

FINANCIAL INSTITUTIONS INC
Form 10-Q
August 05, 2016
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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 June 30, 2016

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 14,528,319 shares of Common Stock, \$0.01 par value, outstanding as of July 28, 2016.

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FINANCIAL INSTITUTIONS, INC.

Form 10-Q

For the Quarterly Period Ended June 30, 2016

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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 (Unaudited)***(Dollars in thousands, except share and per share data)*

	June 30, 2016	December 31, 2015
ASSETS		
Cash and due from banks	\$ 67,624	\$ 60,121
Securities available for sale, at fair value	619,719	544,395
Securities held to maturity, at amortized cost (fair value of \$490,833 and \$490,064, respectively)	478,549	485,717
Loans held for sale	209	1,430
Loans (net of allowance for loan losses of \$28,525 and \$27,085, respectively)	2,183,306	2,056,677
Company owned life insurance	62,456	63,045
Premises and equipment, net	40,562	39,445
Goodwill and other intangible assets, net	76,252	66,946
Other assets	56,912	63,248
Total assets	\$ 3,585,589	\$ 3,381,024
LIABILITIES AND SHAREHOLDERS EQUITY		
Deposits:		
Noninterest-bearing demand	\$ 626,240	\$ 641,972
Interest-bearing demand	560,284	523,366
Savings and money market	960,325	928,175
Time deposits	711,156	637,018
Total deposits	2,858,005	2,730,531
Short-term borrowings	338,300	293,100
Long-term borrowings, net of issuance costs of \$975 and \$1,010, respectively	39,025	38,990
Other liabilities	28,083	24,559
Total liabilities	3,263,413	3,087,180
Shareholders equity:		
Series A 3% preferred stock, \$100 par value; 1,533 shares authorized; 1,492 shares issued	149	149
Series B-1 8.48% preferred stock, \$100 par value; 200,000 shares authorized; 171,906 shares issued	17,191	17,191
Total preferred equity	17,340	17,340

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Common stock, \$0.01 par value; 50,000,000 shares authorized; 14,692,214 and 14,397,509 shares issued, respectively	147	144
Additional paid-in capital	81,255	72,690
Retained earnings	227,184	218,920
Accumulated other comprehensive loss	(654)	(11,327)
Treasury stock, at cost 163,695 and 207,317 shares, respectively	(3,096)	(3,923)
Total shareholders' equity	322,176	293,844
Total liabilities and shareholders' equity	\$ 3,585,589	\$ 3,381,024

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		Six months ended	
	June 30,	June 30,	June 30,	June 30,
	2016	2015	2016	2015
Interest income:				
Interest and fees on loans	\$ 22,368	\$ 20,446	\$ 44,425	\$ 40,583
Interest and dividends on investment securities	5,877	5,513	11,455	10,373
Other interest income	1		1	
Total interest income	28,246	25,959	55,881	50,956
Interest expense:				
Deposits	2,086	1,827	4,045	3,447
Short-term borrowings	344	213	683	443
Long-term borrowings	617	515	1,235	515
Total interest expense	3,047	2,555	5,963	4,405
Net interest income	25,199	23,404	49,918	46,551
Provision for loan losses	1,952	1,288	4,320	4,029
Net interest income after provision for loan losses	23,247	22,116	45,598	42,522
Noninterest income:				
Service charges on deposits	1,755	1,964	3,479	3,843
Insurance income	1,183	1,057	2,855	2,665
ATM and debit card	1,421	1,283	2,746	2,476
Investment advisory	1,365	541	2,608	1,028
Company owned life insurance	486	493	1,854	960
Investments in limited partnerships	36	55	92	529
Loan servicing	112	96	228	263
Net gain on sale of loans held for sale	78	39	156	108
Net gain on disposal of investment securities	1,387		2,000	1,062
Net gain on disposal of other assets	82	16	86	20
Other	1,011	911	2,029	1,798
Total noninterest income	8,916	6,455	18,133	14,752
Noninterest expense:				
Salaries and employee benefits	10,818	10,606	22,432	20,829
Occupancy and equipment	3,664	3,375	7,289	7,074
Professional services	2,833	866	4,280	1,834
Computer and data processing	913	810	1,717	1,512
Supplies and postage	464	508	1,058	1,071
FDIC assessments	441	415	877	833

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Advertising and promotions	347	238	724	477
Other	2,640	2,418	4,961	4,617
Total noninterest expense	22,120	19,236	43,338	38,247
Income before income taxes	10,043	9,335	20,393	19,027
Income tax expense	2,892	2,750	5,624	5,641
Net income	\$ 7,151	\$ 6,585	\$ 14,769	\$ 13,386
Preferred stock dividends	366	366	731	731
Net income available to common shareholders	\$ 6,785	\$ 6,219	\$ 14,038	\$ 12,655
Earnings per common share (Note 3):				
Basic	\$ 0.47	\$ 0.44	\$ 0.97	\$ 0.90
Diluted	\$ 0.47	\$ 0.44	\$ 0.97	\$ 0.90
Cash dividends declared per common share	\$ 0.20	\$ 0.20	\$ 0.40	\$ 0.40
Weighted average common shares outstanding:				
Basic	14,434	14,078	14,415	14,071
Diluted	14,489	14,121	14,477	14,118

See accompanying notes to the consolidated financial statements.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Consolidated Statements of Comprehensive Income (Unaudited)

<i>(Dollars in thousands)</i>	Three months ended June 30,		Six months ended June 30,	
	2016	2015	2016	2015
Net income	\$ 7,151	\$ 6,585	\$ 14,769	\$ 13,386
Other comprehensive income (loss), net of tax:				
Net unrealized (losses) gains on securities available for sale	3,311	(6,207)	10,394	(2,946)
Pension and post-retirement obligations	140	140	279	275
Total other comprehensive income (loss), net of tax	3,451	(6,067)	10,673	(2,671)
Comprehensive income	\$ 10,602	\$ 518	\$ 25,442	\$ 10,715

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)

Six months ended June 30, 2016 and 2015

<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, 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
Restricted stock awards issued, net			(1,060)			1,060	
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
Balance at January 1, 2016	\$ 17,340	\$ 144	\$ 72,690	\$ 218,920	\$ (11,327)	\$ (3,923)	\$ 293,844
Comprehensive income:							
Net income				14,769			14,769
Other comprehensive income, net of tax					10,673		10,673
Common stock issued		3	8,097				8,100
Share-based compensation plans:							
Share-based compensation			432				432
Stock options exercised			19			767	786
			(17)			17	

Restricted stock awards issued, net								
Excess tax benefit on share-based compensation			13					13
Stock awards			21		43			64
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				(5,774)				(5,774)
Balance at June 30, 2016	\$ 17,340	\$ 147	\$ 81,255	\$ 227,184	\$ (654)	\$ (3,096)	\$ 322,176	

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,	
	2016	2015
Cash flows from operating activities:		
Net income	\$ 14,769	\$ 13,386
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	2,990	2,671
Net amortization of premiums on securities	1,503	1,547
Provision for loan losses	4,320	4,029
Share-based compensation	432	370
Deferred income tax expense	(150)	202
Proceeds from sale of loans held for sale	7,671	7,321
Originations of loans held for sale	(6,294)	(6,906)
Income on company owned life insurance	(1,854)	(960)
Net gain on sale of loans held for sale	(156)	(108)
Net gain on disposal of investment securities	(2,000)	(1,062)
Net gain on sale and disposal of other assets	(86)	(20)
(Increase) decrease in other assets	(780)	1,009
Increase in other liabilities	2,434	820
Net cash provided by operating activities	22,799	22,299
Cash flows from investing activities:		
Purchases of available for sale securities	(176,913)	(241,906)
Purchases of held to maturity securities	(23,699)	(39,570)
Proceeds from principal payments, maturities and calls on available for sale securities	57,707	57,787
Proceeds from principal payments, maturities and calls on held to maturity securities	31,147	16,394
Proceeds from sales of securities available for sale	62,275	29,508
Net loan originations	(131,323)	(101,567)
Proceeds from company owned life insurance, net of purchases	2,443	(34)
Proceeds from sales of other assets	318	167
Purchases of premises and equipment	(3,422)	(2,891)
Cash consideration paid for acquisition, net of cash acquired	(868)	
Net cash used in investing activities	(182,335)	(282,112)
Cash flows from financing activities:		
Net increase in deposits	127,474	205,711
Net increase in short-term borrowings	45,200	15,796
Issuance of long-term debt		40,000
Debt issuance costs		(1,060)
Purchase of common stock for treasury		(41)

