FINANCIAL INSTITUTIONS INC
Form 10-Q
August 06, 2013
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# UNITED STATES

# SECURITIES AND EXCHANGE COMMISSION

**Washington, D.C. 20549**

# Form 10-Q

**(Mark One)**

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

**For the quarterly period ended June 30, 2013**

**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** | **(I.R.S. Employer** |
| **incorporation or organization)** | **Identification No.)** |
| **220 LIBERTY STREET, WARSAW, NEW YORK** | **14569** |
| **(Address of principal executive offices)** | **(Zip Code)** |

**Registrant s telephone number, including area code: (585) 786-1100**

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No ¨

Indicate by check mark whether the regsitrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

| | | | |
|---|---|---|---|
| Large accelerated filer | ¨ | Accelerated filer | x |
| Non-accelerated filer | ¨ (Do not check if a smaller company) | Smaller reporting company | ¨ |

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ¨ No x

The registrant had 13,808,890 shares of Common Stock, $0.01 par value, outstanding as of July 31, 2013.

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**FINANCIAL INSTITUTIONS, INC.**

**Form 10-Q**

**For the Quarterly Period Ended June 30, 2013**

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## PART I. FINANCIAL INFORMATION

**ITEM 1. Financial Statements**

### FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

### Consolidated Statements of Financial Condition

| *(Dollars in thousands, except share and per share data)* | June 30, 2013 (Unaudited) | December 31, 2012 |
|---|---|---|
| **ASSETS** | | |
| Cash and cash equivalents: | | |
| Cash and due from banks | $ 50,833 | $ 60,342 |
| Federal funds sold and interest-bearing deposits in other banks | 94 | 94 |
| Total cash and cash equivalents | 50,927 | 60,436 |
| Securities available for sale, at fair value | 810,549 | 823,796 |
| Securities held to maturity, at amortized cost (fair value of $17,821 and $18,478, respectively) | 17,348 | 17,905 |
| Loans held for sale | 3,423 | 1,518 |
| Loans (net of allowance for loan losses of $25,590 and $24,714, respectively) | 1,717,824 | 1,681,012 |
| Company owned life insurance | 48,273 | 47,386 |
| Premises and equipment, net | 36,899 | 36,618 |
| Goodwill and other intangible assets, net | 50,190 | 50,389 |
| Other assets | 46,870 | 44,805 |
| Total assets | $ 2,782,303 | $ 2,763,865 |
| **LIABILITIES AND SHAREHOLDERS EQUITY** | | |
| Deposits: | | |
| Noninterest-bearing demand | $ 511,802 | $ 501,514 |
| Interest-bearing demand | 475,448 | 449,744 |
| Savings and money market | 713,459 | 655,598 |
| Time deposits | 623,527 | 654,938 |
| Total deposits | 2,324,236 | 2,261,794 |
| Short-term borrowings | 193,413 | 179,806 |
| Other liabilities | 19,766 | 68,368 |
| Total liabilities | 2,537,415 | 2,509,968 |
| Shareholders equity: | | |
| Series A 3% preferred stock, $100 par value; 1,533 shares authorized and 1,499 shares issued | 150 | 150 |
| Series B-1 8.48% preferred stock, $100 par value, 200,000 shares authorized, 172,445 and 173,210 shares issued, respectively | 17,244 | 17,321 |
| Total preferred equity | 17,394 | 17,471 |
| Common stock, $0.01 par value, 50,000,000 shares authorized and 14,161,597 shares issued | 142 | 142 |
| Additional paid-in capital | 67,480 | 67,710 |
| Retained earnings | 179,564 | 172,244 |
| Accumulated other comprehensive (loss) income | (13,134) | 3,253 |
| Treasury stock, at cost 353,207 and 373,888 shares, respectively | (6,558) | (6,923) |

| | | |
|---|---|---|
| Total shareholders equity | 244,888 | 253,897 |
| Total liabilities and shareholders equity | $ 2,782,303 | $ 2,763,865 |

See accompanying notes to the consolidated financial statements.

