

FINANCIAL INSTITUTIONS INC
Form 10-Q
May 06, 2014
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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 March 31, 2014

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 13,851,876 shares of Common Stock, \$0.01 par value, outstanding as of April 30, 2014.

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FINANCIAL INSTITUTIONS, INC.

Form 10-Q

For the Quarterly Period Ended March 31, 2014

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

<i>(Dollars in thousands, except share and per share data)</i>	March 31, 2014 (Unaudited)	December 31, 2013
ASSETS		
Cash and cash equivalents:		
Cash and due from banks	\$ 72,307	\$ 59,598
Federal funds sold and interest-bearing deposits in other banks	94	94
Total cash and cash equivalents	72,401	59,692
Securities available for sale, at fair value	674,650	609,400
Securities held to maturity, at amortized cost (fair value of \$256,091 and \$250,657, respectively)	253,576	249,785
Loans held for sale	900	3,381
Loans (net of allowance for loan losses of \$27,152 and \$26,736, respectively)	1,821,688	1,806,883
Company owned life insurance	49,582	49,171
Premises and equipment, net	36,121	36,009
Goodwill and other intangible assets, net	49,913	50,002
Other assets	56,788	64,313
Total assets	\$ 3,015,619	\$ 2,928,636
LIABILITIES AND SHAREHOLDERS EQUITY		
Deposits:		
Noninterest-bearing demand	\$ 532,914	\$ 535,472
Interest-bearing demand	541,660	470,733
Savings and money market	812,734	717,928
Certificates of deposit	646,112	595,923
Total deposits	2,533,420	2,320,056
Short-term borrowings	196,746	337,042
Other liabilities	22,588	16,699
Total liabilities	2,752,754	2,673,797
Shareholders equity:		
Series A 3% preferred stock, \$100 par value, 1,533 shares authorized and 1,496 shares issued	149	149

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Series B-1 8.48% preferred stock, \$100 par value, 200,000 shares authorized and 171,927 shares issued	17,193	17,193
Total preferred equity	17,342	17,342
Common stock, \$0.01 par value, 50,000,000 shares authorized and 14,161,597 shares issued	142	142
Additional paid-in capital	67,182	67,574
Retained earnings	190,375	186,137
Accumulated other comprehensive (loss) income	(6,424)	(10,187)
Treasury stock, at cost 308,614 and 332,242 shares, respectively	(5,752)	(6,169)
Total shareholders' equity	262,865	254,839
Total liabilities and shareholders' equity	\$ 3,015,619	\$ 2,928,636

See accompanying notes to the consolidated financial statements.

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

<i>(In thousands, except per share amounts)</i>	Three months ended March 31,	
	2014	2013
Interest income:		
Interest and fees on loans	\$ 20,267	\$ 20,379
Interest and dividends on investment securities	4,792	4,369
Total interest income	25,059	24,748
Interest expense:		
Deposits	1,525	1,671
Short-term borrowings	259	190
Total interest expense	1,784	1,861
Net interest income	23,275	22,887
Provision for loan losses	2,106	2,709
Net interest income after provision for loan losses	21,169	20,178
Noninterest income:		
Service charges on deposits	2,250	2,141
ATM and debit card	1,174	1,249
Investments in limited partnerships	626	161
Investment advisory	563	699
Company owned life insurance	403	415
Loan servicing	154	73
Net gain on disposal of investment securities	313	892
Net gain on sale of loans held for sale	105	200
Net (loss) gain on disposal of other assets	(35)	1
Other	804	722
Total noninterest income	6,357	6,553
Noninterest expense:		
Salaries and employee benefits	9,256	9,709
Occupancy and equipment	3,235	3,169
Professional services	972	937
Computer and data processing	723	704
Supplies and postage	512	680
FDIC assessments	422	361

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Advertising and promotions	179	214
Other	1,914	1,810
Total noninterest expense	17,213	17,584
Income before income taxes	10,313	9,147
Income tax expense	3,094	2,998
Net income	\$ 7,219	\$ 6,149
Preferred stock dividends	366	368
Net income available to common shareholders	\$ 6,853	\$ 5,781
Earnings per common share (Note 2):		
Basic	\$ 0.50	\$ 0.42
Diluted	\$ 0.50	\$ 0.42
Cash dividends declared per common share	\$ 0.19	\$ 0.18
Weighted average common shares outstanding:		
Basic	13,773	13,717
Diluted	13,824	13,767

See accompanying notes to the consolidated financial statements.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Consolidated Statements of Comprehensive Income (Loss) (Unaudited)

<i>(Dollars in thousands)</i>	Three months ended March 31,	
	2014	2013
Net income	\$ 7,219	\$ 6,149
Other comprehensive income (loss), net of tax:		
Net unrealized gains (losses) on securities available for sale	3,744	(2,315)
Pension and post-retirement obligations	19	199
Total other comprehensive income (loss), net of tax	3,763	(2,116)
Comprehensive income	\$ 10,982	\$ 4,033

