

FINANCIAL INSTITUTIONS INC

Form 10-Q

November 09, 2011

**Table of Contents**

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549**

**Form 10-Q**

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

**For the quarterly period ended September 30, 2011**

**or**

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

**Commission File Number: 000-26481**

(Exact name of registrant as specified in its charter)

**NEW YORK**

(State or other jurisdiction of incorporation or organization)

**16-0816610**

(I.R.S. Employer Identification No.)

**220 LIBERTY STREET, WARSAW, NEW YORK**

(Address of principal executive offices)

**14569**

(Zip Code)

Registrant's telephone number, including area code: **(585) 786-1100**

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

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

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

Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller reporting company

(Do not check if a smaller company)

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes  No

The registrant had 13,805,116 shares of Common Stock, \$0.01 par value, outstanding as of November 1, 2011.



**FINANCIAL INSTITUTIONS, INC.**  
**Form 10-Q**  
**For the Quarterly Period Ended September 30, 2011**  
**TABLE OF CONTENTS**

	<b>PAGE</b>
<b><u>PART I. FINANCIAL INFORMATION</u></b>	
<u>ITEM 1. Financial Statements</u>	
<u>Consolidated Statements of Financial Condition</u> <u>at September 30, 2011 (Unaudited) and December 31, 2010</u>	3
<u>Consolidated Statements of Income (Unaudited)</u> <u>Three and nine months ended September 30, 2011 and 2010</u>	4
<u>Consolidated Statement of Changes in Shareholders' Equity (Unaudited)</u> <u>Nine months ended September 30, 2011 and 2010</u>	5
<u>Consolidated Statements of Cash Flows (Unaudited)</u> <u>Nine months ended September 30, 2011 and 2010</u>	6
<u>Notes to Consolidated Financial Statements (Unaudited)</u>	7
<u>ITEM 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	27
<u>ITEM 3. Quantitative and Qualitative Disclosures About Market Risk</u>	44
<u>ITEM 4. Controls and Procedures</u>	44
<b><u>PART II. OTHER INFORMATION</u></b>	
<u>ITEM 1. Legal Proceedings</u>	45
<u>ITEM 1A. Risk Factors</u>	45
<u>ITEM 6. Exhibits</u>	45
<u>Signatures</u>	46
<u>Exhibit 31.1</u>	
<u>Exhibit 31.2</u>	
<u>Exhibit 32</u>	
<u>EX-101 INSTANCE DOCUMENT</u>	
<u>EX-101 SCHEMA DOCUMENT</u>	
<u>EX-101 CALCULATION LINKBASE DOCUMENT</u>	
<u>EX-101 LABELS LINKBASE DOCUMENT</u>	
<u>EX-101 PRESENTATION LINKBASE DOCUMENT</u>	
<u>EX-101 DEFINITION LINKBASE DOCUMENT</u>	



**Table of Contents****PART I. FINANCIAL INFORMATION****ITEM 1. Financial Statements****FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES****Consolidated Statements of Financial Condition**

<i>(Dollars in thousands, except share and per share data)</i>	<b>September 30, 2011 (Unaudited)</b>	<b>December 31, 2010</b>
<b>ASSETS</b>		
Cash and cash equivalents:		
Cash and due from banks	\$ 67,507	\$ 38,964
Federal funds sold and interest-bearing deposits in other banks	94	94
Total cash and cash equivalents	67,601	39,058
Securities available for sale, at fair value	679,487	666,368
Securities held to maturity, at amortized cost (fair value of \$23,821 and \$28,849, respectively)	23,127	28,162
Loans held for sale	2,403	3,138
Loans (net of allowance for loan losses of \$22,977 and \$20,466, respectively)	1,412,150	1,325,524
Company owned life insurance	45,054	26,053
Premises and equipment, net	33,397	33,263
Goodwill	37,369	37,369
Other assets	58,223	55,372
Total assets	\$ 2,358,811	\$ 2,214,307
<b>LIABILITIES AND SHAREHOLDERS EQUITY</b>		
Deposits:		
Noninterest-bearing demand	\$ 395,267	\$ 350,877
Interest-bearing demand	404,925	374,900
Savings and money market	476,122	417,359
Certificates of deposit	707,357	739,754
Total deposits	1,983,671	1,882,890
Short-term borrowings	103,075	77,110
Long-term borrowings		26,767
Other liabilities	31,210	15,396
Total liabilities	2,117,956	2,002,163
Shareholders equity:		
Series A 3% preferred stock, \$100 par value; 1,533 shares authorized and issued	153	153
Series A preferred stock, \$5,000 liquidation preference per share, 7,503 shares authorized; 7,503 shares issued at December 31, 2010		36,210
Series B-1 8.48% preferred stock, \$100 par value, 200,000 shares authorized, 173,253 and 174,223 shares issued, respectively	17,326	17,422

Edgar Filing: FINANCIAL INSTITUTIONS INC - Form 10-Q

Total preferred equity	17,479	53,785
Common stock, \$0.01 par value, 50,000,000 shares authorized; 14,161,597 and 11,348,122 shares issued, respectively	142	113
Additional paid-in capital	67,011	26,029
Retained earnings	154,461	144,599
Accumulated other comprehensive income (loss)	8,407	(4,722)
Treasury stock, at cost 355,767 and 410,616 shares, respectively	(6,645)	(7,660)
Total shareholders equity	240,855	212,144
Total liabilities and shareholders equity	\$ 2,358,811	\$ 2,214,307

See accompanying notes to the consolidated financial statements.

**Table of Contents**

**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**  
**Consolidated Statements of Income (Unaudited)**

<i>(In thousands, except per share amounts)</i>	<b>Three months ended</b>		<b>Nine months ended</b>	
	<b>September 30,</b>		<b>September 30,</b>	
	<b>2011</b>	<b>2010</b>	<b>2011</b>	<b>2010</b>
Interest income:				
Interest and fees on loans	\$ 19,180	\$ 19,069	\$ 57,286	\$ 56,401
Interest and dividends on investment securities	4,594	5,117	13,957	15,801
Other interest income				10
<b>Total interest income</b>	<b>23,774</b>	<b>24,186</b>	<b>71,243</b>	<b>72,212</b>
Interest expense:				
Deposits	2,728	3,739	8,859	11,253
Short-term borrowings	172	107	354	270
Long-term borrowings	256	547	1,321	1,968
<b>Total interest expense</b>	<b>3,156</b>	<b>4,393</b>	<b>10,534</b>	<b>13,491</b>
<b>Net interest income</b>	<b>20,618</b>	<b>19,793</b>	<b>60,709</b>	<b>58,721</b>
Provision for loan losses	3,480	2,184	5,618	4,707
<b>Net interest income after provision for loan losses</b>	<b>17,138</b>	<b>17,609</b>	<b>55,091</b>	<b>54,014</b>
Noninterest income:				
Service charges on deposits	2,257	2,528	6,605	7,260
ATM and debit card	1,117	1,046	3,256	3,034
Broker-dealer fees and commissions	541	263	1,329	1,002
Company owned life insurance	422	271	967	822
Loan servicing	64	267	662	687
Net gain on sale of loans held for sale	318	197	659	374
Net gain on disposal of investment securities	2,340	70	2,347	139
Impairment charges on investment securities				(526)
Net gain (loss) on disposal of other assets	7	(188)	44	(186)
Other	970	677	2,289	1,574
<b>Total noninterest income</b>	<b>8,036</b>	<b>5,131</b>	<b>18,158</b>	<b>14,180</b>
Noninterest expense:				
Salaries and employee benefits	9,104	8,131	26,359	24,422
Occupancy and equipment	2,722	2,736	8,209	8,177
Computer and data processing	603	552	1,854	1,738
Professional services	570	534	1,823	1,618
Supplies and postage	461	442	1,337	1,318
FDIC assessments	437	629	1,212	1,865
Advertising and promotions	477	338	895	877
Loss on extinguishment of debt	1,083		1,083	
Other	1,555	1,574	4,743	4,529



Edgar Filing: FINANCIAL INSTITUTIONS INC - Form 10-Q

Total noninterest expense	17,012	14,936	47,515	44,544
Income before income taxes	8,162	7,804	25,734	23,650
Income tax expense	2,664	2,141	8,697	7,461
Net income	\$ 5,498	\$ 5,663	\$ 17,037	\$ 16,189
Preferred stock dividends	368	839	1,508	2,518
Accretion of discount on Series A preferred stock		93	1,305	274
Net income available to common shareholders	\$ 5,130	\$ 4,731	\$ 14,224	\$ 13,397
Earnings per common share (Note 2):				
Basic	\$ 0.38	\$ 0.44	\$ 1.10	\$ 1.24
Diluted	\$ 0.37	\$ 0.43	\$ 1.09	\$ 1.23
Cash dividends declared per common share	\$ 0.12	\$ 0.10	\$ 0.34	\$ 0.30
Weighted average common shares outstanding:				
Basic	13,635	10,778	12,876	10,762
Diluted	13,704	10,870	12,968	10,824
See accompanying notes to the consolidated financial statements.				

**Table of Contents**

**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**  
**Consolidated Statement of Changes in Shareholders' Equity (Unaudited)**  
**Nine months ended September 30, 2011 and 2010**

<i>(Dollars in thousands, except per share data)</i>	Preferred Equity	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Treasury Stock	Total Shareholders' Equity
<b>Balance at January 1, 2010</b>	\$ 53,418	\$ 113	\$ 26,940	\$ 131,371	\$ (3,702)	\$ (9,846)	\$ 198,294
Comprehensive income:							
Net income				16,189			16,189
Other comprehensive income, net of tax					6,504		6,504
Total comprehensive income							22,693
Purchases of treasury stock						(69)	(69)
Share-based compensation plans:							
Share-based compensation			807				807
Stock options exercised			(52)			187	135
Restricted stock awards issued, net			(1,843)			1,843	
Directors' retainer			(15)			112	97
Accretion of discount on Series A preferred stock	274			(274)			
Cash dividends declared:							
Series A 3% Preferred-\$2.25 per share				(3)			(3)
Series A Preferred-\$187.50 per share				(1,407)			(1,407)
Series B-1 8.48% Preferred-\$6.36 per share				(1,108)			(1,108)
Common-\$0.30 per share				(3,250)			(3,250)
<b>Balance at September 30, 2010</b>	<b>\$ 53,692</b>	<b>\$ 113</b>	<b>\$ 25,837</b>	<b>\$ 141,518</b>	<b>\$ 2,802</b>	<b>\$ (7,773)</b>	<b>\$ 216,189</b>
<b>Balance at January 1, 2011</b>	<b>\$ 53,785</b>	<b>\$ 113</b>	<b>\$ 26,029</b>	<b>\$ 144,599</b>	<b>\$ (4,722)</b>	<b>\$ (7,660)</b>	<b>\$ 212,144</b>
Comprehensive income:							
Net income				17,037			17,037
Other comprehensive income, net of tax					13,129		13,129
Total comprehensive income							30,166
Issuance of common stock		29	43,098				43,127
Purchases of treasury stock						(205)	(205)

Edgar Filing: FINANCIAL INSTITUTIONS INC - Form 10-Q

Repurchase of warrant issued to U.S. Treasury		(2,080)		(2,080)			
Redemption of Series A preferred stock	(37,515)	68		(37,447)			
Repurchase of Series B-1 8.48% preferred stock	(96)			(96)			
Share-based compensation plans:							
Share-based compensation		863		863			
Stock options exercised		(28)	119	91			
Restricted stock awards issued, net		(991)	991				
Excess tax benefit on share-based compensation		64		64			
Directors' retainer		(12)	110	98			
Accretion of discount on Series A preferred stock	1,305		(1,305)				
Cash dividends declared:							
Series A 3% preferred-\$2.25 per share			(4)	(4)			
Series A preferred-\$53.24 per share			(399)	(399)			
Series B-1 8.48% preferred-\$6.36 per share			(1,105)	(1,105)			
Common-\$0.34 per share			(4,362)	(4,362)			
<b>Balance at September 30, 2011</b>	<b>\$ 17,479</b>	<b>\$ 142</b>	<b>\$ 67,011</b>	<b>\$ 154,461</b>	<b>\$ 8,407</b>	<b>\$ (6,645)</b>	<b>\$ 240,855</b>

See accompanying notes to the consolidated financial statements.

**Table of Contents**

**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**  
**Consolidated Statements of Cash Flows (Unaudited)**

<i>(Dollars in thousands)</i>	<b>Nine months ended</b>	
	<b>September 30,</b>	
	<b>2011</b>	<b>2010</b>
Cash flows from operating activities:		
Net income	\$ 17,037	\$ 16,189
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	2,580	2,672
Net amortization of premiums on securities	4,227	1,671
Provision for loan losses	5,618	4,707
Share-based compensation	863	807
Deferred income tax expense	2,122	1,179
Proceeds from sale of loans held for sale	20,464	26,245
Originations of loans held for sale	(19,070)	(28,994)
Net gain on sale of loans held for sale	(659)	(374)
Increase in company owned life insurance	(967)	(822)
Net gain on disposal of investment securities	(2,347)	(139)
Impairment charges on investment securities		526
Net (gain) loss on sale and disposal of other assets	(44)	186
Loss on extinguishment of debt	1,083	
Decrease in other assets	353	389
(Decrease) increase in other liabilities	(216)	1,398
<b>Net cash provided by operating activities</b>	<b>31,044</b>	<b>25,640</b>
Cash flows from investing activities:		
Purchases of investment securities:		
Available for sale	(130,587)	(346,773)
Held to maturity	(12,018)	(16,747)
Proceeds from principal payments, maturities and calls on investment securities:		
Available for sale	126,908	163,962
Held to maturity	18,304	24,210
Proceeds from sales and calls of securities available for sale	10,077	88,090
Net increase in loans, excluding sales	(105,514)	(64,683)
Loans sold or participated to others	13,033	
Purchases of company owned life insurance	(18,034)	(33)
Proceeds from sales of other assets	509	509
Purchases of premises and equipment	(3,056)	(1,774)
<b>Net cash used in investing activities</b>	<b>(100,378)</b>	<b>(153,239)</b>
Cash flows from financing activities:		
Net increase in deposits	100,781	203,442
Net increase (decrease) in short-term borrowings	25,965	(19,575)
Repayments of long-term borrowings	(26,767)	(20,079)
Proceeds from issuance of common stock, net of issuance costs	43,127	
Purchases of common stock for treasury	(205)	(69)

Edgar Filing: FINANCIAL INSTITUTIONS INC - Form 10-Q

Repurchase of warrant issued to U.S. Treasury	(2,080)	
Redemption of Series A preferred stock	(37,447)	
Repurchase of Series B-1 8.48% preferred stock	(96)	
Proceeds from stock options exercised	91	135
Excess tax benefit on share-based compensation	64	
Cash dividends paid to preferred shareholders	(1,750)	(2,518)
Cash dividends paid to common shareholders	(3,806)	(3,248)
Net cash provided by financing activities	97,877	158,088
Net increase in cash and cash equivalents	28,543	30,489
Cash and cash equivalents, beginning of period	39,058	42,959
Cash and cash equivalents, end of period	\$ 67,601	73,448

See accompanying notes to the consolidated financial statements.

**Table of Contents**

**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**  
**Notes to Consolidated Financial Statements (Unaudited)**

**(1.) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES****Nature of Operations**

Financial Institutions, Inc., a financial holding company organized under the laws of New York State ( New York or NYS ), and its subsidiaries provide deposit, lending and other financial services to individuals and businesses in Central and Western New York. The Company has also expanded its indirect lending network to include relationships with franchised automobile dealers in the Capital District of New York and Northern Pennsylvania. The Company owns all of the capital stock of Five Star Bank, a New York State chartered bank, and Five Star Investment Services, Inc., a broker-dealer subsidiary offering noninsured investment products. References to the Company mean the consolidated reporting entities and references to the Bank mean Five Star Bank.

**Basis of Presentation**

The consolidated financial statements include the accounts of the Company and its subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation. The accounting and reporting policies conform to U.S. generally accepted accounting principles ( GAAP ). Certain information and footnote disclosures normally included in financial statements prepared in conformity with GAAP have been condensed or omitted pursuant to such rules and regulations. However, in the opinion of management, the accompanying consolidated financial statements reflect all adjustments of a normal and recurring nature necessary to present fairly the consolidated balance sheet, statements of income, shareholders equity and cash flows for the periods indicated, and contain adequate disclosure to make the information presented not misleading. Prior years consolidated financial statements are re-classified whenever necessary to conform to the current year s presentation. These consolidated financial statements should be read in conjunction with the Company s 2010 Annual Report on Form 10-K. The results of operations for any interim period are not necessarily indicative of the results which may be expected for the entire year.

**Use of Estimates**

The preparation of these financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates. Material estimates relate to the determination of the allowance for loan losses, assumptions used in the defined benefit pension plan accounting, the carrying value of goodwill and deferred tax assets, and the valuation and other than temporary impairment considerations related to the securities portfolio.