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**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**

**Consolidated Statements of Income (Unaudited)**

| *(In thousands, except per share amounts)* | Three months ended June 30, 2013 | Three months ended June 30, 2012 | Six months ended June 30, 2013 | Six months ended June 30, 2012 |
|---|---|---|---|---|
| Interest income: | | | | |
| Interest and fees on loans | $ 20,064 | $ 19,512 | $ 40,443 | $ 39,048 |
| Interest and dividends on investment securities | 4,278 | 4,219 | 8,647 | 8,133 |
| Total interest income | 24,342 | 23,731 | 49,090 | 47,181 |
| Interest expense: | | | | |
| Deposits | 1,665 | 2,169 | 3,336 | 4,567 |
| Short-term borrowings | 153 | 174 | 343 | 285 |
| Total interest expense | 1,818 | 2,343 | 3,679 | 4,852 |
| Net interest income | 22,524 | 21,388 | 45,411 | 42,329 |
| Provision for loan losses | 1,193 | 1,459 | 3,902 | 2,844 |
| Net interest income after provision for loan losses | 21,331 | 19,929 | 41,509 | 39,485 |
| Noninterest income: | | | | |
| Service charges on deposits | 2,568 | 1,974 | 4,709 | 3,809 |
| ATM and debit card | 1,317 | 1,072 | 2,566 | 2,149 |
| Broker-dealer fees and commissions | 650 | 434 | 1,349 | 1,021 |
| Company owned life insurance | 438 | 441 | 853 | 867 |
| Net gain on disposal of investment securities | 332 | 1,237 | 1,224 | 1,568 |
| Loan servicing | 152 | 409 | 225 | 503 |
| Net gain on sale of loans held for sale | 35 | 325 | 235 | 658 |
| Impairment charges on investment securities | | | | (91) |
| Net gain on disposal of other assets | 38 | 29 | 39 | 35 |
| Other | 846 | 769 | 1,729 | 1,622 |
| Total noninterest income | 6,376 | 6,690 | 12,929 | 12,141 |
| Noninterest expense: | | | | |
| Salaries and employee benefits | 9,226 | 9,071 | 18,935 | 18,127 |
| Occupancy and equipment | 3,035 | 2,715 | 6,204 | 5,485 |
| Professional services | 1,093 | 1,080 | 2,030 | 1,791 |
| Computer and data processing | 812 | 886 | 1,516 | 1,486 |
| Supplies and postage | 608 | 573 | 1,288 | 1,031 |
| FDIC assessments | 364 | 304 | 725 | 601 |
| Advertising and promotions | 253 | 137 | 467 | 238 |
| Other | 2,071 | 1,815 | 3,881 | 3,479 |
| Total noninterest expense | 17,462 | 16,581 | 35,046 | 32,238 |
| Income before income taxes | 10,245 | 10,038 | 19,392 | 19,388 |
| Income tax expense | 3,395 | 3,382 | 6,393 | 6,536 |

| | | | | |
|---|---|---|---|---|
| Net income | $ 6,850 | $ 6,656 | $ 12,999 | $ 12,852 |
| Preferred stock dividends | 367 | 368 | 735 | 737 |
| Net income available to common shareholders | $ 6,483 | $ 6,288 | $ 12,264 | $ 12,115 |
| Earnings per common share (Note 3): | | | | |
| Basic | $ 0.47 | $ 0.46 | $ 0.89 | $ 0.89 |
| Diluted | $ 0.47 | $ 0.46 | $ 0.89 | $ 0.88 |
| Cash dividends declared per common share | $ 0.18 | $ 0.14 | $ 0.36 | $ 0.27 |
| Weighted average common shares outstanding: | | | | |
| Basic | 13,739 | 13,697 | 13,728 | 13,686 |
| Diluted | 13,767 | 13,750 | 13,767 | 13,742 |

See accompanying notes to the consolidated financial statements.

