FINANCIAL INSTITUTIONS INC
Form 10-Q
August 08, 2018
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended June 30, 2018

or

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from ________ to ________

Commission File Number: 000-26481

(Exact name of registrant as specified in its charter)

NEW YORK	16-0816610
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

220 LIBERTY STREET, WARSAW, NEW YORK 14569
(Address of principal executive offices) (Zip Code)
Registrant's telephone number, including area code: (585) 786-1100

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes 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 provided 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 15,924,959 shares of Common Stock, $0.01 par value, outstanding as of July 31, 2018.

FINANCIAL INSTITUTIONS, INC.

Form 10-Q

For the Quarterly Period Ended June 30, 2018

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PART I. FINANCIAL INFORMATION

ITEM 1. Financial Statements

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Consolidated Statements of Financial Condition (Unaudited)

(Dollars in thousands, except share and per share data)	June 30, 2018	December 31, 2017
ASSETS		
Cash and due from banks	$ 89,094	$ 99,195
Securities available for sale, at fair value	492,228	524,973
Securities held to maturity, at amortized cost (fair value of $465,542 and $512,983, respectively)	474,803	516,466
Loans held for sale	2,014	2,718
Loans (net of allowance for loan losses of $33,955 and $34,672, respectively)	2,866,257	2,700,345
Company owned life insurance	66,188	65,288
Premises and equipment, net	43,681	45,189
Goodwill and other intangible assets, net	79,188	74,703
Other assets	77,862	76,333
Total assets	$ 4,191,315	$ 4,105,210
LIABILITIES AND SHAREHOLDERS' EQUITY		
Deposits:		
Noninterest-bearing demand	$ 719,084	$ 718,498
Interest-bearing demand	658,107	634,203
Savings and money market	1,012,972	1,005,317
Time deposits	872,004	852,156
Total deposits	3,262,167	3,210,174
Short-term borrowings	472,800	446,200
Long-term borrowings, net of issuance costs of $833 and $869, respectively	39,167	39,131
Other liabilities	30,244	28,528
Total liabilities	3,804,378	3,724,033
Shareholders' equity:		
Series A 3% preferred stock, $100 par value; 1,533 shares authorized; 1,439 shares issued	144	144
Series B-1 8.48% preferred stock, $100 par value; 200,000 shares authorized; 171,847 shares issued	17,185	17,185
Total preferred equity	17,329	17,329
Common stock, $0.01 par value; 50,000,000 shares authorized; 16,056,178 shares issued	161	161
Additional paid-in capital	122,144	121,058
Retained earnings	270,171	257,078
Accumulated other comprehensive loss	(20,296)	(11,916)

Treasury stock, at cost – 132,019 and 131,240 shares, respectively	(2,572)	(2,533)
Total shareholders' equity	386,937	381,177
Total liabilities and shareholders' equity	$4,191,315	$ 4,105,210

See accompanying notes to the consolidated financial statements.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Consolidated Statements of Income (Unaudited)

(In thousands, except per share amounts)	Three months ended		Six months ended	
	June 30, 2018	2017	June 30, 2018	2017
Interest income:				
Interest and fees on loans	$ 31,343	$ 25,469	$ 61,101	$ 50,085
Interest and dividends on investment securities	5,525	5,898	11,166	11,795
Other interest income	—	42	4	67
Total interest income	36,868	31,409	72,271	61,947
Interest expense:				
Deposits	4,253	2,500	7,709	4,731
Short-term borrowings	1,912	870	3,613	1,564
Long-term borrowings	618	617	1,236	1,235
Total interest expense	6,783	3,987	12,558	7,530
Net interest income	30,085	27,422	59,713	54,417
Provision for loan losses	40	3,832	2,989	6,613
Net interest income after provision for loan losses	30,045	23,590	56,724	47,804
Noninterest income:				
Service charges on deposits	1,703	1,840	3,441	3,585
Insurance income	1,018	1,133	2,417	2,564
ATM and debit card	1,531	1,456	2,952	2,785
Investment advisory	1,911	1,429	3,689	2,860
Company owned life insurance	443	473	893	918
Investments in limited partnerships	123	135	691	105
Loan servicing	203	123	318	243
Net gain on sale of loans held for sale	131	72	227	120
Net gain on investment securities	7	210	7	416
Net gain on derivative instruments	78	—	252	—
Net gain on other assets	9	6	12	4
Contingent consideration liability adjustment	—	1,200	—	1,200
Other	1,392	1,256	2,634	2,369
Total noninterest income	8,549	9,333	17,533	17,169
Noninterest expense:				
Salaries and employee benefits	12,871	11,986	26,300	23,355
Occupancy and equipment	4,167	4,184	8,574	8,148
Professional services	896	1,057	1,779	2,072
Computer and data processing	1,358	1,312	2,593	2,483
Supplies and postage	548	467	1,060	1,004
FDIC assessments	480	469	988	926
Advertising and promotions	721	645	1,698	1,107
Amortization of intangibles	305	291	593	588

Goodwill impairment	—	1,575	—	1,575
Other	2,099	1,955	3,967	3,625
Total noninterest expense	23,445	23,941	47,552	44,883
Income before income taxes	15,149	8,982	26,705	20,090
Income tax expense	2,979	2,736	5,247	5,901
Net income	$ 12,170	$ 6,246	$ 21,458	$ 14,189
Preferred stock dividends	366	366	731	731
Net income available to common shareholders	$ 11,804	$ 5,880	$ 20,727	$ 13,458
Earnings per common share (Note 3):				
Basic	$ 0.74	$ 0.40	$ 1.30	$ 0.92
Diluted	$ 0.74	$ 0.40	$ 1.30	$ 0.92
Cash dividends declared per common share	$ 0.24	$ 0.21	$ 0.48	$ 0.42

See accompanying notes to the consolidated financial statements.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Consolidated Statements of Comprehensive Income (Unaudited)

