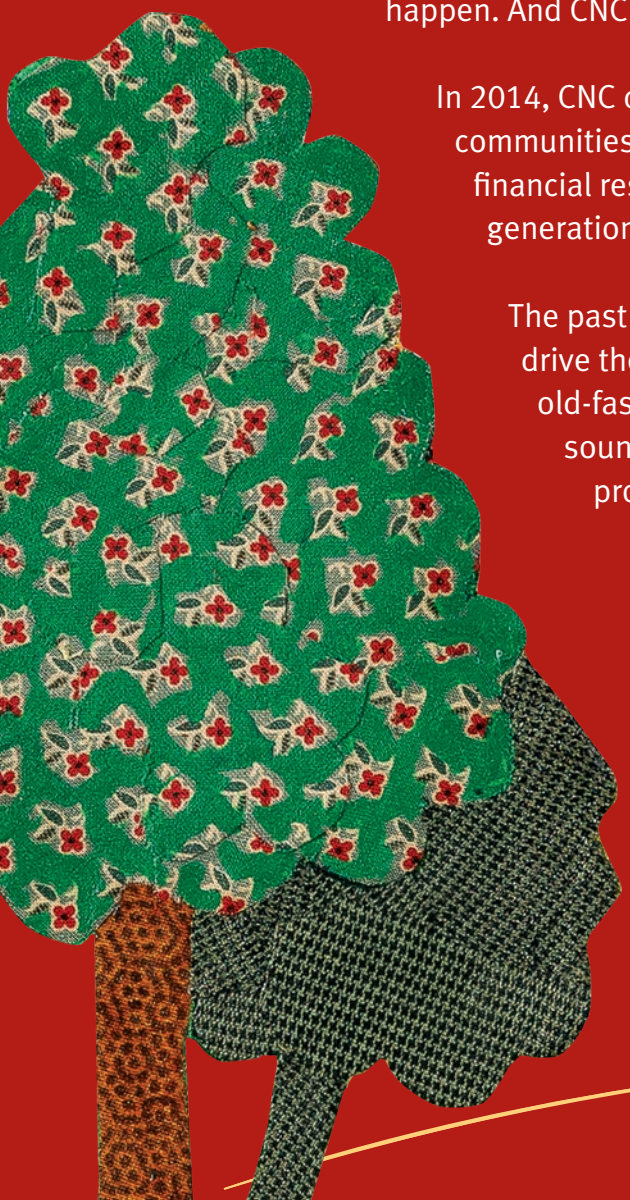
Helping to make our community greater than the sum of its parts.

"We play a crucial role in the development of the communities we serve—and are dedicated to doing so purposefully and honorably."

— Frank H. Hamlin, III, President and CEO

Dedicated to carefully cultivating the communities we serve.

Our region is a colorful canvas of smart, skilled, and talented individuals—and productive, successful, and innovative businesses. On their own, they're capable of great things. But it's when they work together that truly amazing things happen. And CNC helps complete the picture.



In 2014, CNC continued to play a key role in developing its communities—bringing individuals and businesses together with the financial resources they need to reach their goals and fuel the next generation of growth and vitality.

The past year also proved that—while technology continues to drive the evolution of banking in the information age—good, old-fashioned intermediation of deposits into loans, through sound underwriting standards, still produces predictable profits and benefits everyone.

Looking forward, shareholders can expect a solid dividend, steady returns, and effective management. Through our distinctive bank offices and innovative technologies, we'll further enhance the customer experience. And our colleagues will give back to the communities they serve, as they always have. Overall, it paints a vibrant image of the future.

MF CNB-13989/04-15

Table of Contents

CHAIRMAN'S LETTER TO SHAREHOLDERS 2014

AN OPPORTUNITY TO PAUSE AND REFLECT—THE NEW CONTEXT FOR FINANCE:

PROLOGUE:

The context for Finance in the new world was fostered by the Financial Crisis 2008-09 which transformed the status quo of the Pre-Crisis 2003-07 period of the **now global economy** to the Post 2010 period. The **growth rates of three classifications of economies** made by economists by size and type which were easily distinguishable during the recent Great Recession (GR) tell a revealing story. The Global Financial Crisis (2008-09) and resulting GR have changed global finance.

First, the *Emerging Economies* grew continuously during these three periods: 7.6% (Pre-GR), **3.0% (GR)**, and 31.0% (Post-GR). The *World Economy* "all in" suffered a slight roll back as it was 4.6% (Pre-GR), **-.2% (GR)**, and 5.0% (Post-GR). The US and the Euro Union, as *High Income-Advanced Economies,* were badly battered 4.6% (Pre-GR), **-4.0% (GR)**, and 3.0% (Post-GR). Obviously, the sheer size of the last category would be expected to take the brunt of the Great Recession and that the smaller "Emerging's" could and would react and recover more quickly. Importantly, the **dramatic resiliency** of the Emerging economies is quite telling and of significance for the future of global Finance in the coming decades.

My goal here is to touch upon a range of topics which emerged from the Crisis and which bear keeping in mind as part of the contextual fabric of our business going forward, though which to varying degrees may or may not weigh directly upon Canandaigua National Corporation's (CNC) market opportunities or significantly affect our balance sheet choices. Even if not, we may, out of an abundance of caution, want to avoid the consequences of these factors by modifying our course well in advance of them becoming directly relevant to our operations. Ultimately, I hope you will come to the conclusion that we are in a wonderful position to exploit for "fun and profit" a wide range of opportunities to serve our constituencies, and realize upon our mission to continue to build upon the number of customer relationships within our communities wherever they may be situated.

As we look back over the success of 2014 as presented by our CEO's well written annual report, it is a chance to reflect on **how last year fits into the context of the changing world of Finance** and specifically our prospects as we emerge from the Recovery from the Financial Crisis of 2008-09. As you recall, the Crisis exploded upon the world scene in March of 2008 marked by the abrupt failure of Bear-Sterns, the first of several of the iconic Investment Banking firms that would fail. Faced with pending insolvency, they were rescued by the giant bank holding company, JPMorgan-Chase (aka "the Lower Bank" in Canandaigua), followed six months later in September by the bankruptcy of the much larger investment house of Lehman Brothers and its aftermath of economic and financial chaos which now has settled out after seven years of struggle. Today, we simply observe that **there are virtually no longer any standalone investment banking firms left.** These firms ruled, indeed dominated, Wall Street as an industry for the seven decades since the end of World War II. The others that vanished virtually overnight were: Merrill Lynch (rescued by Bank of America), Morgan Stanley and Goldman Sachs which converted to Financial Holding Companies.

As the securities markets began to unravel in the face of growing uncertainty which eventually did lead to abject panic and the market's collapse, the investment industry had sought waiver from the SEC of the controversial "mark to market" accounting rule applied to securities traded on public exchanges. The SEC denied their request in favor of insisting on an "Old Testament" discipline and consistency of rigid enforcement of the accounting rules despite the presence of unprecedented exigent circumstances.

These were rules which were not authored by the SEC, but rather adopted from the Financial Accounting Standards Board (FASB) which is the independent group that oversees the professional standards of the country's CPAs and auditing professionals. The FASB rules required the "mark to market" each day of the value of all holdings of such assets traded on public exchanges, even if not sold, meaning treating "Unrealized" losses (theoretical) of assets just held in one's portfolio as actual losses as if they HAD BEEN SOLD, namely, a "Realized" loss pursuant to an intentional sales transaction. This, of course, had the effect to expand the losses of the day's limited actual market transactions **to the entire universe of the issued stock in the hands of the public.** This acted as an accelerant rather than tempering the liquidity crisis much like adding "gasoline to the conflagration " of the mounting losses of many firms which had leveraged up in the course of events and trends of the day, even heavily so.

If this were not enough, the failure of the SEC to suspend the above fair value accounting rules allowed for a second wave of the contagion to develop, which triggered margin calls in connection with those assets used as **collateral** held by counter parties securing performance on the primary obligations, even if the primary was not threatened by default. A firestorm of instability exponentially engulfed the investment markets fueling panic that further contributed to what would become the utter **dismemberment** of world financial markets altogether.

Not since the Great Crash of 1907, over a Century ago, had the banks on Wall Street refused to extend overnight credit to any of their brethren on the "Street" or via the commercial paper markets. The lack of liquidity to lubricate commerce brought the business of Wall Street to a grinding halt!

The latter two, Morgan Stanley and Goldman Sachs, each suffered a hemorrhaging of their capital accounts week-over-week caused by the developing free fall in the market prices of mortgage backed securities, and thus the values of their holdings in investment portfolios and their market collateral. Seeing the handwriting on the wall, they both hurriedly sought refuge to escape the fate of Lehman Brothers had met by beseeching the Federal Reserve Bank of New York to allow each to convert instantly from its business corporation form of charter to re-charter as a Financial Holding Company (like CNC) subject to the Federal Reserve more robust supervision and significantly higher capital standards. "Robust" meaning the SEC's focus traditionally had been on consumer protection aspects and accuracy and distribution of corporate financial information and significantly, for this time, had not given a "hoot" about the financial and balance sheet strength of the Investment Banks. The SEC had no statutory mandate to determine or regulate the level of capital that investment companies must maintain to stand behind new dynamic and rapidly growing product offerings involving much more complex transactions (risk) and intricate global exposures which **necessarily attended the new uncharted waters from that which** had traditionally been the case.

Morgan and Goldman did escape before the "hammer" of insolvency, then in motion, finished its fall…counting them out. They willingly agreed to surrender and embrace the far more conservative ("stogy") higher capital standards (lower leverage) common in the Banking industry. Banks typically sported common equity ratios of 6-8% versus 1-1 1/2% typical for the balance sheets then of most Investment Banking firms. Only a few years earlier most, Investment Banking firms abandoned the partnership form of business organization, and thereby relieved themselves of the burdens of personal liability for the losses of the firm. Before 2004, partners commonly leveraged their business assets with debt of only 8-to-1 the firm's equity or 12.5% common equity similar to banks such as ours, and considered even that traditional prudential upper limit pretty risky to back by hearth and home. The move to public company form was accomplished by floating a corporate Initial Public Offering (IPO) to raise the replacement capital from new public investors thereby enabling those to "cash out" (substitute) their partnership capital with the newly raised fresh capital, from their new shareholders garnered from the "investors-speculators" assembled

in public markets. This allowed them to take advantage of the opportunity to leverage the "new" products (complex) coming to market for distribution by leveraging that new fresh capital in turn to an unprecedented degree of 50-to-1 in the quest for a quicker shot at huge revenues and profits! This explosion of leverage levels would sow the seeds of the ultimate catastrophic destruction of the stand-alone Investment Banking industry in just a few short months to a year! **As it turned out, it was LEVERAGE that killed the Investment Banking firms,** since with normal leverage of the partnership traditionally of 8-to-1 which would have been of a scale (smaller) which would have allowed private capital markets (bottom feeders) to seize the opportunity (albeit high risk) and come to the rescue as had been the case in the past.

Yet, today the Recovery is undeniably nearing completion with the Dow Jones Average (DOW) having touched the 18,000 mark in 4th Quarter '14 and settling after the New Year at a 17,500 level through the 1st Quarter '15. Recall the roller coaster ride of the DOW which started from its peak of 14,000 near October of 2007, then slipped into a free fall to less than half that dipping to 6,500 in March of 2009 after just 18 short months. It took four years to recover to that former peak of 14,000 in the 1st Quarter of 2013 and **then to continue its bull market to 18,024 on December 22nd just before Christmas 2014.** Generally, it is unemployment which is the "lagging indicator," and finally it fell solidly below 6% at 5.5% in February of 2015. Inflation for 2015 is forecasted likely to settle after adjustments at 2.4%, just an "eyelash" above the six-year average for the "recovery." In a surprise development, oil has dropped to a level of $50 a barrel at one half of last July's figure of over $100. Gasoline prices at this writing average $2.05 a gallon or down 45% from last June when the price stood at $3.68, according to AAA. This translates into $60 a month savings for the average consumer or more than many workers have received in a pay raise in some years. Growth for 2015 is seen by economists likely to fall between the 2.4% of 2014 and perhaps edging up to 3.0%, at the very least signaling continued growth and recovery. Even though there are always those who are disappointed, this six-year bull market augers well for the future and for CNC driving revenue growth of our principal books of business (lending and investment management) at a nice but sustainable rate.

A NEW TWIST AS A "STRONG DOLLAR" TAKES CENTER STAGE vs. THE EURO's FLAGGING PROSPECTS:

Catching many by surprise, a novel aspect of our financial context has been the surge in the dollar value against the Euro and other principal currencies of the world. This is a "welcome" change, though there is always the other side of the trade balance "coin," which reminds us that every **shift in relative value of currencies changes the export-import mix of trade balances (a key topic of international political sensitivities) among sovereign nations** when one currency moves markedly with respect to the value of another. This has been driven principally by two factors:

First, has been the long announced move by **the Fed to "normalize" the level (raise) of interest rates in order to restore the normal ranges of interest rates familiar to microeconomic management of the money supply.** This is important to the Fed's fulfillment of its statutory mandate as expressed in the Federal Reserve Act to manage to the **objectives of monetary policy-to maximize employment, promote stable prices, and moderate long-term interest rates.** Through the FOMC minutes made public after its regular meetings every six weeks the Fed has stated its intention to maintain price stability while managing to the inflation target at or above 2% as being desirable. Thus, heralding policies designed to raise interest rates on US Treasury Bonds would have the expected effect of attracting investors both domestic and foreign to bid up and acquire US Bonds. Dollars are required to buy dollar denominated US Bonds, thus resulting in a stronger exchange rate for the supply of those dollars. This would be an "open field running" strategy for a time so long as inflation is not an issue which the Fed has signaled, "It is NOT." We expect this strategy to continue for this year which will bolster the economy, improve confidence in all sectors, and increase investment performance accordingly.

Secondly, the European Central Bank (ECB) implementing its own strategy has commenced an aggressive **program of Quantitative Easing (QE)** to stimulate its faltering recovery by buying up sovereign debt of its 22 member nations, as a way of infusing money supply into the Monetary Union, to stimulate growth, by lowering interest rates, and thereby encouraging the export (lower pricing) of European goods purchasable by a cheaper currency (Euro) relative to the dollar denominate goods whose value continues to rise, in part, because of its popularity as the world's preference for exchange. Additionally, this surge of popularity is driven by the dramatic drop in oil prices, which for many reasons changes the balance of the world's social and political situation, and also because customarily oil sales are settled in dollars as the preferred exchange currency, thereby creating yet another element of demand for dollars to buy reserves of oil at attractive prices ($50).

PERFORMANCE IN 2014—STRATEGIC POSITIONING FOR THE FUTURE:

Early in 2015 CNB experienced significant debit card losses ($1 Million) resulting from fraudulent transactions regarding the Target Corporations data systems breach involving financial information stolen of some 40 million customers; yet we managed to end the year with earnings of $10.84 per share, above budget of $10.27, and nearly 7.5% over 2013's $10.09 per share as reported by our CEO in his report to you. This performance continues the rolling 3-year average of CNC's Return on Equity (ROE) of nicely over 13% which places which is in the top 10% of publically traded community banks. **This track record is a demonstration of the durability and flexibility of our team to respond to exigencies beyond our control, but NOT beyond our capacity to manage alternatives to recover, and deliver positive results despite having to field a few "curve balls."** This has been an important feature of our success in the past and portends well for our future, as our world of finance continues to grow in complexity, "globalness" and opportunity. An organization such as ours that demonstrates a capacity to "play" successfully in the rough and tumble, dynamic environment (reality) which we live in will offer our markets and customers alike the assurance of our continued prospects for success by deftly and adroitly executing on any strategic direction we wish to choose. A positive!

