

FINANCIAL INSTITUTIONS INC
Form 10-Q
August 04, 2017
Table of Contents

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

Form 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2017

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

Emerging growth company

If an emerging growth company, indicate by check mark if the Registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards pursuant to Section 13(a) of the Exchange Act

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 15,128,256 shares of Common Stock, \$0.01 par value, outstanding as of July 27, 2017.

Table of Contents

FINANCIAL INSTITUTIONS, INC.

Form 10-Q

For the Quarterly Period Ended June 30, 2017

TABLE OF CONTENTS

| | PAGE |
|---|-------------|
| PART I. <u>FINANCIAL INFORMATION</u> | |
| ITEM 1. <u>Financial Statements</u> | |
| <u>Consolidated Statements of Financial Condition (Unaudited) - at June 30, 2017 and December 31, 2016</u> | 3 |
| <u>Consolidated Statements of Income (Unaudited) - Three and six months ended June 30, 2017 and 2016</u> | 4 |
| <u>Consolidated Statements of Comprehensive Income (Unaudited) - Three and six months ended June 30, 2017 and 2016</u> | 5 |
| <u>Consolidated Statements of Changes in Shareholders' Equity (Unaudited) - Six months ended June 30, 2017 and 2016</u> | 6 |
| <u>Consolidated Statements of Cash Flows (Unaudited) - Six months ended June 30, 2017 and 2016</u> | 7 |
| <u>Notes to Consolidated Financial Statements (Unaudited)</u> | 8 |
| ITEM 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u> | 36 |
| ITEM 3. <u>Quantitative and Qualitative Disclosures About Market Risk</u> | 54 |
| ITEM 4. <u>Controls and Procedures</u> | 55 |
| PART II. <u>OTHER INFORMATION</u> | |
| ITEM 1. <u>Legal Proceedings</u> | 56 |
| ITEM 6. <u>Exhibits</u> | 56 |
| <u>Signatures</u> | 57 |

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, 2017 | December 31, 2016 |
|--|--------------------------|------------------------------|
| ASSETS | | |
| Cash and due from banks | \$ 84,537 | \$ 71,277 |
| Securities available for sale, at fair value | 540,575 | 539,926 |
| Securities held to maturity, at amortized cost (fair value of \$534,902 and \$539,991, respectively) | 533,471 | 543,338 |
| Loans held for sale | 1,864 | 1,050 |
| Loans (net of allowance for loan losses of \$33,159 and \$30,934, respectively) | 2,483,713 | 2,309,227 |
| Company owned life insurance | 64,381 | 63,455 |
| Premises and equipment, net | 46,328 | 42,398 |
| Goodwill and other intangible assets, net | 73,477 | 75,640 |
| Other assets | 63,192 | 64,029 |
| Total assets | \$ 3,891,538 | \$ 3,710,340 |
| LIABILITIES AND SHAREHOLDERS EQUITY | | |
| Deposits: | | |
| Noninterest-bearing demand | \$ 677,124 | \$ 677,076 |
| Interest-bearing demand | 631,451 | 581,436 |
| Savings and money market | 999,125 | 1,034,194 |
| Time deposits | 824,786 | 702,516 |
| Total deposits | 3,132,486 | 2,995,222 |
| Short-term borrowings | 347,500 | 331,500 |
| Long-term borrowings, net of issuance costs of \$904 and \$939, respectively | 39,096 | 39,061 |
| Other liabilities | 24,815 | 24,503 |
| Total liabilities | 3,543,897 | 3,390,286 |
| 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 |
| | 153 | 147 |

Edgar Filing: FINANCIAL INSTITUTIONS INC - Form 10-Q

| | | |
|---|--------------|--------------|
| Common stock, \$0.01 par value; 50,000,000 shares authorized; 15,263,811 and 14,692,214 shares issued, respectively | | |
| Additional paid-in capital | 98,856 | 81,755 |
| Retained earnings | 245,236 | 237,687 |
| Accumulated other comprehensive loss | (11,293) | (13,951) |
| Treasury stock, at cost 137,355 and 154,617 shares, respectively | (2,651) | (2,924) |
| Total shareholders' equity | 347,641 | 320,054 |
| Total liabilities and shareholders' equity | \$ 3,891,538 | \$ 3,710,340 |

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, 2017 | June 30, 2016 | June 30, 2017 | June 30, 2016 |
| Interest income: | | | | |
| Interest and fees on loans | \$ 25,469 | \$ 22,368 | \$ 50,085 | \$ 44,425 |
| Interest and dividends on investment securities | 5,898 | 5,877 | 11,795 | 11,455 |
| Other interest income | 42 | 1 | 67 | 1 |
| Total interest income | 31,409 | 28,246 | 61,947 | 55,881 |
| Interest expense: | | | | |
| Deposits | 2,500 | 2,086 | 4,731 | 4,045 |
| Short-term borrowings | 870 | 344 | 1,564 | 683 |
| Long-term borrowings | 617 | 617 | 1,235 | 1,235 |
| Total interest expense | 3,987 | 3,047 | 7,530 | 5,963 |
| Net interest income | 27,422 | 25,199 | 54,417 | 49,918 |
| Provision for loan losses | 3,832 | 1,952 | 6,613 | 4,320 |
| Net interest income after provision for loan losses | 23,590 | 23,247 | 47,804 | 45,598 |
| Noninterest income: | | | | |
| Service charges on deposits | 1,840 | 1,755 | 3,585 | 3,479 |
| Insurance income | 1,133 | 1,183 | 2,564 | 2,855 |
| ATM and debit card | 1,456 | 1,421 | 2,785 | 2,746 |
| Investment advisory | 1,429 | 1,365 | 2,860 | 2,608 |
| Company owned life insurance | 473 | 486 | 918 | 1,854 |
| Investments in limited partnerships | 135 | 36 | 105 | 92 |
| Loan servicing | 123 | 112 | 243 | 228 |
| Net gain on sale of loans held for sale | 72 | 78 | 120 | 156 |
| Net gain on investment securities | 210 | 1,387 | 416 | 2,000 |
| Net gain on other assets | 6 | 82 | 4 | 86 |
| Contingent consideration liability adjustment | 1,200 | | 1,200 | |
| Other | 1,256 | 1,011 | 2,369 | 2,029 |
| Total noninterest income | 9,333 | 8,916 | 17,169 | 18,133 |
| Noninterest expense: | | | | |
| Salaries and employee benefits | 11,986 | 10,818 | 23,355 | 22,432 |
| Occupancy and equipment | 4,184 | 3,664 | 8,148 | 7,289 |
| Professional services | 1,229 | 2,833 | 2,428 | 4,280 |
| Computer and data processing | 1,312 | 1,159 | 2,483 | 2,246 |
| Supplies and postage | 467 | 464 | 1,004 | 1,058 |

Edgar Filing: FINANCIAL INSTITUTIONS INC - Form 10-Q

| | | | | |
|--|---------------|---------------|---------------|---------------|
| FDIC assessments | 469 | 441 | 926 | 877 |
| Advertising and promotions | 473 | 530 | 751 | 957 |
| Amortization of intangibles | 291 | 315 | 588 | 637 |
| Goodwill impairment | 1,575 | | 1,575 | |
| Other | 1,955 | 1,896 | 3,625 | 3,562 |
| Total noninterest expense | 23,941 | 22,120 | 44,883 | 43,338 |
| Income before income taxes | 8,982 | 10,043 | 20,090 | 20,393 |
| Income tax expense | 2,736 | 2,892 | 5,901 | 5,624 |
| Net income | \$ 6,246 | \$ 7,151 | \$ 14,189 | \$ 14,769 |
| Preferred stock dividends | 366 | 366 | 731 | 731 |
| Net income available to common shareholders | \$ 5,880 | \$ 6,785 | \$ 13,458 | \$ 14,038 |
| Earnings per common share (Note 3): | | | | |
| Basic | \$ 0.40 | \$ 0.47 | \$ 0.92 | \$ 0.97 |
| Diluted | \$ 0.40 | \$ 0.47 | \$ 0.92 | \$ 0.97 |
| Cash dividends declared per common share | \$ 0.21 | \$ 0.20 | \$ 0.42 | \$ 0.40 |
| Weighted average common shares outstanding: | | | | |
| Basic | 14,664 | 14,434 | 14,572 | 14,415 |
| Diluted | 14,702 | 14,489 | 14,615 | 14,477 |

See accompanying notes to the consolidated financial statements.

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

| <i>(Dollars in thousands)</i> | Three months ended | | Six months ended | |
|--|---------------------------|-------------|-------------------------|-------------|
| | June 30, | | June 30, | |
| | 2017 | 2016 | 2017 | 2016 |
| Net income | \$ 6,246 | \$ 7,151 | \$ 14,189 | \$ 14,769 |
| Other comprehensive income (loss), net of tax: | | | | |
| Net unrealized gains (losses) on securities available for sale | 1,722 | 3,311 | 2,316 | 10,394 |
| Pension and post-retirement obligations | 171 | 140 | 342 | 279 |
| Total other comprehensive income (loss), net of tax | 1,893 | 3,451 | 2,658 | 10,673 |
| Comprehensive income | \$ 8,139 | \$ 10,602 | \$ 16,847 | \$ 25,442 |

See accompanying notes to the consolidated financial statements.

Table of Contents

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Consolidated Statements of Changes in Shareholders Equity (Unaudited)

Six months ended June 30, 2017 and 2016

| <i>(Dollars in thousands, except per share data)</i> | | | Additional | Accumulated | | | |
|--|------------------|---------------|------------------|-------------------|--------------------|-------------------|-------------------|
| | Preferred | Common | Paid-in | Retained | Other | Treasury | Total |
| | Equity | Stock | Capital | Earnings | Loss | Stock | Shareholders |
| | | | | | | | Equity |
| 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 |
| Restricted stock awards issued, net | | | (17) | | | 17 | |
| 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 |
| Balance at December 31, 2016 | \$ 17,340 | \$ 147 | \$ 81,755 | \$ 237,687 | \$ (13,951) | \$ (2,924) | \$ 320,054 |
| Cumulative-effect adjustment | | | (279) | 279 | | | |
| Balance at January 1, 2017 | \$ 17,340 | \$ 147 | \$ 81,476 | \$ 237,966 | \$ (13,951) | \$ (2,924) | \$ 320,054 |
| Comprehensive income: | | | | | | | |
| Net income | | | | 14,189 | | | 14,189 |
| Other comprehensive income, net of tax | | | | | 2,658 | | 2,658 |
| Common stock issued | | 6 | 16,702 | | | | 16,708 |
| Purchases of common stock for treasury | | | | | | (148) | (148) |

Edgar Filing: FINANCIAL INSTITUTIONS INC - Form 10-Q

| | | | | | | | |
|---|------------------|---------------|------------------|-------------------|--------------------|-------------------|-------------------|
| Share-based compensation plans: | | | | | | | |
| Share-based compensation | | | | 605 | | | 605 |
| Stock options exercised | | | | 5 | | 374 | 379 |
| Restricted stock awards issued, net | | | | 29 | | (29) | |
| Stock awards | | | | 39 | | 76 | 115 |
| 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-\$0.42 per share | | | | | | (6,188) | (6,188) |
| Balance at June 30, 2017 | \$ 17,340 | \$ 153 | \$ 98,856 | \$ 245,236 | \$ (11,293) | \$ (2,651) | \$ 347,641 |

See accompanying notes to the consolidated financial statements.

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

| <i>(Dollars in thousands)</i> | Six months ended June 30, | |
|--|--------------------------------------|------------------|
| | 2017 | 2016 |
| Cash flows from operating activities: | | |
| Net income | \$ 14,189 | \$ 14,769 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 3,053 | 2,990 |
| Net amortization of premiums on securities | 1,654 | 1,503 |
| Provision for loan losses | 6,613 | 4,320 |
| Share-based compensation | 605 | 432 |
| Deferred income tax expense (benefit) | 652 | (150) |
| Proceeds from sale of loans held for sale | 3,779 | 7,671 |
| Originations of loans held for sale | (4,473) | (6,294) |
| Income from company owned life insurance | (918) | (1,854) |
| Net gain on sale of loans held for sale | (120) | (156) |
| Net gain on investment securities | (416) | (2,000) |
| Goodwill impairment | 1,575 | |
| Net gain on other assets | (4) | (86) |
| (Increase) decrease in other assets | (1,085) | (780) |
| (Decrease) increase in other liabilities | (2,535) | 2,434 |
| Net cash provided by operating activities | 22,569 | 22,799 |
| Cash flows from investing activities: | | |
| Purchases of available for sale securities | (40,858) | (176,913) |
| Purchases of held to maturity securities | (41,522) | (23,699) |
| Proceeds from principal payments, maturities and calls on available for sale securities | 18,424 | 57,707 |
| Proceeds from principal payments, maturities and calls on held to maturity securities | 53,481 | 31,147 |
| Proceeds from sales of securities available for sale | 25,307 | 62,275 |
| Net loan originations | (181,253) | (131,323) |
| Proceeds from company owned life insurance, net of purchases | (8) | 2,443 |
| Proceeds from sales of other assets | 102 | 318 |
| Purchases of premises and equipment | (6,374) | (3,422) |
| Cash consideration paid for acquisition, net of cash acquired | | (868) |
| Net cash used in investing activities | (172,701) | (182,335) |
| Cash flows from financing activities: | | |
| Net increase in deposits | 137,264 | 127,474 |
| Net increase in short-term borrowings | 16,000 | 45,200 |
| Proceeds from issuance of common stock | 16,708 | |
| Purchase of common stock for treasury | (148) | |

Edgar Filing: FINANCIAL INSTITUTIONS INC - Form 10-Q

| | | |
|---|-----------|-----------|
| Proceeds from stock options exercised | 379 | 786 |
| Excess tax benefit on share-based compensation, net | | 13 |
| Cash dividends paid to common and preferred shareholders | (6,811) | (6,434) |
| Net cash provided by financing activities | 163,392 | 167,039 |
| Net increase in cash and cash equivalents | 13,260 | 7,503 |
| Cash and cash equivalents, beginning of period | 71,277 | 60,121 |
| Cash and cash equivalents, end of period | \$ 84,537 | \$ 67,624 |
| Supplemental information: | | |
| Cash paid for interest | \$ 6,501 | \$ 5,492 |
| Cash paid for income taxes | 5,849 | 3,224 |
| Noncash investing and financing activities: | | |
| Real estate and other assets acquired in settlement of loans | 154 | 374 |
| Accrued and declared unpaid dividends | 3,511 | 3,256 |
| Increase in net unsettled security purchases | 3,081 | 1,250 |
| 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. | | |

Table of Contents

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

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

Nature of Operations

Financial Institutions, Inc. (the Company) is a financial holding company organized in 1931 under the laws of New York State (New York). The Company provides diversified financial services through its subsidiaries, Five Star Bank, Scott Danahy Naylor, LLC (SDN) 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 also has indirect lending network relationships with franchised automobile dealers in the Capital District of New York and Northern and Central Pennsylvania. SDN provides a broad range of insurance services to personal and business clients across 45 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 the Company and its subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation. The accounting and reporting policies conform to U.S. generally accepted accounting principles (GAAP). Certain information and footnote disclosures normally included in financial statements prepared in conformity with GAAP have been condensed or omitted pursuant to such rules and regulations. However, in the opinion of management, the accompanying consolidated financial statements reflect all adjustments of a normal and recurring nature necessary 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. These consolidated financial statements should be read in conjunction with the Company's 2016 Annual Report on Form 10-K for the year ended December 31, 2016. 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 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. Management has made an initial scope assessment and additional progress is expected to be made in the third quarter of 2017 to address the changes pursuant to Topic 606. The Company has not yet determined the impact ASU 2014-09 will have on its financial statements.

Table of Contents**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Unaudited)****(1.) BASIS OF PRESENTATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES
(Continued)**

In January 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 financial statements.

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 financial statements.

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 could previously 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 adoption of ASU 2016-09 did not have a significant impact on the Company's financial statements.

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 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 financial statements.

In August 2016, the FASB issued ASU No. 2016-15, *Statement of Cash Flows (Topic 230) - Classification of Certain Cash Receipts and Cash Payments*. ASU 2016-15 provides guidance on the following eight specific cash flow issues: 1) debt prepayment or debt extinguishment costs; 2) settlement of zero-coupon debt instruments or other debt instruments with coupon interest rates that are insignificant in relation to the effective interest rate of the borrowing; 3) contingent consideration payments made after a business combination; 4) proceeds from the settlement of insurance claims; 5) proceeds from the settlement of corporate-owned life insurance policies, including bank-owned life insurance policies; 6) distributions received from equity method investees; 7) beneficial interests in securitization transactions; and 8) separately identifiable cash flows and application of the predominance principle. The guidance is effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. Early adoption is permitted, including adoption in an interim period. As this guidance only affects the classification within the statement of cash flows, this ASU is not expected to have a significant impact on the Company's financial statements.