See accompanying notes to the consolidated financial statements.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Consolidated Statements of Changes in Shareholders' Equity (Unaudited)

Three months ended March 31, 2014 and 2013

<i>(Dollars in thousands, except per share data)</i>	Preferred Equity	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Treasury Stock	Total Shareholders' Equity
Balance at January 1, 2013	\$ 17,471	\$ 142	\$ 67,710	\$ 172,244	\$ 3,253	\$ (6,923)	\$ 253,897
Comprehensive income:							
Net income				6,149			6,149
Other comprehensive loss, net of tax					(2,116)		(2,116)
Purchases of common stock for treasury						(229)	(229)
Repurchase of Series B-1 8.48% preferred stock	(52)		(1)				(53)
Share-based compensation plans:							
Share-based compensation			102				102
Stock options exercised			(2)			15	13
Restricted stock awards issued, net			(496)			496	
Excess tax benefit on share-based compensation			6				6
Cash dividends declared:							
Series A 3% Preferred-\$0.75 per share				(1)			(1)
Series B-1 8.48% Preferred-\$2.12 per share				(367)			(367)
Common-\$0.18 per share				(2,471)			(2,471)
Balance at March 31, 2013	\$ 17,419	\$ 142	\$ 67,319	\$ 175,554	\$ 1,137	\$ (6,641)	\$ 254,930
Balance at January 1, 2014	\$ 17,342	\$ 142	\$ 67,574	\$ 186,137	\$ (10,187)	\$ (6,169)	\$ 254,839
Comprehensive income:							
Net income				7,219			7,219
Other comprehensive income, net of tax					3,763		3,763
Purchases of common stock for treasury						(194)	(194)
Share-based compensation plans:							

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Share-based compensation	103	103
Stock options exercised		110
Restricted stock awards issued, net	(501)	501
Excess tax benefit on share-based compensation	6	6
Cash dividends declared:		
Series A 3% Preferred-\$0.75 per share	(1)	(1)
Series B-1 8.48% Preferred-\$2.12 per share	(365)	(365)
Common-\$0.19 per share	(2,615)	(2,615)
Balance at March 31, 2014	\$ 17,342 \$ 142 \$ 67,182 \$ 190,375 \$ (6,424) \$ (5,752) \$ 262,865	

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)*

	Three months ended March 31,	
	2014	2013
Cash flows from operating activities:		
Net income	\$ 7,219	\$ 6,149
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	1,013	1,051
Net amortization of premiums on securities	885	1,328
Provision for loan losses	2,106	2,709
Share-based compensation	103	102
Deferred income tax expense	275	1,702
Proceeds from sale of loans held for sale	4,804	10,288
Originations of loans held for sale	(3,071)	(10,712)
Increase in company owned life insurance	(403)	(415)
Net gain on sale of loans held for sale	(105)	(200)
Net gain on disposal of investment securities	(313)	(892)
Net loss (gain) on sale and disposal of other assets	35	(1)
Decrease in other assets	4,891	2,192
Increase (decrease) in other liabilities	3,111	(857)
Net cash provided by operating activities	20,550	12,444
Cash flows from investing activities:		
Purchases of available for sale securities	(95,366)	(124,157)
Purchases of held to maturity securities	(5,735)	(1,076)
Proceeds from principal payments, maturities and calls on available for sale securities	16,617	45,067
Proceeds from principal payments, maturities and calls on held to maturity securities	4,398	1,483
Proceeds from sales of securities available for sale	19,470	952
Net loan originations	(16,155)	(13,570)
Purchases of company owned life insurance	(8)	(7)
Proceeds from sales of other assets		239
Purchases of premises and equipment	(1,071)	(1,712)
Net cash used in investing activities	(77,850)	(92,781)
Cash flows from financing activities:		
Net increase in deposits	213,364	147,703
Net decrease in short-term borrowings	(140,296)	(40,186)
Repurchase of preferred stock		(53)
Purchase of common stock for treasury	(194)	(229)
Proceeds from stock options exercised	110	13
Excess tax benefit on share-based compensation, net	6	6

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Cash dividends paid to common and preferred shareholders	(2,981)	(2,562)
Net cash provided by financing activities	70,009	104,692
Net increase in cash and cash equivalents	12,709	24,355
Cash and cash equivalents, beginning of period	59,692	60,436
Cash and cash equivalents, end of period	\$ 72,401	\$ 84,791
Supplemental information:		
Cash paid for interest	\$ 1,659	\$ 1,812
Cash paid for income taxes	3,100	140
Noncash investing and financing activities:		
Real estate and other assets acquired in settlement of loans	97	410
Accrued and declared unpaid dividends	2,981	2,839
Increase (decrease) in net unsettled security purchases	2,797	(43,978)
Loans transferred from held for sale to held for investment	853	
See accompanying notes to the consolidated financial statements.		