Unfortunately, Congress itself and its attempts at financial reforms as I have witnessed over four decades in response to the financial crises **has amounted to too little too late and/or directed at the wrong targets, namely traditional community such as ours banks.** This causes a significant drag and added expense on operations which eventually lead directly to the detriment of the Retained Earnings (lower) each year AFTER a "pound of flesh" in taxes to the sovereign and the "just desserts" in dividends to the community of **deserving owners** of the bank, leaving the balance of about 40% as OUR WELLSPRING OF NEW CAPITAL RETAINED IN THE COMPANY COMPOUNDING TO SUPPORT FUTURE GROWTH. Despite the drag and added expense of government interference, we are secretly pleased that we win the game anyway by virtue of being able to add to our capital account each year through Retained Earning over the recent four years compounded at the annual rate of 9.9%, on track to double the common equity of our company in eight years! Yes, really! A positive positioning!

Over the last third of a century, the population of banks in the US has declined precipitously from 14,500 to 6,400 community-regional oriented institutions principally focused on gathering deposits and making loans directly (up close and personal) to people (mortgages and cars) and small businesses (where those people work). The bank in each location acts in the nature of a "midwife" attending skillfully to the natural birthing of regional economies surrounding those banks. By this they facilitate commerce in the region, assist by prudentially providing leverage to monetize creative initiatives, ideas and yes, dreams which creates value, a tax bases in the form of income flows and property values which support governments, citizen and business alike. This productive collaboration of the local community resources redounds to an integrated Gross National Product (GNP) and a standard of living, freedom of thought, action and innovation which is the envy of the world.

However, when no one was looking, the banking industry in our country has evolved into an **oligopoly** of banking and financial services. **Whose idea was it, anyway, to create such a lopsided construct of size** where 33 Banks (1/2%) with command of more than 90% of the bankable assets of the country dominate the field of 6,400 community and regionals Banks (99.5%) with less than 10% of those bankable assets? **Congress, the architect? Certainly with all their laws they must have had a hand in it.** Wall Street versus Main Street? Maybe, but these two alternatives ARE dramatically different business models.

This difference just evolved through a complex series of events but certainly through the confluences of short term thinking and a compulsion to unbridled speculation and reckless, irresponsible, behavior rationalized by the moto of "caveat emptor" let the buyer beware (be the sucker) which over the years led to the Crisis and the distressing state in which we found finance at the beginning 2008. Yes, this drove a consolidation of 55% of the number of charters borne mostly by the very smallest of banks under $100 million in footings (an average branch office today), but over the same period a nearly threefold increase in deposits to $9.6 trillion for the industry, still as vital or better than before. Efficiency provided by technology led the way. **We redefined community banking and flourished along with successful startups who also saw the opportunity to fill the vacuum left by the legacy giants of the industry whose strategic course was to focus on worldwide opportunities of the emerging global economy at the expense of ignoring smaller, local community markets and their operations and continue to do so.** Again, a positive positioning for our business lines!

Banking then, and today, is divided into two broad categories silhouetted like a dumbbell with Wall Street populated by the Four Mega Bank Holding Companies (BHC): JPMorgan Chase & Co., Bank of America Corp., Citigroup Inc. and Wells Fargo & Co., on the one hand, complex, globally interconnected enterprises in the extreme, and on the other, with M**ain Street populated by Community Banks numbering 6,400 federal or state charters** located in thousands of communities at the other end of the spectrum of which the largest 250 or so are medium sized BHCs ($1-5 Billion-the "sweet" spot) such as CNC. Main Street Bankers make the vast majority of the small business loans in the USA, (small business is the cradle of the new Gross Domestic Product (GDP). Regional Banks larger than we have **loans** on their books which constitute 61% of their assets and the Four Mega Banks have booked on their balance sheets loans constituting only 31% of assets, and consistently generate **well over half of their revenues** NOT from direct lending but from manufacturing and distributing newly underwritten securities **and** trading actively for their own account securities originated elsewhere of all kinds sourced from worldwide markets. These operations are funded primarily with funds of deposit/borrowings of short maturities (90 days) gathered in wholesale money markets and commercial paper available from domestic and foreign market sources. **It is a positive that we are among those who are positioned in what is regarded as the "sweet spot" in size—large enough to effectively succeed in any business we strategically choose to pursue and small enough to grow and nurture ultimately the prize relationships available in each market.**

Significantly, we are fortunate to being in a near optimal situation being loaned fully to 80% of our assets with direct loans about evenly spread between businesses and consumers, funding both sides of the equation of commerce. These loan assets are nearly all funded by core deposits (88%) gathered from the same communities in which the loans are originated. Our securities portfolio investments are managed primarily to provide for liquidity to support our strategies related to lending, and our offerings in our fee generating lines of businesses (LOB). **Thus, 94% of our assets are "earning assets" generating interest revenues,** the balance of 6% consists of cash, real property which is our plant, and general miscellaneous, in descending order of amounts. **We have an enviable high utilization of our assets as "earning assets."**

The loan revenues constitute 67% of our total revenues; where the remaining 33% of revenues come from our fee generating businesses: Wealth Management, Mortgage Operations, and Bank Account Payment Services. We have **no revenues generated by proprietary trading strategies of our own securities since our investment securities have been earmarked to manage our essential liquidity functions.** However, the rage and focus of Regulators today brings a new scrutiny directed specifically to institutions of over $50 billion (which number is just 33) which must now demonstrate they have access to liquidity in much higher amounts than was the case in pre-Crisis levels. Fortunately, we and others which are smaller and are members of the tradition community bank sector are not required to carry this extra measure of liquidity because they present a lower risk profile being principally engaged in direct lending and not securities manufacturing and distribution and proprietary trading which must confront the much higher risks which are inherent in volatile securities markets. Moreover, generally speaking, the earning available from bond investments for liquidly yield **less revenues** than the same amount invested in a direct loan A positive development for our future positioning.

Thus, it is evident that the Mega Banks of Wall Street and the Community-oriented banks of Main Street are dramatically different business models. The Mega Banks, by virtue of their complexity of product lines, business lines, global interconnectivity and exposure to uncertainties cause by market volatility, both domestic and foreign, present a **significantly greater risk profile, especially in economic down turns which history shows are inevitable.**

In stark contrast is the demonstrability simple, easily understood set of traditional banking products, services and functions of the vast majority of community banks focused on the local, personal service, education and financial advice offered typically face-to-face, up close and personal, with the intention of creating a lasting and sustaining mutually beneficial, multilayered RELATIONSHIP with a growing number of customers/clients who share in the same community style orientation and the prospect for its growth and sustainability for the foreseeable future. Moreover, there is a difference in KIND and RELIABILITY of the principal sources of a community-oriented bank's revenues, especially from the volatility and uncertainty of the global securities markets, which host proprietary trading (proceeds of sale) embedded in the investment banking functions. The Wall Street context is totally dependent on the effective workings of the interconnectivity of global markets and their documented long history of ping ponging between irrational exuberance and euphoria in one moment, to abject fear and panic in the next. Their necessary massive exposure to this volatility wracking markets, known to be affected by random geopolitical events, has **proven to be far more risky than most could have imagined.** There is no comparison between the huge degree of systemic risk associated with a principal dependence on revenues drawn from proceeds of sale of inherently fragile markets and those of community banks' programmed, routine revenue streams of monthly loan payments and better yet the fees generated by non-interest financial services enumerated above. The latter's (CNC's) cash flows **have virtually no exposure to the fragility and vicissitudes of the worldwide securities markets constantly perturbed by a context of the constant puzzle and dynamics of the invisible reality, and popular noisy myths (unreality) which drive the behaviors which affects finance reacting to the geopolitical scene. A positive circumstance for our positioning of our balance sheet choices (avoiding exposure to market forces) for success in the future.**

Congressional response to the Crisis was Dodd-Frank, and the international response was the Basil III Accords, both a prescription "for one size fits all" in a world flooded with an infinite variety of unique situations in the field. I trust at this point you, the reader, may understand better that given the clear differences between the business models, their attending sources of degree of reliability of revenues, and the ultimate degree of risk to the financial health of the enterprise accompanying each model is anything but a testament of extremes of the attributes

and character that exist distinguishing the two models in terms of the fundamentals of the complexity, size, scope of demographic, geography, culture, style and mission. Demonstratively, such a singular prescription proffered by legislation and policy is misguided without significant tailoring amendments to take into account these clear distinctions of character and context and therefore in our experience is not likely to be effective to significantly change the actions and behavior of their target audiences, namely, the consumers of financial services, and much less the supplier of those financial services, being banks of ALL sizes and complexity.

What then is to be in done? What position should each business model take that is recommended and informed by the data and/or long held and validated principles of banking and finance, traditional perhaps, but never out of date. The tipping point as far as risk to society goes, is not size per se, but **the difference between the complex structure and interconnectivity of the Wall Street banks which is the key, that is, is distinctly differentiated from the simple, direct and community/local orientation structure of community and regional banks that service nearly three quarters of the territory of our Country,** outside of the 10 largest metropolitan areas. Congress has called for more capital on the balance sheet, with additional amounts to serve as buffers for good measure, and especially so, for the 33 Financial Institutions over $50 Billion in assets to include stress testing, enhanced provisions for increased liquidity reserves for contingencies and increased oversight for everyone. The problem with this prescription is that it is suitable and even required for the complex, global interconnected enterprise which was complicit in the activities that caused the Crisis of global proportions and out of the need to place limits to control proprietary trading and the attending mischief that accompanies the quest for huge revenues/profits which encouraged commonly the use of dangerous levels of borrowing leverage and exposure to the attending risk. And, today the same four Mega Banks are reporting in 2014 activities which account for 90% of the US Bank trading revenue leaving the rest of 10% to the community banks. **Accordingly, this prescription is not relevant to the context of community or regional banks, nor necessary, or warranted by, those of us who have intentionally chosen the traditional, non-global interconnected and complex banking model, as amply demonstrated and proven success of our consistent and intentional measured performance and growth over the immediate past 15 years which extends back way before the Crisis. Steady as you go wins the prize in finance and banking.**

Capital is important on any balance sheet, but the emphasis here is misplaced for community banks **since more capital on the balance sheets of the banks that actually failed in the Crisis would NOT have been enough to insulate and save the majority of the failed operations from their demise.** More important to assure the sustainability of community banks is the access to and growth of a steady supply of **Retained Earnings (after dividends and taxes)**, the ready and least expensive source of new capital required to underwrite the growth of most community banks. Frustrating is the increased cost of regulatory oversight ranging from 4% to 16% of operating expenses without enhancing the value proposition we offer to customers and tragically wastes, indeed, robs us of that increment which would necessarily flow to Retained Earnings and build our capital strength which has been the universal call to arms sounded by the regulators worldwide post Crisis—more capital, and I might add **internally generated** by gains in successful operations by reduction of regulation which is not purposeful as applied to those who by choice are traditional, noncomplex, simply structured, domestic community banks! It is the dynamics of our Statement of Earnings, and its concluding account, the net new Retained Earnings (RE) which added (8.7%) to the common equity of the bank which has, in the past and will continue in the future, to assure our sustainability and relative success measured and generated within and at our local community level and not from the outside. To go outside as in the case of seeking capital by floating a public offering to sell stock in the securities markets comes at a significant costs to raise the same dollars as the dollars raised by a growth 8.7% of new capital retained by a successful year of performance.

Many important quarters confuse size with capacity to achieve that quality and growth of earnings predictably each year and therefore often are ignored or overlooked and understandably dismiss the quality record of durability, ingenuity of people who populate the non-metropolitan, non-suburban areas and, in turn, the Banks which are responsible for underwriting the very sustainability of those communities at the Main Street level. The Mega Banks command 85% of the nation's bankable assets and equally claim 85% of the media spotlight, but leave the Community Banks with the remaining 15% of the bankable resources to the shadows of obscurity. **But, CNC's performance throughout the last decade encompassing the Crisis was superlative in every regard, metric, and is representative of durability of the traditional community-oriented business model, which shone brightly, nonetheless, as the outlier experience in the face of the Crisis that crippled the Mega Banks and buried the stand alone investment banking industry. Positioned as an "outlier," you see, is a good orientation to assume for the future.**

Congress, a quarter century ago, set forth legislation governing Credit Cards (the only "plastic" in popular use then) and in its "wisdom," chose to tag the issuing entity, generally a bank, with the responsibility to bear/absorb the card holder's losses occasioned by illegal (fraudulent) accessing of card credit lines by an unauthorized person ("thief"). The issuer bank was deemed the appropriate entity to bear this (social) loss and thus be made the indemnifier, insurer and absolutely, strictly liable for all "fraud losses," since they, as the issuer, were in the **best position to set the price of the facility/product to account for and absorb the cost of that loss.** This was based on the typical credit card pricing including annual fees, but more important were the revenues gathered at the 18% rate of interest on balances. Of the 18%, **typically 6% was budgeted for losses.** The Credit Card is the agreement to draw upon a loan line availability which is **unsecured**, prearranged, underwritten and priced appropriately to recover the cost to administer, delivery by computer networks, monthly payment collection per the loan contract and a reserve for significant charge-off of losses, plus an after income tax profit on a par or **better of 1.00% to 1.25% net return on asset, an industry standard.**

Debit Cards emerged first at ATMs in the mid-eighties, but in the last decade the use of debit cards exploded as the most used means of retail payment. The debit cards' popularity is due to i**ts features and convenience which are dramatically different in kind and concept** from the Credit Card.

The Debit Card is "a horse of a very different color," not at all similar in kind and concept to the Credit Card. In essence, the **Debit Card is an "electronic" check.** In terms of presentment for payment, whether by paper check or electronic messaging commenced by the swipe of the debit card through the card reader device, **both are reduced to the <u>same electronically transmitted message</u> which records the transaction on the customer's account statement at the bank.** The check is a paper "Pay to the Order of," and the swipe of the Debit Card is an electronic authorization equivalent to the writings on the check to direct payment to the merchant purveyor of goods and services. This is not an advance on a credit line, but a withdrawal of collected funds "owned" by the bank but by agreement subject to the bank customer's call by an "Order to Pay" to the owner of the store through the store's card reader machine. This processes the payment for the goods and services by recording the Debit Card customer's information by transmitting it to the bank and the amount to be paid to complete and account for the transaction conveniently. **The Debit Card is an adjunct to the checking account service, not a standalone product which would allow separate pricing which can factor in the cost associated with the misuse of that "plastic." The law of check forgery assigns the responsibility for that fraud to the Bank** since the bank can examine, in theory, the signature on the check of its maker with the customer's signature on the signature card on file and **refuse payment for the "non-authorized looking" signature and return the check without loss to the customer or depository bank.** The progress of technology of the "Debit e-check" is the

"signature" authorizing the payment is in the form of the Card number, and PIN password, which is the means by which the **information is certified as correct and the transaction is authenticated** in the same fashion that placing the "signature" on the check authenticates the check which when it is thus received by the bank issuing the card validates the "Order to Pay" and such order is lawful and in accordance with the agreement. **It is the USE of the correct information and PIN by the thief which is the crime of the fraud. The bank honored what WERE VALID authorizations and PINs and dutifully complied with the order. The dilemma, of course, is that the bank had no way of knowing that "A" valid ID and PIN were not "THE" valid ID and PIN!** Of course, the Bank has no way of controlling the secure handling of this vital information and PIN which is being managed by the consumer and his choices of places to do business and those retailers who are the direct beneficiaries of such a convenient and "final" means of securing "good" funds at the instant of the purchase, as good and final as if cash had been used. Moreover, this format does not accommodate the opportunity as with the credit card format to price the transaction by 18% interest charge to cover the inevitability of fraud losses inherent in this payment option of a Debit Card which has long been recognized as attending transactions completed with the other "plastic" namely the Credit Card .