Table of Contents**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Unaudited)****(1.) BASIS OF PRESENTATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES
(Continued)**

In January 2017, the FASB issued ASU No. 2017-04, *Intangibles - Goodwill and Other (Topic 350) - Simplifying the Test for Goodwill Impairment*. ASU 2017-04 simplifies the subsequent measurement of goodwill by eliminating Step 2 from the goodwill impairment test. Under the new guidance, an entity will recognize an impairment charge for the amount by which the carrying value exceeds the fair value. This standard is effective for annual or any interim goodwill impairment tests in fiscal years beginning after December 15, 2019. Early adoption is permitted for interim or annual goodwill impairment tests performed on testing dates after January 1, 2017. The Company early adopted ASU 2017-04 during the quarter ended June 30, 2017, in connection with the interim goodwill impairment test that was performed. For additional details, see Note 6, Goodwill and Other Intangible Assets. The early adoption of ASU 2017-04 did not have a significant impact on the Company's financial statements.

In March 2017, the FASB issued ASU No. 2017-07, *Compensation - Retirement Benefits (Topic 715) - Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost*, which provides additional guidance on the presentation of net periodic pension and postretirement benefit costs in the income statement and on the components eligible for capitalization. The amendments in this ASU require that an employer report the service cost component of the net periodic benefit costs in the same income statement line item as other compensation costs arising from services rendered by employees during the period. The non-service-cost components of net periodic benefit costs are to be presented in the income statement separately from the service cost components and outside a subtotal of income from operations. The ASU also allows for the capitalization of the service cost components, when applicable (i.e., as a cost of internally manufactured inventory or a self-constructed asset). The amendments are effective for annual periods beginning after December 15, 2017, including interim periods within those annual periods; early adoption is permitted as of the beginning of an annual period for which financial statements (interim or annual) have not been issued or made available for issuance. The amendments in this ASU are to be applied retrospectively. The Company is assessing the impact of ASU 2017-07 on its financial statements.

In March 2017, the FASB issued ASU No. 2017-08, *Receivables - Nonrefundable Fees and Other Costs (Subtopic 310-20) - Premium Amortization on Purchased Callable Debt Securities*. These amendments shorten the amortization period for certain callable debt securities held at a premium. Specifically, the amendments require the premium to be amortized to the earliest call date. The amendments do not require an accounting change for securities held at a discount; the discount continues to be amortized to maturity. The guidance is effective for public business entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. Early adoption is permitted, including adoption in an interim period. If an entity early adopts in an interim period, any adjustments should be reflected as of the beginning of the fiscal year that includes that interim period. The amendments should be applied on a modified retrospective basis, with a cumulative-effect adjustment directly to retained earnings as of the beginning of the period of adoption. The Company is assessing the impact of ASU 2017-08 on its financial statements.

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 \$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 consideration 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. 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

- 11 -

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

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

| | Three months ended June 30, | | Six months ended June 30, | |
|--|--|-------------|--------------------------------------|-------------|
| | 2017 | 2016 | 2017 | 2016 |
| Net income available to common shareholders | \$ 5,880 | \$ 6,785 | \$ 13,458 | \$ 14,038 |
| Weighted average common shares outstanding: | | | | |
| Total shares issued | 14,858 | 14,692 | 14,776 | 14,686 |
| Unvested restricted stock awards | (44) | (75) | (50) | (77) |
| Treasury shares | (150) | (183) | (154) | (194) |
| Total basic weighted average common shares outstanding | 14,664 | 14,434 | 14,572 | 14,415 |
| Incremental shares from assumed: | | | | |
| Exercise of stock options | 10 | 21 | 12 | 24 |
| Vesting of restricted stock awards | 28 | 34 | 31 | 38 |
| Total diluted weighted average common shares outstanding | 14,702 | 14,489 | 14,615 | 14,477 |
| Basic earnings per common share | \$ 0.40 | \$ 0.47 | \$ 0.92 | \$ 0.97 |
| Diluted earnings per common share | \$ 0.40 | \$ 0.47 | \$ 0.92 | \$ 0.97 |
| 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 |
| Total | | 8 | 3 | 4 |

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

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

| | Amortized Cost | Unrealized Gains | Unrealized Losses | Fair Value |
|---|-------------------|---------------------|----------------------|---------------|
| <u>June 30, 2017</u> | | | | |
| Securities available for sale: | | | | |
| U.S. Government agency and government sponsored enterprises | \$ 187,545 | \$ 844 | \$ 818 | \$ 187,571 |
| Mortgage-backed securities: | | | | |
| Federal National Mortgage Association | 308,724 | 1,014 | 2,400 | 307,338 |
| Federal Home Loan Mortgage Corporation | 30,653 | 125 | 487 | 30,291 |
| Government National Mortgage Association | 13,674 | 311 | 18 | 13,967 |
| Collateralized mortgage obligations: | | | | |
| Federal National Mortgage Association | 248 | 1 | 1 | 248 |
| Federal Home Loan Mortgage Corporation | 55 | | | 55 |
| Privately issued | | 875 | | 875 |
| Total mortgage-backed securities | 353,354 | 2,326 | 2,906 | 352,774 |
| Asset-backed securities | | 230 | | 230 |
| Total available for sale securities | \$ 540,899 | \$ 3,400 | \$ 3,724 | \$ 540,575 |
| Securities held to maturity: | | | | |
| State and political subdivisions | 289,684 | 4,864 | 346 | 294,202 |
| Mortgage-backed securities: | | | | |
| Federal National Mortgage Association | 10,076 | 13 | 71 | 10,018 |
| Federal Home Loan Mortgage Corporation | 3,250 | | 130 | 3,120 |
| Government National Mortgage Association | 26,678 | | 275 | 26,403 |
| Collateralized mortgage obligations: | | | | |
| Federal National Mortgage Association | 86,011 | 39 | 1,245 | 84,805 |
| Federal Home Loan Mortgage Corporation | 96,399 | 162 | 1,420 | 95,141 |
| Government National Mortgage Association | 21,373 | 21 | 181 | 21,213 |
| Total mortgage-backed securities | 243,787 | 235 | 3,322 | 240,700 |
| Total held to maturity securities | \$ 533,471 | \$ 5,099 | \$ 3,668 | \$ 534,902 |
| <u>December 31, 2016</u> | | | | |

Securities available for sale:

| | | | | |
|---|------------|----------|----------|------------|
| U.S. Government agency and government sponsored enterprises | \$ 187,325 | \$ 512 | \$ 1,569 | \$ 186,268 |
| Mortgage-backed securities: | | | | |
| Federal National Mortgage Association | 288,949 | 897 | 4,413 | 285,433 |
| Federal Home Loan Mortgage Corporation | 30,182 | 114 | 807 | 29,489 |
| Government National Mortgage Association | 15,473 | 316 | 15 | 15,774 |
| Collateralized mortgage obligations: | | | | |
| Federal National Mortgage Association | 16,921 | 74 | 125 | 16,870 |
| Federal Home Loan Mortgage Corporation | 5,142 | | 65 | 5,077 |
| Privately issued | | 824 | | 824 |
| Total mortgage-backed securities | 356,667 | 2,225 | 5,425 | 353,467 |
| Asset-backed securities | | 191 | | 191 |
| Total available for sale securities | \$ 543,992 | \$ 2,928 | \$ 6,994 | \$ 539,926 |

- 13 -

Table of Contents

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(4.) INVESTMENT SECURITIES (Continued)

| | Amortized Cost | Unrealized Gains | Unrealized Losses | Fair Value |
|--|-------------------|---------------------|----------------------|---------------|
| December 31, 2016 (continued) | | | | |
| Securities held to maturity: | | | | |
| State and political subdivisions | 305,248 | 2,127 | 1,616 | 305,759 |
| Mortgage-backed securities: | | | | |
| Federal National Mortgage Association | 10,362 | 1 | 124 | 10,239 |
| Federal Home Loan Mortgage Corporation | 3,290 | | 150 | 3,140 |
| Government National Mortgage Association | 24,575 | 18 | 182 | 24,411 |
| Collateralized mortgage obligations: | | | | |
| Federal National Mortgage Association | 83,929 | 21 | 1,573 | 82,377 |
| Federal Home Loan Mortgage Corporation | 101,025 | 80 | 1,827 | 99,278 |
| Government National Mortgage Association | 14,909 | 40 | 162 | 14,787 |
| Total mortgage-backed securities | 238,090 | 160 | 4,018 | 234,232 |
| Total held to maturity securities | \$ 543,338 | \$ 2,287 | \$ 5,634 | \$ 539,991 |

Investment securities with a total fair value of \$835.2 million at June 30, 2017 were pledged 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, | |
|-----------------------|-----------------------------------|-----------|------------------------------|-----------|
| | 2017 | 2016 | 2017 | 2016 |
| Proceeds from sales | \$ 12,957 | \$ 44,648 | \$ 25,307 | \$ 62,275 |
| Gross realized gains | 210 | 1,387 | 416 | 2,000 |
| Gross realized losses | | | | |

The scheduled maturities of securities available for sale and securities held to maturity at June 30, 2017 are shown below (in thousands). Actual expected maturities may differ from contractual maturities because issuers may have the right to call or prepay obligations.

| | Amortized Cost | Fair Value |
|--|---------------------------|-----------------------|
| Debt securities available for sale: | | |
| Due in one year or less | \$ 5 | \$ 5 |
| Due from one to five years | 145,001 | 145,186 |
| Due from five to ten years | 304,637 | 304,083 |
| Due after ten years | 91,256 | 91,301 |
| | \$540,899 | \$540,575 |
| Debt securities held to maturity: | | |
| Due in one year or less | \$ 54,438 | \$ 54,634 |
| Due from one to five years | 166,487 | 170,167 |
| Due from five to ten years | 79,180 | 79,761 |
| Due after ten years | 233,366 | 230,340 |
| | \$533,471 | \$534,902 |

- 14 -

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, 2017 | | | | | | |
| Securities available for sale: | | | | | | |
| U.S. Government agency and government sponsored enterprises | \$ 75,166 | \$ 806 | \$ 1,143 | \$ 12 | \$ 76,309 | \$ 818 |
| Mortgage-backed securities: | | | | | | |
| Federal National Mortgage Association | 207,971 | 2,400 | | | 207,971 | 2,400 |
| Federal Home Loan Mortgage Corporation | 24,963 | 487 | | | 24,963 | 487 |
| Government National Mortgage Association | | | 982 | 18 | 982 | 18 |
| Collateralized mortgage obligations: | | | | | | |
| Federal National Mortgage Association | | | 139 | 1 | 139 | 1 |
| Federal Home Loan Mortgage Corporation | | | 9 | | 9 | |
| Total mortgage-backed securities | 232,934 | 2,887 | 1,130 | 19 | 234,064 | 2,906 |
| Total available for sale securities | 308,100 | 3,693 | 2,273 | 31 | 310,373 | 3,724 |
| Securities held to maturity: | | | | | | |
| State and political subdivisions | 26,030 | 334 | 346 | 12 | 26,376 | 346 |
| Mortgage-backed securities: | | | | | | |
| Federal National Mortgage Association | 6,778 | 71 | | | 6,778 | 71 |
| Federal Home Loan Mortgage Corporation | 1,851 | 75 | 1,269 | 55 | 3,120 | 130 |
| Government National Mortgage Association | 26,403 | 275 | | | 26,403 | 275 |
| Collateralized mortgage obligations: | | | | | | |
| Federal National Mortgage Association | 68,098 | 1,084 | 9,139 | 161 | 77,237 | 1,245 |
| Federal Home Loan Mortgage Corporation | 72,503 | 1,163 | 11,733 | 257 | 84,236 | 1,420 |
| Government National Mortgage Association | 16,702 | 158 | 1,223 | 23 | 17,925 | 181 |
| Total mortgage-backed securities | 192,335 | 2,826 | 23,364 | 496 | 215,699 | 3,322 |

| | | | | | | |
|---------------------------------------|------------|----------|-----------|--------|------------|----------|
| Total held to maturity securities | 218,365 | 3,160 | 23,710 | 508 | 242,075 | 3,668 |
| Total temporarily impaired securities | \$ 526,465 | \$ 6,853 | \$ 25,983 | \$ 539 | \$ 552,448 | \$ 7,392 |

December 31, 2016**Securities available for sale:**

| | | | | | | |
|---|------------|----------|----------|------|------------|----------|
| U.S. Government agencies and government sponsored enterprises | \$ 113,261 | \$ 1,566 | \$ 1,458 | \$ 3 | \$ 114,719 | \$ 1,569 |
| Mortgage-backed securities: | | | | | | |
| Federal National Mortgage Association | 211,491 | 4,413 | | | 211,491 | 4,413 |
| Federal Home Loan Mortgage Corporation | 24,360 | 807 | | | 24,360 | 807 |
| Government National Mortgage Association | 1,111 | 15 | | | 1,111 | 15 |
| Collateralized mortgage obligations: | | | | | | |
| Federal National Mortgage Association | 8,119 | 125 | | | 8,119 | 125 |
| Federal Home Loan Mortgage Corporation | 5,077 | 65 | | | 5,077 | 65 |
| Total mortgage-backed securities | 250,158 | 5,425 | | | 250,158 | 5,425 |
| Total available for sale securities | 363,419 | 6,991 | 1,458 | 3 | 364,877 | 6,994 |

Table of Contents

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(4.) INVESTMENT SECURITIES (Continued)

| | Less than 12 months | | 12 months or longer | | Total | |
|--|---------------------|-------------------|---------------------|-------------------|------------|-------------------|
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| December 31, 2016 (continued) | | | | | | |
| Securities held to maturity: | | | | | | |
| State and political subdivisions | 82,644 | 1,616 | | | 82,644 | 1,616 |
| Mortgage-backed securities: | | | | | | |
| Federal National Mortgage Association | 9,253 | 124 | | | 9,253 | 124 |
| Federal Home Loan Mortgage Corporation | 3,141 | 150 | | | 3,141 | 150 |
| Government National Mortgage Association | 10,736 | 182 | | | 10,736 | 182 |
| Collateralized mortgage obligations: | | | | | | |
| Federal National Mortgage Association | 72,734 | 1,560 | 3,107 | 13 | 75,841 | 1,573 |
| Federal Home Loan Mortgage Corporation | 92,256 | 1,825 | 430 | 2 | 92,686 | 1,827 |
| Government National Mortgage Association | 8,675 | 161 | 531 | 1 | 9,206 | 162 |
| Total mortgage-backed securities | 196,795 | 4,002 | 4,068 | 16 | 200,863 | 4,018 |
| Total held to maturity securities | 279,439 | 5,618 | 4,068 | 16 | 283,507 | 5,634 |
| Total temporarily impaired securities | \$ 642,858 | \$ 12,609 | \$ 5,526 | \$ 19 | \$ 648,384 | \$ 12,628 |

The total number of security positions in the investment portfolio in an unrealized loss position at June 30, 2017 was 296 compared to 463 at December 31, 2016. At June 30, 2017, the Company had positions in 29 investment securities with a fair value of \$26.0 million and a total unrealized loss of \$539 thousand that have been in a continuous unrealized loss position for more than 12 months. At June 30, 2017, there were a total of 267 securities positions in the Company's investment portfolio with a fair value of \$526.5 million and a total unrealized loss of \$6.9 million that had been in a continuous unrealized loss position for less than 12 months. At December 31, 2016, the Company had positions in nine investment securities with a fair value of \$5.5 million and a total unrealized loss of \$19 thousand that had been in a continuous unrealized loss position for more than 12 months. At December 31, 2016, there were a total of 454 securities positions in the Company's investment portfolio with a fair value of \$642.9 million and a total unrealized loss of \$12.6 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, 2017 and 2016.