**Cash Flow Information**

Supplemental cash flow information addressing certain cash payments and noncash investing and financing activities was as follows (in thousands):

	<b>Nine months ended</b>	
	<b>September 30,</b>	
	<b>2011</b>	<b>2010</b>
Cash payments:		
Interest	\$ 12,425	\$ 13,826
Income taxes	5,191	7,020
Noncash investing and financing activities:		
Real estate and other assets acquired in settlement of loans	\$ 237	\$ 136
Accrued and declared unpaid dividends	2,008	1,694
Increase in net unsettled security transactions	1,341	4,059
Net transfer of loans to held for sale	13,576	
Accretion of preferred stock discount	1,305	274

**Recent Accounting Pronouncements**

In September 2011, the Financial Accounting Standard Board ( FASB ) issued Accounting Standards Update ( ASU ) No. 2011-08 *Testing Goodwill for Impairment*. The provisions of ASU No. 2011-08 permit an entity the option to

first perform a qualitative assessment to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount. If an entity believes, as a result of its qualitative assessment, that it is more likely than not that the fair value of a reporting unit is less than its carrying amount, the quantitative impairment test is required. Otherwise, no further impairment testing is required. ASU No. 2011-08 includes examples of events and circumstances that may indicate that a reporting unit's fair value is less than its carrying amount. The provisions of ASU No. 2011-08 are effective for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011. Early adoption is permitted provided that the entity has not yet performed its annual impairment test for goodwill. The Company performs its annual impairment test for goodwill as of September 30 of each year. The adoption of ASU No. 2011-08 is not expected to have a material impact on the Company's consolidated financial statements.

**Table of Contents**

**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**  
**Notes to Consolidated Financial Statements (Unaudited)**

**(1.) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

In June 2011, the FASB issued ASU No. 2011-05 *Comprehensive Income (Topic 220) Presentation of Comprehensive Income*. ASU 2011-05 requires that all non-owner changes in stockholders' equity be presented either in a single continuous statement of comprehensive income or in two separate but consecutive statements. In both choices, an entity is required to present each component of net income along with total net income, each component of other comprehensive income along with a total for other comprehensive income, and a total amount for comprehensive income. ASU 2011-05 is effective retrospectively for fiscal years, and interim periods within those years, beginning after December 15, 2011. The Company is currently assessing the impact of ASU 2011-05 on our comprehensive income presentation.

In May 2011, the FASB issued ASU No. 2011-04 *Fair Value Measurement (Topic 820) Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs*. ASU 2011-04 changes the wording used to describe many of the requirements in GAAP for measuring fair value and for disclosing information about fair value measurements. Consequently, the amendments in this update result in common fair value measurement and disclosure requirements in GAAP and IFRSs (International Financial Reporting Standards). ASU 2011-04 is effective prospectively during interim and annual periods beginning on or after December 15, 2011. Early adoption by public entities is not permitted. The Company is currently assessing the impact of ASU 2011-04 on the Company's consolidated financial statements.

In April 2011, the FASB issued ASU No. 2011-03 *Transfers and Servicing (Topic 860) - Reconsideration of Effective Control for Repurchase Agreement*. ASU 2011-03 removes from the assessment of effective control the criterion relating to the transferor's ability to repurchase or redeem financial assets on substantially the agreed terms, even in the event of default by the transferee. ASU 2011-03 is effective for the first interim or annual period beginning on or after December 15, 2011. The guidance should be applied prospectively to transactions or modifications of existing transactions that occur on or after the effective date. Early adoption is not permitted. The Company believes that the adoption of the standard will not have a significant impact on the Company's consolidated financial statements.

In April 2011, the FASB issued ASU 2011-02 *A Creditor's Determination of Whether a Restructuring is a Troubled Debt Restructuring*, which clarifies when creditors should classify loan modifications as troubled debt restructurings. The guidance is effective for interim and annual periods beginning on or after June 15, 2011, and applies retrospectively to restructurings occurring on or after the beginning of the year. The guidance on measuring the impairment of a receivable restructured in a troubled debt restructuring, as clarified, is effective on a prospective basis. A provision in ASU No. 2011-02 also ends the FASB's deferral of the additional disclosures related to troubled debt restructurings as required by ASU No. 2010-20. The Company adopted the provisions of ASU No. 2010-20 retrospectively to all modifications and restructuring activities that have occurred from January 1, 2011. See Note 4 to the Consolidated Financial Statements for the disclosures required by ASU No. 2010-20.

In January 2011, the FASB issued ASU No. 2011-01 *Deferral of the Effective Date of Disclosures about Troubled Debt Restructurings in Update No. 2010-20*. The provisions of ASU No. 2010-20, *Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses* required the disclosure of more granular information on the nature and extent of troubled debt restructurings and their effect on the allowance for loan losses effective for the Company's reporting period ended March 31, 2011. However, the amendments in ASU No. 2011-01 deferred the effective date related to these disclosures, enabling creditors to provide such disclosures after the FASB completed their project clarifying the guidance for determining what constitutes a troubled debt restructuring.



**Table of Contents**

**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**  
**Notes to Consolidated Financial Statements (Unaudited)**

**(2.) EARNINGS PER COMMON SHARE ( EPS )**

The following table presents a reconciliation of the earnings and shares used in calculating basic and diluted EPS for the three and nine months ended September 30, 2011 and 2010 (in thousands, except per share amounts).

	<b>Three months ended</b>		<b>Nine months ended</b>	
	<b>September 30,</b>		<b>September 30,</b>	
	<b>2011</b>	<b>2010</b>	<b>2011</b>	<b>2010</b>
Net income available to common shareholders	\$ 5,130	\$ 4,731	\$ 14,224	\$ 13,397
Less: Earnings allocated to participating securities	9	27	29	86
Net income available to common shareholders for EPS	\$ 5,121	\$ 4,704	\$ 14,195	\$ 13,311
Weighted average common shares outstanding:				
Total shares issued	14,162	11,348	13,409	11,348
Unvested restricted stock awards	(171)	(161)	(164)	(156)
Treasury shares	(356)	(409)	(369)	(430)
Total basic weighted average common shares outstanding	13,635	10,778	12,876	10,762
Incremental shares from assumed:				
Exercise of stock options		6	3	5
Vesting of restricted stock awards	69	33	59	22
Exercise of warrant		53	30	35
Total diluted weighted average common shares outstanding	13,704	10,870	12,968	10,824
Basic earnings per common share	\$ 0.38	\$ 0.44	\$ 1.10	\$ 1.24
Diluted earnings per common share	\$ 0.37	\$ 0.43	\$ 1.09	\$ 1.23

For each of the periods presented, average shares subject to the following instruments were excluded from the computation of diluted EPS because the effect would be antidilutive:

Stock options	394	390	372	412
Restricted stock awards			5	1
Warrant				124
	394	390	377	537



**Table of Contents**

**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**  
**Notes to Consolidated Financial Statements (Unaudited)**

**(3.) INVESTMENT SECURITIES**

The amortized cost and fair value of investment securities are summarized below (in thousands):

		<b>September 30, 2011</b>		
	<b>Amortized Cost</b>	<b>Unrealized Gains</b>	<b>Unrealized Losses</b>	<b>Fair Value</b>
<b>Securities available for sale:</b>				
U.S. Government agencies and government sponsored enterprises	\$ 108,944	\$ 2,435	\$ 20	\$ 111,359
State and political subdivisions	118,377	3,958	11	122,324
Mortgage-backed securities:				
Federal National Mortgage Association	109,971	3,203		113,174
Federal Home Loan Mortgage Corporation	81,882	1,449		83,331
Government National Mortgage Association	77,708	3,507		81,215
Collateralized mortgage obligations:				
Federal National Mortgage Association	29,968	468	46	30,390
Federal Home Loan Mortgage Corporation	25,615	681	1	26,295
Government National Mortgage Association	101,688	2,189	89	103,788
Privately issued	467	1,741		2,208
Total collateralized mortgage obligations	157,738	5,079	136	162,681
Total mortgage-backed securities	427,299	13,238	136	440,401
Asset-backed securities	451	4,952		5,403
Total available for sale securities	\$ 655,071	\$ 24,583	\$ 167	\$ 679,487
<b>Securities held to maturity:</b>				
State and political subdivisions	\$ 23,127	\$ 694	\$	\$ 23,821

		<b>December 31, 2010</b>		
	<b>Amortized Cost</b>	<b>Unrealized Gains</b>	<b>Unrealized Losses</b>	<b>Fair Value</b>
<b>Securities available for sale:</b>				
U.S. Government agencies and government sponsored enterprises	\$ 141,591	\$ 1,158	\$ 1,965	\$ 140,784
State and political subdivisions	105,622	1,516	1,472	105,666
Mortgage-backed securities:				
Federal National Mortgage Association	96,300	798	1,030	96,068
Federal Home Loan Mortgage Corporation	83,745	321	1,317	82,749
Government National Mortgage Association	102,633	2,422	7	105,048
Collateralized mortgage obligations:				
Federal National Mortgage Association	8,938	231	11	9,158
Federal Home Loan Mortgage Corporation	15,917	329	1	16,245
Government National Mortgage Association	106,969	1,761	289	108,441

Edgar Filing: FINANCIAL INSTITUTIONS INC - Form 10-Q

Privately issued	981	591		1,572
Total collateralized mortgage obligations	132,805	2,912	301	135,416
Total mortgage-backed securities	415,483	6,453	2,655	419,281
Asset-backed securities	564	204	131	637
Total available for sale securities	\$ 663,260	\$ 9,331	\$ 6,223	\$ 666,368
<b>Securities held to maturity:</b>				
State and political subdivisions	\$ 28,162	\$ 687	\$	\$ 28,849

- 10 -

---

**Table of Contents**

**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**  
**Notes to Consolidated Financial Statements (Unaudited)**

**(3.) INVESTMENT SECURITIES (Continued)**

Sales of securities available for sale were as follows (in thousands):

	<b>Three months ended</b>		<b>Nine months ended</b>	
	<b>September 30,</b>		<b>September 30,</b>	
	<b>2011</b>	<b>2010</b>	<b>2011</b>	<b>2010</b>
Proceeds from sales	\$ 15,552	\$ 55,000	\$ 24,452	\$ 88,090
Gross realized gains	2,340	70	2,344	143
Gross realized losses				4

The scheduled maturities of securities available for sale and securities held to maturity at September 30, 2011 are shown below (in thousands). Actual expected maturities may differ from contractual maturities because issuers may have the right to call or prepay obligations.

	<b>Amortized</b>	<b>Fair</b>
	<b>Cost</b>	<b>Value</b>
<b>Debt securities available for sale:</b>		
Due in one year or less	\$ 25,054	\$ 25,275
Due from one to five years	82,417	85,129
Due after five years through ten years	215,000	220,378
Due after ten years	332,600	348,705
	<b>\$ 655,071</b>	<b>\$ 679,487</b>
<b>Debt securities held to maturity:</b>		
Due in one year or less	\$ 16,628	\$ 16,749
Due from one to five years	5,401	5,742
Due after five years through ten years	962	1,156
Due after ten years	136	174
	<b>\$ 23,127</b>	<b>\$ 23,821</b>

The following tables show the investments gross unrealized losses and fair value, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position at September 30, 2011 and December 31, 2010 (in thousands).

	<b>Less than 12 months</b>		<b>September 30, 2011</b>		<b>Total</b>	
	<b>Fair</b>	<b>Unrealized</b>	<b>12 months or longer</b>	<b>Fair</b>	<b>Unrealized</b>	<b>Fair</b>
	<b>Value</b>	<b>Losses</b>	<b>Value</b>	<b>Losses</b>	<b>Value</b>	<b>Losses</b>
<b>Securities available for sale:</b>						
U.S. Government agencies and government sponsored enterprises	\$	\$	\$ 7,572	\$ 20	\$ 7,572	\$ 20
State and political subdivisions	755	2	995	9	1,750	11

Mortgage-backed securities:

Federal National Mortgage Association							
Federal Home Loan Mortgage Corporation							
Government National Mortgage Association							
Collateralized mortgage obligations:							
Federal National Mortgage Association	4,877	35	1,919	11	6,796	46	
Federal Home Loan Mortgage Corporation	419	1			419	1	
Government National Mortgage Association	12,732	89			12,732	89	
Total collateralized mortgage obligations	18,028	125	1,919	11	19,947	136	
Total mortgage-backed securities	18,028	125	1,919	11	19,947	136	
<b>Total temporarily impaired securities</b>	<b>\$ 18,783</b>	<b>\$ 127</b>	<b>\$ 10,486</b>	<b>\$ 40</b>	<b>\$ 29,269</b>	<b>\$ 167</b>	

**Table of Contents**

**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**  
**Notes to Consolidated Financial Statements (Unaudited)**

**(3.) INVESTMENT SECURITIES (Continued)**

	Less than 12 months		December 31, 2010		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
<b>Securities available for sale:</b>						
U.S. Government agencies and government sponsored enterprises	\$ 47,752	\$ 1,911	\$ 8,821	\$ 54	\$ 56,573	\$ 1,965
State and political subdivisions	38,398	1,472			38,398	1,472
Mortgage-backed securities:						
Federal National Mortgage Association	46,777	1,030			46,777	1,030
Federal Home Loan Mortgage Corporation	60,707	1,317			60,707	1,317
Government National Mortgage Association	5,135	7			5,135	7
Collateralized mortgage obligations:						
Federal National Mortgage Association			2,332	11	2,332	11
Federal Home Loan Mortgage Corporation	612	1			612	1
Government National Mortgage Association	17,798	289			17,798	289
Total collateralized mortgage obligations	18,410	290	2,332	11	20,742	301
Total mortgage-backed securities	131,029	2,644	2,332	11	133,361	2,655
Asset-backed securities	111	61	96	70	207	131
<b>Total temporarily impaired securities</b>	<b>\$ 217,290</b>	<b>\$ 6,088</b>	<b>\$ 11,249</b>	<b>\$ 135</b>	<b>\$ 228,539</b>	<b>\$ 6,223</b>

The Company reviews investment securities on an ongoing basis for the presence of other-than-temporary impairment ( OTTI ) with formal reviews performed quarterly. When evaluating debt securities for OTTI, management considers many factors, including: (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, (3) whether the market decline was affected by macroeconomic conditions, and (4) whether the Company has the intention to sell the debt security or whether it is more likely than not that it will be required to sell the debt security before its anticipated recovery. The assessment of whether OTTI exists involves a high degree of subjectivity and judgment and is based on the information available to

management at a point in time.

At September 30, 2011, the Company had positions in 11 investment securities with an amortized cost of \$10.5 million and an unrealized loss of \$40 thousand that have been in a continuous unrealized loss position for more than 12 months.

There were a total of 11 securities positions in the Company's investment portfolio, with an amortized cost of \$18.9 million and a total unrealized loss of \$127 thousand at September 30, 2011, that have been in a continuous unrealized loss position for less than 12 months. The unrealized loss on these investment securities was predominantly caused by changes in market interest rates, average life or credit spreads subsequent to purchase. The fair value of most of the investment securities in the Company's portfolio fluctuates as market interest rates change.

Based on management's review and evaluation of the Company's debt securities as of September 30, 2011, the debt securities with unrealized losses were not considered to be OTTI. As of September 30, 2011, the Company does not intend to sell any debt securities which have an unrealized loss, it is unlikely the Company will be required to sell these securities before recovery and the Company expects to recover the entire amortized cost of these impaired securities.



**Table of Contents**

**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**  
**Notes to Consolidated Financial Statements (Unaudited)**

**(4.) LOANS**

The Company's loan portfolio consisted of the following as of the dates indicated (in thousands):

	<b>Loans, Gross</b>	<b>Net Deferred Loan (Fees) Costs</b>	<b>Loans, Net</b>
<b>September 30, 2011</b>			
Commercial business	\$ 223,708	\$ 88	\$ 223,796
Commercial mortgage	382,267	(726)	381,541
Residential mortgage	116,399	33	116,432
Home equity	218,936	3,704	222,640
Consumer indirect	445,296	20,614	465,910
Other consumer	24,639	169	24,808
<b>Total</b>	<b>\$ 1,411,245</b>	<b>\$ 23,882</b>	<b>1,435,127</b>
Allowance for loan losses			(22,977)
<b>Total loans, net</b>			<b>\$ 1,412,150</b>
<b>December 31, 2010</b>			
Commercial business	\$ 210,948	\$ 83	\$ 211,031
Commercial mortgage	353,537	(607)	352,930
Residential mortgage	129,553	27	129,580
Home equity	205,070	3,257	208,327
Consumer indirect	400,221	17,795	418,016
Other consumer	25,937	169	26,106
<b>Total</b>	<b>\$ 1,325,266</b>	<b>\$ 20,724</b>	<b>1,345,990</b>
Allowance for loan losses			(20,466)
<b>Total loans, net</b>			<b>\$ 1,325,524</b>

Loans held for sale (not included above), all of which were residential mortgage loans, totaled \$2.4 million and \$3.1 million as of September 30, 2011 and December 31, 2010, respectively.

During the third quarter of 2011, the Company sold \$13.0 million of indirect auto loans under a 90%/10% participation agreement, recognizing a gain of \$153 thousand. The Company will continue to service the loans for a fee in accordance with the participation agreement. The Company reclassified those indirect auto loans from portfolio to loans held for sale during the second quarter of 2011.