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**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**

**Consolidated Statements of Comprehensive (Loss) Income (Unaudited)**

| | Three months ended June 30, | | Six months ended June 30, | |
|---|---|---|---|---|
| *(Dollars in thousands)* | 2013 | 2012 | 2013 | 2012 |
| Net income | $ 6,850 | $ 6,656 | $ 12,999 | $ 12,852 |
| Other comprehensive (loss) income, net of tax: | | | | |
| Net unrealized (losses) gains on investment securities | (14,470) | 2,171 | (16,785) | 917 |
| Pension and post-retirement obligations | 199 | 203 | 398 | 405 |
| Total other comprehensive (loss) income | (14,271) | 2,374 | (16,387) | 1,322 |
| Comprehensive (loss) income | $ (7,421) | $ 9,030 | $ (3,388) | $ 14,174 |

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, 2013 and 2012**

| *(Dollars in thousands, except per share data)* | Preferred Equity | Common Stock | Additional Paid-in Capital | Retained Earnings | Accumulated Other Comprehensive Income (Loss) | Treasury Stock | Total Shareholders Equity |
|---|---|---|---|---|---|---|---|
| **Balance at January 1, 2012** | **$ 17,473** | **$ 142** | **$ 67,247** | **$ 158,079** | **$ 945** | **$ (6,692)** | **$ 237,194** |
| Comprehensive income: | | | | | | | |
| Net income | | | | 12,852 | | | 12,852 |
| Other comprehensive loss, net of tax | | | | | 1,322 | | 1,322 |
| Total comprehensive income | | | | | | | 14,174 |
| Purchases of common stock for treasury | | | | | | (525) | (525) |
| Share-based compensation plans: | | | | | | | |
| Share-based compensation | | | 318 | | | | 318 |
| Stock options exercised | | | (5) | | | 31 | 26 |
| Restricted stock awards issued, net | | | (599) | | | 599 | |
| Excess tax benefit on share-based compensation | | | 97 | | | | 97 |
| Directors retainer | | | (10) | | | 107 | 97 |
| Cash dividends declared: | | | | | | | |
| Series A 3% Preferred-$1.50 per share | | | | (2) | | | (2) |
| Series B-1 8.48% Preferred-$4.24 per share | | | | (735) | | | (735) |
| Common-$0.27 per share | | | | (3,698) | | | (3,698) |
| **Balance at June 30, 2012** | **$ 17,473** | **$ 142** | **$ 67,048** | **$ 166,496** | **$ 2,267** | **$ (6,480)** | **$ 246,946** |
| **Balance at January 1, 2013** | **$ 17,471** | **$ 142** | **$ 67,710** | **$ 172,244** | **$ 3,253** | **$ (6,923)** | **$ 253,897** |
| Comprehensive loss: | | | | | | | |
| Net income | | | | 12,999 | | | 12,999 |
| Other comprehensive loss, net of tax | | | | | (16,387) | | (16,387) |
| Total comprehensive loss | | | | | | | (3,388) |
| Purchases of common stock for treasury | | | | | | (229) | (229) |
| Repurchase of Series B-1 8.48% preferred stock | (77) | | (2) | | | | (79) |
| Share-based compensation plans: | | | | | | | |
| Share-based compensation | | | 205 | | | | 205 |
| Stock options exercised | | | (3) | | | 62 | 59 |
| Restricted stock awards issued, net | | | (427) | | | 427 | |
| Excess tax benefit on share-based compensation | | | (10) | | | | (10) |
| Directors retainer | | | 7 | | | 105 | 112 |
| Cash dividends declared: | | | | | | | |
| Series A 3% Preferred-$1.50 per share | | | | (2) | | | (2) |
| Series B-1 8.48% Preferred-$4.24 per share | | | | (733) | | | (733) |
| Common-$0.36 per share | | | | (4,944) | | | (4,944) |
| **Balance at June 30, 2013** | **$ 17,394** | **$ 142** | **$ 67,480** | **$ 179,564** | **$ (13,134)** | **$ (6,558)** | **$ 244,888** |