Based on management's review and evaluation of the Company's debt securities as of June 30, 2017, the debt securities with unrealized losses were not considered to be OTTI. As of June 30, 2017, 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, 2017, 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, 2017</u> | | | |
| Commercial business | \$ 397,802 | \$ 541 | \$ 398,343 |
| Commercial mortgage | 725,793 | (1,729) | 724,064 |
| Residential real estate loans | 425,285 | 6,768 | 432,053 |
| Residential real estate lines | 115,768 | 2,843 | 118,611 |
| Consumer indirect | 797,469 | 29,239 | 826,708 |
| Other consumer | 16,917 | 176 | 17,093 |
| Total | \$ 2,479,034 | \$ 37,838 | 2,516,872 |
| Allowance for loan losses | | | (33,159) |
| Total loans, net | | | \$ 2,483,713 |
| <u>December 31, 2016</u> | | | |
| Commercial business | \$ 349,079 | \$ 468 | \$ 349,547 |
| Commercial mortgage | 671,552 | (1,494) | 670,058 |
| Residential real estate loans | 421,476 | 6,461 | 427,937 |
| Residential real estate lines | 119,745 | 2,810 | 122,555 |
| Consumer indirect | 725,754 | 26,667 | 752,421 |
| Other consumer | 17,465 | 178 | 17,643 |
| Total | \$ 2,305,071 | \$ 35,090 | 2,340,161 |
| Allowance for loan losses | | | (30,934) |
| Total loans, net | | | \$ 2,309,227 |

Loans held for sale (not included above) were comprised entirely of residential real estate mortgages and totaled \$1.9 million and \$1.1 million as of June 30, 2017 and December 31, 2016, respectively.

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

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

| | 30-59 Days Past Due | 60-89 Days Past Due | Greater Than 90 Days | Total Past Due | Nonaccrual | Current | Total Loans |
|---------------------------------|------------------------------------|------------------------------------|-------------------------------------|---------------------------|-------------------|----------------|------------------------|
| <u>June 30, 2017</u> | | | | | | | |
| Commercial business | \$ 44 | \$ | \$ | \$ 44 | \$ 7,312 | \$ 390,446 | \$ 397,802 |
| Commercial mortgage | 302 | | | 302 | 2,189 | 723,302 | 725,793 |
| Residential real estate loans | 843 | 107 | | 950 | 1,579 | 422,756 | 425,285 |
| Residential real estate lines | 194 | | | 194 | 379 | 115,195 | 115,768 |
| Consumer indirect | 1,367 | 408 | | 1,775 | 1,149 | 794,545 | 797,469 |
| Other consumer | 62 | 10 | 11 | 83 | 11 | 16,823 | 16,917 |
| Total loans, gross | \$ 2,812 | \$ 525 | \$ 11 | \$ 3,348 | \$ 12,619 | \$ 2,463,067 | \$ 2,479,034 |
| <u>December 31, 2016</u> | | | | | | | |
| Commercial business | \$ 1,337 | \$ | \$ | \$ 1,337 | \$ 2,151 | \$ 345,591 | \$ 349,079 |
| Commercial mortgage | 48 | | | 48 | 1,025 | 670,479 | 671,552 |
| Residential real estate loans | 1,073 | 253 | | 1,326 | 1,236 | 418,914 | 421,476 |
| Residential real estate lines | 216 | | | 216 | 372 | 119,157 | 119,745 |
| Consumer indirect | 2,320 | 488 | | 2,808 | 1,526 | 721,420 | 725,754 |
| Other consumer | 134 | 15 | 9 | 158 | 7 | 17,300 | 17,465 |
| Total loans, gross | \$ 5,128 | \$ 756 | \$ 9 | \$ 5,893 | \$ 6,317 | \$ 2,292,861 | \$ 2,305,071 |

There were no loans past due greater than 90 days and still accruing interest as of June 30, 2017 and December 31, 2016. There were \$11 thousand and \$9 thousand in consumer overdrafts which were past due greater than 90 days as of June 30, 2017 and December 31, 2016, respectively. Consumer overdrafts are overdrawn deposit accounts which have been reclassified as loans but by their terms do not accrue interest.

Troubled Debt Restructurings

Edgar Filing: FINANCIAL INSTITUTIONS INC - Form 10-Q

A modification of a loan constitutes a troubled debt restructuring (TDR) when a borrower is experiencing financial difficulty and the modification constitutes a concession. Commercial loans modified in a TDR may involve temporary interest-only payments, term extensions, 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 periods indicated (dollars in thousands).

| | Quarter-to-Date | | Year-to-Date | |
|-----------------------------|---------------------|------------------------|---------------------|------------------------|
| | Pre-Modification | Post-Modification | Pre-Modification | Post-Modification |
| | Number of Contracts | Outstanding Investment | Number of Contracts | Outstanding Investment |
| <u>June 30, 2017</u> | | | | |
| Commercial business | | \$ | | \$ |
| Commercial mortgage | | | | |
| Total | | \$ | | \$ |
| <u>June 30, 2016</u> | | | | |
| Commercial business | 1 | \$ 214 | 3 | \$ 526 |
| Commercial mortgage | | | 1 | 550 |
| Total | 1 | \$ 214 | 4 | \$ 1,076 |

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 were previously reported as impaired loans prior to restructuring. Each of the loans restructured during the six months ended June 30, 2016 were on nonaccrual status at the end of the respective period. The modifications related to collateral concessions. 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 either classified as substandard, with an increased risk allowance allocation, or 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, 2017 or 2016. 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, 2017 | | | | | |
| With no related allowance recorded: | | | | | |
| Commercial business | \$ 888 | \$ 1,249 | \$ | \$ 570 | \$ |
| Commercial mortgage | 629 | 629 | | 611 | |
| | 1,517 | 1,878 | | 1,181 | |
| With an allowance recorded: | | | | | |
| Commercial business | 6,574 | 6,623 | 2,698 | 3,257 | |
| Commercial mortgage | 2,078 | 2,078 | 122 | 706 | |
| | 8,652 | 8,701 | 2,820 | 3,963 | |

Edgar Filing: FINANCIAL INSTITUTIONS INC - Form 10-Q

\$ 10,169 \$ 10,579 \$ 2,820 \$ 5,144 \$

December 31, 2016

With no related allowance recorded:

| | | | | | |
|---------------------|--------|----------|----|----------|----|
| Commercial business | \$ 645 | \$ 1,044 | \$ | \$ 1,032 | \$ |
| Commercial mortgage | 673 | 882 | | 725 | |

| | | | | | |
|--|-------|-------|--|-------|--|
| | 1,318 | 1,926 | | 1,757 | |
|--|-------|-------|--|-------|--|

With an allowance recorded:

| | | | | | |
|---------------------|-------|-------|-----|-------|--|
| Commercial business | 1,506 | 1,506 | 694 | 1,141 | |
| Commercial mortgage | 352 | 352 | 124 | 486 | |

| | | | | | |
|--|-------|-------|-----|-------|--|
| | 1,858 | 1,858 | 818 | 1,627 | |
|--|-------|-------|-----|-------|--|

\$ 3,176 \$ 3,784 \$ 818 \$ 3,384 \$

(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, 2017</u> | | |
| Uncriticized | \$ 374,534 | \$ 706,447 |
| Special mention | 6,950 | 11,862 |
| Substandard | 16,318 | 7,484 |
| Doubtful | | |

Edgar Filing: FINANCIAL INSTITUTIONS INC - Form 10-Q

| | | |
|---------------------------------|------------|------------|
| Total | \$ 397,802 | \$ 725,793 |
| <u>December 31, 2016</u> | | |
| Uncriticized | \$ 326,254 | \$ 652,550 |
| Special mention | 10,377 | 12,690 |
| Substandard | 12,448 | 6,312 |
| Doubtful | | |
| Total | \$ 349,079 | \$ 671,552 |

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, 2017</u> | | | | |
| Performing | \$ 423,706 | \$ 115,389 | \$ 796,320 | \$ 16,895 |
| Non-performing | 1,579 | 379 | 1,149 | 22 |
| Total | \$ 425,285 | \$ 115,768 | \$ 797,469 | \$ 16,917 |
| <u>December 31, 2016</u> | | | | |
| Performing | \$ 420,240 | \$ 119,373 | \$ 724,228 | \$ 17,449 |
| Non-performing | 1,236 | 372 | 1,526 | 16 |
| Total | \$ 421,476 | \$ 119,745 | \$ 725,754 | \$ 17,465 |

- 20 -

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, 2017 | | | | | | | |
| Loans: | | | | | | | |
| Ending balance | \$ 397,802 | \$ 725,793 | \$ 425,285 | \$ 115,768 | \$ 797,469 | \$ 16,917 | \$ 2,479,034 |
| Evaluated for impairment: | | | | | | | |
| Individually | \$ 7,258 | \$ 2,164 | \$ | \$ | \$ | \$ | \$ 9,422 |
| Collectively | \$ 390,544 | \$ 723,629 | \$ 425,285 | \$ 115,768 | \$ 797,469 | \$ 16,917 | \$ 2,469,612 |
| Allowance for loan losses: | | | | | | | |
| Ending balance | \$ 14,622 | \$ 3,906 | \$ 1,247 | \$ 232 | \$ 12,833 | \$ 319 | \$ 33,159 |
| Evaluated for impairment: | | | | | | | |
| Individually | \$ 2,683 | \$ 120 | \$ | \$ | \$ | \$ | \$ 2,803 |
| Collectively | \$ 11,939 | \$ 3,786 | \$ 1,247 | \$ 232 | \$ 12,833 | \$ 319 | \$ 30,356 |
| 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 |
|--------------|----------|----------|----------|--------|-----------|--------|-----------|

The following table sets forth the changes in the allowance for loan losses for the three and six month periods ended June 30, 2017 (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, 2017</u> | | | | | | | |
| Beginning balance | \$ 14,003 | \$ 3,667 | \$ 1,440 | \$ 214 | \$ 11,462 | \$ 295 | \$ 31,081 |
| Charge-offs | (656) | | (86) | | (2,204) | (187) | (3,133) |
| Recoveries | 88 | 38 | 8 | 46 | 1,122 | 77 | 1,379 |
| Provision (credit) | 1,187 | 201 | (115) | (28) | 2,453 | 134 | 3,832 |
| Ending balance | \$ 14,622 | \$ 3,906 | \$ 1,247 | \$ 232 | \$ 12,833 | \$ 319 | \$ 33,159 |
| <u>Six months ended June 30, 2017</u> | | | | | | | |
| Beginning balance | \$ 7,225 | \$ 10,315 | \$ 1,478 | \$ 303 | \$ 11,311 | \$ 302 | \$ 30,934 |
| Charge-offs | (1,778) | (10) | (100) | (43) | (5,013) | (390) | (7,334) |
| Recoveries | 246 | 252 | 48 | 56 | 2,173 | 171 | 2,946 |
| Provision (credit) | 8,929 | (6,651) | (179) | (84) | 4,362 | 236 | 6,613 |
| Ending balance | \$ 14,622 | \$ 3,906 | \$ 1,247 | \$ 232 | \$ 12,833 | \$ 319 | \$ 33,159 |

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, 2016 (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, 2016</u> | | | | | | | |
| 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 |
| <u>Six months ended June 30,</u> | | | | | | | |
| <u>2016</u> | | | | | | | |
| 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 |

Risk Characteristics

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

Commercial mortgage loans generally have larger balances and involve a greater degree of risk than residential mortgage loans, potentially resulting in higher potential losses on an individual customer basis. Loan repayment is often dependent on the successful operation and management of the properties, as well as on the collateral securing

the loan. Economic events or conditions in the real estate market could have an adverse impact on the cash flows generated by properties securing the Company's commercial real estate loans and on the value of such properties.

Residential 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****Goodwill**

The carrying amount of goodwill totaled \$64.8 and \$66.4 million as of June 30, 2017 and December 31, 2016, respectively. The Company performs a goodwill impairment test on an annual basis as of September 30th or more frequently if events and circumstances warrant.

| | Banking | Non-Banking | Total |
|----------------------------|----------------|--------------------|--------------|
| Balance, December 31, 2016 | \$ 48,536 | \$ 17,881 | \$ 66,417 |
| Impairment | | (1,575) | (1,575) |
| Balance, June 30, 2017 | \$ 48,536 | \$ 16,306 | \$ 64,842 |

Goodwill is not amortized but, instead, is subject to impairment tests on at least an annual basis, and more frequently if an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying amount. The Company completed an evaluation of the contingent earn out liability related to its 2014 acquisition of SDN during the second quarter of 2017, resulting in a contingent consideration liability adjustment of \$1.2 million. Based on this event, a goodwill impairment test was performed in the second quarter of 2017. Based on its qualitative assessment, the Company concluded it was more likely than not that the fair value of its SDN reporting unit was less than its carrying value. Accordingly, the Company performed a Step 1 review for possible goodwill impairment.

Under Step 1 of the goodwill impairment review, the fair value of the SDN reporting unit was calculated using income and market-based approaches. Under Step 1, it was determined that the carrying value of our SDN reporting unit exceeded its fair value. Based on this assessment, the Company recorded a goodwill impairment charge related to the SDN reporting unit of \$1.6 million during the quarter ended June 30, 2017.

Other Intangible Assets

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, 2017 | December 31, 2016 |
|----------------------------------|--------------------------|------------------------------|
| Other intangibles assets: | | |
| Gross carrying amount | \$ 12,610 | \$ 12,610 |

Edgar Filing: FINANCIAL INSTITUTIONS INC - Form 10-Q

| | | |
|--------------------------|----------|----------|
| Accumulated amortization | (3,975) | (3,387) |
| Net book value | \$ 8,635 | \$ 9,223 |

Amortization expense for total other intangible assets was \$291 thousand and \$588 thousand for the three and six months ended June 30, 2017, and \$315 thousand and \$637 thousand for the three and six months ended June 30, 2016, respectively. As of June 30, 2017, the estimated amortization expense of other intangible assets for the remainder of 2017 and each of the next five years is as follows (in thousands):

| | |
|--------------------------|--------|
| 2017 (remainder of year) | \$ 556 |
| 2018 | 1,035 |
| 2019 | 937 |
| 2020 | 840 |
| 2021 | 738 |
| 2022 | 663 |

- 23 -

Table of Contents**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, 2017 and 2016:

| | Outstanding | Treasury | Issued |
|---|--------------------|-----------------|---------------|
| <u>June 30, 2017</u> | | | |
| Shares outstanding at December 31, 2016 | 14,537,597 | 154,617 | 14,692,214 |
| Common stock issued for at-the-market equity offering | 571,597 | | 571,597 |
| Restricted stock awards issued | 8,510 | (8,510) | |
| Restricted stock awards forfeited | (10,359) | 10,359 | |
| Stock options exercised | 19,520 | (19,520) | |
| Stock awards | 3,914 | (3,914) | |
| Treasury stock purchases | (4,323) | 4,323 | |
| | | | |
| Shares outstanding at June 30, 2017 | 15,126,456 | 137,355 | 15,263,811 |
| | | | |
| <u>June 30, 2016</u> | | | |
| Shares outstanding at December 31, 2015 | 14,190,192 | 207,317 | 14,397,509 |
| Common stock issued for Courier Capital 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 |

On May 30, 2017, the Company entered into a sales agency agreement, with Sandler O'Neill + Partners, L.P. as sales agent, under which it may sell up to \$40 million of its common stock through an at-the-market equity offering program. The Company expects to use the net proceeds of this offering to support organic growth and other general corporate purposes, including contributing capital to its banking subsidiary, Five Star Bank. During the quarter ended June 30, 2017, the Company sold 571,597 shares of its common stock under this program at a weighted average price of \$30.59, representing gross proceeds of \$17.5 million. Net proceeds received were \$16.7 million.