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Proceeds from stock options exercised	786	165
Excess tax benefit on share-based compensation, net	13	1
Cash dividends paid to common and preferred shareholders	(6,434)	(6,356)
Net cash provided by financing activities	167,039	254,216
Net increase in cash and cash equivalents	7,503	(5,597)
Cash and cash equivalents, beginning of period	60,121	58,151
Cash and cash equivalents, end of period	\$ 67,624	\$ 52,554
Supplemental information:		
Cash paid for interest	\$ 5,492	\$ 3,166
Cash paid for income taxes	3,224	1,539
Noncash investing and financing activities:		
Real estate and other assets acquired in settlement of loans	374	130
Accrued and declared unpaid dividends	3,256	3,182
Increase in net unsettled security purchases	1,250	4,023
Common stock issued for acquisition	8,100	
Assets acquired and liabilities assumed in business combinations:		
Fair value of assets acquired	4,848	
Fair value of liabilities assumed	1,845	
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., (the Company) is a financial holding company organized in 1931 under the laws of New York State. The Company provides diversified financial services through its subsidiaries, Five Star Bank, Scott Danahy Naylor, LLC (Scott Danahy Naylor) and Courier Capital, LLC (Courier Capital). 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 Bank has also expanded its indirect lending network to include relationships with franchised automobile dealers in the Capital District of New York and Northern and Central Pennsylvania. Scott Danahy Naylor provides a broad range of insurance services to personal and business clients across 44 states. Acquired on January 5, 2016, Courier Capital provides customized investment management, investment consulting and retirement plan services to individuals, businesses, institutions, foundations and retirement plans across nine states.

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 2015 Annual Report on Form 10-K for the year ended December 31, 2015. The results of operations for any interim periods are not necessarily indicative of the results which may be expected for the entire year.

Reclassifications

Certain reclassifications of previously reported amounts have been made to conform to the current year presentation. Such reclassifications did not impact net income or shareholders' equity as previously reported.

Subsequent Events

The Company has evaluated events and transactions for potential recognition or disclosure through the day the financial statements were issued and determined there were no material recognizable 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, and assumptions used in the defined benefit pension plan accounting.

Recent Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board (FASB) 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 continues to assess the potential impact of ASU 2014-09 on its accounting and disclosures.

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 2016, the FASB issued ASU No. 2016-01, *Financial Instruments – Overall (Subtopic 825-10) Recognition and Measurement of Financial Assets and Financial Liabilities*. ASU 2016-01 is intended to improve the recognition and measurement of financial instruments by requiring equity investments to be measured at fair value with changes in fair value recognized in net income; requiring public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes; requiring separate presentation of financial assets and financial liabilities by measurement category and form of financial asset on the balance sheet or the accompanying notes to the financial statements; eliminating the requirement for public business entities to disclose the method(s) and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured and amortized at cost on the balance sheet; and requiring a reporting organization to present separately in other comprehensive income the portion of the total change in the fair value of a liability resulting from a change in the instrument-specific credit risk when the organization has elected to measure the liability at fair value in accordance with the fair value option for financial instruments. ASU 2016-01 is effective for annual periods and interim periods within those annual periods, beginning after December 15, 2017. The amendments should be applied by means of a cumulative-effect adjustment to the balance sheet as of the beginning of the fiscal year of adoption. The amendments related to equity securities without readily determinable fair values (including disclosure requirements) should be applied prospectively to equity investments that exist as of the date of adoption. The Company is assessing the impact of ASU 2016-01 on its accounting and disclosures.

In February 2016, the FASB issued ASU No. 2016-02, *Leases (Topic 842)*. ASU 2016-02 establishes a right of use model that requires a lessee to record a right of use asset and a lease liability for all leases with terms longer than 12 months. Leases will be classified as either finance or operating, with classification affecting the pattern of expense recognition in the income statement. For lessors, the guidance modifies the classification criteria and the accounting for sales-type and direct financing leases. A lease will be treated as sale if it transfers all of the risks and rewards, as well as control of the underlying asset, to the lessee. If risks and rewards are conveyed without the transfer of control, the lease is treated as a financing. If the lessor doesn't convey risks and rewards or control, an operating lease results. The amendments are effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years for public business entities. Entities are required to use a modified retrospective approach for leases that exist or are entered into after the beginning of the earliest comparative period in the financial statements, with certain practical expedients available. Early adoption is permitted. The Company is assessing the impact of ASU 2016-02 on its accounting and disclosures.

In March 2016, the FASB issued ASU No. 2016-09, *Compensation – Stock Compensation (Topic 718) Improvements to Employee Share-Based Payment Accounting*. ASU 2016-09 requires all income tax effects of awards to be recognized in the income statement when the awards vest or are settled. It also allows an employer to repurchase more of an employee's shares than it can today for tax withholding purposes without triggering liability accounting and to make a policy election for forfeitures as they occur. The guidance is effective for public business entities for fiscal years beginning after December 15, 2016, and interim periods within those years. Early adoption is permitted. The

Company is assessing the impact of ASU 2016-09 on its accounting and disclosures.

In June 2016, the FASB issued ASU No. 2016-13, *Financial Instruments – Credit Losses (Topic 326) – Measurement of Credit Losses on Financial Instruments*. ASU 2016-13 amends guidance on reporting credit losses for financial assets held at amortized cost basis and available for sale debt securities. Topic 326 eliminates the probable initial recognition threshold in current GAAP and, instead, requires an entity to reflect its current estimate of all expected credit losses based on historical experience, current conditions and reasonable and supportable forecasts. The allowance for credit losses is a valuation account that is deducted from the amortized cost basis of the financial assets to present the net amount expected to be collected. The guidance is effective for public business entities for fiscal years beginning after December 15, 2019, and interim periods within those years. Early adoption is permitted beginning after December 15, 2018. The Company is assessing the impact of ASU 2016-13 on its accounting and disclosures.

Table of Contents**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Unaudited)****(2.) BUSINESS COMBINATIONS*****Courier Capital Acquisition***

On January 5, 2016, the Company completed the acquisition of Courier Capital Corporation, a registered investment advisory and wealth management firm with approximately \$1.2 billion in assets under management. Consideration for the acquisition totaled \$9.0 million and included stock of \$8.1 million and \$918 thousand of cash. The acquisition also included up to \$2.8 million of potential future payments of stock and up to \$2.2 million of potential future cash bonuses contingent upon Courier Capital meeting certain EBITDA performance targets through 2018. In addition, the Company purchased two pieces of real property in Buffalo and Jamestown, New York used by Courier Capital for total cash considerations of \$1.3 million. As a result of the acquisition, the Company recorded goodwill of \$6.0 million and other intangible assets of \$3.9 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. Due to the timing of the closing of the acquisition, the fair values of other intangibles recorded are subject to adjustment as additional information becomes available to indicate a more accurate or appropriate fair value for the intangibles during the measurement period, which is not to exceed one year from the acquisition date. The following table presents the allocation of acquisition cost to the assets acquired and liabilities assumed, based on their estimated fair values.

