carried at fair value have been partially charged-off or receive specific allocations as part of the allowance for loan loss accounting. For collateral dependent loans, fair value is commonly based on real estate appraisals. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by independent appraisers to adjust for differences between the comparable sales and income data available. Such adjustments are usually significant and typically result in a Level 3 classification of the inputs for determining fair value. Non-real estate collateral may be valued using an appraisal, net book value per the borrower’s financial statements, or aging reports, adjusted or discounted based on management’s historical knowledge, changes in market conditions from the time of the valuation, and management’s expertise and knowledge of the client and client’s business, typically resulting in a Level 3 fair value classification. Impaired loans are evaluated on a quarterly basis for additional impairment and adjusted accordingly.

OREO: Assets acquired through or instead of loan foreclosures are initially recorded at fair value less costs to sell when acquired, establishing a new cost basis. These assets are subsequently accounted for at lower of cost or fair value less estimated costs to sell. Fair value is commonly based on recent real estate appraisals. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by independent appraisers to adjust for differences between the comparable sales and income data available. Such adjustments are usually significant and typically result in a Level 3 classification of the inputs for determining fair value.

Appraisals for both collateral-dependent impaired loans and OREO are performed by certified general appraisers (commercial properties) or certified residential appraisers (residential properties) whose qualifications and licenses have been reviewed and verified by the Corporation.  Once received, appraisals are reviewed for reasonableness of assumptions, approaches utilized, Uniform Standards of Professional Appraisal Practice and other regulatory compliance, as well as the overall resulting fair value in comparison with independent data sources such as recent market data or industry-wide statistics.  Appraisals are generally completed within the previous 12 month period prior to a property being placed into OREO.  On impaired loans, appraisal values are adjusted based on the age of the appraisal, the position of the lien, the type of the property and its condition.

Derivatives: The fair values of interest rate swaps are based on valuation models using observable market data as of the measurement date (Level 2 inputs). Derivatives are traded in an over-the-counter market where quoted market prices are not always available. Therefore, the fair values of derivatives are determined using quantitative models that utilize multiple market inputs. The inputs will vary based on the type of derivative, but could include interest rates, prices, and indices to generate continuous yield or pricing curves, prepayment rates, and volatility factors to value the position. The Corporation also incorporates credit valuation adjustments to appropriately reflect both its own nonperformance risk and the respective counter-party's nonperformance risk in the fair value measurements. In adjusting the fair value of its derivative contracts for the effect of nonperformance risk, the Corporation has considered the impact of any applicable credit enhancements, such as collateral postings. Although the Corporation has determined that the majority of the inputs used to value its derivatives fall within Level 2 of the fair value hierarchy, the credit valuation adjustments associated with its derivatives utilize credit default rate assumptions (Level 3 inputs).

Assets and liabilities measured at fair value on a recurring basis are summarized below (in thousands):

| | | Fair Value Measurement at June 30, 2018 Using | | |
|---|---|---|---|---|
| Financial Assets: | Fair Value | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| Obligations of U.S. Government and U.S. Government sponsored enterprises | $15,450 | $— | $ 15,450 | $ — |
| Mortgage-backed securities, residential | 198,640 | — | 198,640 | — |
| Obligations of states and political subdivisions | 47,029 | — | 47,029 | — |
| Corporate bonds and notes | 250 | — | 250 | — |
| SBA loan pools | 3,788 | — | 3,788 | — |
| Total available for sale securities | $265,157 | $— | $ 265,157 | $ — |
| | | | | |
| Equity investments | $1,277 | $1,277 | $ — | $ — |
| Derivative assets | 2,304 | — | 2,304 | — |
| | | | | |
| Financial Liabilities: | | | | |
| Derivative liabilities | $2,322 | $— | $ 2,304 | $ 18 |

There were no transfers between Level 1 and Level 2 during the three and six month periods ended June 30, 2018.

| | | Fair Value Measurement at December 31, 2017 Using | | |
|---|---|---|---|---|
| Financial Assets: | Fair Value | Quoted Prices in Active Markets | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |

| | | for Identical Assets (Level 1) | | |
|---|---|---|---|---|
| Obligations of U.S. Government and U.S. Government sponsored enterprises | $15,491 | $— | $ 15,491 | $ — |
| Mortgage-backed securities, residential | 219,909 | — | 219,909 | — |
| Obligations of states and political subdivisions | 53,132 | — | 53,132 | — |
| Corporate bonds and notes | 251 | — | 251 | — |
| SBA loan pools | 4,308 | — | 4,308 | — |
| Total available for sale securities | $293,091 | $— | $ 293,091 | $ — |
| | | | | |
| Equity investments | $1,192 | $1,192 | $ — | $ — |
| Derivative assets | 974 | — | 974 | — |
| | | | | |
| Financial Liabilities: | | | | |
| Derivative liabilities | $1,049 | $— | $ 974 | $ 75 |

28

There were no transfers between Level 1 and Level 2 during the three and six month periods ended June 30, 2017.

The table below presents a reconciliation of all assets and liabilities measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the three-month periods ended June 30, 2018 and June 30, 2017 (in thousands):

| | Assets (Liabilities) | | | |
|---|---|---|---|---|
| | Corporate Bonds and Notes | | Derivative Liabilities | |
| | June 30, 2018 | June 30, 2017 | June 30, 2018 | June 30, 2017 |
| Balance of recurring Level 3 assets at April 1 | $ — | $ 251 | $ (50) | $ (65) |
| Derivative instruments entered into | — | — | (1) | — |
| Total gains or losses for the period: | | | | |
| Included in earnings - other non-interest income | — | — | 33 | (6) |
| Included in other comprehensive income | — | 1 | — | — |
| Balance of recurring Level 3 assets at June 30 | $ — | $ 252 | $ (18) | $ (71) |

The table below presents a reconciliation of all assets and liabilities measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the six month periods ended June 30, 2018 and June 30, 2017 (in thousands):

| | Assets (Liabilities) | | | |
|---|---|---|---|---|
| | Corporate Bonds and Notes | | Derivative Liabilities | |
| | June 30, 2018 | June 30, 2017 | June 30, 2018 | June 30, 2017 |
| Balance of recurring Level 3 assets at January 1 | $ — | $ 250 | $ (75) | $ (68) |
| Derivative instruments entered into | — | — | (1) | — |
| Total gains or losses for the period: | | | | |
| Included in earnings - other non-interest income | — | — | 58 | (3) |
| Included in other comprehensive income | — | 2 | — | — |
| Transfers out of Level 3 | — | — | — | — |
| Balance of recurring Level 3 assets at June 30 | $ — | $ 252 | $ (18) | $ (71) |

The following table presents information related to Level 3 recurring fair value measurements at June 30, 2018 and December 31, 2017 (in thousands):

| Description | Fair Value at June 30, 2018 | Valuation Technique | Unobservable Inputs | Range [Weighted Average] at June 30, 2018 |
|---|---|---|---|---|

| | | | | |
|---|---|---|---|---|
| Derivative liabilities | $ 18 | Historical trend | Credit default rate | 6.76% - 6.76% [6.76%] |

| Description | Fair Value at December 31, 2017 | Valuation Technique | Unobservable Inputs | Range [Weighted Average] at December 31, 2017 |
|---|---|---|---|---|
| Derivative liabilities | $ 75 | Historical trend | Credit default rate | 5.67% - 5.67% [5.67%] |

Assets and liabilities measured at fair value on a non-recurring basis are summarized below (in thousands):

| | | Fair Value Measurement at June 30, 2018 Using | | | |
|---|---|---|---|---|---|
| Financial Assets: | Fair Value | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) | Total Gains (Losses) |
| Impaired Loans: | | | | | |
| Commercial and agricultural: | | | | | |
| Commercial and industrial | $ 12 | $ — | $ — | $ 12 | $ — |
| Total impaired loans | $ 12 | $ — | $ — | $ 12 | $ — |
| Other real estate owned: | | | | | |
| Commercial mortgages: | | | | | |
| Commercial mortgages | $ 534 | $ — | $ — | $ 534 | $ — |
| Residential mortgages | 204 | — | — | 204 | — |
| Consumer loans: | | | | | |
| Home equity lines and loans | 148 | — | — | 148 | — |
| Total other real estate owned, net | $ 886 | $ — | $ — | $ 886 | $ — |

| | | Fair Value Measurement at December 31, 2017 Using | | | |
|---|---|---|---|---|---|
| Financial Assets: | Fair Value | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) | Total Gains (Losses) |
| Impaired Loans: | | | | | |
| Commercial and agricultural: | | | | | |
| Commercial and industrial | $ 96 | $ — | $ — | $ 96 | $ (70 ) |
| Commercial mortgages: | | | | | |
| Commercial mortgages | 411 | — | — | 411 | (105 ) |
| Total impaired loans | $ 507 | $ — | $ — | $ 507 | $ (175 ) |
| Other real estate owned: | | | | | |
| Commercial mortgages: | | | | | |
| Commercial mortgages | $ 1,483 | $ — | $ — | $ 1,483 | $ (43 ) |
| Residential mortgages | 382 | — | — | 382 | — |
| Consumer loans: | | | | | |
| Home equity lines and loans | 75 | — | — | 75 | — |

| | | | | | |
|---|---|---|---|---|---|
| Total other real estate owned, net | $1,940 | $— | $— | $ 1,940 | $ (43 ) |

30

The following tables presents information related to Level 3 non-recurring fair value measurement at June 30, 2018 and December 31, 2017 (in thousands):

| Description | Fair Value at June 30, 2018 | Valuation Technique | Unobservable Inputs | Range [Weighted Average] at June 30, 2018 |
|---|---|---|---|---|
| Impaired loans: | | | | |
| Commercial and agricultural: | | | | |
| Commercial and industrial | $ 12 | Sales comparison | Discount to appraised value | 0.00% - 0.00% [0.00%] |
| | $ 12 | | | |
| OREO: | | | | |
| Commercial mortgages: | | | | |
| Commercial mortgages | $ 534 | Sales comparison | Discount to appraised value | 10.00% - 22.95% [19.98%] |
| Residential mortgages | 204 | Sales comparison | Discount to appraised value | 17.28% - 39.78% [20.44%] |
| Consumer loans: | | | | |
| Home equity lines and loans | 148 | Sales comparison | Discount to appraised value | 20.80% - 20.80% [20.80%] |
| | $ 886 | | | |

| Description | Fair Value at December 31, 2017 | Valuation Technique | Unobservable Inputs | Range [Weighted Average] at December 31, 2017 |
|---|---|---|---|---|
| Impaired loans: | | | | |
| Commercial and agricultural: | | | | |
| Commercial and industrial | $ 96 | Sales comparison | Discount to appraised value | 0.00% - 36.07% [33.02%] |
| Commercial mortgages: | | | | |
| Commercial mortgages | 411 | Sales comparison | Discount to appraised value | 10.00% - 89.98% [51.35%] |
| | $ 507 | | | |
| OREO: | | | | |
| Commercial mortgages: | | | | |
| Commercial mortgages | $ 1,483 | Sales comparison | Discount to appraised value | 10.00% - 22.95% [19.75%] |
| Residential mortgages | 382 | Sales comparison | Discount to appraised value | 17.28% - 27.97% [20.77%] |
| Consumer loans: | | | | |
| Home equity lines and loans | 75 | Sales comparison | Discount to appraised value | 20.80% - 20.80% [20.80%] |
| | $ 1,940 | | | |

FAIR VALUE OF FINANCIAL INSTRUMENTS

The carrying amounts and estimated fair values of other financial instruments, at June 30, 2018 and December 31, 2017, are as follows (in thousands):

| | June 30, 2018 | | | | |
|---|---|---|---|---|---|
| Financial assets: | Carrying Amount | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) | Estimated Fair Value (1) |
| Cash and due from financial institutions | $30,837 | $30,837 | $ — | $ — | $30,837 |
| Interest-bearing deposits in other financial institutions | 3,978 | 3,978 | — | — | 3,978 |
| Equity investments | 1,277 | 1,277 | — | — | 1,277 |
| Securities available for sale | 265,157 | — | 265,157 | — | 265,157 |
| Securities held to maturity | 3,806 | — | 2,309 | 1,481 | 3,790 |
| FHLBNY and FRBNY stock | 5,816 | — | — | — | N/A |
| Loans, net and loans held for sale | 1,315,483 | — | — | 1,296,697 | 1,296,697 |
| Accrued interest receivable | 4,404 | 1 | 737 | 3,666 | 4,404 |
| Derivative assets | 2,304 | — | 2,304 | — | 2,304 |
| | | | | | |
| Financial liabilities: | | | | | |
| Deposits: | | | | | |
| Demand, savings, and insured money market accounts | $1,332,815 | $1,332,815 | $ — | $ — | $1,332,815 |
| Time deposits | 146,094 | — | 146,315 | — | 146,315 |
| FHLBNY overnight advances | 58,950 | — | 58,949 | — | 58,949 |
| Accrued interest payable | 115 | 21 | 94 | — | 115 |
| Derivative liabilities | 2,322 | — | 2,304 | 18 | 2,322 |