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, 2013 | 2012 |
|---|---|---|
| Cash flows from operating activities: | | |
| Net income | $ 12,999 | $ 12,852 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 2,099 | 1,758 |
| Net amortization of premiums on securities | 2,560 | 2,603 |
| Provision for loan losses | 3,902 | 2,844 |
| Share-based compensation | 205 | 318 |
| Deferred income tax expense | 2,771 | 2,591 |
| Proceeds from sale of loans held for sale | 19,379 | 30,528 |
| Originations of loans held for sale | (21,049) | (29,142) |
| Increase in company owned life insurance | (853) | (867) |
| Net gain on sale of loans held for sale | (235) | (658) |
| Net gain on disposal of investment securities | (1,224) | (1,568) |
| Impairment charges on investment securities | | 91 |
| Net gain on sale and disposal of other assets | (39) | (35) |
| Decrease (increase) in other assets | 6,562 | (1,802) |
| (Decrease) increase in other liabilities | (511) | 8,675 |
| Net cash provided by operating activities | 26,566 | 28,188 |
| Cash flows from investing activities: | | |
| Purchases of investment securities: | | |
| Available for sale | (160,140) | (223,454) |
| Held to maturity | (5,166) | (6,847) |
| Proceeds from principal payments, maturities and calls on investment securities: | | |
| Available for sale | 94,956 | 98,123 |
| Held to maturity | 5,723 | 8,421 |
| Proceeds from sales of securities available for sale | 1,327 | 1,670 |
| Net loan originations | (41,340) | (83,300) |
| Purchases of company owned life insurance | (34) | (34) |
| Proceeds from sales of other assets | 467 | 452 |
| Purchases of premises and equipment | (2,258) | (2,135) |
| Net cash received in branch acquisition | | 63,577 |
| Net cash used in investing activities | (106,465) | (143,527) |
| Cash flows from financing activities: | | |
| Net increase in deposits | 62,442 | 74,137 |
| Net increase in short-term borrowings | 13,607 | 50,126 |
| Repurchase of preferred stock | (79) | |
| Purchase of common stock for treasury | (229) | (525) |
| Proceeds from stock options exercised | 59 | 26 |
| Excess tax benefit on share-based compensation, net | (10) | 97 |
| Cash dividends paid to preferred shareholders | (736) | (737) |
| Cash dividends paid to common shareholders | (4,664) | (3,555) |
| Net cash provided by financing activities | 70,390 | 119,569 |

| | | |
|---|---|---|
| Net (decrease) increase in cash and cash equivalents | (9,509) | 4,230 |
| Cash and cash equivalents, beginning of period | 60,436 | 57,583 |
| Cash and cash equivalents, end of period | $ 50,927 | $ 61,813 |
| Supplemental information | | |
| Cash paid for interest | $ 3,679 | $ 5,409 |
| Cash paid for income taxes | 1,697 | 3,302 |
| Noncash investing and financing activities: | | |
| Real estate and other assets acquired in settlement of loans | 626 | 183 |
| Accrued and declared unpaid dividends | 2,841 | 2,287 |
| (Decrease) increase in net unsettled security purchases | (47,972) | 13,938 |
| Assets acquired and liabilities assumed in branch acquisition: | | |
| Loans and other non-cash assets, excluding goodwill and core deposit intangible asset | | 59,966 |
| Deposits and other liabilities | | 130,032 |

See accompanying notes to the consolidated financial statements.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

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

### Nature of Operations

Financial Institutions, Inc., a financial holding company organized under the laws of New York State ( New York or NYS ), and its subsidiaries provide deposit, lending and other financial services to individuals and businesses in Central and Western New York. The Company has also expanded its indirect lending network to include relationships with franchised automobile dealers in the Capital District of New York and Northern Pennsylvania. Financial Institutions, Inc. owns all of the capital stock of Five Star Bank, a New York State chartered bank, and Five Star Investment Services, Inc., a financial services subsidiary offering noninsured investment products and investment advisory services. References to the Company mean the consolidated reporting entities and references to the Bank mean Five Star Bank.