Table of Contents

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(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, 2017 and 2016 (in thousands):

| | Pre-tax Amount | Tax Effect | Net-of-tax Amount |
|---|-------------------|------------|----------------------|
| <u>Three months ended June 30, 2017</u> | | | |
| Securities available for sale and transferred securities: | | | |
| Change in unrealized gain/loss during the period | \$ 2,988 | \$ 1,154 | \$ 1,834 |
| Reclassification adjustment for net gains included in net income ⁽¹⁾ | (184) | (72) | (112) |
| Total securities available for sale and transferred securities | 2,804 | 1,082 | 1,722 |
| Pension and post-retirement obligations: | | | |
| Amortization of prior service credit included in income | (13) | (6) | (7) |
| Amortization of net actuarial loss included in income | 291 | 113 | 178 |
| Total pension and post-retirement obligations | 278 | 107 | 171 |
| Other comprehensive income | \$ 3,082 | \$ 1,189 | \$ 1,893 |
| <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 |
| Reclassification adjustment for net gains included in net income ⁽¹⁾ | (1,417) | (547) | (870) |
| Total securities available for sale and transferred securities | 5,393 | 2,082 | 3,311 |
| Pension and post-retirement obligations: | | | |
| Amortization of prior service credit included in income | (12) | (4) | (8) |
| Amortization of net actuarial loss included in income | 239 | 91 | 148 |
| Total pension and post-retirement obligations | 227 | 87 | 140 |
| Other comprehensive income | \$ 5,620 | \$ 2,169 | \$ 3,451 |
| <u>Six months ended June 30, 2017</u> | | | |

Edgar Filing: FINANCIAL INSTITUTIONS INC - Form 10-Q

| | | | |
|---|---------------|--------------|---------------|
| Securities available for sale and transferred securities: | | | |
| Change in unrealized gain/loss during the period | \$ 4,158 | \$ 1,605 | \$ 2,553 |
| Reclassification adjustment for net gains included in net income ⁽¹⁾ | (387) | (150) | (237) |
| Total securities available for sale and transferred securities | 3,771 | 1,455 | 2,316 |
| Pension and post-retirement obligations: | | | |
| Amortization of prior service credit included in income | (26) | (10) | (16) |
| Amortization of net actuarial loss included in income | 583 | 225 | 358 |
| Total pension and post-retirement obligations | 557 | 215 | 342 |
| Other comprehensive income | \$ 4,328 | \$ 1,670 | \$ 2,658 |
| Six months ended June 30, 2016 | | | |
| 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 |
| Pension and post-retirement obligations: | | | |
| Amortization of prior service credit included in income | (24) | (9) | (15) |
| Amortization of net actuarial loss included in income | 478 | 184 | 294 |
| Total pension and post-retirement obligations | 454 | 175 | 279 |
| Other comprehensive income | \$ 17,381 | \$ 6,708 | \$ 10,673 |

- ⁽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)

Activity in accumulated other comprehensive loss, net of tax, for the three and six month periods ended June 30, 2017 and 2016 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, 2017</u> | | | |
| Balance at beginning of period | \$ (3,135) | \$ (10,051) | \$ (13,186) |
| Other comprehensive income (loss) before reclassifications | 1,834 | | 1,834 |
| Amounts reclassified from accumulated other comprehensive income (loss) | (112) | 171 | 59 |
| Net current period other comprehensive income (loss) | 1,722 | 171 | 1,893 |
| Balance at end of period | \$ (1,413) | \$ (9,880) | \$ (11,293) |
| <u>Three months ended June 30, 2016</u> | | | |
| Balance at beginning of period | \$ 6,387 | \$ (10,492) | \$ (4,105) |
| Other comprehensive income (loss) before reclassifications | 4,181 | | 4,181 |
| Amounts reclassified from accumulated other comprehensive income (loss) | (870) | 140 | (730) |
| Net current period other comprehensive income (loss) | 3,311 | 140 | 3,451 |
| Balance at end of period | \$ 9,698 | \$ (10,352) | \$ (654) |
| <u>Six months ended June 30, 2017</u> | | | |
| Balance at beginning of year | \$ (3,729) | \$ (10,222) | \$ (13,951) |
| Other comprehensive income (loss) before reclassifications | 2,553 | | 2,553 |
| | (237) | 342 | 105 |

Edgar Filing: FINANCIAL INSTITUTIONS INC - Form 10-Q

Amounts reclassified from accumulated
other comprehensive income (loss)

| | | | |
|---|------------|-------------|-------------|
| Net current period other comprehensive income (loss) | 2,316 | 342 | 2,658 |
| Balance at end of period | \$ (1,413) | \$ (9,880) | \$ (11,293) |
| Six months ended June 30, 2016 | | | |
| Balance at beginning of year | \$ (696) | \$ (10,631) | \$ (11,327) |
| Other comprehensive income (loss) before reclassifications | 11,671 | | 11,671 |
| Amounts reclassified from accumulated other comprehensive income (loss) | (1,277) | 279 | (998) |
| Net current period other comprehensive income (loss) | 10,394 | 279 | 10,673 |
| Balance at end of period | \$ 9,698 | \$ (10,352) | \$ (654) |

- 26 -

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

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, 2017 and 2016 (in thousands):

| Details About Accumulated Other Comprehensive Loss Components | Amount Reclassified from Accumulated Other Comprehensive Loss Three months ended June 30, | | Affected Line Item in the Consolidated Statement of Income |
|--|--|----------|---|
| | 2017 | 2016 | |
| Realized gain on sale of investment securities | \$ 210 | \$ 1,387 | Net gain on investment securities |
| Amortization of unrealized holding gains (losses) on investment securities transferred from available for sale to held to maturity | (26) | 30 | Interest income |
| | 184 | 1,417 | Total before tax |
| | (72) | (547) | Income tax expense |
| | 112 | 870 | Net of tax |
| Amortization of pension and post-retirement items: | | | |
| Prior service credit ⁽¹⁾ | 13 | 12 | Salaries and employee benefits |
| Net actuarial losses ⁽¹⁾ | (291) | (239) | Salaries and employee benefits |
| | (278) | (227) | Total before tax |
| | 107 | 87 | Income tax benefit |
| | (171) | (140) | Net of tax |
| Total reclassified for the period | \$ (59) | \$ 730 | |

| | Six months ended | | |
|--|-------------------------|-------------|-----------------------------------|
| | June 30, | | |
| | 2017 | 2016 | |
| Realized gain on sale of investment securities | \$ 416 | \$ 2,000 | Net gain on investment securities |
| Amortization of unrealized holding gains (losses) on investment securities transferred from available for sale to held to maturity | (29) | 79 | Interest income |
| | 387 | 2,079 | Total before tax |
| | (150) | (802) | Income tax expense |
| | 237 | 1,277 | Net of tax |
| Amortization of pension and post-retirement items: | | | |
| Prior service credit ⁽¹⁾ | 26 | 24 | Salaries and employee benefits |
| Net actuarial losses ⁽¹⁾ | (583) | (478) | Salaries and employee benefits |
| | (557) | (454) | Total before tax |
| | 215 | 175 | Income tax benefit |
| | (342) | (279) | Net of tax |
| Total reclassified for the period | \$ (105) | \$ 998 | |

⁽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, approved by the Company's shareholders that are administered by 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 long-term growth 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 2017.

| | Number of Underlying Shares | Weighted Average Per Share Grant Date Fair Value |
|------|--|---|
| RSUs | 25,331 | \$ 32.22 |
| PSUs | 12,531 | 33.07 |

The grant-date fair value for the RSUs granted during the six month period ended June 30, 2017 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 total shareholder return (TSR) targets relative to the SNL Small Cap Bank & Thrift Index, a market index the MD&C Committee has selected as a peer group for this purpose. 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 & Thrift Index over a three-year performance period ended December 31, 2019. The shares earned based on the achievement of the TSR performance requirement, if any, will vest on February 22, 2020 assuming the recipient's continuous service to the Company.

The grant-date fair value of the PSUs granted during the six month period ended June 30, 2017 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 1.45%, (iii) expected dividend yield of 2.41% and (iv) expected stock price volatility over the expected term of the TSR award of 21.9%. The Monte Carlo simulation model is a risk analysis method that selects a random value from a range of estimates.

During the six months ended June 30, 2017, the Company issued a total of 3,914 shares of common stock in-lieu of cash for the annual retainer of five non-employee directors and granted a total of 8,510 restricted shares of common stock to non-employee directors, of which 4,260 shares vested immediately and 4,250 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 \$29.35.

The following is a summary of restricted stock award and restricted stock units activity for the six month period ended June 30, 2017:

| | Number of Shares | Weighted Average Market Price at Grant Date |
|----------------------------------|-----------------------------|--|
| Outstanding at beginning of year | 114,565 | \$ 19.90 |
| Granted | 49,739 | 31.40 |
| Vested | (25,053) | 23.84 |
| Forfeited | (11,359) | 12.81 |
| Outstanding at end of period | 127,892 | \$ 24.23 |

At June 30, 2017, the total unrecognized compensation expense related to the nonvested awards granted and expected to vest was \$2.0 million. This cost is expected to be recognized over a weighted-average period of 2.2 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 first six months of 2017 or 2016. There was no unrecognized compensation expense related to unvested stock options as of June 30, 2017. The following is a summary of stock option activity for the six months ended June 30, 2017 (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 | 49,099 | \$ 19.00 | | |
| Exercised | (19,520) | 19.46 | | |
| Expired | (4,000) | 19.73 | | |
| Outstanding and exercisable at end of period | 25,579 | \$ 18.54 | 0.8 | \$ 288 |

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, 2017 and 2016 was \$277 thousand and \$334 thousand, respectively. The total cash received as a result of option exercises under stock compensation plans for the six months ended June 30, 2017 and 2016 was \$379 thousand and \$786 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, | |
|--|--------------------------------|--------|------------------------------|--------|
| | 2017 | 2016 | 2017 | 2016 |
| Salaries and employee benefits | \$ 221 | \$ 157 | \$ 428 | \$ 255 |
| Other noninterest expense | 145 | 146 | 177 | 177 |
| Total share-based compensation expense | \$ 366 | \$ 303 | \$ 605 | \$ 432 |

(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, | |
|---|--|-------------|--------------------------------------|-------------|
| | 2017 | 2016 | 2017 | 2016 |
| Service cost | \$ 785 | \$ 721 | \$ 1,570 | \$ 1,442 |
| Interest cost on projected benefit obligation | 614 | 602 | 1,227 | 1,203 |
| Expected return on plan assets | (1,194) | (1,150) | (2,388) | (2,300) |
| Amortization of unrecognized prior service credit | (13) | (12) | (26) | (24) |
| Amortization of unrecognized net actuarial loss | 291 | 239 | 583 | 478 |
| Net periodic pension expense | \$ 483 | \$ 400 | \$ 966 | \$ 799 |

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 2017 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 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, 2017 | December 31, 2016 |
|------------------------------|--------------------------|------------------------------|
| Commitments to extend credit | \$ 583,689 | \$ 555,713 |
| Standby letters of credit | 14,026 | 12,689 |

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

The Company also extends rate lock agreements to borrowers related to the origination of residential mortgage loans. To mitigate the interest rate risk inherent in these rate lock agreements when the Company intends to sell the related loan, once originated, as well as closed residential mortgage loans held for sale, the Company enters into forward commitments to sell individual residential mortgages. Rate lock agreements and forward commitments are considered derivatives and are recorded at fair value. Forward sales commitments totaled \$521 thousand at June 30, 2017. The Company had no forward sales commitments at December 31, 2016. 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 |
|---|--|--|--|--------------|
| <u>June 30, 2017</u> | | | | |
| Measured on a recurring basis: | | | | |
| Securities available for sale: | | | | |
| U.S. Government agencies and government sponsored enterprises | \$ | \$ 187,571 | \$ | \$ 187,571 |
| Mortgage-backed securities | | 352,774 | | 352,774 |
| Asset-backed securities | | 230 | | 230 |
| | \$ | \$ 540,575 | \$ | \$ 540,575 |
| Measured on a nonrecurring basis: | | | | |
| Loans: | | | | |
| Loans held for sale | \$ | \$ 1,864 | \$ | \$ 1,864 |
| Collateral dependent impaired loans | | | 5,770 | 5,770 |
| Other assets: | | | | |
| Loan servicing rights | | | 1,014 | 1,014 |
| Other real estate owned | | | 154 | 154 |
| | \$ | \$ 1,864 | \$ 6,938 | \$ 8,802 |

December 31, 2016**Measured on a recurring basis:**

Securities available for sale:

Edgar Filing: FINANCIAL INSTITUTIONS INC - Form 10-Q

| | | | | |
|---|----|------------|----------|------------|
| U.S. Government agencies and government sponsored enterprises | \$ | \$ 186,268 | \$ | \$ 186,268 |
| Mortgage-backed securities | | 353,467 | | 353,467 |
| Asset-backed securities | | 191 | | 191 |
| | \$ | \$ 539,926 | \$ | \$ 539,926 |
| Measured on a nonrecurring basis: | | | | |
| Loans: | | | | |
| Loans held for sale | \$ | \$ 1,050 | \$ | \$ 1,050 |
| Collateral dependent impaired loans | | | 901 | 901 |
| Other assets: | | | | |
| Loan servicing rights | | | 1,075 | 1,075 |
| Other real estate owned | | | 107 | 107 |
| | \$ | \$ 1,050 | \$ 2,083 | \$ 3,133 |

There were no transfers between Levels 1 and 2 during the six months ended June 30, 2017 and 2016. There were no liabilities measured at fair value on a recurring or nonrecurring basis during the six month periods ended June 30, 2017 and 2016.

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 | \$ 5,770 | Appraisal of collateral ⁽¹⁾ | Appraisal adjustments ⁽²⁾ | 0% - 49% discount |
| Loan servicing rights | 1,014 | Discounted cash flow | Discount rate Constant prepayment rate | 5.0% ⁽³⁾ 5.6% ⁽³⁾ |
| Other real estate owned | 154 | Appraisal of collateral ⁽¹⁾ | Appraisal adjustments ⁽²⁾ | 23% - 43% 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, 2017.

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, 2017 Carrying Amount | Estimated Fair Value | December 31, 2016 Carrying Amount | Estimated Fair Value |
|-------------------------------|--|-------------------------------------|----------------------------|---|----------------------------|
| Financial assets: | | | | | |
| Cash and cash equivalents | Level 1 | \$ 84,537 | \$ 84,537 | \$ 71,277 | \$ 71,277 |
| Securities available for sale | Level 2 | 540,575 | 540,575 | 539,926 | 539,926 |
| Securities held to maturity | Level 2 | 533,471 | 534,902 | 543,338 | 539,991 |
| Loans held for sale | Level 2 | 1,864 | 1,864 | 1,050 | 1,050 |
| Loans | Level 2 | 2,477,943 | 2,461,573 | 2,308,326 | 2,285,146 |
| Loans ⁽¹⁾ | Level 3 | 5,770 | 5,770 | 901 | 901 |
| Accrued interest receivable | Level 1 | 9,292 | 9,292 | 9,192 | 9,192 |
| FHLB and FRB stock | Level 2 | 22,764 | 22,764 | 21,780 | 21,780 |
| Financial liabilities: | | | | | |
| Non-maturity deposits | Level 1 | 2,307,700 | 2,307,700 | 2,292,706 | 2,292,706 |
| Time deposits | Level 2 | 824,786 | 822,945 | 702,516 | 701,097 |
| Short-term borrowings | Level 1 | 347,500 | 347,500 | 331,500 | 331,500 |
| Long-term borrowings | Level 2 | 39,096 | 41,468 | 39,061 | 40,701 |
| Accrued interest payable | Level 1 | 6,423 | 6,423 | 5,394 | 5,394 |

⁽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 SDN, 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 services to

Edgar Filing: FINANCIAL INSTITUTIONS INC - Form 10-Q

individuals, businesses, institutions, foundations and retirement plans. Holding company amounts are the primary differences between segment amounts and consolidated totals, and are reflected in the Holding Company and Other column below, along with amounts to eliminate balances and transactions between segments.

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, 2017</u> | | | | |
| Goodwill | \$ 48,536 | \$ 16,306 | \$ | \$ 64,842 |
| Other intangible assets, net | 470 | 8,165 | | 8,635 |
| Total assets | 3,859,183 | 29,594 | 2,761 | 3,891,538 |
| <u>December 31, 2016</u> | | | | |
| Goodwill | \$ 48,536 | \$ 17,881 | \$ | \$ 66,417 |
| Other intangible assets, net | 579 | 8,644 | | 9,223 |
| Total assets | 3,678,230 | 31,166 | 944 | 3,710,340 |

- 34 -

Table of Contents

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(13.) SEGMENT REPORTING (Continued)

| | Banking | Non-Banking | Holding Company and Other | Consolidated Totals |
|--|-----------|-------------|---------------------------------|------------------------|
| <u>Three months ended June 30, 2017</u> | | | | |
| Net interest income (expense) | \$ 28,039 | \$ | \$ (617) | \$ 27,422 |
| Provision for loan losses | (3,832) | | | (3,832) |
| Noninterest income | 6,215 | 2,040 | 1,078 | 9,333 |
| Noninterest expense | (19,840) | (3,428) | (673) | (23,941) |
| Income (loss) before income taxes | 10,582 | (1,388) | (212) | 8,982 |
| Income tax (expense) benefit | (3,048) | (74) | 386 | (2,736) |
| Net income (loss) | \$ 7,534 | \$ (1,462) | \$ 174 | \$ 6,246 |
| <u>Six months ended June 30, 2017</u> | | | | |
| Net interest income (expense) | \$ 55,652 | \$ | \$ (1,235) | \$ 54,417 |
| Provision for loan losses | (6,613) | | | (6,613) |
| Noninterest income | 11,793 | 4,445 | 931 | 17,169 |
| Noninterest expense | (38,324) | (5,262) | (1,297) | (44,883) |
| Income (loss) before income taxes | 22,508 | (817) | (1,601) | 20,090 |
| Income tax (expense) benefit | (6,621) | (296) | 1,016 | (5,901) |
| Net income (loss) | \$ 15,887 | \$ (1,113) | \$ (585) | \$ 14,189 |
| <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) |

Edgar Filing: FINANCIAL INSTITUTIONS INC - Form 10-Q

| | | | | |
|-------------------|----------|--------|------------|----------|
| Net income (loss) | \$ 8,865 | \$ 174 | \$ (1,888) | \$ 7,151 |
|-------------------|----------|--------|------------|----------|

Six months ended June 30, 2016

| | | | | |
|-----------------------------------|-----------|---------|------------|-----------|
| Net interest income (expense) | \$ 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 |

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

- 35 -

Table of Contents

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

This Quarterly Report on Form 10-Q should be read in conjunction with the more detailed and comprehensive disclosures included in our Annual Report on Form 10-K for the year ended December 31, 2016. 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 Quarterly Report on Form 10-Q 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 its subsidiaries (collectively, 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 Quarterly Report on Form 10-Q and our Annual Report on Form 10-K for the fiscal year ended December 31, 2016, 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 material 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;

Edgar Filing: FINANCIAL INSTITUTIONS INC - Form 10-Q

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

We may be unable to successfully implement our growth strategies;

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

Our commercial business and mortgage 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 policies of the Federal Reserve 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 proxy contest for the election of directors at our annual meeting or proposals arising out of shareholder initiatives could cause us to incur 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;

Table of Contents

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

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 (the Bank), Scott Danahy Naylor, LLC (SDN) 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, the Bank. Our indirect lending network includes relationships with franchised automobile dealers in Western and Central New York, the Capital District of New York and Northern and Central Pennsylvania. SDN provides a broad range of insurance services to personal and business clients across 45 states. Courier Capital 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, investment advisory 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 and other financial needs of individuals, municipalities and businesses of the local communities surrounding our primary service area. 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 who 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 - the growth of a diversified and high-quality loan portfolio.