(Dollars in thousands)	Three months ended		Six months ended	
	June 30,		June 30,	
	2018	2017	2018	2017
Net income	$ 12,170	$ 6,246	$ 21,458	$ 14,189
Other comprehensive (loss) income, net of tax:				
Securities available for sale and transferred securities	(2,487)	1,722	(8,757)	2,316
Hedging derivative instruments	227	—	123	—
Pension and post-retirement obligations	127	171	254	342
Total other comprehensive (loss) income, net of tax	(2,133)	1,893	(8,380)	2,658
Comprehensive income	$ 10,037	$ 8,139	$ 13,078	$ 16,847

See accompanying notes to the consolidated financial statements.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Consolidated Statements of Changes in Shareholders' Equity (Unaudited)

Six months ended June 30, 2018 and 2017

(Dollars in thousands, except per share data)	Preferred Equity	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Loss	Treasury Stock	Total Shareholders' Equity
Balance at 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)
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
Balance at December 31, 2017	$ 17,329	$ 161	$ 121,058	$ 257,078	$ (11,916)	$ (2,533)	$ 381,177
Comprehensive income:							
Net income	—	—	—	21,458	—	—	21,458
Other comprehensive loss, net of tax	—	—	—	—	(8,380)	—	(8,380)
Purchases of common stock for treasury	—	—	—	—	—	(113)	(113)
Share-based compensation plans:							
Share-based compensation	—	—	759	—	—	—	759

Stock options exercised	—	—	(15)	—	—	324	309
Restricted stock awards issued, net	—	—	303	—	—	(303)	—
Stock awards	—	—	39	—	—	53	92
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-$0.48 per share	—	—	—	(7,634)	—	—	(7,634)
Balance at June 30, 2018	$ 17,329	$ 161	$ 122,144	$ 270,171	$ (20,296)	$ (2,572)	$ 386,937

See accompanying notes to the consolidated financial statements.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Consolidated Statements of Cash Flows (Unaudited)

(Dollars in thousands)	Six months ended June 30, 2018	2017
Cash flows from operating activities:		
Net income	$21,458	$14,189
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	3,235	3,053
Net amortization of premiums on securities	1,350	1,654
Provision for loan losses	2,989	6,613
Share-based compensation	759	605
Deferred income tax (benefit) expense	(4,978)	652
Proceeds from sale of loans held for sale	9,766	3,779
Originations of loans held for sale	(8,835)	(4,473)
Income on company owned life insurance	(893)	(918)
Net gain on sale of loans held for sale	(227)	(120)
Net gain on investment securities	(7)	(416)
Net gain on other assets	(12)	(4)
Goodwill impairment	—	1,575
Decrease (increase) in other assets	6,785	(1,085)
Decrease in other liabilities	(1,122)	(2,535)
Net cash provided by operating activities	30,268	22,569
Cash flows from investing activities:		
Purchases of available for sale securities	—	(40,858)
Purchases of held to maturity securities	(16,535)	(41,522)
Proceeds from principal payments, maturities and calls on available for sale securities	14,813	18,424
Proceeds from principal payments, maturities and calls on held to maturity securities	59,448	53,481
Proceeds from sales of securities available for sale	5,768	25,307
Net loan originations	(169,315)	(181,253)
Purchases of company owned life insurance, net of proceeds received	(7)	(8)
Proceeds from sales of other assets	259	102
Purchases of premises and equipment	(1,102)	(6,374)
Cash consideration paid for acquisition, net of cash acquired	(4,447)	—
Net cash used in investing activities	(111,118)	(172,701)
Cash flows from financing activities:		
Net increase in deposits	51,993	137,264
Net increase in short-term borrowings	26,600	16,000
Proceeds from issuance of common stock	—	16,708
Purchases of common stock for treasury	(113)	(148)
Proceeds from stock options exercised	309	379
Cash dividends paid to common and preferred shareholders	(8,040)	(6,811)

Net cash provided by financing activities	70,749	163,392
Net (decrease) increase in cash and cash equivalents	(10,101)	13,260
Cash and cash equivalents, beginning of period	99,195	71,277
Cash and cash equivalents, end of period	$89,094	$84,537
Supplemental information:		
Cash paid for interest	$13,187	$6,501
Cash paid for income taxes	1,916	5,849
Noncash investing and financing activities:		
Real estate and other assets acquired in settlement of loans	414	154
Accrued and declared unpaid dividends	4,184	3,511
Increase in net unsettled security purchases	2,136	3,081
Assets acquired and liabilities assumed in business combinations:		
Fair value of assets acquired	2,561	—
Fair value of liabilities assumed	128	—

See accompanying notes to the consolidated financial statements.

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

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

Nature of Operations

Financial Institutions, Inc. (the “Company”) is a financial holding company organized in 1931 under the laws of New York State (“New York”). The Company provides diversified financial services through its subsidiaries, Five Star Bank, Scott Danahy Naylon, LLC (“SDN”), Courier Capital, LLC (“Courier Capital”) and HNP Capital, LLC (“HNP 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. Courier Capital and HNP Capital provide customized investment management, investment consulting and retirement plan services to individuals, businesses, institutions, foundations and retirement plans.

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 2017 Annual Report on Form 10-K for the year ended December 31, 2017. 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 was permitted as of the original effective date – interim and annual periods beginning on or after December 15, 2016. The Company's largest source of revenue is net interest income on financial assets and liabilities, which is explicitly excluded from the scope of ASU 2014-09. Revenue streams that are within the scope of ASU 2014-09 include insurance income, investment advisory fees, service charges on deposits and ATM and debit card fees. The adoption of ASU 2014-09, as of January 1, 2018, did not have a significant impact on the Company's financial statements. The Company adopted ASU 2014-09 using the modified retrospective transition method with no cumulative effect adjustment to opening retained earnings as of January 1, 2018. See "Revenue Recognition" below for additional information related to revenue generated from contracts with customers.

