

FINANCIAL INSTITUTIONS INC
Form 10-Q
August 05, 2015
Table of Contents

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

Form 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2015

or

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

For the transition period from _____ to _____

Commission File Number: 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 (Do not check if a smaller company) Smaller reporting 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 14,184,235 shares of Common Stock, \$0.01 par value, outstanding as of July 31, 2015.

Table of Contents

FINANCIAL INSTITUTIONS, INC.

Form 10-Q

For the Quarterly Period Ended June 30, 2015

TABLE OF CONTENTS

| | PAGE |
|---|-------------|
| PART I. <u>FINANCIAL INFORMATION</u> | |
| ITEM 1. <u>Financial Statements</u> | |
| <u>Consolidated Statements of Financial Condition - at June 30, 2015 (Unaudited) and December 31, 2014</u> | 3 |
| <u>Consolidated Statements of Income (Unaudited) - Three and six months ended June 30, 2015 and 2014</u> | 4 |
| <u>Consolidated Statements of Comprehensive Income (Unaudited) - Three and six months ended June 30, 2015 and 2014</u> | 5 |
| <u>Consolidated Statements of Changes in Shareholders' Equity (Unaudited) - Six months ended June 30, 2015 and 2014</u> | 6 |
| <u>Consolidated Statements of Cash Flows (Unaudited) - Six months ended June 30, 2015 and 2014</u> | 7 |
| <u>Notes to Consolidated Financial Statements (Unaudited)</u> | 8 |
| ITEM 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u> | 31 |
| ITEM 3. <u>Quantitative and Qualitative Disclosures About Market Risk</u> | 51 |
| ITEM 4. <u>Controls and Procedures</u> | 52 |
| PART II. <u>OTHER INFORMATION</u> | |
| ITEM 1. <u>Legal Proceedings</u> | 53 |
| ITEM 1A. <u>Risk Factors</u> | 53 |
| ITEM 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u> | 53 |
| ITEM 6. <u>Exhibits</u> | 54 |
| <u>Signatures</u> | 55 |

Table of Contents**PART I. FINANCIAL INFORMATION****ITEM 1. Financial Statements****FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES****Consolidated Statements of Financial Condition***(Dollars in thousands, except share and per share data)*

| | June 30, 2015 (Unaudited) | December 31, 2014 |
|--|--|------------------------------|
| ASSETS | | |
| Cash and cash equivalents | \$ 52,554 | \$ 58,151 |
| Securities available for sale, at fair value | 772,639 | 622,494 |
| Securities held to maturity, at amortized cost (fair value of \$324,873 and \$298,695, respectively) | 320,820 | 294,438 |
| Loans held for sale | 448 | 755 |
| Loans (net of allowance for loan losses of \$27,500 and \$27,637, respectively) | 1,981,773 | 1,884,365 |
| Company owned life insurance | 61,998 | 61,004 |
| Premises and equipment, net | 37,110 | 36,394 |
| Goodwill and other intangible assets, net | 68,158 | 68,639 |
| Other assets | 63,959 | 63,281 |
| Total assets | \$ 3,359,459 | \$ 3,089,521 |
| LIABILITIES AND SHAREHOLDERS EQUITY | | |
| Deposits: | | |
| Noninterest-bearing demand | \$ 602,143 | \$ 571,260 |
| Interest-bearing demand | 530,861 | 490,190 |
| Savings and money market | 910,215 | 795,835 |
| Certificates of deposit | 613,019 | 593,242 |
| Total deposits | 2,656,238 | 2,450,527 |
| Short-term borrowings | 350,600 | 334,804 |
| Long-term borrowings, net of issuance costs of \$1,045 | 38,955 | |
| Other liabilities | 29,231 | 24,658 |
| Total liabilities | 3,075,024 | 2,809,989 |
| Shareholders equity: | | |
| Series A 3% preferred stock, \$100 par value; 1,533 shares authorized and 1,492 shares issued and outstanding | 149 | 149 |
| Series B-1 8.48% preferred stock, \$100 par value; 200,000 shares authorized and 171,906 shares issued and outstanding | 17,191 | 17,191 |

Edgar Filing: FINANCIAL INSTITUTIONS INC - Form 10-Q

| | | |
|---|--------------|--------------|
| Total preferred equity | 17,340 | 17,340 |
| Common stock, \$0.01 par value; 50,000,000 shares authorized and 14,397,509 shares issued and outstanding | 144 | 144 |
| Additional paid-in capital | 72,279 | 72,955 |
| Retained earnings | 210,337 | 203,312 |
| Accumulated other comprehensive loss | (11,682) | (9,011) |
| Treasury stock, at cost 213,374 and 279,461 shares, respectively | (3,983) | (5,208) |
| Total shareholders equity | 284,435 | 279,532 |
| Total liabilities and shareholders equity | \$ 3,359,459 | \$ 3,089,521 |

See accompanying notes to the consolidated financial statements.

Table of Contents**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES****Consolidated Statements of Income (Unaudited)***(In thousands, except per share amounts)*

| | Three months ended June 30, | | Six months ended June 30, | |
|--|--|---------------|--------------------------------------|---------------|
| | 2015 | 2014 | 2015 | 2014 |
| Interest income: | | | | |
| Interest and fees on loans | \$ 20,446 | \$ 20,230 | \$ 40,583 | \$ 40,497 |
| Interest and dividends on investment securities | 5,513 | 4,653 | 10,373 | 9,445 |
| Total interest income | 25,959 | 24,883 | 50,956 | 49,942 |
| Interest expense: | | | | |
| Deposits | 1,827 | 1,577 | 3,447 | 3,102 |
| Short-term borrowings | 213 | 203 | 443 | 462 |
| Long-term borrowings | 515 | | 515 | |
| Total interest expense | 2,555 | 1,780 | 4,405 | 3,564 |
| Net interest income | 23,404 | 23,103 | 46,551 | 46,378 |
| Provision for loan losses | 1,288 | 1,758 | 4,029 | 3,864 |
| Net interest income after provision for loan losses | 22,116 | 21,345 | 42,522 | 42,514 |
| Noninterest income: | | | | |
| Service charges on deposits | 1,964 | 2,241 | 3,843 | 4,491 |
| Insurance income | 1,057 | 16 | 2,665 | 57 |
| ATM and debit card | 1,283 | 1,257 | 2,476 | 2,431 |
| Investment advisory | 541 | 561 | 1,028 | 1,123 |
| Company owned life insurance | 493 | 425 | 960 | 828 |
| Investments in limited partnerships | 55 | 81 | 529 | 707 |
| Loan servicing | 96 | 176 | 263 | 330 |
| Net gain on sale of loans held for sale | 39 | 50 | 108 | 155 |
| Net gain on disposal of investment securities | | 949 | 1,062 | 1,262 |
| Net gain (loss) on disposal of other assets | 16 | 24 | 20 | (11) |
| Other | 911 | 797 | 1,798 | 1,561 |
| Total noninterest income | 6,455 | 6,577 | 14,752 | 12,934 |
| Noninterest expense: | | | | |
| Salaries and employee benefits | 10,606 | 9,063 | 20,829 | 18,319 |
| Occupancy and equipment | 3,375 | 3,139 | 7,074 | 6,374 |
| Professional services | 866 | 1,384 | 1,834 | 2,356 |
| Computer and data processing | 810 | 777 | 1,512 | 1,500 |

Edgar Filing: FINANCIAL INSTITUTIONS INC - Form 10-Q

| | | | | |
|--|---------------|---------------|---------------|---------------|
| Supplies and postage | 508 | 535 | 1,071 | 1,047 |
| FDIC assessments | 415 | 388 | 833 | 810 |
| Advertising and promotions | 238 | 214 | 477 | 393 |
| Other | 2,418 | 2,308 | 4,617 | 4,222 |
| Total noninterest expense | 19,236 | 17,808 | 38,247 | 35,021 |
| Income before income taxes | 9,335 | 10,114 | 19,027 | 20,427 |
| Income tax expense | 2,750 | 3,082 | 5,641 | 6,176 |
| Net income | \$ 6,585 | \$ 7,032 | \$ 13,386 | \$ 14,251 |
| Preferred stock dividends | 366 | 365 | 731 | 731 |
| Net income available to common shareholders | \$ 6,219 | \$ 6,667 | \$ 12,655 | \$ 13,520 |
| Earnings per common share (Note 3): | | | | |
| Basic | \$ 0.44 | \$ 0.48 | \$ 0.90 | \$ 0.98 |
| Diluted | \$ 0.44 | \$ 0.48 | \$ 0.90 | \$ 0.98 |
| Cash dividends declared per common share | \$ 0.20 | \$ 0.19 | \$ 0.40 | \$ 0.38 |
| Weighted average common shares outstanding: | | | | |
| Basic | 14,078 | 13,791 | 14,071 | 13,782 |
| Diluted | 14,121 | 13,838 | 14,118 | 13,831 |

See accompanying notes to the consolidated financial statements.

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

| <i>(Dollars in thousands)</i> | Three months ended | | Six months ended | |
|--|---------------------------|-------------|-------------------------|-------------|
| | June 30, | | June 30, | |
| | 2015 | 2014 | 2015 | 2014 |
| Net income | \$ 6,585 | \$ 7,032 | \$ 13,386 | \$ 14,251 |
| Other comprehensive income (loss), net of tax: | | | | |
| Net unrealized (losses) gains on securities available for sale | (6,207) | 2,684 | (2,946) | 6,428 |
| Pension and post-retirement obligations | 140 | 20 | 275 | 39 |
| Total other comprehensive income (loss), net of tax | (6,067) | 2,704 | (2,671) | 6,467 |
| Comprehensive income | \$ 518 | \$ 9,736 | \$ 10,715 | \$ 20,718 |

See accompanying notes to the consolidated financial statements.

Table of Contents

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Consolidated Statements of Changes in Shareholders' Equity (Unaudited)

Six months ended June 30, 2015 and 2014

| <i>(Dollars in thousands, except per share data)</i> | Preferred Equity | Common Stock | Additional Paid-in Capital | Retained Earnings | Accumulated Other Comprehensive Loss | Treasury Stock | Total Shareholders' Equity |
|--|---------------------|-----------------|----------------------------------|----------------------|---|-------------------|----------------------------------|
| Balance at January 1, 2014 | \$ 17,342 | \$ 142 | \$ 67,574 | \$ 186,137 | \$ (10,187) | \$ (6,169) | \$ 254,839 |
| Comprehensive income: | | | | | | | |
| Net income | | | | 14,251 | | | 14,251 |
| Other comprehensive income, net of tax | | | | | 6,467 | | 6,467 |
| Purchases of common stock for treasury | | | | | | (195) | (195) |
| Repurchase of Series B-1 8.48% preferred stock | (2) | | | | | | (2) |
| Share-based compensation plans: | | | | | | | |
| Share-based compensation | | | 305 | | | | 305 |
| Stock options exercised | | | (1) | | | 133 | 132 |
| Restricted stock awards issued, net | | | (655) | | | 655 | |
| Cash dividends declared: | | | | | | | |
| Series A 3% Preferred-\$1.50 per share | | | | (2) | | | (2) |
| Series B-1 8.48% Preferred-\$4.24 per share | | | | (729) | | | (729) |
| Common-\$0.38 per share | | | | (5,239) | | | (5,239) |
| Balance at June 30, 2014 | \$ 17,340 | \$ 142 | \$ 67,223 | \$ 194,418 | \$ (3,720) | \$ (5,576) | \$ 269,827 |
| Balance at January 1, 2015 | \$ 17,340 | \$ 144 | \$ 72,955 | \$ 203,312 | \$ (9,011) | \$ (5,208) | \$ 279,532 |
| Comprehensive income: | | | | | | | |
| Net income | | | | 13,386 | | | 13,386 |
| Other comprehensive income, net of tax | | | | | (2,671) | | (2,671) |
| Purchases of common stock for treasury | | | | | | (41) | (41) |
| Share-based compensation plans: | | | | | | | |
| Share-based compensation | | | 370 | | | | 370 |
| Stock options exercised | | | 2 | | | 163 | 165 |
| | | | (1,060) | | | 1,060 | |

Restricted stock awards issued,
net

| | | | | |
|---|------------------|---------------|--------------------|-------------------|
| Excess tax benefit on share-based compensation | 1 | | | 1 |
| Stock awards | 11 | | 43 | 54 |
| Cash dividends declared: | | | | |
| Series A 3% Preferred-\$1.50 per share | | (2) | | (2) |
| Series B-1 8.48% Preferred-\$4.24 per share | | (729) | | (729) |
| Common-\$0.40 per share | | (5,630) | | (5,630) |
| Balance at June 30, 2015 | \$ 17,340 | \$ 144 | \$ 72,279 | \$ 210,337 |
| | | | \$ (11,682) | \$ (3,983) |
| | | | | \$ 284,435 |

See accompanying notes to the consolidated financial statements.

Table of Contents**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES****Consolidated Statements of Cash Flows (Unaudited)***(Dollars in thousands)*

| | Six months ended June 30, | |
|--|--------------------------------------|-----------------|
| | 2015 | 2014 |
| Cash flows from operating activities: | | |
| Net income | \$ 13,386 | \$ 14,251 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 2,671 | 2,061 |
| Net amortization of premiums on securities | 1,547 | 1,582 |
| Provision for loan losses | 4,029 | 3,864 |
| Share-based compensation | 370 | 305 |
| Deferred income tax expense | 202 | 1,066 |
| Proceeds from sale of loans held for sale | 7,321 | 7,705 |
| Originations of loans held for sale | (6,906) | (5,223) |
| Increase in company owned life insurance | (960) | (828) |
| Net gain on sale of loans held for sale | (108) | (155) |
| Net gain on disposal of investment securities | (1,062) | (1,262) |
| Net (gain) loss on sale and disposal of other assets | (20) | 11 |
| Decrease in other assets | 1,009 | 288 |
| Increase (decrease) in other liabilities | 820 | (249) |
| Net cash provided by operating activities | 22,299 | 23,416 |
| Cash flows from investing activities: | | |
| Purchases of available for sale securities | (241,906) | (125,419) |
| Purchases of held to maturity securities | (39,570) | (28,594) |
| Proceeds from principal payments, maturities and calls on available for sale securities | 57,787 | 83,904 |
| Proceeds from principal payments, maturities and calls on held to maturity securities | 16,394 | 16,491 |
| Proceeds from sales of securities available for sale | 29,508 | 61,428 |
| Net loan originations | (101,567) | (65,937) |
| Purchases of company owned life insurance | (34) | (34) |
| Proceeds from sales of other assets | 167 | 623 |
| Purchases of premises and equipment | (2,891) | (2,371) |
| Net cash used in investing activities | (282,112) | (59,909) |
| Cash flows from financing activities: | | |
| Net increase in deposits | 205,711 | 130,022 |
| Net increase (decrease) in short-term borrowings | 15,796 | (82,359) |
| Issuance of long-term debt | 40,000 | |
| Debt issuance costs | (1,060) | |
| Repurchase of preferred stock | | (2) |
| Purchase of common stock for treasury | (41) | (195) |

Edgar Filing: FINANCIAL INSTITUTIONS INC - Form 10-Q

| | | |
|--|-----------|-----------|
| Proceeds from stock options exercised | 165 | 132 |
| Excess tax benefit on share-based compensation, net | 1 | |
| Cash dividends paid to common and preferred shareholders | (6,356) | (5,965) |
| Net cash provided by financing activities | 254,216 | 41,633 |
| Net (decrease) increase in cash and cash equivalents | (5,597) | 5,140 |
| Cash and cash equivalents, beginning of period | 58,151 | 59,692 |
| Cash and cash equivalents, end of period | \$ 52,554 | \$ 64,832 |
| Supplemental information: | | |
| Cash paid for interest | \$ 3,166 | \$ 3,313 |
| Cash paid for income taxes | 1,539 | 8,313 |
| Noncash investing and financing activities: | | |
| Real estate and other assets acquired in settlement of loans | 130 | 311 |
| Accrued and declared unpaid dividends | 3,182 | 2,986 |
| Increase in net unsettled security purchases | 4,023 | 2,260 |
| Loans transferred from held for sale to held for investment | | 853 |
| See accompanying notes to the consolidated financial statements. | | |

Table of Contents

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(1.) BASIS OF PRESENTATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Nature of Operations

Financial Institutions, Inc., (the Parent or the Company) is a financial holding company organized in 1931 under the laws of New York State. The Company offers a broad array of deposit, lending and other financial services to individuals, municipalities and businesses in Western and Central New York through its wholly-owned New York chartered banking subsidiary, Five Star Bank (the Bank). 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. On August 1, 2014, the Company acquired Scott Danahy Naylon Co., Inc., a full service insurance agency located in Amherst, New York. The Company provides insurance and risk consulting services through its wholly-owned insurance subsidiary, Scott Danahy Naylon, LLC (SDN).

Basis of Presentation

The consolidated financial statements include the accounts of Financial Institutions, Inc. 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 applicable rules and regulations of the Securities and Exchange Commission. However, in the opinion of management, the accompanying consolidated financial statements reflect all adjustments of a normal and recurring nature necessary for a fair presentation of the consolidated statements of financial condition, income, comprehensive income, changes in 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 2014 Annual Report on Form 10-K for the year ended December 31, 2014. The results of operations for any interim periods are not necessarily indicative of the results which may be expected for the entire year.

Subsequent Events

The Company has evaluated events and transactions for potential recognition or disclosure through the day the financial statements were issued and determined that there were no subsequent events.

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, the carrying value of goodwill and deferred tax assets, the valuation and other than temporary impairment (OTTI) considerations related to the securities portfolio, and assumptions used in the defined benefit pension plan accounting.

Recent Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board issued Accounting Standards Update (ASU) No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*. ASU 2014-09 implements a common revenue standard that clarifies the principles for recognizing revenue. The core principle of ASU 2014-09 is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. To achieve that core principle, an entity should apply the following steps: (i) identify the contract(s) with a customer, (ii) identify the performance obligations in the contract, (iii) determine the transaction price, (iv) allocate the transaction price to the performance obligations in the contract and (v) recognize revenue when (or as) the entity satisfies a performance obligation. The effective date was recently deferred for one year to the interim and annual periods beginning on or after December 15, 2017. Early adoption is permitted as of the original effective date interim and annual periods beginning on or after December 15, 2016. The Company is evaluating the potential impact of ASU 2014-09 on the Company s financial statements.

In June 2014, the FASB issued ASU 2014-12, *Compensation Stock Compensation (Topic 718)*. The pronouncement was issued to clarify the accounting for share-based payments when the terms of an award provide that a performance target could be achieved after the requisite service period. ASU 2014-12 will be effective for the Company beginning January 1, 2016, though early adoption is permitted. The adoption of ASU 2014-12 is not expected to have a significant impact on the Company s financial statements.

Table of Contents

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

**(1.) BASIS OF PRESENTATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES
(Continued)**

In January 2015, the FASB issued ASU 2015-01, *Income Statement - Extraordinary and Unusual Items (Subtopic 225-20) Simplifying Income Statement Presentation by Eliminating the Concept of Extraordinary Items*. ASU 2015-01 eliminates from U.S. GAAP the concept of extraordinary items, which, among other things, required an entity to segregate extraordinary items considered to be unusual and infrequent from the results of ordinary operations and show the item separately in the income statement, net of tax, after income from continuing operations. ASU 2015-01 will be effective for the Company beginning January 1, 2016, though early adoption is permitted. ASU 2015-01 is not expected to have a significant impact on the Company's financial statements.