Thus, the Congressional design of tagging the fraud loss on the bank failed to keep up on the advance of the new debit card technology which would look back at the vendor who was benefited by the sale and profit to absorb the loss and reasonably is in the best position to price that payment option appropriately and protect the customer's financial information accordingly; and, of course make suitable and fair changes in its contracts and procedures to accommodate a better system to protect commerce. If the currency were counterfeit, the vendor would bear the loss not the Federal Reserve Bank that issued the bill or a bank to which it is presented in a deposit or as a payment.

The Congressional solution for the advent of new technology was their failure to act responsibly to undertake to understand the simple and monumental difference between (1) a credit card draw against a line of credit (LOC) offered by the issuer of the card with (2) the "Order to Pay" originating from a Debit Card against amounts held by the bank as a debt owed to the card holder customer per contract to comply to an "Order to Pay" directed by the cardholder to be drawn from his deposit account (a Debt owed to a depositor by the bank). Understandably, the similarity of the two plastic products might lend itself to a similar assessment of responsibility, but as an architect of the financial systems' products, it is a monumental error in logic and fairness and good economics not to understand the huge differences between the two methods of payments. Identity theft, of which debit card fraud is a targeted subset of the "fraudsters", costs the banking industry billions of dollars annually, which banks are not responsible for, since we have no control over its causes-principally the misuse by thieves of otherwise correct and authorized information used in commerce. **The negligence and carelessness in the securing the consumer's personal financial information is squarely on the shoulders of Target and other huge retailers responsible for the monumental plethora epidemic of incidents.** The lawsuits will eventually redress this miscarriage of justice in favor of the ultimate injured parties, the issuing banks. Congress' failure to take responsibility to correct and redress this travesty, seals the indictment of their incompetency at regulating effectively, much less micromanaging, faulty product development of financial services and banking at any level for failing to understand even the rudiments of the subject or behaviors they dare to direct or interfere with.

The differences of the two payment methods are too numerous to list here, but the Debit Card completes the transaction **with the same finality as the hand delivery of cash.** "Cash and carry" we can all agree is FINAL. The store owner is made whole instantly, and the payment of collected funds is delivered to the seller's account instantly. Not so of the credit card

transaction or check delivery, all of which are subject to a series of conditions which would suspend final payment or reverse them even days after the transaction.

Our people, in a team effort, responded with swift action to overcome this setback by providing alternative strategies and, in six months, more than offset the costs of this faulty product design, allowed by Congress' failing to guard the taxpayer and the financial world against such faulty architecture at Congress's own design. The list of other examples of Congress' design malfeasance is very long indeed and of little use to recite, since this complaint falls on deaf ears. We are positioned nimbly (an advantage we have over our competition) to manage the short coming and simple negligence of those groups who feel they can micromanage our product and services from the halls of Congress or Albany. Over regulation limits innovation and the availability of credit to the consumer, in addition to making it more costly which is always added to the cost of goods sold as it must and passed along to the purchasers of services just as the cost of any "shoplifting activity" which this is but just in another form.

DESIGN ISSUES FOR THE FUTURE OF FINANCE IN THE NEW WORLD, POST RECESSION:

It has been my general observation in plying through the opportunities that life presents to each of us, that at least five workable alternatives are available for every significant decision worth thinking about. This approach has the advantage of avoiding the stress of the popular notion that there MUST BE A CORRECT answer; and what's worse, is to suspend action before we know it.

I prefer to dismiss the absolutes of right and wrong, and substitute criteria which is more **accommodating of action** offered by the labels of "trial" and "error." Most often in business, and even personal affairs, the error is to do **nothing**, abiding the clarification and hopefully elimination of puzzling aspects seeking to eliminate uncertainty, that is, over-think the project. The extreme, delay inhibits the free association of the human mind (genius) which is the garden of innovation and ingenuity that energizes productivity and growth of value. Of course, the risk of delay may have the effect of losing the opportunity altogether. Remember that "good luck" is defined as preparation combined with opportunity appearing somewhat by random. The former we can work on, and the latter is more apt to be serendipitous. **So, getting started now and fine tuning later may be the best course of action for engaging the problem or customer's concern because it acknowledges the concerns of others that something needs to be done by YOU.** This signals the start of adding value from the customer's perspective right away which registers a greater impression (value) now than if experienced days later. Inevitably every choice requires adjustments in application in the "field" and improvisation on the theme of the ultimate purpose to succeed in addressing concern in business or life, for that matter. Thus we first select the persons who are attuned to our culture and who demonstrated a positive, good attitude (personality), since we have found we can train/educate the aptitude required by the craft, relatively easily.

Inventiveness and innovation has, as its foundation, a necessary political environment which supports the concept of "Liberty" of the congressional type which is the progenitor of free flowing action but more importantly a liberated free flowing thought process which prepares the path for every new idea to spring forth, the inductive leap, the well spring of creativity and increased productivity which emerges from **the genius of the art and intellect of the human mind** and taking new action, indeed, direction which accounts for and drives 75% of the growth of the GDP. As I have referenced in this space before, a **Reuters' study of a couple of years age sought to identify the 100 most innovative businesses in the world and found that 40 are resident in the**

US and ZERO reside in China. Despite having a population four times that of the US and the fastest growing economy to boot in percentage terms, it seems China mostly just copies the technology and ideas of others more than they originate new stuff themselves. Their totalitarian form of government is, of course, an environment which is NOT a fertile ground for innovation which requires being utterly free of the suggestion of strictures upon ones liberty of action and thought process, so the germ of free associations and a free spirit can kindle and flourish to **imagine the unimaginable** - The American Dream!

Indeed, in my late teens, I spent a year of research inventing a unique electrical multiple switching device which led to securing a US patent while in college. When I was urged to show it to the Engineering Department at Stromberg-Carlson, it stirred enough interest to get me a job offer the next summer to work in their "skunk works" which did not materialize since the company was sold within the year. Through this intense experience, though, I learned firsthand **that trial and error is the tuition for the next success. Each product which succeeds, though, represents but 10% of the product of experimentation and effort, while the balance of 90% lays "invisible" on the "floor," but even though discarded, those ideas were no less embedded in the success of the 10% recognized as the final product.** It is one of the contradictions of human understanding that readily admires the apparent ease of success in any endeavor: be it art, science, physical prowess or intellect, but the process and effort to get to that end is generally overlooked entirely. When we examine what lies behind the prepared mind more deeply, we always find countless thousands of hours of toil and effort which were undertaken by application of interest, inherent talent (wiring), discipline and PASSION (joy) without financial reward, but out of personal commitment to the subject. **Education, after all, is really not about the literal acquisition of subject matter (memorization) so much as it is about expanding ones' capacity for critical thinking and expression as guided by a good coach.** Every professional: physician, attorney, engineer, pilot, machinist, artist, author, performer, may spend the early years in gathering the known substance of a vocation but spends a lifetime improvising a unique solution to every problem itself always distinguishable and unique. **Indeed, the value is in the differences, the newness from the other kinds and possibilities from whence the <u>value</u> of all progress germinates.** Success financial or otherwise is **what the individual in every context is willing to take responsibility for and act upon, because it is there to do, especially when "no one is looking", which is 95% of the time.** We recognize this expression is what we call "culture", a means of making choices as to one's individual behavior and action which is values driven, and therefore, always active in the moment and **inevitably and solely personal in its nature**…Responsibility and accountability is derived from one's personal nature…Many may disagree offering rationalizations involving nature or nurture or social/political crowd influences or community, cultural persuasions that trump (have no choice) the decision. **I would submit that one's character is made manifest by an abstract of the many choices one makes during life, especially again when no one is looking.**

The payoff of this discussion is critical to the effective management of the human nature of the individuals we attract to our cause and mission as a financial institution offering comprehensive financial services for fun and profit principally to individuals be they growing families or businesses.

The corollary to the observation above that one's character is made manifest by the abstract (record/resume) of one's choices and behaviors which in turn are derivative of personal values held dearly embedded by upbringing and life experiences is the observation that we humans are inclined first to behavior in alignment with those values. Witness the behavioral psychologists find that we are inclined first to do what we want to do when we want to do it, when no one is looking. Face with this inertia of human personality the challenge of management in coaching and guiding the individuals that comprise the team and to format the presentation of a new direction by appealing to and aligning with the values of those individuals.

My observation is we seldom can dictate or mandate a lasting change in behavior, decisions or choices of another without aligning the elements of the desired course of conduct with the values, or at least be compatible with them over time. Thus, education and advice, persuasion, public recognition, and money (last) come to mind as the best strategy to begin the process. That is why we build our organization thoughtfully because we know most of us are driven to activity which allows for doing "cool things with cool people" Thus, having fun and doing work we feel is meaningful are key elements to build a culture of constructive collaboration which we have done at CNC. The positive effect upon performance on every level has been remarkable. If that were easily done then constructive collaborations would run rampant, controversy would be rare and efficiency in human activity would abound. Of course it is NOT easy and requires constant nurturing but is clearly worth the time, effort and expense as our financial performance can attest to.

Congress/Government could actually be effective at governing if such a culture could be established as a priority there and with positive efficiency and effectiveness, not to mention lower expense and the elimination of wasted effort. Alas, the history books attest to the contrary though. This is because for the current behavior to be modified by an external suggestion (rule, law, etc.) the individual must come to an understanding that the **desired behavior is seen by him as aligning with his judgment driven by his values.** In essence, those that urge change are limited severely to an attempt to persuasion which may cause the change in behavior, but only as that persuasion plays to the values of the listener. Thus, what is commonly thought to be pulling a string to gain the desired behavior is **relegated to PUSHING that string with very different prospects of commanding the change in behavior.** Thus, we observe in managing human beings that the **attitude** (values) of the target listener is far more important to success than the **aptitude/skill** required to successfully spawn a constructive collaboration. The culture of an organization is the primary determinate of the functional effectiveness of the collective effort. But sadly so much of human engagement, politics and diplomacy fails to be constructive, positive and effective **for a lack of a positive attitude.**

My step brother, Harlan Calkins, when accepting induction in the Rochester Business Hall of Fame, remarked succinctly: "whatever his role and contributions to the growth of his business, succeeding in the face of competition, and meeting the challenges of finance in good times and bad he continued: that was the easy part! **It was the people problems which were the toughest challenges." Spontaneous laughter erupted reflexively, validating concurrence of everyone in the room.**

Thus, we see how difficult it is to effect change in a heavily regulated industry which has intensified even more now in the aftermath of the Crisis. Frankly, I believe we AT CNB/CNC are light years ahead of the government and the "industry/business crowd" in understanding the importance of culture to enhancement of financial performance of a business. As I look back over what we have accomplished, that success could not have happened but for the coming together in a culture of an uncommonly cohesive group of talented, hardworking but passionate employees dedicated to our cause of underwriting the growth of the community. The financial performance is a means to the End, it is NOT the goal. The goal is to build and acquire lasting mutually beneficial relationships with customers/clients, in keeping with a bilateral exchange of value and collaboration. **What we have built is NOT common but distinctive from the declaration of the Wall Street quest which is to focus moment by moment on the financial aspects driven by stock market imperatives (It's the stock price, stupid!) is obvious enough, and those distinctions are further developed in the chart on the next page.**

Differentiators

WALL STREET MIND SET	CNB/CNC Mind Set
1. Price Driven –Short Term	1. Value Driven – Long Term
2. Transactional	2. Activity=Engagement
3. Revenue- Deal for a fee	3. Revenue- Monthly Installment- 3 mos. to 30 yrs.
4. Vested in Market Activity	4. Vested in Human Activity
5. Price	5. Value
6. Product	6. Relationship
7. Commodity	7. Comprehensive = Custom Made
8. *Caveat Emptor* -Buyer Beware	8. Responsibility for Self & Environment
9. Unsustainable- Risky	9. Sustainability-Managed (Low) Risk
10. Earnings- Maximize	10. Earnings – Optimized (Balance)
11. Performance: Stock Price	11. Sustained Earnings, capital growth (retained earnings) and current Dividends
12. Self-absorbed	12. Selfless
13. Outsource primary underwriting	13. Underwrite ourselves internally
14. Make $	14. Produce Value
15. Exploit Society	15. Enhance Society (benefit)

In the end, as for the Compliance burden which plagues and suffocates our industry, we have skillfully built a team under Steve Swartout, our effective General Counsel and Chief Administrative Officer, which assimilates the waves of regulation which drowns others in our industry, into categories which we manage adroitly to comply with while minimizing the negative impact upon our value proposition we offer each customer. In some cases, perversely I might add, we find opportunities to make a "silk purse out of a sow's ear" by easing the pain of such compliance burdens place by Congress upon our customers as a way to add value to the relationship.

Understanding the dynamics of the foregoing is an essential key to even attempting to guide human behavior. Certainly, such has enormous implications for the success or failure and most importantly the effectiveness of Congress' or Albany's attempts at setting guidelines, legislation, regulations as with any rule making is the senseless task by one group attempting to tell another group how to behave, regardless of the subject and the need to do so. Constitutions, laws passed by legislative bodies, regulations, policies, protocols, standard operating procedures, ops manuals, instructions and safety warnings, and municipal processes, "ad nauseum" have far less success in changing behavior than the authorities which make such pronouncements would like to believe much less acknowledge. In the end common sense voluntarily applied is the key to success of these attempts to dictate behavior.

It was General Pershing who observed that **any "rule" is a generalization and is false in every application. This is obvious enough in practice since each application in each situation is by its nature, unique in the field.** Averages calculated from financial performance measurement **ARE the mathematic equivalent to the generalization** or stereotyping. Then, stating the average performance covering a situation as the proxy for the common experience seems at

first plausible enough in the offing, but also is equally bewitching of the intelligence, since it does not accurately describe any specific occurrence included in the data, each element of which is by its nature unique. Similar word choices or associations bewitch the intelligence because they convey more importance than just the numbers constituting the data. In surgery, to assume the placement of an organ is going to be exactly where it generally is can be a rude awakening when it isn't where it is supposed to be. (Yes, that happens more often than you think.)