**Table of Contents**

**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**  
**Notes to Consolidated Financial Statements (Unaudited)**

**(4.) LOANS (Continued)****Past Due Loans Aging**

The Company's recorded investment, by loan class, in current and nonaccrual loans, as well as an analysis of accruing delinquent loans is set forth as of the dates indicated (in thousands):

	<b>30-59 Days Past Due</b>	<b>60-89 Days Past Due</b>	<b>Greater Than 90 Days</b>	<b>Total Past Due</b>	<b>Nonaccrual</b>	<b>Current</b>	<b>Total Loans</b>
<b>September 30, 2011</b>							
Commercial business	\$ 56	\$	\$	\$ 56	\$ 2,380	\$ 221,272	\$ 223,708
Commercial mortgage	125			125	2,330	379,812	382,267
Residential mortgage	190	3		193	1,996	114,210	116,399
Home equity	368	169		537	501	217,898	218,936
Consumer indirect	512	136		648	586	444,062	445,296
Other consumer	77	6	4	87		24,552	24,639
Total loans, gross	\$ 1,328	\$ 314	\$ 4	\$ 1,646	\$ 7,793	\$ 1,401,806	\$ 1,411,245
<b>December 31, 2010</b>							
Commercial business	\$ 172	\$ 92	\$	\$ 264	\$ 947	\$ 209,737	\$ 210,948
Commercial mortgage	163			163	3,100	350,274	353,537
Residential mortgage	492	6		498	2,102	126,953	129,553
Home equity	428	47		475	875	203,720	205,070
Consumer indirect	656	107		763	514	398,944	400,221
Other consumer	82	1	3	86	41	25,810	25,937
Total loans, gross	\$ 1,993	\$ 253	\$ 3	\$ 2,249	\$ 7,579	\$ 1,315,438	\$ 1,325,266

There were no loans past due greater than 90 days and still accruing interest as of September 30, 2011 and December 31, 2010. There were \$4 thousand and \$3 thousand in consumer overdrafts which were past due greater than 90 days as of September 30, 2011 and December 31, 2010, respectively. Consumer overdrafts are overdrawn deposit accounts which have been reclassified as loans but by their terms do not accrue interest.

**Table of Contents**

**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**  
**Notes to Consolidated Financial Statements (Unaudited)**

**(4.) LOANS (Continued)****Troubled Debt Restructurings**

A modification of a loan constitutes a troubled debt restructuring ( TDR ) when a borrower is experiencing financial difficulty and the modification constitutes a concession. The Company offers various types of concessions when modifying loans, however, forgiveness of principal is rarely granted. Commercial loans modified in a TDR often involve temporary interest-only payments, term extensions, reducing the interest rate for the remaining term of the loan, extending the maturity date at an interest rate lower than the current market rate for new debt with similar risk, requesting additional collateral, releasing collateral for consideration, or substituting or adding a new borrower or guarantor. The following presents, by loan class, information related to loans modified in a TDR during the three and nine months ended September 30, 2011 (in thousands).

	Three Months Ended September 30, 2011			Nine Months Ended September 30, 2011		
	Pre- Modification Outstanding	Post- Modification Outstanding		Pre- Modification Outstanding	Post- Modification Outstanding	
	Number of Contracts	Recorded Investment	Recorded Investment	Number of Contracts	Recorded Investment	Recorded Investment
Commercial business	4	\$ 75	\$ 75	6	\$ 142	\$ 142
Commercial mortgage				1	280	280
Total	4	\$ 75	\$ 75	7	\$ 422	\$ 422

All of the loans identified as TDRs by the Company were previously on nonaccrual status and reported as impaired loans prior to restructuring. The modifications primarily related to extending the amortization periods of the loans. All loans restructured during the nine months ended September 30, 2011 are on nonaccrual status as of September 30, 2011. Nonaccrual loans that are restructured remain on nonaccrual status, but may move to accrual status after they have performed according to the restructured terms for a period of time. The TDR classification did not have a material impact on the Company's determination of the allowance for loan losses because the modified loans were impaired and evaluated for a specific reserve both before and after restructuring.

There were no loans modified as a TDR within the previous 12 months that defaulted during the three and nine months ended September 30, 2011. For purposes of this disclosure, a loan modified as a TDR is considered to have defaulted when the borrower becomes 90 days past due.

**Table of Contents**

**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**  
**Notes to Consolidated Financial Statements (Unaudited)**

**(4.) LOANS (Continued)****Impaired Loans**

Management has determined that specific commercial loans on nonaccrual status and all TDRs are impaired loans. The following table presents data on impaired loans as of the dates indicated (in thousands):

	<b>Recorded Investment</b>	<b>Unpaid Principal Balance</b>	<b>Related Allowance</b>	<b>Quarter-to-Date Average Recorded Investment</b>	<b>Interest Income Recognized</b>	<b>Year- to-Date Average Recorded Investment</b>	<b>Interest Income Recognized</b>
<b>September 30, 2011</b>							
With no related allowance recorded:							
Commercial business	\$ 170	\$ 280	\$	\$ 642	\$	\$ 404	\$
Commercial mortgage	590	608		596		550	
	760	888		1,238		954	
With an allowance recorded:							
Commercial business	2,210	2,210	1,039	950		750	
Commercial mortgage	1,740	1,740	393	2,024		2,272	
	3,950	3,950	1,432	2,974		3,022	
	\$ 4,710	\$ 4,838	\$ 1,432	\$ 4,212	\$	\$ 3,976	\$
<b>December 31, 2010</b>							
With no related allowance recorded:							
Commercial business	\$ 372	\$ 524	\$			\$ 275	\$
Commercial mortgage	187	187				481	
	559	711				756	
With an allowance recorded:							
Commercial business	576	576	149			1,828	
Commercial mortgage	2,913	2,921	883			1,897	
	3,489	3,497	1,032			3,725	
	\$ 4,048	\$ 4,208	\$ 1,032			\$ 4,481	\$

**Credit Quality Indicators**

The Company categorizes loans into risk categories based on relevant information about the ability of borrowers to service their debt such as: current financial information, historical payment experience, credit documentation, public information, and current economic trends, among other factors such as the fair value of collateral. The Company analyzes commercial business and commercial mortgage loans individually by classifying the loans as to credit risk.

Risk ratings are updated any time the situation warrants. The Company uses the following definitions for risk ratings:

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

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

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

Loans not meeting the criteria above that are analyzed individually as part of the process described above are considered Uncriticized or pass-rated loans and are included in groups of homogeneous loans with similar risk and loss characteristics.

**Table of Contents**

**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**  
**Notes to Consolidated Financial Statements (Unaudited)**

**(4.) LOANS (Continued)**

The following table sets forth the Company's commercial loan portfolio, categorized by internally assigned asset classification, as of the dates indicated (in thousands):

	<b>Commercial Business</b>	<b>Commercial Mortgage</b>
<b>September 30, 2011</b>		
Uncriticized	\$ 211,005	\$ 369,865
Special mention	6,501	3,261
Substandard	6,202	9,141
Doubtful		
<b>Total</b>	<b>\$ 223,708</b>	<b>\$ 382,267</b>
<b>December 31, 2010</b>		
Uncriticized	\$ 194,510	\$ 338,061
Special mention	11,479	4,931
Substandard	4,959	10,545
Doubtful		
<b>Total</b>	<b>\$ 210,948</b>	<b>\$ 353,537</b>

The Company utilizes payment status as a means of identifying and reporting problem and potential problem retail loans. The Company considers nonaccrual loans and loans past due greater than 90 days and still accruing interest to be non-performing. The following table sets forth the Company's retail loan portfolio, categorized by payment status, as of the dates indicated (in thousands):

	<b>Residential Mortgage</b>	<b>Home Equity</b>	<b>Consumer Indirect</b>	<b>Other Consumer</b>
<b>September 30, 2011</b>				
Performing	\$ 114,403	\$ 218,435	\$ 444,710	\$ 24,639
Non-performing	1,996	501	586	
<b>Total</b>	<b>\$ 116,399</b>	<b>\$ 218,936</b>	<b>\$ 445,296</b>	<b>\$ 24,639</b>
<b>December 31, 2010</b>				
Performing	\$ 127,451	\$ 204,195	\$ 399,707	\$ 25,896
Non-performing	2,102	875	514	41
<b>Total</b>	<b>\$ 129,553</b>	<b>\$ 205,070</b>	<b>\$ 400,221</b>	<b>\$ 25,937</b>

**Allowance for Loan Losses**

Loans and the related allowance for loan losses at September 30, 2011, are presented below (in thousands):

<b>Commercial</b>	<b>Commercial</b>	<b>Residential</b>	<b>Home</b>	<b>Consumer</b>	<b>Other</b>
-------------------	-------------------	--------------------	-------------	-----------------	--------------

Edgar Filing: FINANCIAL INSTITUTIONS INC - Form 10-Q

	<b>Business</b>	<b>Mortgage</b>	<b>Mortgage</b>	<b>Equity</b>	<b>Indirect</b>	<b>Consumer</b>	<b>Total</b>
<b>Loans:</b>							
Ending balance	\$ 223,708	\$ 382,267	\$ 116,399	\$ 218,936	\$ 445,296	\$ 24,639	\$ 1,411,245
Evaluated for impairment:							
Individually	\$ 2,380	\$ 2,330	\$	\$	\$	\$	\$ 4,710
Collectively	\$ 221,328	\$ 379,937	\$ 116,399	\$ 218,936	\$ 445,296	\$ 24,639	\$ 1,406,535
<b>Allowance for loan losses:</b>							
Ending balance	\$ 4,578	\$ 6,263	\$ 887	\$ 1,150	\$ 9,569	\$ 530	\$ 22,977
Evaluated for impairment:							
Individually	\$ 1,039	\$ 393	\$	\$	\$	\$	\$ 1,432
Collectively	\$ 3,539	\$ 5,870	\$ 887	\$ 1,150	\$ 9,569	\$ 530	\$ 21,545

- 17 -

**Table of Contents**

**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**  
**Notes to Consolidated Financial Statements (Unaudited)**

**(4.) LOANS (Continued)**

The changes in the allowance for loan losses for the three and nine months ended September 30, 2011 were as follows (in thousands):

	<b>Commercial Business</b>	<b>Commercial Mortgage</b>	<b>Residential Mortgage</b>	<b>Home Equity</b>	<b>Consumer Indirect</b>	<b>Other Consumer</b>	<b>Total</b>
<b>Three months ended September 30, 2011</b>							
Beginning balance	\$ 4,011	\$ 5,763	\$ 957	\$ 1,050	\$ 8,319	\$ 532	\$ 20,632
Charge-offs	75	194	36	142	1,226	208	1,881
Recoveries	61	158	45	21	371	90	746
Provision (credit)	581	536	(79)	221	2,105	116	3,480
Ending balance	\$ 4,578	\$ 6,263	\$ 887	\$ 1,150	\$ 9,569	\$ 530	\$ 22,977
<b>Nine months ended September 30, 2011</b>							
Beginning balance	\$ 3,712	\$ 6,431	\$ 1,013	\$ 972	\$ 7,754	\$ 584	\$ 20,466
Charge-offs	390	572	48	404	3,571	687	5,672
Recoveries	325	197	75	38	1,576	354	2,565
Provision (credit)	931	207	(153)	544	3,810	279	5,618
Ending balance	\$ 4,578	\$ 6,263	\$ 887	\$ 1,150	\$ 9,569	\$ 530	\$ 22,977

Activity in the allowance for loan losses during the three and nine months ended September 30, 2010 was as follows (in thousands):

	<b>Three months ended September 30, 2010</b>	<b>Nine months ended September 30, 2010</b>
Beginning balance	\$ 21,825	\$ 20,741
Charge-offs	4,872	7,961
Recoveries	595	2,245
Provision	2,184	4,707
Ending balance	\$ 19,732	\$ 19,732

**Risk Characteristics**

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



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

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

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

**Table of Contents**

**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**  
**Notes to Consolidated Financial Statements (Unaudited)**

**(5.) BORROWINGS**

Outstanding borrowings consisted of the following as of the dates indicated (in thousands):

	<b>September 30, 2011</b>	<b>December 31, 2010</b>
Short-term borrowings:		
Federal funds purchased	\$ 19,519	\$ 38,200
Customer repurchase agreements	43,556	38,910
Federal Home Loan Bank borrowings	40,000	
<b>Total short-term borrowings</b>	<b>103,075</b>	<b>77,110</b>
Long-term borrowings:		
Federal Home Loan Bank borrowings		10,065
Junior subordinated debentures		16,702
<b>Total long-term borrowings</b>		<b>26,767</b>
<b>Total borrowings</b>	<b>\$ 103,075</b>	<b>\$ 103,877</b>

The Company classifies borrowings as short-term or long-term in accordance with the original terms of the agreement. At September 30, 2011, the Company's short-term borrowings had a weighted average rate of 0.49%. At December 31, 2010, the Company's short-term and long-term borrowings had weighted average rates of 0.21% and 7.87%, respectively.

**Junior Subordinated Debentures**

In February 2001, the Company formed Financial Institutions Statutory Trust I (the Trust) for the sole purpose of issuing trust preferred securities. The Company's \$502 thousand investment in the common equity of the Trust was classified in the consolidated statements of financial condition as other assets and \$16.7 million of related 10.2% junior subordinated debentures were classified as long-term borrowings. In 2001, the Company incurred costs relating to the issuance of the debentures totaling \$487 thousand. These costs, which were included in other assets on the consolidated statements of financial condition, were deferred and were being amortized to interest expense using the straight-line method over a twenty year period.

On August 22, 2011, the Company redeemed all of the 10.20% junior subordinated debentures at a redemption price equaling 105.1% of the principal amount redeemed, plus all accrued and unpaid interest. As a result of the redemption, the Company recognized a loss on extinguishment of debt of \$1.1 million, consisting of the redemption premium of \$852 thousand and the write-off of the remaining unamortized issuance costs of \$231 thousand.

**(6.) SHAREHOLDERS' EQUITY****Common Stock**

The changes in shares of common stock were as follows for nine months ended September 30, 2011:

	<b>Outstanding</b>	<b>Treasury</b>	<b>Issued</b>
Shares outstanding at December 31, 2010	10,937,506	410,616	11,348,122
Shares issued in common stock offering	2,813,475		2,813,475
Restricted stock awards issued	53,070	(53,070)	
Stock options exercised	6,357	(6,357)	

Treasury stock purchases	(10,467)	10,467	
Directors' retainer	5,889	(5,889)	
Shares outstanding at September 30, 2011	13,805,830	355,767	14,161,597

**Issuance of Common Stock**

On March 15, 2011, the Company completed the sale of 2,813,475 shares of its common stock through an underwritten public offering at a price of \$16.35 per share. The net proceeds of the offering, after deducting underwriting discounts and commissions and offering expenses, were \$43.1 million. A portion of the proceeds from this offering was used to redeem the Company's Series A preferred stock as described in greater detail below.

**Table of Contents**

**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**  
**Notes to Consolidated Financial Statements (Unaudited)**

**(6.) SHAREHOLDERS EQUITY (Continued)****Redemption of Series A Preferred Stock and Warrant**

In December 2008, under the U.S. Department of the Treasury's (the "Treasury") Troubled Asset Relief Program ("TARP") Capital Purchase Program, the Company entered into a Securities Purchase Agreement—Standard Terms with the Treasury pursuant to which, among other things, the Company sold to the Treasury for an aggregate purchase price of \$37.5 million, 7,503 shares of fixed rate cumulative perpetual preferred stock, Series A ("Series A" preferred stock) and a warrant to purchase up to 378,175 shares of common stock, par value \$0.01 per share, at an exercise price of \$14.88 per share (the "Warrant"), of the Company.

Pursuant to the terms of the Purchase Agreement, the Company's ability to declare or pay dividends on any of its shares was limited. Specifically, the Company was prohibited from paying any dividend with respect to shares of common stock, other junior securities or preferred stock ranking *pari passu* with the Series A preferred stock or repurchasing or redeeming any shares of the Company's common stock, other junior securities or preferred stock ranking *pari passu* with the Series A preferred stock in any quarter unless all accrued and unpaid dividends were paid on the Series A preferred stock for all past dividend periods (including the latest completed dividend period), subject to certain limited exceptions.

The \$37.5 million in proceeds was allocated to the Series A preferred stock and the Warrant based on their relative fair values at issuance (\$35.5 million was allocated to the Series A preferred stock and \$2.0 million to the Warrant). The resulting discount for the Series A preferred stock was to be accreted over five years through retained earnings as a preferred stock dividend. The Warrant was to remain in additional paid-in-capital at its initial book value until it was exercised or expired.

On February 23, 2011, the Company redeemed one-third, or \$12.5 million, of the Series A preferred stock. On March 30, 2011, the remaining \$25.0 million of the Series A preferred stock was redeemed. The unamortized discount related to the Series A preferred stock was charged to retained earnings upon redemption. The complete redemption of the Series A preferred stock removed the TARP restrictions pertaining to the Company's ability to declare and pay dividends and repurchase its common stock, as well as certain restrictions associated with executive compensation.

On May 11, 2011, the Company repurchased the Warrant issued to the Treasury. The repurchase price of \$2.1 million was recorded as a reduction of additional paid-in capital.