In April 2015, the FASB issued ASU 2015-03, *Simplifying the Presentation of Debt Issuance Costs*. Under ASU 2015-03 the Company will present debt issuance costs in the balance sheet as a reduction from the related debt liability rather than as an asset. Amortization of such costs will continue to be reported as interest expense. ASU 2015-03 will be effective for the Company beginning January 1, 2016, though early adoption is permitted. Retrospective adoption is required. The Company early adopted this standard during the quarter ended June 30, 2015, concurrent with the issuance of the Subordinated Notes described in Note 7. Unamortized debt issuance costs of \$1.0 million are included in the net balance of long-term borrowings reported on the Consolidated Statements of Financial Condition. Retrospective application of this standard did not impact previously issued financial statements.

(2.) BUSINESS COMBINATIONS

SDN Acquisition

On August 1, 2014, the Company completed the acquisition of Scott Danahy Naylor Co., Inc., a full service insurance agency located in Amherst, New York. Consideration for the acquisition included both cash and stock totaling \$16.9 million, including up to \$3.4 million of future payments, contingent upon SDN meeting certain revenue targets through 2017. The estimated fair value of the contingent consideration at the date of acquisition was \$3.2 million, which was estimated using a probability-weighted discounted cash flow model. As a result of the acquisition, the Company recorded goodwill of \$12.6 million and other intangible assets of \$6.6 million. The goodwill is not expected to be deductible for income tax purposes. Pro forma results of operations for this acquisition have not been presented because the effect of this acquisition was not material to the Company's consolidated financial statements.

This acquisition was accounted for under the acquisition method in accordance with FASB ASC Topic 805. Accordingly, the assets and liabilities, both tangible and intangible, were recorded at their estimated fair values as of the acquisition date. The following table summarizes the consideration paid for Scott Danahy Naylor Co., Inc. and the amounts of the assets acquired and liabilities assumed.

Edgar Filing: FINANCIAL INSTITUTIONS INC - Form 10-Q

| | |
|--|-----------|
| Consideration paid: | |
| Cash | \$ 8,100 |
| Stock | 5,400 |
| Contingent consideration | 3,227 |
| Fair value of total consideration transferred | 16,727 |
| Fair value of assets acquired: | |
| Cash | 105 |
| Identified intangible assets | 6,640 |
| Premises and equipment, accounts receivable and other assets | 1,094 |
| Total identifiable assets acquired | 7,839 |
| Fair value of liabilities assumed: | |
| Deferred tax liability | 2,556 |
| Other liabilities | 1,173 |
| Total liabilities assumed | 3,729 |
| Fair value of net assets acquired | 4,110 |
| Goodwill resulting from acquisition | \$ 12,617 |

- 9 -

Table of Contents**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Unaudited)****(3.) EARNINGS PER COMMON SHARE (EPS)**

The following table presents a reconciliation of the earnings and shares used in calculating basic and diluted EPS (in thousands, except per share amounts).

| | Three months ended June 30, | | Six months ended June 30, | |
|--|--|-------------|--------------------------------------|-------------|
| | 2015 | 2014 | 2015 | 2014 |
| Net income available to common shareholders | \$ 6,219 | \$ 6,667 | \$ 12,655 | \$ 13,520 |
| Weighted average common shares outstanding: | | | | |
| Total shares issued | 14,398 | 14,162 | 14,398 | 14,162 |
| Unvested restricted stock awards | (100) | (67) | (87) | (65) |
| Treasury shares | (220) | (304) | (240) | (315) |
| Total basic weighted average common shares outstanding | 14,078 | 13,791 | 14,071 | 13,782 |
| Incremental shares from assumed: | | | | |
| Exercise of stock options | 22 | 28 | 22 | 25 |
| Vesting of restricted stock awards | 21 | 19 | 25 | 24 |
| Total diluted weighted average common shares outstanding | 14,121 | 13,838 | 14,118 | 13,831 |
| Basic earnings per common share | \$ 0.44 | \$ 0.48 | \$ 0.90 | \$ 0.98 |
| Diluted earnings per common share | \$ 0.44 | \$ 0.48 | \$ 0.90 | \$ 0.98 |
| 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 | | | | 7 |
| Restricted stock awards | 3 | 3 | 2 | 1 |
| | 3 | 3 | 2 | 8 |

Table of Contents

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(4.) INVESTMENT SECURITIES

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

| | Amortized Cost | Unrealized Gains | Unrealized Losses | Fair Value |
|---|-------------------|---------------------|----------------------|-------------------|
| <u>June 30, 2015</u> | | | | |
| Securities available for sale: | | | | |
| U.S. Government agencies and government sponsored enterprises | \$ 271,774 | \$ 777 | \$ 2,474 | \$ 270,077 |
| Mortgage-backed securities: | | | | |
| Federal National Mortgage Association | 227,129 | 1,933 | 2,307 | 226,755 |
| Federal Home Loan Mortgage Corporation | 28,840 | 501 | 204 | 29,137 |
| Government National Mortgage Association | 43,804 | 1,728 | | 45,532 |
| Collateralized mortgage obligations: | | | | |
| Federal National Mortgage Association | 83,447 | 514 | 1,132 | 82,829 |
| Federal Home Loan Mortgage Corporation | 95,268 | 186 | 2,752 | 92,702 |
| Government National Mortgage Association | 23,828 | 470 | 39 | 24,259 |
| Privately issued | | 1,123 | | 1,123 |
| Total collateralized mortgage obligations | 202,543 | 2,293 | 3,923 | 200,913 |
| Total mortgage-backed securities | 502,316 | 6,455 | 6,434 | 502,337 |
| Asset-backed securities | | 225 | | 225 |
| Total available for sale securities | \$ 774,090 | \$ 7,457 | \$ 8,908 | \$ 772,639 |
| Securities held to maturity: | | | | |
| State and political subdivisions | 289,713 | 4,790 | 451 | 294,052 |
| Mortgage-backed securities: | | | | |
| Federal National Mortgage Association | 9,280 | 6 | 86 | 9,200 |
| Government National Mortgage Association | 21,827 | 5 | 211 | 21,621 |
| Total mortgage-backed securities | 31,107 | 11 | 297 | 30,821 |
| Total held to maturity securities | \$ 320,820 | \$ 4,801 | \$ 748 | \$ 324,873 |
| <u>December 31, 2014</u> | | | | |
| Securities available for sale: | | | | |
| | \$ 160,334 | \$ 1,116 | \$ 975 | \$ 160,475 |

Edgar Filing: FINANCIAL INSTITUTIONS INC - Form 10-Q

U.S. Government agencies and government sponsored enterprises

| | | | | |
|--|-------------------|-----------------|-----------------|-------------------|
| Mortgage-backed securities: | | | | |
| Federal National Mortgage Association | 184,857 | 2,344 | 1,264 | 185,937 |
| Federal Home Loan Mortgage Corporation | 29,478 | 799 | 7 | 30,270 |
| Government National Mortgage Association | 48,800 | 2,022 | | 50,822 |
| Collateralized mortgage obligations: | | | | |
| Federal National Mortgage Association | 76,247 | 489 | 944 | 75,792 |
| Federal Home Loan Mortgage Corporation | 89,623 | 199 | 2,585 | 87,237 |
| Government National Mortgage Association | 29,954 | 598 | 40 | 30,512 |
| Privately issued | | 1,218 | | 1,218 |
| Total collateralized mortgage obligations | 195,824 | 2,504 | 3,569 | 194,759 |
| Total mortgage-backed securities | 458,959 | 7,669 | 4,840 | 461,788 |
| Asset-backed securities | | 231 | | 231 |
| Total available for sale securities | \$ 619,293 | \$ 9,016 | \$ 5,815 | \$ 622,494 |

Securities held to maturity:

| | | | | |
|--|-------------------|-----------------|---------------|-------------------|
| State and political subdivisions | 277,273 | 4,231 | 120 | 281,384 |
| Mortgage-backed securities: | | | | |
| Federal National Mortgage Association | 3,279 | 24 | | 3,303 |
| Government National Mortgage Association | 13,886 | 122 | | 14,008 |
| Total mortgage-backed securities | 17,165 | 146 | | 17,311 |
| Total held to maturity securities | \$ 294,438 | \$ 4,377 | \$ 120 | \$ 298,695 |

Investment securities with a total fair value of \$846.9 million at June 30, 2015 were pledged as collateral to secure public deposits and for other purposes required or permitted by law.

Table of Contents

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(4.) INVESTMENT SECURITIES (Continued)

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

| | Three months ended June 30, | | Six months ended June 30, | |
|-----------------------|--------------------------------|-----------|------------------------------|-----------|
| | 2015 | 2014 | 2015 | 2014 |
| Proceeds from sales | \$ | \$ 41,958 | \$ 29,508 | \$ 61,428 |
| Gross realized gains | | 949 | 1,073 | 1,262 |
| Gross realized losses | | | 11 | |

The scheduled maturities of securities available for sale and securities held to maturity at June 30, 2015 are shown below (in thousands). Actual expected maturities may differ from contractual maturities because issuers may have the right to call or prepay obligations.

| | Amortized Cost | Fair Value |
|--|-------------------|---------------|
| Debt securities available for sale: | | |
| Due in one year or less | \$ 30,008 | \$ 30,008 |
| Due from one to five years | 166,519 | 166,266 |
| Due after five years through ten years | 328,808 | 328,993 |
| Due after ten years | 248,755 | 247,372 |
| | \$ 774,090 | \$ 772,639 |
| Debt securities held to maturity: | | |
| Due in one year or less | \$ 24,064 | \$ 24,158 |
| Due from one to five years | 161,041 | 164,083 |
| Due after five years through ten years | 107,099 | 108,259 |
| Due after ten years | 28,616 | 28,373 |
| | \$ 320,820 | \$ 324,873 |

Unrealized losses on investment securities and the fair value of the related securities, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, were as follows (in thousands):

| | Less than 12 months | | 12 months or longer | | Total | |
|---|---------------------|-------------------|---------------------|-------------------|------------|-------------------|
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| June 30, 2015 | | | | | | |
| Securities available for sale: | | | | | | |
| U.S. Government agencies and government sponsored enterprises | \$ 162,940 | \$ 2,110 | \$ 24,637 | \$ 364 | \$ 187,577 | \$ 2,474 |
| Mortgage-backed securities: | | | | | | |
| Federal National Mortgage Association | 93,817 | 1,779 | 34,433 | 528 | 128,250 | 2,307 |
| Federal Home Loan Mortgage Corporation | 6,005 | 204 | | | 6,005 | 204 |
| Collateralized mortgage obligations: | | | | | | |
| Federal National Mortgage Association | 24,181 | 271 | 19,886 | 861 | 44,067 | 1,132 |
| Federal Home Loan Mortgage Corporation | 21,765 | 484 | 61,553 | 2,268 | 83,318 | 2,752 |
| Government National Mortgage Association | | | 2,306 | 39 | 2,306 | 39 |
| Total collateralized mortgage obligations | 45,946 | 755 | 83,745 | 3,168 | 129,691 | 3,923 |
| Total mortgage-backed securities | 145,768 | 2,738 | 118,178 | 3,696 | 263,946 | 6,434 |
| Total available for sale securities | 308,708 | 4,848 | 142,815 | 4,060 | 451,523 | 8,908 |
| Securities held to maturity: | | | | | | |
| State and political subdivisions | 35,997 | 451 | | | 35,997 | 451 |
| Mortgage-backed securities: | | | | | | |
| Federal National Mortgage Association | 5,724 | 86 | | | 5,724 | 86 |
| Government National Mortgage Association | 15,328 | 211 | | | 15,328 | 211 |
| Total held to maturity securities | 57,049 | 748 | | | 57,049 | 748 |
| Total temporarily impaired securities | \$ 365,757 | \$ 5,596 | \$ 142,815 | \$ 4,060 | \$ 508,572 | \$ 9,656 |

Table of Contents**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Unaudited)****(4.) INVESTMENT SECURITIES (Continued)**

| | Less than 12 months | | 12 months or longer | | Total | |
|---|------------------------|----------------------|---------------------|----------------------|---------------|----------------------|
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| December 31, 2014 | | | | | | |
| Securities available for sale: | | | | | | |
| U.S. Government agencies and government sponsored enterprises | \$ 34,995 | \$ 77 | \$ 41,070 | \$ 898 | \$ 76,065 | \$ 975 |
| Mortgage-backed securities: | | | | | | |
| Federal National Mortgage Association | 2,242 | 8 | 62,592 | 1,256 | 64,834 | 1,264 |
| Federal Home Loan Mortgage Corporation | 3,387 | 7 | | | 3,387 | 7 |
| Collateralized mortgage obligations: | | | | | | |
| Federal National Mortgage Association | 11,228 | 24 | 25,644 | 920 | 36,872 | 944 |
| Federal Home Loan Mortgage Corporation | | | 76,126 | 2,585 | 76,126 | 2,585 |
| Government National Mortgage Association | | | 2,510 | 40 | 2,510 | 40 |
| Total collateralized mortgage obligations | 11,228 | 24 | 104,280 | 3,545 | 115,508 | 3,569 |
| Total mortgage-backed securities | 16,857 | 39 | 166,872 | 4,801 | 183,729 | 4,840 |
| Total available for sale securities | 51,852 | 116 | 207,942 | 5,699 | 259,794 | 5,815 |
| Securities held to maturity: | | | | | | |
| State and political subdivisions | 18,036 | 120 | | | 18,036 | 120 |
| Total temporarily impaired securities | \$ 69,888 | \$ 236 | \$ 207,942 | \$ 5,699 | \$ 277,830 | \$ 5,935 |

The total number of security positions in the investment portfolio in an unrealized loss position at June 30, 2015 was 243 compared to 122 at December 31, 2014. At June 30, 2015, the Company had positions in 32 investment securities with a fair value of \$142.8 million and a total unrealized loss of \$4.1 million that have been in a continuous unrealized loss position for more than 12 months. At June 30, 2015, there were a total of 211 securities positions in the Company's investment portfolio with a fair value of \$365.8 million and a total unrealized loss of \$5.6 million that had been in a continuous unrealized loss position for less than 12 months. At December 31, 2014, the Company had positions in 51 investment securities with a fair value of \$207.9 million and a total unrealized loss of \$5.7 million that have been in a continuous unrealized loss position for more than 12 months. At December 31, 2014, there were a total of 71 securities positions in the Company's investment portfolio with a fair value of \$69.9 million and a total

unrealized loss of \$236 thousand that had been in a continuous unrealized loss position for less than 12 months. The unrealized loss on investment securities was predominantly caused by changes in market interest rates subsequent to purchase. The fair value of most of the investment securities in the Company's portfolio fluctuates as market interest rates change. The Company reviews investment securities on an ongoing basis for the presence of 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 then available to management. There was no impairment recorded during the six months ended June 30, 2015 and 2014.

Based on management's review and evaluation of the Company's debt securities as of June 30, 2015, the debt securities with unrealized losses were not considered to be OTTI. As of June 30, 2015, the Company did not intend to sell any of the securities in a loss position and believes that it is not likely that it will be required to sell any such securities before the anticipated recovery of amortized cost. Accordingly, as of June 30, 2015, management has concluded that unrealized losses on its investment securities are temporary and no further impairment loss has been realized in the Company's consolidated statements of income.

Table of Contents

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(5.) LOANS

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

| | Principal Amount Outstanding | Net Deferred Loan Costs (Fees) | Loans, Net |
|---------------------------------|------------------------------------|--------------------------------------|--------------|
| <u>June 30, 2015</u> | | | |
| Commercial business | \$ 292,674 | \$ 117 | \$ 292,791 |
| Commercial mortgage | 538,034 | (1,444) | 536,590 |
| Residential mortgage | 95,259 | (97) | 95,162 |
| Home equity | 391,645 | 7,209 | 398,854 |
| Consumer indirect | 641,871 | 24,679 | 666,550 |
| Other consumer | 19,141 | 185 | 19,326 |
| Total | \$ 1,978,624 | \$ 30,649 | 2,009,273 |
| Allowance for loan losses | | | (27,500) |
| Total loans, net | | | \$ 1,981,773 |
| <u>December 31, 2014</u> | | | |
| Commercial business | \$ 267,377 | \$ 32 | \$ 267,409 |
| Commercial mortgage | 476,407 | (1,315) | 475,092 |
| Residential mortgage | 100,241 | (140) | 100,101 |
| Home equity | 379,774 | 6,841 | 386,615 |
| Consumer indirect | 636,357 | 25,316 | 661,673 |
| Other consumer | 20,915 | 197 | 21,112 |
| Total | \$ 1,881,071 | \$ 30,931 | 1,912,002 |
| Allowance for loan losses | | | (27,637) |
| Total loans, net | | | \$ 1,884,365 |

Loans held for sale (not included above) were comprised entirely of residential real estate mortgages and totaled \$448 thousand and \$755 thousand as of June 30, 2015 and December 31, 2014, respectively.

Table of Contents**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Unaudited)****(5.) 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):

| | 30-59 Days Past Due | 60-89 Days Past Due | Greater Than 90 Days | Total Past Due | Nonaccrual | Current | Total Loans |
|---------------------------------|------------------------------------|------------------------------------|-------------------------------------|---------------------------|-------------------|----------------|------------------------|
| <u>June 30, 2015</u> | | | | | | | |
| Commercial business | \$ 605 | \$ | \$ | \$ 605 | \$ 4,643 | \$ 287,426 | \$ 292,674 |
| Commercial mortgage | 606 | | | 606 | 3,070 | 534,358 | 538,034 |
| Residential mortgage | 192 | | | 192 | 1,628 | 93,439 | 95,259 |
| Home equity | 454 | 78 | | 532 | 619 | 390,494 | 391,645 |
| Consumer indirect | 1,708 | 364 | | 2,072 | 728 | 639,071 | 641,871 |
| Other consumer | 86 | 52 | 9 | 147 | 11 | 18,983 | 19,141 |
| Total loans, gross | \$ 3,651 | \$ 494 | \$ 9 | \$ 4,154 | \$ 10,699 | \$ 1,963,771 | \$ 1,978,624 |
| <u>December 31, 2014</u> | | | | | | | |
| Commercial business | \$ 28 | \$ | \$ | \$ 28 | \$ 4,288 | \$ 263,061 | \$ 267,377 |
| Commercial mortgage | 83 | | | 83 | 3,020 | 473,304 | 476,407 |
| Residential mortgage | 321 | | | 321 | 1,194 | 98,726 | 100,241 |
| Home equity | 799 | 67 | | 866 | 463 | 378,445 | 379,774 |
| Consumer indirect | 2,429 | 402 | | 2,831 | 1,169 | 632,357 | 636,357 |
| Other consumer | 148 | 48 | 8 | 204 | 11 | 20,700 | 20,915 |
| Total loans, gross | \$ 3,808 | \$ 517 | \$ 8 | \$ 4,333 | \$ 10,145 | \$ 1,866,593 | \$ 1,881,071 |

There were no loans past due greater than 90 days and still accruing interest as of June 30, 2015 and December 31, 2014. There were \$9 thousand and \$8 thousand in consumer overdrafts which were past due greater than 90 days as of June 30, 2015 and December 31, 2014, respectively. Consumer overdrafts are overdrawn deposit accounts which have been reclassified as loans but by their terms do not accrue interest.