Cash	\$ 50
Identified intangible assets	3,928
Premises and equipment, accounts receivable and other assets	870
Deferred tax liability	(1,797)
Other liabilities	(48)
Net assets acquired	\$ 3,003

The amounts assigned to goodwill and other intangible assets for the Courier Capital acquisition are as follows:

	Amount allocated	Useful life (in years)
Goodwill	\$ 6,015	n/a
Other intangible assets customer relationships	3,900	20
Other intangible assets other	28	5

\$ 9,943

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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 June 30,		Six months ended June 30,	
	2016	2015	2016	2015
Net income available to common shareholders	\$ 6,785	\$ 6,219	\$ 14,038	\$ 12,655
Weighted average common shares outstanding:				
Total shares issued	14,692	14,398	14,686	14,398
Unvested restricted stock awards	(75)	(100)	(77)	(87)
Treasury shares	(183)	(220)	(194)	(240)
Total basic weighted average common shares outstanding	14,434	14,078	14,415	14,071
Incremental shares from assumed:				
Exercise of stock options	21	22	24	22
Vesting of restricted stock awards	34	21	38	25
Total diluted weighted average common shares outstanding	14,489	14,121	14,477	14,118
Basic earnings per common share	\$ 0.47	\$ 0.44	\$ 0.97	\$ 0.90
Diluted earnings per common share	\$ 0.47	\$ 0.44	\$ 0.97	\$ 0.90

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				
Restricted stock awards	8	3	4	2
	8	3	4	2

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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, 2016</u>				
Securities available for sale:				
U.S. Government agencies and government sponsored enterprises	\$ 241,583	\$ 6,550	\$ 7	\$ 248,126
Mortgage-backed securities:				
Federal National Mortgage Association	311,783	8,776		320,559
Federal Home Loan Mortgage Corporation	30,743	772		31,515
Government National Mortgage Association	17,390	737	14	18,113
Collateralized mortgage obligations:				
Federal National Mortgage Association	363		1	362
Federal Home Loan Mortgage Corporation	77		1	76
Privately issued		784		784
Total mortgage-backed securities	360,356	11,069	16	371,409
Asset-backed securities		184		184
Total available for sale securities	\$ 601,939	\$ 17,803	\$ 23	\$ 619,719
Securities held to maturity:				
State and political subdivisions	294,507	10,061	1	304,567
Mortgage-backed securities:				
Federal National Mortgage Association	12,047	290		12,337
Government National Mortgage Association	25,978	307	4	26,281
Collateralized mortgage obligations:				
Federal National Mortgage Association	54,246	525	11	54,760
Federal Home Loan Mortgage Corporation	76,655	1,038	2	77,691
Government National Mortgage Association	15,116	85	4	15,197
Total mortgage-backed securities	184,042	2,245	21	186,266
Total held to maturity securities	\$ 478,549	\$ 12,306	\$ 22	\$ 490,833
<u>December 31, 2015</u>				
Securities available for sale:				

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U.S. Government agencies and government sponsored enterprises	\$ 260,748	\$ 1,164	\$ 1,049	\$ 260,863
Mortgage-backed securities:				
Federal National Mortgage Association	209,671	1,092	2,333	208,430
Federal Home Loan Mortgage Corporation	24,564	282	194	24,652
Government National Mortgage Association	26,465	943	4	27,404
Collateralized mortgage obligations:				
Federal National Mortgage Association	16,998	90	154	16,934
Federal Home Loan Mortgage Corporation	5,175	1	91	5,085
Privately issued		809		809
Total mortgage-backed securities	282,873	3,217	2,776	283,314
Asset-backed securities		218		218
Total available for sale securities	\$ 543,621	\$ 4,599	\$ 3,825	\$ 544,395
Securities held to maturity:				
State and political subdivisions	294,423	6,562	4	300,981
Mortgage-backed securities:				
Federal National Mortgage Association	9,242	14	79	9,177
Government National Mortgage Association	25,607	33	159	25,481
Collateralized mortgage obligations:				
Federal National Mortgage Association	56,791		818	55,973
Federal Home Loan Mortgage Corporation	80,570		1,120	79,450
Government National Mortgage Association	19,084	19	101	19,002
Total mortgage-backed securities	191,294	66	2,277	189,083
Total held to maturity securities	\$ 485,717	\$ 6,628	\$ 2,281	\$ 490,064

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

Investment securities with a total fair value of \$856.5 million at June 30, 2016 were pledged and encumbered as collateral to secure public deposits and for other purposes required or permitted by law.

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

	Three months ended June 30,		Six months ended June 30,	
	2016	2015	2016	2015
Proceeds from sales	\$ 44,648	\$	\$ 62,275	\$ 29,508
Gross realized gains	1,387		2,000	1,073
Gross realized losses				11

The scheduled maturities of securities available for sale and securities held to maturity at June 30, 2016 are shown below (in thousands). Actual 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	\$ 5,042	\$ 5,047
Due from one to five years	175,737	179,161
Due after five years through ten years	306,996	317,590
Due after ten years	114,164	117,921
	\$ 601,939	\$ 619,719
Debt securities held to maturity:		
Due in one year or less	\$ 38,909	\$ 39,051
Due from one to five years	176,378	182,498
Due after five years through ten years	92,311	96,184
Due after ten years	170,951	173,100
	\$ 478,549	\$ 490,833

Table of Contents**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Unaudited)****(4.) 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
June 30, 2016						
Securities available for sale:						
U.S. Government agencies and government sponsored enterprises	\$ 9,997	\$ 3	\$ 1,637	\$ 4	\$ 11,634	\$ 7
Mortgage-backed securities:						
Government National Mortgage Association	1,258	14			1,258	14
Collateralized mortgage obligations:						
Federal National Mortgage Association	362	1			362	1
Federal Home Loan Mortgage Corporation	64	1			64	1
Total mortgage-backed securities	1,684	16			1,684	16
Total available for sale securities	11,681	19	1,637	4	13,318	23
Securities held to maturity:						
State and political subdivisions	832	1			832	1
Mortgage-backed securities:						
Government National Mortgage Association			1,635	4	1,635	4
Collateralized mortgage obligations:						
Federal National Mortgage Association	4,119	11			4,119	11
Federal Home Loan Mortgage Corporation	1,196	2			1,196	2
Government National Mortgage Association	3,695	4			3,695	4

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Total mortgage-backed securities	9,010	17	1,635	4	10,645	21
Total held to maturity securities	9,842	18	1,635	4	11,477	22
Total temporarily impaired securities	\$ 21,523	\$ 37	\$ 3,272	\$ 8	\$ 24,795	\$ 45

December 31, 2015

Securities available for sale:

U.S. Government agencies and government sponsored enterprises	\$ 82,298	\$ 735	\$ 26,302	\$ 314	\$ 108,600	\$ 1,049
Mortgage-backed securities:						
Federal National Mortgage Association	123,774	2,134	9,562	199	133,336	2,333
Federal Home Loan Mortgage Corporation	12,660	194			12,660	194
Government National Mortgage Association	1,405	4			1,405	4
Collateralized mortgage obligations:						
Federal National Mortgage Association	7,778	154			7,778	154
Federal Home Loan Mortgage Corporation	4,998	91			4,998	91
Total mortgage-backed securities	150,615	2,577	9,562	199	160,177	2,776
Total available for sale securities	232,913	3,312	35,864	513	268,777	3,825

Securities held to maturity:

State and political subdivisions	3,075	4			3,075	4
Mortgage-backed securities:						
Federal National Mortgage Association	5,666	79			5,666	79
Government National Mortgage Association	8,790	159			8,790	159
Collateralized mortgage obligations:						
Federal National Mortgage Association	55,973	818			55,973	818
Federal Home Loan Mortgage Corporation	79,323	1,120			79,323	1,120
Government National Mortgage Association	14,559	101			14,559	101
Total mortgage-backed securities	164,311	2,277			164,311	2,277
Total held to maturity securities	167,386	2,281			167,386	2,281
Total temporarily impaired securities	\$ 400,299	\$ 5,593	\$ 35,864	\$ 513	\$ 436,163	\$ 6,106