(1) Fair value estimates are made at a specific point in time, based on relevant market information and information about the financial instrument.  These estimates are subjective in nature and involve uncertainties and matters of significant judgment and, therefore, cannot be determined with precision.  Changes in assumptions could significantly affect the estimates.

| | December 31, 2017 | | | | |
|---|---|---|---|---|---|
| Financial assets: | Carrying Amount | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) | Estimated Fair Value (1) |
| Cash and due from financial institutions | $27,966 | $27,966 | $ — | $ — | $27,966 |
| Interest-bearing deposits in other financial institutions | 2,763 | 2,763 | — | — | 2,763 |
| Equity investments | 1,192 | 1,192 | — | — | 1,192 |
| Securities available for sale | 293,091 | — | 293,091 | — | 293,091 |
| Securities held to maturity | 3,781 | — | 1,830 | 1,946 | 3,776 |
| FHLBNY and FRBNY stock | 5,784 | — | — | — | N/A |
| Loans, net | 1,291,205 | — | — | 1,289,584 | 1,289,584 |
| Loans held for sale | 542 | — | 542 | — | 542 |
| Accrued interest receivable | 4,642 | 1 | 867 | 3,774 | 4,642 |
| Derivative assets | 974 | — | 974 | — | 974 |
| | | | | | |
| Financial liabilities: | | | | | |
| Deposits: | | | | | |
| Demand, savings, and insured money market accounts | $1,349,084 | $1,349,084 | $ — | $ — | $1,349,084 |
| Time deposits | 118,362 | — | 118,598 | — | 118,598 |
| Securities sold under agreements to repurchase | 10,000 | — | 10,058 | — | 10,058 |
| FHLBNY overnight advances | 57,700 | — | 57,700 | — | 57,700 |
| FHLBNY term advances | 2,000 | — | 2,001 | — | 2,001 |
| Accrued interest payable | 148 | 24 | 124 | — | 148 |
| Derivative liabilities | 1,049 | — | 974 | 75 | 1,049 |

(1) Fair value estimates are made at a specific point in time, based on relevant market information and information about the financial instrument. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and, therefore, cannot be determined with precision. Changes in assumptions could significantly affect the estimates.

## NOTE 6 GOODWILL AND INTANGIBLE ASSETS

The changes in goodwill included in the core banking segment during the six month periods ended June 30, 2018 and 2017 were as follows (in thousands):

| | 2018 | 2017 |
|---|---|---|
| Beginning of year | $21,824 | $21,824 |
| Acquired goodwill | — | — |
| Ending balance June 30, | $21,824 | $21,824 |

Acquired intangible assets were as follows at June 30, 2018 and December 31, 2017 (in thousands):

| At June 30, 2018 | | At December 31, 2017 | |
|---|---|---|---|
| Balance Acquired | Accumulated Amortization | Balance Acquired | Accumulated Amortization |

| | | | | |
|---|---|---|---|---|
| Core deposit intangibles | $5,975 | $ 5,395 | $5,975 | $ 5,196 |
| Other customer relationship intangibles | 5,633 | 4,504 | 5,633 | 4,327 |
| Total | $11,608 | $ 9,899 | $11,608 | $ 9,523 |

33

Aggregate amortization expense was $0.2 million for both of the three month periods ended June 30, 2018 and 2017. Aggregate amortization expense was $0.4 million for both of the six month periods ended June 30, 2018 and 2017, respectively.

The remaining estimated aggregate amortization expense at June 30, 2018 is listed below (in thousands):

| Year | Estimated Expense |
|---|---|
| 2018 | $ 358 |
| 2019 | 609 |
| 2020 | 484 |
| 2021 | 258 |
| 2022 | — |
| Total | $ 1,709 |

NOTE 7 SECURITIES SOLD UNDER AGREEMENTS TO REPURCHASE

The Corporation enters into sales of securities under agreements to repurchase and the amounts received under these agreements represent borrowings and are reflected as a liability in the consolidated balance sheets. The securities underlying these agreements are included in investment securities in the consolidated balance sheets.

The Corporation has no control over the market value of the securities which fluctuate due to market conditions, however, the Corporation is obligated to promptly transfer additional securities if the market value of the securities falls below the repurchase agreement price. The Corporation manages this risk by utilizing highly marketable and easily priced securities, monitoring these securities for significant changes in market valuation routinely, and maintaining an unpledged securities portfolio believed to be sufficient to cover a decline in the market value of the securities sold under agreements to repurchase.

There were no securities sold under agreements to repurchase as of June 30, 2018.

A summary of securities sold under agreements to repurchase as of December 31, 2017 is as follows (in thousands):

| | December 31, 2017 | | | | |
|---|---|---|---|---|---|
| | Overnight and Continuous | Up to 1 Year | 1 - 3 Years | 3+ Years | Total |
| Mortgage-backed securities, residential | $ — | $ 11,798 | $ — | $ — | $ 11,798 |
| Excess collateral held | — | (1,798 ) | — | — | (1,798 ) |
| Gross amount of recognized liabilities for repurchase agreements | $ — | $ 10,000 | $ — | $ — | $ 10,000 |

NOTE 8 COMMITMENTS AND CONTINGENCIES

The Corporation is a party to certain financial instruments with off-balance sheet risk such as commitments under standby letters of credit, unused portions of lines of credit, overdraft protection and commitments to fund new loans. In accordance with GAAP, these financial instruments are not recorded in the financial statements. The Corporation's policy is to record such instruments when funded. These transactions involve, to varying degrees, elements of credit, interest rate and liquidity risk. Such transactions are generally used by the Corporation to manage clients' requests for funding and other client needs.

The following table lists the contractual amounts of financial instruments with off-balance sheet risk at June 30, 2018 and December 31, 2017 (in thousands):

| | June 30, 2018 | | December 31, 2017 | |
|---|---|---|---|---|
| | Fixed Rate | Variable Rate | Fixed Rate | Variable Rate |
| Commitments to make loans | $17,062 | $32,329 | $16,019 | $28,591 |
| Unused lines of credit | 1,473 | 199,478 | 1,604 | 200,353 |
| Standby letters of credit | — | 14,416 | — | 15,022 |

On June 15, 2018, the Bank, through mediation, reached a resolution by way of a settlement agreement in the matter of Fane v. Chemung Canal Trust Company (the “Action”). The parties agreed to release each other from any and all liabilities, claims, counterclaims, demands, charges, complaints and causes of action, to dismiss the Action with prejudice, and the Bank agreed to pay Fane $3.3 million in connection with the settlement of the Action. As of March 31, 2018, the Corporation had a legal reserve of $2.3 million for the Action and therefore recognized an additional $1.0 million of legal expense during the second quarter of 2018.

In the normal course of business, there are various outstanding claims and legal proceedings involving the Corporation or its subsidiaries. Except for the above matter as of June 30, 2018, we believe that we are not a party to any pending legal, arbitration, or regulatory proceedings that could have a material adverse impact on our financial results or liquidity.

## NOTE 9 ACCUMULATED OTHER COMPREHENSIVE LOSS

Accumulated other comprehensive loss represents the net unrealized holding gains or losses on securities available for sale and the funded status of the Corporation's defined benefit pension plan and other benefit plans, as of the consolidated balance sheet dates, net of the related tax effect.

The following is a summary of the changes in accumulated other comprehensive loss by component, net of tax, for the periods indicated (in thousands):

| | Unrealized Gains and Losses on Securities Available for Sale | Defined Benefit and Other Benefit Plans | Total |
|---|---|---|---|
| Balance at April 1, 2018 | $ (6,924 ) | $ (6,912) | $ (13,836) |
| Other comprehensive income before reclassification | (299 ) | — | (299 ) |
| Amounts reclassified from accumulated other comprehensive income | — | 14 | 14 |
| Net current period other comprehensive income (loss) | (299 ) | 14 | (285 ) |
| Balance at June 30, 2018 | $ (7,223 ) | $ (6,898) | $ (14,121) |

| | Unrealized Gains and Losses on Securities Available for Sale | Defined Benefit and Other Benefit Plans | Total |
|---|---|---|---|

| | | | |
|---|---|---|---|
| Balance at April 1, 2017 | $ (2,379 ) | $ (6,377 ) | $ (8,756 ) |
| Other comprehensive loss before reclassification | 1,772 | — | 1,772 |
| Amounts reclassified from accumulated other comprehensive income | (8 ) | 20 | 12 |
| Net current period other comprehensive income | 1,764 | 20 | 1,784 |
| Balance at June 30, 2017 | $ (615 ) | $ (6,357 ) | $ (6,972 ) |

| | Unrealized Gains and Losses on Securities Available for Sale | Defined Benefit and Other Benefit Plans | Total |
|---|---|---|---|
| Balance at January 1, 2018 | $ (3,415 ) | $ (6,925 ) | $ (10,340 ) |
| Cumulative effect of account change | (202 ) | — | (202 ) |
| Balance at January 1, 2018, as adjusted | (3,617 ) | (6,925 ) | (10,542 ) |
| Other comprehensive income before reclassification | (3,606 ) | — | (3,606 ) |
| Amounts reclassified from accumulated other comprehensive income | — | 27 | 27 |
| Net current period other comprehensive income (loss) | (3,606 ) | 27 | (3,579 ) |
| Balance at June 30, 2018 | $ (7,223 ) | $ (6,898 ) | $ (14,121 ) |

| | Unrealized Gains and Losses on Securities Available for Sale | Defined Benefit and Other Benefit Plans | Total |
|---|---|---|---|
| Balance at January 1, 2017 | $ (4,356 ) | $ (6,398 ) | $ (10,754 ) |
| Other comprehensive income before reclassification | 3,749 | — | 3,749 |
| Amounts reclassified from accumulated other comprehensive income | (8 ) | 41 | 33 |
| Net current period other comprehensive income | 3,741 | 41 | 3,782 |
| Balance at June 30, 2017 | $ (615 ) | $ (6,357 ) | $ (6,972 ) |

The following is the reclassification out of accumulated other comprehensive income for the periods indicated (in thousands):

| Details about Accumulated Other Comprehensive Income Components | Three Months Ended June 30, 2018 | 2017 | Affected Line Item in the Statement Where Net Income is Presented |
|---|---|---|---|
| Unrealized gains and losses on securities available for sale: | | | |
| Realized gains on securities available for sale | $— | $ (12 ) | Net gains (losses) on securities transactions |
| Tax effect | — | 4 | Income tax expense |
| Net of tax | — | (8 ) | |
| Amortization of defined pension plan and other benefit plan items: | | | |
| Prior service costs (a) | $ (55 ) | $ (55 ) | Other components of net periodic pension and postretirement benefits |
| Actuarial losses (a) | 73 | 88 | Other components of net periodic pension and postretirement benefits |
| Tax effect | (4 ) | (13 ) | Income tax expense |
| Net of tax | 14 | 20 | |
| Total reclassification for the period, net of tax | $ 14 | $ 12 | |

(a) These accumulated other comprehensive income components are included in the computation of net periodic pension and other benefit plan costs (see Note 11 for additional information).

| Details about Accumulated Other Comprehensive Income Components | Six Months Ended June 30, 2018 | 2017 | Affected Line Item in the Statement Where Net Income is Presented |
|---|---|---|---|
| Unrealized gains and losses on securities available for sale: | | | |
| Realized gains on securities available for sale | $— | $(12) | Net gains (losses) on securities transactions |
| Tax effect | — | 4 | Income tax expense |
| Net of tax | — | (8) | |
| Amortization of defined pension plan and other benefit plan items: | | | |
| Prior service costs (a) | (110) | (110) | Other components of net periodic pension and postretirement benefits |
| Actuarial losses (a) | 146 | 176 | Other components of net periodic pension and postretirement benefits |
| Tax effect | (9) | (25) | Income tax expense |
| Net of tax | 27 | 41 | |
| Total reclassification for the period, net of tax | $27 | $33 | |

(a) These accumulated other comprehensive income components are included in the computation of net periodic pension and other benefit plan costs (see Note 11 for additional information).