Troubled Debt Restructurings

Edgar Filing: FINANCIAL INSTITUTIONS INC - Form 10-Q

A modification of a loan constitutes a troubled debt restructuring (TDR) when a borrower is experiencing financial difficulty and the modification constitutes a concession. Commercial loans modified in a TDR may 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, collateral concessions, forgiveness of principal, forbearance agreements, or substituting or adding a new borrower or guarantor.

The following table presents information related to loans modified in a TDR during the quarterly periods indicated (dollars in thousands).

| | Quarter-to-Date | | Year-to-Date | |
|-----------------------------|------------------------------|-------------------------------|------------------------------|-------------------------------|
| | Pre-Modification Outstanding | Post-Modification Outstanding | Pre-Modification Outstanding | Post-Modification Outstanding |
| | Number of Recorded Contracts | Investment | Number of Recorded Contracts | Investment |
| <u>June 30, 2015</u> | | | | |
| Commercial business | 2 | \$ 1,342 | 2 | \$ 1,342 |
| Commercial mortgage | | | 1 | 682 |
| Total | 2 | \$ 1,342 | 3 | \$ 2,024 |
| <u>June 30, 2014</u> | | | | |
| Commercial business | 1 | \$ 1,381 | 1 | \$ 1,381 |
| Commercial mortgage | | | | |
| Total | 1 | \$ 1,381 | 1 | \$ 1,381 |

Table of Contents**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Unaudited)****(5.) LOANS (Continued)**

The loans identified as a TDR by the Company during the six month periods ended June 30, 2015 and 2014 were previously on nonaccrual status and reported as impaired loans prior to restructuring. The modifications during the reported periods primarily related to extending amortization periods, forbearance agreements, requesting additional collateral and, in one instance, forgiveness of principal. 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 two commercial business loans with an aggregate pre-default balance of \$1.3 million restructured in the 12 months prior to June 30, 2015 that went into default during the six months ended June 30, 2015. There were no loans modified as a TDR within the previous 12 months that defaulted during the six months ended June 30, 2014. For purposes of this disclosure, a loan modified as a TDR is considered to have defaulted when the borrower becomes 90 days past due.

Impaired Loans

Management has determined that specific commercial loans on nonaccrual status and all loans that have had their terms restructured in a troubled debt restructuring are impaired loans. The following table presents the recorded investment, unpaid principal balance and related allowance of impaired loans as of the dates indicated, and average recorded investment and interest income recognized on impaired loans for the six month periods ended as of the dates indicated (in thousands):

| | Recorded Investment⁽¹⁾ | Unpaid Principal Balance⁽¹⁾ | Related Allowance | Average Recorded Investment | Interest Income Recognized |
|-------------------------------------|--|---|------------------------------|--|---|
| <u>June 30, 2015</u> | | | | | |
| With no related allowance recorded: | | | | | |
| Commercial business | \$ 1,348 | \$ 2,807 | \$ | \$ 1,461 | \$ |
| Commercial mortgage | 1,159 | 1,708 | | 1,171 | |
| | 2,507 | 4,515 | | 2,632 | |
| With an allowance recorded: | | | | | |
| Commercial business | 3,295 | 3,295 | 1,247 | 3,093 | |
| Commercial mortgage | 1,911 | 1,911 | 707 | 2,121 | |

Edgar Filing: FINANCIAL INSTITUTIONS INC - Form 10-Q

| | | | | | |
|-------------------------------------|----------|----------|----------|----------|----|
| | 5,206 | 5,206 | 1,954 | 5,214 | |
| | \$ 7,713 | \$ 9,721 | \$ 1,954 | \$ 7,846 | \$ |
| December 31, 2014 | | | | | |
| With no related allowance recorded: | | | | | |
| Commercial business | \$ 1,408 | \$ 1,741 | \$ | \$ 1,431 | \$ |
| Commercial mortgage | 781 | 920 | | 1,014 | |
| | 2,189 | 2,661 | | 2,445 | |
| With an allowance recorded: | | | | | |
| Commercial business | 2,880 | 2,880 | 1,556 | 1,998 | |
| Commercial mortgage | 2,239 | 2,239 | 911 | 1,560 | |
| | 5,119 | 5,119 | 2,467 | 3,558 | |
| | \$ 7,308 | \$ 7,780 | \$ 2,467 | \$ 6,003 | \$ |

(1) Difference between recorded investment and unpaid principal balance represents partial charge-offs.

Table of Contents**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Unaudited)****(5.) LOANS (Continued)****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 that do not meet 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.

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

| | Commercial Business | Commercial Mortgage |
|-----------------------------|--------------------------------|--------------------------------|
| <u>June 30, 2015</u> | | |
| Uncriticized | \$ 275,639 | \$ 523,226 |
| Special mention | 5,078 | 6,015 |
| Substandard | 11,957 | 8,793 |
| Doubtful | | |

Edgar Filing: FINANCIAL INSTITUTIONS INC - Form 10-Q

| | | |
|---------------------------------|------------|------------|
| Total | \$ 292,674 | \$ 538,034 |
| <u>December 31, 2014</u> | | |
| Uncriticized | \$ 250,961 | \$ 460,880 |
| Special mention | 5,530 | 5,411 |
| Substandard | 10,886 | 10,116 |
| Doubtful | | |
| Total | \$ 267,377 | \$ 476,407 |

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):

| | Residential Mortgage | Home Equity | Consumer Indirect | Other Consumer |
|---------------------------------|---------------------------------|------------------------|------------------------------|---------------------------|
| <u>June 30, 2015</u> | | | | |
| Performing | \$ 93,631 | \$ 391,026 | \$ 641,143 | \$ 19,121 |
| Non-performing | 1,628 | 619 | 728 | 20 |
| Total | \$ 95,259 | \$ 391,645 | \$ 641,871 | \$ 19,141 |
| <u>December 31, 2014</u> | | | | |
| Performing | \$ 99,047 | \$ 379,311 | \$ 635,188 | \$ 20,896 |
| Non-performing | 1,194 | 463 | 1,169 | 19 |
| Total | \$ 100,241 | \$ 379,774 | \$ 636,357 | \$ 20,915 |

Table of Contents**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Unaudited)****(5.) LOANS (Continued)****Allowance for Loan Losses**

Loans and the related allowance for loan losses are presented below as of the dates indicated (in thousands):

| | Commercial Business | Commercial Mortgage | Residential Mortgage | Home Equity | Consumer Indirect | Other Consumer | Total |
|---------------------------------------|--------------------------------|--------------------------------|---------------------------------|------------------------|------------------------------|---------------------------|--------------|
| <u>June 30, 2015</u> | | | | | | | |
| Loans: | | | | | | | |
| Ending balance | \$ 292,674 | \$ 538,034 | \$ 95,259 | \$ 391,645 | \$ 641,871 | \$ 19,141 | \$ 1,978,624 |
| Evaluated for impairment: | | | | | | | |
| Individually | \$ 4,643 | \$ 3,070 | \$ | \$ | \$ | \$ | \$ 7,713 |
| Collectively | \$ 288,031 | \$ 534,964 | \$ 95,259 | \$ 391,645 | \$ 641,871 | \$ 19,141 | \$ 1,970,911 |
| Allowance for loan losses: | | | | | | | |
| Ending balance | \$ 5,334 | \$ 9,358 | \$ 465 | \$ 1,198 | \$ 10,676 | \$ 469 | \$ 27,500 |
| Evaluated for impairment: | | | | | | | |
| Individually | \$ 1,247 | \$ 707 | \$ | \$ | \$ | \$ | \$ 1,954 |
| Collectively | \$ 4,087 | \$ 8,651 | \$ 465 | \$ 1,198 | \$ 10,676 | \$ 469 | \$ 25,546 |
| <u>June 30, 2014</u> | | | | | | | |
| Loans: | | | | | | | |
| Ending balance | \$ 277,609 | \$ 469,936 | \$ 106,342 | \$ 363,243 | \$ 626,418 | \$ 21,205 | \$ 1,864,753 |
| Evaluated for impairment: | | | | | | | |
| Individually | \$ 3,589 | \$ 2,734 | \$ | \$ | \$ | \$ | \$ 6,323 |
| Collectively | \$ 274,020 | \$ 467,202 | \$ 106,342 | \$ 363,243 | \$ 626,418 | \$ 21,205 | \$ 1,858,430 |

Allowance for loan losses:

| | | | | | | | |
|---------------------------|----------|----------|--------|----------|-----------|--------|-----------|
| Ending balance | \$ 5,402 | \$ 7,633 | \$ 618 | \$ 1,607 | \$ 11,446 | \$ 460 | \$ 27,166 |
| Evaluated for impairment: | | | | | | | |
| Individually | \$ 1,056 | \$ 432 | \$ | \$ | \$ | \$ | \$ 1,488 |
| Collectively | \$ 4,346 | \$ 7,201 | \$ 618 | \$ 1,607 | \$ 11,446 | \$ 460 | \$ 25,678 |

The following table sets forth the changes in the allowance for loan losses for the three and six month periods ended June 30, 2015 (in thousands):

| | Commercial Business | Commercial Mortgage | Residential Mortgage | Home Equity | Consumer Indirect | Other Consumer | Total |
|--|------------------------|------------------------|-------------------------|----------------|----------------------|-------------------|-----------|
| <u>Three months ended June 30, 2015</u> | | | | | | | |
| Beginning balance | \$ 5,395 | \$ 8,156 | \$ 558 | \$ 1,430 | \$ 11,205 | \$ 447 | \$ 27,191 |
| Charge-offs | 13 | 201 | 22 | 154 | 1,841 | 154 | 2,385 |
| Recoveries | 86 | 7 | 13 | 9 | 1,196 | 95 | 1,406 |
| Provision (credit) | (134) | 1,396 | (84) | (87) | 116 | 81 | 1,288 |
| Ending balance | \$ 5,334 | \$ 9,358 | \$ 465 | \$ 1,198 | \$ 10,676 | \$ 469 | \$ 27,500 |
| <u>Six months ended June 30, 2015</u> | | | | | | | |
| Beginning balance | \$ 5,621 | \$ 8,122 | \$ 570 | \$ 1,485 | \$ 11,383 | \$ 456 | \$ 27,637 |
| Charge-offs | 1,154 | 810 | 77 | 238 | 4,263 | 413 | 6,955 |
| Recoveries | 134 | 96 | 46 | 19 | 2,301 | 193 | 2,789 |
| Provision | 733 | 1,950 | (74) | (68) | 1,255 | 233 | 4,029 |
| Ending balance | \$ 5,334 | \$ 9,358 | \$ 465 | \$ 1,198 | \$ 10,676 | \$ 469 | \$ 27,500 |

Table of Contents**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Unaudited)****(5.) LOANS (Continued)**

The following table sets forth the changes in the allowance for loan losses for the three and six month periods ended June 30, 2014 (in thousands):

| | Commercial Business | Commercial Mortgage | Residential Mortgage | Home Equity | Consumer Indirect | Other Consumer | Total |
|--|------------------------|------------------------|-------------------------|----------------|----------------------|-------------------|-----------|
| <u>Three months ended June 30, 2014</u> | | | | | | | |
| Beginning balance | \$ 4,689 | \$ 7,980 | \$ 672 | \$ 1,371 | \$ 11,984 | \$ 456 | \$ 27,152 |
| Charge-offs | 3 | 165 | 69 | 156 | 2,331 | 224 | 2,948 |
| Recoveries | 68 | 6 | 8 | 29 | 995 | 98 | 1,204 |
| Provision (credit) | 648 | (188) | 7 | 363 | 798 | 130 | 1,758 |
| Ending balance | \$ 5,402 | \$ 7,633 | \$ 618 | \$ 1,607 | \$ 11,446 | \$ 460 | \$ 27,166 |
| <u>Six months ended June 30, 2014</u> | | | | | | | |
| Beginning balance | \$ 4,273 | \$ 7,743 | \$ 676 | \$ 1,367 | \$ 12,230 | \$ 447 | \$ 26,736 |
| Charge-offs | 71 | 165 | 147 | 262 | 4,786 | 493 | 5,924 |
| Recoveries | 97 | 13 | 29 | 40 | 2,100 | 211 | 2,490 |
| Provision | 1,103 | 42 | 60 | 462 | 1,902 | 295 | 3,864 |
| Ending balance | \$ 5,402 | \$ 7,633 | \$ 618 | \$ 1,607 | \$ 11,446 | \$ 460 | \$ 27,166 |

Risk Characteristics

Commercial business loans primarily consist of loans to small to midsize businesses in our market area in a diverse range of industries. These loans are typically made on the basis of the borrower's ability to make repayment from the cash flow of the borrower's business. Risk arises primarily due to a difference between expected and actual cash flows of the borrowers. 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, potentially resulting in higher 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, and 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)****(6.) GOODWILL AND OTHER INTANGIBLE ASSETS**

The carrying amount of goodwill totaled \$61.2 million as of June 30, 2015 and December 31, 2014. The Company performs a goodwill impairment test on an annual basis or more frequently if events and circumstances warrant.

The Company has other intangible assets that are amortized, consisting of core deposit intangibles and other intangibles (primarily related to customer relationships acquired in connection with the Company's insurance agency acquisition). Changes in the gross carrying amount, accumulated amortization and net book value, were as follows (in thousands):

| | June 30, 2015 | December 31, 2014 |
|----------------------------------|--------------------------|------------------------------|
| Other intangibles assets: | | |
| Gross carrying amount | \$ 8,682 | \$ 8,682 |
| Accumulated amortization | (1,677) | (1,196) |
| Net book value | \$ 7,005 | \$ 7,486 |

Amortization expense for total other intangible assets was \$238 thousand and \$481 thousand for the three and six months ended June 30, 2015, and \$87 thousand and \$176 thousand for the three and six months ended June 30, 2014, respectively. As of June 30, 2015, the estimated amortization expense of other intangible assets for the remainder of 2015 and each of the next five years is as follows (in thousands):

| | |
|--------------------------|--------|
| 2015 (remainder of year) | \$ 461 |
| 2016 | 864 |
| 2017 | 778 |
| 2018 | 689 |
| 2019 | 611 |
| 2020 | 533 |

(7.) BORROWINGS

The Company classifies borrowings as short-term or long-term in accordance with the original terms of the agreement. Outstanding borrowings consisted of the following as of the dates indicated (in thousands):

| June 30, 2015 | December 31, 2014 |
|--------------------------|------------------------------|
|--------------------------|------------------------------|

Edgar Filing: FINANCIAL INSTITUTIONS INC - Form 10-Q

| | | |
|------------------------------------|-------------------|-------------------|
| Short-term borrowings: | | |
| Short-term FHLB borrowings | \$ 350,600 | \$ 295,300 |
| Repurchase agreements | | 39,504 |
| Total short-term borrowings | 350,600 | 334,804 |
| Long-term borrowings: | | |
| Subordinated notes, net | 38,955 | |
| Total borrowings | \$ 389,555 | \$ 334,804 |

Subordinated Notes

On April 15, 2015, the Company issued \$40.0 million of 6.0% fixed to floating rate subordinated notes due April 15, 2030 (the Subordinated Notes) to certain accredited investors. The Subordinated Notes bear interest at a fixed rate of 6.0% per year, payable semi-annually, for the first 10 years. From April 15, 2025 to the April 15, 2030 maturity date, the interest rate will reset quarterly to an annual interest rate equal to the then current three-month London Interbank Offered Rate (LIBOR) plus 3.944%, payable quarterly. The Subordinated Notes are redeemable by the Company at any quarterly interest payment date beginning on April 15, 2025 to maturity at par, plus accrued and unpaid interest. Proceeds, net of debt issuance costs of \$1.1 million, were \$38.9 million. The net proceeds from this offering were used for general corporate purposes, including but not limited to, contribution of capital to the Bank to support both organic growth and opportunistic acquisitions. The Subordinated Notes qualify as Tier 2 capital for regulatory purposes.

The Company adopted ASU 2015-03 that requires debt issuance costs to be reported as a direct deduction from the face of the Notes and not as a deferred charge. Refer to Note 1 for additional information. The debt issuance costs will be amortized as an adjustment to interest expense over 15 years.

Table of Contents**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Unaudited)****(8.) SHAREHOLDERS EQUITY****Common Stock**

The changes in shares of common stock were as follows for the six month periods ended June 30, 2015 and 2014:

| | Outstanding | Treasury | Issued |
|---|--------------------|-----------------|---------------|
| <u>June 30, 2015</u> | | | |
| Shares outstanding at December 31, 2014 | 14,118,048 | 279,461 | 14,397,509 |
| Restricted stock awards issued | 59,834 | (59,834) | |
| Restricted stock awards forfeited | (3,041) | 3,041 | |
| Stock options exercised | 8,722 | (8,722) | |
| Treasury stock purchases | (1,791) | 1,791 | |
| Stock awards | 2,363 | (2,363) | |
| Shares outstanding at June 30, 2015 | 14,184,135 | 213,374 | 14,397,509 |
| <u>June 30, 2014</u> | | | |
| Shares outstanding at December 31, 2013 | 13,829,355 | 332,242 | 14,161,597 |
| Restricted stock awards issued | 43,242 | (43,242) | |
| Restricted stock awards forfeited | (8,144) | 8,144 | |
| Stock options exercised | 7,125 | (7,125) | |
| Treasury stock purchases | (9,102) | 9,102 | |
| Shares outstanding at June 30, 2014 | 13,862,476 | 299,121 | 14,161,597 |

(9.) ACCUMULATED OTHER COMPREHENSIVE LOSS

The following table presents the components of other comprehensive income (loss) for the six month periods ended June 30, 2015 and 2014 (in thousands):

| | Pre-tax Amount | Tax Effect | Net-of-tax Amount |
|---|---------------------------|-------------------|------------------------------|
| <u>June 30, 2015</u> | | | |
| Securities available for sale and transferred securities: | | | |
| Change in unrealized gain/loss during the period | \$ (3,590) | \$ (1,386) | \$ (2,204) |
| Reclassification adjustment for net gains included in net income ⁽¹⁾ | (1,208) | (466) | (742) |

| | | | |
|---|---------------|--------------|--------------|
| Total securities available for sale and transferred securities | (4,798) | (1,852) | (2,946) |
| Amortization of pension and post-retirement items: | | | |
| Prior service credit | (24) | (9) | (15) |
| Net actuarial losses | 471 | 181 | 290 |
| Total pension and post-retirement obligations | 447 | 172 | 275 |
| Other comprehensive loss | \$ (4,351) | \$ (1,680) | \$ (2,671) |
| June 30, 2014 | | | |
| Securities available for sale and transferred securities: | | | |
| Change in unrealized gain/loss during the period | \$ 12,168 | \$ 4,821 | \$ 7,347 |
| Reclassification adjustment for net gains included in net income ⁽¹⁾ | (1,521) | (602) | (919) |
| Total securities available for sale and transferred securities | 10,647 | 4,219 | 6,428 |
| Amortization of pension and post-retirement items: | | | |
| Prior service credit | (24) | (9) | (15) |
| Net actuarial losses | 88 | 34 | 54 |
| Total pension and post-retirement obligations | 64 | 25 | 39 |
| Other comprehensive income | \$ 10,711 | \$ 4,244 | \$ 6,467 |

- ⁽¹⁾ Includes amounts related to the amortization/accretion of unrealized net gains and losses resulting from the Company's reclassification of available for sale investment securities to the held to maturity category. The unrealized net gains/losses will be amortized/accreted over the remaining life of the investment securities as an adjustment of yield.