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(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 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 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 an entity 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 entity 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 adoption of ASU 2016-01, as of January 1, 2018, did not have a significant impact on the Company’s financial statements, except for the fair value disclosures as presented in Note 13 – Fair Value Measurements.

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 a 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. 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. The Company expects an increase in assets and liabilities as a result of recording additional lease contracts where the Company is a leasee.

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 was permitted, including adoption in an interim period. The adoption of ASU 2016-15, as of January 1, 2018, 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 was 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 were to be applied retrospectively. The adoption of ASU 2017-07, as of January 1, 2018, did not have a significant impact on the Company's financial statements.

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

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.

In August 2017, the FASB issued ASU No. 2017-12, Derivatives and Hedging (Topic 815) – Targeted Improvements to Accounting for Hedging Activities. These amendments: (a) expand and refine hedge accounting for both financial and non-financial risk components, (b) align the recognition and presentation of the effects of hedging instruments and hedge items in the financial statements, and (c) include certain targeted improvements to ease the application of current guidance related to the assessment of hedge effectiveness. 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 related to cash flow and net investment hedges existing at the date of adoption 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 presentation and disclosure should be applied prospectively. The Company is assessing the impact of ASU 2017-12 on its financial statements.

In February 2018, the FASB issued ASU No. 2018-02, Income Statement-Reporting Comprehensive Income (Topic 220) – Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income. ASU 2018-02 permits a reclassification from accumulated other comprehensive income to retained earnings for stranded tax effects resulting from the Tax Cuts and Jobs Act (the “TCJ Act”). The guidance is effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Early adoption is permitted, including adoption in any interim period. The amendments should be applied either in the period of adoption or retrospectively to each period (or periods) in which the effect of the change in the federal corporate income tax rate in the TCJ Act is recognized. The Company expects to reclass approximately $2.8 million from accumulated other comprehensive loss to retained earnings when ASU 2018-02 is adopted.

Revenue Recognition

Accounting Standards Codification (“ASC”) 606, Revenue from Contracts with Customers (“ASC 606”), establishes principles for reporting information about the nature, amount, timing and uncertainty of revenue and cash flows arising from the entity’s contracts to provide goods or services to customers. The core principle requires an entity to recognize revenue to depict the transfer of goods or services to customers in an amount that reflects the consideration that it expects to be entitled to receive in exchange for those goods or services recognized as performance obligations are satisfied.

The majority of our revenue-generating transactions are not subject to ASC 606, including revenue generated from financial instruments, such as our loans, letters of credit, derivatives and investment securities, as well as revenue related to our loan servicing activities, as these activities are subject to other GAAP. Descriptions of our primary revenue-generating activities that are within the scope of ASC 606, which are presented in our income statements as components of noninterest income are as follows:

- Transactions and service-based revenues - these include service charges on deposits, investment advisory, and ATM and debit card fees. Revenue is recognized when the transactions occur or as services are performed over primarily monthly or quarterly periods. Payment is typically received in the period the transactions occur or, in some cases, within 90 days of the service period. Fees may be fixed or, where applicable, based on a percentage of transaction size or managed assets.
- Insurance income - Insurance commissions are received on the sale of insurance products, and revenue is recognized upon the placement date of the insurance policies. Payment is normally received within the policy period. In addition to placement, SDN also provides insurance policy related risk management services. Revenue is recognized as these services are provided.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(2.)BUSINESS COMBINATIONS

2018 Activity – HNP Capital Acquisition

On June 1, 2018, the Company completed the acquisition of HNP Capital, an SEC-registered investment advisor with approximately $344 million in assets under management as of June 30, 2018. Consideration for the acquisition totaled $5.1 million in cash. As a result of the acquisition, the Company recorded goodwill of $2.6 million and other intangible assets of $2.5 million. The goodwill and other intangible assets are expected to be deductible for income tax purposes. The allocation of acquisition cost to the assets acquired and liabilities assumed and 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.

2017 Activity - Robshaw & Julian Acquisition

On August 31, 2017, Courier Capital completed the acquisition of the assets of Robshaw & Julian Associates, Inc. (“Robshaw & Julian”), a registered investment advisor with approximately $175 million in assets under management, which increased Courier Capital’s total assets under management to a total of approximately $1.6 billion as of August 31, 2017. Consideration for the acquisition included cash and potential future cash bonuses contingent upon achievement of certain revenue performance targets through August 2020. As a result of the acquisition, Courier Capital recorded goodwill of $1.0 million and other intangible assets of $810 thousand. The goodwill and other intangible assets are expected to be deductible for income tax purposes. The allocation of acquisition cost to the assets acquired and liabilities assumed and 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.

(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		Six months ended	
	June 30,		June 30,	
	2018	2017	2018	2017
Net income available to common shareholders	$ 11,804	$ 5,880	$ 20,727	$ 13,458
Weighted average common shares outstanding:				
Total shares issued	16,056	14,858	16,056	14,776
Unvested restricted stock awards	(4)	(44)	(12)	(50)
Treasury shares	(146)	(150)	(146)	(154)
Total basic weighted average common shares outstanding	15,906	14,664	15,898	14,572
Incremental shares from assumed:				
Exercise of stock options	3	10	5	12

Vesting of restricted stock awards	39	28	42	31
Total diluted weighted average common shares outstanding	15,948	14,702	15,945	14,615
Basic earnings per common share	$ 0.74	$ 0.40	$ 1.30	$ 0.92
Diluted earnings per common share	$ 0.74	$ 0.40	$ 1.30	$ 0.92