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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., is a financial holding company organized in 1931 under the laws of New York State (New York or NYS). Through its wholly-owned New York chartered banking subsidiary, Five Star Bank, Financial Institutions, Inc. offers a broad array of deposit, lending and other financial services to individuals, municipalities and businesses in Western and Central New York. The Company has also expanded its indirect lending network to include relationships with franchised automobile dealers in the Capital District of New York and Northern Pennsylvania. References to the Company mean the consolidated reporting entities and references to the Bank mean Five Star Bank.

Basis of Presentation

The consolidated financial statements include the accounts of 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 such rules and regulations. However, in the opinion of management, the accompanying consolidated financial statements reflect all adjustments of a normal and recurring nature necessary 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 2013 Annual Report on Form 10-K. 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 January 2014, the Financial Accounting Standards Board issued Accounting Standards Update (ASU) No. 2014-04, *Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure*. The

objective of this guidance is to clarify when an in substance repossession or foreclosure occurs, that is, when a creditor should be considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan such that the loan receivable should be derecognized and the real estate property recognized. ASU No. 2014-04 states that an in substance repossession or foreclosure occurs, and a creditor is considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan, upon either (1) the creditor obtaining legal title to the residential real estate property upon completion of a foreclosure or (2) the borrower conveying all interest in the residential real estate property to the creditor to satisfy that loan through completion of a deed in lieu of foreclosure or through a similar legal agreement. Additionally, ASU No. 2014-04 requires interim and annual disclosure of both (1) the amount of foreclosed residential real estate property held by the creditor and (2) the recorded investment in consumer mortgage loans collateralized by residential real estate property that are in the process of foreclosure according to local requirements of the applicable jurisdiction. ASU No. 2014-04 is effective for interim and annual reporting periods beginning after December 15, 2014. The adoption of ASU No. 2014-04 is not expected to have a material impact on the Company's consolidated statements of income and condition.

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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	
	March 31,	
	2014	2013
Net income available to common shareholders	\$ 6,853	\$ 5,781
Weighted average common shares outstanding:		
Total shares issued	14,162	14,162
Unvested restricted stock awards	(64)	(80)
Treasury shares	(325)	(365)
Total basic weighted average common shares outstanding	13,773	13,717
Incremental shares from assumed:		
Exercise of stock options	22	7
Vesting of restricted stock awards	29	43
Total diluted weighted average common shares outstanding	13,824	13,767
Basic earnings per common share	\$ 0.50	\$ 0.42
Diluted earnings per common share	\$ 0.50	\$ 0.42

There were approximately 14 thousand and 151 thousand average shares subject to stock options which were excluded from the computation of diluted EPS for the three month periods ended March 31, 2014 and 2013, respectively, because the effect would be antidilutive.

(3.) INVESTMENT SECURITIES

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

	Amortized	Unrealized	Unrealized	Fair
	Cost	Gains	Losses	Value
March 31, 2014				
Securities available for sale:				
U.S. Government agencies and government sponsored enterprises	\$ 190,967	\$ 1,659	\$ 2,132	\$ 190,494

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Mortgage-backed securities:

Federal National Mortgage Association	174,591	1,561	3,784	172,368
Federal Home Loan Mortgage Corporation	34,713	641	130	35,224
Government National Mortgage Association	60,857	2,164	113	62,908

Collateralized mortgage obligations:

Federal National Mortgage Association	65,427	339	1,708	64,058
Federal Home Loan Mortgage Corporation	104,334	232	3,656	100,910
Government National Mortgage Association	46,172	924	156	46,940
Privately issued		1,402		1,402

Total collateralized mortgage obligations	215,933	2,897	5,520	213,310
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Total mortgage-backed securities	486,094	7,263	9,547	483,810
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Asset-backed securities	18	328		346
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Total available for sale securities	\$ 677,079	\$ 9,250	\$ 11,679	\$ 674,650
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Securities held to maturity:

State and political subdivisions	\$ 253,576	\$ 2,578	\$ 63	\$ 256,091
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	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
December 31, 2013				
Securities available for sale:				
U.S. Government agencies and government sponsored enterprises	\$ 135,840	\$ 1,414	\$ 2,802	\$ 134,452
Mortgage-backed securities:				
Federal National Mortgage Association	173,507	1,511	4,810	170,208
Federal Home Loan Mortgage Corporation	36,737	562	205	37,094
Government National Mortgage Association	61,832	2,152	142	63,842
Collateralized mortgage obligations:				
Federal National Mortgage Association	63,838	261	3,195	60,904
Federal Home Loan Mortgage Corporation	102,660	169	5,856	96,973
Government National Mortgage Association	43,734	913	586	44,061
Privately issued		1,467		1,467
Total collateralized mortgage obligations	210,232	2,810	9,637	203,405
Total mortgage-backed securities	482,308	7,035	14,794	474,549
Asset-backed securities	18	381		399
Total available for sale securities	\$ 618,166	\$ 8,830	\$ 17,596	\$ 609,400
Securities held to maturity:				
State and political subdivisions	\$ 249,785	\$ 1,340	\$ 468	\$ 250,657