Table of Contents

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(9.) ACCUMULATED OTHER COMPREHENSIVE LOSS (Continued)

Activity in accumulated other comprehensive loss, net of tax, for the six month periods ended June 30, 2015 and 2014 was as follows (in thousands):

| | Securities | | |
|--|---------------|-------------|---------------|
| | Available for | Pension and | Accumulated |
| | Sale and | Post- | Other |
| | Transferred | retirement | Comprehensive |
| | Securities | Obligations | Loss |
| June 30, 2015 | | | |
| Balance at beginning of year | \$ 1,625 | \$ (10,636) | \$ (9,011) |
| Other comprehensive income before reclassifications | (2,204) | | (2,204) |
| Amounts reclassified from accumulated other comprehensive loss | (742) | 275 | (467) |
| Net current period other comprehensive income (loss) | (2,946) | 275 | (2,671) |
| Balance at end of period | \$ (1,321) | \$ (10,361) | \$ (11,682) |
| June 30, 2014 | | | |
| Balance at beginning of year | \$ (5,337) | \$ (4,850) | \$ (10,187) |
| Other comprehensive income before reclassifications | 7,347 | | 7,347 |
| Amounts reclassified from accumulated other comprehensive loss | (919) | 39 | (880) |
| Net current period other comprehensive income | 6,428 | 39 | 6,467 |
| Balance at end of period | \$ 1,091 | \$ (4,811) | \$ (3,720) |

The following table presents the amounts reclassified out of each component of accumulated other comprehensive loss for six month periods ended June 30, 2015 and 2014 (in thousands):

| Details About Accumulated Other Comprehensive Loss Components | Amount Reclassified from Accumulated Other Comprehensive Loss Six months ended June 30, | | Affected Line Item in the Consolidated Statement of Income |
|--|---|----------|--|
| | 2015 | 2014 | |
| Realized gain on sale of investment securities | \$ 1,062 | \$ 1,262 | Net gain on disposal of investment securities |
| Amortization of unrealized holding gains (losses) on investment securities transferred from available for sale to held to maturity | 146 | 259 | Interest income |
| | 1,208 | 1,521 | Total before tax |
| | (466) | (602) | Income tax expense |
| | 742 | 919 | Net of tax |
| Amortization of pension and post-retirement items: | | | |
| Prior service credit ⁽¹⁾ | 24 | 24 | Salaries and employee benefits |
| Net actuarial losses ⁽¹⁾ | (471) | (88) | Salaries and employee benefits |
| | (447) | (64) | Total before tax |
| | 172 | 25 | Income tax benefit |
| | (275) | (39) | Net of tax |
| Total reclassified for the period | \$ 467 | \$ 880 | |

⁽¹⁾ These items are included in the computation of net periodic pension expense. See Note 11 Employee Benefit Plans for additional information.

Table of Contents

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(10.) SHARE-BASED COMPENSATION PLANS

The Company maintains certain stock-based compensation plans that were approved by the Company's shareholders and are administered by the Company's Board of Directors, or the Management Development and Compensation Committee of the Board. The share-based compensation plans were established to allow for the grant 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 by giving such persons a proprietary interest in the Company, thereby enhancing their personal interest in the Company's success.

The Company awarded grants of 36,384 shares of restricted common stock to certain members of management during the six months ended June 30, 2015. Thirty percent of the shares subject to each grant will be earned based upon achievement of an EPS performance requirement for the Company's fiscal year ended December 31, 2015. The remaining seventy percent of the shares will be earned based on the Company's achievement of a relative total shareholder return (TSR) performance requirement, on a percentile basis, compared to the SNL Small Cap Bank & Thrifts Index over a three-year performance period ended December 31, 2017. The shares earned based on the achievement of the EPS and TSR performance requirements, if any, will vest on February 25, 2018 assuming the recipient's continuous service to the Company.

The grant-date fair value of the TSR portion of the award granted during the six month period ended June 30, 2015 was determined using the Monte Carlo simulation model on the date of grant, assuming the following (i) expected term of 2.85 years, (ii) risk free interest rate of 0.92%, (iii) expected dividend yield of 3.53% and (iv) expected stock price volatility over the expected term of the TSR award of 26.8%. The grant-date fair value of all other restricted stock awards is equal to the closing market price of the Company's common stock on the date of grant.

The Company granted 12,700 additional shares of restricted common stock to management during the six months ended June 30, 2015. These shares will vest after completion of a three-year service requirement. The average market price of the restricted stock awards on the date of grant was \$22.79.

During the six months ended June 30, 2015, the Company issued a total of 2,363 shares of common stock in-lieu of cash for the annual retainer of three non-employee directors and granted a total of 10,750 restricted shares of common stock to non-employee directors, of which 5,380 shares vested immediately and 5,370 shares will vest after completion of a one-year service requirement. The market price of the stock and restricted stock on the date of grant was \$23.25.

The restricted stock awards granted to management and directors in 2015 do not have rights to dividends or dividend equivalents.

The following is a summary of restricted stock award activity for the six month period ended June 30, 2015:

Weighted

| | Number of Shares | Average Market Price at Grant Date |
|-------------------------------------|-----------------------------|---|
| Outstanding at beginning of year | 59,113 | \$ 17.24 |
| Granted | 59,834 | 17.66 |
| Vested | (16,458) | 20.80 |
| Forfeited | (3,041) | 20.39 |
| Outstanding at end of period | 99,448 | \$ 16.81 |

As of June 30, 2015, there was \$1.1 million of unrecognized compensation expense related to unvested restricted stock awards that is expected to be recognized over a weighted average period of 2.1 years.

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

| | Three months ended | | Six months ended | |
|---|---------------------------|---------------|-------------------------|---------------|
| | June 30, | | June 30, | |
| | 2015 | 2014 | 2015 | 2014 |
| Salaries and employee benefits | \$ 113 | \$ 75 | \$ 191 | \$ 156 |
| Other noninterest expense | 154 | 127 | 179 | 149 |
| Total share-based compensation expense | \$ 267 | \$ 202 | \$ 370 | \$ 305 |

Table of Contents**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Unaudited)****(10.) SHARE-BASED COMPENSATION PLANS (Continued)**

The Company uses the Black-Scholes valuation method to estimate the fair value of its stock option awards. There were no stock options awarded during 2015 or 2014. The following is a summary of stock option activity for the six months ended June 30, 2015 (dollars in thousands, except per share amounts):

| | Number of Options | Weighted Average Exercise Price | Weighted Average Remaining Contractual Term | Aggregate Intrinsic Value |
|--|----------------------|--|---|---------------------------------|
| Outstanding at beginning of year | 135,416 | \$ 19.25 | | |
| Exercised | (8,722) | 18.96 | | |
| Expired | (12,645) | 20.15 | | |
| Outstanding and exercisable at end of period | 114,049 | \$ 19.17 | 1.7 | \$ 646 |

The aggregate intrinsic value (the amount by which the market price of the stock on the date of exercise exceeded the market price of the stock on the date of grant) of option exercises for the six months ended June 30, 2015 and 2014 was \$39 thousand and \$32 thousand, respectively. The total cash received as a result of option exercises under stock compensation plans for the six months ended June 30, 2015 and 2014 was \$165 thousand and \$132 thousand, respectively.

(11.) EMPLOYEE BENEFIT PLANS

The components of the Company's net periodic benefit expense for its pension and post-retirement obligations were as follows (in thousands):

| | Three months ended June 30, | | Six months ended June 30, | |
|---|--------------------------------|---------|------------------------------|---------|
| | 2015 | 2014 | 2015 | 2014 |
| Service cost | \$ 581 | \$ 480 | \$ 1,162 | \$ 959 |
| Interest cost on projected benefit obligation | 583 | 573 | 1,166 | 1,147 |
| Expected return on plan assets | (1,205) | (1,030) | (2,410) | (2,059) |
| Amortization of prior service credit | (12) | (12) | (24) | (24) |
| Amortization of net actuarial losses | 235 | 44 | 471 | 88 |

| | | | | |
|------------------------------|--------|-------|--------|--------|
| Net periodic pension expense | \$ 182 | \$ 55 | \$ 365 | \$ 111 |
|------------------------------|--------|-------|--------|--------|

The net periodic benefit expense is recorded as a component of salaries and employee benefits in the consolidated statements of income. 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. The Company has no minimum required contribution for the 2015 fiscal year.

(12.) 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 Company's 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):

| | June 30, 2015 | December 31, 2014 |
|------------------------------|--------------------------|------------------------------|
| Commitments to extend credit | \$ 487,114 | \$ 450,343 |
| Standby letters of credit | 10,296 | 8,578 |

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 which may require payment by the customer

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

of a termination 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, the Company may enter 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 \$274 thousand and \$1.2 million at June 30, 2015 and December 31, 2014, respectively. In addition, the net change in the fair values of these derivatives was recognized as other noninterest income or other noninterest expense in the consolidated statements of income.

(13.) 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. There have been no changes in the valuation techniques used during the current period. 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. Transfers between levels of the fair value hierarchy are recorded as of the end of the reporting period.

(13.) FAIR VALUE MEASUREMENTS (Continued)

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 issuer'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.

Securities available for sale: 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.

Table of Contents

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

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: Fair value of impaired loans with specific allocations of the allowance for loan losses is measured based on the value of the collateral securing these loans and is classified as Level 3 in the fair value hierarchy. Collateral may be real estate and/or business assets including equipment, inventory and/or accounts receivable and collateral value is determined based on appraisals performed by qualified licensed appraisers hired by the Company. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Appraised and reported values may be discounted based on management's historical knowledge, changes in market conditions from the time of valuation, and/or management's expertise and knowledge of the client and the client's business. Such discounts are typically significant and result in a Level 3 classification of the inputs for determining fair value. Impaired loans are reviewed and evaluated on at least a quarterly basis for additional impairment and adjusted accordingly, based on the same factors identified above.

Loan servicing rights: Loan servicing rights do not trade in an active market with readily observable market data. As a result, the Company estimates the fair value of loan 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. The significant unobservable inputs used in the fair value measurement of the Company's loan servicing rights are the constant prepayment rates and weighted average discount rate. Significant increases (decreases) in any of those inputs in isolation could result in a significantly lower (higher) fair value measurement. Although the constant prepayment rate and the discount rate are not directly interrelated, they will generally move in opposite directions. Loan servicing rights are classified as Level 3 measurements due to the use of significant unobservable inputs, as well as significant management judgment and estimation.

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. The appraisals are sometimes further discounted based on management's historical knowledge, changes in market conditions from the time of valuation, and/or management's expertise and knowledge of the client and client's business. Such discounts are typically significant and result in a Level 3 classification of the inputs for determining fair value. In cases where the carrying amount exceeds the fair value, less costs to sell, an impairment loss is recognized.

Commitments to extend credit and letters of credit: Commitments to extend credit and fund letters of credit are principally at current interest rates, and, therefore, the carrying amount approximates fair value. The fair value of commitments is not material.

Table of Contents

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(13.) FAIR VALUE MEASUREMENTS (Continued)

Assets Measured at Fair Value

The following tables present 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 the dates indicated (in thousands).

| | Quoted Prices in Active Markets for Identical Assets or Liabilities (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) | Total |
|---|--|---|--|------------|
| <u>June 30, 2015</u> | | | | |
| Measured on a recurring basis: | | | | |
| Securities available for sale: | | | | |
| U.S. Government agencies and government sponsored enterprises | \$ | \$ 270,077 | \$ | \$ 270,077 |
| Mortgage-backed securities | | 502,337 | | 502,337 |
| Asset-backed securities | | 225 | | 225 |
| | \$ | \$ 772,639 | \$ | \$ 772,639 |
| Measured on a nonrecurring basis: | | | | |
| Loans: | | | | |
| Loans held for sale | \$ | \$ 448 | \$ | \$ 448 |
| Collateral dependent impaired loans | | | 3,252 | 3,252 |
| Other assets: | | | | |
| Loan servicing rights | | | 1,289 | 1,289 |
| Other real estate owned | | | 165 | 165 |
| | \$ | \$ 448 | \$ 4,706 | \$ 5,154 |
| <u>December 31, 2014</u> | | | | |
| Measured on a recurring basis: | | | | |
| Securities available for sale: | | | | |
| U.S. Government agencies and government sponsored enterprises | \$ | \$ 160,475 | \$ | \$ 160,475 |

Edgar Filing: FINANCIAL INSTITUTIONS INC - Form 10-Q

| | | | | |
|--|----|------------|----------|------------|
| Mortgage-backed securities | | 461,788 | | 461,788 |
| Asset-backed securities | | 231 | | 231 |
| | \$ | \$ 622,494 | \$ | \$ 622,494 |
| Measured on a nonrecurring basis: | | | | |
| Loans: | | | | |
| Loans held for sale | \$ | \$ 755 | \$ | \$ 755 |
| Collateral dependent impaired loans | | | 2,652 | 2,652 |
| Other assets: | | | | |
| Loan servicing rights | | | 1,359 | 1,359 |
| Other real estate owned | | | 194 | 194 |
| | \$ | \$ 755 | \$ 4,205 | \$ 4,960 |

There were no transfers between Levels 1 and 2 during the six months ended June 30, 2015 and 2014. There were no liabilities measured at fair value on a recurring or nonrecurring basis during the six month periods ended June 30, 2015 and 2014.

Table of Contents**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Unaudited)****(13.) FAIR VALUE MEASUREMENTS (Continued)**

The following table presents additional quantitative information about assets measured at fair value on a recurring and nonrecurring basis for which the Company has utilized Level 3 inputs to determine fair value (dollars in thousands).

| Asset | Fair Value | Valuation Technique | Unobservable Input | Unobservable Input Value or Range |
|-------------------------------------|-------------------|--|--|---|
| Collateral dependent impaired loans | \$ 3,252 | Appraisal of collateral ⁽¹⁾ Discounted cash flow | Appraisal adjustments ⁽²⁾ Discount rate Risk premium rate | 0% - 100% discount 4.4% ⁽³⁾ 10.0% ⁽³⁾ |
| Loan servicing rights | 1,289 | Discounted cash flow | Discount rate Constant prepayment rate | 5.1% ⁽³⁾ 12.9% ⁽³⁾ |
| Other real estate owned | 165 | Appraisal of collateral ⁽¹⁾ | Appraisal adjustments ⁽²⁾ | 19% - 53 % discount |

(1) Fair value is generally determined through independent appraisals of the underlying collateral, which generally include various Level 3 inputs which are not identifiable.

(2) Appraisals may be adjusted by management for qualitative factors such as economic conditions and estimated liquidation expenses.

(3) Weighted averages.

Changes in Level 3 Fair Value Measurements

There were no assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) as of or during the six months ended June 30, 2015.

Disclosures about Fair Value of Financial Instruments

The assumptions used below are expected to approximate those that market participants would use in valuing these financial instruments.

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. 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.

The estimated fair value approximates carrying value for cash and cash equivalents, Federal Home Loan Bank (FHLB) and Federal Reserve Bank (FRB) stock, accrued interest receivable, non-maturity deposits, short-term borrowings and accrued interest payable. Fair value estimates for other financial instruments not included elsewhere in this disclosure are discussed below.

Securities held to maturity: The fair value of the Company's investment securities held to maturity is primarily measured using information from a third-party 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: The fair value of the Company's loans was estimated by discounting the expected future cash flows using the current interest rates at which similar loans would be made for the same remaining maturities. Loans were first segregated by type such as commercial, residential mortgage, and consumer, and were then further segmented into fixed and variable rate and loan quality categories. Expected future cash flows were projected based on contractual cash flows, adjusted for estimated prepayments.

Time deposits: The fair value of time deposits was estimated using a discounted cash flow approach that applies prevailing market interest rates for similar maturity instruments. The fair values of the Company's time deposit liabilities do not take into consideration the value of the Company's long-term relationships with depositors, which may have significant value.

Long-term borrowings: Long-term borrowings consist of \$40 million of subordinated notes issued during the second quarter of 2015. The subordinated notes are publicly traded and are valued based on market prices, which are characterized as Level 2 liabilities in the fair value hierarchy.

Table of Contents**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Unaudited)****(13.) FAIR VALUE MEASUREMENTS (Continued)**

The following presents (in thousands) the carrying amount, estimated fair value, and placement in the fair value measurement hierarchy of the Company's financial instruments as of the dates indicated.

| | Level in Fair Value Measurement Hierarchy | June 30, 2015 Carrying Amount | Estimated Fair Value | December 31, 2014 Carrying Amount | Estimated Fair Value |
|-------------------------------|--|-------------------------------------|----------------------------|---|----------------------------|
| Financial assets: | | | | | |
| Cash and cash equivalents | Level 1 | \$ 52,554 | \$ 52,554 | \$ 58,151 | \$ 58,151 |
| Securities available for sale | Level 2 | 772,639 | 772,639 | 622,494 | 622,494 |
| Securities held to maturity | Level 2 | 320,820 | 324,873 | 294,438 | 298,695 |
| Loans held for sale | Level 2 | 448 | 448 | 755 | 755 |
| Loans | Level 2 | 1,978,521 | 1,987,842 | 1,881,713 | 1,887,959 |
| Loans ⁽¹⁾ | Level 3 | 3,252 | 3,252 | 2,652 | 2,652 |
| Accrued interest receivable | Level 1 | 8,623 | 8,623 | 8,104 | 8,104 |
| FHLB and FRB stock | Level 2 | 21,558 | 21,558 | 19,014 | 19,014 |
| Financial liabilities: | | | | | |
| Non-maturity deposits | Level 1 | 2,043,219 | 2,043,219 | 1,857,285 | 1,857,285 |
| Time deposits | Level 2 | 613,019 | 614,066 | 593,242 | 593,793 |
| Short-term borrowings | Level 1 | 350,600 | 350,600 | 334,804 | 334,804 |
| Long-term borrowings | Level 2 | 38,955 | 38,555 | | |
| Accrued interest payable | Level 1 | 5,101 | 5,101 | 3,862 | 3,862 |

⁽¹⁾ Comprised of collateral dependent impaired loans.

(14.) SEGMENT REPORTING

The Company has two reportable operating segments, banking and insurance, which are delineated by the consolidated subsidiaries of Financial Institutions, Inc. The banking segment includes all of the Company's retail and commercial banking operations. The insurance segment includes the activities of SDN, a full service insurance agency that provides a broad range of insurance services to both personal and business clients. The Company operated as one business segment until the acquisition of SDN on August 1, 2014, at which time the new Insurance segment was created for financial reporting purposes. Holding company amounts are the primary differences between segment amounts and consolidated totals, and are reflected in the Holding Company and Other column below, along with amounts to eliminate balances and transactions between segments.