For example, an average, be it the mean or median, is not likely to describe any single element in the collection of data. Take "2" plus "12," and you get "14" which when averaged yields a "7." But there are no "7s" necessarily. So prescribing by rule the behavior for a "7" may well be a wasted effort since no one actually fits the "average" situation described by "7." Simply, it may not exist at all and if it does, it is likely by sheer chance. Again, as a retailer, I order up 100 suits having the precise measurements of my average customer. I expect we can all agree that the chances are very good that **none of the batch of 100 would fit any customer without alterations being required, since every human frame is unique.**

The financial crisis in the US in subprime mortgages involved principally properties located in Florida, Arizona, California, Nevada, and Detroit with their collective experience capturing the dismal headlines of a failing economy and that notion driving the political and legislative agenda applicable to EVERYONE. But those numbers were not descriptive of the situation in the other 46 states, and especially not the Rochester MSA's real estate experience. **So, CNB/CNC's choices and prospects were different in part for the reason that our context–markets in which we chose to do business—thankfully did not undergo the dismal dynamics of those areas which composed the Headlines.**

More directly, though, we avoided those storms and regions because of the choices we deliberately made in the construction of our Balance Sheet to underwrite assets which were known to be immune from regions of the Country and/or specific classification of activities (commercial real estate development) which are generally volatile and plagued with uncertainty. Simply, as a Community Bank we share with 6,400 other "local" banks a business model, based on time honored principles and practices of prudential financial management and underwriting. This is marked by gathering "core" deposits locally along our "Main Streets" and recycling them in the form of loans back along the same streets in "Our Towns." This "traditional" community-oriented business model has served our customers, staff, shareholders, and, by extension the community as a whole very well over portions of three centuries since 1887! By "traditional" we do not mean old fashion, static and thus obsolete, but traditional in the dynamic alignment with the people –those who live, work and play within our influence and with whom we have a current and constructive collaboration, sustaining mutually beneficial relationships, both personally and financially, significantly in equal measure, as a matter of "heart and mind" in combination. This activity is bonded and nurtured by a conversation which is a part of the social DNA and as such, is key to the support and sustaining element of the community itself. **In the end, the financing of communities by this dedicated model of banking is an essential feature and element of every community and is not subject to obsolescence because it falls out of fashion. The nature of human beings never falls out of fashion!**

It is the distinctive virtue of this traditional model, not the precursor of its obsolescence, which primarily underwrites and sustains the vast spans of the rest of our country outside of the 10 largest metropolitan areas where, as I have said before, but bears repeating, community banks dominate and supply three quarters (75%) of the banking services even though we collectively represent less than 15% of the bankable assets, which by **any measure of averages is a seriously small minority.** Thus, as a class we are largely overlooked, underappreciated and seriously misunderstood, especially by our Legislatures and Congress dazzled by size of Wall Street Mega Banks. Recall that 83% of our society lives in urban areas and the members of Congress are distributed by population, thus the focus of congressional debate and problems capturing the

attention of the news and media are **urban in nature.** It is not surprising then that we are subject to a tsunami of legislation and regulation that is conceived and tooled to attack largeness first of all, and thus reflects the urban bias which is not applicable, or even remotely reflective, of the circumstances of community banks in large measure. None of us are fitting the description of the average experience and behaviors of customers of the Mega Banks that the legislation, in its urban bias, supposes our experience and reality to be in practice and substance. Indeed nothing could be could be further from the truth. **And beautifully and ironically, nothing could be more of a competitive advantage for us in our goal to gather ever greater numbers of tangible, mutually beneficial constructive relationships, be they personal or business, as an effective means to achieve our mission to build communities, which by definition begins small one person at a time! Here our membership in the "15% small minority" translates in the context of a unique single customer experience, an event of life altering value-a very "big deal," a start of a relationship for life, not a mere transaction distinguished by coupons, discounts or "rewards."**

Clearly the Financial Crisis, which crushed Wall Street so horribly and mirrored widely the condition of finance throughout the world, blackened the spirt of public confidence and future prospect of millions. **That said, then what was no less than the Greatest Recession in living memory, DID NOT describe in any metric the arch of the CNC/CNB experience, performance, or our prospects for success at all, nor that of our constituents or that of the Rochester MSA. Thankfully!** And isn't it interesting I was surprised to find that we at CNB/CNC shared with the Emerging Economies a modest but unflagging continuous growth throughout the entire period of which befell the High Income-Advanced economies which took the brunt of the misery of the Crisis, as we stated at the beginning of this message.

My purpose of this discussion and its detail is to make absolutely clear how the "numbers" thought to be absolute, and their averages equally so, can and do bewitch the intelligence and understanding of the data by the selection of a substitute number (the calculated average) as a proxy to be reflective of the primary data and how easily that material aspects of the data can be thus lost in the translation. The "Tyranny of the Averages", if I may coin a phrase, and its treachery is embedded in this simple, commonly used analytical technique, which is the "mischief that is the root cause of the problem" may often reside in the material aspects which have been lost or hidden by the "cover" of the average as the first order of simplification.

This is because, more important than the number itself, is the error analysis which attends every measurement (the x % reliability you see expressed relative to polling data) that informs us on its substantive value (reliability). Value is gained and revealed by the ratio of numerator (performance) over denominator (context), a number signifying an index of value embedded in the comparison of those data. Thus, in management the implication of this understanding in practice, acknowledged or not, and in order to be effective in our directives, every rule applied should be conditioned upon inclusion of thoughtful adaptation in the field to the specifics of what must be the unique elements attending that situation. Thus, it is best practice in the management of peoples' behavior to make clear and to enfranchise people with the authority to use **the rule as a guide, not as a substitute for thinking**...but the expectation is one **of taking responsibility** to pause and test by the application of common-sense whether the proposed behavior makes sense in the unique context **using the rule as a guide for final application to guide behavior, as action intended to accomplish a purposeful outcome.**

Admittedly, this enfranchisement is the "tricky' part because in popular practice in management "command and control" of corporations, especially large corporations, is the reluctance by middle management to relinquish decision making authority and control to subordinates lest the consequences of such decisions would become the responsibility (accountability) of the manager, a liability which is fostered by a culture

of fear of getting the wrong answer. We encourage a different view of empowering individuals to make decisions within their demonstrated experience; **the only standard is to add value to the customer relationship and one is encouraged to improvise on that theme of value added. Leave the impact of regulations to the CEO and senior management.** This expression of enfranchisement is at the core of our corporate culture and is driven by the values listed on each associates calling card. This expression is the seminal core notion upon which our corporate culture is based and is founded upon the trust and respect we have with one another. The consequence of this freedom to improvise on this strategic value is in the faith that the worst that can happen is "happy accidents," a condition NOT to be feared, but an unanticipated outcome of a creative free mindedness of the human genius to be celebrated. (Thank you, Tina Fey, famed comedienne of "30 Rock", writer and director). This is a key competitive advantage we have over other providers in our business which fall prey to the traditionally found "command and control" mentality often restricting effectiveness of large organizations, be they public or private sector.

Of course, you now see the difficulty with a society subject to increased "manic rule making" and in a world of increased complexity yields the opposite effect to confuse or paralyze, rather than to persuade individuals' desired behavior to align with the proposed desired outcome or change. Of course, **human beings I observe have a tendency first not to be compliant to rules/directives and only a distant second to be persuaded. That assumes they have read, processed and remembered the language which requires creative listening to the inarticulate or unfamiliar presentation of the authors of such attempts to persuade.** The disabilities created by this state of affairs of manic rule making has been with us for 100 years when the cost of government was 10% of the GDP to the eventual growth of epidemic proportions to our 42% for the USA today, but is exceeded by 50% for the French and much of the European Union.

In this regard, the world of finance which is our subject today, is faced with a gargantuan outpouring of rulemaking as is detailed in his book (2014) by Martin Wolf, Asst. Editor and **Chief Economics Commentator** at the *Financial Times, London,* an experienced observer of international finance for decades entitled **The Shifts and Shocks-*What We've Learned- and Have Still to Learn-from the Financial Crisis:***

"The question remains: will this complex regulatory effort deliver a financial system that is both robust and dynamic? In essence, after all, we need a financial system that will cope with the inevitable shocks while not generating huge shocks of its own. **Will these reforms provide it? In a word, NO. The sheer complexity of the regulatory structure makes it virtually inconceivable that it will work.** Nobody in charge of a bank is going to know and understand all the rules it is supposed to obey. Indeed, nobody is, be they regulatory bodies or the regulated institutions. Operating in such a regulatory quagmire makes it certain that institutions will end up operating contrary to the rules without meaning to do so. It will also create pervasive uncertainty. It is highly undesirable." p. 234

Thus, we have from Martin Wolf, an unvarnished indictment by an acknowledged credible senior observer of global finance, of the attempts at complex regulatory effort at reform, and we conclude, therefore, that we must make the effort to give to whatever form the rules take it's just due, and manage the consequences so as to minimize its impact on the value propositions we offer to our customers, both internal and external, which our success and sustainability primarily depends and continue to seek to do the "right" thing in the best interests of our customer/clients as best we can. It was Hippocrates who said about medicine there are two approaches to unraveling that quandary, the first is science and the other is opinion, whereupon he observed that science leads to knowledge where the latter, opinion, leads to ignorance.

When addressing the problems of the world, we really have a duty to begin and work from the data and knowledge which align with the realities of Mother Nature and the subset human nature as the best of practice to arrive at a serviceable solution.

ELECTION RESULTS HERALDS A LAME DUCK SESSION:

Of course, with an election year now finally "in the can," we sense the latent political clamor does little to clarify any additional understanding as to the key elements of the Great Recession. What we do know, though, the election results did accurately confirm the trends reflected in the polls of gargantuan frustration of the electorate with the failure of the Congress to govern, attend to the People's business, rather than choosing from the very "get go" to start to "run" for reelection again. In January in his State of the Union Address, the President spoke to the Nation in his first chance to place a positive spin on the outcomes of the midterm elections which **saw the dramatic shift in favor of the GOP, ending up with control of both houses of Congress. The President went to great pains to place the best spin on the future prospects and effectiveness of his party to move his agenda, a party that spent most of the election campaign individually distancing themselves from the President's low ratings in the polls regarding popularity/ effectiveness.** This unfortunately portends poorly for any improvement upon the frustration level for what is likely to be a lame duck presidency for his remaining two years. Each party continues to **say** they will each seek the common ground and work to compromise to move the ship of state, **but the prospects wither when the President begins his address by rattling muskets, threatening notably more veto promises in a history of a state of the union message** if the victors should be attempted to claim the spoils. So, it seems the more the "promises to change" are offered, the more we feel the experience is likely to be "business as usual," meaning no useful business at all!

But, as I remarked in last year's letter commenting on the politics of the matter "It's the Math that Gets Us," when Medicare was introduced in 1965, social benefits distributed to persons were a 4.7% share of GDP. This number has grown to the current 14.9% share (2012), a 9.4+% point increase. The nominal growth of the GDP over that term has been 6.8% per year. The actual growth of the social benefits for the period has been 9.4% per year. The benefits cost have out stripped the growth of the GDP by 2.6% per year or 38% faster than the GDP positive movement. Had we contained the growth of the cost of benefits to no more than the 6.8% growth of the GDP, we would be much better off with a lower national debt and lower current deficit now facing us going forward.

But, **unfortunately this shortfall has the effect to be "baked in" to the deficit (perennial) each year at the current rate where the resulting reduced saving rate is short dollar for dollar to meet increased benefits costs such that we can't fund it without borrowing 1/5 of the dollars needed to service the benefit!** The effect of fulfilling the promise of these benefits, which we cannot meet with current revenues, has preempted or crowded out capital investment from the country's budget which has significantly lessened our rate of economic growth (reduced residual savings). The ironic consequence has been to suppress our capacity to create the revenues through increased productivity to pay for these very generous social programs, much less expanded existing programs for the "baby boomers" crowd nigh upon us."

Tax and spend cannot succeed here as it has not worked in the European Union which tragically is in a big mess; but more on that later.

THE CASE FOR RADICAL REFORM IN FINANCE IS CLEAR:

Sad but true, **Finance in the world of today,** Dodd-Frank aside, is more about the system having evolved over time, randomly reacting to short-term fits and starts which populate free markets, all the rage of the last few decades, but not in

accord with any intentional multinational coordinated strategy. Not surprisingly then, as indelibly confirmed in the Crisis, the absence of any such design discipline **is itself a design destined to fail, since its fragility is built-in; simply, the financial system as randomly composed allowed the making of promises (a pension of politicians) which it cannot possibly deliver upon. This is because financial institutions regardless of stripe by their very nature seek to finance long-term, risky and often illiquid assets (loans/mortgages)(30 yrs.) with funds which are short-term, safe, and highly liquid liabilities (commercial paper/deposits)(3 yrs.), thus forming a "maturity gap." This maturity gap has been the conundrum of the ages crying out for an answer which has perplexed economists and philosophers forever…common, but NOT trivial by any means!**

The people who provide the funds regard their deposits and loans (commercial paper) from them to others as a very close substitute for, if not exactly the **same thing as money-a medium for exchange or a means by which to store value.** But the assets held by the institutions to which they have lent are **not** at all like money; the institutions are subject to significant solvency and liquidity risks derived from the inherent risks of ALL their activities. In up markets this may not seem to be a problem masked by the apparent free flowing activity of transacting funds through the markets. But with the first whiff of trouble which threatens the health of those market activities, those very same providers of funds will be panic stricken and overcome by the impulse to leave "the stage" immediately and not wait for the smoke to validate the trouble. Of course, the unscheduled shift from juggling transactions as may be seen as normal activity to actually exit altogether by the providers of these funds will trigger others to flee just when calm would be more auspicious; the assets held by the institutions will then tank in their apparent value in the ensuing fire-sale price opportunity.

But note the critical point to recognize here is that the **value in the mind of the market participants** did not tank because of an inherent degradation of the underlying organic activity of the business that the "stock" represents (ownership), but that **the market activity, so apparent, so vibrant and manifesting such value thereby moments before, stopped abruptly** because all the participants LEFT the floor giving the impression that the stock and the underlying activities therein represented were worthless, since if it could not transact value in exchange, it was no longer "money" having a value, which has an equivalent value of $Zero. Certainly the intrinsic business value did not go to zero (people showed up for work), but since it had no bidders for the stock, then that was deemed to be (incorrectly) to the same effect. But we know that it was the **emotion of fear and panic** that is responsible for the perceived value of Zero which is related directly to the exit of all bidders. **Silly, yes, but deadly serious, in fact.** In February of 2009, sub-prime mortgage backed securities had lost 40% of their initial value devastating the net worth of many highly leveraged businesses that held a large number of these supposedly safe assets (AAA) or had used the same as collateral for other financial assets like credit default swaps (CDS) or collateralized mortgage obligations (CMO). By summer, in some instances these securities were discounted to 94% of their original value—just $0.04 cents on the dollar of instant value as the money left virtually worthless. Emotion can and does drive value to zero.

We are left with the legacy of legislation of **Dodd-Frank manic rulemaking** of 2,500 pages of legislation and 10 times that in regulation which seems **designed to disguise the fact that the function of it all in the end has been to preserve the system that existed prior to the crisis.** Consider that what we know and believe to date: Finance will still be global; it will still continue to rely upon the interaction of vast financial institutions within and through laissez faire capital markets; it will continue to be highly leveraged; and it will continue to **rely on profitability by means of successfully managing huge maturity and risk mismatches (arbitrage).** This legislative scheme is accompanied and motivated by political hubris and anger, fueled by public outcries of "Those Banks did it to us again." This leads to a breakdown of trust between authorities (regulators) and we who as traditional community bankers manage finance respecting its functions (public trust)

but whose voice is drowned out by the clamber to crucify the mega banks and all their participants in rogue Investment Banking operations that marched to the motto of "Caveat Emptor"- "Let the Buyer Beware" – taking no responsibility for the corrupt, fraudulent junk bond poisoning the pond downstream leaving it to the free markets to digest and the rest of us to clean up the trash or worse.

The public outcry was not unexpected given the huge cost to the world of this Crisis tipping $50 Trillion of ruin and human misery. As Martin Wolf observed above, and bears repeating here: **"the sheer complexity of the regulatory structure makes it virtually inconceivable that it will work or could work."** Certainly everyone involved, regulator or regulated institution, is NOT going to be knowledgeable of all the rules that must be complied with and hence will operate contrary to the rule without meaning to do so. Sadly, we are left with the notion that the authorities appear to have largely preserved a system that ironically they also distrust, so that is why the regulatory outcome has been so complex and prescriptive; admittedly, we concede that the enormous increase in complexity has influenced the risk profile of that segment, albeit large segment, of modern finance and an equally complicit huge increase in dollars expended in lobbying the Congressional architects of the oligopoly of finance which has evolved in this country, and oversight of the new financial order. **Adding insult to injury this reform has trampled on and reversed the progress made by CNC and other Community Banks** in solving, by innovative means, the conundrum of the 30-year mortgage booked on a community bank's balance sheet funded by deposits of a 3-year duration as if by magic of an adult conversation and a mutual agreement to proceed, linked in an ongoing mutually beneficial and imminently fair collaboration indefinitely.

Indeed, an example of this is our highly effective and successful use of the CNB (3-year option) mortgage, some 15,000 BOOKED over 30 years, in every case as a quality asset, 30-year term. **WE had found the solution which confounds the industry even today: We could finance a long-term 30-year amortizing obligation funded by short term core deposits with an average duration of a 3-year Treasury maturity without bearing any interest rate mismatch risk by means of a periodic adult discussion with the customer conducted in good faith and to the satisfaction of all parties completed without exception.** The format of the documents which permits this adult conversation was **EXCLUDED from the definition of Qualified Mortgage under Dodd-Frank without data,** certainly without reference to our impeccable experience despite many letters to officials at the Federal Reserve, our examiners, and the OCC, our federal regulator.