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	7	—	6	3
Total	7	—	6	3

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(4.)INVESTMENT SECURITIES

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

	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
June 30, 2018				
Securities available for sale:				
U.S. Government agency and government sponsored enterprises	$ 162,330	$ 11	$ 4,815	$ 157,526
Mortgage-backed securities:				
Federal National Mortgage Association	296,084	52	9,954	286,182
Federal Home Loan Mortgage Corporation	38,387	15	1,655	36,747
Government National Mortgage Association	10,595	140	102	10,633
Collateralized mortgage obligations:				
Federal National Mortgage Association	163	—	—	163
Federal Home Loan Mortgage Corporation	40	—	—	40
Privately issued	—	937	—	937
Total mortgage-backed securities	345,269	1,144	11,711	334,702
Total available for sale securities	$ 507,599	$ 1,155	$ 16,526	$ 492,228
Securities held to maturity:				
State and political subdivisions	250,791	1,287	1,559	250,519
Mortgage-backed securities:				
Federal National Mortgage Association	10,574	—	340	10,234
Federal Home Loan Mortgage Corporation	4,662	—	226	4,436
Government National Mortgage Association	33,934	13	954	32,993
Collateralized mortgage obligations:				
Federal National Mortgage Association	68,906	—	2,966	65,940
Federal Home Loan Mortgage Corporation	85,824	—	3,705	82,119
Government National Mortgage Association	20,112	—	811	19,301
Total mortgage-backed securities	224,012	13	9,002	215,023
Total held to maturity securities	$ 474,803	$ 1,300	$ 10,561	$ 465,542
December 31, 2017				
Securities available for sale:				
U.S. Government agency and government sponsored enterprises	$ 163,025	$ 122	$ 1,258	$ 161,889
Mortgage-backed securities:				
Federal National Mortgage Association	311,830	313	3,220	308,923
Federal Home Loan Mortgage Corporation	41,290	76	675	40,691
Government National Mortgage Association	12,051	193	12	12,232
Collateralized mortgage obligations:				
Federal National Mortgage Association	217	1	1	217
Federal Home Loan Mortgage Corporation	45	—	—	45

Privately issued	—	976	—	976
Total mortgage-backed securities	365,433	1,559	3,908	363,084
Total available for sale securities	$ 528,458	$ 1,681	$ 5,166	$ 524,973

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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, 2017 (continued)				
Securities held to maturity:				
State and political subdivisions	283,557	2,317	662	285,212
Mortgage-backed securities:				
Federal National Mortgage Association	9,732	16	88	9,660
Federal Home Loan Mortgage Corporation	3,213	—	119	3,094
Government National Mortgage Association	26,841	—	330	26,511
Collateralized mortgage obligations:				
Federal National Mortgage Association	76,432	—	1,958	74,474
Federal Home Loan Mortgage Corporation	93,810	3	2,165	91,648
Government National Mortgage Association	22,881	5	502	22,384
Total mortgage-backed securities	232,909	24	5,162	227,771
Total held to maturity securities	$ 516,466	$ 2,341	$ 5,824	$ 512,983

Investment securities with a total fair value of $813.5 million and $838.4 million at June 30, 2018 and December 31, 2017, respectively, 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		Six months ended	
	June 30, 2018	2017	June 30, 2018	2017
Proceeds from sales	$ 5,768	$ 12,957	$ 5,768	$ 25,307
Gross realized gains	9	210	9	416
Gross realized losses	2	—	2	—

The scheduled maturities of securities available for sale and securities held to maturity at June 30, 2018 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	$ 26,364	$ 26,197
Due from one to five years	144,174	140,856
Due after five years through ten years	238,443	229,545
Due after ten years	98,618	95,630
	$ 507,599	$ 492,228
Debt securities held to maturity:		
Due in one year or less	$ 55,989	$ 56,177
Due from one to five years	151,052	151,799
Due after five years through ten years	88,698	85,681
Due after ten years	179,064	171,885
	$ 474,803	$ 465,542

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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, 2018						
Securities available for sale:						
U.S. Government agency and government sponsored enterprises	$123,345	$ 3,328	$30,701	$ 1,487	$154,046	$ 4,815
Mortgage-backed securities:						
Federal National Mortgage Association	219,797	7,637	63,598	2,317	283,395	9,954
Federal Home Loan Mortgage Corporation	21,415	751	14,438	904	35,853	1,655
Government National Mortgage Association	4,410	97	789	5	5,199	102
Collateralized mortgage obligations:						
Federal National Mortgage Association	—	—	77	—	77	—
Federal Home Loan Mortgage Corporation	—	—	7	—	7	—
Total mortgage-backed securities	245,622	8,485	78,909	3,226	324,531	11,711
Total available for sale securities	368,967	11,813	109,610	4,713	478,577	16,526
Securities held to maturity:						
State and political subdivisions	65,548	883	15,698	676	81,246	1,559
Mortgage-backed securities:						
Federal National Mortgage Association	7,662	202	2,572	138	10,234	340
Federal Home Loan Mortgage Corporation	1,474	13	2,962	213	4,436	226
Government National Mortgage Association	11,967	399	13,627	555	25,594	954
Collateralized mortgage obligations:						
Federal National Mortgage Association	16,268	500	49,672	2,466	65,940	2,966
Federal Home Loan Mortgage Corporation	20,606	799	61,513	2,906	82,119	3,705
Government National Mortgage Association	6,940	282	12,361	529	19,301	811
Total mortgage-backed securities	64,917	2,195	142,707	6,807	207,624	9,002
Total held to maturity securities	130,465	3,078	158,405	7,483	288,870	10,561

Total temporarily impaired securities	$499,432	$ 14,891	$268,015	$ 12,196	$767,447	$ 27,087
December 31, 2017						
Securities available for sale:						
U.S. Government agencies and government sponsored enterprises	$95,046	$ 571	$31,561	$ 687	$126,607	$ 1,258
Mortgage-backed securities:						
Federal National Mortgage Association	201,754	1,855	67,383	1,365	269,137	3,220
Federal Home Loan Mortgage Corporation	20,446	192	15,601	483	36,047	675
Government National Mortgage Association	2,432	—	880	12	3,312	12
Collateralized mortgage obligations:						
Federal National Mortgage Association	—	—	119	1	119	1
Federal Home Loan Mortgage Corporation	—	—	8	—	8	—
Total mortgage-backed securities	224,632	2,047	83,991	1,861	308,623	3,908
Total available for sale securities	319,678	2,618	115,552	2,548	435,230	5,166