Edgar Filing: FINANCIAL INSTITUTIONS INC - Form 10-Q

The following tables present information regarding the Company's business segments as of and for the periods indicated (in thousands).

| | Banking | Insurance | Holding Company and Other | Consolidated Totals |
|---------------------------------|----------------|------------------|--|--------------------------------|
| <u>June 30, 2015</u> | | | | |
| Goodwill | \$ 48,536 | \$ 12,617 | \$ | \$ 61,153 |
| Other intangible assets, net | 972 | 6,033 | | 7,005 |
| Total assets | 3,337,787 | 20,960 | 712 | 3,359,459 |
| <u>December 31, 2014</u> | | | | |
| Goodwill | \$ 48,536 | \$ 12,617 | \$ | \$ 61,153 |
| Other intangible assets, net | 1,125 | 6,361 | | 7,486 |
| Total assets | 3,065,109 | 20,368 | 4,044 | 3,089,521 |

- 29 -

Table of Contents

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(14.) SEGMENT REPORTING (Continued)

| | Banking | Insurance | Holding Company and Other | Consolidated Totals |
|--|-----------|-----------|---------------------------------|------------------------|
| <u>Three months ended June 30, 2015</u> | | | | |
| Net interest income | \$ 23,919 | \$ | \$ (515) | \$ 23,404 |
| Provision for loan losses | (1,288) | | | (1,288) |
| Noninterest income | 5,522 | 1,033 | (100) | 6,455 |
| Noninterest expense | (17,668) | (1,050) | (518) | (19,236) |
| Income (loss) before income taxes | 10,485 | (17) | (1,133) | 9,335 |
| Income tax (expense) benefit | (3,107) | 5 | 352 | (2,750) |
| Net income (loss) | \$ 7,378 | \$ (12) | \$ (781) | \$ 6,585 |
| <u>Six months ended June 30, 2015</u> | | | | |
| Net interest income | \$ 47,066 | \$ | \$ (515) | \$ 46,551 |
| Provision for loan losses | (4,029) | | | (4,029) |
| Noninterest income | 12,353 | 2,626 | (227) | 14,752 |
| Noninterest expense | (34,947) | (2,237) | (1,063) | (38,247) |
| Income (loss) before income taxes | 20,443 | 389 | (1,805) | 19,027 |
| Income tax (expense) benefit | (6,056) | (154) | 569 | (5,641) |
| Net income (loss) | \$ 14,387 | \$ 235 | \$ (1,236) | \$ 13,386 |

Table of Contents

ITEM 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

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, 2014. In addition, please read this section in conjunction with our Consolidated Financial Statements and Notes to Consolidated Financial Statements contained herein.

FORWARD LOOKING INFORMATION

Statements and financial analysis contained in this document that are based on other than historical data are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995.

Forward-looking statements provide current expectations or forecasts of future events and include, among others:

statements with respect to the beliefs, plans, objectives, goals, guidelines, expectations, anticipations, and future financial condition, results of operations and performance of Financial Institutions, Inc. and our subsidiaries; and

statements preceded by, followed by or that include the words may, could, should, would, believe, and estimate, expect, intend, plan, projects, or similar expressions.

These forward-looking statements are not guarantees of future performance, nor should they be relied upon as representing management's views as of any subsequent date. Forward-looking statements involve significant risks and uncertainties and actual results may differ materially from those presented, either expressed or implied, in this document and our Annual Report on Form 10-K for the fiscal year ended December 31, 2014, which we refer to as the Form 10-K, including, but not limited to, those presented in the Management's Discussion and Analysis of Financial Condition and Results of Operations. Factors that might cause such differences include, but are not limited to:

greater credit losses than anticipated;

changes in our tax strategies and the value of our deferred tax assets;

limited geographic concentration;

failure to obtain accurate and complete information about or from customers and counterparties;

insurance industry risks on our insurance brokerage subsidiary;

environmental liability risk associated with our lending activities;

changes in the quality or composition of our loan or investment portfolios;

risks through our indirect lending;

changes in banking laws, regulations and regulatory practices;

new or changing tax and accounting rules and interpretations;

legal and regulatory proceedings and related matters;

a breach in security of our information systems, including the occurrence of a cyber incident or a deficiency in cyber security;

technological changes;

failure of other companies to provide key components of our business infrastructure;

incorrect modeling assumptions for business planning purposes;

the failure to attract and retain skilled people;

interest rate risk, changes in interest rate risk and changes in real estate values;

conditions in the financial markets and economic conditions generally;

the fiscal and monetary policies of the federal government and its agencies;

goodwill impairment;

competition in our market area; and

severe weather, natural disasters, acts of war or terrorism, and other external events.

We caution readers not to place undue reliance on any forward-looking statements, which speak only as of the date made, and advise readers that various factors, including those described above, could affect our financial performance and could cause our actual results or circumstances for future periods to differ materially from those anticipated or projected. See also Item 1A, Risk Factors in the Form 10-K for further information. Except as required by law, we do

not undertake, and specifically disclaim 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.

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

Financial Institutions, Inc. (the "Parent") is a financial holding company headquartered in New York State, providing banking and nonbanking financial services to individuals, municipalities and businesses primarily in Western and Central New York. We offer a broad array of deposit, lending and other financial services to individuals, municipalities and businesses primarily in Western and Central New York through our wholly-owned New York chartered banking subsidiary, Five Star Bank. Our indirect lending network includes relationships with franchised automobile dealers in Western and Central New York, the Capital District of New York and Northern Pennsylvania. We also offer insurance services through our wholly-owned insurance subsidiary, Scott Danahy Naylor, LLC ("SDN"), a full service insurance agency which we acquired during the third quarter of 2014. References in this report to "the Company", "we", "our" or "us" mean the consolidated reporting entity and references to "the Bank" mean Five Star Bank.

Our primary sources of revenue are net interest income (interest earned on our loans and securities, net of interest paid on deposits and other funding sources) and noninterest income, particularly fees and other revenue from insurance and financial services provided to customers or ancillary services tied to loans and deposits. Business volumes and pricing drive revenue potential, and tend to be influenced by overall economic factors, including market interest rates, business spending, consumer confidence, economic growth, and competitive conditions within the marketplace. We are not able to predict market interest rate fluctuations with certainty and our asset/liability management strategy may not prevent interest rate changes from having a material adverse effect on our results of operations and financial condition.

Our business strategy has been to maintain a community bank philosophy, which consists of focusing on and understanding the individualized banking needs of individuals, municipalities and businesses of the local communities surrounding our primary service areas. We believe this focus allows us to be more responsive to our customers' needs and provide a high level of personal service that differentiates us from larger competitors, resulting in long-standing and broad based banking relationships. Our core customers are primarily small to medium-sized businesses, individuals and community organizations, which prefer to build banking and insurance relationships with a community bank that combines high quality, competitively-priced products and services with personalized service. Because of our identity and origin as a locally operated bank, we believe that our level of personal service provides a competitive advantage over larger banks, which tend to consolidate decision-making authority outside local communities.

A key aspect of our current business strategy is to foster a community-oriented culture where our customers and employees establish long-standing and mutually beneficial relationships. We believe that we are well-positioned to be a strong competitor within our market area because of our focus on community banking needs and customer service, our comprehensive suite of deposit, loan and insurance products typically found at larger banks, our highly experienced management team and our strategically located banking centers. We believe that the foregoing factors all help to grow our core deposits, which supports a central element of our business strategy - the growth of a diversified and high-quality loan portfolio.

EXECUTIVE OVERVIEW**Summary of 2015 Second Quarter Results**

Net income decreased \$447 thousand or 6% to \$6.6 million for the second quarter of 2015 compared to \$7.0 million for the second quarter of 2014. Net income available to common shareholders for the second quarter of 2015 was \$6.2

million, or \$0.44 per diluted share, compared with \$6.7 million, or \$0.48 per diluted share, for the second quarter of last year. Return on average common equity was 9.24% and return on average assets was 0.81% for the second quarter of 2015 compared to 10.66% and 0.95%, respectively, for the second quarter of 2014.

Competitive pricing pressure in all loan categories and the continuation of a low interest-rate environment, along with our diminishing ability to reduce our cost of funds, continues to place pressure on our net interest margin and net interest income. Net interest income totaled \$23.4 million in the second quarter 2015, up from \$23.1 million in the second quarter 2014. Average earning assets were up \$240.8 million, led by a \$153.8 million increase in investment securities and an \$87.1 million increase in loans in the second quarter of 2015 compared to the same quarter in 2014. The growth in earning assets was partially offset by a lower net interest margin. Second quarter 2015 net interest margin was 3.24%, a decrease of 23 basis points from 3.47% reported in the second quarter of 2014. The decrease in net interest margin reflects lower yields on average earning assets as a result of the low interest rate environment, a slight shift in the composition of average earnings assets as well as increased interest expense related to the subordinated debt issued in April 2015. Average loans and average securities totaled 65.6% and 34.4%, respectively, of average earning assets for the quarter ended June 30, 2015, compared with 68.2% and 31.8%, respectively for the quarter ended June 30, 2014. The \$40.0 million subordinated debt issuance completed in April 2015 strengthened the Bank's capital ratios but reduced the net interest margin in the second quarter by approximately 8 basis points.

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

The provision for loans losses was \$1.3 million in the second quarter of 2015 compared to \$1.8 million in the second quarter of 2014, primarily a result of a decrease in net charge-offs when comparing the same periods. Net charge-offs were \$979 thousand during the second quarter of 2015, a \$765 thousand decrease from the second quarter of 2014. Net charge-offs expressed as an annualized percentage of average loans outstanding were 0.20% during the second quarter of 2015 compared with 0.37% in the second quarter of 2014. See the **Allowance for Loan Losses** and **Non-Performing Assets and Potential Problem Loans** sections of this Management's Discussion and Analysis for further discussion regarding the decreases in the provision for loan losses and net-charge-offs.

Noninterest income totaled \$6.5 million in the second quarter of 2015, compared to \$6.6 million in the second quarter of 2014. Included in these totals are gains realized from the sale of investment securities. Exclusive of those gains, noninterest income was \$6.5 million in the recently completed quarter and \$5.6 million in the second quarter of 2014. The higher noninterest income in the second quarter of 2015 compared to the second quarter of 2014 is primarily a result of a \$1.0 million increase in insurance income, reflecting the contributions from SDN.

Noninterest expense in the second quarter of 2015 totaled \$19.2 million compared with \$17.8 million in the second quarter of 2014. The increase in noninterest expense was largely due to expense attributable to SDN, which we did not own until the third quarter of 2014, and the hiring of additional personnel associated with our expansion initiatives.

The regulatory common equity Tier 1 ratio and total risk-based capital ratio were 9.50%, and 13.17%, respectively, for the second quarter of 2015. See the **Liquidity and Capital Management** section of this Management's Discussion and Analysis for further discussion regarding regulatory capital and the Basel III capital rules, which became effective January 1, 2015.

Issuance of Subordinated Notes

On April 15, 2015, the Parent issued \$40.0 million of 6.0% fixed to floating rate subordinated notes due April 15, 2030 (the **Subordinated Notes**) to certain accredited investors. The Subordinated Notes bear interest at a fixed rate of 6.0% per year, payable semi-annually, for the first 10 years. From April 15, 2025 to April 15, 2030, the interest rate will reset quarterly to an annual interest rate equal to the then current three-month London Interbank Offered Rate (LIBOR) plus 3.944%, payable quarterly. The Subordinated Notes are redeemable by us at any quarterly interest payment date beginning on April 15, 2025 to maturity at par, plus accrued and unpaid interest. The net proceeds from this offering were intended for general corporate purposes, including but not limited to, contribution of capital to the Bank to support both organic growth as well as opportunistic acquisitions. The Parent company contributed \$34.0 million of net proceeds from this offering to the Bank as capital to support general corporate purposes. The notes qualify as Tier 2 capital for regulatory purposes.

We utilized the proceeds of the Subordinated Notes to purchase high-quality investment securities, comprised of mortgage-backed securities, U.S. Government agencies and sponsored enterprise bonds and tax-exempt municipal bonds. All of the securities purchased were of high credit quality with a low to moderate duration. The issuance of the Subordinated Notes decreased second quarter 2015 net interest margin by approximately 8 basis points.

RESULTS OF OPERATIONS**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 shareholders 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.

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

The following table reconciles interest income per the consolidated statements of income to interest income adjusted to a fully taxable equivalent basis (dollars in thousands):

| | Three months ended June 30, | | Six months ended June 30, | |
|--|-----------------------------|-----------|---------------------------|-----------|
| | 2015 | 2014 | 2015 | 2014 |
| Interest income per consolidated statements of income | \$ 25,959 | \$ 24,883 | \$ 50,956 | \$ 49,942 |
| Adjustment to fully taxable equivalent basis | 777 | 701 | 1,529 | 1,396 |
| Interest income adjusted to a fully taxable equivalent basis | 26,736 | 25,584 | 52,485 | 51,338 |
| Interest expense per consolidated statements of income | 2,555 | 1,780 | 4,405 | 3,564 |
| Net interest income on a taxable equivalent basis | \$ 24,181 | \$ 23,804 | \$ 48,080 | \$ 47,774 |

2015 Leverage Strategy

During the second quarter of 2015, we utilized the proceeds of short-term FHLB advances to purchase high-quality investment securities of approximately \$50 million. Our purchase of investment securities was comprised of mortgage-backed securities, U.S. Government agencies and sponsored enterprise bonds and tax-exempt municipal bonds. All of the securities purchased were of high credit quality with a low to moderate duration. This strategy allowed us to increase net interest income by taking advantage of the positive interest rate spread between the FHLB advances and the newly acquired investment securities.

Analysis of Net Interest Income for the Three Months ended June 30, 2015 and 2014

Net interest income on a taxable equivalent basis for the three months ended June 30, 2015, was \$24.2 million, an increase of \$377 thousand or 2% versus the comparable quarter last year. The increase in net interest income was due to an increase in average earning assets of \$240.8 million or 9% compared to the second quarter of 2014. The increase in earning assets included an \$87.1 million increase in average loans and a \$153.8 million increase in average investment securities.

The net interest margin for the second quarter of 2015 was 3.24%, 23 basis points lower than 3.47% for the same period in 2014. This comparable period decrease was a function of a 25 basis point decrease in interest rate spread, partially offset by a higher contribution from net free funds of 2 basis points (due principally to lower rates on interest-bearing liabilities reducing the value of noninterest-bearing deposits and other net free funds). The lower interest rate spread was a result of a 15 basis point decrease in the yield on earning assets and a 10 basis point increase in the cost of interest-bearing liabilities. As previously discussed, the issuance of the Subordinated Notes reduced the net interest margin for the second quarter of 2015 by approximately 8 basis points.

For the second quarter of 2015, the yield on average earning assets of 3.58% was 15 basis points lower than the second quarter of 2014. Loan yields decreased 14 basis points during the second quarter of 2015 to 4.18%. Commercial business and commercial mortgage loan yields in particular, down 13 and 23 basis points, respectively, experienced lower yields because of competitive pricing pressures in a low interest rate environment. The yield on investment securities decreased 1 basis point during the second quarter of 2015 to 2.44%. Overall, the earning asset rate changes reduced interest income by \$619 thousand during the second quarter of 2015, but that was more than offset by a favorable volume variance that increased interest income by \$1.8 million, which collectively drove a \$1.2 million increase in interest income.

The cost of average interest-bearing liabilities of 0.43% in the second quarter of 2015 was 10 basis points higher than the second quarter of 2014. The cost of average interest-bearing deposits and short-term borrowings each increased 2 basis points to 0.35% and 0.38%, respectively, in the second quarter of 2015 compared to the same quarter of 2014. The cost of long-term borrowings for the second quarter of 2015 was 6.23% due to the issuance of the Subordinated Notes in April. Overall, interest-bearing liability rate and volume increases resulted in \$775 thousand of higher interest expense.

Average interest-earning assets were \$2.99 billion for the second quarter 2015, an increase of \$240.8 million or 9% from the comparable quarter last year, with average loans up \$87.1 million and average securities up \$153.8 million. The growth in average loans was comprised of increases in most loan categories, with consumer and commercial loans up \$54.3 million and \$44.9 million, respectively, partially offset by a \$12.1 million decrease in residential mortgage loans. Loans represented 65.6% of average interest-earning assets during second quarter of 2015 compared to 68.2% during the second quarter of 2014. The yield on average loans was 4.18% for the second quarter of 2015, a decrease of 14 basis points compared to 4.32% for the second quarter of 2014. The yield on average loans was negatively impacted by lower average spreads due to increased competition in loan pricing during 2015 compared to 2014. The growth in average securities was primarily a result of securities purchased with proceeds from our previously described leverage strategy and issuance of the Subordinated Notes. Securities represented 34.4% of average interest-earning assets during second quarter of 2015 compared to 31.8% during the second quarter of 2014. The increase in the volume of average securities resulted in a \$920 thousand increase in interest income, coupled with a \$16 thousand increase due to the favorable rate variance.

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

Average interest-bearing liabilities of \$2.37 billion in the second quarter of 2015 were \$212.9 million or 10% higher than the second quarter of 2014. On average, interest-bearing deposits grew \$178.1 million, while noninterest-bearing demand deposits (a principal component of net free funds) were up \$49.5 million. The increase in average deposits was largely due to an increase in deposits from our Insured Cash Sweep (ICS) programs. For further discussion of the Certificate of Deposit Account Registry Service (CDARS) and ICS programs, refer to the Funding Activities - Deposits section of this Management's Discussion and Analysis. Overall, interest-bearing deposit rate and volume changes resulted in \$250 thousand of higher interest expense during the second quarter of 2015. Average short-term and long-term borrowings increased \$1.8 million and \$33.1 million, respectively, between the second quarter periods. The increase in average long-term borrowings for the second quarter of 2015 was due to the issuance of the Subordinated Notes in April.

Analysis of Net Interest Income for the Six Months ended June 30, 2015 and June 30, 2014

Net interest income on a taxable equivalent basis for the first six months of 2015 was \$48.1 million compared to \$47.8 million for the same period last year. The increase in net interest income was due to an increase in average earning assets of \$155.4 million or 6% compared to the first six months of 2014.

The net interest margin for the first six months of 2015 was 3.33%, 16 basis points lower than 3.49% for the same period last year. This comparable period decrease was a function of an 18 basis point decrease in interest rate spread to 3.25% during the first six months of 2015, partially offset by a 2 basis point higher contribution from net free funds. The lower interest rate spread was a net result of a 13 basis point decrease in the yield on earning assets and a 5 basis point increase in the cost of interest-bearing liabilities.

The yield on earning assets was 3.63% for the first six months of 2015, 13 basis points lower than the same period last year, primarily attributable to a decrease in the yields on the loan portfolio during the period (down 17 basis points to 4.22%), partially offset by an increase in the yields on the investment securities portfolio (up 2 basis points, to 2.46%). Overall, earning asset rate changes reduced interest income by \$1.3 million during the first half of 2015, but that was more than offset by a favorable volume variance that increased interest income by \$2.4 million, which collectively drove a \$1.1 million increase in interest income.

The cost on interest-bearing liabilities of 0.38% for the first six months of 2015 was 5 basis points higher than the same period in 2014. Rates on interest-bearing deposits were up 1 basis point to 0.34%. The cost of long-term borrowings for the first half of 2015 was 6.20% due to the issuance of the Subordinated Notes in April. Overall, interest-bearing liability rate and volume increases resulted in \$841 thousand of higher interest expense.

Average interest-earning assets were \$2.91 billion for the first six months of 2015, an increase of \$155.4 million or 6% from the comparable period last year, with average loans up \$76.6 million and average securities up \$79.0 million. The growth in average loans was comprised of increases in most loan categories, with commercial and consumer loans up \$25.4 million and \$64.3 million, respectively, partially offset by a \$13.1 million decrease in residential mortgage loans.