**Comprehensive Income (Loss)**

Presented below is a reconciliation of net income to comprehensive income including the components of other comprehensive income for the periods indicated (in thousands):

	Nine months ended September 30,					
	2011			2010		
	Pre-tax	Tax	Net-of-tax	Pre-tax	Tax	Net-of-tax
	Amount	Expense	Amount	Amount	Expense	Amount
		(Benefit)			(Benefit)	
Securities available for sale:						
Net unrealized gains arising during the period	\$ 23,654	\$ 9,371	\$ 14,283	\$ 9,904	\$ 3,831	\$ 6,073
Reclassification adjustments:						
Realized net gains included in income	(2,347)	(930)	(1,417)	(139)	(54)	(85)
Impairment charges included in income				526	204	322
	21,307	8,441	12,866	10,291	3,981	6,310
	436	173	263	316	122	194

Pension and post-retirement  
benefit liabilities

Other comprehensive income	\$ 21,743	\$ 8,614	13,129	\$ 10,607	\$ 4,103	6,504
Net income			17,037			16,189
Comprehensive income			\$ 30,166			\$ 22,693

The components of accumulated other comprehensive income (loss), net of tax, for the periods indicated were as follows (in thousands):

	<b>September 30, 2011</b>	<b>December 31, 2010</b>
Net actuarial loss and prior service cost on defined benefit pension and post-retirement plans	\$ (6,336)	\$ (6,599)
Net unrealized gain on securities available for sale	14,743	1,877
Accumulated other comprehensive income (loss)	\$ 8,407	\$ (4,722)

**Table of Contents**

**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**  
**Notes to Consolidated Financial Statements (Unaudited)**

**(7.) SHARE-BASED COMPENSATION PLANS**

The Company maintains certain stock-based compensation plans, approved by the Company's shareholders that are administered by the Board, or the Management Development and Compensation Committee of the Board. The share-based compensation plans were established to allow for the granting of compensation awards to attract, motivate and retain employees, executive officers and non-employee directors who contribute to the success and profitability of the Company and to give such persons a proprietary interest in the Company, thereby enhancing their personal interest in the Company's success.

The Company awarded 45,870 restricted shares of common stock to certain members of management during the nine months ended September 30, 2011. The weighted average market price of the restricted stock on the date of grant was \$19.25. Either a service requirement or both service and performance requirements must be satisfied before the participant becomes vested in the shares of common stock. Where applicable, the performance period for the awards is the Company's fiscal year ending on December 31, 2011. The restricted stock awards granted to management in 2011 do not have rights to dividends or dividend equivalents.

During the nine months ended September 30, 2011, the Company granted 7,200 restricted shares of common stock to directors, of which 3,600 shares vested immediately and 3,600 shares vest after completion of a one-year service requirement. The market price of the restricted stock on the date of grant was \$16.55. The director awards were granted with nonforfeitable rights to dividends.

The following is a summary of restricted stock award activity for the nine months ended September 30, 2011:

	<b>Number of Shares</b>	<b>Weighted Average Market Price at Grant Date</b>
Outstanding at beginning of year	150,796	\$ 12.76
Granted	53,070	18.88
Vested	(33,240)	14.63
Outstanding at end of period	170,626	\$ 14.30

The Company amortizes the expense related to restricted stock awards over the vesting period. Share-based compensation expense is included in the consolidated statements of income under salaries and employee benefits for awards granted to management and in other noninterest expense for awards granted to directors. The share-based compensation expense included in the consolidated statements of income is as follows for the periods indicated (in thousands):

	<b>Three months ended September 30,</b>		<b>Nine months ended September 30,</b>	
	<b>2011</b>	<b>2010</b>	<b>2011</b>	<b>2010</b>
Stock options:				
Management Stock Incentive Plan	\$ 23	\$ 46	\$ 51	\$ 96
Director Stock Incentive Plan		10	14	32
Total stock options	23	56	65	128
Restricted stock awards:				
Management Stock Incentive Plan	249	194	694	576
Director Stock Incentive Plan	15	15	104	103

Total restricted stock awards	264	209	798	679
Total share-based compensation	\$ 287	\$ 265	\$ 863	\$ 807

**Table of Contents**

**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**  
**Notes to Consolidated Financial Statements (Unaudited)**

**(8.) EMPLOYEE BENEFIT PLANS****Defined Benefit Pension Plan**

The Company participates in The New York State Bankers Retirement System (the System), a defined benefit pension plan covering substantially all employees, subject to the limitations related to the plan closure effective December 31, 2006. The benefits are based on years of service and the employee's highest average compensation during five consecutive years of employment. The defined benefit plan was closed to new participants effective December 31, 2006. Only employees hired on or before December 31, 2006 and who met participation requirements on or before January 1, 2008 are eligible to receive benefits.

The components of the Company's net periodic benefit expense for its pension plan were as follows (in thousands):

	<b>Three months ended</b>		<b>Nine months ended</b>	
	<b>September 30,</b>		<b>September 30,</b>	
	<b>2011</b>	<b>2010</b>	<b>2011</b>	<b>2010</b>
Service cost	\$ 439	\$ 408	\$ 1,317	\$ 1,224
Interest cost on projected benefit obligation	507	483	1,520	1,450
Expected return on plan assets	(664)	(611)	(1,990)	(1,833)
Amortization of unrecognized prior service cost	5	3	14	9
Amortization of unrecognized loss	152	115	456	344
<b>Net periodic pension cost</b>	<b>\$ 439</b>	<b>\$ 398</b>	<b>\$ 1,317</b>	<b>\$ 1,194</b>

The Company's funding policy is to contribute, at a minimum, an actuarially determined amount that will satisfy the minimum funding requirements determined under the appropriate sections of the Internal Revenue Code. In December 2010, the Company contributed \$4.3 million to the pension plan for fiscal year 2011, which exceeded the minimum required contribution of \$1.5 million.

**(9.) COMMITMENTS AND CONTINGENCIES**

The Company has financial instruments with off-balance sheet risk established in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and standby letters of credit. These instruments involve, to varying degrees, elements of credit and interest rate risk extending beyond amounts recognized in the financial statements.

The Company's exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit and standby letters of credit is essentially the same as that involved with extending loans to customers. The Company uses the same credit underwriting policies in making commitments and conditional obligations as for on-balance sheet instruments.

Off-balance sheet commitments consist of the following (in thousands):

	<b>September</b>	<b>December 31,</b>
	<b>30,</b>	<b>2010</b>
	<b>2011</b>	<b>2010</b>
Commitments to extend credit	\$ 375,562	\$ 357,240
Standby letters of credit	17,817	6,524

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Commitments may expire without being drawn upon; therefore, the total commitment amounts do not necessarily represent future cash requirements. Each customer's creditworthiness is evaluated on a case-by-case basis. The amount of collateral obtained, if any, is based on management's credit evaluation of the borrower. Standby letters of credit are conditional lending commitments issued by the Company to guarantee the



performance of a customer to a third party. These standby letters of credit are primarily issued to support private borrowing arrangements. The credit risk involved in issuing standby letters of credit is essentially the same as that involved in extending loan facilities to customers.

The Company also extends rate lock agreements to borrowers related to the origination of residential mortgage loans. To mitigate the interest rate risk inherent in these rate lock agreements when the Company intends to sell the related loan, once originated, as well as closed residential mortgage loans held for sale, the Company enters into forward commitments to sell individual residential mortgages. Rate lock agreements and forward commitments are considered derivatives and are recorded at fair value. Forward sales commitments totaled \$1.3 million and \$8.0 million at September 30, 2011 and December 31, 2010, respectively.

Table of Contents

**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**  
**Notes to Consolidated Financial Statements (Unaudited)**

**(10.) FAIR VALUE MEASUREMENTS**

**Determination of Fair Value Assets Measured at Fair Value on a Recurring and Nonrecurring Basis**  
**Valuation Hierarchy**

The fair value of an asset or liability is the price that would be received to sell that asset or paid to transfer that liability in an orderly transaction occurring in the principal market (or most advantageous market in the absence of a principal market) for such asset or liability. ASC Topic 820, Fair Value Measurements and Disclosures, establishes a fair value hierarchy for valuation inputs that gives the highest priority to quoted prices in active markets for identical assets or liabilities and the lowest priority to unobservable inputs. The fair value hierarchy is as follows:

**Level 1** Unadjusted quoted prices in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date.

**Level 2** Inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly. These might include quoted prices for similar assets or liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets that are not active, inputs other than quoted prices that are observable for the asset or liability (such as interest rates, volatilities, prepayment speeds, credit risks, etc.) or inputs that are derived principally from or corroborated by market data by correlation or other means.

**Level 3** Unobservable inputs for determining the fair values of assets or liabilities that reflect an entity's own assumptions about the assumptions that market participants would use in pricing the assets or liabilities.

In general, fair value is based upon quoted market prices, where available. If such quoted market prices are not available, fair value is based upon internally developed models that primarily use, as inputs, observable market-based parameters. Valuation adjustments may be made to ensure that financial instruments are recorded at fair value. These adjustments may include amounts to reflect counterparty credit quality and the company's creditworthiness, among other things, as well as unobservable parameters. Any such valuation adjustments are applied consistently over time. The Company's valuation methodologies may produce a fair value calculation that may not be indicative of net realizable value or reflective of future fair values. While management believes the Company's valuation methodologies are appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different estimate of fair value at the reporting date. Furthermore, the reported fair value amounts have not been comprehensively revalued since the presentation dates, and therefore, estimates of fair value after the balance sheet date may differ significantly from the amounts presented herein. A more detailed description of the valuation methodologies used for assets and liabilities measured at fair value, as well as the general classification of such instruments pursuant to the valuation hierarchy, is set forth below.

**Investment securities available for sale:** Pooled trust preferred securities are reported at fair value utilizing Level 3 inputs. Fair values for these securities are determined through the use of internal valuation methodologies appropriate for the specific asset, which may include the use of a discounted expected cash flow analysis or the use of broker quotes. Other securities classified as available for sale are reported at fair value utilizing Level 2 inputs. For these securities, the Company obtains fair value measurements from an independent pricing service. The fair value measurements consider observable data that may include dealer quotes, market spreads, cash flows, the U.S. Treasury yield curve, live trading levels, trade execution data, market consensus prepayment speeds, credit information and the bond's terms and conditions, among other things.

**Loans held for sale:** The fair value of loans held for sale is determined using quoted secondary market prices and investor commitments. Loans held for sale are classified as Level 2 in the fair value hierarchy.

**Collateral dependent impaired loans:** The fair value of impaired loans with specific allocations of the allowance for loan losses is generally based on recent real estate appraisals. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by the appraisers to adjust for differences between the comparable sales and income data available. Such adjustments are typically significant and result in a Level 3 classification of the inputs for determining

fair value.

**Mortgage servicing rights:** Mortgage servicing rights do not trade in an active market with readily observable market data. As a result, the Company estimates the fair value of mortgage servicing rights by using a discounted cash flow model to calculate the present value of estimated future net servicing income. The assumptions used in the discounted cash flow model are those that we believe market participants would use in estimating future net servicing income, including estimates of loan prepayment rates, servicing costs, ancillary income, impound account balances, and discount rates. Significant assumptions in the valuation of mortgage servicing rights include changes in interest rates, estimated loan repayment rates, and the timing of cash flows, among other factors. Mortgage servicing rights are classified as Level 3 measurements due to the use of significant unobservable inputs, as well as significant management judgment and estimation.

**Table of Contents**

**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**  
**Notes to Consolidated Financial Statements (Unaudited)**

**(10.) FAIR VALUE MEASUREMENTS (Continued)**

**Other real estate owned (Foreclosed assets):** Nonrecurring adjustments to certain commercial and residential real estate properties classified as other real estate owned are measured at the lower of carrying amount or fair value, less costs to sell. Fair values are generally based on third party appraisals of the property, resulting in a Level 3 classification. In cases where the carrying amount exceeds the fair value, less costs to sell, an impairment loss is recognized.

**Assets Measured at Fair Value**

The following table presents for each of the fair-value hierarchy levels the Company's assets that are measured at fair value on a recurring and non-recurring basis as of September 30, 2011 (in thousands).

	<b>Level 1 Inputs</b>	<b>Level 2 Inputs</b>	<b>Level 3 Inputs</b>	<b>Total Fair Value</b>
<b>Measured on a recurring basis:</b>				
Securities available for sale:				
U.S. Government agencies and government sponsored enterprises	\$	\$ 111,359	\$	\$ 111,359
State and political subdivisions		122,324		122,324
Mortgage-backed securities		440,401		440,401
Asset-backed securities:				
Trust preferred securities			5,341	5,341
Other		61		61
	\$	\$ 674,145	\$ 5,341	\$ 679,486
<b>Measured on a nonrecurring basis:</b>				
Loans:				
Loans held for sale	\$	\$ 2,403	\$	\$ 2,403
Collateral dependent impaired loans			2,518	2,518
Other assets:				
Mortgage servicing rights			2,084	2,084
Other real estate owned			582	582
	\$	\$ 2,403	\$ 5,184	\$ 7,587

The following table presents for each of the fair-value hierarchy levels the Company's assets that are measured at fair value on a recurring and non-recurring basis as of December 31, 2010 (in thousands).

	<b>Level 1 Inputs</b>	<b>Level 2 Inputs</b>	<b>Level 3 Inputs</b>	<b>Total Fair Value</b>
<b>Measured on a recurring basis:</b>				
Securities available for sale:				
U.S. Government agencies and government sponsored enterprises	\$	\$ 140,784	\$	\$ 140,784
State and political subdivisions		105,666		105,666
Mortgage-backed securities		419,281		419,281
Asset-backed securities:				

Edgar Filing: FINANCIAL INSTITUTIONS INC - Form 10-Q

Trust preferred securities			572	572
Other		65		65
	\$	\$ 665,796	\$ 572	\$ 666,368

**Measured on a nonrecurring basis:**

Loans:				
Loans held for sale	\$	\$ 3,138	\$	\$ 3,138
Collateral dependent impaired loans			2,457	2,457
Other assets:				
Mortgage servicing rights			1,467	1,467
Other real estate owned			741	741
	\$	\$ 3,138	\$ 4,665	\$ 7,803

There were no liabilities measured at fair value on a recurring or nonrecurring basis during the nine month periods ended September 30, 2011 and 2010.

**Table of Contents**

**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**  
**Notes to Consolidated Financial Statements (Unaudited)**

**(10.) FAIR VALUE MEASUREMENTS (Continued)****Changes in Level 3 Fair Value Measurements**

The reconciliation for all assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) is as follows for the periods indicated (in thousands):

	<b>Three months ended</b>		<b>Nine months ended</b>	
	<b>September 30,</b>		<b>September 30,</b>	
	<b>2011</b>	<b>2010</b>	<b>2011</b>	<b>2010</b>
Securities available for sale (Level 3), beginning of period	\$ 6,963	\$ 646	\$ 572	\$ 1,015
Transfers into Level 3				
Sales	(1,674)		(1,674)	
Principal paydowns and other	(250)	37	(54)	176
Total gains/losses (realized/unrealized):				
Included in earnings	1,613		1,613	(526)
Included in other comprehensive income	(1,311)	(35)	4,884	(17)
Securities available for sale (Level 3), end of period	\$ 5,341	\$ 648	\$ 5,341	\$ 648

**Fair Value of Financial Instruments**

The Fair Value of Financial Instruments Subsection of the ASC requires disclosure of the fair value of financial assets and financial liabilities, including those financial assets and financial liabilities that are not measured and reported at fair value on a recurring basis or non-recurring basis.

The following discussion describes the valuation methodologies used for assets and liabilities measured or disclosed at fair value. The techniques utilized in estimating the fair values of financial instruments are reliant on the assumptions used, including discount rates and estimates of the amount and timing of future cash flows. Care should be exercised in deriving conclusions about our business, its value or financial position based on the fair value information of financial instruments presented below.

Fair value estimates are made at a specific point in time, based on available market information and judgments about the financial instrument, including estimates of timing, amount of expected future cash flows and the credit standing of the issuer. Such estimates do not consider the tax impact of the realization of unrealized gains or losses. In some cases, the fair value estimates cannot be substantiated by comparison to independent markets. In addition, the disclosed fair value may not be realized in the immediate settlement of the financial instrument.

The estimated fair value approximates carrying value for cash and cash equivalents, Federal Home Loan Bank ( FHLB ) and Federal Reserve Bank ( FRB ) stock, company owned life insurance, accrued interest receivable, short-term borrowings and accrued interest payable. Fair value estimates for other financial instruments are discussed below.

**Loans held for sale.** The fair value is based on estimates, quoted market prices and investor commitments.

**Loans.** For variable rate loans that re-price frequently, fair value approximates carrying amount. The fair value for fixed rate loans is estimated through discounted cash flow analysis using interest rates currently being offered on loans with similar terms and credit quality. For criticized and classified loans, fair value is estimated by discounting expected cash flows at a rate commensurate with the risk associated with the estimated cash flows, or estimates of fair value discounts based on observable market information.

**Deposits.** The fair values for demand accounts, money market and savings deposits are equal to their carrying amounts. The fair values of certificates of deposit are estimated using a discounted cash flow approach that applies prevailing market interest rates for similar maturity instruments.

***Long-term borrowings and junior subordinated debentures.*** The fair value for long-term borrowings and junior subordinated debentures are estimated using a discounted cash flow approach that applies prevailing market interest rates for similar maturity instruments.

**Table of Contents**

**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**  
**Notes to Consolidated Financial Statements (Unaudited)**

**(10.) FAIR VALUE MEASUREMENTS (Continued)**

The fair value of a financial instrument is the current amount that would be exchanged between willing parties, other than in a forced liquidation. Fair value is best determined based upon quoted market prices. However, in many instances, there are no quoted market prices for the Company's various financial instruments. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. Accordingly, the fair value estimates may not be realized in an immediate settlement of the instrument. The accounting guidelines exclude certain financial instruments and all non-financial instruments from its disclosure requirements. Accordingly, the aggregate fair value amounts presented at September 30, 2011 and December 31, 2010 may not necessarily represent the underlying fair value of the Company.