We accomplished this by every three years having an **adult conversation with the customer** who would agree to **an adjustment to their mortgage rate up or down to match the spread over the cost of funds on deposit which currently was funding their mortgage on our books. Yes, so long as the mortgage is outstanding and in force there is a continuously changing cost to fund that mortgage still on our books.** It is popular to believe that the funds which continuously support the mortgage balance outstanding have a fixed rate for the life of the mortgage. This would require the depositor to accept the same rate on his CDs for 30 years which would be silly to ask of anyone. Not a single one of these mortgages required foreclosure. By regulation they have been mischaracterized as a short-term maturity or **"balloon loan" requiring a payoff in three years. In our practice, we never had cause to exercise this option and NO loan was ever required to be paid off, but rather the parties agreed, in every case, to continue the mutually beneficial arrangement, and the loan continued to remain on the books of the bank.**

We had found and used for years a popular solution to the quandary of the financial system's inherent problem of the mismatch maturity conundrum which plagues the industry today. Yet, the regulatory and legislative response was to dismiss out of hand in an untutored exercise of regulatory indiscretion devoid

of supporting data and an insult to the integrity and intellect of rational oversight of modern day finance. Sad, but true.

Yet, the Dodd-Frank Congress **has chosen to enshrine a fixed payment and fixed interest rate for the term of a 30-year mortgage. As defined, we would not put a QM on our Books for 30 years funded by a continuous rolling 3-year cost of funds which bears a near certain risk of being a negative spread situation ten times during that term. We regard booking such a loan an unsafe and unsound practice citing the utter failure of the Savings and Loans industry in the 1980s as the prime example of the error of such an arrangement on our books.** In the alternative, it is our practice to sell to Freddie or Fannie or some substitute commercial bank, all such long-term fixed rate mortgages with servicing and the customer relationship retained. Of course, those GSEs remain in a government run conservancy even today since they **were taken over by the government as a casualty of the Crisis caused by their wide spread investments in securities backed by mortgages, most of which were NOT underwritten to traditional bank underwriting standards, all with predictable ruinous results.**

Mismatches of maturity of the loan and risk of the funding by deposits and additional borrowing to engage in direct lending springs from a perfectly natural preference of savers for financial products that are both liquid and safe. Not often spoken of is the huge "utility value" and **peace of mind gathered from having cash in the bank to meet the monthly cash flows** in connection with the cycles of the income and expenses of the home or business. Customers also see it as important to have enough ready reserves especially against contingency, such as health problems, but in the Crisis, attention turned to the possibility of unscheduled unemployment. It is evident attitudes have changed, giving greater intangible value to having the cash in the bank, compared with the tangibility of earning a few dollars of interest (subject to income tax). Consider while walking in the desert during the heat of the day how you might quickly value the availability of the water in the bottle in your backpack and not a whit of concern about its price, especially if you were beginning to feel you were……LOST!……True story!

In the end, the mark of the mischief and skullduggery running rampant through practices in the financial world during the Crisis, even to the highest levels, are marked and measured by the fines and settlements paid to date by JPMorgan –Chase stemming from questionable processes credited to their mortgage businesses are nearing $30 Billion. Standard and Poor's rating agency settlement of $1.2 Billion of claims relating to errors in their rating of mortgaged-back securities as AAA and AA which ultimately were valued in markets as "junk bonds" and worthless. Every Mega Bank has been tainted by these practices and finds it better to settle in order to just move on with today's business. They admitted no wrong doing, of course. But it remains, the fees levied were derived from information gathered from internal memos showing a reluctance on the part of insiders of the rating agency to lower the AAA and AA ratings of the employer's bank - issuer of the mortgaged back securities lest the employer be "upset" and not reemploy that rating agency. There is a silver lining to this, though. A few weeks ago, I was with my friend and our Lt. Gov. Kathy Hochul, who was detailing the economic development plan for New York with a number of programs, one of which is specifically being funded by the "windfall" of a onetime only $5.6 billion of these fines and settlements garnered from NY State's share of the take of these fines paid by the Wall Street Mega Banks.

FINANCE, INSPITE OF THE RISKS, IF PRUDENTIALLY MONITORED IS BENEFICIAL TO SOCIETY:

But in the scheme of things, there are many undertakings which present unsafe dangers other than financial mismatches which are regulated but not prohibited, such as automobiles and airplanes, because their benefits outweigh the costs. **That said, there are at least two exceptional features of finance as distinct from the other examples of risky products and activities: first are the huge negative consequences external from our usual associations with these**

activities—that being the irresponsibility of some can create a generalized panic and crisis; and second, the economic and social costs of financial crises are exponentially enormous. For example, Martin Wolf, of the *Financial Times, London,* **observes that in the UK the financial Crisis delivered the fourth worst fiscal shock to Great Britain in the last two hundred years after the Napoleonic Wars, the First World War and the Second World War.**

The US GDP in the last quarter of 2013 was 17% below its historic trend. It's Wolf's contention, these are huge short falls. If we assume our growth to be, for now, at or above 3% on average and that the discount rate for the GDP is the same 3%, then the cumulative present value of the short fall lost in US GDP over the next century of the Crisis, would be seventeen times the GDP of 2013. **Such costs are not trivial since they are on the order of the financial costs of world wars!** So, advice to our politicians would be reasonably to avoid wars in favor of investing those funds in saving which would redound and multiply to increase productivity of our GDP and sustainability of our standard of living which is the envy of the world. What a concept!

HOW DO WE PROPOSE TO PROCEED GIVEN THIS REVIEW OF OUR SITUATION (UNIQUE) GIVEN THE LAYERS OF CONTEXTS WE HAVE DISCUSSED?:

A thoughtful analysis of its current status and how we got here invites discussion of the complex interaction among at least three macro forces among a host of other items to focus on: (1) globalization, (2) extreme destabilization by imbalances of trade and capital flows across sovereign country boarders (Euro Union), and (3) our extremely fragile financial system; **sadly, all sources of underlying fundamental instability which plagues the finance world which is the progenitor of the next crisis which is sure to visit us eventually.** That so, I **hasten to add the goal of these remarks is to illustrate that WE at CNC have the choice as to the degree we choose to participate or avoid the mistakes of the future crises.** Indeed, the conscious choices we have made in the past, avoided the horrible financial damages wreaked upon the world's social order by the irresponsible behavior of mega financial players in the world's misadventures in finance, and were as intentional and deliberate as they were irresponsible and tragic in outcome to the wide sectors of the world's innocent and unsuspecting societies.

We as a society prefer to personify our heroes and demons rather than deal with the debate of conflicting positions of substance, ideas and concepts which populated the world of Finance during the Crisis, and take stock of the wisdom and foolishness of our "human being" ways and results. Frightened at first, then angry, were the members of Congress whose solution and retribution was the passage of the Dodd-Frank Act. This is the customary response of political beings I have observed over the decades to divert attention of any suggestion that their failures, short sightedness, and negligent design was at the root of the cause of the Crisis and regulators who fell short of anticipating or responded inappropriately.

One example of this is the Congressional leadership called on Bill Isaac, former Chairman of the FDIC during the Thrift Crisis of the mid-1980s. In his book, Bill describes a gathering of Congressional members who were in a state of shock and awe and unprepared to understand, much less lead or aid in a solution. Threats of piano wire strung around the necks of Wall Street CEOs and their children were reported to hearings before the Senate Banking committee as a gage of the scope and intensity of the hate of Bankers and the personal anger of the mob like atmosphere, especially when it was announced that the CEOs and Senior Officers of Wall Street were to be paid those contractual performance bonuses while the DOW plunged to 6,500 March '09 from 14,000 a year or so earlier. Yes, with the hint of Greed and Fraud in the air running rampant and "NOBODY GOES TO JAIL" yelled the chorus of confused and angry citizens. It was seriously ugly.

But, please do not confuse a result for a cause. True, in a Crisis human nature will supply numbers whose reaction to the chaos encourages and begets the company of **Greed and Fraudulent behavior. But such behavior does not come close to explaining the scope, scale, and colossal damage and destruction of the Crisis which touched every corner and soul in the world.** That is because **Crises are perennial** and spring from the very nature of societies comprised of diverse groups of human beings. **Yes, we all contribute to the vagaries which morph into instability which randomly fly out of control.** It has been a **myth of economists of the last three decades that with modern knowledge and understanding we can eliminate the financial Crisis. But history reveals that they are perennial, so we best work on how to prepare to restore stability when instability inevitably appears and encourages a recovery by means of strategies which generally must be redesigned since every Crisis is unique for all intents and purposes.** They exist in the nature of the social interaction of the whole of human beings which comprise the "all" of the society resident on the earth as life circumstances bounce us randomly from euphoria to abject fear and panic

We as multiple populations of the entire world were this time all spontaneously over-leveraging our financial situation, in the context of global stimulation fostered by the Internet, without regard to the consequences of trade and capital balances and flows (the tail that wags the politics of international relations).

So, we can start by acknowledging that it is perfectly possible that a crisis is a natural phenomenon of a dynamic and healthy economy which strays beyond sustainable boundaries, rather than as was commonly thought among modern economists of this day that we were beyond falling into that trap. The 1929 Crash was over 80 years ago; beyond the life expectancy of most practicing economists. Proof positive, as we have remarked before, **the only thing new in the world of Finance is that which has been forgotten.** And so the world of finance DID fall into the trap. The learning here then is gleaned from the word "perennial," meaning: Crises appear periodically on their own rhythm. Thus, we would be wise to conduct business with this certainty in mind so we avoid its worst effects by being prepared for the possibility and prepare to style solutions and corrections to the system appropriate to the situation at hand in all of its uniqueness.

The challenges before us stem from our belief that we are a democracy of an expansive and liberal nature, believing in free markets and competition which we acknowledge are powerful forces of human nature driving a dynamic economy which we identify as the workings of economics theory. This theory manifests itself in the commerce which produces the "juice" which is the value we recognize as the product of the effort. This, in turn, creates the economic base supporting both municipal and private sector enterprises, the growth of productivity by means of the incorporation of new ideas and the ultimate enhancement of GDP and underwriting the standard of living which is the envy of the world.

At its best Finance is a language, nay, a universally understood conversation, indeed a magical quality, derived from the collaboration of shared values and culture guiding human behavior when no one is looking, which is most of the time, to manage all matters economic in nature (tangibly) which supports and is necessary to human survival of all on the planet, as individuals and as a community. The government and politics so often referred to and deferred to is another parallel **conversation as a Democracy in nature** presumably directed to the same goal of collaboration in community but by a different consensus methodology. **Finance, though, arrives at what is viable and sustainable in terms of resources identified and expended while the other Social-Political model relies on shared beliefs of what is desirable socially measured by political metrics that are values which are intangible, which are distinctive from the viability and distribution of the tangible financial resources available. Balance is required between**

the two approaches to achieve broad acceptance of how we as a society are going to organize ourselves to sustain and improve upon our prospects and have peace in our community in our time.

We are not alone in our quest.

Here "our community" importantly includes along with the United States the so called **"Eurozone" encompassing 22 sovereign countries chained together in an uneasy monetary union which are showing signs of its tragically defective architecture represented by 22 financial ministers, (political appointees) and 6-8 additional trade associates waiting in the wings to join up.** It comes as no surprise that this conclave of politicians gathering with other financial and intellectual ivory tower elites might as a grand chorus fail to effectively guide the financial system adroitly as a practical matter. This is obvious enough from their performance to date as challenged by the Crisis events.

Simply, the European Central Bank (ECB) as the chief administrator of the Eurozone IS NOT the Federal Reserve either in structure or authority. This is a serious problem for the subject of global economics and its vitality because of the prominence of Europe to the Western Economies of the Free World. Thus, I have chosen to give a cursory review of the "Euro" and its current state, post Crisis and current focus of the news media to understand that which may not affect CNC's prospects directly in Upstate New York, but because it is important to our national interest as a significant trading partner and collaborator to America, financially, culturally and historically, and as such informs the context of which we are a constituent part of the globalized evolution well on its way. If we learned anything from the Crisis, it was the high degree of interconnectivity and diversity of the world's multiple sovereign economies (reference the performance data, Prologue above).

The ECB ministers to Monetary Policy (supply of Euros in circulation) by manipulating interest rates by the familiar mechanism of buying and selling Bonds (Sovereign) of all the constituent members, **stabilized prices in fulfillment of their principle mandate. In contrast, the Federal Reserve System from its beginnings in 1913 was structured as a network of 12 District Banks which are independent but operated under a National Bank charter which is special in a number of ways.**

First, at the birth of our Nation in the late 18th Century, there was **created a secure Political Union** with a Constitution which would be tested in time (Civil War), but nonetheless provided a stage, **upon which, an economic AND a monetary union could be constructed slowly (the brainchild of a young Alexander Hamilton).** The Constitution also embodied key assumptions about the **existence and permanence of a national debt (a key collective "safe asset") and federal taxing power (ultimate central fiscal capacity) as well as a National Currency and the Commerce Clause (truly free interstate trade.)**

Second, by the beginning of the 20th Century, having survived the Civil War and the stresses thereof on finance, the Federal Reserve evolved and its offices morphed into being the Bank for the United States Treasury as it is today. Through the 12 District Banks, our national currency was distributed, recovered and shredded when it is no longer serviceable (worn out). At first, this was in conjunction with banks like Canandaigua National Bank which was authorized to issue and distribute **"National Currency"** (collateralized by US Treasury Bonds owned by the bank) signed by his hand in ink by my Grandfather "G. W. Hamlin, President" in 1902 and later in the series 1928 a printed facsimile and the Chairman of the Board at the time. Thereafter, the Fed moved to become the exclusive issuer of our nation's currency now labelled as a, "Federal Reserve Note" on the front with the placard "This note is legal tender for all debts public or private" appearing to the left of the portrait on

each bill. **Not to be forgotten as a hedge on the back of each bill there appears "IN GOD WE TRUST" as a matter of full disclosure that: money is "fiat based," meaning it is founded on an article of faith, which fortunately is a concept embraced universally.**

Third, under Article 13 of the Federal Reserve Act of 1913, the US Treasury can issue its Bonds through the Federal Reserve which thereby is also authorized to monetize these government obligations which money can then find its way into public circulation in the financial system to provide liquidity (medium of exchange and method by which value may be demonstrated) as needed to allow those entities which are solvent (positive net worth) to engage in commerce with other likeminded entities of positive net worth, and so it goes to repeat itself to generate GDP. This is what was done in 2008 when the Crisis exploded upon the finance scene and money markets for the first time in one hundred years seized up, meaning closed in the face of the panic and uncertainty. **The Federal Reserve flooded the banking and money markets with liquidity by boundless supply of money (medium of exchange) to facilitate commerce among financially viable (solvent) entities** which normally would have "primed the pump" with short term commercial paper and interbank borrowing which had vanished overnight. This principally worked to stave off an even greater financial disaster than had occurred in 2008, if the initial contagion of the utter lock up of the liquidity in the financial system was allowed to collapse the entire system. The European Union does not have a comparable capacity as the Fed Article 13.

Fourth, the Federal Reserve, through its Federal Open Market Committee (FOMC) deliberation through the special offices of the Federal Reserve Bank of New York, effects the supply of money (Dollars) in the Banking System (aggregate of bank deposits resident in the United States) by buying or selling **US Treasury Bonds, the safe asset (risk of default free)** not a random set of sovereign bonds of 22 countries with obviously differing credit quality depending on the fiscal practice of each member.

In comparison, neither the Eurozone nor the European Union comprises a political union; exit is conceivable from both and openly discusses; there is no central fiscal authority; nor any common debt backed by all the members; and no appetite by creditor nations to entertain such. Obviously, what we were able to pull off in 2008 with the Triumvirate of the President of New York Fed, the Chairman of the Federal Reserve, and US Treasurer was amazingly effective, but is NOT within the grasp of the European Union under its current architecture and polyglot of language and culture. Yes, the 13 Colonies thought of themselves as separate country/states too, but it took a hundred years and the Civil War to mature into this current status; the envy of the world.