Average interest-bearing liabilities of \$2.31 billion in the first six months of 2015 were \$146.4 million or 7% higher than the first six months of 2014. On average, interest-bearing deposits grew \$140.2 million, while noninterest-bearing demand deposits were up \$44.9 million and average short-term borrowings decreased \$10.4 million. Average

long-term borrowings increased \$16.6 million during the first half of 2015 due to the issuance of the Subordinated Notes in April.

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

The following tables set 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).

| | Three months ended June 30, | | | | | |
|--|-----------------------------|---------------------|-----------------|--------------------|---------------------|-----------------|
| | 2015 | | | 2014 | | |
| | Average Balance | Average Interest | Average Rate | Average Balance | Average Interest | Average Rate |
| Interest-earning assets: | | | | | | |
| Federal funds sold and interest-earning deposits | \$ 26 | \$ | 0.39% | \$ 94 | \$ | 0.07% |
| Investment securities ⁽¹⁾ : | | | | | | |
| Taxable | 741,355 | 4,069 | 2.20 | 621,967 | 3,353 | 2.16 |
| Tax-exempt ⁽²⁾ | 288,285 | 2,221 | 3.08 | 253,888 | 2,001 | 3.15 |
| Total investment securities | 1,029,640 | 6,290 | 2.44 | 875,855 | 5,354 | 2.45 |
| Loans: | | | | | | |
| Commercial business | 284,535 | 2,922 | 4.12 | 275,105 | 2,912 | 4.25 |
| Commercial mortgage | 509,317 | 5,823 | 4.59 | 473,883 | 5,692 | 4.82 |
| Residential mortgage | 96,474 | 1,134 | 4.70 | 108,535 | 1,306 | 4.81 |
| Home equity | 390,135 | 3,733 | 3.84 | 346,911 | 3,428 | 3.96 |
| Consumer indirect | 664,222 | 6,281 | 3.79 | 651,150 | 6,297 | 3.88 |
| Other consumer | 18,848 | 553 | 11.76 | 20,855 | 595 | 11.44 |
| Total loans | 1,963,531 | 20,446 | 4.18 | 1,876,439 | 20,230 | 4.32 |
| Total interest-earning assets | 2,993,197 | 26,736 | 3.58 | 2,752,388 | 25,584 | 3.73 |
| Allowance for loan losses | (27,924) | | | (27,551) | | |
| Other noninterest-earning assets | 297,838 | | | 248,898 | | |
| Total assets | \$ 3,263,111 | | | \$ 2,973,735 | | |
| Interest-bearing liabilities: | | | | | | |
| Deposits: | | | | | | |
| Interest-bearing demand | \$ 561,570 | \$ 197 | 0.14% | \$ 509,398 | \$ 151 | 0.12% |
| Savings and money market | 929,701 | 289 | 0.12 | 789,956 | 232 | 0.12 |
| Time deposits | 616,145 | 1,341 | 0.87 | 629,945 | 1,194 | 0.76 |
| Total interest-bearing deposits | 2,107,416 | 1,827 | 0.35 | 1,929,299 | 1,577 | 0.33 |
| Short-term borrowings | 226,577 | 213 | 0.38 | 224,801 | 203 | 0.36 |
| Long-term borrowings | 33,053 | 515 | 6.23 | | | |

Edgar Filing: FINANCIAL INSTITUTIONS INC - Form 10-Q

| | | | | | | |
|--|--------------|-----------|---------|--------------|-----------|---------|
| Total borrowings | 259,630 | 728 | 1.12 | 224,801 | 203 | 0.36 |
| Total interest-bearing liabilities | 2,367,046 | 2,555 | 0.43 | 2,154,100 | 1,780 | 0.33 |
| Noninterest-bearing demand deposits | 587,396 | | | 537,895 | | |
| Other noninterest-bearing liabilities | 21,320 | | | 13,583 | | |
| Shareholders equity | 287,349 | | | 268,157 | | |
| Total liabilities and shareholders equity | \$ 3,263,111 | | | \$ 2,973,735 | | |
| Net interest income (tax-equivalent) | | \$ 24,181 | | | \$ 23,804 | |
| Interest rate spread | | | 3.15% | | | 3.40% |
| Net earning assets | \$ 626,151 | | | \$ 598,288 | | |
| Net interest margin (tax-equivalent) | | | 3.24% | | | 3.47% |
| Ratio of average interest-earning assets to average interest-bearing liabilities | | | 126.45% | | | 127.77% |

(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%.

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

| | Six months ended June 30, | | | | | |
|--|---------------------------|----------|-----------------|--------------------|----------|-----------------|
| | 2015 | | | 2014 | | |
| | Average Balance | Interest | Average Rate | Average Balance | Interest | Average Rate |
| Interest-earning assets: | | | | | | |
| Federal funds sold and interest-earning deposits | \$ 75 | \$ | 0.23% | \$ 204 | \$ | 0.08% |
| Investment securities ⁽¹⁾ : | | | | | | |
| Taxable | 686,299 | 7,532 | 2.20 | 638,151 | 6,854 | 2.15 |
| Tax-exempt ⁽²⁾ | 282,792 | 4,370 | 3.09 | 251,917 | 3,987 | 3.17 |
| Total investment securities | 969,091 | 11,902 | 2.46 | 890,068 | 10,841 | 2.44 |
| Loans: | | | | | | |
| Commercial business | 274,729 | 5,646 | 4.14 | 270,148 | 5,823 | 4.35 |
| Commercial mortgage | 494,095 | 11,374 | 4.64 | 473,312 | 11,198 | 4.77 |
| Residential mortgage | 97,861 | 2,308 | 4.72 | 110,949 | 2,679 | 4.83 |
| Home equity | 388,102 | 7,445 | 3.87 | 337,922 | 6,711 | 4.00 |
| Consumer indirect | 662,982 | 12,707 | 3.86 | 646,720 | 12,881 | 4.02 |
| Other consumer | 19,290 | 1,103 | 11.53 | 21,455 | 1,205 | 11.32 |
| Total loans | 1,937,059 | 40,583 | 4.22 | 1,860,506 | 40,497 | 4.39 |
| Total interest-earning assets | 2,906,225 | 52,485 | 3.63 | 2,750,778 | 51,338 | 3.76 |
| Allowance for loan losses | (27,904) | | | (27,153) | | |
| Other noninterest-earning assets | 311,400 | | | 245,966 | | |
| Total assets | \$ 3,189,721 | | | \$ 2,969,591 | | |
| Interest-bearing liabilities: | | | | | | |
| Deposits: | | | | | | |
| Interest-bearing demand | \$ 556,564 | \$ 353 | 0.13% | \$ 510,231 | \$ 311 | 0.12% |
| Savings and money market | 884,709 | 506 | 0.12 | 775,956 | 467 | 0.12 |
| Time deposits | 609,169 | 2,588 | 0.86 | 624,068 | 2,324 | 0.75 |
| Total interest-bearing deposits | 2,050,442 | 3,447 | 0.34 | 1,910,255 | 3,102 | 0.33 |
| Short-term borrowings | 239,103 | 443 | 0.37 | 249,470 | 462 | 0.37 |
| Long-term borrowings | 16,618 | 515 | 6.20 | | | |
| Total borrowings | 255,721 | 958 | 0.75 | 249,470 | 462 | 0.37 |
| Total interest-bearing liabilities | 2,306,163 | 4,405 | 0.38 | 2,159,725 | 3,564 | 0.33 |
| Noninterest-bearing demand deposits | 576,011 | | | 531,158 | | |

Edgar Filing: FINANCIAL INSTITUTIONS INC - Form 10-Q

| | | |
|--|--------------|--------------|
| Other noninterest-bearing liabilities | 21,386 | 13,800 |
| Shareholders equity | 286,161 | 264,908 |
| Total liabilities and shareholders equity | \$ 3,189,721 | \$ 2,969,591 |
| Net interest income (tax-equivalent) | \$ 48,080 | \$ 47,774 |
| Interest rate spread | 3.25% | 3.43% |
| Net earning assets | \$ 600,062 | \$ 591,053 |
| Net interest margin (tax-equivalent) | 3.33% | 3.49% |
| Ratio of average interest-earning assets to average interest-bearing liabilities | 126.02% | 127.37% |

- 37 -

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 income 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):

| | Three months ended June 30, 2015 vs. 2014 | | | Six months ended June 30, 2015 vs. 2014 | | |
|--|--|--------------|--------------|--|----------------|--------------|
| | Volume | Rate | Total | Volume | Rate | Total |
| Increase (decrease) in: | | | | | | |
| Interest income: | | | | | | |
| Federal funds sold and interest-earning deposits | \$ | \$ | \$ | \$ | \$ | \$ |
| Investment securities: | | | | | | |
| Taxable | 654 | 62 | 716 | 526 | 152 | 678 |
| Tax-exempt | 266 | (46) | 220 | 479 | (96) | 383 |
| Total investment securities | 920 | 16 | 936 | 1,005 | 56 | 1,061 |
| Loans: | | | | | | |
| Commercial business | 98 | (88) | 10 | 98 | (275) | (177) |
| Commercial mortgage | 413 | (282) | 131 | 483 | (307) | 176 |
| Residential mortgage | (143) | (29) | (172) | (310) | (61) | (371) |
| Home equity | 417 | (112) | 305 | 969 | (235) | 734 |
| Consumer indirect | 125 | (141) | (16) | 319 | (493) | (174) |
| Other consumer | (59) | 17 | (42) | (124) | 22 | (102) |
| Total loans | 851 | (635) | 216 | 1,435 | (1,349) | 86 |
| Total interest income | 1,771 | (619) | 1,152 | 2,440 | (1,293) | 1,147 |
| Interest expense: | | | | | | |
| Deposits: | | | | | | |
| Interest-bearing demand | 16 | 30 | 46 | 29 | 13 | 42 |
| Savings and money market | 42 | 15 | 57 | 63 | (24) | 39 |
| Time deposits | (27) | 174 | 147 | (56) | 320 | 264 |
| Total interest-bearing deposits | 31 | 219 | 250 | 36 | 309 | 345 |
| Short-term borrowings | 2 | 8 | 10 | (19) | | (19) |
| Long-term borrowings | 258 | 257 | 515 | 258 | 257 | 515 |
| Total borrowings | 260 | 265 | 525 | 239 | 257 | 496 |
| Total interest expense | 291 | 484 | 775 | 275 | 566 | 841 |

| | | | | | | |
|----------------------------|----------|------------|--------|----------|------------|--------|
| Net interest income | \$ 1,480 | \$ (1,103) | \$ 377 | \$ 2,165 | \$ (1,859) | \$ 306 |
|----------------------------|----------|------------|--------|----------|------------|--------|

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 \$1.3 million and \$4.0 million for the three and six month periods ended June 30, 2015, compared with provisions of \$1.8 million and \$3.9 million for the corresponding periods in 2014, respectively. See the Allowance for Loan Losses and Non-Performing Assets and Potential Problem Loans sections of this Management's Discussion and Analysis for further discussion.

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 | | Six months ended | |
|---|--------------------|-----------------|------------------|------------------|
| | June 30, | | June 30, | |
| | 2015 | 2014 | 2015 | 2014 |
| Service charges on deposits | \$ 1,964 | \$ 2,241 | \$ 3,843 | \$ 4,491 |
| Insurance income | 1,057 | 16 | 2,665 | 57 |
| ATM and debit card | 1,283 | 1,257 | 2,476 | 2,431 |
| Investment advisory | 541 | 561 | 1,028 | 1,123 |
| Company owned life insurance | 493 | 425 | 960 | 828 |
| Investments in limited partnerships | 55 | 81 | 529 | 707 |
| Loan servicing | 96 | 176 | 263 | 330 |
| Net gain on sale of loans held for sale | 39 | 50 | 108 | 155 |
| Net gain on disposal of investment securities | | 949 | 1,062 | 1,262 |
| Net gain (loss) on disposal of other assets | 16 | 24 | 20 | (11) |
| Other | 911 | 797 | 1,798 | 1,561 |
| Total noninterest income | \$ 6,455 | \$ 6,577 | \$ 14,752 | \$ 12,934 |

Service charges on deposit accounts decreased \$277 thousand or 12% in the second quarter of 2015 and \$648 thousand or 14% for the six months ended June 30, 2015, compared to the same periods a year earlier. The decreases were primarily due to a decrease in the amount of checking account overdraft activity.

Insurance income increased \$1.0 million and \$2.6 million for the three and six months ended June 30, 2015, respectively, over the same periods in 2014. The increases reflect the contributions from SDN, which was acquired during the third quarter 2014 as part of the Company's strategy to diversify its business lines and increase noninterest income through additional fee-based services.

Investment advisory income decreased \$20 thousand or 4% and \$95 thousand or 8%, in the three and six months ended June 30, 2015, respectively, compared to the same periods of 2014. Investment advisory income fluctuates mainly due to sales volume, which decreased during the first half of 2015.

Company owned life insurance increased by \$68 thousand or 16% in the second quarter of 2015 and \$132 thousand or 16% for the six months ended June 30, 2015, compared to the same periods a year earlier. The increases were primarily due to new policies purchased during the third and fourth quarters of 2014.

We have investments in limited partnerships, primarily small business investment companies, and account for these investments under the equity method. Income from investments in limited partnerships was \$55 thousand and \$529 thousand for the three and six months ended June 30, 2015, respectively. The income from these equity method investments fluctuates based on the performance of the underlying investments.

Loan servicing income decreased \$80 thousand and \$67 thousand during the three and six months ended June 30, 2015, compared to the same periods a year earlier, primarily due to lower fees collected as a result of a decrease in the sold and serviced portfolio.

During the first quarter of 2015 we recognized net gains on investment securities totaling \$1.1 million from the sale of six agency securities and nine mortgage backed securities. There were no sales of securities during the second quarter of 2015. We recognized pre-tax gains on investment securities of \$313 thousand from the sale of 6 securities during the first quarter of 2014 and gains of \$949 thousand from the sale of 15 securities during the second quarter of 2014. 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 \$114 thousand or 14% in the second quarter of 2015 and \$237 thousand or 15% for the six months ended June 30, 2015, compared to the same periods a year earlier. Merchant services income and credit card correspondent income comprised the majority of the comparable 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 | | Six months ended | |
|----------------------------------|---------------------|------------------|-------------------------|------------------|
| | ended | | June 30, | |
| | June 30, | 2014 | 2015 | 2014 |
| Salaries and employee benefits | \$ 10,606 | \$ 9,063 | \$ 20,829 | \$ 18,319 |
| Occupancy and equipment | 3,375 | 3,139 | 7,074 | 6,374 |
| Professional services | 866 | 1,384 | 1,834 | 2,356 |
| Computer and data processing | 810 | 777 | 1,512 | 1,500 |
| Supplies and postage | 508 | 535 | 1,071 | 1,047 |
| FDIC assessments | 415 | 388 | 833 | 810 |
| Advertising and promotions | 238 | 214 | 477 | 393 |
| Other | 2,418 | 2,308 | 4,617 | 4,222 |
| Total noninterest expense | \$ 19,236 | \$ 17,808 | \$ 38,247 | \$ 35,021 |

During the three and six month periods ended June 30, 2015, salaries and employee benefits increased by \$1.5 million and \$2.5 million, respectively, when compared to the same periods one year earlier. Salaries expense increased \$1.0 million and \$2.1 million for the three and six months ended June 30, 2015, respectively, when compared to the same periods one year earlier. The increases in salaries expense reflect the SDN acquisition and the hiring of additional personnel associated with our expansion initiatives, both of which occurred during the second half of 2014. Employee benefits expense increased \$537 thousand and \$456 thousand for the three and six months ended June 30, 2015, respectively, when compared to the same periods one year earlier. The increases in employee benefits expense were primarily due to higher medical expenses and higher expense related to our defined benefit retirement plan. We typically experience higher medical claims in the second quarter each year under the Company's self-insured plan as more employees have converted to high-deductible health plans. We recognized a combined net periodic pension expense of \$182 thousand and \$365 thousand on our pension and post-retirement obligations during the three and six months ended June 30, 2015, respectively, compared to \$55 thousand and \$111 thousand during the three and six months ended June 30, 2014, respectively. Defined benefit pension expense increased during the three and six months ended June 30, 2015 compared to the same periods in 2014 primarily due to increased benefit plan cost from the use of a lower discount rate and the impact of changes in mortality assumptions.

Occupancy and equipment expense increased by \$236 thousand in the second quarter of 2015 and \$700 thousand for the six months ended June 30, 2015, when compared to the same periods one year earlier. The increases were primarily related to higher contractual service expenses and incremental expenses from the SDN facility.

Professional fees decreased \$518 thousand in the second quarter of 2015 and \$522 thousand in the six months ended June 30, 2015, compared to the same periods a year earlier. The second quarter of 2014 professional fees expense included professional services associated with the acquisition of SDN.

FDIC assessments increased \$27 thousand or 7% in the second quarter of 2015 and \$23 thousand or 3% for the six months ended June 30, 2015, compared to the same periods a year earlier. The increased assessments are a direct result of the growth in our balance sheet.

Advertising and promotions costs were up \$24 thousand in the second quarter of 2015 and \$84 thousand for the six months ended June 30, 2015, compared to the same periods a year earlier, due to the timing of marketing campaigns and promotions. We proactively market our products but vary the timing based on projected benefits and needs.

Other noninterest expense was \$2.4 million in the second quarter of 2015 and \$4.6 million for the six months ended June 30, 2015, representing increases of \$110 thousand and \$395 thousand, respectively, from the same periods in 2014. Other noninterest expense for the three and six months ended June 30, 2015 included increases of \$152 thousand and \$304 thousand, respectively, in intangible asset amortization attributable to the SDN acquisition.

The efficiency ratio for the second quarter of 2015 was 62.00% compared with 60.15% for the second quarter of 2014, and 61.13% for the six months ended June 30, 2015, compared to 58.54% for the same period a year ago. The efficiency ratio is calculated by dividing total noninterest expense, excluding other real estate expense and amortization of intangible assets, by net revenue, defined as the sum of tax-equivalent net interest income and noninterest income before net gains and impairment charges on investment securities. The broadening of our financial services and accompanying increased spending has resulted in a shift in our efficiency ratio as a measure of productivity. As we begin to provide more diversified financial services our efficiency ratio is expected to be in the low 60% range. This approach will decrease our sensitivity to traditional banking revenues which are subject to interest rate changes.

Table of Contents

MANAGEMENT'S DISCUSSION AND ANALYSIS

Income Taxes

We recorded income tax expense of \$2.8 million in the second quarter of 2015, compared to of \$3.1 million in the second quarter of 2014. For the six months ended June 30, 2015, income tax expense totaled \$5.6 million compared to \$6.2 million in the same period of 2014. The effective tax rates for the three and six month periods ended June 30, 2015 were 29.5% and 29.6%, respectively, in comparison to 30.5% and 30.2% for the three and six months ended June 30, 2014, respectively. The decreases in income tax expense were primarily due to lower pre-tax income. Effective tax rates are impacted by items of income and expense that are not subject to federal or state taxation. Our 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. In addition, our effective tax rate reflects the New York State tax savings generated by our real estate investment trust, which commenced operations during February 2014.

In March 2014, the New York legislature approved changes in the state tax law that will be phased-in over two years, beginning in 2015. The primary changes that impact us include the repeal of the Article 32 franchise tax on banking corporations (Article 32) for 2015, expanded nexus standards for 2015 and a reduction in the corporate tax rate for 2016. We expect the repeal of Article 32 and the expanded nexus standards to lower our taxable income apportioned to New York to 85% in 2015 from 100% in 2014. In addition, the New York state income tax rate will be reduced from 7.1% to 6.5% in 2016.