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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, 2017 (continued)						
Securities held to maturity:						
State and political subdivisions	36,368	295	14,492	367	50,860	662
Mortgage-backed securities:						
Federal National Mortgage Association	3,766	29	2,694	59	6,460	88
Federal Home Loan Mortgage Corporation	—	—	3,094	119	3,094	119
Government National Mortgage Association	17,327	136	9,184	194	26,511	330
Collateralized mortgage obligations:						
Federal National Mortgage Association	16,830	202	57,645	1,756	74,475	1,958
Federal Home Loan Mortgage Corporation	23,727	337	66,467	1,828	90,194	2,165
Government National Mortgage Association	15,401	340	5,635	162	21,036	502
Total mortgage-backed securities	77,051	1,044	144,719	4,118	221,770	5,162
Total held to maturity securities	113,419	1,339	159,211	4,485	272,630	5,824
Total temporarily impaired securities	$433,097	$ 3,957	$274,763	$ 7,033	$707,860	$ 10,990

The total number of security positions in the investment portfolio in an unrealized loss position at June 30, 2018 was 563 compared to 411 at December 31, 2017. At June 30, 2018, the Company had positions in 187 investment securities with a fair value of $268.0 million and a total unrealized loss of $12.2 million that have been in a continuous unrealized loss position for more than 12 months. At June 30, 2018, there were a total of 376 securities positions in the Company's investment portfolio with a fair value of $499.4 million and a total unrealized loss of $14.9 million that had been in a continuous unrealized loss position for less than 12 months. At December 31, 2017, the Company had positions in 172 investment securities with a fair value of $274.8 million and a total unrealized loss of $7.0 million that had been in a continuous unrealized loss position for more than 12 months. At December 31, 2017, there were a total of 239 securities positions in the Company's investment portfolio with a fair value of $433.1 million and a total unrealized loss of $4.0 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, 2018 and 2017.

Based on management’s review and evaluation of the Company’s debt securities as of June 30, 2018, the debt securities with unrealized losses were not considered to be OTTI. As of June 30, 2018, 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, 2018, management has concluded that unrealized losses on its investment securities are temporary and no further impairment loss has been realized in the Company’s consolidated statements of income.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(5.)LOANS

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

	Principal Amount Outstanding	Net Deferred Loan (Fees) Costs	Loans, Net
June 30, 2018			
Commercial business	$506,265	$756	$507,021
Commercial mortgage	869,192	(2,143)	867,049
Residential real estate loans	481,841	8,099	489,940
Residential real estate lines	110,319	2,968	113,287
Consumer indirect	874,718	31,519	906,237
Other consumer	16,508	170	16,678
Total	$2,858,843	$41,369	2,900,212
Allowance for loan losses			(33,955)
Total loans, net			$2,866,257
December 31, 2017			
Commercial business	$449,763	$563	$450,326
Commercial mortgage	810,851	(1,943)	808,908
Residential real estate loans	457,761	7,522	465,283
Residential real estate lines	113,422	2,887	116,309
Consumer indirect	845,682	30,888	876,570
Other consumer	17,443	178	17,621
Total	$2,694,922	$40,095	2,735,017
Allowance for loan losses			(34,672)
Total loans, net			$2,700,345

Loans held for sale (not included above) were comprised entirely of residential real estate mortgages and totaled $2.0 million and $2.7 million as of June 30, 2018 and December 31, 2017, respectively.

Past Due Loans Aging

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

	30-59 Days Past Due	60-89 Days Past Due	Greater Than 90 Days	Total Past Due	Nonaccrual	Current	Total Loans
June 30, 2018							
Commercial business	$51	$—	$ —	$51	$ 4,026	$502,188	$506,265
Commercial mortgage	387	—	—	387	2,151	866,654	869,192
Residential real estate loans	605	64	—	669	2,138	479,034	481,841
Residential real estate lines	79	107	—	186	288	109,845	110,319
Consumer indirect	1,869	492	—	2,361	1,124	871,233	874,718
Other consumer	58	18	4	80	—	16,428	16,508
Total loans, gross	$3,049	$681	$ 4	$3,734	$ 9,727	$2,845,382	$2,858,843
December 31, 2017							
Commercial business	$64	$36	$ —	$100	$ 5,344	$444,319	$449,763
Commercial mortgage	56	375	—	431	2,623	807,797	810,851
Residential real estate loans	1,908	56	—	1,964	2,252	453,545	457,761
Residential real estate lines	349	—	—	349	404	112,669	113,422
Consumer indirect	2,806	672	—	3,478	1,895	840,309	845,682
Other consumer	174	15	11	200	2	17,241	17,443
Total loans, gross	$5,357	$1,154	$ 11	$6,522	$ 12,520	$2,675,880	$2,694,922

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(5.)LOANS (Continued)

There were no loans past due greater than 90 days and still accruing interest as of June 30, 2018 and December 31, 2017. There were $4 thousand and $11 thousand in consumer overdrafts which were past due greater than 90 days as of June 30, 2018 and December 31, 2017, respectively. Consumer overdrafts are overdrawn deposit accounts which have been reclassified as loans but by their terms do not accrue interest.

Troubled Debt Restructurings

A modification of a loan constitutes a troubled debt restructuring ("TDR") when a borrower is experiencing financial difficulty and the modification constitutes a concession. Commercial loans modified in a TDR may involve temporary interest-only payments, term extensions, reducing the interest rate for the remaining term of the loan, extending the maturity date at an interest rate lower than the current market rate for new debt with similar risk, collateral concessions, forgiveness of principal, forbearance agreements, or substituting or adding a new borrower or guarantor.