## NOTE 10 REVENUE FROM CONTRACTS WITH CUSTOMERS

All of the Corporation's revenue from contracts with customers in the scope of ASC 606 is recognized within non-interest income. The following table presents the Corporation's non-interest income by revenue stream and reportable segment for the three and six months ended June 30, 2018 and 2017 (in thousands). Items outside the scope of ASC 606 are noted as such.

| | Three Months Ended June 30, 2018 | | | |
|---|---|---|---|---|
| Revenue by Operating Segment: | Core Banking | WMG | Holding Company, CFS, and CRM[c] | Total |
| Non-interest income | | | | |
| Service charges on deposit accounts | | | | |
| Overdraft fees | $939 | $— | $ — | $939 |
| Other | 205 | — | — | 205 |
| Interchange revenue from debit card transactions | 996 | — | — | 996 |
| WMG fee income | — | 2,373 | — | 2,373 |
| CFS fee and commission income | — | — | 135 | 135 |
| Net gains (losses) on sales of OREO | (48) | — | — | (48) |
| Net gains on sales of loans[a] | 59 | — | — | 59 |
| Loan servicing fees[a] | 22 | — | — | 22 |
| Other[a] | 649 | — | (5) | 644 |
| Total non-interest income (loss) | $2,822 | $2,373 | $ 130 | $5,325 |

| Revenue by Operating Segment: | Three Months Ended June 30, 2017 (b) Core Banking | WMG | Holding Company, CFS, and CRM[c] | Total |
|---|---|---|---|---|
| Non-interest income | | | | |
| Service charges on deposit accounts | | | | |
| Overdraft fees | $971 | $— | $ — | $971 |
| Other | 254 | — | — | 254 |
| Interchange revenue from debit card transactions | 964 | — | — | 964 |
| WMG fee income | — | 2,269 | — | 2,269 |
| CFS fee and commission income | — | — | 174 | 174 |
| Net gains (losses) on sales of OREO | (9) | — | — | (9) |
| Net gains on sales of loans[a] | 53 | — | — | 53 |
| Loan servicing fees[a] | 21 | — | — | 21 |
| Net gains (losses) on sales of securities[a] | 12 | — | — | 12 |
| Other[a] | 368 | — | (55) | 313 |
| Total non-interest income | $2,634 | $2,269 | $ 119 | $5,022 |

(a) Not within scope of ASC 606.
(b) The Corporation elected the modified retrospective approach of adoption; therefore, prior period balances are presented under legacy GAAP and may not be comparable to current year presentation.
(c) The Holding Company, CFS, and CRM column above includes amounts to eliminate transactions between segments.

A description of the Corporation's revenue streams accounted for under ASC 606 follows:

| Revenue by Operating Segment: | Six Months Ended June 30, 2018 Core Banking | WMG | Holding Company, CFS, and CRM[c] | Total |
|---|---|---|---|---|
| Non-interest income | | | | |
| Service charges on deposit accounts | | | | |
| Overdraft fees | $1,904 | $— | $ — | $1,904 |
| Other | 404 | — | — | 404 |
| Interchange revenue from debit card transactions | 2,031 | — | — | 2,031 |
| WMG fee income | — | 4,689 | — | 4,689 |
| CFS fee and commission income | — | — | 245 | 245 |
| Net gains (losses) on sales of OREO | (4) | — | — | (4) |
| Net gains on sales of loans[a] | 105 | — | — | 105 |
| Loan servicing fees[a] | 45 | — | — | 45 |
| Other[a] | 1,520 | — | (139) | 1,381 |
| Total non-interest income (loss) | $6,005 | $4,689 | $ 106 | $10,800 |

| Revenue by Operating Segment: | Six Months Ended June 30, 2017 (b) Core Banking | WMG | Holding Company, CFS, and CRM[c] | Total |
|---|---|---|---|---|
| Non-interest income | | | | |
| Service charges on deposit accounts | | | | |
| Overdraft fees | $1,950 | $— | $ — | $1,950 |
| Other | 459 | — | — | 459 |
| Interchange revenue from debit card transactions | 1,884 | — | — | 1,884 |
| WMG fee income | — | 4,378 | — | 4,378 |
| CFS fee and commission income | — | — | 312 | 312 |
| Net gains on sales of OREO | 8 | — | — | 8 |
| Net gains on sales of loans[a] | 122 | — | — | 122 |
| Loan servicing fees[a] | 41 | — | — | 41 |
| Net gains (losses) on sales of securities[a] | 12 | — | — | 12 |
| Other[a] | 763 | — | (60 ) | 703 |
| Total non-interest income | $5,239 | $4,378 | $ 252 | $9,869 |

(a) Not within scope of ASC 606.
(b) The Corporation elected the modified retrospective approach of adoption; therefore, prior period balances are presented under legacy GAAP and may not be comparable to current year presentation.
(c) The Holding Company, CFS, and CRM column above includes amounts to eliminate transactions between segments.

A description of the Corporation's revenue streams accounted for under ASC 606 follows:

Service Charges on Deposit Accounts: The Corporation earns fees from its deposit customers for transaction-based, account maintenance, and overdraft services. Transaction-based fees, which included services such as ATM use fees, stop payment charges, statement rendering, and ACH fees, are recognized at the time the transaction is executed as that is the point in time the Corporation fulfills the customer's request. Account maintenance fees, which relate primarily to monthly maintenance, are recognized at the time the maintenance occurs. Overdraft fees are recognized at the point in time that the overdraft occurs. Service charges on deposits are withdrawn from the customer's account balance.

Interchange Income from Debit Card Transactions: The Corporation earns interchange fees from debit cardholder transactions conducted through the Mastercard payment network. Interchange fees from cardholder transactions represent a percentage of the underlying transaction value and are recognized daily, concurrently with the transaction processing services provided to cardholder.

WMG Fee Income (Gross): The Corporation earns wealth management fees from its contracts with trust customers to manage assets for investment, and/or to transact on their accounts. These fees are primarily earned over time as the Corporation provides the contracted monthly or quarterly services and are generally assessed based on a tiered scale of the market value of assets under management (AUM) at quarter-end.

CFS Fee and Commission Income (Net): The Corporation earns fees from investment brokerage services provided to its customers by a third-party service provider. The Corporation receives commissions from the third-party service provider on a monthly basis based upon customer activity for the month. The Corporation (i) acts as an agent in arranging the relationship between the customer and the third-party service provider and (ii) does not control the services rendered to the customers. Investment brokerage fees are presented net of related costs. The Corporation also earns fees from tax services provided to its customers.

Net Gains/Losses on Sales of OREO: The Corporation records a gain or loss from the sale of OREO when control of the property transfers to the buyer, which generally occurs at the time of an executed deed. When the Corporation finances the sale of OREO to the buyer, the Corporation assesses whether the buyer is committed to perform their obligations under the contract and whether collectability of the transaction price is probable. Once these criteria are met, the OREO asset is derecognized and the gain or loss on sale is recorded upon the transfer of control of the property to the buyer. In determining the gain or loss on the sale, the Corporation adjusts the transaction price and related gain (loss) on sale if a significant financing component is present.

NOTE 11 COMPONENTS OF QUARTERLY AND YEAR TO DATE NET PERIODIC BENEFIT COSTS

The components of net periodic expense for the Corporation's pension and other benefit plans for the periods indicated are as follows (in thousands):

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2018 | 2017 | 2018 | 2017 |
| Qualified Pension Plan | | | | |
| Service cost, benefits earned during the period | $— | $— | $— | $— |
| Interest cost on projected benefit obligation | 384 | 403 | 769 | 806 |
| Expected return on plan assets | (826 ) | (785 ) | (1,652) | (1,570) |
| Amortization of unrecognized transition obligation | — | — | — | — |
| Amortization of unrecognized prior service cost | — | — | — | — |
| Amortization of unrecognized net loss | 44 | 58 | 87 | 116 |
| Net periodic pension benefit | $(398) | $(324) | $(796) | $(648) |
| | | | | |
| Supplemental Pension Plan | | | | |
| Service cost, benefits earned during the period | $— | $— | $— | $— |
| Interest cost on projected benefit obligation | 12 | 12 | 24 | 24 |
| Expected return on plan assets | — | — | — | — |
| Amortization of unrecognized prior service cost | — | — | — | — |
| Amortization of unrecognized net loss | 2 | 1 | 4 | 2 |
| Net periodic supplemental pension cost | $14 | $13 | $28 | $26 |
| | | | | |
| Postretirement Plan, Medical and Life | | | | |
| Service cost, benefits earned during the period | $— | $— | $— | $— |
| Interest cost on projected benefit obligation | 4 | 4 | 7 | 8 |
| Expected return on plan assets | — | — | — | — |
| Amortization of unrecognized prior service cost | (55 ) | (55 ) | (110 ) | (110 ) |
| Amortization of unrecognized net loss | 27 | 29 | 55 | 58 |
| Net periodic postretirement, medical and life benefit | $(24 ) | $(22 ) | $(48 ) | $(44 ) |

NOTE 12 SEGMENT REPORTING

The Corporation manages its operations through two primary business segments: core banking and WMG. The core banking segment provides revenues by attracting deposits from the general public and using such funds to originate consumer, commercial, commercial real estate, and residential mortgage loans, primarily in the Corporation's local markets, and to invest in securities. The WMG services segment provides revenues by providing trust and investment advisory services to clients.

Accounting policies for the segments are the same as those described in Note 1 of the Corporation's 2017 Annual Report on Form 10-K, which was filed with the SEC on March 8, 2018. Summarized financial information concerning the Corporation's reportable segments and the reconciliation to the Corporation's consolidated results are shown in the following table. Income taxes are allocated based on the separate taxable income of each entity and indirect overhead expenses are allocated based on reasonable and equitable allocations applicable to the reportable segment. The Holding Company, CFS, and CRM column below includes amounts to eliminate transactions between segments (in thousands).

| | Three months ended June 30, 2018 | | | |
|---|---|---|---|---|
| | Core Banking | WMG | Holding Company, CFS, and CRM | Consolidated Totals |
| Interest and dividend income | $15,861 | $— | $ 8 | $ 15,869 |
| Interest expense | 852 | — | — | 852 |
| Net interest income | 15,009 | — | 8 | 15,017 |
| Provision for loan losses | 2,362 | — | — | 2,362 |
| Net interest income after provision for loan losses | 12,647 | — | 8 | 12,655 |
| Other non-interest income | 2,822 | 2,373 | 130 | 5,325 |
| Legal accruals and settlements | 989 | — | — | 989 |
| Other non-interest expenses | 12,014 | 1,629 | 335 | 13,978 |
| Income (loss) before income tax expense (benefit) | 2,466 | 744 | (197 ) | 3,013 |
| Income tax expense (benefit) | 342 | 190 | (46 ) | 486 |
| Segment net income (loss) | $2,124 | $ 554 | $ (151 ) | $ 2,527 |

| | Three months ended June 30, 2017 | | | |
|---|---|---|---|---|
| | Core Banking | WMG | Holding Company, CFS, and CRM | Consolidated Totals |
| Interest and dividend income | $14,680 | $— | $ 4 | $ 14,684 |
| Interest expense | 734 | — | — | 734 |
| Net interest income | 13,946 | — | 4 | 13,950 |
| Provision for loan losses | 421 | — | — | 421 |
| Net interest income after provision for loan losses | 13,525 | — | 4 | 13,529 |
| Other non-interest income | 2,634 | 2,269 | 119 | 5,022 |
| Legal accruals and settlements | 850 | — | — | 850 |
| Other non-interest expenses | 11,700 | 1,467 | 315 | 13,482 |
| Income (loss) before income tax expense (benefit) | 3,609 | 802 | (192 ) | 4,219 |
| Income tax expense (benefit) | 1,018 | 304 | (59 ) | 1,263 |
| Segment net income (loss) | $2,591 | $ 498 | $ (133 ) | $ 2,956 |

| | Six months ended June 30, 2018 | | | |
|---|---|---|---|---|
| | Core Banking | WMG | Holding Company, CFS, and CRM | Consolidated Totals |
| Interest and dividend income | $31,523 | $— | $ 15 | $ 31,538 |
| Interest expense | 1,621 | — | — | 1,621 |
| Net interest income | 29,902 | — | 15 | 29,917 |
| Provision for loan losses | 3,071 | — | — | 3,071 |
| Net interest income after provision for loan losses | 26,831 | — | 15 | 26,846 |
| Other non-interest income | 6,005 | 4,689 | 106 | 10,800 |
| Other non-interest expenses | 24,429 | 3,107 | 608 | 28,144 |
| Income (loss) before income tax expense (benefit) | 7,418 | 1,582 | (487 ) | 8,513 |
| Income tax expense (benefit) | 1,236 | 403 | (92 ) | 1,547 |
| Segment net income (loss) | $6,182 | $1,179 | $ (395 ) | $ 6,966 |

| | | | | |
|---|---|---|---|---|
| Segment assets | $1,694,891 | $3,844 | $11,431 | $1,710,166 |

| | Six months ended June 30, 2017 | | | |
|---|---|---|---|---|
| | Core Banking | WMG | Holding Company, CFS, and CRM | Consolidated Totals |
| Interest and dividend income | $28,991 | $— | $ 7 | $ 28,998 |
| Interest expense | 1,554 | — | — | 1,554 |
| Net interest income | 27,437 | — | 7 | 27,444 |
| Provision for loan losses | 1,461 | — | — | 1,461 |
| Net interest income after provision for loan losses | 25,976 | — | 7 | 25,983 |
| Other non-interest income | 5,239 | 4,378 | 252 | 9,869 |
| Legal accruals and settlements | 850 | — | — | 850 |
| Other non-interest expenses | 23,144 | 2,772 | 611 | 26,527 |
| Income (loss) before income tax expense (benefit) | 7,221 | 1,606 | (352) | 8,475 |
| Income tax expense (benefit) | 2,066 | 609 | (135) | 2,540 |
| Segment net income (loss) | $5,155 | $997 | $ (217) | $ 5,935 |
| | | | | |
| Segment assets | $1,706,266 | $4,863 | $ 7,443 | $ 1,718,572 |

NOTE 13 STOCK COMPENSATION

Board of Directors' Stock Compensation

Pursuant to the Corporation's Directors' Compensation Plan, members of the Board of Directors receive common shares of the Corporation equal in value to the amount of fees individually earned during the previous year for service as a director. The common shares are distributed to the Corporation's individual board members from treasury shares of the Corporation on or about January 15 following the calendar year of service.