The estimated fair values of financial instruments were as follows (in thousands):

	<b>September 30, 2011</b>		<b>December 31, 2010</b>	
	<b>Carrying</b>	<b>Estimated</b>	<b>Carrying</b>	<b>Estimated</b>
	<b>Amount</b>	<b>Fair</b>	<b>Amount</b>	<b>Fair</b>
		<b>Value</b>		<b>Value</b>
<b>Financial assets:</b>				
Cash and cash equivalents	\$ 67,601	\$ 67,601	\$ 39,058	\$ 39,058
Securities available for sale	679,487	679,487	666,368	666,368
Securities held to maturity	23,127	23,821	28,162	28,849
Loans held for sale	2,403	2,493	3,138	3,138
Loans	1,412,150	1,472,929	1,325,524	1,388,787
Accrued interest receivable	7,869	7,869	7,613	7,613
FHLB and FRB stock	7,848	7,848	6,353	6,353
<b>Financial liabilities:</b>				
Demand, savings and money market deposits	1,276,314	1,276,314	1,143,136	1,143,136
Certificate of deposit	707,357	709,390	739,754	740,440
Short-term borrowings	103,075	103,075	77,110	77,110
Long-term borrowings (excluding junior subordinated debentures)			10,065	10,244
Junior subordinated debentures			16,702	10,564
Accrued interest payable	5,729	5,729	7,620	7,620



**Table of Contents**

**ITEM 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**  
**FORWARD LOOKING INFORMATION**

*This Quarterly Report on Form 10-Q should be read in conjunction with the more detailed and comprehensive disclosures included in our Annual Report on Form 10-K for the year ended December 31, 2010. In addition, please read this section in conjunction with our Consolidated Financial Statements and Notes to Consolidated Financial Statements contained herein.*

Statements and financial analysis contained in this document that are not historical facts are forward looking statements made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995 (the Act). In addition, certain statements may be contained in our future filings with SEC, in press releases, and in oral and written statements made by or with our approval that are not statements of historical fact and constitute forward-looking statements within the meaning of the Act. Forward looking statements describe our future plans, strategies and expectations and are based on certain assumptions. Words such as may, could, should, would, anticipate, estimate, expect, intend, plan, target, plan, projects, and other similar expressions are intended to identify forward-looking statements but are not the exclusive means of identifying such statements.

The Company cautions readers not to place undue reliance on any forward-looking statements, which speak only as of the date made, and advises readers that various factors, including those identified by the Company under the heading Risk Factors in Item 1A of Part I of our Annual Report on Form 10-K for the year ended December 31, 2010, and our quarterly report on Form 10-Q for the quarter ended June 30, 2011, could affect the Company's financial performance and could cause the Company's actual results or circumstances for future periods to differ materially from those anticipated or projected.

Except as required by law, the Company does not undertake, and specifically disclaims any obligation to publicly release any revisions to any forward-looking statements to reflect the occurrence of anticipated or unanticipated events or circumstances after the date of such statements.

**SIGNIFICANT EVENTS**

**Common Stock Offering**

On March 15, 2011, we completed the sale of 2,813,475 shares of our common stock through an underwritten public offering at a price of \$16.35 per share. The net proceeds of the offering, after deducting underwriting discounts and commissions and offering expenses, amounted to \$43.1 million. A portion of the proceeds from this offering was used to redeem the Company's Series A preferred stock and the junior subordinated debentures.

**Redemption of Series A Preferred Stock**

In the first quarter of 2011, we fully redeemed \$37.5 million of its fixed rate cumulative perpetual preferred stock, Series A (Series A preferred stock) issued in connection with the U.S. Department of the Treasury's (the Treasury) Troubled Asset Relief Program's (TARP) Capital Purchase Program. The redemption was funded, in part, by the proceeds of the common stock offering discussed above and from cash on hand at the parent company. The redemption resulted in a one-time, non-cash redemption charge of \$1.2 million, reflecting the accelerated accretion of the remaining discount on the preferred stock, which reduced 2011 year-to-date diluted earnings per common share by \$0.09.

The complete redemption of the Series A preferred stock removed the TARP restrictions pertaining to our ability to declare and pay dividends and repurchase its common stock, as well as certain restrictions associated with executive compensation.

During the second quarter of 2011, we repurchased the warrant to purchase up to 378,175 shares of the Company's common stock at an exercise price of \$14.88 per share issued to the Treasury. The repurchase price of \$2.1 million was recorded as a reduction of additional paid-in capital.

**Redemption of Junior Subordinated Debentures**

On August 22, 2011, we redeemed all of the 10.20% junior subordinated debentures at a redemption price equaling 105.1% of the principal amount redeemed, plus all accrued and unpaid interest. As a result of the redemption, we recognized a loss on extinguishment of debt of \$1.1 million, consisting of the redemption premium of \$852 thousand and a write-off of the remaining unamortized issuance costs of \$231 thousand. A portion of the proceeds from the common stock offering earlier this year were utilized to effectuate the redemption.

See the section titled "Liquidity and Capital Resources" included herein for additional information regarding the impact of this transaction on regulatory capital.

**Table of Contents****MANAGEMENT'S DISCUSSION AND ANALYSIS****RESULTS OF OPERATIONS****Summary of Performance**

Net income decreased \$165 thousand or 3% to \$5.5 million for the third quarter of 2011 compared to \$5.7 million for the third quarter of 2010. The decrease during the third quarter of 2011 was primarily the result of a \$1.3 million increase in the provision for loan losses, an increase of \$2.1 million in noninterest expense and an increase of \$523 thousand in income tax expense, offset by a \$825 thousand increase in net interest income and \$2.9 million increase in noninterest income.

Net income available to common shareholders for the third quarter of 2011 was \$5.1 million, or \$0.37 per diluted share, compared with \$4.7 million, or \$0.43 per diluted share, for the third quarter of last year. Return on average equity was 9.07% and return on average assets was 0.95% for the third quarter of 2011 compared to 10.40% and 1.04%, respectively, for the third quarter of 2010.

Net income for the nine months ended September 30, 2011 totaled \$17.0 million, an increase of \$848 thousand or 5% from \$16.2 million for the same period in 2010. The increase in year-to-date net income for 2011 was driven by a \$2.0 million increase in net interest income and a \$4.0 million increase in noninterest income, partly offset by increases of \$911 thousand in the provision for loan losses, \$3.0 million in noninterest expense and \$1.2 million in income tax expense. For the first nine months of 2011, net income available to common shareholders was \$14.2 million, or \$1.09 per diluted share, compared with \$13.4 million, or \$1.23 per diluted share, for the first nine months of 2010. Return on average equity was 9.95% and return on average assets was 1.01% for the nine months ended September 30, 2011 compared to 10.37% and 1.01%, respectively, for the same period in 2010.

The 2011 third quarter and year-to-date earnings per share amounts were impacted by the 2,813,475 additional shares of common stock issued in conjunction with our public stock offering that occurred late in the first quarter of 2011. In addition, year-to-date earnings for 2011 were reduced by \$1.2 million, or \$0.09 per common share, for the accelerated discount accretion related to the redemption of the Series A preferred stock issued pursuant to the TARP Capital Purchase Program.

**Net Interest Income and Net Interest Margin**

Net interest income is the primary source of our revenue. Net interest income is the difference between interest income on interest-earning assets, such as loans and investment securities, and the interest expense on interest-bearing deposits and other borrowings used to fund interest-earning and other assets or activities. Net interest income is affected by changes in interest rates and by the amount and composition of earning assets and interest-bearing liabilities, as well as the sensitivity of the balance sheet to changes in interest rates, including characteristics such as the fixed or variable nature of the financial instruments, contractual maturities and repricing frequencies.

Interest rate spread and net interest margin are utilized to measure and explain changes in net interest income. Interest rate spread is the difference between the yield on earning assets and the rate paid for interest-bearing liabilities that fund those assets. The net interest margin is expressed as the percentage of net interest income to average earning assets. The net interest margin exceeds the interest rate spread because noninterest-bearing sources of funds ( net free funds ), principally noninterest-bearing demand deposits and stockholders' equity, also support earning assets. To compare tax-exempt asset yields to taxable yields, the yield on tax-exempt investment securities is computed on a taxable equivalent basis. Net interest income, interest rate spread, and net interest margin are discussed on a taxable equivalent basis.

The following table reconciles interest income per the consolidated statements of income to interest income adjusted to a fully taxable equivalent basis:

	<b>Three months ended</b>		<b>Nine months ended</b>	
	<b>September 30,</b>		<b>September 30,</b>	
	<b>2011</b>	<b>2010</b>	<b>2011</b>	<b>2010</b>
Interest income per consolidated statements of income	\$ 23,774	\$ 24,186	\$ 71,243	\$ 72,212
Adjustment to fully taxable equivalent basis	511	395	1,559	1,367

Interest income adjusted to a fully taxable equivalent basis	24,285	24,581	72,802	73,579
Interest expense per consolidated statements of income	3,156	4,393	10,534	13,491
Net interest income on a taxable equivalent basis	\$ 21,129	\$ 20,188	\$ 62,268	\$ 60,088

***Analysis of Net Interest Income for the Three Months ended September 30, 2011 and September 30, 2010***

Net interest income on a taxable equivalent basis for the three months ended September 30, 2011, was \$21.1 million, an increase of \$941 thousand or 5% versus the comparable quarter last year. The increase in taxable equivalent net interest income was primarily attributable to favorable volume variances (as changes in the balances and mix of earning assets and interest-bearing liabilities added \$2.0 million to taxable equivalent net interest income), partly offset by unfavorable rate variances (as the impact of changes in the interest rate environment and product pricing reduced taxable equivalent net interest income by \$1.1 million).

**Table of Contents****MANAGEMENT'S DISCUSSION AND ANALYSIS**

The net interest margin for the third quarter of 2011 was 4.02%, 4 basis points lower than 4.06% for the same period in 2010. This comparable period decrease was a function of a 1 basis point increase in interest rate spread, offset by a 5 basis point lower contribution from net free funds (due principally to lower rates on interest-bearing liabilities reducing the value of noninterest-bearing deposits and other net free funds). The higher interest rate spread was a net result of a 33 basis point decrease in the yield on earning assets and a 34 basis point decrease in the cost of interest-bearing liabilities.

The yield on earning assets was 4.62% for the third quarter of 2011, 33 basis points lower than the third quarter of 2010. Loan yields decreased 34 basis points to 5.45%, also impacted by the lower interest rate environment. Commercial mortgage and consumer indirect loans in particular, down 29 and 71 basis points, respectively, experienced lower yields given the competitive pricing pressures in a low interest rate environment. The yield on investment securities dropped 35 basis points to 2.95%, also impacted by the lower interest rate environment and prepayments of mortgage-related investment securities. Overall, earning asset rate changes reduced interest income by \$1.9 million.

The cost of average interest-bearing liabilities of 0.75% in the third quarter of 2011 was 34 basis points lower than the third quarter of 2010. The average cost of interest-bearing deposits was 0.72% in 2011, 26 basis points lower than 2010, reflecting the lower rate environment, mitigated by a focus on product pricing to retain balances. The cost of short-term funding decreased 30 basis points to 0.47%, while the cost of long-term borrowings increased by 197 basis points to 9.74%. The cost of long-term borrowings increased as the Company repaid lower priced debt, leaving the higher fixed rate 10.20% junior subordinated debentures as a larger percentage of total outstanding long-term debt. As previously discussed, we repaid the junior subordinated debentures (included in long-term borrowings) in full during the third quarter of 2011. The interest-bearing liability rate changes resulted in \$799 thousand of lower interest expense.

Average interest-earning assets were \$2.090 billion for the third quarter of 2011, an increase of \$113.5 million or 6% from the comparable quarter last year, with average loans up \$89.4 million and average securities up \$24.8 million. The growth in average loans was comprised of increases in consumer loans (up \$66.9 million, primarily indirect loans) and commercial loans (up \$41.0 million), while residential mortgages declined (down \$18.5 million).

Average interest-bearing liabilities of \$1.665 billion in the third quarter of 2011 were \$68.7 million or 4% higher than the third quarter of 2010. On average, interest-bearing deposits decreased \$3.2 million (primarily attributable to decreased retail time deposits), while noninterest-bearing demand deposits (a principal component of net free funds) were up \$38.9 million. Average borrowings increased \$71.9 million between the third quarter periods, with short-term borrowings higher by \$89.4 million and long-term funding lower by \$17.5 million.

***Analysis of Net Interest Income for the Nine Months ended September 30, 2011 and September 30, 2010***

Net interest income on a taxable equivalent basis for the first nine months of 2011 was \$62.3 million, an increase of \$2.2 million or 4% versus the same period last year. The increase in taxable equivalent net interest income was primarily attributable to a favorable volume variance (as changes in the balances and mix of earning assets and interest-bearing liabilities added \$5.6 million to taxable equivalent net interest income), partially offset by an unfavorable rate variance (as the impact of changes in the interest rate environment and product pricing decreased taxable equivalent net interest income by \$3.5 million).

The net interest margin for the first nine months of 2011 was 4.02%, 7 basis points lower than 4.09% for the same period last year. This comparable period decrease was a function of a 3 basis point decrease in interest rate spread, combined with a 4 basis point lower contribution from net free funds. The decline in the interest rate spread was a net result of a 31 basis point decrease in the yield on earning assets, largely offset by a 28 basis point reduction in the cost of interest-bearing liabilities.

The yield on earning assets was 4.70% for the first nine months of 2011, 31 basis points lower than the same period last year, attributable to decreases in the yields on the investment security portfolio (down 43 basis points, to 2.97%) and loan portfolio (down 29 basis points to 5.59%).

The rate on interest-bearing liabilities of 0.85% for the first nine months of 2011 was 28 basis points lower than the same period in 2010. Rates on interest-bearing deposits were down 23 basis points to 0.77%. The cost of short-term

borrowings decreased 21 basis points to 0.53%, while the cost of long-term funding increased by 181 basis points. As previously discussed, the cost of long-term borrowings has increased due to a change in the mix of outstanding long-term debt.

Average interest-earning assets were \$2.067 billion for the first nine months of 2011, an increase of \$105.8 million or 5% from the comparable period last year, with average loans up \$88.7 million and average securities up \$23.5 million. The growth in average loans was comprised of increases in consumer loans (up \$71.6 million, primarily indirect loans) and commercial loans (up \$34.2 million), while residential mortgages declined (down \$17.1 million).

Average interest-bearing liabilities of \$1.657 billion in the first nine months of 2011 were \$61.4 million or 4% higher than the first nine months of 2010. On average, interest-bearing deposits grew \$40.1 million (attributable to increases of \$21.4 million in retail deposits and \$18.7 million in public deposits), while noninterest-bearing demand deposits were up \$36.4 million. Average borrowings increased \$21.3 million between the first nine months of 2011 and the same period in 2010 due to increased short-term borrowings, offset by repayment of long-term borrowings upon maturity.

**Table of Contents****MANAGEMENT'S DISCUSSION AND ANALYSIS**

The following tables sets forth certain information relating to the consolidated balance sheets and reflects the average yields earned on interest-earning assets, as well as the average rates paid on interest-bearing liabilities for the periods indicated (in thousands).

	<b>Three months ended September 30,</b>					
	<b>2011</b>			<b>2010</b>		
	<b>Average Balance</b>	<b>Interest</b>	<b>Average Rate</b>	<b>Average Balance</b>	<b>Interest</b>	<b>Average Rate</b>
<b>Interest-earning assets:</b>						
Federal funds sold and interest-earning deposits	\$ 93	\$	0.18%	\$ 842	\$	0.23%
Investment securities <sup>(1)</sup> :						
Taxable	552,129	3,647	2.64	576,031	4,349	3.02
Tax-exempt <sup>(2)</sup>	140,815	1,458	4.14	92,144	1,163	5.05
Total investment securities	692,944	5,105	2.95	668,175	5,512	3.30
Loans:						
Commercial business	216,980	2,591	4.74	206,071	2,474	4.76
Commercial mortgage	368,071	5,254	5.66	337,992	5,069	5.95
Residential mortgage	118,952	1,678	5.64	137,451	1,992	5.80
Home equity	217,808	2,399	4.37	202,621	2,307	4.52
Consumer indirect	450,813	6,608	5.82	397,161	6,535	6.53
Other consumer	24,644	650	10.47	26,541	692	10.34
Total loans	1,397,268	19,180	5.45	1,307,837	19,069	5.79
Total interest-earning assets	2,090,305	24,285	4.62	1,976,854	24,581	4.95
Allowance for loan losses	(21,118)			(21,317)		
Other noninterest-earning assets	225,669			208,096		
Total assets	\$ 2,294,856			\$ 2,163,633		
<b>Interest-bearing liabilities:</b>						
Deposits:						
Interest-bearing demand	\$ 366,567	\$ 144	0.16%	\$ 360,947	\$ 164	0.18%
Savings and money market	436,336	248	0.23	402,601	274	0.27
Certificates of deposit	706,435	2,336	1.31	749,021	3,301	1.75
Total interest-bearing deposits	1,509,338	2,728	0.72	1,512,569	3,739	0.98
Short-term borrowings	145,007	172	0.47	55,562	107	0.77
Long-term borrowings	10,527	256	9.74	28,072	547	7.77
Total borrowings	155,534	428	1.10	83,634	654	3.12
	1,664,872	3,156	0.75	1,596,203	4,393	1.09

## Total interest-bearing liabilities

Noninterest-bearing demand deposits

375,518 336,591

Other noninterest-bearing liabilities

14,087 14,755

Shareholders equity

240,379 216,084

Total liabilities and shareholders equity

\$ 2,294,856 \$ 2,163,633

Net interest income (tax-equivalent)

\$ 21,129 \$ 20,188

Interest rate spread

3.87% 3.86%

Net earning assets

\$ 425,433 \$ 380,651

Net interest margin (tax-equivalent)

4.02% 4.06%

Ratio of average interest-earning assets to average interest-bearing liabilities

125.55% 123.85%

(1) Investment securities are shown at amortized cost and include non-performing securities.