Table of Contents

MANAGEMENT'S DISCUSSION AND ANALYSIS

EXECUTIVE OVERVIEW

Summary of 2017 Second Quarter Results

Net income decreased \$905 thousand or 13% to \$6.2 million for the second quarter of 2017 compared to \$7.2 million for the second quarter of 2016. Net income available to common shareholders for the second quarter of 2017 was \$5.9 million, or \$0.40 per diluted share, compared with \$6.8 million, or \$0.47 per diluted share, for the second quarter of last year. Return on average equity was 7.44% and return on average assets was 0.65% for the second quarter of 2017 compared to 9.07% and 0.82%, respectively, for the second quarter of 2016.

Net interest income totaled \$27.4 million in the second quarter of 2017, up from \$25.2 million in the second quarter of 2016. Average earning assets were up \$326.8 million, led by a \$300.0 million increase in average loans in the second quarter of 2017 compared to the same quarter in 2016. The growth in earning assets was partially offset by a lower net interest margin. Second quarter of 2017 net interest margin was 3.18%, a decrease of five basis points from 3.23% reported in the second quarter of 2016.

The provision for loans losses was \$3.8 million in the second quarter of 2017 compared to \$2.0 million in the second quarter of 2016. Net charge-offs during the recent quarter were \$1.8 million, up from \$1.0 million from the second quarter of 2016. Net charge-offs expressed as an annualized percentage of average loans outstanding were 0.29% during the second quarter of 2017 compared with 0.19% in the second quarter of 2016. 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 increases in the provision for loan losses and net charge-offs.

Noninterest income totaled \$9.3 million in the second quarter of 2017, compared to \$8.9 million in the second quarter of 2016. Included in these totals are net gains realized from the sale of investment securities totaling \$210 thousand for the second quarter of 2017 and \$1.4 million for the second quarter of 2016. Exclusive of this item, noninterest income was \$9.1 million in the second quarter of 2017 and \$7.5 million in the second quarter of 2016, where a significant component of the increase was the \$1.2 million non-cash fair value adjustment of contingent consideration related to the acquisition of SDN.

Noninterest expense in the second quarter of 2017 totaled \$23.9 million compared with \$22.1 million in the second quarter of 2016. The increase in noninterest expense was primarily the result of the \$1.6 million non-cash goodwill impairment charge related to our acquisition of SDN combined with higher salaries and employee benefits and occupancy and equipment expenses related to our organic growth initiatives, including the residential mortgage lending expansion. The increase was partially offset by a decrease in professional services. Professional services in the second quarter of 2016 included approximately \$1.7 million of expense associated with responding to the demands of an activist shareholder.

The regulatory Common equity Tier 1 ratio and Total risk-based capital ratio were 9.86%, and 13.09%, respectively, for the second quarter of 2017. 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.

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.

We use interest rate spread and net interest margin 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.

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

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

| | Three months ended June 30, | | Six months ended June 30, | |
|--|-----------------------------|-----------|---------------------------|-----------|
| | 2017 | 2016 | 2017 | 2016 |
| Interest income per consolidated statements of income | \$ 31,409 | \$ 28,246 | \$ 61,947 | \$ 55,881 |
| Adjustment to fully taxable equivalent basis | 805 | 785 | 1,619 | 1,578 |
| Interest income adjusted to a fully taxable equivalent basis | 32,214 | 29,031 | 63,566 | 57,459 |
| Interest expense per consolidated statements of income | 3,987 | 3,047 | 7,530 | 5,963 |
| Net interest income on a taxable equivalent basis | \$ 28,227 | \$ 25,984 | \$ 56,036 | \$ 51,496 |

Analysis of Net Interest Income for the Three Month Periods ended June 30, 2017 and 2016

Net interest income on a taxable equivalent basis for the three months ended June 30, 2017, was \$28.2 million, an increase of \$2.2 million versus the comparable quarter last year. The increase in net interest income was due to an increase in average earning assets of \$326.8 million or 10% compared to the second quarter of 2016.

The net interest margin for the second quarter of 2017 was 3.18%, five basis points lower than 3.23% for the same period in 2016. This comparable period decrease was a function of a six basis point decrease in interest rate spread, partially offset by a higher contribution from net free funds of one basis point (due principally to increases in average noninterest-bearing deposits and other net free funds). The lower interest rate spread was a result of an eight basis point increase in the cost of average interest-bearing liabilities partly offset by a two basis point increase in the yield on earning assets.

For the second quarter of 2017, the yield on average earning assets of 3.63% was two basis points higher than the second quarter of 2016. Loan yields decreased one basis point to 4.16% when comparing the second quarter of 2017 to the same period in 2016. The yield on investment securities decreased one basis point during the second quarter of 2017 to 2.47%. Overall, the earning asset rate changes reduced interest income by \$16 thousand during the second quarter of 2017, but that was more than offset by a favorable volume variance that increased interest income by \$3.2 million, which collectively drove a \$3.2 million increase in interest income.

Average interest-earning assets were \$3.56 billion for the second quarter 2017, an increase of \$326.8 million or 10% from the comparable quarter last year, with average loans up \$300.0 million and average securities up \$10.5 million. The growth in average loans reflected increases in most loan categories. Commercial loans, in particular, were up \$149.7 million or 16% from the second quarter of 2016. In addition, consumer indirect loans were up \$118.7 million or 17% from the second quarter of 2016. Loans represented 69.0% of average interest-earning assets during the second quarter of 2017 compared to 66.7% during the second quarter of 2016. The increase in the volume of average

loans resulted in a \$3.1 million increase in interest income. Securities represented 30.5% of average interest-earning assets during the second quarter of 2017 compared to 33.3% during the second quarter of 2016. The increase in the volume of average securities resulted in an \$81 thousand increase in interest income, partially offset by a \$40 thousand decrease due to the unfavorable rate variance.

The cost of average interest-bearing liabilities of 0.56% in the second quarter of 2017 was eight basis points higher than the second quarter of 2016. The cost of average interest-bearing deposits increased four basis points to 0.41% and the cost of short-term borrowings increased 43 basis points to 1.08% in the second quarter of 2017 compared to the same quarter of 2016. The cost of long-term borrowings for the second quarter of 2017 decreased one basis point to 6.32% compared to the same quarter of 2016. Overall, interest-bearing liability rate and volume increases resulted in \$940 thousand of higher interest expense.

Average interest-bearing liabilities of \$2.83 billion in the second quarter of 2017 were \$283.2 million or 11% higher than the second quarter of 2016. On average, interest-bearing deposits grew \$173.4 million, while noninterest-bearing demand deposits (a principal component of net free funds) were up \$37.0 million. The increase in average deposits was due in part to seasonal inflows of municipal deposits, successful business development efforts in retail banking, and an increase in deposits from our Certificate of Deposit Account Registry Service (CDARS) and Insured Cash Sweep (ICS) programs. For further discussion of the CDARS and ICS programs, refer to the Funding Activities Deposits section of this Management s Discussion and Analysis. Overall, interest-bearing deposit rate and volume changes resulted in \$415 thousand of higher interest expense during the second quarter of 2017. Average borrowings increased \$109.8 million compared to the second quarter of 2016. Overall, short and long-term borrowing rate and volume changes resulted in \$525 thousand of higher interest expense during the second quarter of 2017.

Table of Contents**MANAGEMENT'S DISCUSSION AND ANALYSIS*****Analysis of Net Interest Income for the Six Months ended June 30, 2017 and June 30, 2016***

Net interest income on a taxable equivalent basis for the first six months of 2017 was \$56.0 million compared to \$51.5 million for the same period last year. The increase in net interest income was due to an increase in average earning assets of \$337.0 million or 11% compared to the first six months of 2016.

The net interest margin for the first six months of 2017 was 3.20%, five basis points lower than 3.25% for the same period last year. This comparable period decrease was a function of a six basis point decrease in interest rate spread to 3.09% during the first six months of 2017, partially offset by a one basis point higher contribution from net free funds. The lower interest rate spread was a result of a six basis point increase in the cost of average interest-bearing liabilities.

The yield on earning assets was 3.63% for the first six months of 2017 and 2016. Loan yields decreased two basis points during the first six months of 2017 to 4.17%. The yield on investment securities decreased one basis point during the first six months of 2017 to 2.47%. Overall, the earning asset rate changes reduced interest income by \$327 thousand during the first six months of 2017, but that was more than offset by a favorable volume variance that increased interest income by \$6.4 million, which collectively drove a \$6.1 million increase in interest income.

Average interest-earning assets were \$3.52 billion for the first six months of 2017, an increase of \$337.0 million or 11% from the comparable period last year, with average loans up \$287.4 million and average securities up \$36.4 million. The growth in average loans was comprised of increases in most loan categories. Commercial loans, in particular, were up \$146.8 million or 16% from the first half of 2016. Residential real estate loans increased \$43.0 million or 11% and consumer indirect loans increased \$104.3 million or 15% when comparing the first six months of 2017 with the same period in 2016. Loans represented 68.7% of average interest-earning assets during the first six months of 2017 compared to 66.9% during the first six months of 2016. The increase in the volume of average loans resulted in a \$5.9 million increase in interest income, partially offset by a \$250 thousand decrease due to the unfavorable rate variance. Securities represented 30.9% of average interest-earning assets during the first six months of 2017 compared to 33.1% during the first six months of 2016. The increase in the volume of average securities resulted in a \$457 thousand increase in interest income, partially offset by a \$77 thousand decrease due to the unfavorable rate variance.

The cost of interest-bearing liabilities of 0.54% for the first six months of 2017 was six basis points higher than the same period in 2016. Rates on interest-bearing deposits were up three basis points to 0.39% for the first six months of 2017 versus the same period in 2016. The cost of short-term borrowings for the first six months of 2017 was 0.97% or 34 basis points higher than 0.63% for the same period last year. The cost of long-term borrowings for the first six months of 2017 decreased one basis point to 6.32% compared to the same period of 2016. Overall, interest-bearing liability rate and volume increases resulted in \$1.6 million of higher interest expense.

Average interest-bearing liabilities of \$2.79 billion in the first six months of 2017 were \$289.5 million or 12% higher than the first six months of 2016. On average, interest-bearing deposits grew \$181.6 million, while noninterest-bearing demand deposits were up \$38.3 million. Overall, interest-bearing deposit rate and volume changes resulted in \$685 thousand of higher interest expense during the first six months of 2017. Average borrowings increased \$107.9 million compared to the first six months of 2016. Overall, short and long-term borrowing rate and volume changes resulted in \$881 thousand of higher interest expense during the first six months of 2017.

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

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

| | Three months ended June 30, | | | | | |
|--|-----------------------------|---------------------|-----------------|--------------------|---------------------|-----------------|
| | 2017 | | | 2016 | | |
| | Average Balance | Average Interest | Average Rate | Average Balance | Average Interest | Average Rate |
| Interest-earning assets: | | | | | | |
| Federal funds sold and interest-earning deposits | \$ 16,639 | \$ 42 | 1.03% | \$ 316 | \$ | 0.49% |
| Investment securities ⁽¹⁾ : | | | | | | |
| Taxable | 783,173 | 4,402 | 2.25 | 784,166 | 4,419 | 2.25 |
| Tax-exempt ⁽²⁾ | 302,497 | 2,301 | 3.04 | 291,054 | 2,243 | 3.08 |
| Total investment securities | 1,085,670 | 6,703 | 2.47 | 1,075,220 | 6,662 | 2.48 |
| Loans: | | | | | | |
| Commercial business | 385,938 | 4,150 | 4.31 | 329,901 | 3,458 | 4.22 |
| Commercial mortgage | 700,010 | 8,042 | 4.61 | 606,360 | 6,872 | 4.56 |
| Residential real estate loans | 430,237 | 4,023 | 3.74 | 391,826 | 3,850 | 3.93 |
| Residential real estate lines | 119,333 | 1,178 | 3.96 | 125,212 | 1,182 | 3.80 |
| Consumer indirect | 802,379 | 7,574 | 3.79 | 683,722 | 6,491 | 3.82 |
| Other consumer | 16,680 | 502 | 12.07 | 17,562 | 516 | 11.81 |
| Total loans | 2,454,577 | 25,469 | 4.16 | 2,154,583 | 22,369 | 4.17 |
| Total interest-earning assets | 3,556,886 | 32,214 | 3.63 | 3,230,119 | 29,031 | 3.61 |
| Allowance for loan losses | (31,924) | | | (28,307) | | |
| Other noninterest-earning assets | 322,175 | | | 305,948 | | |
| Total assets | \$ 3,847,137 | | | \$ 3,507,760 | | |
| Interest-bearing liabilities: | | | | | | |
| Deposits: | | | | | | |
| Interest-bearing demand | \$ 651,485 | \$ 225 | 0.14% | \$ 579,497 | \$ 208 | 0.14% |
| Savings and money market | 1,054,997 | 362 | 0.14 | 1,017,911 | 330 | 0.13 |
| Time deposits | 762,874 | 1,913 | 1.01 | 698,505 | 1,547 | 0.89 |
| Total interest-bearing deposits | 2,469,356 | 2,500 | 0.41 | 2,295,913 | 2,085 | 0.37 |
| Short-term borrowings | 323,562 | 870 | 1.08 | 213,826 | 344 | 0.65 |
| Long-term borrowings | 39,085 | 617 | 6.32 | 39,015 | 618 | 6.33 |

Edgar Filing: FINANCIAL INSTITUTIONS INC - Form 10-Q

| | | | | | | |
|--|--------------|-----------|---------|--------------|-----------|---------|
| Total borrowings | 362,647 | 1,487 | 1.64 | 252,841 | 962 | 1.52 |
| Total interest-bearing liabilities | 2,832,003 | 3,987 | 0.56 | 2,548,754 | 3,047 | 0.48 |
| Noninterest-bearing demand deposits | 658,926 | | | 621,912 | | |
| Other noninterest-bearing liabilities | 19,481 | | | 19,923 | | |
| Shareholders equity | 336,727 | | | 317,171 | | |
| Total liabilities and shareholders equity | \$ 3,847,137 | | | \$ 3,507,760 | | |
| Net interest income (tax-equivalent) | | \$ 28,227 | | | \$ 25,984 | |
| Interest rate spread | | | 3.07% | | | 3.13% |
| Net earning assets | \$ 724,883 | | | \$ 681,365 | | |
| Net interest margin (tax-equivalent) | | | 3.18% | | | 3.23% |
| Ratio of average interest-earning assets to average interest-bearing liabilities | | | 125.60% | | | 126.73% |

(1) Investment securities are shown at amortized cost.

(2) The interest on tax-exempt securities is calculated on a tax equivalent basis assuming a Federal tax rate of 35%.