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

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

| | Investment Securities Portfolio Composition | | | |
|---|--|-----------------------|---------------------------|-----------------------|
| | June 30, 2015 | | December 31, 2014 | |
| | Amortized Cost | Fair Value | Amortized Cost | Fair Value |
| Securities available for sale: | | | | |
| U.S. Government agencies and government-sponsored enterprise securities | \$ 271,774 | \$ 270,077 | \$ 160,334 | \$ 160,475 |
| Mortgage-backed securities: | | | | |
| Agency mortgage-backed securities | 502,316 | 501,214 | 458,959 | 460,570 |
| Non-Agency mortgage-backed securities | | 1,123 | | 1,218 |
| Asset-backed securities | | 225 | | 231 |
| Total available for sale securities | 774,090 | 772,639 | 619,293 | 622,494 |
| Securities held to maturity: | | | | |
| State and political subdivisions | 289,713 | 294,052 | 277,273 | 281,384 |
| Mortgage-backed securities | 31,107 | 30,821 | 17,165 | 17,311 |
| Total held to maturity securities | 320,820 | 324,873 | 294,438 | 298,695 |
| Total investment securities | \$ 1,094,910 | \$ 1,097,512 | \$ 913,731 | \$ 921,189 |

The available for sale (AFS) investment securities portfolio increased \$150.1 million or 24%, from \$622.5 million at December 31, 2014 to \$772.6 million at June 30, 2015. The AFS portfolio had net unrealized losses totaling \$1.5 million at June 30, 2015 and unrealized gains totaling \$3.2 million at December 31, 2014, respectively. The unrealized losses in the AFS portfolio were predominantly caused by changes in market interest rates. The fair value of most of the investment securities in the AFS portfolio fluctuates as market interest rates change.

Impairment Assessment

We review investment securities on an ongoing basis for the presence of other than temporary impairment (OTTI) with formal reviews performed quarterly. Declines in the fair value of held to maturity and available for sale securities below their cost that are deemed to be other than temporary are reflected in earnings as realized losses to the extent the impairment is related to credit losses or the security is intended to be sold or will be required to be sold. The amount

of the impairment related to non-credit related factors is recognized in other comprehensive income. Evaluating whether the impairment of a debt security is other than temporary involves assessing the intent to sell the debt security or the likelihood of being required to sell the security before the recovery of its amortized cost basis. In determining whether the OTTI includes a credit loss, we use our best estimate of the present value of cash flows expected to be collected from the debt security considering factors such as: the length of time and the extent to which the fair value has been less than the amortized cost basis, adverse conditions specifically related to the security, an industry, or a geographic area, the historical and implied volatility of the fair value of the security, the payment structure of the debt security and the likelihood of the issuer being able to make payments that increase in the future, failure of the issuer of the security to make scheduled interest or principal payments, any changes to the rating of the security by a rating agency, and recoveries or additional declines in fair value subsequent to the balance sheet date. 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.

Securities Deemed to be Other-Than-Temporarily Impaired

There were no securities deemed to be other-than-temporarily impaired during the six month periods ended June 30, 2015 and 2014.

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

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

| | Loan Portfolio Composition | | | |
|---------------------------|----------------------------|------------|-------------------|------------|
| | June 30, 2015 | | December 31, 2014 | |
| | Amount | % of Total | Amount | % of Total |
| Commercial business | \$ 292,791 | 14.6% | \$ 267,409 | 14.0% |
| Commercial mortgage | 536,590 | 26.7 | 475,092 | 24.9 |
| Total commercial | 829,381 | 41.3 | 742,501 | 38.9 |
| Residential mortgage | 95,162 | 4.7 | 100,101 | 5.2 |
| Home equity | 398,854 | 19.8 | 386,615 | 20.2 |
| Consumer indirect | 666,550 | 33.2 | 661,673 | 34.6 |
| Other consumer | 19,326 | 1.0 | 21,112 | 1.1 |
| Total consumer | 1,084,730 | 54.0 | 1,069,400 | 55.9 |
| Total loans | 2,009,273 | 100.0% | 1,912,002 | 100.0% |
| Allowance for loan losses | 27,500 | | 27,637 | |
| Total loans, net | \$ 1,981,773 | | \$ 1,884,365 | |

Total loans increased \$97.3 million, or 5%, to \$2.00 billion at June 30, 2015 from \$1.91 billion at December 31, 2014. The increase in loans was attributable to organic growth, primarily in the commercial loan portfolios.

Commercial loans increased \$86.9 million and represented 41.3% of total loans as of June 30, 2015, a result of our continued commercial business development efforts.

Residential mortgage loans decreased \$4.9 million to \$95.2 million as of June 30, 2015 in comparison to \$100.1 million as of December 31, 2014. This category of loans decreased as we continue to sell the majority of our newly originated and refinanced residential mortgages to the secondary market rather than adding them to our portfolio.

Our home equity portfolio, which consists of home equity loans and lines, totaled \$398.9 million and represented 19.8% of total loans as of June 30, 2015. Approximately 81% of the loans in the home equity portfolio were first lien positions as of June 30, 2015.

The consumer indirect portfolio totaled \$666.6 million as of June 30, 2015 and represented 33.2% of total loans as of June 30, 2015. During the first six months of 2015, we originated \$149.3 million in indirect auto loans with a mix of

approximately 41% new auto and 59% used auto. This compares with \$158.7 million in indirect auto loans with a mix of approximately 42% new auto and 58% used auto for the same period in 2014. Our origination volumes and mix of new and used vehicles financed fluctuates depending on general market conditions.

Loans Held for Sale and Loan Servicing Rights

Loans held for sale (not included in the loan portfolio composition table) were entirely comprised of residential real estate mortgages and totaled \$448 thousand and \$755 thousand as of June 30, 2015 and December 31, 2014, respectively.

We sell certain qualifying newly originated or refinanced residential real estate mortgages on the secondary market. Residential real estate mortgages serviced for others, which are not included in the consolidated statements of financial condition, amounted to \$204.9 million and \$215.2 million as of June 30, 2015 and December 31, 2014, respectively, as runoff outpaced production in the first six months of 2015.

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).

| | Loan Loss Analysis | | | |
|--|------------------------------------|--------------|----------------------------------|--------------|
| | Three months ended June 30, | | Six months ended June 30, | |
| | 2015 | 2014 | 2015 | 2014 |
| Balance as of beginning of period | \$ 27,191 | \$ 27,152 | \$ 27,637 | \$ 26,736 |
| Charge-offs: | | | | |
| Commercial business | 13 | 3 | 1,154 | 71 |
| Commercial mortgage | 201 | 165 | 810 | 165 |
| Residential mortgage | 22 | 69 | 77 | 147 |
| Home equity | 154 | 156 | 238 | 262 |
| Consumer indirect | 1,841 | 2,331 | 4,263 | 4,786 |
| Other consumer | 154 | 224 | 413 | 493 |
| Total charge-offs | 2,385 | 2,948 | 6,955 | 5,924 |
| Recoveries: | | | | |
| Commercial business | 86 | 68 | 134 | 97 |
| Commercial mortgage | 7 | 6 | 96 | 13 |
| Residential mortgage | 13 | 8 | 46 | 29 |
| Home equity | 9 | 29 | 19 | 40 |
| Consumer indirect | 1,196 | 995 | 2,301 | 2,100 |
| Other consumer | 95 | 98 | 193 | 211 |
| Total recoveries | 1,406 | 1,204 | 2,789 | 2,490 |
| Net charge-offs | 979 | 1,744 | 4,166 | 3,434 |
| Provision for loan losses | 1,288 | 1,758 | 4,029 | 3,864 |
| Balance at end of period | \$ 27,500 | \$ 27,166 | \$ 27,500 | \$ 27,166 |
| Net loan charge-offs to average loans (annualized) | 0.20% | 0.37% | 0.43% | 0.37% |
| Allowance for loan losses to total loans | 1.37% | 1.43% | 1.37% | 1.43% |
| Allowance for loan losses to non-performing loans | 257% | 306% | 257% | 306% |

The allowance for loan losses represents the estimated amount of probable credit losses inherent in our loan portfolio. We perform periodic, systematic reviews of the loan portfolio to estimate probable losses in the respective loan portfolios. In addition, we regularly evaluate prevailing economic and business conditions, industry concentrations, changes in the size and characteristics of the portfolio and other pertinent factors. Based on this analysis, we believe

the overall allowance for loan losses is adequate as of June 30, 2015.

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 our loan products and customers.

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 increase the allowance based on their judgments about information available to them at the time of their examination.

Net charge-offs of \$979 thousand in the second quarter of 2015 represented 0.20% of average loans on an annualized basis compared to \$1.7 million or 0.37% in the second quarter of 2014. For the six months ended June 30, 2015 net charge-offs of \$4.2 million represented 0.43% of average loans compared to \$3.4 million or 0.37% of average loans for same period in 2014. The year-to-date increase in net charge-offs was primarily driven by the charge-off during the first quarter of 2015 of two commercial loan relationships totaling \$1.7 million that had been previously reserved by the Company.

The allowance for loan losses was \$27.5 million at June 30, 2015, compared with \$27.6 million at December 31, 2014. The ratio of the allowance for loan losses to total loans was 1.37% at June 30, 2015, compared with 1.45% at December 31, 2014. The ratio of allowance for loan losses to non-performing loans was 257% at June 30, 2015, compared with 272% at December 31, 2014.

Table of Contents**MANAGEMENT'S DISCUSSION AND ANALYSIS****Non-Performing Assets and Potential Problem Loans**

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

| | Non-Performing Assets | |
|---|------------------------------|------------------------------|
| | June 30, 2015 | December 31, 2014 |
| Nonaccrual loans: | | |
| Commercial business | \$ 4,643 | \$ 4,288 |
| Commercial mortgage | 3,070 | 3,020 |
| Residential mortgage | 1,628 | 1,194 |
| Home equity | 619 | 463 |
| Consumer indirect | 728 | 1,169 |
| Other consumer | 11 | 11 |
| | | |
| Total nonaccrual loans | 10,699 | 10,145 |
| Accruing loans 90 days or more delinquent | 9 | 8 |
| | | |
| Total non-performing loans | 10,708 | 10,153 |
| Foreclosed assets | 165 | 194 |
| | | |
| Total non-performing assets | \$ 10,873 | \$ 10,347 |
| | | |
| Non-performing loans to total loans | 0.53% | 0.53% |
| Non-performing assets to total assets | 0.32% | 0.33% |

Changes in the level of nonaccrual loans typically represent increases for loans that reach a specified past due status, offset by reductions for loans that are charged-off, paid down, sold, transferred to foreclosed real estate, or are no longer classified as nonaccrual because they have returned to accrual status. Activity in nonaccrual loans for the three and six months ended June 30, 2015 was as follows (in thousands):

| | Three months ended June 30, 2015 | Six months ended June 30, 2015 |
|---------------------------------------|---|---|
| Nonaccrual loans, beginning of period | \$ 11,064 | \$ 10,145 |
| Additions | 3,611 | 10,383 |
| Payments | (1,295) | (2,587) |
| Charge-offs | (2,313) | (6,759) |
| Returned to accruing status | (289) | (353) |

| | | |
|--|-----------|-----------|
| Transferred to other real estate or repossessed assets | (79) | (130) |
| Nonaccrual loans, end of period | \$ 10,699 | \$ 11,699 |

Non-performing assets include non-performing loans and foreclosed assets. Non-performing assets at June 30, 2015 were \$10.9 million, an increase of \$526 thousand from \$10.3 million at December 31, 2014. The primary component of non-performing assets is non-performing loans, which were \$10.7 million or 0.53% of total loans at June 30, 2015, an increase of \$554 thousand from \$10.1 million or 0.53% of total loans at December 31, 2014. Included in non-performing loans at June 30, 2015 is one \$2.5 million commercial credit relationship which we placed on nonaccrual status during the first quarter of 2015. This downgrade resulted in an increase in our provision for losses of approximately \$800 thousand during the first quarter of 2015. The loans comprising this credit relationship are performing in accordance with their contractual terms as of June 30, 2015 and the Company continues to monitor this relationship closely.

Approximately \$4.1 million, or 38%, of the \$10.7 million in non-performing loans as of June 30, 2015 were current with respect to payment of principal and interest, but were classified as non-accruing because repayment in full of principal and/or interest was uncertain. Included in nonaccrual loans are troubled debt restructurings (TDRs) of \$3.3 million and \$3.0 million at June 30, 2015 and December 31, 2014, respectively. We had no TDRs that were accruing interest as of June 30, 2015 or December 31, 2014.

Foreclosed assets consist of real property formerly pledged as collateral for loans, which we have acquired through foreclosure proceedings or acceptance of a deed in lieu of foreclosure. Foreclosed asset holdings represented four properties totaling \$165 thousand at June 30, 2015 and four properties totaling \$194 thousand at December 31, 2014.

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

Potential problem loans are loans classified as substandard that are currently performing, but information known about possible credit problems of the borrowers causes us 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. We identified \$13.0 million and \$13.7 million in loans that continued to accrue interest which were classified as substandard as of June 30, 2015 and December 31, 2014, respectively.

FUNDING ACTIVITIES**Deposits**

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

| | Deposit Composition | | | |
|--|----------------------------|-----------------------|--------------------------|-----------------------|
| | June 30, 2015 | | December 31, 2014 | |
| | Amount | % of Total | Amount | % of Total |
| Noninterest-bearing demand | \$ 602,143 | 22.6% | \$ 571,260 | 23.3% |
| Interest-bearing demand | 530,861 | 20.0 | 490,190 | 20.0 |
| Savings and money market | 910,215 | 34.3 | 795,835 | 32.5 |
| Certificates of deposit < \$100,000 | 348,002 | 13.1 | 347,899 | 14.2 |
| Certificates of deposit of \$100,000 or more | 265,017 | 10.0 | 245,343 | 10.0 |
| Total deposits | \$ 2,656,238 | 100.0% | \$ 2,450,527 | 100.0% |

We offer a variety of deposit products designed to attract and retain customers, with the primary focus on building and expanding long-term relationships. At June 30, 2015, total deposits were \$2.66 billion, representing an increase of \$205.7 million in comparison to \$2.45 billion as of December 31, 2014. Certificates of deposit were approximately 23% and 24% of total deposits at June 30, 2015 and December 31, 2014, respectively. Depositors remain hesitant to invest in time deposits, such as certificates of deposit, for long periods due to the low interest rate environment. This has resulted in lower amounts being placed in time deposits for generally shorter terms.

Nonpublic deposits, the largest component of our funding sources, totaled \$1.95 billion and \$1.84 billion at June 30, 2015 and December 31, 2014, respectively, and represented 74% and 75% of total deposits as of the end of each period, respectively. We have managed this segment of funding through a strategy of competitive pricing that minimizes the number of customer relationships that have only a single service high cost deposit account.

As an additional source of funding, we offer a variety of public (municipal) deposit products to the towns, villages, counties and school districts within our market. Public deposits generally range from 20% to 30% of our total deposits. There is a high degree of seasonality in this component of funding, because the level of deposits varies with the seasonal cash flows for these public customers. We maintain the necessary levels of short-term liquid assets to

accommodate the seasonality associated with public deposits. Total public deposits were \$701.3 million and \$607.5 million at June 30, 2015 and December 31, 2014, respectively, and represented 26% and 25% of total deposits as of the end of each period, respectively. The increase in public deposits during 2015 was due mainly higher municipal deposits resulting from successful business development efforts.

We had no traditional brokered deposits at June 30, 2015 or December 31, 2014; however, we do participate in the Certificate of Deposit Account Registry Service (CDARS) and Insured Cash Sweep (ICS) programs, which enable depositors to receive FDIC insurance coverage for deposits otherwise exceeding the maximum insurable amount. CDARS and ICS deposits are considered brokered deposits for regulatory reporting purposes. Through these programs, deposits in excess of the maximum insurable amount are placed with multiple participating financial institutions. Reciprocal CDARS deposits and ICS deposits totaled \$79.9 million and \$119.2 million, respectively, at June 30, 2015, compared to \$79.7 million and \$67.1 million, respectively, at December 31, 2014. The year-to-date increase in ICS deposits is primarily due to customer balances transferred from the customer repurchase agreement product. See the Borrowings section below for further discussion.

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

The Company classifies borrowings as short-term or long-term in accordance with the original terms of the applicable agreement. Outstanding borrowings consisted of the following as of the dates indicated (in thousands):

| | June 30, 2015 | December 31, 2014 |
|------------------------------------|--------------------------|------------------------------|
| Short-term borrowings: | | |
| Short-term FHLB borrowings | \$ 350,600 | \$ 295,300 |
| Repurchase agreements | | 39,504 |
| Total short-term borrowings | 350,600 | 334,804 |
| Long-term borrowings: | | |
| Subordinated notes | 38,955 | |
| Total borrowings | \$ 389,555 | \$ 334,804 |

Short-term Borrowings

We have credit capacity with the FHLB and can borrow through facilities that include amortizing and term advances or repurchase agreements. We had approximately \$29 million of immediate credit capacity with the FHLB as of June 30, 2015. We had approximately \$490 million in secured borrowing capacity at the Federal Reserve Bank (FRB) discount window, none of which was outstanding at June 30, 2015. The FHLB and FRB credit capacity are collateralized by securities from our investment portfolio and certain qualifying loans. We had approximately \$120 million of credit available under unsecured federal funds purchased lines with various banks as of June 30, 2015. Additionally, we had approximately \$199 million of unencumbered liquid securities available for pledging.

Federal funds purchased are short-term borrowings that typically mature within one to ninety days. Short-term repurchase agreements are secured overnight borrowings with customers. Short-term FHLB borrowings have original maturities of up to one year and include overnight borrowings which we typically utilize to address short term funding needs as they arise. Short-term FHLB borrowings at June 30, 2015 consisted of \$169.0 million in overnight borrowings and \$181.6 million in short-term advances. Short-term FHLB borrowings at December 31, 2014 consisted of \$129.0 million in overnight borrowings and \$166.3 million in short-term advances. During the second quarter of 2015, we discontinued the customer repurchase agreement product and transferred most of those customers into the ICS deposit product.

The Parent has a revolving line of credit with a commercial bank allowing borrowings up to \$20.0 million in total as an additional source of working capital. At June 30, 2015, no amounts have been drawn on the line of credit.

Long-term Borrowings

On April 15, 2015, the Company issued the Subordinated Notes to certain accredited investors. The Subordinated Notes bear interest at a fixed rate of 6.0% per year, payable semi-annually, for the first 10 years. From April 15, 2025 to April 15, 2030, the interest rate will reset quarterly to an annual interest rate equal to the then current three-month London Interbank Offered Rate (LIBOR) plus 3.944%, payable quarterly. The Subordinated Notes are redeemable by the Company at any quarterly interest payment date beginning on April 15, 2025 to maturity at par, plus accrued and unpaid interest. Debt issuance costs totaled \$1.1 million and are being amortized as an adjustment to interest expense over 15 years. The Subordinated Notes qualify as Tier 2 capital for regulatory purposes. The net proceeds from this offering were intended for general corporate purposes, including but not limited to, contribution of capital to the Bank to support both organic growth and opportunistic acquisitions.