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(4.) INVESTMENT SECURITIES (Continued)

The Company had 29 security positions in the investment portfolio in an unrealized loss position at June 30, 2016 compared to 174 at December 31, 2015. At June 30, 2016, the Company had positions in 6 investment securities with a fair value of \$3.3 million and a total unrealized loss of \$8 thousand that have been in a continuous unrealized loss position for more than 12 months. At June 30, 2016, there were a total of 23 securities positions in the Company's investment portfolio with a fair value of \$21.5 million and a total unrealized loss of \$37 thousand that had been in a continuous unrealized loss position for less than 12 months. At December 31, 2015, the Company had positions in 14 investment securities with a fair value of \$35.9 million and a total unrealized loss of \$513 thousand that had been in a continuous unrealized loss position for more than 12 months. At December 31, 2015, there were a total of 160 securities positions in the Company's investment portfolio with a fair value of \$400.3 million and a total unrealized loss of \$5.6 million 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 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 six months ended June 30, 2016 and 2015.

Based on management's review and evaluation of the Company's debt securities as of June 30, 2016, the debt securities with unrealized losses were not considered to be other-than-temporarily impaired. As of June 30, 2016, 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, 2016, 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 (Fees) Costs	Loans, Net
<u>June 30, 2016</u>			
Commercial business	\$ 349,076	\$ 356	\$ 349,432
Commercial mortgage	615,547	(1,406)	614,141
Residential real estate loans	402,538	5,829	408,367
Residential real estate lines	122,360	2,694	125,054
Consumer indirect	672,018	24,890	696,908
Other consumer	17,752	177	17,929
Total	\$ 2,179,291	\$ 32,540	2,211,831
Allowance for loan losses			(28,525)
Total loans, net			\$ 2,183,306
<u>December 31, 2015</u>			
Commercial business	\$ 313,475	\$ 283	\$ 313,758
Commercial mortgage	567,481	(1,380)	566,101
Residential real estate loans	376,023	5,051	381,074
Residential real estate lines	124,766	2,581	127,347
Consumer indirect	652,494	24,446	676,940
Other consumer	18,361	181	18,542
Total	\$ 2,052,600	\$ 31,162	2,083,762
Allowance for loan losses			(27,085)
Total loans, net			\$ 2,056,677

Loans held for sale (not included above) were comprised entirely of residential real estate mortgages and totaled \$209 thousand and \$1.4 million as of June 30, 2016 and December 31, 2015, 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
June 30, 2016							
Commercial business	\$ 46	\$	\$	\$ 46	\$ 2,312	\$ 346,718	\$ 349,076
Commercial mortgage					1,547	614,000	615,547
Residential real estate loans	562	52		614	1,485	400,439	402,538
Residential real estate lines	315			315	182	121,863	122,360
Consumer indirect	1,221	233		1,454	1,015	669,549	672,018
Other consumer	99	25	11	135	4	17,613	17,752
Total loans, gross	\$ 2,243	\$ 310	\$ 11	\$ 2,564	\$ 6,545	\$ 2,170,182	\$ 2,179,291
December 31, 2015							
Commercial business	\$ 321	\$ 612	\$	\$ 933	\$ 3,922	\$ 308,620	\$ 313,475
Commercial mortgage	68	146		214	947	566,320	567,481
Residential real estate loans	723	395		1,118	1,848	373,057	376,023
Residential real estate lines	199	34		233	235	124,298	124,766
Consumer indirect	1,975	286		2,261	1,467	648,766	652,494
Other consumer	98	13	8	119	13	18,229	18,361
Total loans, gross	\$ 3,384	\$ 1,486	\$ 8	\$ 4,878	\$ 8,432	\$ 2,039,290	\$ 2,052,600

There were no loans past due greater than 90 days and still accruing interest as of June 30, 2016 and December 31, 2015. There were \$11 thousand and \$8 thousand in consumer overdrafts which were past due greater than 90 days as of June 30, 2016 and December 31, 2015, respectively. Consumer overdrafts are overdrawn deposit accounts which have been reclassified as loans but by their terms do not accrue interest.

Troubled Debt Restructurings

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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, reductions in the interest rate for the remaining term of the loan, extensions of 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 Number of Recorded Contracts	Post- Modification Outstanding Recorded Investment	Pre- Modification Outstanding Number of Recorded Contracts	Post- Modification Outstanding Recorded Investment
June 30, 2016				
Commercial business	1	\$ 214	3	\$ 526
Commercial mortgage			1	550
Total	1	\$ 214	4	\$ 1,076
June 30, 2015				
Commercial business	2	\$ 1,342	2	\$ 1,342
Commercial mortgage			1	682
Total	2	\$ 1,342	3	\$ 2,024

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, 2016 and 2015 were previously reported as impaired loans prior to restructuring. Each of the loans restructured during the six months ended June 30, 2016 and 2015 were on nonaccrual status at the end of the respective period. The modifications related to collateral concessions and forbearance agreements. 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 classifications 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 six months ended June 30, 2016 or 2015. 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
June 30, 2016					
With no related allowance recorded:					
Commercial business	\$ 1,209	\$ 1,752	\$	\$ 1,678	\$
Commercial mortgage	777	986		1,114	
	1,986	2,738		2,792	
With an allowance recorded:					
Commercial business	1,103	1,103	476	1,323	
Commercial mortgage	770	900	131	510	
	1,873	2,003	607	1,833	

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\$ 3,859 \$ 4,741 \$ 607 \$ 4,625 \$

December 31, 2015

With no related allowance recorded:

Commercial business	\$ 1,441	\$ 1,810	\$	\$ 1,352	\$
Commercial mortgage	937	1,285		1,013	

	2,378	3,095		2,365	
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With an allowance recorded:

Commercial business	2,481	2,481	996	1,946	
Commercial mortgage	10	10	10	449	

	2,491	2,491	1,006	2,395	
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\$ 4,869 \$ 5,586 \$ 1,006 \$ 4,760 \$

(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, 2016</u>		
Uncriticized	\$ 333,564	\$ 594,576
Special mention	8,796	15,098
Substandard	6,716	5,873
Doubtful		

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Total	\$ 349,076	\$ 615,547
<u>December 31, 2015</u>		
Uncriticized	\$ 298,413	\$ 551,603
Special mention	4,916	9,015
Substandard	10,146	6,863
Doubtful		
Total	\$ 313,475	\$ 567,481

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 Real Estate Loans	Residential Real Estate Lines	Consumer Indirect	Other Consumer
<u>June 30, 2016</u>				
Performing	\$ 401,053	\$ 122,178	\$ 671,003	\$ 17,737
Non-performing	1,485	182	1,015	15
Total	\$ 402,538	\$ 122,360	\$ 672,018	\$ 17,752
<u>December 31, 2015</u>				
Performing	\$ 374,175	\$ 124,531	\$ 651,027	\$ 18,340
Non-performing	1,848	235	1,467	21
Total	\$ 376,023	\$ 124,766	\$ 652,494	\$ 18,361

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 Real Estate Loans	Residential Real Estate Lines	Consumer Indirect	Other Consumer	Total
June 30, 2016							
Loans:							
Ending balance	\$ 349,076	\$ 615,547	\$ 402,538	\$ 122,360	\$ 672,018	\$ 17,752	\$ 2,179,291
Evaluated for impairment:							
Individually	\$ 2,281	\$ 1,532	\$	\$	\$	\$	\$ 3,813
Collectively	\$ 346,795	\$ 614,015	\$ 402,538	\$ 122,360	\$ 672,018	\$ 17,752	\$ 2,175,478
Allowance for loan losses:							
Ending balance	\$ 6,197	\$ 9,496	\$ 1,444	\$ 318	\$ 10,696	\$ 374	\$ 28,525
Evaluated for impairment:							
Individually	\$ 466	\$ 129	\$	\$	\$	\$	\$ 595
Collectively	\$ 5,731	\$ 9,367	\$ 1,444	\$ 318	\$ 10,696	\$ 374	\$ 27,930
June 30, 2015							
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
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Evaluated for
impairment:

Individually	\$ 1,247	\$ 707	\$	\$	\$	\$	\$ 1,954
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Collectively	\$ 4,087	\$ 8,651	\$ 465	\$ 1,198	\$ 10,676	\$ 469	\$ 25,546
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The following table sets forth the changes in the allowance for loan losses for the three and six month periods ended June 30, 2016 (in thousands):

	Residential Residential		Commercial Commercial		Real Estate Real Estate	Consumer	Other	Total
	Business	Mortgage	Loans	Lines	Indirect	Consumer		
Three months ended June 30, 2016								
Beginning balance	\$ 5,436	\$ 9,715	\$ 1,384	\$ 345	\$ 10,297	\$ 391		\$ 27,568
Charge-offs	(42)	(8)	(134)	(47)	(1,898)	(119)		(2,248)
Recoveries	69	6	100	3	994	81		1,253
Provision (credit)	734	(217)	94	17	1,303	21		1,952
Ending balance	\$ 6,197	\$ 9,496	\$ 1,444	\$ 318	\$ 10,696	\$ 374		\$ 28,525
Six months ended June 30, 2016								
Beginning balance	\$ 5,540	\$ 9,027	\$ 1,347	\$ 345	\$ 10,458	\$ 368		\$ 27,085
Charge-offs	(644)	(12)	(180)	(51)	(4,396)	(276)		(5,559)
Recoveries	169	11	125	7	2,164	203		2,679
Provision	1,132	470	152	17	2,470	79		4,320
Ending balance	\$ 6,197	\$ 9,496	\$ 1,444	\$ 318	\$ 10,696	\$ 374		\$ 28,525

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, 2015 (in thousands):

	Commercial Business	Commercial Mortgage	Residential Real Estate Loans	Residential Real Estate Lines	Consumer Indirect	Other Consumer	Total
<u>Three months ended</u>							
<u>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,</u>							
<u>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

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, 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 real estate loans (comprised of conventional mortgages and home equity loans) and residential real estate lines (comprised of 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 \$66.4 and \$60.4 million as of June 30, 2016 and December 31, 2015, respectively. The Company performs a goodwill impairment test on an annual basis as of September 30 or more frequently if events and circumstances warrant.

	Banking	Non-Banking	Total
Balance, December 31, 2015	\$ 48,536	\$ 11,866	\$ 60,402
Acquisition		6,015	6,015
Balance, June 30, 2016	\$ 48,536	\$ 17,881	\$ 66,417

Goodwill and other intangible assets added during the period relates to the Courier Capital acquisition, which was completed on January 5, 2016. See Note 2 Business Combinations for additional information.

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

	June 30, 2016	December 31, 2015
Other intangibles assets:		
Gross carrying amount	\$ 12,610	\$ 8,682
Accumulated amortization	(2,775)	(2,138)
Net book value	\$ 9,835	\$ 6,544

Amortization expense for total other intangible assets was \$315 thousand and \$637 thousand for the three and six months ended June 30, 2016, \$238 thousand and \$481 thousand for the three and six months ended June 30, 2015, respectively. As of June 30, 2016, the estimated amortization expense of other intangible assets for the remainder of 2016 and each of the next five years is as follows (in thousands):

2016 (remainder of year)	\$ 612
2017	1,144
2018	1,035
2019	937

2020	840
2021	738

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(7.) SHAREHOLDERS EQUITY

Common Stock

The changes in shares of common stock were as follows for the six month periods ended June 30, 2016 and 2015:

	Outstanding	Treasury	Issued
<u>June 30, 2016</u>			
Shares outstanding at December 31, 2015	14,190,192	207,317	14,397,509
Common stock issued for acquisition	294,705		294,705
Restricted stock awards issued	8,800	(8,800)	
Restricted stock awards forfeited	(7,983)	7,983	
Stock options exercised	40,561	(40,561)	
Stock awards	2,244	(2,244)	
Shares outstanding at June 30, 2016	14,528,519	163,695	14,692,214
<u>June 30, 2015</u>			
Shares outstanding at December 31, 2014	14,118,048	279,461	14,397,509
Restricted stock awards issued	49,084	(49,084)	
Restricted stock awards forfeited	(2,271)	2,271	
Stock options exercised	3,722	(3,722)	
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

(8.) ACCUMULATED OTHER COMPREHENSIVE LOSS

The following tables present the components of other comprehensive income (loss) for the three and six month periods ended June 30, 2016 and 2015 (in thousands):

	Pre-tax Amount	Tax Effect	Net-of-tax Amount
<u>Three months ended June 30, 2016</u>			
Securities available for sale and transferred securities:			
Change in unrealized gain/loss during the period	\$ 6,810	\$ 2,629	\$ 4,181
	(1,417)	(547)	(870)

Reclassification adjustment for net gains included in net income ⁽¹⁾

Total securities available for sale and transferred securities	5,393	2,082	3,311
Amortization of pension and post-retirement items:			
Prior service credit	(12)	(4)	(8)
Net actuarial losses	239	91	148
Total pension and post-retirement obligations	227	87	140
Other comprehensive income	\$ 5,620	\$ 2,169	\$ 3,451

Three months ended June 30, 2015

Securities available for sale and transferred securities:			
Change in unrealized gain/loss during the period	\$ (9,986)	\$ (3,822)	\$ (6,164)
Reclassification adjustment for net gains included in net income ⁽¹⁾	(69)	(26)	(43)
Total securities available for sale and transferred securities	(10,055)	(3,848)	(6,207)
Amortization of pension and post-retirement items:			
Prior service credit	(12)	(4)	(8)
Net actuarial losses	235	87	148
Total pension and post-retirement obligations	223	83	140
Other comprehensive loss	\$ (9,832)	\$ (3,765)	\$ (6,067)

- ⁽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)****(8.) ACCUMULATED OTHER COMPREHENSIVE LOSS (Continued)**

	Pre-tax Amount	Tax Effect	Net-of-tax Amount
<u>Six months ended June 30, 2016</u>			
Securities available for sale and transferred securities:			
Change in unrealized gain/loss during the period	\$ 19,006	\$ 7,335	\$ 11,671
Reclassification adjustment for net gains included in net income ⁽¹⁾	(2,079)	(802)	(1,277)
Total securities available for sale and transferred securities	16,927	6,533	10,394
Amortization of pension and post-retirement items:			
Prior service credit	(24)	(9)	(15)
Net actuarial losses	478	184	294
Total pension and post-retirement obligations	454	175	279
Other comprehensive income	\$ 17,381	\$ 6,708	\$ 10,673
<u>Six months ended 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)

- ⁽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.