### Basis of Presentation

The consolidated financial statements include the accounts of Financial Institutions, Inc. and its subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation. The accounting and reporting policies conform to U.S. generally accepted accounting principles ( GAAP ). Certain information and footnote disclosures normally included in financial statements prepared in conformity with GAAP have been condensed or omitted pursuant to such rules and regulations. However, in the opinion of management, the accompanying consolidated financial statements reflect all adjustments of a normal and recurring nature necessary for a fair presentation of the consolidated statements of financial condition, income, comprehensive income, changes in shareholders equity and cash flows for the periods indicated, and contain adequate disclosure to make the information presented not misleading. Prior years consolidated financial statements are re-classified whenever necessary to conform to the current year s presentation. These consolidated financial statements should be read in conjunction with the Company s 2012 Annual Report on Form 10-K. The results of operations for any interim periods are not necessarily indicative of the results which may be expected for the entire year.

### Subsequent Events

The Company has evaluated events and transactions for potential recognition or disclosure through the day the financial statements were issued.

### 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, assumptions used in the defined benefit pension plan accounting, the carrying value of goodwill and deferred tax assets, and the valuation and other than temporary impairment considerations related to the securities portfolio.

### Reclassifications

Certain reclassifications have been made to the prior years financial statements in order to reflect retrospective adjustments made to the balance of goodwill at December 31, 2012 to reflect the effect of these measurement period adjustments made in accordance with accounting requirements. The reclassifications had no impact on shareholders equity or net income.

### Recent Accounting Pronouncements

In February 2013, the Financial Accounting Standards Board issued Accounting Standards Update ( ASU ) No. 2013-02, *Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income*. ASU No. 2013-02 does not amend any existing requirements for reporting net income or other comprehensive income in the financial statements. ASU No. 2013-02 requires an entity to disaggregate the total change of each component of other comprehensive income (e.g., unrealized gains or losses on available-for-sale investment securities) and separately present reclassification adjustments and current period other comprehensive income. The provisions of ASU No. 2013-02 also requires that entities present either in a single note or parenthetically on the face of the financial statements, the effect of significant amounts reclassified from each component of accumulated other comprehensive income based on its source (e.g., unrealized gains or losses on available-for-sale investment securities) and the income statement line item affected by the reclassification (e.g., realized gains (losses) on sales of investment securities). If a

component is not required to be reclassified to net income in its entirety (e.g., amortization of defined benefit plan items), entities would instead cross reference to the related note to the financial statements for additional information (e.g., pension footnote). The Company adopted the provisions of ASU No. 2013-02 effective January 1, 2013. As the Company provided these required disclosures in the notes to the consolidated financial statements, the adoption of ASU No. 2013-02 had no impact on the Company s consolidated statements of income and condition. See Note 8 Accumulated Other Comprehensive Income to the consolidated financial statements for the disclosures required by ASU No. 2013-02.

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**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**

**Notes to Consolidated Financial Statements (Unaudited)**

**(2.) BRANCH ACQUISITIONS**

On January 19, 2012, the Bank entered into agreements with First Niagara Bank, National Association ( First Niagara ) to acquire four retail bank branches in Medina, Brockport, Batavia and Waterloo, New York (the First Niagara Branches ) and four retail bank branches previously owned by HSBC Bank USA, National Association ( HSBC ) in Elmira, Elmira Heights, Horseheads and Albion, New York (the HSBC Branches ). First Niagara assigned its rights to the HSBC branches in connection with its acquisition of HSBC s Upstate New York banking franchise. Under the terms of the agreements, the Bank assumed substantially all related deposits and purchased the related branch premises and certain performing loans. The transaction to acquire the First Niagara Branches was completed on June 22, 2012 and the transaction to acquire the HSBC Branches was completed on August 17, 2012. The combined assets acquired and deposits assumed in the two transactions were recorded at their estimated fair values as follows (in thousands):

| | |
|---|---|
| Cash | $ 195,778 |
| Loans | 75,635 |
| Bank premises and equipment | 1,938 |
| Goodwill | 11,167 |
| Core deposit intangible asset | 2,042 |
| Other assets | 601 |
| Total assets acquired | $ 287,161 |
| Deposits assumed | $ 286,819 |
| Other liabilities | 342 |
| Total liabilities assumed | $ 287,161 |

The transactions were accounted for using the acquisition method of accounting and accordingly, assets acquired, liabilities assumed and consideration exchanged were recorded at their estimated fair values on the acquisition dates. Fair values are preliminary and in certain cases are subject to refinement for up to one year after the closing date of the acquisition as additional information relative to fair values becomes available. During the three months ended March 31, 2013, the Company recorded a decrease to the estimated fair value of liabilities assumed and an increase to the related deferred income taxes based upon information obtained subsequent to the acquisition. In addition to changes in those assets and liabilities, the revisions resulted in a reduction in goodwill approximating $432 thousand.