Additionally, the Chief Executive Officer of the Corporation, who does not receive cash compensation as a member of the Board of Directors, is awarded common shares equal in value to the average of those awarded to board members not employed by the Corporation who have served for 12 months during the prior year.

During January 2018 and 2017, 6,015 and 7,880 shares, respectively, were re-issued from treasury to fund the stock component of directors' compensation. An expense of $100 thousand and $75 thousand related to this compensation was recognized during the three month periods ended June 30, 2018 and 2017, respectively. An expense of $184 thousand and $154 thousand related to this compensation was recognized during the six month periods ended June 30, 2018 and 2017, respectively. This expense is accrued as shares are earned.

Restricted Stock Plan

Pursuant to the Corporation’s Restricted Stock Plan, the Corporation may make discretionary grants of restricted stock to officers other than the Corporation's Chief Executive Officer. Compensation expense is recognized over the vesting period of the awards based on the fair value of the stock at issue date.

A summary of restricted stock activity for the three month period ended June 30, 2018 is presented below:

| | Shares | Weighted–Average Grant Date Fair Value |
|---|---|---|
| Nonvested at April 1, 2018 | 23,933 | $ 38.12 |
| Granted | — | — |
| Vested | (849 ) | 44.84 |
| Forfeited or cancelled | — | — |
| Nonvested at June 30, 2018 | 23,084 | $ 37.88 |

A summary of restricted stock activity for the six month period ended June 30, 2018 is presented below:

| | Shares | Weighted–Average Grant Date Fair Value |
|---|---|---|
| Nonvested at January 1, 2018 | 25,522 | $ 38.01 |
| Granted | — | — |
| Vested | (2,438 ) | 39.28 |
| Forfeited or cancelled | — | — |
| Nonvested at June 30, 2018 | 23,084 | $ 37.88 |

As of June 30, 2018, there was $838 thousand of total unrecognized compensation cost related to nonvested shares granted under the Plan. The cost is expected to be recognized over a weighted-average period of 3.26 years. The total fair value of shares vested was $112 thousand and $16 thousand for the six month periods ended June 30, 2018 and 2017, respectively.

## Item 2: Management's Discussion and Analysis of Financial Condition and Results of Operations

### Introduction

The following is the MD&A of the Corporation in this Quarterly Report on Form 10-Q for the three and six months ended June 30, 2018 and 2017. Reference should be made to the accompanying unaudited consolidated financial statements and footnotes, and the Corporation’s 2017 Annual Report on Form 10-K, which was filed with the SEC on March 8, 2018, for an understanding of the following discussion and analysis. See the list of commonly used abbreviations and terms on pages 3–5.

The MD&A included in this Form 10-Q 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 and in Part I, Item 1A, Risk Factors, on pages 17–24 of the Corporation’s 2017 Form 10-K. For a discussion of use of non-GAAP financial measures, see pages 64–67 of the Corporation's 2017 Form 10-K or pages 70-73 in this Form 10-Q.

The Corporation has been a financial holding company since 2000, 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 income 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 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.

Forward-looking Statements

This discussion contains forward-looking statements within the meaning of Section 27A of the Securities Act and Section 21E of the Exchange Act. 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” in the Corporation’s 2017 Annual Report on Form 10-K.  These 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 upon request from the Corporate Secretary at (607) 737-3746. 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 Three Months Ended June 30, 2018 | March 31, 2018 | Dec. 31, 2017 | Sept. 30, 2017 | June 30, 2017 | As of or for the Six Months Ended June 30, 2018 | June 30, 2017 |
|---|---|---|---|---|---|---|---|
| RESULTS OF OPERATIONS | | | | | | | |
| Interest income | $15,869 | $15,669 | $15,560 | $15,497 | $14,684 | $31,538 | $28,998 |
| Interest expense | 852 | 769 | 780 | 734 | 734 | 1,621 | 1,554 |
| Net interest income | 15,017 | 14,900 | 14,780 | 14,763 | 13,950 | 29,917 | 27,444 |
| Provision for loan losses | 2,362 | 709 | 6,272 | 1,289 | 421 | 3,071 | 1,461 |
| Net interest income after provision for loan losses | 12,655 | 14,191 | 8,508 | 13,474 | 13,529 | 26,846 | 25,983 |
| Non-interest income | 5,325 | 5,475 | 5,456 | 5,166 | 5,022 | 10,800 | 9,869 |
| Non-interest expense | 14,967 | 14,166 | 13,111 | 13,276 | 14,332 | 29,133 | 27,377 |
| Income before income tax expense | 3,013 | 5,500 | 853 | 5,364 | 4,219 | 8,513 | 8,475 |
| Income tax expense | 486 | 1,061 | 3,012 | 1,710 | 1,263 | 1,547 | 2,540 |
| Net income (loss) | $2,527 | $4,439 | $(2,159) | $3,654 | $2,956 | $6,966 | $5,935 |
| | | | | | | | |
| Basic and diluted earnings per share | $0.52 | $0.92 | $(0.45) | $0.76 | $0.62 | $1.44 | $1.24 |
| Average basic and diluted shares outstanding | 4,828 | 4,822 | 4,809 | 4,802 | 4,797 | 4,825 | 4,793 |
| | | | | | | | |
| PERFORMANCE RATIOS - Annualized | | | | | | | |
| Return on average assets | 0.59 % | 1.06 % | (0.50 )% | 0.85 % | 0.69 % | 0.82 % | 0.70 % |
| Return on average equity | 6.70 % | 11.96 % | (5.53 )% | 9.46 % | 7.90 % | 9.31 % | 8.06 % |
| Return on average tangible equity (a) | 7.94 % | 14.21 % | (6.55 )% | 11.24 % | 9.43 % | 11.05 % | 9.66 % |
| Efficiency ratio (a) (b) | 67.47 % | 68.21 % | 63.43 % | 64.83 % | 69.28 % | 67.84 % | 69.27 % |

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| Non-interest expense to average assets | 3.52 % | 3.37 % | 3.01 % | 3.09 % | 3.34 % | 3.45 % | 3.23 % |
| Loans to deposits | 90.23 % | 86.94 % | 89.40 % | 83.85 % | 82.14 % | 90.23 % | 82.14 % |
| | | | | | | | |
| YIELDS / RATES - Fully Taxable Equivalent | | | | | | | |
| Yield on loans | 4.33 % | 4.34 % | 4.26 % | 4.34 % | 4.18 % | 4.34 % | 4.18 % |
| Yield on investments | 2.21 % | 2.22 % | 2.15 % | 2.16 % | 2.01 % | 2.22 % | 2.01 % |
| Yield on interest-earning assets | 3.94 % | 3.94 % | 3.82 % | 3.86 % | 3.65 % | 3.94 % | 3.65 % |
| Cost of interest-bearing deposits | 0.24 % | 0.20 % | 0.20 % | 0.20 % | 0.20 % | 0.22 % | 0.20 % |
| Cost of borrowings | 2.41 % | 2.23 % | 2.42 % | 2.95 % | 2.82 % | 2.31 % | 2.94 % |
| Cost of interest-bearing liabilities | 0.32 % | 0.29 % | 0.28 % | 0.27 % | 0.26 % | 0.30 % | 0.28 % |
| Interest rate spread | 3.62 % | 3.65 % | 3.54 % | 3.59 % | 3.39 % | 3.64 % | 3.37 % |
| Net interest margin, fully taxable equivalent | 3.73 % | 3.75 % | 3.63 % | 3.68 % | 3.47 % | 3.74 % | 3.46 % |
| | | | | | | | |
| CAPITAL | | | | | | | |
| Total equity to total assets at end of period | 8.88 % | 8.84 % | 8.77 % | 8.91 % | 8.84 % | 8.88 % | 8.84 % |
| Tangible equity to tangible assets at end of period (a) | 7.60 % | 7.55 % | 7.48 % | 7.62 % | 7.53 % | 7.60 % | 7.53 % |
| | | | | | | | |
| Book value per share | $31.42 | $31.16 | $31.10 | $32.11 | $31.67 | $31.42 | $31.67 |
| Tangible book value per share (a) | 26.55 | 26.24 | 26.14 | 27.09 | 26.60 | 26.55 | 26.60 |
| Period-end market value per share | 50.11 | 46.47 | 48.10 | 47.10 | 40.88 | 50.11 | 40.88 |
| Dividends declared per share | 0.26 | 0.26 | 0.26 | 0.26 | 0.26 | 0.52 | 0.52 |
| | | | | | | | |
| AVERAGE BALANCES | | | | | | | |
| | $1,328,386 | $1,315,207 | $1,291,414 | $1,259,919 | $1,237,189 | $1,321,834 | $1,226,377 |

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| Loans and loans held for sale (c) | | | | | | | |
| Earning assets | 1,625,591 | 1,623,748 | 1,639,257 | 1,615,833 | 1,634,955 | 1,624,676 | 1,620,290 |
| Total assets | 1,703,722 | 1,703,047 | 1,727,616 | 1,707,111 | 1,723,664 | 1,703,386 | 1,709,014 |
| Deposits | 1,495,410 | 1,488,708 | 1,516,390 | 1,512,685 | 1,532,819 | 1,492,076 | 1,514,374 |
| Total equity | 151,216 | 150,495 | 154,767 | 153,244 | 150,155 | 150,857 | 148,408 |
| Tangible equity (a) | 127,591 | 126,665 | 130,759 | 129,024 | 125,720 | 127,130 | 123,864 |
| | | | | | | | |
| ASSET QUALITY | | | | | | | |
| Net charge-offs | $4,107 | $480 | $805 | $699 | $277 | $4,587 | $610 |

45

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| Non-performing loans (d) | 12,790 | 17,280 | 17,324 | 14,028 | 15,208 | 12,790 | 15,208 |
| Non-performing assets (e) | 13,676 | 19,113 | 19,264 | 14,216 | 15,545 | 13,676 | 15,545 |
| Allowance for loan losses | 19,645 | 21,390 | 21,161 | 15,694 | 15,104 | 19,645 | 15,104 |
| | | | | | | | |
| Annualized net charge-offs to average loans | 1.24% | 0.15% | 0.25% | 0.22% | 0.10% | 0.70% | 0.10% |
| Non-performing loans to total loans | 0.96% | 1.31% | 1.32% | 1.09% | 1.21% | 0.96% | 1.21% |
| Non-performing assets to total assets | 0.80% | 1.12% | 1.13% | 0.82% | 0.90% | 0.80% | 0.90% |
| Allowance for loan losses to total loans | 1.47% | 1.62% | 1.61% | 1.22% | 1.21% | 1.47% | 1.21% |
| Allowance for loan losses to non-performing loans | 153.60% | 123.78% | 122.15% | 111.88% | 99.32% | 153.60% | 99.32% |

(a) See the GAAP to Non-GAAP reconciliations.
(b) Efficiency ratio is non-interest expense less merger and acquisition expenses less amortization of intangible assets less legal reserve divided by the total of fully taxable equivalent net interest income plus non-interest income less net gains on securities transactions.
(c) Loans and loans held for sale do not reflect the allowance for loan losses.
(d) Non-performing loans include non-accrual loans only.
(e) Non-performing assets include non-performing loans plus other real estate owned.

In addition to analyzing the Corporation's results on a reported basis, management uses certain non-GAAP financial measures because it believes these non-GAAP financial measures provide information to investors about the underlying operational performance and trends of the Corporation and, therefore, facilitate a comparison of the Corporation with the performance of its competitors. Non-GAAP financial measures used by the Corporation may not be comparable to similarly named non-GAAP financial measures used by other companies. Refer to pages 70-73 for further explanation and reconciliation of the Corporation's use of non-GAAP measures.

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-Q. For a complete description of the trends and uncertainties, as well as the risks and critical accounting estimates affecting the Corporation, this Form 10-Q should be read in its entirety.