There were no loans modified as a TDR during the six months ended June 30, 2018 and 2017. There were no loans modified as a TDR within the previous 12 months that defaulted during the six months ended June 30, 2018 and 2017. 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 months ended June 30, 2018 and twelve-month period ended December 31, 2017 (in thousands):

	Recorded Investment (1)	Unpaid Principal Balance (1)	Related Allowance	Average Recorded Investment	Interest Income Recognized
June 30, 2018					
With no related allowance recorded:					
Commercial business	$ 1,174	$ 1,639	$ —	$ 1,347	$ —
Commercial mortgage	557	557	—	579	—
	1,731	2,196	—	1,926	—
With an allowance recorded:					
Commercial business	2,990	2,990	1,226	3,397	—

Commercial mortgage	2,071	2,071	517	2,255	—
	5,061	5,061	1,743	5,652	—
	$ 6,792	$ 7,257	$ 1,743	$ 7,578	$ —
December 31, 2017					
With no related allowance recorded:					
Commercial business	$ 1,635	$ 2,370	$ —	$ 853	$ —
Commercial mortgage	584	584	—	621	—
	2,219	2,954	—	1,474	—
With an allowance recorded:					
Commercial business	3,853	3,853	2,056	4,468	—
Commercial mortgage	2,528	2,528	115	1,516	—
	6,381	6,381	2,171	5,984	—
	$ 8,600	$ 9,335	$ 2,171	$ 7,458	$ —

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

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(5.)LOANS (Continued)

Credit Quality Indicators

The Company categorizes loans into risk categories based on relevant information about the ability of borrowers to service their debt such as: current financial information, historical payment experience, credit documentation, public information, and current economic trends, among other factors such as the fair value of collateral. The Company analyzes commercial business and commercial mortgage loans individually by classifying the loans as to credit risk. Risk ratings are updated any time the situation warrants. The Company uses the following definitions for risk ratings:

Special Mention: Loans classified as special mention have a potential weakness that deserves management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the loan or of the Company's credit position at some future date.

Substandard: Loans classified as substandard are inadequately protected by the current net worth and paying capacity of the obligor or of the collateral pledged, if any. Loans so classified have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the Company will sustain some loss if the deficiencies are not corrected.

Doubtful: Loans classified as doubtful have all the weaknesses inherent in those classified as substandard, with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable.

Loans that do not meet the criteria above that are analyzed individually as part of the process described above are considered "uncriticized" or pass-rated loans and are included in groups of homogeneous loans with similar risk and loss characteristics.

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

	Commercial Business	Commercial Mortgage
June 30, 2018		
Uncriticized	$ 473,370	$ 850,919
Special mention	21,413	10,457
Substandard	11,482	7,816
Doubtful	—	—
Total	$ 506,265	$ 869,192
December 31, 2017		
Uncriticized	$ 429,692	$ 791,127

Special mention	7,120	12,185
Substandard	12,951	7,539
Doubtful	—	—
Total	$ 449,763	$ 810,851

The Company utilizes payment status as a means of identifying and reporting problem and potential problem retail loans. The Company considers nonaccrual loans and loans past due greater than 90 days and still accruing interest to be non-performing. The following table sets forth the Company's retail loan portfolio, categorized by payment status, as of the dates indicated (in thousands):

	Residential Real Estate Loans	Residential Real Estate Lines	Consumer Indirect	Other Consumer
June 30, 2018				
Performing	$ 479,703	$ 110,031	$ 873,594	$ 16,504
Non-performing	2,138	288	1,124	4
Total	$ 481,841	$ 110,319	$ 874,718	$ 16,508
December 31, 2017				
Performing	$ 455,509	$ 113,018	$ 843,787	$ 17,430
Non-performing	2,252	404	1,895	13
Total	$ 457,761	$ 113,422	$ 845,682	$ 17,443

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(5.)LOANS (Continued)

Allowance for Loan Losses

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

	Commercial Business	Commercial Mortgage	Residential Real Estate Loans	Residential Real Estate Lines	Consumer Indirect	Other Consumer	Total
June 30, 2018							
Loans:							
Ending balance	$ 506,265	$ 869,192	$ 481,841	$ 110,319	$ 874,718	$ 16,508	$ 2,858,843
Evaluated for impairment:							
Individually	$ 4,164	$ 2,628	$ —	$ —	$ —	$ —	$ 6,792
Collectively	$ 502,101	$ 866,564	$ 481,841	$ 110,319	$ 874,718	$ 16,508	$ 2,852,051
Allowance for loan losses:							
Ending balance	$ 14,242	$ 5,371	$ 1,255	$ 248	$ 12,520	$ 319	$ 33,955
Evaluated for impairment:							
Individually	$ 1,226	$ 517	$ —	$ —	$ —	$ —	$ 1,743
Collectively	$ 13,016	$ 4,854	$ 1,255	$ 248	$ 12,520	$ 319	$ 32,212
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

The following table sets forth the changes in the allowance for loan losses for the three and six-month periods ended June 30, 2018 (in thousands):

	Commercial Business	Commercial Mortgage	Residential	Residential	Consumer Indirect	Other Consumer	Total

			Real Estate Loans	Real Estate Lines			
Three months ended June 30, 2018							
Beginning balance	$ 14,942	$ 5,473	$ 1,400	$ 218	$ 13,232	$ 329	$ 35,594
Charge-offs	(336)	-	(10)	(7)	(2,621)	(235)	(3,209)
Recoveries	77	1	63	12	1,304	73	1,530
Provision (credit)	(441)	(103)	(198)	25	605	152	40
Ending balance	$ 14,242	$ 5,371	$ 1,255	$ 248	$ 12,520	$ 319	$ 33,955
Six months ended June 30, 2018							
Beginning balance	$ 15,668	$ 3,696	$ 1,322	$ 180	$ 13,415	$ 391	$ 34,672
Charge-offs	(441)	(4)	(29)	(101)	(5,615)	(668)	(6,858)
Recoveries	197	8	132	15	2,634	166	3,152
Provision (credit)	(1,182)	1,671	(170)	154	2,086	430	2,989
Ending balance	$ 14,242	$ 5,371	$ 1,255	$ 248	$ 12,520	$ 319	$ 33,955