(2) The interest on tax-exempt securities is calculated on a tax equivalent basis assuming a Federal tax rate of 35% and 34% for the three months ended September 30, 2011 and 2010, respectively.



**Table of Contents****MANAGEMENT'S DISCUSSION AND ANALYSIS**

Nine months ended September 30,

	2011		2010		Average	
	Average Balance	Interest	Average Rate	Average Balance	Interest	Rate
<b>Interest-earning assets:</b>						
Federal funds sold and interest-earning deposits	\$ 155	\$	0.21%	\$ 6,513	\$ 10	0.21%
Investment securities <sup>(1)</sup> :						
Taxable	556,077	11,063	2.65	567,871	13,146	3.09
Tax-exempt <sup>(2)</sup>	140,311	4,453	4.23	105,005	4,022	5.11
Total investment securities	696,388	15,516	2.97	672,876	17,168	3.40
Loans:						
Commercial business	212,337	7,617	4.80	206,439	7,438	4.82
Commercial mortgage	363,547	15,701	5.77	335,291	15,182	6.05
Residential mortgage	123,569	5,250	5.67	140,702	6,246	5.92
Home equity	213,001	7,098	4.46	200,806	6,861	4.57
Consumer indirect	433,578	19,677	6.07	371,743	18,570	6.68
Other consumer	24,860	1,943	10.45	27,243	2,104	10.33
Total loans	1,370,892	57,286	5.59	1,282,224	56,401	5.88
Total interest-earning assets	2,067,435	72,802	4.70	1,961,613	73,579	5.01
Allowance for loan losses	(20,912)			(21,131)		
Other noninterest-earning assets	215,409			204,619		
Total assets	\$ 2,261,932			\$ 2,145,101		
<b>Interest-bearing liabilities:</b>						
Deposits:						
Interest-bearing demand	\$ 384,651	\$ 467	0.16%	\$ 380,065	\$ 532	0.19%
Savings and money market	446,355	785	0.24	408,228	844	0.28
Certificates of deposit	715,390	7,607	1.42	718,043	9,877	1.84
Total interest-bearing deposits	1,546,396	8,859	0.77	1,506,336	11,253	1.00
Short-term borrowings	89,419	354	0.53	48,852	270	0.74
Long-term borrowings	21,265	1,321	8.29	40,506	1,968	6.48
Total borrowings	110,684	1,675	2.02	89,358	2,238	3.34
Total interest-bearing liabilities	1,657,080	10,534	0.85	1,595,694	13,491	1.13
	361,393			324,955		

Noninterest-bearing demand deposits			
Other noninterest-bearing liabilities	14,537	15,641	
Shareholders' equity	228,922	208,811	
Total liabilities and shareholders' equity	\$ 2,261,932	\$ 2,145,101	
Net interest income (tax-equivalent)	\$ 62,268	\$ 60,088	
Interest rate spread		3.85%	3.88%
Net earning assets	\$ 410,355	\$ 365,919	
Net interest margin (tax-equivalent)		4.02%	4.09%
Ratio of average interest-earning assets to average interest-bearing liabilities		124.76%	122.93%

(1) Investment securities are shown at amortized cost and include non-performing securities.

(2) The interest on tax-exempt securities is calculated on a tax equivalent basis assuming a Federal tax rate of 35% and 34% for the nine months ended September 30, 2011 and 2010, respectively.

**Table of Contents****MANAGEMENT'S DISCUSSION AND ANALYSIS**

The following table presents, on a tax equivalent basis, the relative contribution of changes in volumes and changes in rates to changes in net interest income for the periods indicated. The change in interest not solely due to changes in volume or rate has been allocated in proportion to the absolute dollar amounts of the change in each (in thousands):

Increase (decrease) in:	Three months ended September 30, 2011 vs. 2010			Nine months ended September 30, 2011 vs. 2010		
	Volume	Rate	Total	Volume	Rate	Total
<b>Interest income:</b>						
Federal funds sold and interest-earning deposits	\$	\$	\$	\$ (10)	\$	\$ (10)
Investment securities:						
Taxable	(175)	(527)	(702)	(268)	(1,815)	(2,083)
Tax-exempt	532	(237)	295	1,198	(767)	431
Total investment securities	357	(764)	(407)	930	(2,582)	(1,652)
Loans:						
Commercial business	130	(13)	117	212	(33)	179
Commercial mortgage	437	(252)	185	1,241	(722)	519
Residential mortgage	(262)	(52)	(314)	(737)	(259)	(996)
Home equity	169	(77)	92	409	(172)	237
Consumer indirect	829	(756)	73	2,906	(1,799)	1,107
Other consumer	(50)	8	(42)	(186)	25	(161)
Total loans	1,253	(1,142)	111	3,845	(2,960)	885
<b>Total interest income</b>	1,610	(1,906)	(296)	4,765	(5,542)	(777)
<b>Interest expense:</b>						
Deposits:						
Interest-bearing demand	3	(23)	(20)	6	(71)	(65)
Savings and money market	22	(48)	(26)	74	(133)	(59)
Certificates of deposit	(179)	(786)	(965)	(36)	(2,234)	(2,270)
Total interest-bearing deposits	(154)	(857)	(1,011)	44	(2,438)	(2,394)
Short-term borrowings	119	(54)	65	177	(93)	84
Long-term borrowings	(403)	112	(291)	(1,099)	452	(647)
Total borrowings	(284)	58	(226)	(922)	359	(563)
<b>Total interest expense</b>	(438)	(799)	(1,237)	(878)	(2,079)	(2,957)
<b>Net interest income</b>	\$ 2,048	\$ (1,107)	\$ 941	\$ 5,643	\$ (3,463)	\$ 2,180

**Provision for Loan Losses**

The provision for loan losses is based upon credit loss experience, growth or contraction of specific segments of the loan portfolio, and the estimate of losses inherent in the current loan portfolio. There were provisions for loan losses of \$3.5 million and \$5.6 million for the three and nine month periods ended September 30, 2011, compared with provisions of \$2.2 million and \$4.7 million for the corresponding periods in 2010, respectively. See Allowance for

Loan Losses under the section titled Lending Activities included herein for additional information.

**Table of Contents****MANAGEMENT'S DISCUSSION AND ANALYSIS****Noninterest Income**

The following table details the major categories of noninterest income for the periods presented (in thousands):

	Three months ended		Nine months ended	
	September 30,		September 30,	
	2011	2010	2011	2010
Service charges on deposits	\$ 2,257	\$ 2,528	\$ 6,605	\$ 7,260
ATM and debit card	1,117	1,046	3,256	3,034
Broker-dealer fees and commissions	541	263	1,329	1,002
Company owned life insurance	422	271	967	822
Loan servicing	64	267	662	687
Net gain on sale of loans held for sale	318	197	659	374
Net gain on disposal of investment securities	2,340	70	2,347	139
Impairment charges on investment securities				(526)
Net gain (loss) on disposal of other assets	7	(188)	44	(186)
Other	970	677	2,289	1,574
Total noninterest income	\$ 8,036	\$ 5,131	\$ 18,158	\$ 14,180

The components of noninterest income fluctuated as discussed below.

Service charges on deposit accounts were down \$271 thousand or 11% in the third quarter of 2011 and \$655 thousand or 9% for the nine months ended September 30, 2011, compared to the same periods a year earlier due to changes in customer behavior and recent regulatory changes that include requirements for customers to opt in for overdraft coverage of certain types of electronic banking activities

ATM and debit card income was up \$71 thousand and \$222 thousand, respectively, or 7% in the three and nine months ended September 30, 2011, compared to the same periods of 2010. The increased popularity of electronic banking and transaction processing has resulted in higher ATM and debit card point-of-sale usage income.

Broker-dealer fees and commissions were up \$278 thousand and \$327 thousand, respectively, in the three and nine months ended September 30, 2011, compared to the same periods in 2010, mainly due to increased sales volume.

Company owned life insurance income was up \$151 thousand or 56% in the third quarter of 2011 and \$145 thousand or 18% for the nine months ended September 30, 2011, compared to the same periods in 2010. The increases were the result of an additional \$18.0 million investment in company owned life insurance during the third quarter of 2011.

Loan servicing income was down \$203 thousand or 76% in the third quarter of 2011 and \$25 thousand or 4% for the nine months ended September 30, 2011, compared to the same periods a year ago. Loan servicing income decreased as a result of more rapid amortization of servicing rights due to loans paying off, lower fees collected due to a decrease in the sold and serviced portfolio and write-downs on capitalized mortgage servicing assets. A write-down of \$162 thousand was recorded in the third quarter of 2011 due to the valuation of its mortgage servicing rights portfolio.

Net gain on loans held for sale increased \$121 thousand and \$285 thousand, respectively, in the three and nine months ended September 30, 2011, compared to the same periods of 2010, mainly due to the \$153 thousand gain relating to the servicing retained sale of \$13.0 million of indirect auto loans during July 2011.

Net gains from the sales of investment securities were \$2.3 million for the three and nine month periods ended September 30, 2011, compared to \$70 thousand and \$139 thousand for the same periods in 2010, respectively. The current year includes net gains of \$1.6 million from the third quarter sale of three pooled trust-preferred securities that had been written down in prior periods and included in non-performing assets. We continue to monitor the market for the trust-preferred securities and evaluate the potential for future dispositions. Net gains of \$726 thousand from the sale of three mortgage-backed securities were also recognized during the third quarter of 2011. The amount and timing of our sale of investments securities is dependent on a number of factors, including our prudent efforts to realize gains while managing duration, premium and credit risk.

Other noninterest income increased \$293 thousand or 43% in the third quarter of 2011 and \$715 thousand or 45% for the nine months ended September 30, 2011, compared to the same periods a year earlier. Other noninterest income for the third quarter of 2011 includes \$152 thousand related to insurance proceeds received for losses relating to an irregular instance of fraudulent debit card activity during the fourth quarter of 2010. Merchant services fees paid by customers for account management and electronic processing of transactions and income from the Company's capital investment in several limited partnerships also contributed to the 2011 increases.

**Table of Contents****MANAGEMENT'S DISCUSSION AND ANALYSIS****Noninterest Expense**

The following table details the major categories of noninterest expense for the periods presented (in thousands):

	Three months ended		Nine months ended	
	September 30,		September 30,	
	2011	2010	2011	2010
Salaries and employee benefits	\$ 9,104	\$ 8,131	\$ 26,359	\$ 24,422
Occupancy and equipment	2,722	2,736	8,209	8,177
Computer and data processing	603	552	1,854	1,738
Professional services	570	534	1,823	1,618
Supplies and postage	461	442	1,337	1,318
FDIC assessments	437	629	1,212	1,865
Advertising and promotions	477	338	895	877
Loss on extinguishment of debt	1,083		1,083	-
Other	1,555	1,574	4,743	4,529
Total noninterest expense	\$ 17,012	\$ 14,936	\$ 47,515	\$ 44,544

The components of noninterest expense fluctuated as discussed below.

The largest noninterest expense increase in the three and nine month periods ended September 30, 2011 was in salaries and employee benefits, which increased by \$973 thousand or 12% and \$1.9 million or 8%, respectively, over the same periods one year earlier. The increases reflect higher medical expenses as well as an increase in estimated incentive compensation, which was previously limited under the TARP Capital Purchase Program. The Company's staffing levels were consistent between the three and nine month periods ended September 30, 2011 and the comparable periods in 2010.

Professional services expenses increased \$36 thousand or 7% and \$205 thousand or 13%, respectively, in the three and nine months ended September 30, 2011, compared to the same periods of 2010. Professional fees increased primarily due to legal and shareholder expenses related to the transactions identified earlier as significant events.

FDIC assessments for the third quarter and first nine months of 2011 are down considerably compared to the same periods of 2010, primarily a result of changes made by the FDIC in the method of calculating assessment rates.

Advertising and promotions costs were up \$139 thousand or 41% in the third quarter of 2011 compared to the same quarter last year earlier due to increases in business development expenses and the opening of a new branch in suburban Rochester.

The Company redeemed all of the 10.20% junior subordinated debentures during the third quarter of 2011. As a result of the redemption, the Company recognized a loss on extinguishment of debt of \$1.1 million, consisting of a redemption premium of \$852 thousand and a write-off of the remaining unamortized issuance costs of \$231 thousand. The efficiency ratio measures the amount of expense that is incurred to generate a dollar of revenue. The efficiency ratio for the third quarter of 2011 was 62.97% compared with 59.05% for the third quarter of 2010, and 60.58% for the nine months ended September 30, 2011, compared to 59.50% for the same period a year ago. Our increased efficiency ratio was primarily the result of the aforementioned \$1.1 million loss on extinguishment of debt. The efficiency ratio equals noninterest expense less other real estate expense as a percentage of net revenue, defined as the sum of tax-equivalent net interest income and noninterest income before net gains on investment securities.

**Income Taxes**

The Company recorded income tax expense of \$2.7 million in the third quarter of 2011, compared to income tax expense of \$2.1 million in the third quarter of 2010. For the nine month period ended September 30, 2011, income tax expense totaled \$8.7 million compared to \$7.5 million in the same period of 2010. These changes were due in part to increases of \$358 thousand and \$2.1 million in pre-tax income for the three and nine month periods of 2011, respectively, compared to the prior year. In addition, 2010 tax expense was reduced by a one-time tax benefit of \$606

thousand recorded during the quarter ended September 30, 2010 relating to certain amendments to the New York State ( NYS ) tax law pertaining to banking corporations which were enacted during that quarter. The Company s effective tax rates were 32.6% and 33.8% for the three and nine months ended September 30, 2011, respectively, compared with 27.4% and 31.5% in the same periods last year, respectively. Effective tax rates are impacted by items of income and expense that are not subject to federal or state taxation. The Company s effective tax rates reflect the impact of these items, which include, but are not limited to, interest income from tax-exempt securities and earnings on company owned life insurance.



**Table of Contents****MANAGEMENT'S DISCUSSION AND ANALYSIS****ANALYSIS OF FINANCIAL CONDITION****INVESTING ACTIVITIES**

The following table sets forth selected information regarding the composition of the Company's investment securities portfolio as of the dates indicated (in thousands):

	<b>Investment Securities Portfolio Composition</b>			
	<b>September 30, 2011</b>		<b>December 31, 2010</b>	
	<b>Amortized Cost</b>	<b>Fair Value</b>	<b>Amortized Cost</b>	<b>Fair Value</b>
<b>Securities available for sale:</b>				
U.S. Government agency and government-sponsored enterprise securities	\$ 108,944	\$ 111,359	\$ 141,591	\$ 140,784
State and political subdivisions	118,377	122,324	105,622	105,666
Mortgage-backed securities:				
Agency mortgage-backed securities	426,832	438,193	414,502	417,709
Non-Agency mortgage-backed securities	467	2,208	981	1,572
Asset-backed securities	451	5,403	564	637
Total available for sale securities	655,071	679,487	663,260	666,368
<b>Securities held to maturity:</b>				
State and political subdivisions	23,127	23,821	28,162	28,849
Total investment securities	\$ 678,198	\$ 703,308	\$ 691,422	\$ 695,217

**Impairment Assessment**

The Company reviews investment securities on an ongoing basis for the presence of other-than-temporary impairment ( OTTI ) with formal reviews performed quarterly. When evaluating debt securities for OTTI, management considers many factors, including: (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, (3) whether the market decline was affected by macroeconomic conditions, and (4) whether the Company has the intention to sell the debt security or whether it is more likely than not that it will be required to sell the debt security before its anticipated recovery. The assessment of whether OTTI exists involves a high degree of subjectivity and judgment and is based on the information available to management at a point in time.

The table below summarizes unrealized losses in each category of the securities portfolio at the end of the periods indicated (in thousands).

	<b>Unrealized Losses on Investment Securities</b>			
	<b>September 30, 2011</b>		<b>December 31, 2010</b>	
	<b>Unrealized Losses</b>	<b>% of Total</b>	<b>Unrealized Losses</b>	<b>% of Total</b>
<b>Securities available for sale:</b>				
U.S. Government agencies and government sponsored enterprises	\$ 20	12.0%	\$ 1,965	31.6%
State and political subdivisions	11	6.6	1,472	23.6
Mortgage-backed securities:				
Agency mortgage-backed securities	136	81.4	2,655	42.7
Non-Agency mortgage-backed securities				

Asset-backed securities				131	2.1
Total available for sale securities	\$	167	100.0	\$ 6,223	100.0
<b>Securities held to maturity:</b>					
State and political subdivisions					
Total investment securities	\$	167	100.0%	\$ 6,223	100.0%

**U.S. Government Agencies and Government Sponsored Enterprises ( GSE ).** As of September 30, 2011, there were 5 securities in the U.S. Government agencies and GSE portfolio that were in an unrealized loss position. Each of these was in an unrealized loss position for 12 months or longer and had an aggregate amortized cost of \$7.6 million and unrealized losses of \$20 thousand. Because the decline in fair value is attributable to changes in interest rates, and not credit quality, and because we do not have the intent to sell these securities and it is likely that we will not be required to sell the securities before their anticipated recovery, we do not consider these securities to be other-than-temporarily impaired at September 30, 2011.