Perhaps the most important distinction between the Federal Reserve and the ECB is the structure designed to separate the working and deliberation of the Fed from political influence of any kind. No Fed Governor or Director of a District Bank or officer may be an elected or appointed official of any government of any kind, not even a dog catcher or volunteer on a Town Planning Board, and certainly not a source of any political contributions. It was the latter constraint I personally found convenient when I was solicited for political contributions when I was a Director of the Federal Reserve Bank of New York from 1997-2002, for 6 years!

The Fed's mandate is to focus on full employment, optimal level of inflation, and manage price stability through setting of interest rate targets derived from its FOMC activities to eliminate the supply of money in the system (tightening) by selling US Treasury securities (soaking up or removing the garnered proceeds from the system) or releasing money (easing) into the system by reversing this process by giving cash in return for a purchase of bonds with the proceeds deposited in a commercial bank. **This is a much boarder charter of responsibility than the narrowly construed focus on just price stability required of the ECB charter.**

Thus, the tragic flaw in this structural architecture comes to roost when Greece (youth unemployment 55%) or Italy (wide spread corruption) needed an accommodation and there was no means to expand liquidity in the system by the creation of a single debt instrument that aligned the responsibility to repay by the commerce of the same economy seeking the need for increased money supply. **Germany was the strongest economy with the wherewithal to do it, but lacked the political will understandably to take on responsibility of one country member (Germany) to bail out another country (Greece)** with the transfer of and accepting the risk of default of the suffering country's poorly managed economy. The same would be true of other debtor nations like Portugal (youth unemployment 55%), Spain (real estate bubble) and Ireland (default on foreign deposits).

It so happens that as of this writing the European Union is all about the Greece situation which is coming to a head since the numbers require it. Though the bankruptcy of Greece, its financial ruin and withdrawal from the currency union (Euro) would not affect CNB per se, it will be a strategically messy business for the European Union to resolve. This must be delicately handled since Italy, Spain, and Portugal are all in a destabilized condition under an austerity program but for different reasons. Over the last six years, Greek debt has risen from 109% of GDP to a runaway 175% despite tax increases and expense reductions and really needs a massive intervention of a debt reduction program with their creditors, where 80% of their debt is held by the Eurozone membership. The Union has its cultural partition of the frugal north, that includes the Finns, Dutch, and of course Germany who expects the Greeks to keep their agreement under the present bailout plan and the other half comprised of the profligate southern cohorts. **This squeeze of austerity (in the context of a 25% unemployment rate) has succeeded in bringing the popular front into the streets in animated protests, driving a regime change in a recent election, and sweeping the far-left populist party into office on promises of cutting the suffocating debt, a public-spending spree led by rehiring 12,000 municipal employees, abandoning privatization, and introducing a big raise in the minimum wage to undo the hard won gains in Greece's competitive position.** All these initiatives may well have a domino effect on the resolve of continuing austerity programs elsewhere like Italy and even France and strengthen those who have become disenchanted by the Euro Union and its dictates and disciplines.

This is not a pretty picture, and there are few alternatives in the offing; those that are, not "a walk in the park", likely painfully unpopular, even if possible to "pull off".

This is a problem for the US since the Eurozone is the second largest capitalist market in the world and a significant trading partner of the America. They did not have the resolve or the capacity to deal with these mounting problems in 2008. Since then, much of the Eurozone has seen growth but because of the lack of a consensus to act; the default option has been to kick the can down the road and hope. It is awkward since their policy initiatives are not coordinated with ours (the better practice), but just the reverse since they are behind us in the recovery. They are beginning Qualitative Easing just as the US has discontinued and the ECB is lowering interest rates as an incentive to stimulate the economy just as we are preparing to do an increase in rates to more normal ranges to get back to managing monetary policy by interest rates and control inflation at an optimum rate of 2%+. Generally it is better when whole economies can coordinate these big moves to manage finance and monetary policy rather than work in apposition because of the obvious efficiency and effectiveness are gained in coordination.

LESSONS LEARNED AND COURSES TO CONSIDER:

What we can gather from this discussion of the recent past and may give a hint for consideration of future strategic moves, and has been established with clarity, a **reality of the perennial nature of Crises.** That said then, what is needed is to develop an understanding of how to **protect the financial system,** which we acknowledge is so important to much in our daily lives, **from the excesses of an economy** that itself evolves totality from the admixture of human behaviors **so as to protect that economy** from the **excess from the financial system! A dynamic balance is called for to maintain the best resolution of this societal tension (yes, a good thing).**

If I may be permitted an aviator's metaphor: Other than the utility of the altimeter which is obvious enough to judge one's proximity to the ground or mountain obstacle, **the most important instrument on the panel for safe operations of the airplane in flight is a working airspeed indicator, specifically the green arc inscribing the range of the design speed limits for the effective operations of the airplane.** Suffice it to say, slowing below the low end, say 75 mph, the wings of the airplane are no longer passing through the air fast enough for the wings to operate as wings and develop lifting forces greater than the weight of the airplane to fly level or climb. In this low end case, the wing is said to have "stalled" (no lift) and the airplane ceases to fly, but takes on the characteristics of a rock and falls to the ground. On the high side of the range at 200 mph, the green changes to yellow, and at 240 mph there is a "Red" line, meaning not to exceed. If the speed exceeds the green arc, special care must be taken that conditions are "smooth air" rather than turbulent. If turbulent, such as in a thunder storm, (normally avoidance is the best course), the forces on the wing or the control surfaces deflections may bend the structure with a force beyond its engineered design. Beyond the Red line, the risk of over speeding is running a risk more than bending, to include failure of the structure. This is a bad thing!

The green arc limits are different for each model of aircraft but the message is the same, that operation within the green arc is the proper range to sustain control flight, which is the goal-sustainability. Simple to do, but these limits are absolutely critical to observe literally to the nth degree. So it is for managing the economy using the tools of finance, which like airplanes in a weathered environment, is complex with multiple variables but perfectly safe in operations if managed intelligently and continuously monitored with a goal of sustained flight subject to command (control of the basics). Both are susceptible to random acts of natural or human origins, so monitoring is an important engagement to maintain.

The largest Banks (regulated) and Shadow Banks (unregulated) together set off into the financial weather uncharted with little understanding of the limitations or utilities of their financial instruments or computer models. Not surprisingly, they came upon situations unfamiliar to them and lost control of their operations, hence their destination and destiny. By over leveraging (speeding) from a green range of 8/1 to 13/1 to the red range of 40/1 and 50/1, they were dangerously beyond the prudential limits of the financial green arc, and additionally they failed adherence to prudential practices and time honored principals of financial flight with a watchful eye to anticipate well understood human frailties and behaviors which are liable to discount the quality of the credit (mismanage liquidity-run out of gas). In the extreme, a rocket ride can peter out, and the speed drops below the green, the prospects "fall out of the sky" and declare bankruptcy, and a total loss has to be charged off (plane totaled). They crashed and burned and caused enormous collateral destruction to innocent populations below leaving ruin, unemployment and misery. **They were reckless in the extreme as they were intentionally bent on doing something without understanding the consequences of collateral damage.** The numbers do not mince their meanings; there is a "physics" to finance despite the dominance of human factors **and the resulting "numbers" from the application of the physics are unforgiving and unalterable!**

Why are these distinctions pertinent to our learnings and inform our behaviors in the future? **I have spoken to you before about how human behavior is driven and guided by PERSONAL CHOICES and behaviors driven largely by emotions molded by our core values, especially when nobody is looking, which IS 95% of the time. It is also human nature to** rationalize our decisions and actions to our significant other(s) by a **cost benefit analysis which is expressed in tangible monetary terms** but the money is usually just the **minor third of the total value. Our** complete sense of value includes the elements of numerous feelings of an intangible nature, such as the "rush" that follow success or "downer" that attaches to failure. Moreover, these intangible impressions constitute the major two thirds that thus dominate the evaluation process and thus, likely will drive the course of the decision.

This observation aligns with the history and data of building successful human relationships and their collective beneficial outcomes to which the performance metrics of CNC bears witness as but one example. This has been especially true in the world of finance. Early in my career in finance, I was puzzled how individuals made decisions about their financial affairs, that is, they DID NOT follow the numbers reflecting their best interests, but mostly followed an altogether "different beat." **It follows that the world of finance is commanded largely by emotions first and rational conduct a distant second.**

In markets, we expect a sustainable growth of a well-run enterprise to ring in at 8% per annum, well within the green arc. Consider that the common stock of a company is the first derivative, that is, a security (ownership) which captures the organic growth of value of the enterprise and its earnings which are expected to be distributed in the form of dividends. The growth of the balance sheet by Assets acquired and retained earnings added to the Common Equity is eventually reflected in the abstract in the value of the stock at a price in markets calculated based on a multiple of tangible book value or on the present value of the demonstrated dividend distribution expressed as a multiple of earnings per share history (tangible). To that we add an intangible increment of value which is informed by the perceived **value in the future of the combination of the growth in earnings associated with those assets and their inherent growth in and of themselves at the end of the day.** I have spoken to you in previous letters that the activity of some $30 Trillion/year on Wall Street is 99.2% trading, a zero sum game among speculators ("the gypsies") masquerading as investors and bears no relation to the organic operations of the underlying companies. The balance of the activity .8% is the $250 Billion of raising new fresh capital to underwrite a new enterprise or new expansion of a growing enterprise. Remember, in early March of 2009, Citi Group stock price had plunged to $1.69/shares, sadly a value less than their current ATM transaction fee and on a day that the DOW closed at 6,500 from 14,000 a year or so earlier. Citi lost 95% of its market capitalization. The next year, 2010, it was cited in the Wall Street Journal as the best performing stock of the Year! Well, of course, since the year before the company's stock "cratered." Equally obviously is most of the NYSE companies cash operations and performance did not drop 50% with the DOW.

MAGIC OF FINANCE—A SACRED PUBLIC TRUST—MANAGED TO ITS PUBLIC MISSION:

It is shocking to me that something so simple could wreak such havoc with the functioning of the most highly sophisticated state of Finance as it is in its entire history. **First of all, finance per se is not a product, service or good, but simply an idea, a concept. It is in the nature of a language spoken across the world, common to all societies and universally understood. Indeed, its interactions are in the nature of a conversation whereby we communicate our priorities and concerns, commitments to act and behaviors chosen displaying our needs and wants in the process, along with the relative value and weights which we attach to them.** As I have remarked before, because of the universality of the concepts and beliefs which underlie finance and its acceptance given its ubiquitous nature, **it as a subject rises to a status of being a Sacred Public Trust which occupies an essential**

place in the DNA of societies of inescapable importance to everyone, as is the case with the quality of the air and the water which are necessities for daily life. It is hard to fathom passing the day in the modern world without having to utilize the use and benefits of finance via the payment system, safekeeping of value via currency and bank deposits **or its very creation of tangible money as the loan proceeds are deposited against an intangible note which promises to repay over time. This latter is the magic of leverage which works to elevate and monetize an ephemeral dream into tangible commerce which grows the GDP** and which is the foundation of our dynamic standard of living which is the envy of the world.

This is demonstrated on the front and back of each currency note, as I have said: "Federal Reserve Note" and "In God We Trust." "Fiat money," is what it is called, and it boils down to, the fact that it is simply an article of faith in which we and the world believe. That said, an important factor materially standing behind this notion IS the character and reputation of the government (economy) that backs that currency, namely its dynamic stability and sustainability. "Dynamic" because it exists in a state of continuous change and motion and "stable" because its value and availability has a predictability over time which lends to its capacity to store value reliably in an accessible and thus conveniently usable form.

The Crisis was caused by the reckless operations of the largest financial institutions which abused their responsibility as fiduciaries of Finance, a Sacred Trust for the benefit of the Public. They conducted their businesses in a way that was destructive to the workings of finance and its dynamic stability, much to the monstrous damage to the innocent citizenry of the world and the stored value of the entire system. Some $50 Trillion dollars accumulated by commerce and human energy, which as a direct consequence of this reckless behavior, caused this enormous value to vanish from the balance sheets of the world-to be gone forever.

The root causes of the Crisis are revealed as a practical matter in an examination into the fundamentals of the business models of a dozen of the largest financial institutions in 2007. Irrespective of formal charter, each was functionally engaged in Investment Banking operations and securities underwriting (manufacturing instrument) together with a focus on proprietary buying and selling securities (on their own account) with concomitant market exposures as to price volatility and instability with the proceeds of such Investment Banking operation constituting their principal source of revenues. The trading revenues alone of the top five of these combined was 90% of such revenue in 2014 of the entire banking system, just to place a finer point on it. Secondly, it was the record breaking levels of financial leverage employed never before seen, much less anticipated in the history of finance which added "malice a forethought" to the reckless abuse of the Sacred Public Trust of the first, meaning the degree of focus on proprietary trading at the expense of traditional banking thesis.

On the other hand, there are a large number (6,200) of small traditional "community" banks, characterized by an intermediary process of cycling deposits of a region (community) into funding loans (underwriting business and consumer activity) in the same region (community). As these loans are paid down they form new deposits to start the recycling again, relying on monthly payments on such loan obligations as their principal cash flow/revenues. Significantly, this revenue flow is not dependent on market activities as to price or liquidity but only upon an agreement to pay, which is dependent only upon the daily toil of the borrower to a net positive constructive activity at the end of the day and payment at the end of the month.

The trouble lies in the management of financial risks which are different but inherently lurking in each style of operation but in different degrees and type of risk. Payment methodology associated with each relates to HOW the revenues are earned for the P & L accounting and the second is the choice of asset forming the object of the transaction from which the earnings come.

We will examine the home mortgage (loan) transaction and the source and quality (character of deposit) of its funding which was the category of lending and funding transactions that the Crisis was most involved with, and involved all the elements present in the root cause of the Crisis.

In the Bank setting, the mortgage loan is funded (financed) by deposits which are gathered, created, or otherwise brought to the bank in many forms for safekeeping of stored value at a convenient location and in a common format. Popularly, we take something of value such as currency or a check drawn to our order and "make the deposit" which delivery is acknowledged by a receipt. The records of the bank reflect that value on its ledger under the customer's named account and we think of that as "my" money in the vault.

Actually, though, the bank legally owns that money and you have freely given it the bank subject to its contact agreement to honor your call to place that value as you might direct by the magic words: "Pay to the Order of." This transformation of money from cash or check is ultimately to an entry on the ledger of the bank is no more or less of a concept than the tangible coin itself is a symbol of the associated value. **It is just a change in format not value.** We all agree, though, this format has many benefits to the customer since this value is stored in a convenient form which by agreement we will send to wherever and whomever you direct or place it in an alternative investment for a return (interest from the bank, or purchase stocks and bonds for your account, hold custody of those for you and distribute income we receive as your agent as you direct).

Moreover, the deposit is backed by the bank's capital and insured by the FDIC which the bank pays the premium on because it owns the deposit. Good arrangement. The ATM that you place a plastic card into to draw $200 delivers the $200 but NOT because it was your money in the machine, but because the owner of the machine and the money in it was transferred by the bank's systems and connections online in accordance with your authority manifested either by your signature or plastic PIN entered on a key pad. This electronic authority approved taking money from the bank's money and delivering it to you AS PER the agreement. You don't have to own these computers to use them, we do or we pay for their use by you, since you are our customer. How convenient. Now the $200 belongs to you again.

So my purpose in this detailed description is to outline the real facts and demystify the mystery surrounding the nature of money in its many forms. Other than gold, other forms of money are a manifestation of some agreement and record of activity in an account ledger keeping track of the value or description of property interest.