The Company acquired the loan portfolios at a fair value discount of $824 thousand. The discount represents expected credit losses, net of market interest rate adjustments. The discount on loans receivable will be amortized to interest income over the estimated remaining life of the acquired loans using the level yield method. The time deposit premium of $335 thousand will be accreted over the estimated remaining life of the related deposits as a reduction of interest expense. The core deposit intangible asset will be amortized on an accelerated basis over the estimated average life of the core deposits.

All goodwill and core deposit intangible assets arising from this acquisition are expected to be deductible for tax purposes.

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**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**

**Notes to Consolidated Financial Statements (Unaudited)**

**(3.) EARNINGS PER COMMON SHARE ( EPS )**

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

| | Three months ended June 30, | | Six months ended June 30, | |
|---|---|---|---|---|
| | 2013 | 2012 | 2013 | 2012 |
| Net income available to common shareholders | $ 6,483 | $ 6,288 | $ 12,264 | $ 12,115 |
| Less: Earnings allocated to participating securities | | | | 3 |
| Net income available to common shareholders for EPS | $ 6,483 | $ 6,288 | $ 12,264 | $ 12,112 |
| Weighted average common shares outstanding: | | | | |
| Total shares issued | 14,162 | 14,162 | 14,162 | 14,162 |
| Unvested restricted stock awards | (66) | (123) | (73) | (125) |
| Treasury shares | (357) | (342) | (361) | (351) |
| Total basic weighted average common shares outstanding | 13,739 | 13,697 | 13,728 | 13,686 |
| Incremental shares from assumed: | | | | |
| Exercise of stock options | 5 | 3 | 6 | 3 |
| Vesting of restricted stock awards | 23 | 50 | 33 | 53 |
| Total diluted weighted average common shares outstanding | 13,767 | 13,750 | 13,767 | 13,742 |
| Basic earnings per common share | $ 0.47 | $ 0.46 | $ 0.89 | $ 0.89 |
| Diluted earnings per common share | $ 0.47 | $ 0.46 | $ 0.89 | $ 0.88 |
| 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 | 225 | 307 | 188 | 317 |
| Restricted stock awards | 9 | 2 | 5 | 1 |
| | 234 | 309 | 193 | 318 |

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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, 2013** | | | | |
| **Securities available for sale:** | | | | |
| U.S. Government agencies and government sponsored enterprises | $ 113,683 | $ 1,638 | $ 2,382 | $ 112,939 |
| State and political subdivisions | 222,726 | 2,853 | 2,873 | 222,706 |
| Mortgage-backed securities: | | | | |
| Federal National Mortgage Association | 156,614 | 1,648 | 5,295 | 152,967 |
| Federal Home Loan Mortgage Corporation | 36,980 | 670 | 70 | 37,580 |
| Government National Mortgage Association | 46,597 | 2,307 | | 48,904 |
| Collateralized mortgage obligations: | | | | |
| Federal National Mortgage Association | 70,210 | 605 | 1,489 | 69,326 |
| Federal Home Loan Mortgage Corporation | 109,913 | 357 | 3,455 | 106,815 |
| Government National Mortgage Association | 55,008 | 1,522 | 299 | 56,231 |
| Privately issued | | 2,604 | | 2,604 |
| Total collateralized mortgage obligations | 235,131 | 5,088 | 5,243 | 234,976 |
| Total mortgage-backed securities | 475,322 | 9,713 | 10,608 | 474,427 |
| Asset-backed securities | 18 | 459 | | 477 |
| Total available for sale securities | $ 811,749 | $ 14,663 | $ 15,863 | $ 810,549 |
| **Securities held to maturity:** | | | | |
| State and political subdivisions | $ 17,348 | $ 473 | $ | $ 17,821 |
| **December 31, 2012** | | | | |
| **Securities available for sale:** | | | | |
| U.S. Government agencies and government sponsored enterprises | $ 128,097 | $ 3,667 | $ 69 | $ 131,695 |
| State and political subdivisions | 188,997 | 6,285 | 72 | 195,210 |
| Mortgage-backed securities: | | | | |
| Federal National Mortgage Association | 147,946 | 4,394 | 188 | 152,152 |
| Federal Home Loan Mortgage Corporation | 65,426 | 1,430 | | 66,856 |
| Government National Mortgage Association | 56,166 | 3,279 | | 59,445 |
| Collateralized mortgage obligations: | | | | |
| Federal National Mortgage Association | 60,805 | 1,865 | 2 | 62,668 |
| Federal Home Loan Mortgage Corporation | 78,581 | 1,911 | | 80,492 |
| Government National Mortgage Association | 70,989 | 2,168 | | 73,157 |
| Privately issued | 73 | 1,025 | | 1,098 |
| Total collateralized mortgage obligations | 210,448 | 6,969 | 2 | 217,415 |
| Total mortgage-backed securities | 479,986 | 16,072 | 190 | 495,868 |