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

| | Six months ended June 30, | | | | | |
|--|---------------------------|----------|-----------------|--------------------|----------|-----------------|
| | 2017 | | | 2016 | | |
| | Average Balance | Interest | Average Rate | Average Balance | Interest | Average Rate |
| Interest-earning assets: | | | | | | |
| Federal funds sold and interest-earning deposits | \$ 13,377 | \$ 67 | 1.01% | \$ 193 | \$ 1 | 0.53% |
| Investment securities ⁽¹⁾ : | | | | | | |
| Taxable | 783,593 | 8,786 | 2.24 | 759,125 | 8,524 | 2.25 |
| Tax-exempt ⁽²⁾ | 304,261 | 4,628 | 3.04 | 292,286 | 4,510 | 3.09 |
| Total investment securities | 1,087,854 | 13,414 | 2.47 | 1,051,411 | 13,034 | 2.48 |
| Loans: | | | | | | |
| Commercial business | 374,715 | 7,936 | 4.27 | 323,022 | 6,705 | 4.17 |
| Commercial mortgage | 689,370 | 15,885 | 4.65 | 594,251 | 13,585 | 4.60 |
| Residential real estate loans | 429,993 | 8,077 | 3.76 | 386,952 | 7,682 | 3.97 |
| Residential real estate lines | 120,457 | 2,370 | 3.97 | 126,264 | 2,390 | 3.81 |
| Consumer indirect | 785,228 | 14,817 | 3.81 | 680,927 | 13,022 | 3.85 |
| Other consumer | 16,818 | 1,000 | 11.99 | 17,744 | 1,041 | 11.80 |
| Total loans | 2,416,581 | 50,085 | 4.17 | 2,129,160 | 44,425 | 4.19 |
| Total interest-earning assets | 3,517,812 | 63,566 | 3.63 | 3,180,764 | 57,460 | 3.63 |
| Allowance for loan losses | (31,606) | | | (27,973) | | |
| Other noninterest-earning assets | 314,853 | | | 303,814 | | |
| Total assets | \$ 3,801,059 | | | \$ 3,456,605 | | |
| Interest-bearing liabilities: | | | | | | |
| Deposits: | | | | | | |
| Interest-bearing demand | \$ 642,861 | \$ 443 | 0.14% | \$ 575,960 | \$ 411 | 0.14% |
| Savings and money market | 1,042,748 | 687 | 0.13 | 991,770 | 654 | 0.13 |
| Time deposits | 742,254 | 3,601 | 0.98 | 678,521 | 2,981 | 0.88 |
| Total interest-bearing deposits | 2,427,863 | 4,731 | 0.39 | 2,246,251 | 4,046 | 0.36 |
| Short-term borrowings | 325,368 | 1,564 | 0.97 | 217,576 | 683 | 0.63 |
| Long-term borrowings | 39,076 | 1,235 | 6.32 | 39,006 | 1,235 | 6.33 |
| Total borrowings | 364,444 | 2,799 | 1.54 | 256,582 | 1,918 | 1.50 |
| Total interest-bearing liabilities | 2,792,307 | 7,530 | 0.54 | 2,502,833 | 5,964 | 0.48 |
| Noninterest-bearing demand deposits | 658,063 | | | 619,751 | | |

Edgar Filing: FINANCIAL INSTITUTIONS INC - Form 10-Q

| | | |
|--|--------------|--------------|
| Other noninterest-bearing liabilities | 20,307 | 20,842 |
| Shareholders' equity | 330,382 | 313,179 |
| Total liabilities and shareholders' equity | \$ 3,801,059 | \$ 3,456,605 |
| Net interest income (tax-equivalent) | \$ 56,036 | \$ 51,496 |
| Interest rate spread | 3.09% | 3.15% |
| Net earning assets | \$ 725,505 | \$ 677,931 |
| Net interest margin (tax-equivalent) | 3.20% | 3.25% |
| Ratio of average interest-earning assets to average interest-bearing liabilities | 125.98% | 127.09% |

(1) Investment securities are shown at amortized cost.

(2) The interest on tax-exempt securities is calculated on a tax equivalent basis assuming a Federal tax rate of 35%.

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

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

| Increase (decrease) in: | Three months ended June 30, 2017 vs. 2016 | | | Six months ended June 30, 2017 vs. 2016 | | |
|--|--|-----------------|-----------------|--|-------------------|-----------------|
| | Volume | Rate | Total | Volume | Rate | Total |
| Interest income: | | | | | | |
| Federal funds sold and interest-earning deposits | \$ 41 | \$ 1 | \$ 42 | \$ 66 | \$ | \$ 66 |
| Investment securities: | | | | | | |
| Taxable | (6) | (11) | (17) | 274 | (12) | 262 |
| Tax-exempt | 87 | (29) | 58 | 183 | (65) | 118 |
| Total investment securities | 81 | (40) | 41 | 457 | (77) | 380 |
| Loans: | | | | | | |
| Commercial business | 601 | 91 | 692 | 1,093 | 138 | 1,231 |
| Commercial mortgage | 1,075 | 95 | 1,170 | 2,191 | 109 | 2,300 |
| Residential real estate loans | 365 | (192) | 173 | 823 | (428) | 395 |
| Residential real estate lines | (57) | 53 | (4) | (112) | 92 | (20) |
| Consumer indirect | 1,120 | (37) | 1,083 | 1,970 | (175) | 1,795 |
| Other consumer | (27) | 13 | (14) | (55) | 14 | (41) |
| Total loans | 3,077 | 23 | 3,100 | 5,910 | (250) | 5,660 |
| Total interest income | 3,199 | (16) | 3,183 | 6,433 | (327) | 6,106 |
| Interest expense: | | | | | | |
| Deposits: | | | | | | |
| Interest-bearing demand | 25 | (8) | 17 | 46 | (14) | 32 |
| Savings and money market | 12 | 20 | 32 | 34 | (1) | 33 |
| Time deposits | 150 | 216 | 366 | 294 | 326 | 620 |
| Total interest-bearing deposits | 187 | 228 | 415 | 374 | 311 | 685 |
| Short-term borrowings | 228 | 298 | 526 | 425 | 456 | 881 |
| Long-term borrowings | 1 | (2) | (1) | 2 | (2) | |
| Total borrowings | 229 | 296 | 525 | 427 | 454 | 881 |
| Total interest expense | 416 | 524 | 940 | 801 | 765 | 1,566 |
| Net interest income | \$ 2,783 | \$ (540) | \$ 2,243 | \$ 5,632 | \$ (1,092) | \$ 4,540 |

Provision for Loan Losses

The provision for loan losses is based upon credit loss experience, growth or contraction of specific segments of the loan portfolio, and the estimate of losses inherent in the current loan portfolio. The provision for loan losses for the three and six month periods ended June 30, 2017 were \$3.8 million and \$6.6 million, respectively, compared to \$2.0 million and \$4.3 million for the corresponding periods in 2016. The increase in provision is primarily attributable to growth in the total loan portfolio combined with the impact of the downgrade of one commercial credit relationship. The downgrade necessitated a provision and increase in allowance for loan losses of approximately \$925 thousand.

See the Allowance for Loan Losses and Non-Performing Assets and Potential Problem Loans sections of this Management's Discussion and Analysis for further discussion.

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

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

| | Three months ended | | Six months ended | |
|---|--------------------|-----------------|------------------|------------------|
| | June 30, | | June 30, | |
| | 2017 | 2016 | 2017 | 2016 |
| Service charges on deposits | \$ 1,840 | \$ 1,755 | \$ 3,585 | \$ 3,479 |
| Insurance income | 1,133 | 1,183 | 2,564 | 2,855 |
| ATM and debit card | 1,456 | 1,421 | 2,785 | 2,746 |
| Investment advisory | 1,429 | 1,365 | 2,860 | 2,608 |
| Company owned life insurance | 473 | 486 | 918 | 1,854 |
| Investments in limited partnerships | 135 | 36 | 105 | 92 |
| Loan servicing | 123 | 112 | 243 | 228 |
| Net gain on sale of loans held for sale | 72 | 78 | 120 | 156 |
| Net gain on investment securities | 210 | 1,387 | 416 | 2,000 |
| Net gain on other assets | 6 | 82 | 4 | 86 |
| Contingent consideration liability adjustment | 1,200 | | 1,200 | |
| Other | 1,256 | 1,011 | 2,369 | 2,029 |
| Total noninterest income | \$ 9,333 | \$ 8,916 | \$ 17,169 | \$ 18,133 |

Insurance income decreased \$291 thousand, or 10%, to \$2.6 million for the first six months of 2017 compared to \$2.9 million for the first half of 2016. The decrease was primarily due to the loss of legacy SDN accounts.

Investment advisory income increased to \$2.9 million in the first half of 2017 compared to \$2.6 million in the first half of 2016, reflecting higher assets under managements driven by favorable market conditions and successful business development efforts.

Income from company owned life insurance decreased to \$918 thousand in the first six months of 2017 compared to \$1.9 million in the same period in 2016, as the first quarter of 2016 included \$911 thousand of death benefit proceeds.

We have investments in limited partnerships, primarily small business investment companies, and account for these investments under the equity method. The income from these equity method investments fluctuates based on the performance of the underlying investments.

During the first half of 2017, we recognized net gains on investment securities totaling \$416 thousand from the sale of four agency securities and six mortgage backed securities. The \$2.0 million in gains realized during the first half of 2016 resulted from the sale of 17 agency securities and nine mortgage backed securities. The amount and timing of our sale of investment securities is dependent on a number of factors, including our prudent efforts to realize gains while managing duration, premium and credit risk.

In the second quarter of 2017, we recognized a \$1.2 million non-cash fair value adjustment of the contingent liability related to the SDN acquisition. We also recognized \$1.6 million of goodwill impairment related to the same acquisition.

- 44 -

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

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

| | Three months ended June 30, | | Six months ended June 30, | |
|----------------------------------|--|------------------|--------------------------------------|------------------|
| | 2017 | 2016 | 2017 | 2016 |
| | Salaries and employee benefits | \$ 11,986 | \$ 10,818 | \$ 23,355 |
| Occupancy and equipment | 4,184 | 3,664 | 8,148 | 7,289 |
| Professional services | 1,229 | 2,833 | 2,428 | 4,280 |
| Computer and data processing | 1,312 | 1,159 | 2,483 | 2,246 |
| Supplies and postage | 467 | 464 | 1,004 | 1,058 |
| FDIC assessments | 469 | 441 | 926 | 877 |
| Advertising and promotions | 473 | 530 | 751 | 957 |
| Amortization of intangibles | 291 | 315 | 588 | 637 |
| Goodwill impairment | 1,575 | | 1,575 | |
| Other | 1,955 | 1,896 | 3,625 | 3,562 |
| Total noninterest expense | \$ 23,941 | \$ 22,120 | \$ 44,883 | \$ 43,338 |

Salaries and employee benefits expense increased by \$923 thousand or 4% in the first half of 2017 compared to the same period in 2016, primarily due to additional personnel to support our organic growth initiatives.

Occupancy and equipment expense increased \$859 thousand in the first half of 2017 compared to the same period in 2016, primarily due to organic growth initiatives.

Professional services decreased \$1.9 million when comparing the first six months of 2017 to the same period in 2016. The prior year includes approximately \$2.1 million of professional services associated with responding to the demands of an activist shareholder.

Computer and data processing expense increased \$237 thousand, or 11%, when comparing the first half of 2017 to the first half of 2016 primarily due to information technology projects to maintain and improve our infrastructure.

We recognized \$1.6 million of goodwill impairment in the second quarter of 2017 related to the SDN acquisition. For additional discussion related to the goodwill impairment see Note 6, Goodwill and Other Intangible Assets, of the notes to consolidated financial statements.

Our efficiency ratio for the six months ended June 30, 2017 was 61.66% compared with 64.08% for the first half of 2016. The lower efficiency ratio is a result of the higher net interest income and noninterest income associated with our organic growth initiatives. The efficiency ratio is calculated by dividing total noninterest expense by net revenue, defined as the sum of tax-equivalent net interest income and noninterest income before net gains on investment

securities. An increase in the efficiency ratio indicates that more resources are being utilized to generate the same volume of income, while a decrease indicates a more efficient allocation of resources. The efficiency ratio, a banking industry financial measure, is not required by GAAP. However, the efficiency ratio is used by management in its assessment of financial performance specifically as it relates to noninterest expense control. Management also believes such information is useful to investors in evaluating Company performance.

Income Taxes

For the six months ended June 30, 2017 and 2016, we recorded income tax expense of \$5.9 million and \$5.6 million, respectively. The effective tax rates for the year-to-date periods in 2017 and 2016 were 29.4% and 27.6%, respectively. The increase in income tax expense and effective tax rate was primarily due to the non-taxable death benefits proceeds on company owned life insurance received in the first quarter of 2016. In addition, the higher effective tax rate in 2017 was a result of the \$1.6 million non-cash goodwill impairment charge related to the SDN acquisition, partially offset by the \$1.2 million non-cash fair value adjustment of the contingent consideration liability related to the SDN acquisition, both of which were non-taxable adjustments. Effective tax rates are impacted by items of income and expense that are not subject to federal or state taxation. Our effective tax rates reflect the impact of these items, which include, but are not limited to, interest income from tax-exempt securities and earnings on company owned life insurance. In addition, our effective tax rate for 2017 and 2016 reflects the New York State tax savings generated by our real estate investment trust.

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

The following table summarizes the composition of our investment securities portfolio as of the dates indicated (in thousands):

| | Investment Securities Portfolio Composition | | | |
|---|--|---------------------|---------------------------|---------------------|
| | June 30, 2017 | | December 31, 2016 | |
| | Amortized Cost | Fair Value | Amortized Cost | Fair Value |
| Securities available for sale (AFS): | | | | |
| U.S. Government agencies and government-sponsored enterprise securities | \$ 187,545 | \$ 187,571 | \$ 187,325 | \$ 186,268 |
| Mortgage-backed securities: | | | | |
| Agency mortgage-backed securities | 353,354 | 351,899 | 356,667 | 352,643 |
| Non-Agency mortgage-backed securities | | 875 | | 824 |
| Asset-backed securities | | 230 | | 191 |
| Total AFS securities | 540,899 | 540,575 | 543,992 | 539,926 |
| Securities held to maturity (HTM): | | | | |
| State and political subdivisions | 289,684 | 294,202 | 305,248 | 305,759 |
| Mortgage-backed securities | 243,787 | 240,700 | 238,090 | 234,232 |
| Total HTM securities | 533,471 | 534,902 | 543,338 | 539,991 |
| Total investment securities | \$ 1,074,370 | \$ 1,075,477 | \$ 1,087,330 | \$ 1,079,917 |

The AFS investment securities portfolio increased \$649 thousand from \$539.9 million at December 31, 2016 to \$540.6 million at June 30, 2017. The AFS portfolio had net unrealized losses totaling \$324 thousand and \$4.1 million at June 30, 2017 and December 31, 2016, respectively. The unrealized losses in the AFS portfolio were predominantly caused by changes in market interest rates. The fair value of most of the investment securities in the AFS portfolio fluctuates as market interest rates change.

Security Yields and Maturities Schedule

The following table sets forth certain information regarding the amortized cost (Cost), weighted average yields (Yield) and contractual maturities of our debt securities portfolio as of June 30, 2017. Mortgage-backed securities are included in maturity categories based on their stated maturity date. Actual maturities may differ from the contractual maturities presented because borrowers may have the right to call or prepay certain investments. No tax-equivalent

adjustments were made to the weighted average yields (dollars in thousands).

| | Due in one year or less | | Due from one to five years | | Due after five years through ten years | | Due after ten years | | Total | |
|--|-------------------------------|--------------|-------------------------------|--------------|--|--------------|------------------------|--------------|---------------------|--------------|
| | Cost | Yield | Cost | Yield | Cost | Yield | Cost | Yield | Cost | Yield |
| Available for sale debt securities: | | | | | | | | | | |
| U.S. Government agencies and government-sponsored enterprises | \$ 5 | 0.78% | \$ 32,610 | 1.67% | \$ 150,720 | 2.33% | \$ 4,210 | 1.84% | \$ 187,545 | 2.20% |
| Mortgage-backed securities | | | 112,391 | 1.90 | 153,917 | 2.52 | 87,046 | 2.27 | 353,354 | 2.26 |
| | 5 | 0.78 | 145,001 | 1.85 | 304,637 | 2.43 | 91,256 | 2.25 | 540,899 | 2.24 |
| Held to maturity debt securities: | | | | | | | | | | |
| State and political subdivisions | 54,438 | 1.80 | 166,487 | 2.15 | 68,759 | 1.87 | | | 289,684 | 2.02 |
| Mortgage-backed securities | | | | | 10,421 | 1.65 | 233,366 | 2.18 | 243,787 | 2.16 |
| | 54,438 | 1.80 | 166,487 | 2.15 | 79,180 | 1.85 | 233,366 | 2.18 | 533,471 | 2.08 |
| Total investment securities | \$ 54,443 | 1.80% | \$ 311,488 | 2.01% | \$ 383,817 | 2.31% | \$ 324,622 | 2.20% | \$ 1,074,370 | 2.16% |

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

We review investment securities on an ongoing basis for the presence of other than temporary impairment (OTTI) with formal reviews performed quarterly. Declines in the fair value of held to maturity and available for sale securities below their cost that are deemed to be other than temporary are reflected in earnings as realized losses to the extent the impairment is related to credit losses or the security is intended to be sold or will be required to be sold. The amount of the impairment related to non-credit related factors is recognized in other comprehensive income. Evaluating whether the impairment of a debt security is other than temporary involves assessing i.) the intent to sell the debt security or ii.) the likelihood of being required to sell the security before the recovery of its amortized cost basis. In determining whether the OTTI includes a credit loss, we use our best estimate of the present value of cash flows expected to be collected from the debt security considering factors such as: a.) the length of time and the extent to which the fair value has been less than the amortized cost basis, b.) adverse conditions specifically related to the security, an industry, or a geographic area, c.) the historical and implied volatility of the fair value of the security, d.) the payment structure of the debt security and the likelihood of the issuer being able to make payments that increase in the future, e.) failure of the issuer of the security to make scheduled interest or principal payments, f.) any changes to the rating of the security by a rating agency, and g.) recoveries or additional declines in fair value subsequent to the balance sheet date. The assessment of whether OTTI exists involves a high degree of subjectivity and judgment and is based on the information available to management at a point in time. There were no securities deemed to be other-than-temporarily impaired during the six month periods ended June 30, 2017 and 2016.