Thus, the deposit in its simplest form is a number entered in the ledger book of the bank (electronic record). It is subject to the call of the owner and may earn interest while owned by the bank. We divide deposits broadly into two categories: Demand and Savings. Of those, the tendency is for most amounts to remain on deposit for an indefinite time which may be **88% of the total deposits on the books which we call "Core" deposits. It is this category which we lend to others in the form of mortgages and other loans which tend to be long-term arrangements which are appropriate for Core deposits which are at the bank for historically long periods. They are a stable source of funding of everything in the community by making loans** for houses, cars, education, businesses and governments. This is especially noteworthy for CNB because **our deposits increase during times of recession,** so there is more money on deposit as people value safety and convenient access to cash and most importantly availability (utility over investment earning value). Importantly for CNB, we in the worst of times, have more resources for making more loans and thence more revenues to grow our usefulness to the community and our financial strength to weather the **storms caused by the reckless conduct that generally comes from the <u>excesses</u> of Wall Street.** This occurs just when the demand for money and conditions make that capacity to prime the pumps of those

folks who are still firing on all cylinders—**a priority for the recovery to get things started again. In bad times, there are many who are soundly situated to move forward and invest just when many are flying off their rockers in a panic. Consider a 10% unemployment rate is high and a misery real enough for those in that minority category. But the fact remains that 90% of the work force is still at work, "firing on all cylinders." That is a lot of folks still "at bat" who can use financial services and loans. It is really a very individual affair despite the impression of widespread gloom often given by the Headlines.**

Thus, the importance of this discussion is that CNB's historical viability demonstrated for all financial seasons is entirely attributed by the choices we make with respect to the business assets we choose to pursue, and HOW we underwrite and decision the management of those financial assets and investments for ourselves and our customers we choose carefully to "partner with." That is the safety and soundness of this mechanism as applied to our operations and is assured by what WE DO, not by what is happening with other banks and investment firms here and elsewhere. The key to banking in bad times is the choices we make to make good loans in good times, because then we avoid the fate of those who were not as studious or careful in their financial dealings which then appear during the "down turn." **Our markets are highly diverse in their financial activities which is a good thing, though not a necessary thing, since there is always good business to be had in every season. Strong banks in troubled times have the advantage over the many with trouble which tends to be a disproportionate distraction which is expensive and inhibits attending to the gathering of new revenue.**

Our performance and fortunes during the last recession are proof positive that if done carefully, this business model is more secure than most for weathering the future storms. Our choices and strategies were intentional and in accord with time honored principles and aligned with a thoughtful consideration of human nature in all of its forms and seasons.

The road to good banking is paved by good customers who are financially responsible and who add value to the community by taking responsibility for themselves and others about them and are inclined to collaborate with others to do their part. Attitude is often more telling of success than aptitude alone.

Core deposits (long term) are our principal source of intermediary funding for our direct lending, which we target to book and retain on our balance sheet (vs. sell to Freddie/Fannie etc.) This is the chief differentiator from the mythology principally employed by the big banks' business model employed by Wall Street.

Wall Street mega banks are really involved with two businesses, the smaller one funded by recycling core deposits, as we do. Their major revenue sources are derived from the origination of securitized mortgage assets gathered up and bundled in groups of 500 to 1,000 loans as securities which are sold in retail markets to sovereign governments or large pension funds and insurance companies. The investors receive returns as the mortgage payments are passed through and servicing expenses are paid.

The Sellers of the securities use the proceeds of sales they recover and repay the wholesale funding and profits with or without servicing released. The risk of the repayment of interest and principal is passed to the investor funds. In the alternative, the Investment Bank would buy wholesale money in the market for 90 days (short-term), specifically for originating (funding and packaging) a group of mortgages to be distributed to bond holders who buy such packages of money revenue streams known as Mortgage Backed Security, and for the long term the mortgage is an asset on the books of the banks.

Both the Securities monger and the Banker are buying the monthly revenue streams paid by the home owner. But this is where the similarity ends. The relationship of borrower (home owner) and the "investor"

in the debt securities (mortgage note) is quite different and remote. Contacts with the borrower and the security owner are all but cutoff, and **the servicer collecting the monthly payments is in a commodity business of collections AND the securities are often sold multiple times. Servicers are changed often which effectively severs any chance of any relationship.**

This is not as important in an up economy, but becomes critical to the collection of the loan with a downturn in the economy when the borrower and lender are both under pressure to manage the orderly repayment of the loan as agreed and neither of the original parties are knowledgeable or on the same page with one another. So, if an adjustment or refinancing is called for, the only recourse generally requires that the entire obligation be just paid off and start anew. In the troubled situation, that starting anew is not available as a practical matter since the credit file no longer qualifies. In the case of a refinancing, the government's attempt to provide assistance programs during and after the Crisis has not been met with tangible success.

THE IMPORTANCE OF UNDERWRITING IS CRITICAL TO PRODUCTION OF QUALITY RELATION BOUND ASSETS.

In the Bank's mortgage case the relationship is first person, direct, and long term for the duration of the arrangement which is "underwritten and booked" on the records of the bank. The once a month payment is to a "familiar face" which generally is a business, which allows the bank to provide other services such a checking and savings, investment services, and advice and counsel. **Most importantly, the mortgage is actively on the books of the bank, and the financial risk for each the borrower and the bank are linked together for the duration.** This is by definition a complex comprehensive relationship, and a good thing! The application and the underwriting of the loan is a personal exercise and allows access by proximity to much more of the surrounding context and information about the borrower, the property financed, and the community.

The three C's of credit is where we all started. **There are no short cuts to good quality lending or financial management of investible asset of clients. If you don't have good quality (judgement), then you are not in banking or investment management; you are in a regulator nightmare. Quality, like family, is always first, then all that follows is constructive and fun, and there isn't any second rule but to refer to rule # 1!**

Capacity to pay: not just the credit score and employment status but the reputation and success of the employer is a matter of important intelligence as well as the **attitude** of the borrower, since that all goes to the reliability of the revenue stream (demonstrated financial responsibility) that is going to service the repayment. **Collateral** and its value: the collateral and its neighborhood would be familiar to the community bank and the values therein, and future prospect of value bearing is the backup resource to recover the loan if the first source fails for any reason. **Character:** most important is the character of the borrower as to honesty, responsibility, and experience in the conduct of his financial affairs as evidenced by the presence of savings. The ability to make a reasonable down payment speaks volumes as to a prudential management of the borrower's lifestyle and credit dealings.

Contrast the foregoing to the Investment Banking model of "Originate and Distribute." Here the relationship is attenuated where the borrower and the ultimate lender never meet but deal only through multiple third-party intermediaries. Capacity to pay is relegated to the **credit score index** provided by an **impersonal entity** and a pay stub. Collateral is limited to an impersonal opinion of an appraisal of property, both appraiser and property unknown to the lender. And Character is not available in the documents in the absence of a personal

interview. There is little in the file which will give any insight into performance of the loan during a down turn, i.e., evidence of prudential management of financial affairs.

The "originate and distribute" securitization method is the ultimate commoditization of the entire mortgage transaction, impersonal relationship throughout. The investor lender's and the borrower's risk profiles are NOT aligned, as is the case above of the loan on the books of the traditional bank for the duration. Thus, the attention to the underwriting quality is ignored in the subprime context, to the peril of the entire financial world. That is, securitization and packaging of 500 loans obliterates any data or opportunity for a personal commitment to materialize, which is the only hook to deal with in the context of a troubled loan, even for legitimate causes.

Here is where these distinctions as to the degree of risk change as it relates to loan structure comes home to roost. When the bank borrower is 90 days past due, the loan **(direct lending)** is moved into substandard category (known risky relationship) and an addition to the reserve account at the bank for loan losses is charged against earnings of 10% of the outstanding balance. If the mortgage is in a group of 500 loans bunched in a security on the other hand and the economy is challenged besides, it is likely there are a number of similarly defaulted loans in the group of 500 which are also seriously past due, but who and how many there are not **known (more risk assumed) because there is no active relationship and no means of knowing.** This injects **elements of uncertainty of a different kind** in this **more remote indirect lending structure** involving uncertainty and **thus riskier** than the single direct lending case. Here there is no charge against a reserve since it is not a direct loan. But the increased risked is acknowledged in the market by a 30% discount in the market value of the security backed by that bunch of collateral. If this mortgage backed instrument is then combined with other asset backed securities in a CMO (collateralized mortgage obligation), the same similar events, and larger numbers **lead to a greater uncertainty which signals a much greater risk.** So, in six months that instrument draws a bid of just 4% of the par value, a discount of 96% or to nearly worthless, and a charge off then is required against current earnings 100% (real case…ouch! True story. Thankfully at another bank).

Approximately 75% of the fixed-rate mortgages for the last two year before the Crisis broke in 2007 were originated and distributed by this securitization process, by an informal, unregulated "shadow banking industry" which baled stacks of applications and form **mortgages with little or no underwriting or standard appraisals and which were sold in worldwide markets under the mantra of "Buyer Beware."**

If that were not enough, the death knell was sounded when the largest banks were committed to the business of extending huge lines of credit amounting to increased leverage in the billions of dollars which sadly had the effect of supporting an accelerated growth of the real estate bubble values worldwide. When the bubble burst, it exploded and took down the entire financial system focus on that sector of the industry which was running wild on fictional or inflated appraisals of the real estate collateral. Ultimately it took all of the heretofore iconic Investment Banks to their grave. Markets went along with the craziness since the pace of transactions was so large the liquidity pace thereby represented was mistaken for the tangible values inherent in the transactions until the house of cards fell apart and that apparent value was seen to be false "house of cards"-with catastrophic consequences.

That is exactly what happened when subprime mortgage backed securities got a black eye, the uncertainty generated tanked the market place values so quickly that the panic was off to the races. Because mortgage backed securities were regarded as good as gold, first mortgage on residences, they were more popular than Treasuries because they had a slightly better coupon. So when these securities "tanked" in value and margin calls exploded on credit extensions, which themselves were fine but

whose collateral was tainted with suspicion, **that poisoned the well and magnified the spread of the contagion to the primary credit being collateralized and introduced a massive destabilization of world markets and multiple failures of financial institutions.**

The direct lending business was untouched by the panic since the loans were on the books of the bank (isolated from all forms of market activity), secured by direct collateral which was tangible and inspected, and in the few cases of trouble in a properly underwritten mortgage; the first instinct was to work it out with a customer known to the bank as a person, not bail from the investment relationship and foreclose. With the complete underwriting data in the file, refinancing the customer in trouble was always a better course of action if reasonable, but that option is not available for the troubled borrower lost in a bunch of 500 other borrowers bundled in a security for which none of these alternatives are available because of the choice of format (securitization) and funding (wholesale market). When an unknown credit is in distress the vacuum of information is fickle and "you are done."

WALL STREET VERSUS MAIN STREET—A CHOICE OF BUSINESS MODEL:

In the chart, on page thirteen (13) of this letter, at the end lists and contrasts the function and focal characteristics of each model. Suffice it to say that in the main, the list establishes the elements of disparity between the two, nay places them at the absolute opposite ends of the spectrum. The these elements illustrate pre-dominate, differentiating themes the specifics of how they are constructed giving rise the character and underlying values driving each modality.

Performance of Wall Street Financial Institutions (Citi Group, JPMorgan Chase, Bank of America, and Wells Fargo) is measured in value of their stock price at the close of the day on the NY Stock Exchange, driven by quarterly earnings, which are derived from Revenues more than half of which are sourced from Investment Banking operations trading securities for their proprietary account. This was exacerbated by high volumes of underwriting of securities for sale to others secured by first lien residential home mortgages and other assets such as autos loans. These securities generally were rated AA and AAA because of the home mortgage and auto liens securing the loan payments, thus the repayment streams servicing the security's obligation to bond holders and trading them in open retail markets and further trading in other securities all buying and selling for their own account. As of this writing, Standard and Poor's, the rating agency, was fined $1.2 billion for damages to investors for these ratings which turned out to be wrong in the extreme, accounting for this record fine levied against such rating agency. The filings appeared to contain e-mails which voice reluctance to lower ratings on these "sub-prime" mortgage securities since the "bank" customer who requested the rating was the underwriter and distributor of the bonds. This has been a long standing contentious issue for the rating industry because of the high potential of the conflict of interest in securing such a business client, much less retain the business, of such issuer client in the future. Certainly an expensive mistake for reluctance!

The securitizing business is funded largely by short-term funds bought in the wholesale money markets at current interest rates for 90 days and then rolled over for successive terms, etc. Once underwritten, such asset back securities are sold in security form to Freddie and Fannie or to others to include: pension funds, insurance companies, and sovereign foreign governments through retail markets. The proceeds of these transactions repay the short term borrowings in the wholesale markets, and the balance is rolled back into yet another iteration of this cycle, while the profits are syphoned off and booked along with the revenues gathered from other investment functions resulting in huge revenues, but at equally huge risks as it turned out given the historic volatility, unreliability, and fickle sustainability of such markets. A serious complicating factor was they were trafficking in new, complex sophisticated financial instruments **which had not been exchange tested in transparent open markets** and consequently for them not at all transparent as to "sketchy" details and pricing in spite of

their popularity and apparent liquidity. It was this apparent liquidity which was interpreted at first by markets **as an incident of confirmation of value** but proved to be quite to the contrary when suspicion arouse about the quality of the **underlying mortgage collateral**—suspicions of growing past dues and defaults which were well beyond those expected from a AAA or AA investment quality rating.

In stark contrast, we at CNB/CNC generate our principal source of revenues from the monthly payments in connection with the loans and mortgages outstanding on our books. The balance of our revenues come from fees generated from three business lines: financial services of fiduciary, custodial and investment management of our customer's estates, trusts, and securities under our custody and management (investment advice); and payment services of every kind from operations of our mortgage subsidiary. The loan operations are funded by money deposits placed in our hands by customers for the purposes of conveniently paying their financial obligations as well as maintaining savings, investments, and financial reserves for contingencies. These deposits historically are stable because the purposes which the depositor has in mind, the "utility value," may be greater than the investment return component (interest) which is the predominate purpose of money placed short term in the wholesale money markets and is the source of funding used in the securities business detailed above

In the Year 2009 we saw the full brunt of the developing Great Recession and reported here that in the two-year period ending 2009 and including 2008, our Consumer Deposits increased **38% over two years** or three times what any seasoned observer would have expected. That commanding growth was not because of the high rate of interest offered, then 10 basis points (.001%) occasioned, you will remember by the historic impact of the Federal Reserve lowering interest rates to jump start commerce and the flagging economy. Clearly some other dynamic was in operation. "Money in the Bank" has always had an intrinsic value above and beyond the investment value as indicated by the interest rate. Evident here was the enormous value attached to these relatively large amounts on deposit which in turn provided a tangible sense of relief in the form of "Peace of Mind" and "Sleeping at Night," that the home fires were not at risk. In good times, it is easy to overlook the elements that comprise what we really value above the obvious cost and price of things, namely the intangible value which is quite often larger than the first two elements combined.

This discussion describes what we refer to as "Core Deposits," 88% of our deposit base or specifically that which represents the base line of the level which is not drawn below in the course of ordinary daily operation of our payment and exchange transactions cleared in the normal course of commerce which we facilitate, and that residual is not demonstrated to be particularly influenced by the investment return aspects so often the focus of public attention relating to interest rate changes either in the market or in CNB's own setting of fair interest rate on funds entrusted to us and demonstrably secure under our prudential management. Yes, in the conduct of Finance, that sacred public trust so often taken for granted, is the heart that beats to sustain our economy, no less.

In 2008 the money markets froze! Banks and other financial institutions refused to lend over night to one another, truly a historic moment. The last time that happened was in the Crash of 1907, 100 years earlier. Then, the only person who could provide funds by an immediate draft of collected funds to keep the pump of commerce primed was not the Treasury of the United States but J. P. Morgan himself. He was the only one available who had the wherewithal to infuse liquidity into the system to restore the confidence of the private sector market participants, which was then as it has always been, the ultimate solution to restore the running of orderly markets. Even in 2008, the triumvirate which "fixed" the Crisis had as their ultimate objective to restore the confidence of private sector capital to return to the fray since, contrary to popular belief, the private sector has more money than the government in the long run. This is because it is the private sector that is the ultimate source

of the tax base (income flows and property values) that funds all public payment activities which is the fuel that the public sector burns in its governmental operational functions.