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

	Three months ended March 31,	
	2014	2013
Proceeds from sales	\$ 19,470	\$ 952
Gross realized gains	313	892

The scheduled maturities of securities available for sale and securities held to maturity at March 31, 2014 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	\$ 49,052	\$ 49,051
Due from one to five years	51,365	52,669
Due after five years through ten years	252,569	248,478
Due after ten years	324,093	324,452
	\$ 677,079	\$ 674,650
Debt securities held to maturity:		
Due in one year or less	\$ 24,841	\$ 24,908
Due from one to five years	111,876	112,972
Due after five years through ten years	116,817	118,157
Due after ten years	42	54
	\$ 253,576	\$ 256,091

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(3.) INVESTMENT SECURITIES (Continued)

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
March 31, 2014						
Securities available for sale:						
U.S. Government agencies and government sponsored enterprises	\$ 82,112	\$ 1,072	\$ 22,184	\$ 1,060	\$ 104,296	\$ 2,132
Mortgage-backed securities:						
Federal National Mortgage Association	96,533	2,416	25,166	1,368	121,699	3,784
Federal Home Loan Mortgage Corporation	8,490	130			8,490	130
Government National Mortgage Association	6,097	113			6,097	113
Collateralized mortgage obligations:						
Federal National Mortgage Association	35,545	656	15,645	1,052	51,190	1,708
Federal Home Loan Mortgage Corporation	71,893	2,158	20,989	1,498	92,882	3,656
Government National Mortgage Association	8,417	156			8,417	156
Total collateralized mortgage obligations	115,855	2,970	36,634	2,550	152,489	5,520
Total mortgage-backed securities	226,975	5,629	61,800	3,918	288,775	9,547
Total available for sale securities	309,087	6,701	83,984	4,978	393,071	11,679
Securities held to maturity:						
State and political subdivisions	10,907	63			10,907	63
Total temporarily impaired securities	\$ 319,994	\$ 6,764	\$ 83,984	\$ 4,978	\$ 403,978	\$ 11,742

December 31, 2013

Securities available for sale:						
U.S. Government agencies and government sponsored enterprises	\$ 86,177	\$ 2,788	\$ 2,717	\$ 14	\$ 88,894	\$ 2,802
Mortgage-backed securities:						
Federal National Mortgage Association	103,778	3,491	20,689	1,319	124,467	4,810
Federal Home Loan Mortgage Corporation	14,166	205			14,166	205
Government National Mortgage Association	14,226	142			14,226	142
Collateralized mortgage obligations:						
Federal National Mortgage Association	35,632	2,586	11,760	609	47,392	3,195
Federal Home Loan Mortgage Corporation	72,655	4,980	15,762	876	88,417	5,856
Government National Mortgage Association	8,396	586			8,396	586
Total collateralized mortgage obligations	116,683	8,152	27,522	1,485	144,205	9,637
Total mortgage-backed securities	248,853	11,990	48,211	2,804	297,064	14,794
Total available for sale securities	335,030	14,778	50,928	2,818	385,958	17,596
Securities held to maturity:						
State and political subdivisions	72,269	468			72,269	468
Total temporarily impaired securities	\$ 407,299	\$ 15,246	\$ 50,928	\$ 2,818	\$ 458,227	\$ 18,064

The total number of security positions in the investment portfolio in an unrealized loss position at March 31, 2014 was 141 compared to 331 at December 31, 2013. At March 31, 2014, the Company had positions in 21 investment securities with a fair value of \$84.0 million and a total unrealized loss of \$5.0 million that have been in a continuous unrealized loss position for more than 12 months. There were a total of 120 securities positions in the Company's investment portfolio, with a fair value of \$320.0 million and a total unrealized loss of \$6.8 million at March 31, 2014, that have been in a continuous unrealized loss position for less than 12 months. The unrealized loss on these investment securities was predominantly caused by changes in market interest rates subsequent to purchase. The fair value of most of the investment securities in the Company's portfolio fluctuates as market interest rates change.

Table of Contents**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Unaudited)****(3.) INVESTMENT SECURITIES (Continued)**

The Company reviews investment securities on an ongoing basis for the presence of other-than-temporary impairment (OTTI) with formal reviews performed quarterly. When evaluating debt securities for OTTI, management considers many factors, including: (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, (3) whether the market decline was affected by macroeconomic conditions, and (4) whether the Company has the intention to sell the debt security or whether it is more likely than not that it will be required to sell the debt security before its anticipated recovery. The assessment of whether OTTI exists involves a high degree of subjectivity and judgment and is based on the information then available to management. There was no impairment recorded during the three months ended March 31, 2014 and 2013.

Based on management's review and evaluation of the Company's debt securities as of March 31, 2014, the debt securities with unrealized losses were not considered to be OTTI. As of March 31, 2014, 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 March 31, 2014, 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.