| | | | | |
|---|---|---|---|---|
| Asset-backed securities | 121 | 902 | | 1,023 |
| Total available for sale securities | $ 797,201 | $ 26,926 | $ 331 | $ 823,796 |
| **Securities held to maturity:** | | | | |
| State and political subdivisions | $ 17,905 | $ 573 | $ | $ 18,478 |

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

| | Three months ended June 30, | | Six months ended June 30, | |
|---|---|---|---|---|
| | **2013** | **2012** | **2013** | **2012** |
| Proceeds from sales | $ 375 | $ 1,310 | $ 1,327 | $ 1,670 |
| Gross realized gains | 332 | 1,237 | 1,224 | 1,568 |

**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**

**Notes to Consolidated Financial Statements (Unaudited)**

**(4.) INVESTMENT SECURITIES (Continued)**

The scheduled maturities of securities available for sale and securities held to maturity at June 30, 2013 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 | $ 11,277 | $ 11,455 |
| Due from one to five years | 117,978 | 120,658 |
| Due after five years through ten years | 350,860 | 343,317 |
| Due after ten years | 331,634 | 335,119 |
| | $ 811,749 | $ 810,549 |
| **Debt securities held to maturity:** | | |
| Due in one year or less | $ 13,009 | $ 13,107 |
| Due from one to five years | 3,605 | 3,837 |
| Due after five years through ten years | 647 | 765 |
| Due after ten years | 87 | 112 |
| | $ 17,348 | $ 17,821 |

There were no unrealized losses in held to maturity securities at June 30, 2013 or December 31, 2012. Unrealized losses on investment securities available for sale 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, 2013** | | | | | | |
| U.S. Government agencies and government sponsored enterprises | $ 61,730 | $ 2,377 | $ 2,868 | $ 5 | $ 64,598 | $ 2,382 |
| State and political subdivisions | 108,166 | 2,873 | | | 108,166 | 2,873 |
| Mortgage-backed securities: | | | | | | |
| Federal National Mortgage Association | 98,712 | 5,295 | | | 98,712 | 5,295 |
| Federal Home Loan Mortgage Corporation | 4,270 | 70 | | | 4,270 | 70 |
| Collateralized mortgage obligations: | | | | | | |
| Federal National Mortgage Association | 52,604 | 1,488 | 665 | 1 | 53,269 | 1,489 |
| Federal Home Loan Mortgage Corporation | 96,267 | 3,455 | | | 96,267 | 3,455 |
| Government National Mortgage Association | 6,682 | 299 | | | 6,682 | 299 |
| Total collateralized mortgage obligations | 155,553 | 5,242 | 665 | 1 | 156,218 | 5,243 |