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):

| | Three Months Ended June 30, | | | |
|---|---|---|---|---|
| | 2018 | 2017 | Change | Percentage Change |
| Net interest income | $15,017 | $13,950 | $1,067 | 7.6 % |
| Non-interest income | 5,325 | 5,022 | 303 | 6.0 % |
| Non-interest expense | 14,967 | 14,332 | 635 | 4.4 % |
| Pre-provision income | 5,375 | 4,640 | 735 | 15.8 % |
| Provision for loan losses | 2,362 | 421 | 1,941 | 461.0 % |
| Income tax expense | 486 | 1,263 | (777 ) | (61.5 )% |
| Net income | $2,527 | $2,956 | $(429 ) | (14.5 )% |
| | | | | |
| Basic and diluted earnings per share | $0.52 | $0.62 | $(0.10 ) | (16.1 )% |
| | | | | |
| Selected financial ratios: | | | | |
| Return on average assets | 0.59 % | 0.69 % | | |

| | | | | |
|---|---|---|---|---|
| Return on average equity | 6.70 | % | 7.90 | % |
| Net interest margin, fully taxable equivalent | 3.73 | % | 3.47 | % |
| Efficiency ratio | 67.47 | % | 69.28 | % |
| Non-interest expenses to average assets | 3.52 | % | 3.34 | % |

Net income for the second quarter of 2018 was $2.5 million, or $0.52 per share, compared with $3.0 million, or $0.62 per share, for the same period in the prior year. Return on average equity for the quarter was 6.70%, compared with 7.90% for the prior year quarter. The decrease in net income was driven by increases in non-interest expense and provision for loan losses, partially offset by increases in net interest income and non-interest income and a decrease in income tax expense.

Net interest income
Net interest income increased $1.1 million, or 7.6%, compared with the same period in the prior year. The increase was due primarily to increases in interest income from the commercial and indirect consumer loan portfolios and a decrease in interest expense on securities sold under agreements to repurchase, partially offset by decreases in interest income from taxable securities and interest-earning deposits and an increase in interest expense on deposits and borrowed funds.

Non-interest income
Non-interest income increased $0.3 million, or 6.0%, compared with the same period in the prior year. The increase was due primarily to increases in WMG fee income and other non-interest income.

Non-interest expense
Non-interest expense increased $0.6 million, or 4.4%, compared with the same period in the prior year. The increase was due primarily to increases in salaries and wages, data processing expenses, legal accruals and settlements, marketing and advertising expenses, other real estate owned expenses, and other non-interest expenses. For the three months ended June 30, 2018, non-interest expense to average assets was 3.52%, compared with 3.34% for the same period in the prior year.

Provision for loan losses
The provision for loan losses increased $1.9 million, or 461.0%, compared to the same period in the prior year. The increase was due primarily to an increase in the historical loss factor of the commercial and industrial loan portfolio, due to the charge-off of multiple large commercial loans to one borrower for $3.6 million during the second quarter of 2018, compared to the same period in the prior year. Net charge-offs increased $3.8 million, compared with the same period in the prior year, mostly due to the previously mentioned charge-off of multiple loans to one borrower.

Income tax expense
Income tax expense decreased $0.8 million, or 61.5%, compared to the same period in the prior year. The decrease was due primarily to the decline in the Federal income tax rate from 34% to 21%, with the enactment of the Tax Act. Additionally, the Corporation increased income generated from CCTC Funding Corp., a real estate investment trust subsidiary of the Bank, reducing the Corporation’s state income tax. Finally, the Corporation recognized a $1.2 million decline in income before income tax expense for the quarter, when compared to the same period in the prior year.

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):

| | Six Months Ended June 30, | | | |
|---|---|---|---|---|
| | 2018 | 2017 | Change | Percentage Change |
| Net interest income | $29,917 | $27,444 | $2,473 | 9.0 % |
| Non-interest income | 10,800 | 9,869 | 931 | 9.4 % |
| Non-interest expense | 29,133 | 27,377 | 1,756 | 6.4 % |
| Pre-provision income | 11,584 | 9,936 | 1,648 | 16.6 % |
| Provision for loan losses | 3,071 | 1,461 | 1,610 | 110.2 % |
| Income tax expense | 1,547 | 2,540 | (993 ) | (39.1 )% |
| Net income | $6,966 | $5,935 | $1,031 | 17.4 % |
| | | | | |
| Basic and diluted earnings per share | $1.44 | $1.24 | $0.20 | 16.1 % |
| | | | | |
| Selected financial ratios: | | | | |
| Return on average assets | 0.82 % | 0.70 % | | |
| Return on average equity | 9.31 % | 8.06 % | | |
| Net interest margin, fully taxable equivalent | 3.74 % | 3.46 % | | |
| Efficiency ratio | 67.84 % | 69.27 % | | |
| Non-interest expense to average assets | 3.45 % | 3.23 % | | |

Net income for the six months ended June 30, 2018 was $7.0 million, or $1.44 per share, compared with $5.9 million, or $1.24 per share, for the same period in the prior year. Return on average equity for the six months ended June 30, 2018 was 9.31%, compared with 8.06% for the same period in the prior year. The increase in net income from the prior year period 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 provision for loan losses.

Net interest income

Net interest income increased $2.5 million, or 9.0%, compared with the same period in the prior year. The increase was due primarily to increases in interest income from the commercial and indirect consumer loan portfolios and tax exempt securities and a decrease in interest expense on securities sold under agreements to repurchase, partially offset by decreases in interest income from taxable securities and interest-earning deposits and an increase in interest expense on deposits and borrowed funds.

Non-interest income

Non-interest income increased $0.9 million, or 9.4%, compared to the same period in the prior year. The increase was due primarily to increases in WMG fee income, interchange revenue from debit card transactions, and other non-interest income.

Non-interest expense

Non-interest expense increased $1.8 million, or 6.4%, compared to the same period in the prior year. The increase was due primarily to increases in salaries and wages, data processing expenses, professional services, marketing and advertising expenses, other real estate owned expenses, and other non-interest expenses, partially offset by decreases in furniture and equipment expenses and an increased credit in other components of net periodic pension benefits. For the six months ended June 30, 2018, non-interest expense to average assets was 3.45%, compared with 3.23% for the same period in the prior year.

Provision for loan losses

The provision for loan losses increased $1.6 million, or 110.2%, compared to the same period in the prior year. The increase was due primarily to an increase in the historical loss factor of the commercial and industrial loan portfolio, due to the charge-off of multiple large commercial loans to one borrower for $3.6 million during the first six months of 2018, compared to the same period in the prior year. Net charge-offs increased $4.0 million, compared with the same period in the prior year, mostly due to the previously mentioned charge-off of multiple loans to one borrower.

Income tax expense
Income tax expensed decreased $1.0 million, or 39.1%, compared to the same period in the prior year. The decrease was due primarily to the decline in the Federal income tax rate from 34% to 21%, with the enactment of the Tax Act. Additionally, the Corporation increased income generated from CCTC Funding Corp., a real estate investment trust subsidiary of the Bank, reducing the Corporation's state income tax.

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 three and six months ended June 30, 2018 and 2017. For a discussion of the Critical Accounting Policies, Estimates and Risks and Uncertainties that affect the Consolidated Results of Operations, see page 70 of this Form 10-Q and page 60 of the Corporation's 2017 Form 10-K.

Net Interest Income

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

| | Three Months Ended June 30, | | | |
|---|---|---|---|---|
| | 2018 | 2017 | Change | Percentage Change |
| Interest and dividend income | $15,869 | $14,684 | $1,185 | 8.1 % |
| Interest expense | 852 | 734 | 118 | 16.1 % |
| Net interest income | $15,017 | $13,950 | $1,067 | 7.6 % |

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 paid on interest-bearing liabilities such as deposits and borrowings, is the largest contributor to the Corporation's earnings.

Net interest income for the three months ended June 30, 2018 totaled $15.0 million compared with $14.0 million for the same period in the prior year, an increase of $1.1 million, or 7.6%. Interest and fees from loans increased $1.5 million, while interest from investments, including interest-earning deposits, decreased $0.3 million in the second quarter of 2018 as compared to the same period in the prior year. Interest expense on deposits and borrowed funds both increased $0.1 million, while interest expense on securities sold under agreements to repurchase decreased $0.1 million in the second quarter of 2018 when compared to the same period in the prior year. Fully taxable equivalent net interest margin was 3.73% for the three months ended June 30, 2018 compared with 3.47% for the same period in the prior year. Average interest-earning assets decreased $9.4 million in the second quarter of 2018, compared to the same period in the prior year due primarily to a decrease in the average balances of interest-earning deposits and taxable securities. The average yield on interest-earning assets increased 29 basis points, while the average cost of interest-bearing liabilities increased six basis points in the second quarter of 2018, compared to the same period in the prior year. The increase in the average yield on interest-earning assets can be mostly attributed to a 23 basis points increase in the average yield on commercial loans, due to an increase in PRIME and LIBOR, and a $75.9 million increase in the average balance of commercial loans, compared to the same period in the prior year. The increase in the average cost of interest-bearing liabilities can be attributed to a 14 basis points increase in the average cost of time deposits and a $14.2 million increase in the average balance of FHLB advances and repos, offset by a 41 basis points decline in the average cost of FHLB advances and repos due to the maturity of one $4.0 million FHLB advance (3.90% rate) in October 2017, one $2.0 million FHLB term advance (3.05%) in January 2018, and one $10.0 million repurchase agreement (3.72% rate) in May 2018.

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

| | Six Months Ended June 30, | | | |
|---|---|---|---|---|
| | 2018 | 2017 | Change | Percentage Change |
| Interest and dividend income | $31,538 | $28,998 | $2,540 | 8.8 % |
| Interest expense | 1,621 | 1,554 | 67 | 4.3 % |
| Net interest income | $29,917 | $27,444 | $2,473 | 9.0 % |

Net interest income for the six months ended June 30, 2018 totaled $29.9 million compared with $27.4 million for the same period in the prior year, an increase of $2.5 million, or 9.0%. Interest and fees from loans increased $3.0 million, while interest from investments, including interest-earning deposits, decreased $0.5 million for the six months ended June 30, 2018 as compared to the same period in the prior year. Interest expense on borrowed funds increased $0.2 million, while interest expense on securities sold under agreements to repurchase decreased $0.2 million for the six months ended June 30, 2018 as compared to the same period in the prior year. Fully taxable equivalent net interest margin was 3.74% for the six months ended June 30, 2018 compared with 3.46% for the same period in the prior year. Average interest-earning assets increased $4.4 million for the six months ended June 30, 2018 as compared to the same period in the prior year due primarily to an increase in the average balance of commercial and consumer loans and tax-exempt securities. The average yield on interest-earning assets increased 29 basis points, while the average cost of interest-bearing liabilities increased two basis points for the six months ended June 30, 2018 as compared to the same period in the prior year. The increase in the average yield on interest-earning assets can be mostly attributed to a 24 basis points increase in the average yield on commercial loans, due to an increase in PRIME and LIBOR, and a $79.7 million increase in the average balance of commercial loans, compared to the same period in the prior year. The increase in the average cost of interest-bearing liabilities can be attributed to a two basis points increase in the average cost of savings and money market accounts, a five basis points increase in the average cost of time deposits and a $12.6 million increase in the average balance of FHLB advances and repos, offset by a 63 basis points decline in the average cost of FHLB advances and repos due to the maturity of one $4.0 million FHLB term advance (3.90% rate) in October 2017, one $3.0 million FHLB term advance (2.91% rate) in December 2017, one $2.0 million FHLB term advance (3.05% rate) in January 2018, and one $10.0 million repurchase agreement (3.72% rate) in May 2018.

Average Consolidated Balance Sheet and Interest Analysis

The following tables present certain information related to the Corporation's average consolidated balance sheets and its consolidated statements of income for the three and six months ended June 30, 2018 and 2017. For the purpose of the tables 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.

AVERAGE CONSOLIDATED BALANCE SHEETS AND NET INTEREST INCOME ANALYSIS

| (in thousands) | Three Months Ended June 30, 2018 | | | Three Months Ended June 30, 2017 | | |
|---|---|---|---|---|---|---|
| | Average Balance | Interest | Yield/Rate | Average Balance | Interest | Yield/Rate |
| Interest-earning assets: | | | | | | |
| Commercial loans | $855,121 | $9,663 | 4.53 % | $779,218 | $8,357 | 4.30 % |
| Mortgage loans | 194,244 | 1,800 | 3.72 % | 201,093 | 1,867 | 3.72 % |
| Consumer loans | 279,021 | 2,873 | 4.13 % | 256,878 | 2,658 | 4.15 % |
| Taxable securities | 240,800 | 1,266 | 2.11 % | 275,275 | 1,400 | 2.04 % |
| Tax-exempt securities | 52,527 | 363 | 2.77 % | 51,027 | 401 | 3.15 % |
| Interest-earning deposits | 3,878 | 10 | 1.03 % | 71,464 | 193 | 1.08 % |
| Total interest-earning assets | 1,625,591 | 15,975 | 3.94 % | 1,634,955 | 14,876 | 3.65 % |
| | | | | | | |
| Non-earning assets: | | | | | | |
| Cash and due from banks | 27,130 | | | 24,446 | | |
| Premises and equipment, net | 26,287 | | | 28,205 | | |
| Other assets | 56,002 | | | 54,033 | | |
| Allowance for loan losses | (21,218) | | | (15,060) | | |
| AFS valuation allowance | (10,070) | | | (2,915) | | |
| Total assets | $1,703,722 | | | $1,723,664 | | |
| | | | | | | |
| Interest-bearing liabilities: | | | | | | |
| Interest-bearing demand deposits | $131,863 | $28 | 0.09 % | $142,892 | $33 | 0.09 % |
| Savings and insured money market deposits | 774,020 | 419 | 0.22 % | 822,989 | 394 | 0.19 % |
| Time deposits | 130,432 | 161 | 0.50 % | 137,502 | 122 | 0.36 % |
| FHLBNY advances, securities sold under agreements to repurchase, and other debt | 40,557 | 244 | 2.41 % | 26,341 | 185 | 2.82 % |
| Total interest-bearing liabilities | 1,076,872 | 852 | 0.32 % | 1,129,724 | 734 | 0.26 % |
| | | | | | | |
| Non-interest-bearing liabilities: | | | | | | |
| Demand deposits | 459,095 | | | 429,436 | | |
| Other liabilities | 16,539 | | | 14,349 | | |
| Total liabilities | 1,552,506 | | | 1,573,509 | | |
| Shareholders' equity | 151,216 | | | 150,155 | | |
| Total liabilities and shareholders’ equity | $1,703,722 | | | $1,723,664 | | |
| Fully taxable equivalent net interest income | | 15,123 | | | 14,142 | |
| Net interest rate spread (1) | | | 3.62 % | | | 3.39 % |
| Net interest margin, fully taxable equivalent (2) | | | 3.73 % | | | 3.47 % |
| Taxable equivalent adjustment | | (106) | | | (192) | |
| Net interest income | | $15,017 | | | $13,950 | |

(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.