It may not seem like it, but Congress has nothing to spend if not for the organic operations and activities of the private sector to create value through its creative genius, activities, and effectiveness. We at CNC are the midwives of this birthing of constructive production of value, stoking the GDP, through our management of finance in a careful and thoughtful stewardship that respects the sacred trust to the public as it always has been. This must not be abused again by the largest financial institutions in this country in their conduct of reckless underwriting practices leveraged to the hilt.

Moreover, in our long history, our experience has been uniformly that deposits grow significantly in every recession. As a result, we not only retain the availability of the deposits with which we make and fund loans, but our deposits grow on average of 12% during the year or two of such down turns. **More deposits yield the funding availability for more loans and more revenues just at the time the experience of the general banking industry is just the reverse.** Query, then, what is really more important in a trek across the desert, a bottle of water or its price-at any cost? Again, I rephrase: what is more important to the mortgage customer proposing to buy a house, the availability of the money to fund the mortgage, or the interest rate which is the focus of everyone's attention? And then if you need more convincing, remember the interest, whatever the rate, is deductible against one's income tax. Answer: **The availability, of course, has always been more important. In mid-1983, people still wanted to move into a house from an apartment even at a mortgage rate of 14% and 40% down, inflation was running 13% and the 6-month CD paid 16%, the prime rate was 21.5%, and the law firms in Rochester were closed one weekday, since there was no one making mortgages to close.**

With this detail explained clearly, the two business models are not at all the same. To describe each by the same term "Bank," as many a reporter has done, is an ERROR in the factum in the extreme. The Wall Street model was to **originate and distribute** mortgages by means of a securitization process which packaged the monthly stream of the mortgage payment (principal and interest) which was secured by the value of the real estate property funded in the beginning by wholesale short-term 90-day money which was repaid by the proceeds of the permanent sale of the AAA securities in the retail markets for placement in some pension fund. **This was in and out in 90 days.**

In contrast, the CNB/CNC model is **to underwrite and book** for the duration, theoretically for 20-30 years, **but effective durations are 12 years.** People move up as their prospects improve. The Bank standard of underwriting is responsible for: evaluating the credit of the mortgage customer by considering. Their demonstrated capacity to pay; reviewing a third party appraisal for sufficient value of the collateral to meet the loan-to-value bar of 80% or less as a second means to pay the debt and then some as a margin; and coming to a judgment that their character is responsible, prudential (down payment 20%), honest, meaning they are more likely than not to meet their obligation as agreed.

We are now in a mutually beneficial agreement and have established a relationship which will likely build. Our fortunes and interests are aligned since we will have more money in the mortgage than the customer until the life of the loan extends to 22-24 years (for interest rates of 4% -10%), **respectively since it takes that long to pay down the principal balance to 50%. Should a need arise to refinance or adjust the agreement for a good reason, we are inclined to do what is best since we have more money at stake, literally.** In most cases there is a change in circumstances before that time lapses, and the family decides to upgrade or right size so they sell to

pursue new opportunities. Typically the duration of the mortgage with an initial term of 30 years is 12 years on average, certainly way before the 50% pay down mark on the mortgage.

Wall Street is in the "relationship" for 90 days and CNB for YEARS with contact every month as the monthly payments are booked. Wall Street is about transactions and growing the dollars, while our focus at **CNB is on the relationship with the whole family which is decades long** and involves the opportunities to develop a financial partnership which is mutually beneficial, both financially and socially.

Because we personally share the same community environment and character as our customers, we clearly are in an entirely different business and relationship as we collaborate to manage the affairs of our client. This provides context as well as a first person observation of the personality of the client and, thereby we are better able to judge his prospects for success of managing financial affairs adroitly.

In the context of a transactional environment of Wall Street, the advantages of an active relationship are not available. In down-turns what we gather from the underwriting process is enormously relevant and matters tremendously since it bears directly on our understanding of the capacity of the customer to manage the challenges before him. That is often the key judgment made initially: 1) to working it out with the customer, or 2) bail-out of a relationship which is no longer mutually beneficial, charge the loan off, and seek legal remedies.

This brings us to consider the importance of **credit quality** in the business of finance as it is presented in the context of our discussion of the two distinctive business models: Wall Street's originate and distribute and CNB's underwrite and book.

FINAL THOUGHTS FOR THE JOURNEY THROUGH FINANCE OF THE FUTURE:

The bottom line reaction to the Crisis is that the CNC, traditional deposit intermediary recycling the community's deposits into community loans and mortgages, is a spectacular finance business model of demonstrated durability for all financial seasons and, more importantly, sustainable in an environment in which we acknowledge Crises are an important and perennial cyclical reality to expect and manage.

A culture which first focuses on human elements and behaviors as being the dominate drivers of finance and its behaviors, and a mission to balance its effects on four constituencies: customers relations, associates/colleagues, shareholder owners, and by extension the health and sustainable prosperity of the community at large is our passion, purpose, and guide for all that we do.

And financial performance is important, but also necessary, as a means of assuring the sustainability of our financial vitality in order to fulfill our mission.

The root cause of the Crisis was embedded in the nature of human relationships which we share with one another and from which arise perennial cycles as individuals make their own choices when no one is looking, not surprisingly, as demonstrated repeatedly by history and data. The aggregate impact of those myriad individual zigs and zags produce vitality and instability within the collective activity which we call society. That said, it has been borne out by this recent experience that Finance is especially fragile because it only takes a few irresponsible people to cause unmitigated damage to the system and the society which it serves.

Because Finance is a sacred public trust and is fragile, we who tend to its workings and magic must take care to watch for and manage the instabilities that accompany human events and seek to manage its vitality in the service of mankind.

The reality of this history bakes in the propensity of humans to trial and error, give and take of overlapping generations, and billions of "actors" on the stage of life improvising on their themes with many diverse courses, some in conflict with one or more others.

Of the regulatory responses which are embedded in that character is the activity of having one group of individuals attempt to direct and regulate the behavior of others which creates, by necessity, an instability inherent to such an attempt or activity and which by the nature of the participants are predisposed to accept the interference in their choices of behavior without resistance. But never-the-less, we are presented each cycle with a flood of attempts to reregulate. Of these ambitious "re-regulatory" efforts which **seem important, indeed vital, raising capital sharply and making macro prudential regulation work are two of them we can endorse.**

Micro regulation is concerned with managing financial behavior and activity by way of interest rates, managing the monetary policy and the money supply, fine tuning inflation, promoting price stability, and full employment. Macro regulation is concerned with larger issues of the economy such as income disparity, trade balances, capital flows over borders, fixing the cause of instability, dealing with insufficient demand, and excessive debt (leverage). Normal monetary policy (micro regulation) was not used to address the financial Crisis in 2008. The response of the triumvirate to the Crisis was the exercise of macro regulation in spades to save the world from further destruction.

One of the few effective ideas to come out of Dodd-Frank was the formation of the Systemic Risk Council (SRC) charged with identifying systemically important nonbank institutions (SIFI) for heightened oversight by the Federal Reserve in accordance with prudential standards recommended by the Financial Stability Oversight Council (FSOC) for risk-based capital, leverage, liquidity, contingent capital resolution plans, credit exposure reports, and concentration limits, etc.

MetLife, the mega insurance company, was just cited by the FSOC as being a "systemically important nonbank institution" (SIFI) and became subject to this oversight. This action was immediately met with a legal objection disputing the status per se and questioning whether or not that was appropriately applied to MetLife.

Likewise GE Capital has announce their exit from financial services in part because they too were another of the four non-banks designated as "systemically important financial institutions" subjecting them to closer oversight and tougher standards on capital buffers against losses. They were the 7th largest bank in the US at the beginning of the Crisis, and the largest issuer of commercial paper. Instead of traditional bank style deposits their primary source for funding was to take advantage of GE's stellar credit rating to finance itself by selling bonds and short term 90 day paper to underwrite their wide array of commercial and consumer loan and mortgage products here and around the world the profits from which were about half of GE's net earnings, a huge presence in the financial industry. But in the depth of the Crisis when the commercial paper markets dried up they had to seek relief from the government and along with the other big players suffered losses causing them to cut the dividend, though they always managed to remain solvent. Then, finally under the new flood of Dodd-Frank and other regulations the increased expenses assaulting the return on equity drove them to the decision to sell off all their financial earnings assets except two categories directly related to their core business now to be manufacturing 90%. The financing of two of their large manufacturing business of turbines for electric power generations and jet engines for aviation will continue to be financed through GE Capital.

The increased capital standards under Basil III have already been announced for phase-in by 2019 by bank regulators, requiring all banks to add a "buffer" of 2.5% to their risk-based capital and the Mega Banks to add an additional buffer on top of that. The impact on CNC is modest since the change in common equity to reach the new standard is a move from about 7.5% to 9.0% or 150 basis points (1.5%), not terribly more than we have had to operate as "well capitalized" for 20 years, since in the old days,

when the emphasis was on Return on Assets (ROA) not return of common equity (ROE). Moreover, we have already operated with a buffer of capital by simply having only a 22 basis point net charge off for 13 years even through the Crisis. The average for all FDIC insured banks reached 300 basis points (3.00%) at one point.

That is, others banks have always had to charge off higher amounts of their loans than we have since a greater amount of money was lost and written off. The regulator sees this as an indication that on average the banks should have more capital as a buffer. In our case we have added that buffer to our retained earnings and common equity which has been incrementally greater each of the last 13 years than the average FDIC bank. So, we are ahead of the game because of our credit quality consistently demonstrated over that 13-year period which included the worst recession in living memory. In any event the common equity account stands as the ultimate protection of our depositors from the risk of the loans we make with those deposit funds entrusted to our care. Theoretically, the lower leverage called for by the reforms adds a margin of safety that we have NOT been required to have because of the choices we have made in the construction of our balance sheet which is directly responsible for our lower-than-average charge offs of our FDIC colleagues. In this regard, we carefully choose assets to book dependent upon the kinds of activities we are going to underwrite relative to the risk attached inherently to those activities which might affect the orderly repayment of that loan.

But as we speak, Freddie and Fannie are astonishingly proposing to offer a 30-year, fixed-rate, fixed-payment mortgage with a 3% down payment. What! With the error analysis of +/- 5%, the 3% down is effectively no down payment (where is the equity?). A social policy requiring no down payment is NOT helping a first-time buyer into a home, it is enabling an unsound financial experience and is an affront to the three C's of sound Credit (for both parties).

In my experience no one has made legislation that requires the consumer to take responsibility for the conduct of his financial dealings. The regulation is always directed to restrict the supplier of credit when it is **the demand behavior of the consumer which must be redressed if we are to remedy the problem.** Consider the solution to the Crisis was that every mortgage started with the borrower supplying a 20-25% down payment. That implies that responsible saver would be a priority/condition and the applicant has already demonstrated character and effective management of financial affairs. If we all had a balance sheet populated by such quality credit then more capital needed in the banking system would not be required. But, alas, human nature doesn't come to the task with that quality and attitude in place. But that is a choice we make as an educator and advisor of our clients-to help them learn for themselves the value of managing their financial affairs responsibly, AND they make good customers too. The law can require us to take the application but cannot require us to make a non-creditworthy loan.

CLOSING REMARKS:

I have covered many topics: The Crisis teaches us: globalization is real; trade balance a key; fragility of Finance exists; the excessive leverage of 40/1 destroyed the Investment Banking industry; the real estate bubble was worldwide; that there is no substitute for good credit underwriting (3 C's of Credit), shortcut this at your peril; credit risk expands when its administration grows remote from the borrower/activity; direct lending (less risk) is a connected mutual relationship; securitization is a remote commodity disconnected (+RISK) and embedded with much mischief; Federal Reserve is amazing versus the Euro Union which is a flawed mess and cannot lead, much less survive, without reform; CNC is effectively staffed, innovative, and a nimble problem solver; CNB is a robust bank model for all seasons; CNC's success stems from execution of its game plan, NOT agendas driven by regulators or competitors; aggressive regulation must be given its due but managed so as not to taint the

customer's value proposition-our life's blood and future; we acknowledge the importance of many concepts but can do little about most except manage to avoid their consequences; the structural deficit is linked to government fiscal irresponsibility; macro and micro prudential policy/supervision we should keep up with and understand; **Crises are perennial so plan accordingly;** work around Congressional negligent designs; protect Finance and the economy from the excess and instabilities inherent in both; prudential loan customers are the secret to sound bank capital; culture is important since it drives celectial financial performance; the efficacy of good character to loan work-outs; Wall Street focus – short-term profits versus Main Street focus – building mutually profitable relationships; and short-term Shareholder Value (Wall Street) versus long-term sharing in the profit (Main Street).

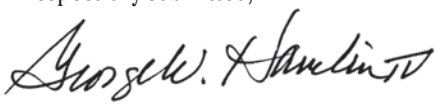
Balancing all of these elements while we strive to improve and provide value to our customer's experience is the key to doing the right thing grounded in time-honored principles of banking and finance and with integrity of intellect and self-using our values as a guide to innovative and improvisation.

We submit, therefore, that our business model has once again proved its value, especially in the modern world of finance in the 21st Century; an environment of great change and opportunity and which many would say is different and unchartered and therefore uncertain as to outcome, thus more risky. I have observed, however, though it is accurate there have been many changes in the past 35 years in the **technology and the effect that has had on our operations and communications (positive), the substance of what we do functionally and substantively in financial services, and the role we play in the management of the economy and human relationships remain tied to the humanity that we serve which remains the SAME in all of its variety.** That is, what we do now is manage money, leverage, credit, investments, finance, and the economy which continues to be in essence mostly managing and understanding human behavior and emotion-driven behavior, which in the nature of human beings has not changed and is to be celebrated in all of its eccentricities and surprising delights and innovations. I am betting it will not change materially either and in its dynamic variety in the future. The change we have noticed is in the technology which speeds up the communications embracing a world economy; it is to be greeted, not with fear, but excitement and the challenge and opportunity which it offers.

We have much to be thankful for and quietly proud of because the talent gathered here together is the "best of show" as has been demonstrated by our performance in the year 2014, as in every other year past and promised for the future.

There is more to come of the story. Stay tuned.

Respectfully submitted,



George W. Hamlin, IV,
Chairman of the Board

"This 'traditional' community-oriented business model has served our customers, staff, shareholders, and, by extension, the community as a whole very well over portions of three centuries since 1887! By 'traditional' we do not mean old-fashioned, static, and thus obsolete, but traditional in the dynamic alignment with the people—those who live, work, and play within our influence and with whom we have a current, constructive collaboration, sustaining mutually beneficial relationships, both personally and financially, significantly in equal measure, as a matter of 'heart and mind' in combination."

— George W. Hamlin, IV, Chairman

"Finishing the year better than budget, as we have, speaks to the effectiveness, creativity, and agility of the people that make this organization thrive."

— Frank H. Hamlin, III, President and CEO

About the Artist

Lynne Feldman has lived in the Greater Rochester region since 1978, and is an active member of our local art community. She worked exclusively in oils for more than 30 years, until she was introduced to—and fell in love with—the technique of fabric collage and acrylics on canvas about 10 years ago. These collage works are a combination of cut and pieced fabrics glued onto canvas, and then painted with acrylic paints.

Ms. Feldman's local commissions include Strong Memorial Hospital, The Jewish Home of Rochester, Anthony Square Community Center, and The Jewish Community Center of Greater Rochester. Her studio has been in the Anderson Arts Building (in what is now Neighborhood of the Arts) for the past 28 years.

Canandaigua
National
Corporation