Table of Contents

MANAGEMENT'S DISCUSSION AND ANALYSIS

LIQUIDITY AND CAPITAL MANAGEMENT

Liquidity

The objective of maintaining adequate liquidity is to assure that we meet our financial obligations. These obligations include the withdrawal of deposits on demand or at their contractual maturity, the repayment of matured borrowings, the ability to fund new and existing loan commitments and the ability to take advantage of new business opportunities. We achieve liquidity by maintaining a strong base of core customer funds, maturing short-term assets, our ability to sell or pledge 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, core 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 primary source of our non-deposit borrowings is FHLB advances, of which we had \$350.6 million outstanding at June 30, 2015. In addition to this amount, we have additional collateralized wholesale borrowing capacity of \$639 million from various funding sources which include the FHLB, Federal Reserve Bank, and commercial banks that we can use to fund lending activities, liquidity needs, and/or to adjust and manage our asset and liability position.

The Parent's funding requirements consist primarily of dividends to shareholders, debt service, income taxes, operating expenses, funding of nonbank subsidiaries, repurchases of our stock, and acquisitions. The Parent obtains funding to meet obligations from dividends received from the Bank, net taxes collected from subsidiaries included in the federal consolidated tax return, and the issuance of debt and equity securities. In addition, the Parent maintains a revolving line of credit with a commercial bank for an aggregate amount of up to \$20.0 million, all of which was available at June 30, 2015. The line of credit has a one year term and matures in May 2016. Funds drawn will be used for general corporate purposes and backup liquidity.

Cash and cash equivalents were \$52.6 million as of June 30, 2015, a decrease of \$5.6 million from \$58.2 million as of December 31, 2014. Net cash provided by operating activities totaled \$22.3 million and the principal source of operating activity cash flow was net income adjusted for noncash income and expense items. Net cash used in investing activities totaled \$282.1 million, which included outflows of \$101.6 million for net loan originations and \$177.8 million from net investment securities transactions. Net cash provided by financing activities of \$254.2 million was attributed to a \$205.7 million increase in deposits, net proceeds of \$38.9 million from the Subordinated Notes issuance and a \$15.8 million increase in short-term borrowings, partly offset by \$6.4 million in dividend payments.

Capital Management

We actively manage capital, commensurate with our risk profile, to enhance shareholder value. We also seek to maintain capital levels for the Company and the Bank at amounts in excess of the regulatory well-capitalized thresholds. Periodically, we may respond to market conditions by implementing changes to our overall balance sheet positioning to manage our capital position.

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 our 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.

On April 15, 2015, the Parent issued the Subordinated Notes to certain accredited investors. See the Executive Overview section of this Management's Discussion and Analysis for further discussion regarding the issuance of the Subordinated Notes. The Parent contributed \$34.0 million of the net proceeds from the Subordinated Notes offering to the Bank as capital to support both organic growth and opportunistic acquisitions.

Shareholders' equity was \$284.4 million at June 30, 2015, an increase of \$4.9 million from \$279.5 million at December 31, 2014. Net income for the year increased shareholders' equity by \$13.4 million, which was partially offset by common and preferred stock dividends declared of \$6.4 million. Accumulated other comprehensive income included in shareholders' equity decreased \$2.7 million during the first six months of 2015 due primarily to higher net unrealized losses on securities available for sale.

The final rules implementing the Basel Committee on Banking Supervision's (BCBS) capital guidelines for U.S. banks became effective for the Company on January 1, 2015, with full compliance with all of the final requirements phased in over a multi-year schedule, to be fully phased-in by January 1, 2019. As of June 30, 2015, the Company's capital levels remained characterized as well-capitalized under the new rules. We continue to evaluate the potential impact that regulatory rules may have on our liquidity and capital management strategies, including Basel III and those required under the Dodd-Frank Act. See the Basel III Capital Rules section below for further discussion.

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

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

| | June 30, 2015 | December 31, 2014 |
|---|--------------------------|------------------------------|
| Common shareholders' equity | \$ 267,095 | \$ 262,192 |
| Less: Goodwill and other intangible assets ⁽¹⁾ | 62,244 | 68,639 |
| Net unrealized (loss) gain on investment securities ⁽²⁾ | (1,321) | 1,625 |
| Net periodic pension & postretirement benefits plan adjustments | (10,361) | (10,636) |
| Other | 150 | |
| Common equity Tier 1 (CET1) capital | 216,383 | n/a |
| Plus: Preferred stock | 17,340 | 17,340 |
| Less: Other | 225 | |
| Tier 1 Capital | 233,498 | 219,904 |
| Plus: Qualifying allowance for loan losses | 27,500 | 26,262 |
| Subordinated Notes | 38,955 | |
| Total regulatory capital ⁽³⁾ | \$ 299,953 | \$ 246,166 |
| Adjusted average total assets (for leverage capital purposes) ⁽³⁾ | \$ 3,196,238 | \$ 2,993,050 |
| Total risk-weighted assets ⁽³⁾ | \$ 2,278,114 | \$ 2,099,626 |
| Regulatory Capital Ratios ⁽³⁾ | | |
| Tier 1 leverage (Tier 1 capital to adjusted average assets) | 7.31% | 7.35% |
| CET1 capital (CET1 capital to total risk-weighted assets) | 9.50 | n/a |
| Tier 1 capital (Tier 1 capital to total risk-weighted assets) | 10.25 | 10.47 |
| Total risk-based capital (Total risk-based capital to total risk-weighted assets) | 13.17 | 11.72 |

(1) June 30, 2015 calculated net of deferred tax liabilities.

(2) Includes unrealized gains and losses related to the Company's reclassification of available for sale investment securities to the held to maturity category.

(3) June 30, 2015 calculated under Basel III rules, which became effective January 1, 2015.

Edgar Filing: FINANCIAL INSTITUTIONS INC - Form 10-Q

The Company's and the Bank's actual and required regulatory capital ratios were as follows (dollars in thousands):

| | | Actual | | For Capital Adequacy Purposes | | Well Capitalized | |
|---------------------------|---------|------------|-------|-------------------------------|-------|------------------|-------|
| | | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| June 30, 2015 | | | | | | | |
| Tier 1 leverage: | Company | \$ 233,498 | 7.31% | \$ 127,850 | 4.00% | \$ 159,812 | 5.00% |
| | Bank | 257,220 | 8.06 | 127,851 | 4.00 | 159,476 | 5.00 |
| CET1 capital: | Company | 216,383 | 9.50 | 102,515 | 4.50 | 148,077 | 6.50 |
| | Bank | 257,220 | 11.33 | 102,183 | 4.50 | 147,598 | 6.50 |
| Tier 1 capital: | Company | 233,498 | 10.25 | 136,687 | 6.00 | 182,249 | 8.00 |
| | Bank | 257,220 | 11.33 | 136,244 | 6.00 | 181,659 | 8.00 |
| Total risk-based capital: | Company | 299,953 | 13.17 | 182,249 | 8.00 | 227,811 | 10.00 |
| | Bank | 284,720 | 12.54 | 181,659 | 8.00 | 227,074 | 10.00 |
| December 31, 2014 | | | | | | | |
| Tier 1 leverage: | Company | \$ 219,904 | 7.35% | \$ 119,722 | 4.00% | \$ 149,653 | 5.00% |
| | Bank | 215,672 | 7.21 | 119,671 | 4.00 | 149,588 | 5.00 |
| Tier 1 capital: | Company | 219,904 | 10.47 | 83,985 | 4.00 | 125,977 | 6.00 |
| | Bank | 215,672 | 10.28 | 83,889 | 4.00 | 125,834 | 6.00 |
| Total risk-based capital: | Company | 246,166 | 11.72 | 167,970 | 8.00 | 209,962 | 10.00 |
| | Bank | 241,905 | 11.53 | 167,779 | 8.00 | 209,723 | 10.00 |

As previously discussed, the Parent company contributed \$34.0 million of net proceeds from the Subordinated Notes offering to the Bank as capital to support both organic growth and opportunistic acquisitions. The Bank's leverage ratio and total risk-based capital ratio increased to 8.06% and 12.54%, respectively, at June 30, 2015, compared to 7.21% and 11.53%, respectively, at December 31, 2014, all of which exceeded the regulatory thresholds required to be classified as a well capitalized institution as established by the Bank's primary banking regulators.

Table of Contents

MANAGEMENT'S DISCUSSION AND ANALYSIS

Basel III Capital Rules

In July 2013, the FRB and the FDIC approved the final rules implementing the BCBS's capital guidelines for U.S. banks. Under the final rules, minimum requirements will increase for both the quantity and quality of capital held by the Company. The rules include a new common equity Tier 1 capital to risk-weighted assets minimum ratio of 4.5%, raise the minimum ratio of Tier 1 capital to risk-weighted assets from 4.0% to 6.0%, require a minimum ratio of total capital to risk-weighted assets of 8.0%, and require a minimum Tier 1 leverage ratio of 4.0%. A new capital conservation buffer is also established above the regulatory minimum capital requirements. This capital conservation buffer will be phased in beginning January 1, 2016 at 0.625% of risk-weighted assets and will increase each subsequent year by an additional 0.625% until reaching its final level of 2.5% on January 1, 2019. Strict eligibility criteria for regulatory capital instruments were also implemented under the final rules. The final rules also revise the definition and calculation of Tier 1 capital, total capital, and risk-weighted assets.

The phase-in period for the final rules became effective for the Company on January 1, 2015, with full compliance with all of the final rules' requirements phased in over a multi-year schedule, to be fully phased-in by January 1, 2019. As of June 30, 2015, the Company's capital levels remained characterized as "well-capitalized" under the new rules.

Dividend Restrictions

In the ordinary course of business we are dependent upon dividends from the Bank to provide funds for the payment of 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**

Quantitative and qualitative disclosures about market risk were presented at December 31, 2014 in Item 7A of the Company's Annual Report on Form 10-K for the year ended December 31, 2014, as filed with the Securities and Exchange Commission on March 6, 2015. The following is an update of the discussion provided therein.

Portfolio Composition

With the exception of the \$40.0 million of 6.0% fixed to floating rate subordinated notes issued by the Company on April 15, 2015, there was no material change in the composition of assets, deposit liabilities or borrowings from December 31, 2014 to June 30, 2015. See the section titled "Analysis of Financial Condition" in Part I, Item 2, "Management's Discussion and Analysis of Financial Condition and Results of Operations" for a discussion of asset, deposit and borrowing activity during the period.

Net Interest Income at Risk

A primary tool used to manage interest rate risk is rate shock simulation, which measures rate sensitivity. Rate shock simulation is a modeling technique used to estimate the impact of changes in rates on net interest income as well as economic value of equity. At June 30, 2015, the Company was generally neutral to slightly liability sensitive, meaning that, in most cases, net interest income tends to remain relatively unchanged or in certain rising rate conditions, decline slightly.

Net interest income at risk is measured 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 12 months. The following table sets forth the estimated changes to net interest income over the 12-month period ending June 30, 2016 assuming instantaneous changes in interest rates for the given rate shock scenarios (dollars in thousands):

| | Changes in Interest Rate | | | |
|-------------------------------|---------------------------------|----------------|----------------|----------------|
| | -100 bp | +100 bp | +200 bp | +300 bp |
| Change in net interest income | \$ (902) | \$ (47) | \$ 599 | \$ (1,103) |
| % Change | (0.92)% | (0.05)% | 0.61% | (1.13)% |

In addition to the changes in interest rate scenarios listed above, other scenarios are typically modeled to measure interest rate risk. These scenarios vary depending on the economic and interest rate environment.

The simulations referenced above and below are 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.

Economic Value of Equity At Risk

The economic (or fair) value of financial instruments on our balance sheet will also vary under the interest rate scenarios previously discussed. This is measured by simulating changes in our economic value of equity (EVE), which is calculated by subtracting the estimated fair value of liabilities from the estimated fair value of assets. Fair

values for financial instruments are estimated by discounting projected cash flows (principal and interest) at current replacement rates for each account type, while fair values of non-financial assets and liabilities are assumed to equal book value and do not vary with interest rate fluctuations. An economic value simulation is a static measure for balance sheet accounts at a given point in time, but this measurement can change substantially over time as the characteristics of our balance sheet evolve and as interest rate and yield curve assumptions are updated.

The amount of change in economic value under different interest rate scenarios depends on the characteristics of each class of financial instrument, including the stated interest rate or spread relative to current market rates or spreads, the likelihood of prepayment, whether the rate is fixed or floating, and the maturity date of the instrument. As a general rule, fixed-rate financial assets become more valuable in declining rate scenarios and less valuable in rising rate scenarios, while fixed-rate financial liabilities gain in value as interest rates rise and lose value as interest rates decline. The longer the duration of the financial instrument, the greater the impact a rate change will have on its value. In our economic value simulations, estimated prepayments are factored in for financial instruments with stated maturity dates, and decay rates for non-maturity deposits are projected based on historical data (back-testing).

Table of Contents

The analysis that follows presents the estimated EVE resulting from market interest rates prevailing at a given quarter-end (Pre-Shock Scenario), and under other interest rate scenarios (each a Rate Shock Scenario) represented by immediate, permanent, parallel shifts in interest rates from those observed at June 30, 2015 and December 31, 2014. The analysis additionally presents a measurement of the interest rate sensitivity at June 30, 2015 and December 31, 2014. EVE amounts are computed under each respective Pre- Shock Scenario and Rate Shock Scenario. An increase in the EVE amount is considered favorable, while a decline is considered unfavorable.

| | June 30, 2015 | | | December 31, 2014 | | |
|-----------------------------|---------------|-----------|-------------------|-------------------|-----------|-------------------|
| | EVE | Change | Percentage Change | EVE | Change | Percentage Change |
| Rate Shock Scenario: | | | | | | |
| Pre-Shock Scenario | \$ 502,621 | | | \$ 476,735 | | |
| - 100 Basis Points | 514,277 | \$ 11,656 | 2.32% | 489,184 | \$ 12,449 | 2.61% |
| + 100 Basis Points | 478,066 | (24,555) | (4.89) | 466,983 | (9,752) | (2.05) |
| + 200 Basis Points | 451,020 | (51,601) | (10.27) | 453,868 | (22,867) | (4.80) |

The Pre-Shock Scenario EVE was \$502.6 million at June 30, 2015, compared to \$476.7 million at December 31, 2014. The increase in the Pre-Shock Scenario EVE at June 30, 2015, compared to December 31, 2014 resulted primarily from a more favorable valuation of non-maturity deposits and commercial mortgages that reflected alternative funding and investment rate changes used for discounting future cash flows.

The +200 basis point Rate Shock Scenario EVE decreased from \$453.9 million at December 31, 2014 to \$451.0 million at June 30, 2015, reflecting less favorable asset valuations that reflected investment rate changes offset by more favorable valuation of non-maturity deposits. The percentage change in the EVE amount from the Pre-Shock Scenario to the +200 basis point Rate Shock Scenario decreased from to (4.80)% at December 31, 2014 to (10.27)% at June 30, 2015. The decrease in sensitivity resulted from a reduced benefit in the asset valuations in the +200 basis point Rate Shock Scenario EVE as of June 30, 2015, compared to December 31, 2014.

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

As of June 30, 2015, 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 under the Exchange Act is accumulated and communicated to management, including the Company's 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 June 30, 2015 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

- 52 -

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, 2014, as filed with the Securities and Exchange Commission.

ITEM 1A. Risk Factors

The Company has experienced no material changes in its risk factors from the disclosure included in the Company's Annual Report on Form 10-K for the year ended December 31, 2014, as filed with the Securities and Exchange Commission.

ITEM 2. Unregistered Sales of Equity Securities and Use of Proceeds.

On May 6, 2015, the Company issued a total of 2,363 shares of our common stock as the stock component of our annual retainer to three non-employee directors and 10,750 restricted shares of our common stock as our annual stock award to each of our non-employee directors without registration under the Securities Act of 1933, as amended (the Securities Act). These shares were issued under our 2015 Long-Term Incentive Plan (the Plan), which was approved by our shareholders at the annual meeting on May 6, 2015, but prior to our filing of a Form S-8 registration statement under the Securities Act for the Plan. These shares of common stock are subject to the resale prohibition under the Securities Act and may not be sold or transferred without registration except in accordance with Rule 144 of the Securities Act.

The issuances of securities set forth above were made without registration under the Securities Act in reliance on the exemption from registration pursuant to Section 4(a)(2) of the Securities Act based on our directors' financial sophistication and knowledge of the Company.

Table of Contents**ITEM 6. Exhibits**

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

| Exhibit Number | Description | Location |
|-----------------------|--|--|
| 1.1 | Underwriting Agreement, dated April 9, 2015, by and among Financial Institutions, Inc., and Sterne Agee & Leach, Inc. | Incorporated by reference to Exhibit 1.1 of the Form 8-K, dated April 10, 2015 |
| 4.1 | Subordinated Indenture, dated as of April 15, 2015, between Financial Institutions, Inc. and Wilmington Trust, National Association, as Trustee. | Incorporated by reference to Exhibit 4.1 of the Form 8-K, dated April 15, 2015 |
| 4.2 | First Supplemental Indenture, dated as of April 15, 2015, between Financial Institutions, Inc. and Wilmington Trust, National Association, as Trustee. | Incorporated by reference to Exhibit 4.2 of the Form 8-K, dated April 15, 2015 |
| 4.3 | Form of Global Note to represent the 6.00% Fixed-to-Floating Rate Subordinated Notes due April 15, 2030. | Incorporated by reference to Exhibit 4.3 of the Form 8-K, dated April 15, 2015 |
| 10.1 | Financial Institutions, Inc. 2015 Long-Term Incentive Plan | Filed Herewith |
| 10.2 | Form of Director Annual Restricted Stock Award Agreement Pursuant to the Financial Institutions, Inc. 2015 Long-Term Incentive Plan | Filed Herewith |
| 10.3 | Form of Director In Lieu of Cash Fees Stock Award Agreement Pursuant to the Financial Institutions, Inc. 2015 Long-Term Incentive Plan | Filed Herewith |
| 10.4 | Form of Restricted Stock Award Agreement Pursuant to the Financial Institutions, Inc. 2015 Long-Term Incentive Plan | Filed Herewith |
| 10.5 | Form of Performance Stock Award Agreement Pursuant to the Financial Institutions, Inc. 2015 Long-Term Incentive Plan | Filed Herewith |
| 10.6 | Form of Restricted Stock Unit Award Agreement Pursuant to the Financial Institutions, Inc. 2015 Long-Term Incentive Plan | Filed Herewith |
| 10.7 | Form of Performance Stock Unit Award Agreement Pursuant to the Financial Institutions, Inc. 2015 Long-Term Incentive Plan | Filed Herewith |
| 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 | |

Edgar Filing: FINANCIAL INSTITUTIONS INC - Form 10-Q

| | |
|---------|--|
| 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 |

- 54 -

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/ Martin K. Birmingham , August 5, 2015
Martin K. Birmingham
President and Chief Executive Officer
(Principal Executive Officer)

/s/ Kevin B. Klotzbach , August 5, 2015
Kevin B. Klotzbach
Executive Vice President, Chief Financial Officer and
Treasurer
(Principal Financial Officer)

/s/ Michael D. Grover , August 5, 2015
Michael D. Grover
Senior Vice President and Chief Accounting Officer
(Principal Accounting Officer)