AVERAGE CONSOLIDATED BALANCE SHEETS AND NET INTEREST INCOME ANALYSIS

| (in thousands) | Six Months Ended June 30, 2018 | | | Six Months Ended June 30, 2017 | | |
|---|---|---|---|---|---|---|
| | Average Balance | Interest | Yield/ Rate | Average Balance | Interest | Yield/ Rate |
| Interest-earning assets: | | | | | | |
| Commercial loans | $849,927 | $19,096 | 4.53% | $770,267 | $16,387 | 4.29% |
| Mortgage loans | 194,579 | 3,610 | 3.74% | 199,740 | 3,754 | 3.79% |
| Consumer loans | 277,328 | 5,717 | 4.16% | 256,370 | 5,300 | 4.17% |
| Taxable securities | 245,382 | 2,557 | 2.10% | 273,935 | 2,823 | 2.08% |
| Tax-exempt securities | 53,570 | 742 | 2.79% | 47,910 | 747 | 3.14% |
| Interest-bearing deposits | 3,890 | 32 | 1.66% | 72,068 | 348 | 0.97% |
| Total interest-earning assets | 1,624,676 | 31,754 | 3.94% | 1,620,290 | 29,359 | 3.65% |
| | | | | | | |
| Non-earning assets: | | | | | | |
| Cash and due from banks | 27,191 | | | 25,161 | | |
| Premises and equipment, net | 26,415 | | | 28,429 | | |
| Other assets | 54,882 | | | 53,994 | | |
| Allowance for loan losses | (21,236) | | | (14,706) | | |
| AFS valuation allowance | (8,542) | | | (4,154) | | |
| Total assets | $1,703,386 | | | $1,709,014 | | |
| | | | | | | |
| Interest-bearing liabilities: | | | | | | |
| Interest-bearing demand deposits | $141,632 | $63 | 0.09% | $147,895 | $67 | 0.09% |
| Savings and insured money market deposits | 772,019 | 793 | 0.21% | 803,269 | 771 | 0.19% |
| Time deposits | 123,813 | 253 | 0.41% | 139,366 | 250 | 0.36% |
| FHLBNY advances, securities sold under agreements to repurchase, and other debt | 44,616 | 512 | 2.31% | 31,973 | 466 | 2.94% |
| Total interest-bearing liabilities | 1,082,080 | 1,621 | 0.30% | 1,122,503 | 1,554 | 0.28% |
| | | | | | | |
| Non-interest-bearing liabilities: | | | | | | |
| Demand deposits | 454,612 | | | 423,844 | | |
| Other liabilities | 15,837 | | | 14,259 | | |
| Total liabilities | 1,552,529 | | | 1,560,606 | | |
| Shareholders' equity | 150,857 | | | 148,408 | | |
| Total liabilities and shareholders’ equity | $1,703,386 | | | $1,709,014 | | |
| Fully taxable equivalent net interest income | | 30,133 | | | 27,805 | |
| Net interest rate spread (1) | | | 3.64% | | | 3.37% |
| Net interest margin, fully taxable equivalent (2) | | | 3.74% | | | 3.46% |
| Taxable equivalent adjustment | | (216) | | | (361) | |
| Net interest income | | $29,917 | | | $27,444 | |

(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.

Changes Due to Rate and Volume

Net interest income can be analyzed in terms of the impact of changes in rates and volumes. The tables below illustrate the extent to which changes in interest rates and the volume of average interest-earning assets and interest-bearing liabilities have affected the Corporation's interest income and interest expense during the three and six months ended June 30, 2018 and 2017. 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 these tables, 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 periods 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

| | Three Months Ended June 30, 2018 vs. 2017 Increase/(Decrease) | | |
|---|---|---|---|
| (in thousands) | Total Change | Due to Volume | Due to Rate |
| Interest and dividend income on: | | | |
| Commercial loans | $1,306 | $ 843 | $463 |
| Mortgage loans | (67) | (67) | — |
| Consumer loans | 215 | 228 | (13) |
| Taxable investment securities | (134) | (180) | 46 |
| Tax-exempt investment securities | (38) | 12 | (50) |
| Interest-earning deposits | (183) | (174) | (9) |
| Total interest and dividend income, fully taxable equivalent | 1,099 | 662 | 437 |
| | | | |
| Interest expense on: | | | |
| Interest-bearing demand deposits | (5) | (5) | — |
| Savings and insured money market deposits | 25 | (27) | 52 |
| Time deposits | 39 | (6) | 45 |
| FHLBNY advances, securities sold under agreements to repurchase and other debt | 59 | 89 | (30) |
| Total interest expense | 118 | 51 | 67 |
| Net interest income, fully taxable equivalent | $981 | $ 611 | $370 |

| (in thousands) | Six Months Ended June 30, 2018 vs. 2017 Increase/(Decrease) Total Change | Due to Volume | Due to Rate |
|---|---|---|---|
| Interest and dividend income on: | | | |
| Commercial loans | $2,709 | $1,758 | $951 |
| Mortgage loans | (144) | (95) | (49) |
| Consumer loans | 417 | 430 | (13) |
| Taxable investment securities | (266) | (293) | 27 |
| Tax-exempt investment securities | (5) | 83 | (88) |
| Interest-earning deposits | (316) | (462) | 146 |
| Total interest and dividend income | 2,395 | 1,421 | 974 |
| Interest expense on: | | | |
| Interest-bearing demand deposits | (4) | (4) | — |
| Savings and insured money market deposits | 22 | (37) | 59 |
| Time deposits | 3 | (30) | 33 |
| FHLBNY advances, securities sold under agreements to repurchase and other debt | 46 | 159 | (113) |
| Total interest expense | 67 | 88 | (21) |
| Net interest income, fully taxable equivalent | $2,328 | $1,333 | $995 |

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 both the second quarter of 2018 and 2017 were $2.4 million and $0.4 million, respectively. The increase in the provision for loan losses for the three months ended June 30, 2018, compared to the same period in the prior year, can be mostly attributed to an increase in the historical loss factor of the commercial and industrial loan portfolio, due to the charge-off of multiple large commercial loans to one borrower for $3.6 million during the second quarter of 2018 when compared to the same period in the prior year.

The provision for loan losses for the six months ended June 30, 2018 and 2017 were $3.1 million and $1.5 million, respectively. The increase in the provision for loan losses for the six months ended June 30, 2018, compared to the same period in the prior year, can be mostly attributed to an increase in the historical loss factor of the commercial and industrial loan portfolio, due to the charge-off of multiple large commercial loans to one borrower for $3.6 million during the six months ended June 30, 2018 when compared to the same period in the prior year.

Net charge-offs for the three months ended June 30, 2018 and 2017 were $4.1 million and $0.3 million, respectively. Net charge-offs for the six months ended June 30, 2018 and 2017 were $4.6 million and $0.6 million, respectively. As previously discussed, the increase in net charge offs for the three and six months ended June 30, 2018 can be attributed to the charge-off of multiple large commercial loans to one borrower for $3.6 million during the second quarter of 2018.

Non-interest income

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

| | Three Months Ended June 30, | | | |
|---|---|---|---|---|
| | 2018 | 2017 | Change | Percentage Change |
| WMG fee income | $2,373 | $2,269 | $ 104 | 4.6 % |
| Service charges on deposit accounts | 1,144 | 1,225 | (81 ) | (6.6 )% |
| Interchange revenue from debit card transactions | 996 | 964 | 32 | 3.3 % |
| Net gains on securities transactions | — | 12 | (12 ) | (100.0 )% |
| Net gains on sales of loans held for sale | 59 | 53 | 6 | 11.3 % |
| Net gains (losses) on sales of other real estate owned | (48 ) | (9 ) | (39 ) | 433.3 % |
| Income from bank owned life insurance | 17 | 18 | (1 ) | (5.6 )% |
| CFS fee and commission income | 136 | 174 | (38 ) | (21.8 )% |
| Other | 648 | 316 | 332 | 105.1 % |
| Total non-interest income | $5,325 | $5,022 | $ 303 | 6.0 % |

Total non-interest income for the second quarter of 2018 increased $0.3 million compared with the same period in the prior year. The increase was mostly due to increases in WMG fee income and other non-interest income.

WMG fee income
The increase in WMG fee income, compared to the same period in the prior year, can be mostly attributed to an increase in assets under management or administration. The market value of total assets under management or administration in WMG was $1.894 billion at June 30, 2018, including $289.7 million of assets under management or administration for the Corporation, compared to $1.826 billion at June 30, 2017, including $323.9 million of assets under management or administration for the Corporation, an increase of $68.2 million, or 3.7%.

Other
The increase in other non-interest income, compared to the same period in the prior year, can be mostly attributed to an increase in swap fee income and other real estate owned rental income.

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

| | Six Months Ended June 30, | | | |
|---|---|---|---|---|
| | 2018 | 2017 | Change | Percentage Change |
| WMG fee income | $4,689 | $4,378 | $ 311 | 7.1 % |
| Service charges on deposit accounts | 2,308 | 2,409 | (101 ) | (4.2 )% |
| Interchange revenue from debit card transactions | 2,031 | 1,884 | 147 | 7.8 % |
| Net gains on securities transactions | — | 12 | (12 ) | (100.0 )% |
| Net gains on sales of loans held for sale | 105 | 122 | (17 ) | (13.9 )% |
| Net gains (losses) on sales of other real estate owned | (4 ) | 8 | (12 ) | (150.0 )% |
| Income from bank owned life insurance | 33 | 35 | (2 ) | (5.7 )% |
| CFS fee and commission income | 246 | 313 | (67 ) | (21.4 )% |

| | | | | |
|---|---|---|---|---|
| Other | 1,392 | 708 | 684 | 96.6 % |
| Total non-interest income | $10,800 | $9,869 | $931 | 9.4 % |

Total non-interest income for the six months ended June 30, 2018 increased $0.9 million compared with the same period in the prior year. The increase was mostly due to increases in WMG fee income, interchange revenue from debit card transactions, and other non-interest income, partially offset by a decrease in service charges on deposit accounts.

WMG fee income
The increase in WMG fee income, compared to the same period in the prior year, can be mostly attributed to an increase in assets under management or administration. The market value of total assets under management or administration in WMG was $1.894 billion at June 30, 2018, including $289.7 million of assets under management or administration for the Corporation, compared to $1.826 billion at June 30, 2017, including $323.9 million of assets under management or administration for the Corporation, an increase of $68.2 million, or 3.7%.

Service charges on deposit accounts
The decrease in service charges on deposit accounts, compared to the same period in the prior year, can be mostly attributed to a decline in overdraft fees and other service charges.

Other
The increase in other non-interest income, compared to the same period in the prior year, can be mostly attributed to a $0.4 million New York State sales tax refund received during the first quarter of 2018 and increases in swap fee income and other real estate owned rental income.