(4.) 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
March 31, 2014			
Commercial business	\$ 268,308	\$ 44	\$ 268,352
Commercial mortgage	469,725	(962)	468,763
Residential mortgage	110,290	(126)	110,164
Home equity	326,744	5,604	332,348
Consumer indirect	620,916	26,630	647,546
Other consumer	21,488	179	21,667
Total	\$ 1,817,471	\$ 31,369	1,848,840
Allowance for loan losses			(27,152)

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Total loans, net \$ 1,821,688

December 31, 2013

Commercial business	\$ 265,751	\$ 15	\$ 265,766
Commercial mortgage	470,312	(1,028)	469,284
Residential mortgage	113,101	(56)	113,045
Home equity	320,658	5,428	326,086
Consumer indirect	609,390	26,978	636,368
Other consumer	22,893	177	23,070

Total \$ 1,802,105 \$ 31,514 1,833,619

Allowance for loan losses (26,736)

Total loans, net \$ 1,806,883

Loans held for sale (not included above) were comprised entirely of residential real estate mortgages and totaled \$900 thousand and \$3.4 million as of March 31, 2014 and December 31, 2013, respectively.

Table of Contents**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Unaudited)****(4.) LOANS (Continued)****Past Due Loans Aging**

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

	30-59 Days Past Due	60-89 Days Past Due	Greater Than 90 Days	Total Past Due	Nonaccrual	Current	Total Loans
March 31, 2014							
Commercial business	\$ 1,943	\$	\$	\$ 1,943	\$ 3,706	\$ 262,659	\$ 268,308
Commercial mortgage	1,290			1,290	9,545	458,890	469,725
Residential mortgage	468			468	760	109,062	110,290
Home equity	378			378	826	325,540	326,744
Consumer indirect	1,258	354		1,612	1,387	617,917	620,916
Other consumer	85	53	6	144	40	21,304	21,488
Total loans, gross	\$ 5,422	\$ 407	\$ 6	\$ 5,835	\$ 16,264	\$ 1,795,372	\$ 1,817,471
December 31, 2013							
Commercial business	\$ 558	\$ 199	\$	\$ 757	\$ 3,474	\$ 261,520	\$ 265,751
Commercial mortgage	800			800	9,663	459,849	470,312
Residential mortgage	542			542	1,078	111,481	113,101
Home equity	750	143		893	925	318,840	320,658
Consumer indirect	2,129	476		2,605	1,471	605,314	609,390
Other consumer	126	72	6	204	5	22,684	22,893
Total loans, gross	\$ 4,905	\$ 890	\$ 6	\$ 5,801	\$ 16,616	\$ 1,779,688	\$ 1,802,105

There were no loans past due greater than 90 days and still accruing interest as of March 31, 2014 and December 31, 2013. There were \$6 thousand in consumer overdrafts which were past due greater than 90 days as of March 31, 2014 and December 31, 2013. Consumer overdrafts are overdrawn deposit accounts which have been reclassified as loans but by their terms do not accrue interest.

Troubled Debt Restructurings

A modification of a loan constitutes a troubled debt restructuring (TDR) when a borrower is experiencing financial difficulty and the modification constitutes a concession. The Company offers various types of concessions when

modifying loans, however, forgiveness of principal is seldom granted. 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, requesting additional collateral, releasing collateral for consideration, 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).

	Number of Contracts	Pre- Modification Outstanding Recorded Investment	Post- Modification Outstanding Recorded Investment
March 31, 2014			
Commercial business		\$	\$
Commercial mortgage			
Total		\$	\$
March 31, 2013			
Commercial business	2	\$ 189	\$ 181
Commercial mortgage			
Total	2	\$ 189	\$ 181

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

All of the loans identified as TDRs by the Company during the three month period ended March 31, 2013 were previously on nonaccrual status and reported as impaired loans prior to restructuring. The modifications primarily related to extending the amortization periods of the loans. Nonaccrual loans that are restructured remain on nonaccrual status, but may move to accrual status after they have performed according to the restructured terms for a period of time. The TDR classification did not have a material impact on the Company's determination of the allowance for loan losses because the modified loans were impaired and evaluated for a specific reserve both before and after restructuring.

There were no loans modified as a TDR within the previous 12 months that defaulted during the three months ended March 31, 2014 or 2013. 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 three 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
March 31, 2014					
With no related allowance recorded:					
Commercial business	\$ 1,869	\$ 2,420	\$	\$ 1,831	\$
Commercial mortgage	1,095	1,126		937	
	2,964	3,546		2,768	
With an allowance recorded:					
Commercial business	1,837	1,857	397	1,669	
Commercial mortgage	8,450	8,850	926	8,657	
	10,287	10,707	1,323	10,326	
	\$ 13,251	\$ 14,253	\$ 1,323	\$ 13,094	\$

December 31, 2013

With no related allowance recorded:

Commercial business	\$ 1,777	\$ 2,273	\$	\$ 659	\$
Commercial mortgage	875	906		760	
	2,652	3,179		1,419	

With an allowance recorded:

Commercial business	1,697	1,717	201	3,196
Commercial mortgage	8,788	9,188	1,057	3,758
	10,485	10,905	1,258	6,954