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(5.)LOANS (Continued)

The following table sets forth the changes in the allowance for loan losses for the three and six-month periods ended June 30, 2017 (in thousands):

	Commercial Business	Commercial Mortgage	Residential Real Estate Loans	Residential Real Estate Lines	Consumer Indirect	Other Consumer	Total
Three months ended June 30, 2017							
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
Six months ended June 30, 2017							
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

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 based on 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.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(6.)GOODWILL AND OTHER INTANGIBLE ASSETS

Goodwill

The carrying amount of goodwill totaled $68.4 million and $65.8 million as of June 30, 2018 and December 31, 2017. The Company performs a goodwill impairment test on an annual basis as of October 1st or more frequently if events and circumstances warrant.

	Banking	Non-Banking	Total
Balance, December 31, 2017	$48,536	$ 17,304	$65,840
Acquisition	—	2,572	2,572
Balance, June 30, 2018	$48,536	$ 19,876	$68,412

Goodwill and other intangible assets added during the period relates to the acquisition of HNP Capital, which was completed on June 1, 2018. See Note 2 – Business Combinations for additional information.

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). Gross carrying amount, accumulated amortization and net book value, were as follows (in thousands):

	June 30, 2018	December 31, 2017
Other intangibles assets:		
Gross carrying amount	$15,926	$ 13,420
Accumulated amortization	(5,150)	(4,557)
Net book value	$10,776	$ 8,863

Amortization expense for total other intangible assets was $305 thousand and $593 thousand for the three and six months ended June 30, 2018, and $291 thousand and $588 thousand for the three and six months ended June 30, 2017, respectively. As of June 30, 2018, the estimated amortization expense of other intangible assets for the remainder of 2018 and each of the next five years is as follows (in thousands):

2018 (remainder of year)	$664

2019	1,250
2020	1,134
2021	1,014
2022	923
2023	852

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Notes to Consolidated Financial Statements (Unaudited)

(7.)DERIVATIVE INSTRUMENT AND HEDGING ACTIVITIES

Risk Management Objective of Using Derivatives

The Company is exposed to certain risks arising from both its business operations and economic conditions. The Company principally manages its exposures to a wide variety of business and operational risks through management of its core business activities. The Company manages economic risks, including interest rate, liquidity and credit risk, primarily by managing the amount, sources, and duration of its assets and liabilities, and the use of derivative financial instruments. Specifically, the Company enters into derivative financial instruments to manage exposures that arise from business activities that result in the receipt or payment of future known and uncertain cash amounts, the value of which are determined by interest rates. The Company’s derivative financial instruments are used to manage differences in the amount, timing, and duration of the Company’s known or expected cash receipts and its known or expected cash payments.

Cash Flow Hedges of Interest Rate Risk

The Company’s objectives in using interest rate derivatives are to add stability to interest expense and to manage its exposure to interest rate movements. To accomplish this objective, the Company primarily uses interest rate caps as part of its interest rate risk management strategy. Interest rate caps designated as cash flow hedges involve the receipt of variable amounts from a counterparty if interest rates rise above the strike rate on the contract in exchange for an up-front premium. During 2018, such derivatives were used to hedge the variable cash flows associated with short-term borrowings.

For derivatives designated and that qualify as cash flow hedges of interest rate risk, the gain or loss on the derivative is recorded in accumulated other comprehensive income (loss) and subsequently reclassified into interest expense in the same period(s) during which the hedged transaction affects earnings. Amounts reported in accumulated other comprehensive income (loss) related to derivatives will be reclassified to interest expense as interest payments are made on the Company’s borrowings. The ineffective portion of the change in fair value of the derivatives is recognized directly in earnings. The Company’s cash flow hedge derivatives did not have any hedge ineffectiveness recognized in earnings during the three and six months ended June 30, 2018 and 2017. During the next twelve months, the Company estimates that an additional $54 thousand will be reclassified as an increase to interest expense.

Interest Rate Swaps

The Company executes interest rate swaps with commercial banking customers to facilitate their respective risk management strategies. These interest rate swaps are simultaneously hedged by offsetting interest rate swaps that the Company executes with a third party, such that the Company minimizes its net risk exposure resulting from such transactions. As the interest rate swaps associated with this program do not meet hedge accounting requirements, changes in the fair value of both the customer swaps and the offsetting swaps are recognized directly in earnings.

Credit-risk-related Contingent Features

The Company has agreements with certain of its derivative counterparties that contain one or more of the following provisions: (a) if the Company defaults on any of its indebtedness, including a default where repayment of the indebtedness has not been accelerated by the lender, the Company could also be declared in default on its derivative obligations, and (b) if the Company fails to maintain its status as a well-capitalized institution, the counterparty could terminate the derivative positions and the Company would be required to settle its obligations under the agreements.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(7.)DERIVATIVE INSTRUMENT AND HEDGING ACTIVITIES (Continued)

Fair Values of Derivative Instruments on the Balance Sheet

The table below presents the notional amounts, respective fair values of the Company’s derivative financial instruments, as well as their classification on the balance sheet as of June 30, 2018 and December 31, 2017 (in thousands):

	Gross notional amount		Asset derivatives			Liability derivatives		
			Balance	Fair value		Balance	Fair value	
	June 30, 2018	Dec. 31, 2017	sheet line item	June 30, 2018	Dec. 31, 2017	sheet line item	June 30, 2018	Dec. 31, 2017
Derivatives designated as hedging instruments								
Cash flow hedges	$100,000	$—	Other assets	$1,201	$ —	Other liabilities	$—	$ —
Total derivatives	$100,000	$—		$1,201	$ —		$—	$ —
Derivatives not designated as hedging instruments								
Interest rate swaps	$6,440	$—	Other assets	$105	$ —	Other liabilities	$139	$ —
Credit contracts	34,811	12,282	Other assets	—	—	Other liabilities	13	4
Total derivatives	$41,251	$12,282		$105	$ —		$152	$ 4