Table of Contents**MANAGEMENT'S DISCUSSION AND ANALYSIS**

**State and Political Subdivisions.** As of September 30, 2011, the state and political subdivisions ( municipals ) portfolio totaled \$145.4 million, of which \$122.3 million was classified as available for sale. As of that date, \$23.1 million was classified as held to maturity with a fair value of \$23.8 million. As of September 30, 2011, there were 7 municipals in an unrealized loss position, all of which were available for sale. Of these, 3 were in an unrealized loss position for 12 months or longer and had an aggregate amortized cost of \$1.0 million and unrealized losses of \$9 thousand.

Although there has been a considerable amount of negative information regarding municipal entities in certain states in the U.S., our portfolio is concentrated in municipalities within our geographic footprint and there is currently no indication that the underlying credit issuers (counties, towns, villages, cities, schools, etc.) are likely to default on their debt. Additionally, most of the available for sale bonds are General Obligation issues which require the taxing authority to increase taxes as needed to repay the bond holders.

Because the decline in fair value is attributable to changes in interest rates, and not credit quality, and because we do not have the intent to sell these securities and it is likely that we will not be required to sell the securities before their anticipated recovery, we do not consider these securities to be other-than-temporarily impaired at September 30, 2011.

**Agency Mortgage-backed Securities.** With the exception of the non-Agency mortgage-backed securities ( non-Agency MBS ) discussed below, all of the mortgage-backed securities held by us as of September 30, 2011, were issued by U.S. Government sponsored entities and agencies ( Agency MBS ), primarily GNMA. The contractual cash flows of our Agency MBS are guaranteed by FNMA, FHLMC or GNMA. The GNMA mortgage-backed securities are backed by the full faith and credit of the U.S. Government.

As of September 30, 2011, there were positions in 10 securities in the Agency MBS portfolio that were in an unrealized loss position. Of these, 3 securities with an aggregate amortized cost of \$1.9 million and unrealized losses of \$11 thousand were in an unrealized loss position for 12 months or longer. Given the high credit quality inherent in Agency MBS, we do not consider any of the unrealized losses on such MBS to be credit related or other-than-temporary as of September 30, 2011. Furthermore, as of September 30, 2011, we did not intend to sell any of Agency MBS that were in an unrealized loss position, all of which were performing in accordance with their terms.

**Non-Agency Mortgage-backed Securities.** Our non-Agency MBS portfolio consists of positions in three privately issued whole loan collateralized mortgage obligations with a fair value of \$2.2 million and net unrealized gains of \$1.7 million as of September 30, 2011. As of that date, each of the three non-Agency MBS were rated below investment grade. None of these securities were in an unrealized loss position. To date, we have recognized aggregate OTTI charges of \$6.0 million due to reasons of credit quality against these securities, all of which was recorded prior to 2010.

**Asset-backed Securities ( ABS ).** As of September 30, 2011, the fair value of the ABS portfolio totaled \$5.4 million and consisted of positions in 12 securities, the majority of which are pooled trust preferred securities ( TPS ) issued primarily by financial institutions and, to a lesser extent, insurance companies located throughout the United States. As a result of some issuers defaulting and others electing to defer interest payments, we considered all but one of the ABS securities to be non-performing and stopped accruing interest on the investments during 2009.

Since the second quarter of 2008, we have written down each of the securities in the ABS portfolio, resulting in aggregate OTTI charges of \$27.3 million through December 31, 2010. We expect to recover the remaining amortized cost of \$451 thousand on the securities. As of September 30, 2011, each of the securities in the ABS portfolio was rated below investment grade. None of these securities were in an unrealized loss position.

The market for these securities began to improve during the second quarter of 2011, resulting in substantial increases to their fair value since the beginning of the year. During that time, there were no additions to the portfolio as the increase relates solely to an increase in the fair value of each of the 12 securities in the portfolio. During the third quarter of 2011, we recognized a gain of \$1.6 million from the sale of three ABS securities. The three securities had a fair value of \$154 thousand at December 31, 2010. The Company continues to monitor the market for these securities and evaluate the potential for future dispositions.

**Other Investments.** As a member of the FHLB the Bank is required to hold FHLB stock. The amount of required FHLB stock is based on the Bank's asset size and the amount of borrowings from the FHLB. We have assessed the

ultimate recoverability of our FHLB stock and believe that no impairment currently exists. As a member of the FRB system, we are required to maintain a specified investment in FRB stock based on a ratio relative to our capital. The FHLB stock and FRB stock are recorded at cost and included in other assets. Our ownership of FHLB stock totaled \$4.0 million and \$2.5 million at September 30, 2011 and December 31, 2010, respectively. The increase in FHLB stock was required due to an increased level of borrowings. Our ownership of FRB stock totaled \$3.9 million at September 30, 2011 and December 31, 2010.

Table of Contents**MANAGEMENT'S DISCUSSION AND ANALYSIS****LENDING ACTIVITIES**

The following table sets forth selected information regarding the composition of the Company's loan portfolio as of the dates indicated (in thousands).

	<b>Loan Portfolio Composition</b>			
	<b>September 30, 2011</b>		<b>December 31, 2010</b>	
	<b>Amount</b>	<b>% of Total</b>	<b>Amount</b>	<b>% of Total</b>
Commercial business	\$ 223,796	15.6%	\$ 211,031	15.7%
Commercial mortgage	381,541	26.6	352,930	26.2
Total commercial	605,337	42.2	563,961	41.9
Residential mortgage	116,432	8.1	129,580	9.6
Home equity	222,640	15.5	208,327	15.5
Consumer indirect	465,910	32.5	418,016	31.1
Other consumer	24,808	1.7	26,106	1.9
Total consumer	713,358	49.7	652,449	48.5
Total loans	1,435,127	100.0%	1,345,990	100.0%
Allowance for loan losses	22,977		20,466	
Total loans, net	\$ 1,412,150		\$ 1,325,524	

Total loans increased by 7% to \$1.435 billion as of September 30, 2011 from \$1.346 billion as of December 31, 2010. Commercial loans increased \$41.4 million from December 31, 2010 and represented 42.2% of total loans as of September 30, 2011, a result of the Company's continued focus on commercial business development programs.

Residential mortgage loans decreased \$13.2 million to \$116.4 million as of September 30, 2011 in comparison to \$129.6 million as of December 31, 2010. This category of loans decreased as the majority of newly originated and refinanced residential mortgages were sold in the secondary market rather than being added to the portfolio. The Company does not engage in sub-prime or other high-risk residential mortgage lending as a line-of-business.

Consumer loans totaled \$713.4 million as of September 30, 2011, an increase of \$60.9 million or 9% from December 31, 2010. The consumer indirect portfolio increased 12% to \$465.9 million as of September 30, 2011, from \$418.0 million as of December 31, 2010. During the nine months of 2011, the Company originated \$192.7 million in indirect auto loans with a mix of approximately 46% new auto and 54% used auto. We continue to grow our indirect lending network by further expanding our relationships with dealerships in not only our historical Western and Central New York footprint, but in our relatively new Capital District of New York and Northern Pennsylvania markets.

**Loans Held for Sale and Loan Servicing Rights.** Loans held for sale (not included in the loan portfolio composition table) totaled \$2.4 million and \$3.1 million as of September 30, 2011 and December 31, 2010, respectively, all of which were residential real estate loans. We sell certain qualifying newly originated and refinanced residential real estate mortgages in the secondary market. The sold and serviced residential real estate loan portfolio decreased to \$307.5 million as of September 30, 2011 from \$328.9 million as of December 31, 2010. The decrease in the sold and serviced portfolio resulted from payments and payoffs on existing loans outpacing new loan origination and refinancing volumes.

During the third quarter of 2011, we recognized a gain of \$153 thousand from the sale of \$13.0 million of indirect auto loans which had been reclassified from portfolio to loans held for sale at June 30, 2011. The loans were sold pursuant to a 90%/10% participation agreement. The Company will continue to service the loans for a fee in accordance with the participation agreement. We sold the indirect consumer loans to test our access to the secondary market. Although we currently have no intent to sell additional consumer indirect loans, we believe this portfolio could provide a significant source of liquidity in a reasonable time period, if needed. The sold and serviced indirect auto loan portfolio was \$11.8 million as of September 30, 2011.

**Table of Contents****MANAGEMENT'S DISCUSSION AND ANALYSIS****Allowance for Loan Losses**

The following table sets forth an analysis of the activity in the allowance for loan losses for the periods indicated (in thousands).

	<b>Loan Loss Analysis</b>			
	<b>Three months ended</b>		<b>Nine months ended</b>	
	<b>September 30,</b>		<b>September 30,</b>	
	<b>2011</b>	<b>2010</b>	<b>2011</b>	<b>2010</b>
Balance as of beginning of period	\$ 20,632	\$ 21,825	\$ 20,466	\$ 20,741
Charge-offs:				
Commercial business	75	3,166	390	3,356
Commercial mortgage	194	40	572	249
Residential mortgage	36	118	48	172
Home equity	142	54	404	142
Consumer indirect	1,226	1,189	3,571	3,349
Other consumer	208	305	687	693
<b>Total charge-offs</b>	<b>1,881</b>	<b>4,872</b>	<b>5,672</b>	<b>7,961</b>
Recoveries:				
Commercial business	61	58	325	242
Commercial mortgage	158	28	197	478
Residential mortgage	45	2	75	18
Home equity	21	5	38	32
Consumer indirect	371	401	1,576	1,100
Other consumer	90	101	354	375
<b>Total recoveries</b>	<b>746</b>	<b>595</b>	<b>2,565</b>	<b>2,245</b>
<b>Net charge-offs</b>	<b>1,135</b>	<b>4,277</b>	<b>3,107</b>	<b>5,716</b>
Provision for loan losses	3,480	2,184	5,618	4,707
<b>Balance at end of period</b>	<b>\$ 22,977</b>	<b>\$ 19,732</b>	<b>\$ 22,977</b>	<b>\$ 19,732</b>
Net loan charge-offs to average loans (annualized)	0.32%	1.30%	0.30%	0.60%
Allowance for loan losses to total loans	1.60%	1.49%	1.60%	1.49%
Allowance for loan losses to non-performing loans	295%	268%	295%	268%

The allowance for loan losses represents the estimated amount of probable credit losses inherent in the Company's loan portfolio. The Company performs periodic, systematic reviews of the loan portfolio to estimate probable losses in the respective loan portfolios. In addition, the Company regularly evaluates prevailing economic and business conditions, industry concentrations, changes in the size and characteristics of the portfolio and other pertinent factors. The process used by the Company to determine the overall allowance for loan losses is based on this analysis. Based on this analysis the Company believes the allowance for loan losses is adequate as of September 30, 2011.

Assessing the adequacy of the allowance for loan losses involves substantial uncertainties and is based upon management's evaluation of the amounts required to meet estimated charge-offs in the loan portfolio after weighing a variety of factors, including the risk-profile of the Company's loan products and customers. The Company does not

engage in sub-prime or other high-risk residential mortgage lending as a line-of-business. The Company primarily originates fixed and variable rate one-to-four family residential mortgages collateralized by owner-occupied properties located within its central and western New York marketplace, which has been relatively stable in recent years. Residential mortgages collateralized by one-to-four family residential real estate generally have been originated in amounts of no more than 85% of appraised value or have mortgage insurance.

The adequacy of the allowance for loan losses is subject to ongoing management review. While management evaluates currently available information in establishing the allowance for loan losses, future adjustments to the allowance may be necessary if conditions differ substantially from the assumptions used in making the evaluations. In addition, various regulatory agencies, as an integral part of their examination process, periodically review a financial institution's allowance for loan losses. Such agencies may require the financial institution to recognize additions to the allowance based on their judgments about information available to them at the time of their examination.



**Table of Contents****MANAGEMENT'S DISCUSSION AND ANALYSIS**

The provision for loan losses for the three and nine months ended September 30, 2011 was \$3.5 million and \$5.6 million, respectively, compared to a provision for loan losses of \$2.2 million and \$4.7 million for the three and nine months ended September 30, 2010, respectively. This reflected the combination of strong loan growth and the expectation of a weaker and prolonged economic recovery. Net charge-offs of \$1.1 million were recorded for the third quarter of 2011, compared to \$4.3 million for the same quarter a year ago. Year-to-date net charge-offs of \$3.1 million have been recorded in 2011, compared to \$5.7 million through September 30, 2010. Net charge-offs for the third quarter of 2010 included a \$3.1 million for the charge-off a participation interest in one commercial business loan. In addition, the provision for loan losses and net charge-offs for the first nine months of 2010 were favorably impacted by a \$354 thousand recovery in the first quarter of 2010 on one commercial real estate relationship that was charged-off during 2008 and 2009.

**Non-Performing Assets and Potential Problem Loans**

The table below sets forth the amounts and categories of the Company's non-performing assets at the dates indicated (in thousands).

	<b>Delinquent and Non-Performing Assets</b>		
	<b>September 30, 2011</b>	<b>December 31, 2010</b>	<b>September 30, 2010</b>
Nonaccrual loans:			
Commercial business	\$ 2,380	\$ 947	\$ 801
Commercial mortgage	2,330	3,100	2,519
Residential mortgage	1,996	2,102	2,378
Home equity	501	875	1,153
Consumer indirect	586	514	511
Other consumer		41	2
Total nonaccrual loans	7,793	7,579	7,364
Accruing loans 90 days or more delinquent	4	3	1
Total non-performing loans	7,797	7,582	7,365
Foreclosed assets	582	741	463
Non-performing investment securities	5,341	572	648
Total non-performing assets	\$ 13,720	\$ 8,895	\$ 8,476
Non-performing loans to total loans	0.54%	0.56%	0.56%
Non-performing assets to total assets	0.58%	0.40%	0.38%

Activity in nonaccrual loans for periods indicated was as follows (in thousands).

	<b>Three months ended September 30, 2011</b>	<b>Nine months ended September 30, 2011</b>
Nonaccrual loans, beginning of period	\$ 6,975	\$ 7,579
Additions	4,556	10,567
Payments	(1,477)	(4,161)

Edgar Filing: FINANCIAL INSTITUTIONS INC - Form 10-Q

Charge-offs	(1,755)	(5,274)
Returned to accruing status	(374)	(681)
Transferred to other real estate or repossessed assets	(132)	(237)
Nonaccrual loans, end of period	\$ 7,793	\$ 7,793

Non-performing assets include non-performing loans, foreclosed assets and non-performing investment securities. Non-performing assets at September 30, 2011 were \$13.7 million or 0.58% of total assets, an increase of \$4.8 million from the \$8.9 million or 0.40% of total assets at December 31, 2010.

Non-performing investment securities are included in non-performing assets at fair value and represent securities on which the Company has stopped accruing interest. These non-performing investment securities totaled \$5.3 million at September 30, 2011, compared to \$572 thousand at December 31, 2010. The \$4.8 million increase relates solely to an increase in the fair value of each of the securities classified as non-performing. The market for these securities began to improve during the second quarter of 2011, resulting in substantial increases to their fair value since the beginning of the year. There have been no securities transferred to non-performing status since the first quarter of 2009. During the third quarter of 2011, the Company recognized gains of \$1.6 million from the sale of three of the 14 securities classified as non-performing at December 31, 2010. The three securities had a fair value of \$154 thousand at December 31, 2010. The Company continues to monitor the market for these securities and evaluate the potential for future dispositions.

**Table of Contents****MANAGEMENT'S DISCUSSION AND ANALYSIS**

Non-performing loans totaled \$7.8 million or 0.54% of total loans at September 30, 2011, an increase of \$215 thousand from the \$7.6 million or 0.56% of total loans at December 31, 2010. The ratio of non-performing loans to total loans continues to compare favorably to the average of our peer group, which was 3.43% of total loans at June 30, 2011, the most recent period for which information is available (Source: Federal Financial Institutions Examination Council Bank Holding Company Performance Report as of June 30, 2011 Top-tier bank holding companies having consolidated assets between \$1 billion and \$3 billion). Included in nonaccrual loans are troubled debt restructurings ( TDRs ) of \$435 thousand and \$534 thousand at September 30, 2011 and December 31, 2010, respectively.

Foreclosed assets consist of real property formerly pledged as collateral to loans, which we have acquired through foreclosure proceedings or acceptance of a deed in lieu of foreclosure. Foreclosed asset holdings consisted of 9 properties (4 commercial properties and 5 residential properties) totaling \$582 thousand at September 30, 2011 and 13 properties (5 commercial properties and 8 residential properties) totaling \$741 thousand at December 31, 2010.

Potential problem loans are loans that are currently performing, but information known about possible credit problems of the borrowers causes management to have concern as to the ability of such borrowers to comply with the present loan payment terms and may result in disclosure of such loans as nonperforming at some time in the future. These loans remain in a performing status due to a variety of factors, including payment history, the value of collateral supporting the credits, and/or personal or government guarantees. Management considers loans classified as substandard, which continue to accrue interest, to be potential problem loans. We identified \$10.6 million and \$11.5 million in loans that continued to accrue interest which were classified as substandard as of September 30, 2011 and December 31, 2010, respectively.