\$ 13,137	\$ 14,084	\$ 1,258	\$ 8,373	\$
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(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)****(4.) 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
March 31, 2014		
Uncriticized	\$ 249,625	\$ 449,042
Special mention	8,133	3,713
Substandard	10,550	16,970
Doubtful		
Total	\$ 268,308	\$ 469,725

December 31, 2013		
Uncriticized	\$ 250,553	\$ 449,447
Special mention	6,311	6,895
Substandard	8,887	13,970
Doubtful		
Total	\$ 265,751	\$ 470,312

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
March 31, 2014				
Performing	\$ 109,530	\$ 325,918	\$ 619,529	\$ 21,442
Non-performing	760	826	1,387	46
Total	\$ 110,290	\$ 326,744	\$ 620,916	\$ 21,488
December 31, 2013				
Performing	\$ 112,023	\$ 319,733	\$ 607,919	\$ 22,882
Non-performing	1,078	925	1,471	11
Total	\$ 113,101	\$ 320,658	\$ 609,390	\$ 22,893

Table of Contents**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Unaudited)****(4.) LOANS (Continued)****Allowance for Loan Losses**

The following tables set forth the changes in the allowance for loan losses for the three month periods ended as of the dates indicated (in thousands):

	Commercial Business	Commercial Mortgage	Residential Mortgage	Home Equity	Consumer Indirect	Other Consumer	Total
March 31, 2014							
Allowance for loan losses:							
Beginning balance	\$ 4,273	\$ 7,743	\$ 676	\$ 1,367	\$ 12,230	\$ 447	\$ 26,736
Charge-offs	68		78	106	2,455	269	2,976
Recoveries	29	7	21	11	1,105	113	1,286
Provision	455	230	53	99	1,104	165	2,106
Ending balance	\$ 4,689	\$ 7,980	\$ 672	\$ 1,371	\$ 11,984	\$ 456	\$ 27,152
Evaluated for impairment:							
Individually	\$ 397	\$ 926	\$	\$	\$	\$	\$ 1,323
Collectively	\$ 4,292	\$ 7,054	\$ 672	\$ 1,371	\$ 11,984	\$ 456	\$ 25,829
Loans:							
Ending balance	\$ 268,308	\$ 469,725	\$ 110,290	\$ 326,744	\$ 620,916	\$ 21,488	\$ 1,817,471
Evaluated for impairment:							
Individually	\$ 3,706	\$ 9,545	\$	\$	\$	\$	\$ 13,251
Collectively	\$ 264,602	\$ 460,180	\$ 110,290	\$ 326,744	\$ 620,916	\$ 21,488	\$ 1,804,220
March 31, 2013							
Allowance for loan losses:							
Beginning balance	\$ 4,884	\$ 6,581	\$ 740	\$ 1,282	\$ 10,715	\$ 512	\$ 24,714
Charge-offs	239	3	162	269	1,718	252	2,643

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Recoveries	37	14	17	37	805	137	1,047
Provision	485	379	73	233	1,510	29	2,709

Ending balance	\$ 5,167	\$ 6,971	\$ 668	\$ 1,283	\$ 11,312	\$ 426	\$ 25,827
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Evaluated for impairment:

Individually	\$ 1,335	\$ 657	\$	\$	\$	\$	\$ 1,992
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Collectively	\$ 3,832	\$ 6,314	\$ 668	\$ 1,283	\$ 11,312	\$ 426	\$ 23,835
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Loans:

Ending balance	\$ 259,054	\$ 425,586	\$ 126,058	\$ 287,844	\$ 563,428	\$ 24,581	\$ 1,686,551
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Evaluated for impairment:

Individually	\$ 5,616	\$ 2,767	\$	\$	\$	\$	\$ 8,383
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Collectively	\$ 253,438	\$ 422,819	\$ 126,058	\$ 287,844	\$ 563,428	\$ 24,581	\$ 1,678,168
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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(4.) LOANS (Continued)

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 of higher risk and typically are made on the basis of the borrower's ability to make repayment from the cash flow of the borrower's business. Further, the collateral securing the loans may depreciate over time, may be difficult to appraise and may fluctuate in value. The credit risk related to commercial loans is largely influenced by general economic conditions and the resulting impact on a borrower's operations or on the value of underlying collateral, if any.

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

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

Consumer indirect and other consumer loans may entail greater credit risk than residential mortgage loans and home equities, particularly in the case of other consumer loans which are unsecured or, in the case of indirect consumer loans, secured by depreciable assets, such as automobiles or boats. In such cases, any repossessed collateral for a defaulted consumer loan may not provide an adequate source of repayment of the outstanding loan balance. In addition, consumer loan collections are dependent on the borrower's continuing financial stability, 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.

(5.) GOODWILL AND OTHER INTANGIBLE ASSETS

The carrying amount of goodwill totaled \$48.5 million as of March 31, 2014 and December 31, 2013. The goodwill relates to the Company's primary subsidiary and reporting unit, Five Star Bank. The Company performs a goodwill impairment test on an annual basis or more frequently if events and circumstances warrant.