LENDING ACTIVITIES

The following table summarizes the composition of our loan portfolio, excluding loans held for sale and including net unearned income and net deferred fees and costs, as of the dates indicated (in thousands).

| | Loan Portfolio Composition | | | |
|-------------------------------|-----------------------------------|-------------------|--------------------------|-------------------|
| | June 30, 2017 | | December 31, 2016 | |
| | Amount | % of Total | Amount | % of Total |
| Commercial business | \$ 398,343 | 15.8% | \$ 349,547 | 14.9% |
| Commercial mortgage | 724,064 | 28.8 | 670,058 | 28.6 |
| Total commercial | 1,122,407 | 44.6 | 1,019,605 | 43.5 |
| Residential real estate loans | 432,053 | 17.2 | 427,937 | 18.3 |
| Residential real estate lines | 118,611 | 4.7 | 122,555 | 5.2 |
| Consumer indirect | 826,708 | 32.8 | 752,421 | 32.2 |
| Other consumer | 17,093 | 0.7 | 17,643 | 0.8 |
| Total consumer | 1,394,465 | 55.4 | 1,320,556 | 56.5 |
| Total loans | 2,516,872 | 100.0% | 2,340,161 | 100.0% |

Edgar Filing: FINANCIAL INSTITUTIONS INC - Form 10-Q

| | | |
|---------------------------------|---------------------|---------------------|
| Less: Allowance for loan losses | 33,159 | 30,934 |
| Total loans, net | \$ 2,483,713 | \$ 2,309,227 |

Total loans increased \$176.7 million to \$2.52 billion at June 30, 2017 from \$2.34 billion at December 31, 2016. The increase in loans was attributable to our organic growth initiatives.

Commercial loans increased \$102.8 million and represented 44.6% of total loans as of June 30, 2017, a result of our continued commercial business development efforts.

The consumer indirect portfolio totaled \$826.7 million and represented 32.8% of total loans as of June 30, 2017. During the first half of 2017, we originated \$223.2 million in indirect auto loans with a mix of approximately 41% new auto and 59% used auto. During the first half of 2016, we originated \$157.8 million in indirect auto loans with a mix of approximately 41% new auto and 59% used auto. Our origination volumes and mix of new and used vehicles financed fluctuate depending on general market conditions.

Loans Held for Sale and Loan Servicing Rights

Loans held for sale (not included in the loan portfolio composition table) were entirely comprised of residential real estate loans and totaled \$1.9 million and \$1.1 million as of June 30, 2017 and December 31, 2016, respectively.

We sell certain qualifying newly originated or refinanced residential real estate loans on the secondary market. Residential real estate loans serviced for others, which are not included in the consolidated statements of financial condition, amounted to \$165.5 million and \$173.7 million as of June 30, 2017 and December 31, 2016, respectively.

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

The following table summarizes the activity in the allowance for loan losses for the periods indicated (in thousands).

| | Loan Loss Analysis | | | |
|---|------------------------------------|--------------|----------------------------------|--------------|
| | Three months ended June 30, | | Six months ended June 30, | |
| | 2017 | 2016 | 2017 | 2016 |
| Balance as of beginning of period | \$ 31,081 | \$ 27,568 | \$ 30,934 | \$ 27,085 |
| Charge-offs: | | | | |
| Commercial business | 656 | 42 | 1,778 | 644 |
| Commercial mortgage | | 8 | 10 | 12 |
| Residential real estate loans | 86 | 134 | 100 | 180 |
| Residential real estate lines | | 47 | 43 | 51 |
| Consumer indirect | 2,204 | 1,898 | 5,013 | 4,396 |
| Other consumer | 187 | 119 | 390 | 276 |
| Total charge-offs | 3,133 | 2,248 | 7,334 | 5,559 |
| Recoveries: | | | | |
| Commercial business | 88 | 69 | 246 | 169 |
| Commercial mortgage | 38 | 6 | 252 | 11 |
| Residential real estate loans | 8 | 100 | 48 | 125 |
| Residential real estate lines | 46 | 3 | 56 | 7 |
| Consumer indirect | 1,122 | 994 | 2,173 | 2,164 |
| Other consumer | 77 | 81 | 171 | 203 |
| Total recoveries | 1,379 | 1,253 | 2,946 | 2,679 |
| Net charge-offs | 1,754 | 995 | 4,388 | 2,880 |
| Provision for loan losses | 3,832 | 1,952 | 6,613 | 4,320 |
| Balance at end of period | \$ 33,159 | \$ 28,525 | \$ 33,159 | \$ 28,525 |
| Net loan charge-offs to average loans (annualized) | 0.29% | 0.19% | 0.37% | 0.27% |
| Allowance for loan losses to total loans | 1.32% | 1.29% | 1.32% | 1.29% |
| Allowance for loan losses to non-performing loans | 263% | 435% | 263% | 435% |

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

losses is adequate as of June 30, 2017.

Assessing the adequacy of the allowance for loan losses involves substantial uncertainties and is based upon management's evaluation of the amounts required to meet estimated charge-offs in the loan portfolio after weighing a variety of factors, including the risk-profile of our loan products and customers.

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

Net charge-offs of \$1.8 million in the second quarter of 2017 represented 0.29% of average loans on an annualized basis compared to \$995 thousand or 0.19% in the second quarter of 2016. For the six months ended June 30, 2017, net charge-offs of \$4.4 million represented 0.37% of average loans, compared to \$2.9 million or 0.27% of average loans for the same period in 2016. The allowance for loan losses was \$33.2 million at June 30, 2017, compared with \$30.9 million at December 31, 2016. The ratio of the allowance for loan losses to total loans was 1.32% at June 30, 2017 and December 31, 2016. The ratio of allowance for loan losses to non-performing loans was 263% at June 30, 2017, compared with 489% at December 31, 2016.

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

The table below summarizes our non-performing assets at the dates indicated (in thousands).

| | Non-Performing Assets | |
|--|------------------------------|------------------------------|
| | June 30, 2017 | December 31, 2016 |
| Nonaccrual loans: | | |
| Commercial business | \$ 7,312 | \$ 2,151 |
| Commercial mortgage | 2,189 | 1,025 |
| Residential real estate loans | 1,579 | 1,236 |
| Residential real estate lines | 379 | 372 |
| Consumer indirect | 1,149 | 1,526 |
| Other consumer | 11 | 7 |
| Total nonaccrual loans | 12,619 | 6,317 |
| Accruing loans or consumer overdrafts 90 days or more delinquent | 11 | 9 |
| Total non-performing loans | 12,630 | 6,326 |
| Foreclosed assets | 154 | 107 |
| Total non-performing assets | \$ 12,784 | \$ 6,433 |
| Non-performing loans to total loans | 0.50% | 0.27% |
| Non-performing assets to total assets | 0.33% | 0.17% |

Changes in the level of nonaccrual loans typically represent increases for loans that reach a specified past due status, offset by reductions for loans that are charged-off, paid down, sold, transferred to foreclosed real estate, or are no longer classified as nonaccrual because they have returned to accrual status. Activity in nonaccrual loans for the three and six months ended June 30, 2017 was as follows (in thousands):

| | Three months ended June 30, 2017 | Six months ended June 30, 2017 |
|---------------------------------------|---|---|
| Nonaccrual loans, beginning of period | \$ 8,010 | \$ 6,317 |
| Additions | 10,222 | 17,302 |
| Payments | (1,465) | (2,563) |
| Charge-offs | (3,030) | (7,124) |
| Returned to accruing status | (964) | (1,159) |

Edgar Filing: FINANCIAL INSTITUTIONS INC - Form 10-Q

| | | |
|--|-----------|-----------|
| Transferred to other real estate or repossessed assets | (154) | (154) |
| Nonaccrual loans, end of period | \$ 12,619 | \$ 12,619 |

Non-performing assets include non-performing loans and foreclosed assets. Non-performing assets at June 30, 2017 were \$12.8 million, an increase of \$6.4 million from the \$6.4 million balance at December 31, 2016. The primary component of non-performing assets is non-performing loans, which were \$12.6 million or 0.50% of total loans at June 30, 2017, compared with \$6.3 million or 0.27% of total loans at December 31, 2016.

Approximately \$4.4 million, or 35%, of the \$12.6 million in non-performing loans as of June 30, 2017 were current with respect to payment of principal and interest, but were classified as non-accruing because repayment in full of principal and/or interest was uncertain. Included in nonaccrual loans are troubled debt restructurings (TDRs) of \$850 thousand and \$1.4 million at June 30, 2017 and December 31, 2016, respectively. We had one TDR that was accruing interest as of June 30, 2017, and we had no TDRs that were accruing interest as of December 31, 2016.

Foreclosed assets consist of real property formerly pledged as collateral for loans, which we have acquired through foreclosure proceedings or acceptance of a deed in lieu of foreclosure. Foreclosed asset holdings represented three properties totaling \$154 thousand at June 30, 2017 and four properties totaling \$107 thousand at December 31, 2016.

Potential problem loans are loans that are currently performing, but information known about possible credit problems of the borrowers causes us to have concern as to the ability of such borrowers to comply with the present loan payment terms and may result in disclosure of such loans as nonperforming at some time in the future. These loans remain in a performing status due to a variety of factors, including payment history, the value of collateral supporting the credits, and/or personal or government guarantees. We consider loans classified as substandard, which continue to accrue interest, to be potential problem loans. We identified \$14.3 million and \$15.6 million in loans that continued to accrue interest which were classified as substandard as of June 30, 2017 and December 31, 2016, respectively.

Table of Contents**MANAGEMENT'S DISCUSSION AND ANALYSIS****FUNDING ACTIVITIES****Deposits**

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

| | Deposit Composition | | | |
|------------------------------------|----------------------------|-----------------------|--------------------------|-----------------------|
| | June 30, 2017 | | December 31, 2016 | |
| | Amount | % of Total | Amount | % of Total |
| Noninterest-bearing demand | \$ 677,124 | 21.6% | \$ 677,076 | 22.6% |
| Interest-bearing demand | 631,451 | 20.2 | 581,436 | 19.4 |
| Savings and money market | 999,125 | 31.9 | 1,034,194 | 34.5 |
| Time deposits < \$250,000 | 685,242 | 21.8 | 602,715 | 20.2 |
| Time deposits of \$250,000 or more | 139,544 | 4.5 | 99,801 | 3.3 |
| Total deposits | \$ 3,132,486 | 100.0% | \$ 2,995,222 | 100.0% |

We offer a variety of deposit products designed to attract and retain customers, with the primary focus on building and expanding long-term relationships. At June 30, 2017, total deposits were \$3.13 billion, representing an increase of \$137.3 million for the year. Time deposits were approximately 26% of total deposits at June 30, 2017 and 24% at December 31, 2016.

Nonpublic deposits, the largest component of our funding sources, totaled \$2.29 billion and \$2.19 billion at June 30, 2017 and December 31, 2016, respectively, and represented 73% of total deposits as of the end of each period. We have managed this segment of funding through a strategy of competitive pricing that minimizes the number of customer relationships that have only a single service high cost deposit account.

As an additional source of funding, we offer a variety of public (municipal) deposit products to the towns, villages, counties and school districts within our market. Public deposits generally range from 20% to 30% of our total deposits. There is a high degree of seasonality in this component of funding, because the level of deposits varies with the seasonal cash flows for these public customers. We maintain the necessary levels of short-term liquid assets to accommodate the seasonality associated with public deposits. Total public deposits were \$837.8 million and \$803.6 million at June 30, 2017 and December 31, 2016, respectively, and represented 27% of total deposits as of the end of each period. The increase in public deposits during 2017 was due largely to successful business development efforts.

We had no traditional brokered deposits at June 30, 2017 or December 31, 2016; however, we do participate in the CDARS and ICS programs, which enable depositors to receive FDIC insurance coverage for deposits otherwise exceeding the maximum insurable amount. CDARS and ICS deposits are considered brokered deposits for regulatory reporting purposes. Through these programs, deposits in excess of the maximum insurable amount are placed with multiple participating financial institutions. Reciprocal CDARS deposits and ICS deposits totaled \$167.6 million and

\$137.5 million, respectively, at June 30, 2017, compared to \$143.2 million and \$152.9, respectively, at December 31, 2016.

Borrowings

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

| | June 30, 2017 | December 31, 2016 |
|--|--------------------------|------------------------------|
| Short-term borrowings - Short-term FHLB borrowings | \$ 347,500 | \$ 331,500 |
| Long-term borrowings - Subordinated notes | 39,096 | 39,061 |
| Total borrowings | \$ 386,596 | \$ 370,561 |

Short-term Borrowings

Short-term FHLB borrowings have original maturities of less than one year and include overnight borrowings which we typically utilize to address short term funding needs as they arise. Short-term FHLB borrowings at June 30, 2017 consisted of \$187.6 million in overnight borrowings and \$159.9 million in short-term advances. The maximum amount of Short-term FHLB borrowings outstanding at any month-end during the six months ended June 30, 2017 was \$355.6 million. Short-term FHLB borrowings at December 31, 2016 consisted of \$171.5 million in overnight borrowings and \$160.0 million in short-term advances.

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

We have credit capacity with the FHLB and can borrow through facilities that include amortizing and term advances or repurchase agreements. We had approximately \$50.0 million of immediate credit capacity with the FHLB as of June 30, 2017. We had approximately \$579.0 million in secured borrowing capacity at the Federal Reserve Bank (FRB) discount window, none of which was outstanding at June 30, 2017. The FHLB and FRB credit capacity are collateralized by securities from our investment portfolio and certain qualifying loans. We had approximately \$140.0 million of credit available under unsecured federal funds purchased lines with various banks as of June 30, 2017. Additionally, we had approximately \$223.2 million of unencumbered liquid securities available for pledging.

The Parent has a revolving line of credit with a commercial bank allowing borrowings up to \$20.0 million in total as an additional source of working capital. At June 30, 2017, no amounts have been drawn on the line of credit.

Long-term Borrowings

On April 15, 2015, we issued \$40.0 million of Subordinated Notes in a registered public offering. The Subordinated Notes bear interest at a fixed rate of 6.0% per year, payable semi-annually, for the first 10 years. From April 15, 2025 to the April 15, 2030 maturity date, the interest rate will reset quarterly to an annual interest rate equal to the then current three-month London Interbank Offered Rate (LIBOR) plus 3.944%, payable quarterly. The Subordinated Notes are redeemable by us at any quarterly interest payment date beginning on April 15, 2025 to maturity at par, plus accrued and unpaid interest. Proceeds, net of debt issuance costs of \$1.1 million, were \$38.9 million. The Subordinated Notes qualify as Tier 2 capital for regulatory purposes.

LIQUIDITY AND CAPITAL MANAGEMENT**Liquidity**

The objective of maintaining adequate liquidity is to assure that we meet our financial obligations. These obligations include the withdrawal of deposits on demand or at their contractual maturity, the repayment of matured borrowings, the ability to fund new and existing loan commitments and the ability to take advantage of new business opportunities. We achieve liquidity by maintaining a strong base of both core customer funds and maturing short-term assets; we also rely on our ability to sell or pledge securities and lines-of-credit and our overall ability to access to the financial and capital markets.