**FUNDING ACTIVITIES****Deposits**

The Company offers a broad array of deposit products including noninterest-bearing demand, interest-bearing demand, savings and money market accounts and certificates of deposit. We rely primarily on providing excellent customer service and long-standing relationships with customers to attract and retain deposits. We continuously evaluate our branch network to determine how to best serve our customers efficiently and to improve our profitability. In July 2011, we upgraded our presence in the Rochester market by relocating a branch from North Chili to a newly built branch in an attractive location in Chili Center. We intend to continue to pursue expansion in our market area by growing and enhancing our branch network and anticipate additional expansion in the coming years.

The following table summarizes the composition of our deposits at the dates indicated (dollars in thousands).

	<b>Deposit Composition</b>			
	<b>September 30, 2011</b>		<b>December 31, 2010</b>	
	<b>Amount</b>	<b>% of Total</b>	<b>Amount</b>	<b>% of Total</b>
Noninterest-bearing demand	\$ 395,267	19.9%	\$ 350,877	18.6%
Interest-bearing demand	404,925	20.4	374,900	19.9
Savings and money market	476,122	24.0	417,359	22.2
Certificates of deposit less than \$100,000	510,088	25.8	555,840	29.5
Certificates of deposit of \$100,000 or more	197,269	9.9	183,914	9.8
<b>Total deposits</b>	<b>\$ 1,983,671</b>	<b>100.0%</b>	<b>\$ 1,882,890</b>	<b>100.0%</b>

Nonpublic deposits represent the largest component of the Company's funding. Total nonpublic deposits were \$1.517 billion and \$1.501 billion as of September 30, 2011 and December 31, 2010, respectively. The Company continues to manage this segment of funding through a strategy of competitive pricing and relationship-based sales and marketing that minimizes the number of customer relationships that have only a single high-cost deposit account.

The Company offers a variety of public deposit products to the many towns, villages, counties, school districts and other public entities within our market. Public deposits generally range from 20 to 25% of the Company's total deposits. As of September 30, 2011, total public deposits were \$466.5 million in comparison to \$382.2 million as of December 31, 2010. There is a high degree of seasonality in this component of funding, as the level of deposits varies with the seasonal cash flows for these public customers. The Company maintains the necessary levels of short-term liquid assets and alternative liquidity sources to accommodate the seasonality associated with public deposits.

**Table of Contents****MANAGEMENT'S DISCUSSION AND ANALYSIS****Borrowings**

The following table summarizes the Company's borrowings as of the dates indicated (in thousands).

	<b>September 30, 2011</b>	<b>December 31, 2010</b>
Customer repurchase agreements	\$ 43,556	\$ 38,910
Federal funds purchased	19,519	38,200
FHLB borrowings	40,000	10,065
Junior subordinated debentures		16,702
 Total borrowings	 \$ 103,075	 \$ 103,877

The Company has credit capacity with the FHLB and can borrow through facilities that include amortizing and term advances or repurchase agreements. The Company had approximately \$106 million of immediate credit capacity with FHLB as of September 30, 2011. The Company had approximately \$370 million in secured borrowing capacity at the Federal Reserve Bank ( FRB ) Discount Window, none of which was outstanding at September 30, 2011. The FHLB and FRB credit capacity are collateralized by securities from the Company's investment portfolio and certain qualifying loans. FHLB borrowings increased by approximately \$30 million during 2011 due primarily to the purchase of municipal and agency mortgage-backed securities as part of a leverage strategy implemented during the second quarter of 2011. During the third quarter of 2011, the Company redeemed all of its 10.20% junior subordinated debentures and recognized a \$1.1 million loss on the extinguishment of debt.

Funds are borrowed on an overnight basis through retail repurchase agreements with bank customers and federal funds purchased from other financial institutions. Retail repurchase agreement borrowings are collateralized by securities of U.S. Government agencies. The Company had approximately \$79 million of credit available under unsecured federal funds purchased lines with various banks as of September 30, 2011.

**Equity Activities**

Total shareholders' equity was \$240.9 million at September 30, 2011, an increase of \$28.8 million from \$212.1 million at December 31, 2010. During February 2011, the Company redeemed \$12.5 million of Series A preferred stock issued to the U.S. Treasury. During March 2011, the Company successfully completed a follow-on common equity offering, issuing 2,813,475 shares of common stock at a price of \$16.35 per share before associated offering expenses. After deducting underwriting and other offering costs, the Company received net proceeds of approximately \$43.1 million. Prior to the end of the first quarter of 2011, the Company utilized a portion of the net proceeds to redeem the remaining \$25.0 million in Series A preferred stock. The warrant issued to the Treasury was repurchased for \$2.1 million during the second quarter of 2011 and recorded as a reduction of additional paid-in capital.

**Table of Contents**

**MANAGEMENT'S DISCUSSION AND ANALYSIS**

**LIQUIDITY AND CAPITAL RESOURCES**

**Liquidity**

The objective of maintaining adequate liquidity is to assure the ability of the Company to meet its financial obligations. These obligations include the withdrawal of deposits on demand or at their contractual maturity, the servicing and repayment of debt and preferred equity obligations, the ability to fund new and existing loan commitments, to take advantage of new business opportunities and to satisfy other operating requirements. The Company achieves liquidity by maintaining a strong base of core customer funds, maturing short-term assets, its ability to sell securities, lines of credit, and access to the financial and capital markets.

Liquidity for the Bank is managed through the monitoring of anticipated changes in loans, the investment portfolio, deposits and wholesale funds. The strength of the Bank's liquidity position is a result of its base of core customer deposits. These core deposits are supplemented by wholesale funding sources that include credit lines with the other banking institutions, the FHLB and the FRB.

The Bank had no brokered deposits at September 30, 2011, however it does participate in the Certificate of Deposit Account Registry Service ( CDARS ) program, which enables depositors to receive FDIC insurance coverage for deposits otherwise exceeding the maximum insurable amount. Through the CDARS program, deposits in excess of the maximum insurable amount are placed with multiple participating financial institutions. Reciprocal CDARS deposits totaled \$17.0 million at September 30, 2011.

The primary sources of liquidity for FII are dividends from the Bank and access to financial and capital markets. Dividends from the Bank are limited by various regulatory requirements related to capital adequacy and earnings trends. The Bank relies on cash flows from operations, core deposits, borrowings and short-term liquid assets. Five Star Investment Services relies on cash flows from operations and funds from FII when necessary.

The Company's cash and cash equivalents were \$67.6 million as of September 30, 2011, an increase of \$28.5 million from \$39.1 million as of December 31, 2010. The Company's net cash provided by operating activities totaled \$31.0 million. Net cash used in investing activities totaled \$100.4 million, which included cash outflows of \$92.5 million for net loan originations and \$12.7 million from investment securities transactions. Net cash provided by financing activities of \$97.9 million was attributed to a \$100.8 million increase in deposits and \$43.1 million in net proceeds from the issuance of common stock, partly offset by the \$37.5 million payment to redeem the Series A preferred stock and \$5.6 million in dividend payments.

**Capital Resources**

Banks and financial holding companies are subject to various regulatory capital requirements administered by state and federal banking agencies. Failure to meet minimum capital requirements can result in certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material impact on the Company's consolidated financial statements. Capital adequacy guidelines and, additionally for banks, prompt corrective action regulations, involve quantitative measures of assets, liabilities, and certain off-balance-sheet items calculated under regulatory accounting practices. Capital amounts and classifications are also subject to qualitative judgments by regulators about components, risk weighting and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the Company and the Bank to maintain minimum amounts and ratios of Total and Tier 1 capital to risk-weighted assets and of Tier 1 capital to average assets (all as defined in the regulations). These minimum amounts and ratios are included in the table below.

The Company's and the Bank's Tier 1 capital consists of shareholders' equity excluding unrealized gains and losses on securities available for sale (except for unrealized losses which have been determined to be other than temporary and recognized as expense in the consolidated statements of income), goodwill and other intangible assets and disallowed portions of deferred tax assets. Tier 1 capital for the Company includes, subject to limitation, \$17.5 million of preferred stock. The Company and the Bank's total capital are comprised of Tier 1 capital for each entity plus a permissible portion of the allowance for loan losses.

As previously discussed, the Company redeemed all of its 10.20% junior subordinated debentures on August 22, 2011. Subsequent to repayment of the junior subordinated debentures, the Trust redeemed its \$16.2 million of trust preferred securities. The trust preferred securities were subject to mandatory redemption, in whole or in part, upon

repayment of the junior subordinated debentures.

The Tier 1 and total capital ratios are calculated by dividing the respective capital amounts by risk-weighted assets. Risk-weighted assets are calculated based on regulatory requirements and include total assets, excluding goodwill and other intangible assets and disallowed portions of deferred tax assets, allocated by risk weight category and certain off-balance-sheet items (primarily loan commitments and securities more than one level below investment grade that are subject to the low level exposure rules). The leverage ratio is calculated by dividing Tier 1 capital by adjusted quarterly average total assets, which exclude goodwill and other intangible assets and disallowed portions of deferred tax assets.

**Table of Contents****MANAGEMENT'S DISCUSSION AND ANALYSIS**

The following table reflects the ratios and their components (dollars in thousands).

	<b>September 30, 2011</b>	<b>December 31, 2010</b>
Total shareholders' equity	\$ 240,855	\$ 212,144
Less: Unrealized gain on securities available for sale, net of tax	14,743	1,877
Unrecognized net periodic pension & postretirement benefits (costs), net of tax	(6,336)	(6,599)
Disallowed goodwill and other intangible assets	37,369	37,369
Disallowed deferred tax assets		14,608
Plus: Qualifying trust preferred securities		16,200
 Tier 1 capital	 \$ 195,079	 \$ 181,089
 Adjusted average total assets (for leverage capital purposes)	 \$ 2,250,562	 \$ 2,177,911
 Tier 1 leverage ratio (Tier 1 capital to adjusted average total assets)	 8.67%	 8.31%
 Total Tier 1 capital	 \$ 195,079	 \$ 181,089
Plus: Qualifying allowance for loan losses	19,968	18,363
 Total risk-based capital	 \$ 215,047	 \$ 199,452
 Net risk-weighted assets	 \$ 1,594,450	 \$ 1,466,957
 Tier 1 capital ratio (Tier 1 capital to net risk-weighted assets)	 12.23%	 12.34%
Total risk-based capital ratio (Total risk-based capital to net risk-weighted assets)	13.49%	13.60%
The Company's and the Bank's actual and required regulatory capital ratios were as follows (in thousands):		

		<b>Actual</b>		<b>For Capital Adequacy Purposes</b>		<b>Well Capitalized</b>	
		<b>Amount</b>	<b>Ratio</b>	<b>Amount</b>	<b>Ratio</b>	<b>Amount</b>	<b>Ratio</b>
<b>September 30, 2011:</b>							
Tier 1 leverage:	Company	\$ 195,079	8.67%	\$ 90,022	4.00%	\$ 112,528	5.00%
	Bank	178,793	7.96	89,826	4.00	112,282	5.00
Tier 1 capital:	Company	195,079	12.23	63,778	4.00	95,667	6.00
	Bank	178,793	11.25	63,585	4.00	95,378	6.00
Total risk-based capital:	Company	215,047	13.49	127,556	8.00	159,445	10.00
	Bank	198,702	12.50	127,171	8.00	158,964	10.00

**December 31, 2010:**



Edgar Filing: FINANCIAL INSTITUTIONS INC - Form 10-Q

Tier 1 leverage:	Company	\$ 181,089	8.31%	\$ 87,116	4.00%	\$ 108,896	5.00%
	Bank	156,957	7.22	86,958	4.00	108,697	5.00
Tier 1 capital:	Company	181,089	12.34	58,678	4.00	88,017	6.00
	Bank	156,957	10.74	58,450	4.00	87,674	6.00
Total risk-based capital:	Company	199,452	13.60	117,357	8.00	146,696	10.00
	Bank	175,250	11.99	116,899	8.00	146,124	10.00

**Dividend Restrictions**

In the ordinary course of business, the Company is dependent upon dividends from Five Star Bank to provide funds for the payment of interest expense on the junior subordinated debentures, dividends to shareholders and to provide for other cash requirements. Banking regulations may limit the amount of dividends that may be paid. Approval by regulatory authorities is required if the effect of dividends declared would cause the regulatory capital of the Bank to fall below specified minimum levels. Approval is also required if dividends declared exceed the net profits for that year combined with the retained net profits for the preceding two years.

**Table of Contents****ITEM 3. Quantitative and Qualitative Disclosures About Market Risk**

The principal objective of the Company's interest rate risk management is to evaluate the interest rate risk inherent in certain assets and liabilities, determine the appropriate level of risk to the Company given its business strategy, operating environment, capital and liquidity requirements and performance objectives, and manage the risk consistent with the guidelines approved by the Company's Board of Directors. The Company's management is responsible for reviewing with the Board its activities and strategies, the effect of those strategies on the net interest margin, the fair value of the portfolio and the effect that changes in interest rates will have on the portfolio and exposure limits. Management develops an Asset-Liability Policy that meets strategic objectives and regularly reviews the activities of the Bank.

The primary tool the Company uses to manage interest rate risk is a rate shock simulation to measure the rate sensitivity of the balance sheet. Rate shock simulation is a modeling technique used to estimate the impact of changes in rates on net interest income and economic value of equity. The Company measures net interest income at risk by estimating the changes in net interest income resulting from instantaneous and sustained parallel shifts in interest rates of different magnitudes over a period of twelve months. This simulation is based on management's assumption as to the effect of interest rate changes on assets and liabilities and assumes a parallel shift of the yield curve. It also includes certain assumptions about the future pricing of loans and deposits in response to changes in interest rates. Further, it assumes that delinquency rates would not change as a result of changes in interest rates, although there can be no assurance that this will be the case. While this simulation is a useful measure as to net interest income at risk due to a change in interest rates, it is not a forecast of the future results and is based on many assumptions that, if changed, could cause a different outcome.

In addition to the changes in interest rate scenarios listed above, the Company typically runs other scenarios to measure interest rate risk, which vary depending on the economic and interest rate environments.

The Company has experienced no material changes in market risk due to changes in interest rates since the Company's Annual Report on Form 10-K for the year ended December 31, 2010, dated March 7, 2011, as filed with the Securities and Exchange Commission.

**ITEM 4. Controls and Procedures*****Evaluation of disclosure controls and procedures***

As of September 30, 2011, the Company carried out an evaluation, under the supervision and with the participation of the Company's management, including the Company's Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures pursuant to Rule 13a-15(b), as adopted by the Securities and Exchange Commission (SEC) under the Securities Exchange Act of 1934 (Exchange Act). Based upon that evaluation, the Company's Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures were effective as of the end of the period covered by this report.

Disclosure controls and procedures are the controls and other procedures that are designed to ensure that information required to be disclosed in the reports that the Company files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed in the reports that the Company files or submits to the SEC under the Exchange Act is accumulated and communicated to management, including the Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

***Changes in internal control over financial reporting***

There were no changes in the Company's internal control over financial reporting that occurred during the quarter ended September 30, 2011 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

**Table of Contents****PART II. OTHER INFORMATION****ITEM 1. Legal Proceedings**

The Company has experienced no material developments in its legal proceedings from the disclosure included in the Company's Annual Report on Form 10-K for the year ended December 31, 2010, dated March 7, 2011, as filed with the Securities and Exchange Commission.

**ITEM 1A. Risk Factors**

You should carefully consider the factors discussed under Part I, Item 1A, "Risk Factors" in the Company's Annual Report on Form 10-K for the year ended December 31, 2010, and our quarterly report on Form 10-Q for the quarter ended June 30, 2011. These factors could materially adversely affect our business, financial condition, liquidity, results of operations and capital position, and could cause our actual results to differ materially from our historical results or the results contemplated by the forward-looking statements contained in this report.

**ITEM 6. Exhibits**

(a) The following is a list of all exhibits filed or incorporated by reference as part of this Report.

<b>Exhibit Number</b>	<b>Description</b>	<b>Location</b>
31.1	Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 - Principal Executive Officer	Filed Herewith
31.2	Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 - Principal Financial Officer	Filed Herewith
32	Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002	Filed Herewith
*101.INS	XBRL Instance Document	
*101.SCH	XBRL Taxonomy Extension Schema Document	
*101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document	
*101.LAB	XBRL Taxonomy Extension Label Linkbase Document	
*101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document	
*101.DEF	XBRL Taxonomy Extension Definition Linkbase Document	

\* Pursuant to Rule 406T of Regulation S-T, the information in this exhibit shall not be deemed to be filed for purposes of Section 18 of the Securities Exchange Act of 1934, or otherwise subject to the liability of that section, and shall not be incorporated by reference into any registration statement, prospectus or other document filed under the Securities Act of 1933, or the Securities Exchange Act of 1934, except as shall be expressly set forth by specific reference in such filings.

**Table of Contents**

**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

**FINANCIAL INSTITUTIONS, INC.**

*/s/ Peter G. Humphrey* , November 9, 2011

Peter G. Humphrey  
President and Chief Executive Officer  
(Principal Executive Officer)

*/s/ Karl F. Krebs* , November 9, 2011

Karl F. Krebs  
Executive Vice President and Chief Financial Officer  
(Principal Financial and Principal Accounting Officer)