The Company's other intangible assets, consisting entirely of a core deposit intangible asset, were as follows (in thousands):

	March 31, 2014	December 31, 2013
Gross carrying amount	\$ 2,042	\$ 2,042
Accumulated amortization	(665)	(576)
Net carrying value	\$ 1,377	\$ 1,466

Amortization expense for the core deposit intangible was \$89 thousand and \$101 thousand for the three months ended March 31, 2014 and 2013, respectively. As of March 31, 2014, the estimated core deposit intangible amortization expense for the remainder of 2014 and each of the next five years is as follows (in thousands):

2014 (remainder of year)	\$ 252
2015	296
2016	251
2017	205
2018	160
2019	115

Table of Contents**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Unaudited)****(6.) SHAREHOLDERS EQUITY****Common Stock**

The changes in shares of common stock were as follows for the three month periods ended March 31, 2014 and 2013:

	Outstanding	Treasury	Issued
March 31, 2014			
Shares outstanding at December 31, 2013	13,829,355	332,242	14,161,597
Restricted stock awards issued	33,842	(33,842)	
Restricted stock awards forfeited	(7,037)	7,037	
Stock options exercised	5,925	(5,925)	
Treasury stock purchases	(9,102)	9,102	
Shares outstanding at March 31, 2014	13,852,983	308,614	14,161,597
March 31, 2013			
Shares outstanding at December 31, 2012	13,787,709	373,888	14,161,597
Restricted stock awards issued	33,035	(33,035)	
Restricted stock awards forfeited	(6,237)	6,237	
Stock options exercised	800	(800)	
Treasury stock purchases	(11,349)	11,349	
Shares outstanding at March 31, 2013	13,803,958	357,639	14,161,597

(7.) ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS)

The following table presents the components of other comprehensive income (loss) for the three month periods ended March 31, 2014 and 2013 (in thousands):

	Pre-tax Amount	Tax Effect	Net-of-tax Amount
March 31, 2014			
Securities available for sale and transferred securities:			
Change in unrealized gain/loss during the period	\$ 6,650	\$ 2,634	\$ 4,016
Reclassification adjustment for net gains included in net income ⁽¹⁾	(450)	(178)	(272)

Total securities available for sale and transferred securities	6,200	2,456	3,744
Amortization of pension and post-retirement items:			
Prior service credit	(12)	(5)	(7)
Net actuarial losses	44	18	26
Total pension and post-retirement obligations	32	13	19
Other comprehensive income	\$ 6,232	\$ 2,469	\$ 3,763
March 31, 2013			
Securities available for sale:			
Change in unrealized gain/loss during the period	\$ (2,942)	\$ (1,166)	\$ (1,776)
Reclassification adjustment for net gains included in net income	(892)	(353)	(539)
Total securities available for sale	(3,834)	(1,519)	(2,315)
Amortization of pension and post-retirement items:			
Prior service credit	(12)	(5)	(7)
Net actuarial losses	341	135	206
Total pension and post-retirement obligations	329	130	199
Other comprehensive loss	\$ (3,505)	\$ (1,389)	\$ (2,116)

- (1) Includes amounts related to the amortization/accretion of unrealized net gains and losses related to 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)****(7.) ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS) (Continued)**

Activity in accumulated other comprehensive income (loss), net of tax, for the three month periods ended March 31, 2014 and 2013 was as follows (in thousands):

	Securities Available for Sale and Transferred Securities	Pension and Post- retirement Obligations	Accumulated Other Comprehensive Income (Loss)
March 31, 2014			
Balance at beginning of year	\$ (5,337)	\$ (4,850)	\$ (10,187)
Other comprehensive income before reclassifications	4,016		4,016
Amounts reclassified from accumulated other comprehensive income	(272)	19	(253)
Net current period other comprehensive income	3,744	19	3,763
Balance at end of period	\$ (1,593)	\$ (4,831)	\$ (6,424)
March 31, 2013			
Balance at beginning of year	\$ 16,060	\$ (12,807)	\$ 3,253
Other comprehensive (loss) income before reclassifications	(1,776)		(1,776)
Amounts reclassified from accumulated other comprehensive income	(539)	199	(340)
Net current period other comprehensive (loss) income	(2,315)	199	(2,116)
Balance at end of period	\$ 13,745	\$ (12,608)	\$ 1,137

The following table presents the amounts reclassified out of each component of accumulated other comprehensive income (loss) for the three month periods ended March 31, 2014 and 2013 (in thousands):

Details About Accumulated Other Comprehensive Income Component	Amount Reclassified from Accumulated Other Comprehensive Income Three months ended March 31, 2014 2013		Affected Line Item in the Consolidated Statement of Income
Realized gain on sale of investment securities	\$ 313	\$ 892	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	137		Interest income
	450	892	Total before tax
	(178)	(353)	Income tax expense
	272	539	Net of tax
Amortization of pension and post-retirement items:			
Prior service credit ⁽¹⁾	12	12	Salaries and employee benefits
Net actuarial losses ⁽¹⁾	(44)	(341)	Salaries and employee benefits
	(32)	(329)	Total before tax
	13	130	Income tax benefit
	(19)	(199)	Net of tax
Total reclassified for the period	\$ 253	\$ 340	

- ⁽¹⁾ These items are included in the computation of net periodic pension expense. See Note 9 Employee Benefit Plans for additional information.