Non-interest expense

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

| | Three Months Ended June 30, | | | |
|---|---|---|---|---|
| | 2018 | 2017 | Change | Percentage Change |
| Compensation expense: | | | | |
| Salaries and wages | $5,564 | $5,422 | $142 | 2.6 % |
| Pension and other employee benefits | 1,518 | 1,540 | (22) | (1.4)% |
| Total compensation expense | 7,082 | 6,962 | 120 | 1.7 % |
| | | | | |
| Non-compensation expense: | | | | |
| Other components of net periodic pension and postretirement benefits | (408) | (333) | (75) | 22.5 % |
| Net occupancy expense | 1,643 | 1,702 | (59) | (3.5)% |
| Furniture and equipment expense | 702 | 781 | (79) | (10.1)% |
| Data processing expense | 1,764 | 1,587 | 177 | 11.2 % |
| Professional services | 508 | 417 | 91 | 21.8 % |
| Legal accruals and settlements | 989 | 850 | 139 | 16.4 % |
| Amortization of intangible assets | 182 | 213 | (31) | (14.6)% |
| Marketing and advertising expense | 255 | 118 | 137 | 116.1 % |
| Other real estate owned expense | 100 | 11 | 89 | 809.1 % |
| FDIC insurance | 301 | 309 | (8) | (2.6)% |
| Loan expense | 184 | 166 | 18 | 10.8 % |
| Other | 1,665 | 1,549 | 116 | 7.5 % |
| Total non-compensation expense | 7,885 | 7,370 | 515 | 7.0 % |
| Total non-interest expense | $14,967 | $14,332 | $635 | 4.4 % |

Total non-interest expense for the second quarter of 2018 increased $0.6 million compared with the same period in the prior year. The increase was due to increases in compensation expense and non-compensation expense.

Compensation expense

The increase in compensation expense, compared to the same period in the prior year, can be mostly attributable to an increase in salaries and wages. The increase in salaries and wages can be attributed to annual merit increases and an increase in the number of employees associated with two denovo branches opened in 2018, compared to the same period in the prior year. The Bank opened one denovo branch in Schenectady, New York in January 2018 and one denovo branch in Wilton, New York in May 2018.

Non-compensation expense
The increase in non-compensation expense, compared to the same period in the prior year, can be mostly attributed to increases in data processing, legal accruals and settlements, marketing and advertising expenses, other real estate owned expenses, and other non-interest expenses. The increase in data processing can be attributed to the timing of projects and the addition of two new denovo branches in 2018. The increase in legal accruals and settlements can be attributed to the settlement agreement in the matter of Fane vs. Chemung Canal Trust Company (the "Action") during the second quarter of 2018. As noted within the Current Report on Form 8-K filed on June 15, 2018, the two parties agreed to release each other from any and all liabilities, claims, counterclaims, demands, charges, complaints and causes of action, to dismiss the Action with prejudice, and the Bank agreed to pay Fane $3.3 million in connection with the settlement of the Action. The increase in marketing and advertising expenses can be attributed to the promotion of two new denovo branches in 2018 and the timing of campaigns and sponsored events. The increase in other real estate owned expenses can be attributed to additional OREO properties, compared to the prior year period.

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

| | Six Months Ended June 30, | | | |
|---|---|---|---|---|
| | 2018 | 2017 | Change | Percentage Change |
| Compensation expense: | | | | |
| Salaries and wages | $11,278 | $10,697 | $581 | 5.4 % |
| Pension and other employee benefits | 3,176 | 3,091 | 85 | 2.7 % |
| Total compensation expense | 14,454 | 13,788 | 666 | 4.8 % |
| | | | | |
| Non-compensation expense: | | | | |
| Other components of net periodic pension and postretirement benefits | (816) | (666) | (150) | N/M |
| Net occupancy expense | 3,251 | 3,308 | (57) | (1.7)% |
| Furniture and equipment expense | 1,360 | 1,462 | (102) | (7.0)% |
| Data processing expense | 3,506 | 3,191 | 315 | 9.9 % |
| Professional services | 1,048 | 717 | 331 | 46.2 % |
| Legal accruals and settlements | 989 | 850 | 139 | 16.4 % |
| Amortization of intangible assets | 376 | 439 | (63) | (14.4)% |
| Marketing and advertising expense | 604 | 367 | 237 | 64.6 % |
| Other real estate owned expense | 238 | 31 | 207 | 667.7 % |
| FDIC insurance | 618 | 634 | (16) | (2.5)% |
| Loan expense | 353 | 282 | 71 | 25.2 % |
| Other | 3,152 | 2,974 | 178 | 6.0 % |
| Total non-compensation expense | 14,679 | 13,589 | 1,090 | 8.0 % |
| Total non-interest expense | $29,133 | $27,377 | $1,756 | 6.4 % |

Total non-interest expense for the six months ended June 30, 2018 increased $1.8 million compared with the same period in the prior year. The increase was due to increases in compensation expense and non-compensation expense.

Compensation expense
The increase in compensation expense, compared to the same period in the prior year, can be mostly attributable to an increase in salaries and wages. The increase in salaries and wages can be attributed to annual merit increases and an increase in the number of employees associated with two denovo branches opened in 2018, compared to the same period in the prior year. The Bank opened one denovo branch in Schenectady, New York in January 2018 and one denovo branch in Wilton, New York in May 2018.

Non-compensation expense
The increase in non-compensation expense, compared to the same period in the prior year, can be mostly attributed to increases in data processing, professional services, legal accruals and settlements, marketing and advertising expenses, other real estate owned expenses, and other non-interest expenses. The increase in data processing can be attributed to the timing of projects and the addition of two new denovo branches in 2018. The increase in legal accruals and settlements can be attributed to the settlement agreement in the matter of Fane vs. Chemung Canal Trust Company (the "Action") during the second quarter of 2018. As noted within the Current Report on Form 8-K filed on June 15, 2018, the two parties agreed to release each other from any and all liabilities, claims, counterclaims, demands, charges, complaints and causes of action, to dismiss the Action with prejudice, and the Bank agreed to pay Fane $3.3 million in connection with the settlement of the Action. The increase in marketing and advertising expenses can be attributed to the promotion of two new denovo branches in 2018 and the timing of campaigns and sponsored events. The increase in other real estate owned expenses can be attributed to additional OREO properties, compared to the prior year period.

Income tax expense

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

| | Three Months Ended June 30, | | | |
|---|---|---|---|---|
| | 2018 | 2017 | Change | Percentage Change |
| Income before income tax expense | $3,013 | $4,219 | $(1,206) | (28.6)% |
| Income tax expense | 486 | 1,263 | (777) | (61.5)% |
| Effective tax rate | 16.1 % | 29.9 % | | |

The decrease in the effective tax rate was due primarily to the decline in the Federal income tax rate from 34% to 21%, with the enactment of the Tax Act. Additionally, the Corporation increased income generated from CCTC Funding Corp., a real estate investment trust subsidiary of the Bank, reducing the Corporation’s state income tax. Finally, the Corporation recognized a $1.2 million decline in income before income tax expense for the quarter, when compared to the same period in the prior year.

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

| | Six Months Ended June 30, | | | |
|---|---|---|---|---|
| | 2018 | 2017 | Change | Percentage Change |
| Income before income tax expense | $8,513 | $8,475 | $ 38 | 0.4 % |
| Income tax expense | 1,547 | 2,540 | (993) | (39.1)% |
| Effective tax rate | 18.2 % | 30.0 % | | |

The decrease in the effective tax rate was due primarily to the decline in the Federal income tax rate from 34% to 21%, with the enactment of the Tax Act. Additionally, the Corporation increased income generated from CCTC Funding Corp., a real estate investment trust subsidiary of the Bank, reducing the Corporation’s state income tax.

Financial Condition

The following table presents selected financial information at the dates indicated, and the dollar and percent change (in thousands):

| | June 30, 2018 | December 31, 2017 | Change | Percentage Change |
|---|---|---|---|---|
| ASSETS | | | | |
| Total cash and cash equivalents | $34,815 | $30,729 | $4,086 | 13.3 % |
| Total investment securities | 274,779 | 302,656 | (27,877 ) | (9.2 )% |
| | | | | |
| Loans, net of deferred loan fees | 1,334,444 | 1,311,824 | 22,620 | 1.7 % |
| Allowance for loan losses | (19,645 ) | (21,161 ) | 1,516 | (7.2 )% |
| Loans, net | 1,314,799 | 1,290,663 | 24,136 | 1.9 % |
| | | | | |
| Goodwill and other intangible assets, net | 23,533 | 23,909 | (376 ) | (1.6 )% |
| Other assets | 62,240 | 59,663 | 2,577 | 4.3 % |
| Total assets | $1,710,166 | $1,707,620 | $2,546 | 0.1 % |
| | | | | |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | | | |
| Total deposits | $1,478,909 | $1,467,446 | $11,463 | 0.8 % |
| FHLBNY advances and other debt | 63,361 | 74,217 | (10,856 ) | (14.6 )% |
| Other liabilities | 16,116 | 16,144 | (28 ) | (0.2 )% |
| Total liabilities | 1,558,386 | 1,557,807 | 579 | — % |
| | | | | |
| Total shareholders’ equity | 151,780 | 149,813 | 1,967 | 1.3 % |
| Total liabilities and shareholders’ equity | $1,710,166 | $1,707,620 | $2,546 | 0.1 % |

Investment securities
The decrease in investment securities can be mostly attributed to pay-downs, maturities, and an increase in unrealized losses.

Loans, net
The increase in total loans can be attributed to increases of $22.4 million in commercial mortgages and $9.8 million in indirect consumer loans, partially offset by decreases of $5.5 million in commercial and agriculture loans, $1.0 million in residential mortgages, and $3.0 million in other consumer loans.

Goodwill and other intangible assets, net
The decrease in goodwill and other intangible assets, net can be attributed to the amortization of intangible assets.

Other assets
The increase in other assets can be mostly attributed to the fair market value adjustment to interest rate swaps of $1.3 million at June 30, 2018 and increases in operating prepaid assets and the net deferred tax asset as compared to December 31, 2017.

Deposits
The increase in deposits can be attributed to increases of $8.6 million in money market accounts, $3.7 million in savings deposits, and $27.7 million in time deposits, due to a rate promotion, offset by decreases of $5.4 million in non-interest-bearing demand deposits and $23.2 million in interest-bearing demand deposits.

FHLBNY advances and other debt
The decrease in FHLBNY advances and other debt can be mostly attributed to an increase in deposits and decline in securities, offset by growth in the loan portfolio.

Shareholders' equity
The increase in retained earnings of $4.5 million was due primarily to earnings of $7.0 million, offset by $2.5 million in dividends declared during the first half of 2018. The increase in accumulated other comprehensive loss of $3.8 million can be attributed to the decline in the fair market value of the securities portfolio. Also, additional-paid-in capital decreased $0.1 million and treasury stock decreased $1.3 million, due to the issuance of shares to the Corporation's employee benefit stock plans.

Assets under management or administration
The market value of total assets under management or administration in WMG was $1.894 billion at June 30, 2018, including $289.7 million of assets held under management or administration for the Corporation, compared with $1.952 billion at December 31, 2017, including $346.8 million of assets held under management or administration for the Corporation, a decrease of $57.6 million, or 3.0%. The decline in total assets under management or administration can be mostly attributed to a decrease in the Corporation's pledged securities portfolio for municipal deposits, which is held by WMG.

Securities

The Corporation's Funds Management Policy includes an investment policy that in general, requires debt securities purchased for the bond portfolio to carry a minimum agency rating of "A". After an independent credit analysis is performed, the policy also allows the Corporation to purchase local municipal obligations that are not rated. The Corporation intends to maintain a reasonable level of securities to provide adequate liquidity and in order to have securities available to pledge to secure public deposits, repurchase agreements and other types of transactions. Fluctuations in the fair value of the Corporation's securities relate primarily to changes in interest rates.

Marketable securities are classified as Available for Sale, while investments in local municipal obligations are generally classified as Held to Maturity. The composition of the available for sale segment of the securities portfolio is summarized in the table as follows (in thousands):
SECURITIES AVAILABLE FOR SALE

| | June 30, 2018 | | | | December 31, 2017 | | | |
|---|---|---|---|---|---|---|---|---|
| | Amortized Cost | Estimated Fair Value | Percent of Total Estimated Fair Value | | Amortized Cost | Estimated Fair Value | Percent of Total Estimated Fair Value | |
| Obligations of U.S. Government sponsored enterprises | $15,489 | $15,450 | 5.8 | % | $15,492 | $15,491 | 5.3 | % |
| Mortgage-backed securities, residential and collateralized mortgage obligations | 207,708 | 198,640 | 74.9 | % | 224,939 | 219,909 | 75.0 | % |
| Obligations of states and political subdivisions | 47,574 | 47,029 | 17.8 | % | 52,928 | 53,132 | 18.1 | % |
| Other securities | 4,081 | 4,038 | 1.5 | % | 4,588 | 4,559 | 1.6 | % |
| Total | $274,852 | $265,157 | 100.0 | % | $297,947 | $293,091 | 100.0 | % |

The available for sale segment of the securities portfolio totaled $265.2 million at June 30, 2018, a decrease of $27.9 million, or 9.5%, from $293.1 million at December 31, 2017. The decrease can be mostly attributed to pay-downs, maturities, and an increase in unrealized losses.

The held to maturity segment of the securities portfolio consists of obligations of political subdivisions in the Corporation's market areas and certificates of deposit. These securities totaled $3.8 million at June 30, 2018, flat compared to December 31, 2017.