Activity in accumulated other comprehensive loss, net of tax, for the three and six month periods ended June 30, 2016 and 2015 was as follows (in thousands):

	Securities Available for Sale and Transferred Securities	Pension and Post- retirement Obligations	Accumulated Other Comprehensive Loss
<u>Three months ended June 30, 2016</u>			
Balance at beginning of period	\$ 6,387	\$ (10,492)	\$ (4,105)
Other comprehensive income before reclassifications	4,181		4,181
Amounts reclassified from accumulated other comprehensive loss	(870)	140	(730)
Net current period other comprehensive income	3,311	140	3,451
Balance at end of period	\$ 9,698	\$ (10,352)	\$ (654)
<u>Three months ended June 30, 2015</u>			
Balance at beginning of period	\$ 4,886	\$ (10,501)	\$ (5,615)
Other comprehensive loss before reclassifications	(6,164)		(6,164)
Amounts reclassified from accumulated other comprehensive loss	(43)	140	97
Net current period other comprehensive income (loss)	(6,207)	140	(6,067)
Balance at end of period	\$ (1,321)	\$ (10,361)	\$ (11,682)

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(8.) ACCUMULATED OTHER COMPREHENSIVE LOSS (Continued)

	Securities Available for Sale and Transferred Securities	Pension and Post- retirement Obligations	Accumulated Other Comprehensive Loss
<u>Six months ended June 30, 2016</u>			
Balance at beginning of period	\$ (696)	\$ (10,631)	\$ (11,327)
Other comprehensive income before reclassifications	11,671		11,671
Amounts reclassified from accumulated other comprehensive loss	(1,277)	279	(998)
Net current period other comprehensive income	10,394	279	10,673
Balance at end of period	\$ 9,698	\$ (10,352)	\$ (654)
<u>Six months ended June 30, 2015</u>			
Balance at beginning of period	\$ 1,625	\$ (10,636)	\$ (9,011)
Other comprehensive loss 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)

The following tables present the amounts reclassified out of each component of accumulated other comprehensive loss for the three and six month periods ended June 30, 2016 and 2015 (in thousands):

Details About Accumulated Other Comprehensive Loss Components	Amount Reclassified from Accumulated Other Comprehensive Loss	Affected Line Item in the Consolidated Statement of Income
--	--	--

	Three months ended June 30,		
	2016	2015	
Realized gain on sale of investment securities	\$ 1,387	\$	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	30	69	Interest income
	1,417	69	Total before tax
	(547)	(26)	Income tax expense
	870	43	Net of tax
Amortization of pension and post-retirement items:			
Prior service credit ⁽¹⁾	12	12	Salaries and employee benefits
Net actuarial losses ⁽¹⁾	(239)	(235)	Salaries and employee benefits
	(227)	(223)	Total before tax
	87	83	Income tax benefit
	(140)	(140)	Net of tax
Total reclassified for the period	\$ 730	\$ (97)	

⁽¹⁾ These items are included in the computation of net periodic pension expense. See Note 10 Employee Benefit Plans for additional information.

Table of Contents**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Unaudited)****(8.) ACCUMULATED OTHER COMPREHENSIVE LOSS (Continued)**

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
	2016	2015	
Realized gain on sale of investment securities	\$ 2,000	\$ 1,062	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	79	146	Interest income
	2,079	1,208	Total before tax
	(802)	(466)	Income tax expense
	1,277	742	Net of tax
Amortization of pension and post-retirement items:			
Prior service credit ⁽¹⁾	24	24	Salaries and employee benefits
Net actuarial losses ⁽¹⁾	(478)	(471)	Salaries and employee benefits
	(454)	(447)	Total before tax
	175	172	Income tax benefit
	(279)	(275)	Net of tax
Total reclassified for the period	\$ 998	\$ 467	

⁽¹⁾ These items are included in the computation of net periodic pension expense. See Note 10 Employee Benefit Plans for additional information.

Table of Contents**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Unaudited)****(9.) 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 (the MD&C 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 MD&C Committee approved the grant of restricted stock units (RSUs) and performance share units (PSUs) shown in the table below to certain members of management during the first six months of 2016.

	Number of Underlying Shares	Weighted Average Per Share Grant Date Fair Value
RSUs	14,500	\$ 24.21
PSUs	24,084	22.94

The grant-date fair value for the RSUs granted during the six month period ended June 30, 2016 is equal to the closing market price of our common stock on the date of grant reduced by the present value of the dividends expected to be paid on the underlying shares.

The number of PSUs that ultimately vest is contingent on achieving specified EPS targets and specified total shareholder return (TSR) targets relative to the SNL Small Cap Bank & Thrifts Index. 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, 2016. The remaining seventy percent of the shares will be earned based on the Company's achievement of a relative 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, 2018. The shares earned based on the achievement of the EPS and TSR performance requirements, if any, will vest on February 24, 2019 assuming the recipient's continuous service to the Company.

The grant-date fair value for the EPS portion of the PSUs granted during the six month period ended June 30, 2016 is equal to the closing market price of our common stock on the date of grant reduced by the present value of the dividends expected to be paid on the underlying shares. The grant-date fair value of the TSR portion of the PSUs granted during the six month period ended June 30, 2016 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 0.88%, (iii) expected dividend yield of 2.99% and (iv) expected stock price volatility over the expected term of the TSR

award of 24.3%.

During the six months ended June 30, 2016, the Company issued a total of 2,244 shares of common stock in-lieu of cash for the annual retainer of four non-employee directors and granted a total of 8,800 restricted shares of common stock to non-employee directors, of which 4,400 shares vested immediately and 4,400 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 \$28.38.

The following is a summary of restricted stock award activity for the six month period ended June 30, 2016:

	Number of Shares	Weighted Average Market Price at Grant Date
Outstanding at beginning of year	82,908	\$ 17.23
Granted	8,800	28.38
Vested	(9,770)	25.56
Forfeited	(7,983)	19.47
Outstanding at end of period	73,955	\$ 17.22

At June 30, 2016, the total unrecognized compensation cost related to the nonvested awards granted and expected to vest was \$1.3 million. This cost is expected to be recognized over a weighted-average period of 2.1 years.

Table of Contents**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Unaudited)****(9.) 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 2016 or 2015. The following is a summary of stock option activity for the six months ended June 30, 2016 (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	102,249	\$ 19.21		
Exercised	(40,561)	19.39		
Expired	(2,000)	19.70		
Outstanding and exercisable at end of period	59,688	\$ 19.07	1.3	\$ 418

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, 2016 and 2015 was \$334 thousand and \$39 thousand, respectively. The total cash received as a result of option exercises under stock compensation plans for the six months ended June 30, 2016 and 2015 was \$787 thousand and \$165 thousand, respectively.

The Company amortizes the expense related to stock-based compensation 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 June 30,		Six months ended June 30,	
	2016	2015	2016	2015
Salaries and employee benefits	\$ 157	\$ 113	\$ 255	\$ 191
Other noninterest expense	146	154	177	179
Total share-based compensation expense	\$ 303	\$ 267	\$ 432	\$ 370

(10.) 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,	
	2016	2015	2016	2015
Service cost	\$ 721	\$ 581	\$ 1,442	\$ 1,162
Interest cost on projected benefit obligation	602	583	1,203	1,166
Expected return on plan assets	(1,150)	(1,205)	(2,300)	(2,410)
Amortization of prior service credit	(12)	(12)	(24)	(24)
Amortization of net actuarial losses	239	235	478	471
Net periodic pension expense	\$ 400	\$ 182	\$ 799	\$ 365

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 2016 fiscal year.

Table of Contents**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Unaudited)****(11.) 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, 2016	December 31, 2015
Commitments to extend credit	\$ 518,186	\$ 514,818
Standby letters of credit	11,750	11,746

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 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 \$617 thousand and \$1.3 million at June 30, 2016 and December 31, 2015, 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.

(12.) 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)****(12.) 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)****(12.) 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
June 30, 2016				
Measured on a recurring basis:				
Securities available for sale:				
U.S. Government agencies and government sponsored enterprises	\$	\$ 248,126	\$	\$ 248,126
Mortgage-backed securities		371,409		371,409
Asset-backed securities		184		184
	\$	\$ 619,719	\$	\$ 619,719
Measured on a nonrecurring basis:				
Loans:				
Loans held for sale	\$	\$ 209	\$	\$ 209
Collateral dependent impaired loans			1,232	1,232
Other assets:				
Loan servicing rights			1,183	1,183
Other real estate owned			281	281
	\$	\$ 209	\$ 2,696	\$ 2,905

December 31, 2015**Measured on a recurring basis:**

Securities available for sale:

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U.S. Government agencies and government sponsored enterprises	\$	\$ 260,863	\$	\$ 260,863
Mortgage-backed securities		283,314		283,314
Asset-backed securities		218		218
	\$	\$ 544,395	\$	\$ 544,395

Measured on a nonrecurring basis:

Loans:				
Loans held for sale	\$	\$ 1,430	\$	\$ 1,430
Collateral dependent impaired loans			1,485	1,485
Other assets:				
Loan servicing rights			1,241	1,241
Other real estate owned			163	163
	\$	\$ 1,430	\$ 2,889	\$ 4,319

There were no transfers between Levels 1 and 2 during the six months ended June 30, 2016 and 2015. There were no liabilities measured at fair value on a recurring or nonrecurring basis during the six month periods ended June 30, 2016 and 2015.