Table of Contents**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Unaudited)****(8.) 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 and to give such persons a proprietary interest in the Company, thereby enhancing their personal interest in the Company's success.

The Company awarded grants of 22,642 shares of restricted common stock to certain members of management during the three months ended March 31, 2014. Fifty 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, 2014. The remaining fifty 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 a defined group of peer companies over a three-year performance period ended December 31, 2016. The shares earned based on the achievement of the EPS and TSR performance requirements, if any, will vest based on the recipient's continuous service to the Company on December 31, 2016.

The grant-date fair value of the TSR portion of the award granted during the three month period ended March 31, 2014 was determined using the Monte Carlo simulation model on the date of grant, assuming the following (i) expected term of 2.87 years, (ii) risk free interest rate of 0.62%, (iii) expected dividend yield of 3.59% and (iv) expected stock price volatility over the expected term of the TSR award of 39.4%. The grant-date fair value of all other restricted stock awards is equal to the closing market price of our common stock on the date of grant.

In addition, the Company granted 11,200 shares of restricted common stock to management during the three months ended March 31, 2014. The shares will vest after completion of a three-year service requirement. The market price of the restricted stock awards on the date of grant was \$21.19.

The restricted stock awards granted to management in 2014 do not have rights to dividends or dividend equivalents.

The following is a summary of restricted stock award activity for the three month period ended March 31, 2014:

	Number of Shares	Weighted Average Market Price at Grant Date
Outstanding at beginning of year	65,040	\$ 16.92
Granted	33,842	17.63
Vested	(24,728)	17.02
Forfeited	(7,037)	20.07

Outstanding at end of period	67,117	\$	16.91
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As of March 31, 2014, there was \$737 thousand of unrecognized compensation expense related to unvested restricted stock awards that is expected to be recognized over a weighted average period of 2.4 years.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(8.) 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 2014 or 2013. The following is a summary of stock option activity for the three months ended March 31, 2014 (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	192,934	\$ 19.83		
Exercised	(5,925)	18.62		
Expired	(15,623)	23.78		
Outstanding and exercisable at end of period	171,386	\$ 19.52	2.5	\$ 602

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 three months ended March 31, 2014 and 2013 was \$25 thousand and \$3 thousand, respectively. The total cash received as a result of option exercises under stock compensation plans for the three months ended March 31, 2014 and 2013 was \$110 thousand and \$13 thousand, respectively.

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 March 31,	
	2014	2013
Salaries and employee benefits	\$ 81	\$ 85
Other noninterest expense	22	17
Total share-based compensation expense	\$ 103	\$ 102

(9.) 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	
	March 31,	
	2014	2013
Service cost	\$ 479	\$ 516
Interest cost on projected benefit obligation	574	505
Expected return on plan assets	(1,029)	(921)
Amortization of prior service credit	(12)	(12)
Amortization of net actuarial losses	44	341
Net periodic pension expense	\$ 56	\$ 429

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 2014 fiscal year.

Table of Contents**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Unaudited)****(10.) 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):

	March 31, 2014	December 31, 2013
Commitments to extend credit	\$ 434,700	\$ 431,236
Standby letters of credit	10,403	8,618

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

The Company also extends rate lock agreements to borrowers related to the origination of residential mortgage loans. To mitigate the interest rate risk inherent in these rate lock agreements, 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 \$532 thousand at March 31, 2014. There were no forward sales commitments outstanding as of December 31, 2013. 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.

(11.) 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.

Table of Contents**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Unaudited)****(11.) 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 company's creditworthiness, among other things, as well as unobservable parameters. Any such valuation adjustments are applied consistently over time. The Company's valuation methodologies may produce a fair value calculation that may not be indicative of net realizable value or reflective of future fair values. While management believes the Company's valuation methodologies are appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different estimate of fair value at the reporting date. Furthermore, the reported fair value amounts have not been comprehensively revalued since the presentation dates, and therefore, estimates of fair value after the balance sheet date may differ significantly from the amounts presented herein. A more detailed description of the valuation methodologies used for assets and liabilities measured at fair value, as well as the general classification of such instruments pursuant to the valuation hierarchy, is set forth below.

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.

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)****(11.) 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
March 31, 2014				
Measured on a recurring basis:				
Securities available for sale:				
U.S. Government agencies and government sponsored enterprises	\$	\$ 190,494	\$	\$ 190,494
Mortgage-backed securities		483,810		483,810
Asset-backed securities		346		346
	\$	\$ 674,650	\$	\$ 674,650