Liquidity for the Bank is managed through the monitoring of anticipated changes in loans, the investment portfolio, core deposits and wholesale funds. The strength of the Bank's liquidity position is a result of its base of core customer deposits. These core deposits are supplemented by wholesale funding sources that include credit lines with the other banking institutions, the FHLB and the FRB. The primary source of our non-deposit borrowings is FHLB advances, of which we had \$347.5 million outstanding at June 30, 2017. In addition to this amount, we have additional collateralized wholesale borrowing capacity of approximately \$769.0 million from various funding sources which include the FHLB, the FRB, and commercial banks that we can use to fund lending activities, liquidity needs, and/or to adjust and manage our asset and liability position.

The Parent's funding requirements consist primarily of dividends to shareholders, debt service, income taxes, operating expenses, funding of nonbank subsidiaries, repurchases of our stock, and acquisitions. The Parent obtains funding to meet obligations from dividends received from the Bank, net taxes collected from subsidiaries included in the federal

consolidated tax return, and the issuance of debt and equity securities. In addition, the Parent maintains a revolving line of credit with a commercial bank for an aggregate amount of up to \$20.0 million, all of which was available at June 30, 2017. The line of credit has a one year term and matures in May 2018. Funds drawn would be used for general corporate purposes and backup liquidity.

Cash and cash equivalents were \$84.5 million as of June 30, 2017, up \$13.2 million from \$71.3 million as of December 31, 2016. Net cash provided by operating activities totaled \$22.6 million and the principal source of operating activity cash flow was net income adjusted for noncash income and expense items. Net cash used in investing activities totaled \$172.7 million, which included outflows of \$181.3 million for net loan originations and inflows of \$14.8 million from net investment securities transactions. Net cash provided by financing activities of \$163.4 million was attributed to a \$137.3 million increase in deposits, \$16.7 million from the at-the-market common stock offering and a \$16.0 million increase in short-term borrowings, partly offset by \$6.8 million in dividend payments.

Capital Management

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

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

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

Shareholders' equity was \$347.6 million at June 30, 2017, an increase of \$27.6 million from \$320.1 million at December 31, 2016. Net income for the year and stock issued from the at-the-market common stock offering increased shareholders' equity by \$14.2 million and \$16.7 million, respectively, which were partially offset by common and preferred stock dividends declared of \$6.9 million. Accumulated other comprehensive loss included in shareholders' equity decreased \$2.7 million during the first six months of 2017 due primarily to lower net unrealized losses on securities available for sale.

The FRB and FDIC have adopted a system using risk-based capital guidelines to evaluate the capital adequacy of banks and bank holding companies. The final rules implementing the Basel Committee on Banking Supervision's (BCBS) capital guidelines for U.S. banks became effective for the Company on January 1, 2015, with full compliance with all of the final requirements phased in over a multi-year schedule, to be fully phased-in by January 1, 2019. As of June 30, 2017, the Company's capital levels remained characterized as well-capitalized under these rules.

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

| | June 30, 2017 | December 31, 2016 |
|---|--------------------------|------------------------------|
| Common shareholders' equity | \$ 330,301 | \$ 302,714 |
| Less: Goodwill and other intangible assets, net of deferred tax liabilities | 67,908 | 68,759 |
| Net unrealized (loss) gain on investment securities ⁽¹⁾ | (1,413) | (3,729) |
| Net periodic pension & postretirement benefits plan adjustments | (9,880) | (10,222) |
| Other | | |
| Common equity Tier 1 (CET1) capital | 273,686 | 247,906 |
| Plus: Preferred stock | 17,340 | 17,340 |
| Less: Other | | |
| Tier 1 Capital | 291,026 | 265,246 |
| Plus: Qualifying allowance for loan losses | 33,159 | 30,934 |
| Subordinated Notes | 39,096 | 39,061 |

Edgar Filing: FINANCIAL INSTITUTIONS INC - Form 10-Q

| | | |
|---|--------------|--------------|
| Total regulatory capital | \$ 363,281 | \$ 335,241 |
| Adjusted average total assets (for leverage capital purposes) | \$ 3,778,477 | \$ 3,602,377 |
| Total risk-weighted assets | \$ 2,775,746 | \$ 2,584,161 |

Regulatory Capital Ratios

| | | |
|---|-------|-------|
| Tier 1 leverage (Tier 1 capital to adjusted average assets) | 7.70% | 7.36% |
| CET1 capital (CET1 capital to total risk-weighted assets) | 9.86 | 9.59 |
| Tier 1 capital (Tier 1 capital to total risk-weighted assets) | 10.48 | 10.26 |
| Total risk-based capital (Total regulatory capital to total risk-weighted assets) | 13.09 | 12.97 |

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

BCBS Capital Rules

The BCBS Capital Rules include a new common equity Tier 1 capital to risk-weighted assets minimum ratio of 4.5%, increase the minimum Tier 1 capital to risk-weighted assets ratio from 4.0% to 6.0%, require a minimum total capital to risk-weighted assets ratio of 8.0%, and require a minimum Tier 1 leverage ratio of 4.0%. A new capital conservation buffer is also established above the regulatory minimum capital requirements, effectively increasing the minimum required risk-weighted asset ratios. This capital conservation buffer is being phased-in as of January 1, 2016 at 0.625% of risk-weighted assets and increases each subsequent year by an additional 0.625% until reaching its final level of 2.5% on January 1, 2019. Banking institutions with a capital conservation buffer below the minimum level will face constraints on dividends, equity repurchases and compensation based on the amount of the shortfall. The BCBS Capital Rules also provide for a countercyclical capital buffer that is applicable to only certain covered institutions and does not have any current applicability to the Company or the Bank. Strict eligibility criteria for regulatory capital instruments were also implemented under the final rules. The final rules also revised the definition and calculation of Tier 1 capital, total capital, and risk-weighted assets.

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

The following table presents actual and required capital ratios as of June 30, 2017 and December 31, 2016 for the Company and the Bank under the BCBS Capital Rules. The minimum required capital amounts presented include the minimum required capital levels as of those dates based on the phase-in provisions of the BCBS Capital Rules and the minimum required capital levels as of January 1, 2019 when the BCBS Capital Rules have been fully phased-in. Capital levels required to be considered well capitalized are based upon prompt corrective action regulations, as amended to reflect the changes under the BCBS Capital Rules (in thousands):

| | Actual | | Minimum Capital Required Phase-in Schedule | | Minimum Capital Required Basel III Fully Phased-in | | Required to be Considered Well Capitalized | |
|--------------------------|------------|-------|--|-------|--|-------|--|-------|
| | Amount | Ratio | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| June 30, 2017 | | | | | | | | |
| Tier 1 leverage: | | | | | | | | |
| Company | \$ 291,026 | 7.70% | \$ 151,139 | 4.00% | \$ 151,139 | 4.00% | \$ 188,924 | 5.00% |
| Bank | 311,463 | 8.26 | 150,739 | 4.00 | 150,739 | 4.00 | 188,424 | 5.00 |
| CET1 capital: | | | | | | | | |
| Company | 273,686 | 9.86 | 159,605 | 5.75 | 194,302 | 7.00 | 180,423 | 6.50 |
| Bank | 311,463 | 11.26 | 159,077 | 5.75 | 193,659 | 7.00 | 179,826 | 6.50 |
| Tier 1 capital: | | | | | | | | |
| Company | 291,026 | 10.48 | 201,242 | 7.25 | 235,938 | 8.50 | 222,060 | 8.00 |
| Bank | 311,463 | 11.26 | 200,576 | 7.25 | 235,158 | 8.50 | 221,325 | 8.00 |
| Total capital: | | | | | | | | |
| Company | 363,281 | 13.09 | 256,756 | 9.25 | 291,453 | 10.50 | 277,575 | 10.00 |
| Bank | 344,622 | 12.46 | 255,907 | 9.25 | 290,489 | 10.50 | 276,656 | 10.00 |
| December 31, 2016 | | | | | | | | |
| Tier 1 leverage: | | | | | | | | |
| Company | \$ 265,246 | 7.36% | \$ 144,095 | 4.00% | \$ 144,095 | 4.00% | \$ 180,119 | 5.00% |
| Bank | 284,765 | 7.92 | 143,862 | 4.00 | 143,862 | 4.00 | 179,828 | 5.00 |
| CET1 capital: | | | | | | | | |
| Company | 247,906 | 9.59 | 132,438 | 5.13 | 180,891 | 7.00 | 167,970 | 6.50 |
| Bank | 284,765 | 11.06 | 132,014 | 5.13 | 180,312 | 7.00 | 167,432 | 6.50 |
| Tier 1 capital: | | | | | | | | |
| Company | 265,246 | 10.26 | 171,201 | 6.63 | 219,654 | 8.50 | 206,733 | 8.00 |
| Bank | 284,765 | 11.06 | 170,652 | 6.63 | 218,950 | 8.50 | 206,070 | 8.00 |
| Total capital: | | | | | | | | |
| Company | 335,241 | 12.97 | 222,884 | 8.63 | 271,337 | 10.50 | 258,416 | 10.00 |
| Bank | 315,699 | 12.26 | 222,170 | 8.63 | 270,467 | 10.50 | 257,588 | 10.00 |

Dividend Restrictions

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

- 53 -

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

Quantitative and qualitative disclosures about market risk were presented at December 31, 2016 in Item 7A of the Company's Annual Report on Form 10-K for the year ended December 31, 2016, as filed with the Securities and Exchange Commission on March 7, 2017. The following is an update of the discussion provided therein.

Portfolio Composition

There was no material change in the composition of assets, deposit liabilities or borrowings from December 31, 2016 to June 30, 2017. See the section titled "Analysis of Financial Condition" in Part I, Item 2, "Management's Discussion and Analysis of Financial Condition and Results of Operations" for a discussion of asset, deposit and borrowing activity during the period.

Net Interest Income at Risk

A primary tool used to manage interest rate risk is "rate shock" simulation to measure the rate sensitivity. Rate shock simulation is a modeling technique used to estimate the impact of changes in rates on net interest income as well as economic value of equity. At June 30, 2017, the Company was slightly asset sensitive, meaning that net interest income increases in rising rate conditions.

Net interest income at risk is measured by estimating the changes in net interest income resulting from instantaneous and sustained parallel shifts in interest rates of different magnitudes over a period of 12 months. The following table sets forth the estimated changes to net interest income over the 12-month period ending June 30, 2018 assuming instantaneous changes in interest rates for the given rate shock scenarios (dollars in thousands):

| | Changes in Interest Rate | | | |
|-------------------------------|---------------------------------|----------------|-------------|----------------|
| | | | +200 | |
| | -100 bp | +100 bp | bp | +300 bp |
| Change in net interest income | \$(1,687) | \$ 896 | \$ 1,752 | \$ 150 |
| % Change | (1.44)% | 0.76% | 1.49% | 0.13% |

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

The simulation referenced above is based on our assumption as to the effect of interest rate changes on assets and liabilities and assumes a parallel shift of the yield curve. It also includes certain assumptions about the future pricing of loans and deposits in response to changes in interest rates. Further, it assumes that delinquency rates would not change as a result of changes in interest rates, although there can be no assurance that this will be the case. While this simulation is a useful measure as to net interest income at risk due to a change in interest rates, it is not a forecast of future results, does not measure the effect of changing interest rates on noninterest income and is based on many assumptions that, if changed, could cause a different outcome.

Economic Value of Equity At Risk

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

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

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

Table of Contents

The analysis that follows presents the estimated EVE resulting from market interest rates prevailing at a given quarter-end (Pre-Shock Scenario), and under other interest rate scenarios (each a Rate Shock Scenario) represented by immediate, permanent, parallel shifts in interest rates from those observed at June 30, 2017 and December 31, 2016. The analysis additionally presents a measurement of the interest rate sensitivity at June 30, 2017 and December 31, 2016. EVE amounts are computed under each respective Pre- Shock Scenario and Rate Shock Scenario. An increase in the EVE amount is considered favorable, while a decline is considered unfavorable.

| Rate Shock Scenario: | June 30, 2017 | | | December 31, 2016 | | |
|----------------------|---------------|-----------|-------------------|-------------------|-----------|-------------------|
| | EVE | Change | Percentage Change | EVE | Change | Percentage Change |
| Pre-Shock Scenario | \$ 561,824 | | | \$ 532,744 | | |
| - 100 Basis Points | 572,906 | \$ 11,082 | 1.97% | 543,506 | \$ 10,762 | 2.02% |
| + 100 Basis Points | 542,437 | (19,387) | (3.45) | 507,924 | (24,820) | (4.66) |
| + 200 Basis Points | 520,382 | (41,442) | (7.38) | 481,692 | (51,052) | (9.58) |
| + 300 Basis Points | 485,535 | (76,289) | (13.58) | 445,207 | (87,537) | (16.43) |

The Pre-Shock Scenario EVE was \$561.8 million at June 30, 2017, compared to \$532.7 million at December 31, 2016. The increase in the Pre-Shock Scenario EVE at June 30, 2017 resulted primarily from a more favorable valuation of non-maturity deposits that reflected alternative funding rate changes used for discounting future cash flows.

The +200 basis point Rate Shock Scenario EVE increased from \$481.7 million at December 31, 2016 to \$520.4 million at June 30, 2017, reflecting the more favorable valuation of non-maturity deposits. The percentage change in the EVE amount from the Pre-Shock Scenario to the +200 basis point Rate Shock Scenario decreased from (9.58)% at December 31, 2016 to (7.38)% at June 30, 2017. The decrease in sensitivity resulted from an increased benefit in the valuation of non-maturity deposits in the +200 basis point Rate Shock Scenario EVE as of June 30, 2017, compared to December 31, 2016.

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

As of June 30, 2017, the Company carried out an evaluation, under the supervision and with the participation of the Company's management, including the Company's Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures pursuant to Rule 13a-15(b), as adopted by the Securities and Exchange Commission (SEC) under the Securities Exchange Act of 1934, as amended (Exchange Act). Based upon that evaluation, the Company's Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures were effective as of the end of the period covered by this report.

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

Changes in internal control over financial reporting

There were no changes in the Company's internal control over financial reporting that occurred during the quarter ended June 30, 2017 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

- 55 -

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

The Company has experienced no material developments in its legal proceedings from the disclosure included in the Company's Annual Report on Form 10-K for the year ended December 31, 2016, dated March 7, 2017, as filed with the SEC.

ITEM 6. Exhibits

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

| Exhibit Number | Description | Location |
|-----------------------|--|---|
| 10.1 | Amended and Restated Executive Agreement, dated May 3, 2017, by and between the Company and Martin K. Birmingham | Incorporated by reference to Exhibit 10.1 of the Form 8-K, dated May 4, 2017 |
| 10.2 | Amended and Restated Executive Agreement, dated May 3, 2017, by and between the Company and Kevin B. Klotzbach | Incorporated by reference to Exhibit 10.2 of the Form 8-K, dated May 4, 2017 |
| 10.3 | Executive Agreement, dated May 3, 2017, by and between the Company and Michael D. Burneal | Incorporated by reference to Exhibit 10.3 of the Form 8-K, dated May 4, 2017 |
| 10.4 | Executive Agreement, dated May 3, 2017, by and between the Company and Jeffrey P. Kenefick | Incorporated by reference to Exhibit 10.4 of the Form 8-K, dated May 4, 2017 |
| 10.5 | Executive Agreement, dated May 3, 2017, by and between the Company and William L. Kreienberg | Incorporated by reference to Exhibit 10.5 of the Form 8-K, dated May 4, 2017 |
| 10.6 | Sales Agency Agreement, dated May 30, 2017, by and between the Company and Sandler O'Neill + Partners, L.P. | Incorporated by reference to Exhibit 10.1 of the Form 8-K, dated May 30, 2017 |
| 31.1 | Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 Principal Executive Officer | Filed Herewith |
| 31.2 | Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 Principal Financial Officer | Filed Herewith |
| 32 | Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 | Filed Herewith |
| 101.INS | XBRL Instance Document | |

- 101.SCH XBRL Taxonomy Extension Schema Document
- 101.CAL XBRL Taxonomy Extension Calculation
Linkbase Document
- 101.LAB XBRL Taxonomy Extension Label Linkbase
Document
- 101.PRE XBRL Taxonomy Extension Presentation
Linkbase Document
- 101.DEF XBRL Taxonomy Extension Definition Linkbase
Document

Table of Contents

SIGNATURES

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

FINANCIAL INSTITUTIONS, INC.

/s/ Martin K. Birmingham , August 4, 2017
Martin K. Birmingham
President and Chief Executive Officer
(Principal Executive Officer)

/s/ Kevin B. Klotzbach , August 4, 2017
Kevin B. Klotzbach
Executive Vice President, Chief Financial Officer and Treasurer
(Principal Financial Officer)

/s/ Michael D. Grover , August 4, 2017
Michael D. Grover
Senior Vice President and Chief Accounting Officer
(Principal Accounting Officer)