Table of Contents**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Unaudited)****(12.) 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	\$ 1,232	Appraisal of collateral ⁽¹⁾	Appraisal adjustments ⁽²⁾	35% - 50% discount
Loan servicing rights	1,183	Discounted cash flow	Discount rate	4.4% ⁽³⁾
			Constant prepayment rate	15.4% ⁽³⁾
Other real estate owned	281	Appraisal of collateral ⁽¹⁾	Appraisal adjustments ⁽²⁾	13% - 72% 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, 2016.

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)****(12.) 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, 2016		December 31, 2015	
		Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
Financial assets:					
Cash and cash equivalents	Level 1	\$ 67,624	\$ 67,624	\$ 60,121	\$ 60,121
Securities available for sale	Level 2	619,719	619,719	544,395	544,395
Securities held to maturity	Level 2	478,549	490,833	485,717	490,064
Loans held for sale	Level 2	209	215	1,430	1,430
Loans	Level 2	2,182,074	2,202,286	2,055,192	2,046,235
Loans ⁽¹⁾	Level 3	1,232	1,232	1,485	1,485
Accrued interest receivable	Level 1	8,919	8,919	8,609	8,609
FHLB and FRB stock	Level 2	22,086	22,086	19,991	19,991
Financial liabilities:					
Non-maturity deposits	Level 1	2,146,849	2,146,849	2,093,513	2,093,513
Time deposits	Level 2	711,156	712,905	637,018	636,159
Short-term borrowings	Level 1	338,300	338,300	293,100	293,100
Long-term borrowings	Level 2	39,025	37,566	38,990	40,313
Accrued interest payable	Level 1	5,147	5,147	4,676	4,676

⁽¹⁾ Comprised of collateral dependent impaired loans.

(13.) SEGMENT REPORTING

The Company has two reportable segments: Banking and Non-Banking. These reportable segments have been identified and organized based on the nature of the underlying products and services applicable to each segment, the type of customers to whom those products and services are offered and the distribution channel through which those products and services are made available.

The banking segment includes all of the Company's retail and commercial banking operations. The non-banking segment includes the activities of Scott Danahy Naylon, a full service insurance agency that provides a broad range of insurance services to both personal and business clients, and Courier Capital, an investment advisor and wealth management firm that provides customized investment management, investment consulting and retirement plan

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services to individuals, businesses, institutions, foundations and retirement plans. The Company operated as two business segments (banking and insurance) until the acquisition of Courier Capital on January 5, 2016, at which time the insurance segment was re-named as the non-banking segment to reflect the inclusion of Courier Capital which has similar products, services and reporting, as noted above. Holding company amounts primarily reflect the 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.

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

	Banking	Non-Banking	Holding Company and Other	Consolidated Totals
<u>June 30, 2016</u>				
Goodwill	\$ 48,536	\$ 17,881	\$	\$ 66,417
Other intangible assets, net	3,733	6,102		9,835
Total assets	3,553,354	30,315	1,920	3,585,589
<u>December 31, 2015</u>				
Goodwill	\$ 48,536	\$ 11,866	\$	\$ 60,402
Other intangible assets, net	829	5,715		6,544
Total assets	3,356,987	20,315	3,722	3,381,024

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(13.) SEGMENT REPORTING (Continued)

	Banking	Non-Banking ⁽¹⁾	Holding Company and Other	Consolidated Totals
<u>Three months ended June 30, 2016</u>				
Net interest income (expense)	\$ 25,816	\$	\$ (617)	\$ 25,199
Provision for loan losses	(1,952)			(1,952)
Noninterest income	6,944	2,050	(78)	8,916
Noninterest expense	(18,054)	(1,764)	(2,302)	(22,120)
Income (loss) before income taxes	12,754	286	(2,997)	10,043
Income tax (expense) benefit	(3,889)	(112)	1,109	(2,892)
Net income (loss)	\$ 8,865	\$ 174	\$ (1,888)	\$ 7,151
<u>Six months ended June 30, 2016</u>				
Net interest income	\$ 51,153	\$	\$ (1,235)	\$ 49,918
Provision for loan losses	(4,320)			(4,320)
Noninterest income	13,807	4,534	(208)	18,133
Noninterest expense	(36,399)	(3,570)	(3,369)	(43,338)
Income (loss) before income taxes	24,241	964	(4,812)	20,393
Income tax (expense) benefit	(6,990)	(376)	1,742	(5,624)
Net income (loss)	\$ 17,251	\$ 588	\$ (3,070)	\$ 14,769
<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)

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Net income (loss)	\$ 7,378	\$ (12)	\$ (781)	\$ 6,585
Six months ended June 30, 2015				
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

(1) Includes activity from Courier Capital since January 5, 2016 (the date of acquisition).

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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, 2015. 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. (the Parent) and our subsidiaries (together, the Company, we, our or us); 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, 2015, 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:

If we experience greater credit losses than anticipated, earnings may be adversely impacted;

Our tax strategies and the value of our deferred tax assets could adversely affect our operating results and regulatory capital ratios;

Geographic concentration may unfavorably impact our operations;

We depend on the accuracy and completeness of information about or from customers and counterparties;

Our insurance brokerage subsidiary is subject to risk related to the insurance industry;

Our investment advisory and wealth management operations are subject to risk related to the financial services industry;

Our inability to successfully implement our growth strategies;

We are subject to environmental liability risk associated with our lending activities;

Commercial real estate and business loans increase our exposure to credit risks;

Our indirect lending involves risk elements in addition to normal credit risk;

We accept deposits that do not have a fixed term and which may be withdrawn by the customer at any time for any reason;

Any future FDIC insurance premium increases may adversely affect our earnings;

We are highly regulated and may be adversely affected by changes in banking laws, regulations and regulatory practices;

New or changing tax and accounting rules and interpretations could significantly impact our strategic initiatives, results of operations, cash flows, and financial condition;

Legal and regulatory proceedings and related matters could adversely affect us and banking industry in general;

A breach in security of our or third party information systems, including the occurrence of a cyber incident or a deficiency in cyber security, may subject us to liability, result in a loss of customer business or damage our brand image;

We face competition in staying current with technological changes to compete and meet customer demands;

We rely on other companies to provide key components of our business infrastructure;

We use financial models for business planning purposes that may not adequately predict future results;

We may not be able to attract and retain skilled people;

Acquisitions may disrupt our business and dilute shareholder value;

We are subject to interest rate risk;

Our business may be adversely affected by conditions in the financial markets and economic conditions generally;

The fiscal and monetary policies of the federal government and its agencies have a significant impact on our earnings;

The soundness of other financial institutions could adversely affect us;

The value of our goodwill and other intangible assets may decline in the future;

A future proxy contest for the election of directors at our annual meeting or proposals arising out of shareholder initiatives could cause us to incur additional substantial costs and could negatively affect our business;

We operate in a highly competitive industry and market area;

Severe weather, natural disasters, acts of war or terrorism, and other external events could significantly impact our business;

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MANAGEMENT'S DISCUSSION AND ANALYSIS

Liquidity is essential to our businesses;

We may need to raise additional capital in the future and such capital may not be available on acceptable terms or at all;

We rely on dividends from our subsidiaries for most of our revenue;

We may not pay or may reduce the dividends on our common stock;

We may issue debt and equity securities or securities convertible into equity securities, any of which may be senior to our common stock as to distributions and in liquidation, which could dilute our current shareholders or negatively affect the value of our common stock;

Our certificate of incorporation, our bylaws, and certain banking laws may have an anti-takeover effect; and

The market price of our common stock may fluctuate significantly in response to a number of factors. 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.