Effect of Derivative Instruments on the Income Statement

The table below presents the effect of the Company’s derivative financial instruments on the income statement for the three and six months ended June 30, 2018 and 2017 (in thousands):

		Gain (loss) recognized in income		Gain (loss) recognized in income	
		Three months ended		Six months ended	
	Line item of gain (loss)	June 30,		June 30,	
Undesignated derivatives	recognized in income	2018	2017	2018	2017

Interest rate swaps	Net gain on derivative instruments	$ 70	$ —	$ 70	$ —
Credit contracts	Net gain on derivative instruments	8	—	182	—
Total undesignated		$ 78	$ —	$ 252	$ —

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(8.)SHAREHOLDERS' EQUITY

Common Stock

The changes in shares of common stock were as follows for the six months ended June 30, 2018 and 2017:

	Outstanding	Treasury	Issued
June 30, 2018			
Shares at December 31, 2017	15,924,938	131,240	16,056,178
Restricted stock awards issued	7,370	(7,370)	—
Restricted stock awards forfeited	(23,901)	23,901	—
Stock options exercised	16,650	(16,650)	—
Stock awards	2,724	(2,724)	—
Treasury stock purchases	(3,622)	3,622	—
Shares at June 30, 2018	15,924,159	132,019	16,056,178
June 30, 2017			
Shares 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 at June 30, 2017	15,126,456	137,355	15,263,811

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(9.)ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS)

The following table presents the components of other comprehensive income (loss) for the three and six months ended June 30, 2018 and 2017 (in thousands):

	Pre-tax Amount	Tax Effect	Net-of-tax Amount
Three months ended June 30, 2018			
Securities available for sale and transferred securities:			
Change in unrealized gain/loss during the period	$(3,414)	$(860)	$ (2,554)
Reclassification adjustment for net gains included in net income [1]	90	23	67
Total securities available for sale and transferred securities	(3,324)	(837)	(2,487)
Hedging derivative instruments:			
Change in unrealized gain/loss during the period	303	76	227
Pension and post-retirement obligations:			
Amortization of prior service credit included in income	(18)	(5)	(13)
Amortization of net actuarial loss included in income	188	48	140
Total pension and post-retirement obligations	170	43	127
Other comprehensive loss	$(2,851)	$(718)	$ (2,133)
Six months ended June 30, 2018			
Securities available for sale and transferred securities:			
Change in unrealized gain/loss during the period	$(11,879)	$(2,994)	$ (8,885)
Reclassification adjustment for net gains included in net income [1]	172	44	128
Total securities available for sale and transferred securities	(11,707)	(2,950)	(8,757)
Hedging derivative instruments:			
Change in unrealized gain/loss during the period	164	41	123
Pension and post-retirement obligations:			
Amortization of prior service credit included in income	(36)	(10)	(26)
Amortization of net actuarial loss included in income	375	95	280
Total pension and post-retirement obligations	339	85	254
Other comprehensive loss	$(11,204)	$(2,824)	$ (8,380)

(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.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(9.)ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS) (Continued)

	Pre-tax Amount	Tax Effect	Net-of-tax Amount
Three months ended June 30, 2017			
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
Hedging derivative instruments:			
Change in unrealized gain/loss during the period	—	—	—
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
Six months ended June 30, 2017			
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
Hedging derivative instruments:			
Change in unrealized gain/loss during the period	—	—	—
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

(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.

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(9.)ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS) (Continued)

Activity in accumulated other comprehensive income (loss), net of tax, for the three and six months ended June 30, 2018 and 2017 was as follows (in thousands):

	Hedging Derivative Instruments	Securities Available for Sale and Transferred Securities	Pension and Post-retirement Obligations	Accumulated Other Comprehensive Income (Loss)
Three months ended June 30, 2018				
Balance at beginning of period	$ (104)	$ (9,545)	$ (8,514)	$ (18,163)
Other comprehensive income (loss) before reclassifications	227	(2,554)	—	(2,327)
Amounts reclassified from accumulated other comprehensive income (loss)	—	67	127	194
Net current period other comprehensive income (loss)	227	(2,487)	127	(2,133)
Balance at end of period	$ 123	$ (12,032)	$ (8,387)	$ (20,296)
Six months ended June 30, 2018				
Balance at beginning of period	$ —	$ (3,275)	$ (8,641)	$ (11,916)
Other comprehensive income (loss) before reclassifications	123	(8,885)	—	(8,762)
Amounts reclassified from accumulated other comprehensive income (loss)	—	128	254	382
Net current period other comprehensive income (loss)	123	(8,757)	254	(8,380)
Balance at end of period	$ 123	$ (12,032)	$ (8,387)	$ (20,296)
Three months ended June 30, 2017				
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)
Six months ended June 30, 2017				
Balance at beginning of period	$ —	$ (3,729)	$ (10,222)	$ (13,951)
Other comprehensive income (loss) before reclassifications	—	2,553	—	2,553
Amounts reclassified from accumulated other comprehensive income (loss)	—	(237)	342	105
Net current period other comprehensive income (loss)	—	2,316	342	2,658
Balance at end of period	$ —	$ (1,413)	$ (9,880)	$ (11,293)

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(9.)ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS) (Continued)

The following table presents the amounts reclassified out of each component of accumulated other comprehensive income (loss) for the three and six months ended June 30, 2018 and 2017 (in thousands):

Details About Accumulated Other Comprehensive Income (Loss) Components	Amount Reclassified from Accumulated Other Comprehensive Income (Loss) Three months ended June 30, 2018	Affected Line Item in the Consolidated Statement of Income