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)

x **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	**16-0816610**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**
220 LIBERTY STREET, WARSAW, NEW YORK	**14569**
(Address of principal executive offices)	**(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 x 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 x No ¨

Indicate by check mark whether the regsitrant 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 x
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 x

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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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

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.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Consolidated Statements of Income (Unaudited)

(In thousands, except per share amounts)	Three months ended June 30,		Six months ended June 30,	
	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

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)

(Dollars in thousands)	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

(Dollars in thousands, except per share data)	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.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Consolidated Statements of Cash Flows (Unaudited)

(Dollars in thousands)	Six months ended June 30, 2016	Six months ended June 30, 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)

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.

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 Naylon, LLC (Scott Danahy Naylon) 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 Naylon 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.

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.

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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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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(3.) EARNINGS PER COMMON SHARE (EPS)

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

	Three months ended June 30,		Six months ended June 30,	
	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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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(4.) INVESTMENT SECURITIES

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

	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
June 30, 2016				
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
December 31, 2015				
Securities available for sale:				

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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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

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

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.

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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
June 30, 2016			
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
December 31, 2015			
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.

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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

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		
	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
June 30, 2016						
Commercial business	1	$ 214	$ 214	3	$ 526	$ 526
Commercial mortgage				1	550	550
Total	1	$ 214	$ 214	4	$ 1,076	$ 1,076
June 30, 2015						
Commercial business	2	$ 1,342	$ 1,342	2	$ 1,342	$ 1,342
Commercial mortgage				1	682	330
Total	2	$ 1,342	$ 1,342	3	$ 2,024	$ 1,672

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	

	$	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		
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		
	$	4,869	$	5,586	$	1,006	$	4,760	$	

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

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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
June 30, 2016		
Uncriticized	$ 333,564	$ 594,576
Special mention	8,796	15,098
Substandard	6,716	5,873
Doubtful		

Total	$ 349,076	$ 615,547
December 31, 2015		
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
June 30, 2016				
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
December 31, 2015				
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

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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
Evaluated for impairment:							
Individually	$ 1,247	$ 707	$	$	$	$	$ 1,954
Collectively	$ 4,087	$ 8,651	$ 465	$ 1,198	$ 10,676	$ 469	$ 25,546

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):

	Commercial Business	Commercial Mortgage	Residential Real Estate Loans	Residential Real Estate Lines	Consumer Indirect	Other Consumer	Total
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

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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
Three months ended June 30, 2015							
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	