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 our Western and Central New York footprint. The Company provides diversified financial services through its subsidiaries, Five Star Bank, Scott Danahy Naylor, LLC (**Scott Danahy Naylor**) and Courier Capital, LLC (**Courier Capital**). 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 Bank has also expanded its indirect lending network to include relationships with franchised automobile dealers in the Capital District of New York and Northern and Central Pennsylvania. Scott Danahy Naylor provides a broad range of insurance services to personal and business clients across 44 states. Courier Capital, which we acquired on January 5, 2016, provides customized investment management, investment consulting and retirement plan services to individuals, businesses, institutions, foundations and retirement plans across nine states.

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, insurance and wealth management 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, insurance and wealth management 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, namely the growth of a diversified and high-quality loan portfolio.

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MANAGEMENT'S DISCUSSION AND ANALYSIS

EXECUTIVE OVERVIEW

Summary of 2016 Second Quarter Results

Net income increased \$566 thousand or 9% to \$7.2 million for the second quarter of 2016 compared to \$6.6 million for the second quarter of 2015. Net income available to common shareholders for the second quarter of 2016 was \$6.8 million, or \$0.47 per diluted share, compared with \$6.2 million, or \$0.44 per diluted share, for the second quarter of last year. Return on average equity was 9.07% and return on average assets was 0.80% for the second quarter of 2016 compared to 9.19% and 0.78%, respectively, for the second quarter of 2015.

Net interest income totaled \$25.2 million in the second quarter 2016, up from \$23.4 million in the second quarter 2015. Average earning assets were up \$236.9 million, led by a \$191.1 million increase in average loans in the second quarter of 2016 compared to the same quarter in 2015. The increase in average loans was primarily attributable to organic commercial loan growth. Second quarter 2016 net interest margin was 3.23%, a slight decrease from 3.24% reported in the second quarter of 2015.

The provision for loans losses was \$2.0 million in the second quarter of 2016 compared to \$1.3 million in the second quarter of 2015. Net charge-offs during the recent quarter were \$1.0 million, unchanged from the second quarter of 2015. Net charge-offs expressed as an annualized percentage of average loans outstanding were 0.19% during the second quarter of 2016 compared with 0.20% in the second quarter of 2015. 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 \$8.9 million in the second quarter of 2016, compared to \$6.5 million in the second quarter of 2015. Included in the second quarter of 2016 are net gains realized from the sale of investment securities totaling \$1.4 million. The higher noninterest income in the second quarter 2016 compared to the same quarter last year is also a result of the investment advisory income from Courier Capital. The increases in insurance income and ATM and debit income were partially offset by a decrease in service charges on deposits when comparing the second quarter periods.

Noninterest expense in the second quarter of 2016 totaled \$22.1 million compared with \$19.2 million in the second quarter of 2015. The increase in noninterest expense reflected higher professional services associated with responding to the proxy contest with Clover Partners, L.P., which amounted to \$1.7 million in the second quarter of 2016. The second quarter of 2016 also included increases in salaries and employee benefits and occupancy and equipment costs reflecting the addition of Courier Capital.

The regulatory Common equity Tier 1 ratio and Total risk-based capital ratio were 9.63%, and 13.08%, respectively, for the second quarter of 2016. 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.

Courier Capital Acquisition

On January 5, 2016, we completed the acquisition of Courier Capital Corporation, a registered investment advisory and wealth management firm with approximately \$1.2 billion in assets under management. Consideration for the

acquisition totaled \$9.0 million and included stock of \$8.1 million and \$918 thousand of cash. The acquisition also included \$2.8 million of potential future payments of stock and \$2.2 million of potential future cash bonuses contingent upon Courier Capital meeting certain EBITDA performance targets through 2018. In addition, the Company purchased two pieces of real property in Buffalo and Jamestown, New York used by Courier Capital for total cash considerations of \$1.3 million. As a result of the acquisition, we recorded goodwill of \$6.0 million and other intangible assets of \$3.9 million. The goodwill is not expected to be deductible for income tax purposes. Courier Capital now operates as a subsidiary of Financial Institutions, Inc. and an affiliate of Five Star Bank and Scott Danahy Naylor.

We expect to realize the following benefits from this acquisition:

Grow and diversify our noninterest income by offering investment advisory services

Further increase revenue by cross-selling between our banking, insurance and wealth management lines of business

Retain capable management with extensive experience in the investment advisory and wealth management industry

Improve our presence and brand recognition in the Buffalo marketplace

Provide access to a new customer base in our target expansion markets of Rochester and Buffalo

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MANAGEMENT'S DISCUSSION AND ANALYSIS

2016 Outlook

We began 2016 in a strong financial condition and with positive momentum. We expect net interest income to increase in 2016. We anticipate an increase in earning assets as we remain focused on loan growth, which will be primarily funded through deposit gathering. However, the benefit to net interest income from increased earning assets is expected to be partially offset by slight downward pressure on net interest margin. We plan to maintain a disciplined approach to loan pricing, but asset yields remain under pressure due to the low interest rate environment and flattening of the yield curve, while the opportunity for deposit repricing remains limited.

We expect our commercial loan portfolio to grow in a manner that is consistent with our strategic initiatives and continued support of middle market small business lending. Automobile loan originations remained strong through the first half of 2016, reflecting the positive impact from our investment in building automotive dealer relationships. The residential real estate portfolio, which includes both first and junior lien residential real estate related products, is expected to increase as we remain focused on the customer experience and our convenient application process.

We anticipate the increase in total loans will modestly outpace growth in total deposits. This anticipated outcome reflects our continued focus on targeting loyal relationship-based deposit customers rather than those that are more price sensitive. We expect to continue managing our overall cost of funds using short-term borrowings, as well as our continued shift in mix of deposits towards low- and no-cost demand deposits and money market deposit accounts.

Noninterest income during 2016 is expected to be higher than 2015, reflecting our continued efforts to increase both account and transaction-based fee income, coupled with the benefit of revenue from our fee-based subsidiaries, Scott Danahy Naylor and Courier Capital. We anticipate that the results of these efforts will further reduce our reliance on traditional spread-based net interest income, as fee-based activities are a relatively stable revenue source during periods of changing interest rates.

Noninterest expense is expected to increase in 2016 with the addition of Courier Capital, coupled with higher salaries and benefits costs associated with our expansion initiatives, including the opening of additional financial solution centers. We remain committed to diligent expense control and implemented several initiatives designed to reduce operating expenses late in the first quarter of 2016. We expect those specific savings to be reflected throughout the remainder of the year, however we do plan to continue to invest in our business with a focus on revenue enhancing initiatives to further accelerate our growth in the communities we serve.

We do not expect significant changes in overall asset quality and allowance measurements.

The effective tax rate for 2016 is expected to be slightly higher than it was in 2015, as the lower effective tax rate in 2015 was partly driven by historic tax credits claimed in 2015. However, our 2016 effective tax rate will continue to reflect the positive impacts of tax-exempt income (including the \$911 thousand of non-taxable company owned life death benefit proceeds received in the first quarter of 2016), tax advantaged investments, the formation of our real estate investment trust in early 2014 and benefits from New York State tax law changes that began going into effect during 2015.

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MANAGEMENT'S DISCUSSION AND ANALYSIS

RESULTS OF OPERATIONS

Net Interest Income and Net Interest Margin

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

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

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