Loans

The Corporation has reporting systems to monitor: (i) loan origination and concentrations, (ii) delinquent loans, (iii) non-performing assets, including non-performing loans, troubled debt restructurings, and other real estate owned, (iv) impaired loans, and (v) potential problem loans.  Management reviews these systems on a regular basis.

The table below presents the Corporation's loan composition by segment at the dates indicated, and the dollar and percent change from December 31, 2017 to June 30, 2018 (in thousands):

LOANS

| | June 30, 2018 | December 31, 2017 | Dollar Change | Percentage Change |
|---|---|---|---|---|
| Commercial and agricultural | $193,516 | $199,007 | $(5,491) | (2.8)% |
| Commercial mortgages | 666,693 | 644,330 | 22,363 | 3.5 % |
| Residential mortgages | 193,423 | 194,440 | (1,017) | (0.5)% |
| Indirect consumer loans | 162,813 | 153,060 | 9,753 | 6.4 % |
| Other consumer loans | 117,999 | 120,987 | (2,988) | (2.5)% |
| Total loans, net of deferred loan fees | $1,334,444 | $1,311,824 | $22,620 | 1.7 % |

Portfolio loans totaled $1.334 billion at June 30, 2018, an increase of $22.6 million, or 1.7%, from $1.312 billion at December 31, 2017. The increase in loans can be attributed to increases of $22.4 million in commercial mortgages and $9.8 million in indirect consumer loans, offset by decreases of $5.5 million in commercial and agricultural loans, $1.0 million in residential mortgages, and $3.0 million in other consumer loans. The growth in commercial mortgages was due primarily to an increase in the Capital Bank division in the Albany, New York region. The decline in commercial and agricultural loans can be mostly attributable to the charge-off of multiple large commercial loans to one borrower for $3.6 million during the second quarter of 2018.

Residential mortgage loans totaled $193.4 million at June 30, 2018, a decrease of $1.0 million, or 0.5%, from December 31, 2017. During the six months ended June 30, 2018, $5.0 million of newly originated residential mortgages were sold in the secondary market to Freddie Mac and $0.2 million of residential mortgages were sold to the State of New York Mortgage Agency.

The Corporation anticipates that future growth in portfolio loans will continue to be in commercial mortgages and commercial and industrial loans, especially within the Capital Bank division of the Bank. The table below presents the Corporation's outstanding loan balance by bank division (in thousands):

LOANS BY DIVISION

| | June 30, 2018 | December 31, 2017 | December 31, 2016 | December 31, 2015 | December 31, 2014 |
|---|---|---|---|---|---|
| Chemung Canal Trust Company* | $624,177 | $ 630,732 | $ 636,836 | $ 683,137 | $ 724,099 |
| Capital Bank Division | 710,267 | 681,092 | 563,454 | 485,496 | 397,475 |
| Total loans | $1,334,444 | $ 1,311,824 | $ 1,200,290 | $ 1,168,633 | $ 1,121,574 |

* All loans, excluding those originated by the Capital Bank division.

Loan concentrations are considered to exist when there are amounts loaned to a multiple number of borrowers engaged in similar activities which would cause them to be similarly impacted by economic or other conditions. Specific industries are identified using NAICS codes. The Corporation monitors specific NAICS industry classifications of commercial loans to identify concentrations greater than 10.0% of total loans. At June 30, 2018 and December 31, 2017, commercial loans to borrowers involved in the real estate, and real estate rental and lending businesses were 45.4% and 48.1% of total loans, respectively. No other concentration of loans existed in the commercial loan portfolio in excess of 10.0% of total loans as of June 30, 2018 and December 31, 2017.

Non-Performing Assets

Non-performing assets consist of non-accrual loans, non-accrual troubled debt restructurings and other real estate owned that has been acquired in partial or full satisfaction of loan obligations or upon foreclosure.

61

Past due status on all loans is based on the contractual terms of the loan. It is generally the Corporation's policy that a loan 90 days past due be placed in non-accrual status unless factors exist that would eliminate the need to place a loan in this status. A loan may also be designated as non-accrual at any time if payment of principal or interest in full is not expected due to deterioration in the financial condition of the borrower. At the time loans are placed in non-accrual status, the accrual of interest is discontinued and previously accrued interest is reversed. All payments received on non-accrual loans are applied to principal. Loans are considered for return to accrual status when they become current as to principal and interest and remain current for a period of six consecutive months or when, in the opinion of management, the Corporation expects to receive all of its original principal and interest. In the case of non-accrual loans where a portion of the loan has been charged off, the remaining balance is kept in non-accrual status until the entire principal balance has been recovered.

The following table summarizes the Corporation's non-performing assets, excluding acquired PCI loans (in thousands):
NON-PERFORMING ASSETS

| | June 30, 2018 | | December 31, 2017 | |
|---|---|---|---|---|
| Non-accrual loans | $7,076 | | $11,389 | |
| Non-accrual troubled debt restructurings | 5,714 | | 5,935 | |
| Total non-performing loans | 12,790 | | 17,324 | |
| Other real estate owned | 886 | | 1,940 | |
| Total non-performing assets | $13,676 | | $19,264 | |
| | | | | |
| Ratio of non-performing loans to total loans | 0.96 | % | 1.32 | % |
| Ratio of non-performing assets to total assets | 0.80 | % | 1.13 | % |
| Ratio of allowance for loan losses to non-performing loans | 153.60 | % | 122.14 | % |
| | | | | |
| Accruing loans past due 90 days or more (1) | $17 | | $29 | |
| Accruing troubled debt restructurings (1) | 1,360 | | 1,728 | |

(1) These loans are not included in non-performing assets above.

Non-Performing Loans

Non-performing loans totaled $12.8 million at June 30, 2018, or 0.96% of total loans, compared with $17.3 million at December 31, 2017, or 1.32% of total loans. Non-performing assets, which are comprised of non-performing loans and other real estate owned, was $13.7 million, or 0.80% of total assets, at June 30, 2018, compared with $19.3 million, or 1.13% of total assets, at December 31, 2017. The decline in non-performing assets can be mostly attributed to the charge-off of multiple large commercial loans to one borrower for $3.6 million and the sale of one other real estate owned property during the second quarter of 2018.

Not included in non-performing loan totals are $0.8 million of acquired loans that the Corporation has identified as PCI loans as of December 31, 2017. The PCI loans are accounted for under separate accounting guidance, Accounting Standards Codification (“ASC”) Subtopic 310-30, “Receivables - Loans and Debt Securities Acquired with Deteriorated Credit Quality” as disclosed in Note 4 of the financial statements. There were no PCI loans as of June 30, 2018.

Accruing Loans Past due 90 Days or More

The recorded investment in accruing loans past due 90 days or more totaled $17 thousand at June 30, 2018, a decrease of $12 thousand from December 31, 2017.

Troubled Debt Restructurings

The Corporation works closely with borrowers that have financial difficulties to identify viable solutions that minimize the potential for loss.  In that regard, the Corporation modified the terms of select loans to maximize their collectability.  The modified loans are considered TDRs under current accounting guidance.  Modifications generally involve short-term deferrals of principal and/or interest payments, reductions of scheduled payment amounts, interest rates or principal of the loan, and forgiveness of accrued interest.  As of June 30, 2018, the Corporation had $5.7 million of non-accrual TDRs compared with $5.9 million as of December 31, 2017.  As of June 30, 2018, the Corporation had $1.4 million of accruing TDRs compared with $1.7 million as of December 31, 2017.

Impaired Loans

A loan is classified as impaired when, based on current information and events, it is probable that the Corporation will be unable to collect both the principal and interest due under the contractual terms of the loan agreement. Impaired loans at June 30, 2018 totaled $9.4 million, including TDRs of $7.1 million, compared to $14.1 million, including TDRs of $7.7 million, at December 31, 2017. Not included in the impaired loan totals are acquired loans which the Corporation has identified as PCI loans, as these loans are accounted for under ASC Subtopic 310-30 as noted under the above discussion of non-performing loans. The decrease in impaired loans was due primarily to a decrease in impaired commercial and industrial loans, mostly due to the charge-off of multiple large commercial loans to one borrower for $3.6 million during the second quarter of 2018. Included in the recorded investment of impaired loans at June 30, 2018, are loans totaling $3.5 million for which impairment allowances of $1.7 million have been specifically allocated to the allowance for loan losses. As of December 31, 2017, the impaired loan total included $8.1 million of loans for which specific impairment allowances of $5.9 million were allocated to the allowance for loan losses. The decrease in impaired loans can be mostly attributed to the charge-off of multiple large commercial loans to one borrower for $3.6 million during the second quarter of 2018.

The majority of the Corporation's impaired loans are secured and measured for impairment based on collateral evaluations. It is the Corporation's policy to obtain updated appraisals, by independent third parties, on loans secured by real estate at the time a loan is determined to be impaired. An impairment measurement is performed based upon the most recent appraisal on file to determine the amount of any specific allocation or charge-off. In determining the amount of any specific allocation or charge-off, the Corporation will make adjustments to reflect the estimated costs to sell the property. Upon receipt and review of the updated appraisal, an additional measurement is performed to determine if any adjustments are necessary to reflect the proper provisioning or charge-off. Impaired loans are reviewed on a quarterly basis to determine if any changes in credit quality or market conditions would require any additional allocation or recognition of additional charge-offs. Real estate values in the Corporation's market area have been holding steady. Non-real estate collateral may be valued using (i) an appraisal, (ii) net book value of the collateral per the borrower’s financial statements, or (iii) accounts receivable aging reports, that may be adjusted based on management’s knowledge of the client and client’s business. If market conditions warrant, future appraisals are obtained for both real estate and non-real estate collateral.

Allowance for Loan Losses

The allowance is an amount that management believes will be adequate to absorb probable incurred losses on existing loans. The allowance is established based on management’s evaluation of the probable incurred losses inherent in our portfolio in accordance with GAAP, and is comprised of both specific valuation allowances and general valuation allowances.

A loan is classified as impaired when, based on current information and events, it is probable that the Corporation will be unable to collect both the principal and interest due under the contractual terms of the loan agreement. Specific valuation allowances are established based on management’s analysis of individually impaired loans. Factors considered by management in determining impairment include payment status, evaluations of the underlying collateral, expected cash flows, delinquent or unpaid property taxes, and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower’s prior payment record, and the amount of the shortfall in relation to the principal and interest owed. If a loan is determined to be impaired and is placed on non-accrual status, all future payments received are applied to principal and a portion of the allowance is allocated so that the loan is reported, net, at the present value of estimated future cash flows using the loan’s existing rate or at the fair value of collateral if repayment is expected solely from the collateral.

The general component covers non-impaired loans and is based on historical loss experience adjusted for current qualitative factors.  Loans not impaired but classified as substandard and special mention use a historical loss factor on a rolling five-year history of net losses.  For all other unclassified loans, the historical loss experience is determined by portfolio class and is based on the actual loss history experienced by the Corporation over the most recent two years.  This actual loss experience is supplemented with other qualitative factors based on the risks present for each portfolio class.  These qualitative factors include consideration of the following: (1) lending policies and procedures, including underwriting standards and collection, charge-off and recovery policies, (2) national and local economic and business conditions and developments, including the condition of various market segments, (3) loan profiles and volume of the portfolio, (4) the experience, ability, and depth of lending management and staff, (5) the volume and severity of past due, classified and watch-list loans, non-accrual loans, troubled debt restructurings, and other modifications (6) the quality of the Bank’s loan review system and the degree of oversight by the Bank’s Board of Directors, (7) collateral related issues: secured vs. unsecured, type, declining valuation environment and trend of other related factors, (8) the existence and effect of any concentrations of credit, and changes in the level of such concentrations, (9) the effect of external factors, such as competition and legal and regulatory requirements, on the level of estimated credit losses in the Bank’s current portfolio and (10) the impact of the global economy.

The allowance for loan losses is increased through a provision for loan losses charged to operations.  Loans are charged against the allowance for loan losses when management believes that the collectability of all or a portion of the principal is unlikely.  Management's evaluation of the adequacy of the allowance for loan losses is performed on a periodic basis and takes into consideration such factors as the credit risk grade assigned to the loan, historical loan loss experience and review of specific impaired loans.  While management uses available information to recognize losses on loans, future additions to the allowance may be necessary based on changes in economic conditions.  In addition, various regulatory agencies, as an integral part of their examination process, periodically review the Corporation's allowance for loan losses. Such agencies may require the Corporation to recognize additions to the allowance based on their judgments about information available to them at the time of their examination.

The allowance for loan losses was $19.6 million at June 30, 2018, down from $21.2 million at December 31, 2017.  The ratio of allowance for loan losses to total loans was 1.47% at June 30, 2018, down from 1.61% at December 31, 2017.  Net charge-offs for the six months ended June 30, 2018 and 2017 were $4.6 million and $0.6 million, respectively. The increase in net charge-offs can be mostly attributed to the charge-off of multiple large commercial loans to one borrower for $3.6 million during the second quarter of 2018.

The table below summarizes the Corporation’s loan loss experience for the six months ended June 30, 2018 and 2017 (in thousands, except ratio data):