| | | | | | | |
|---|---|---|---|---|---|---|
| Total mortgage-backed securities | 258,535 | 10,607 | 665 | 1 | 259,200 | 10,608 |
| Total temporarily impaired securities | $ 428,431 | $ 15,857 | $ 3,533 | $ 6 | $ 431,964 | $ 15,863 |
| **December 31, 2012** | | | | | | |
| U.S. Government agencies and government sponsored enterprises | $ 13,265 | $ 67 | $ 2,967 | $ 2 | $ 16,232 | $ 69 |
| State and political subdivisions | 8,471 | 72 | | | 8,471 | 72 |
| Mortgage-backed securities: | | | | | | |
| Federal National Mortgage Association | 25,200 | 188 | | | 25,200 | 188 |
| Collateralized mortgage obligations: | | | | | | |
| Federal National Mortgage Association | | | 1,173 | 2 | 1,173 | 2 |
| Total collateralized mortgage obligations | | | 1,173 | 2 | 1,173 | 2 |
| Total mortgage-backed securities | 25,200 | 188 | 1,173 | 2 | 26,373 | 190 |
| Total temporarily impaired securities | $ 46,936 | $ 327 | $ 4,140 | $ 4 | $ 51,076 | $ 331 |

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**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**

**Notes to Consolidated Financial Statements (Unaudited)**

**(4.) INVESTMENT SECURITIES (Continued)**

The total number of security positions in the investment portfolio in an unrealized loss position at June 30, 2013 was 429 compared to 52 at December 31, 2012. At June 30, 2013, the Company had positions in 5 investment securities with a fair value of $3.5 million and a total unrealized loss of $6 thousand that have been in a continuous unrealized loss position for more than 12 months. There were a total of 424 securities positions in the Company s investment portfolio, with a fair value of $428.4 million and a total unrealized loss of $15.9 million at June 30, 2013, that have been in a continuous unrealized loss position for less than 12 months. The unrealized loss on these investment securities was predominantly caused by changes in market interest rates subsequent to purchase. The fair value of most of the investment securities in the Company s portfolio fluctuates as market interest rates change.

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.

No impairment was recorded in the six months ended June 30, 2013. During the six months ended June 30, 2012, the Company recognized an OTTI charge of $91 thousand related to a privately issued whole loan CMO that was determined to be impaired due to credit quality.

Based on management s review and evaluation of the Company s debt securities as of June 30, 2013, the debt securities with unrealized losses were not considered to be OTTI. As of June 30, 2013, the Company does not have the intent 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, 2013, 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.

**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, 2013** | | | |
| Commercial business | $ 257,784 | $ (52) | $ 257,732 |
| Commercial mortgage | 438,513 | (998) | 437,515 |
| Residential mortgage | 117,939 | 178 | 118,117 |
| Home equity | 301,429 | 4,786 | 306,215 |
| Consumer indirect | 572,350 | 27,236 | 599,586 |
| Other consumer | 24,107 | 142 | 24,249 |
| Total | $ 1,712,122 | $ 31,292 | 1,743,414 |
| Allowance for loan losses | | | (25,590) |
| Total loans, net | | | $ 1,717,824 |
| **December 31, 2012** | | | |
| Commercial business | $ 258,706 | $ (31) | $ 258,675 |
| Commercial mortgage | 414,282 | (958) | 413,324 |
| Residential mortgage | 133,341 | 179 | 133,520 |
| Home equity | 282,503 | 4,146 | 286,649 |
| Consumer indirect | 559,964 | 26,830 | 586,794 |
| Other consumer | 26,657 | 107 | 26,764 |
| Total | $ 1,675,453 | $ 30,273 | 1,705,726 |
| Allowance for loan losses | | | (24,714) |
| Total loans, net | | | $ 1,681,012 |

Loans held for sale (not included above) were comprised entirely of residential real estate mortgages and totaled $3.4 million and $1.5 million as of June 30, 2013 and December 31, 2012, respectively.

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**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**

**Notes to Consolidated Financial Statements (Unaudited)**

**(5.) LOANS (Continued)**

**Past Due Loans Aging**

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

| | 30-59 Days Past Due | 60-89 Days Past Due | Greater Than 90 Days | Total Past Due | Nonaccrual | Current | Total Loans |
|---|---|---|---|---|---|---|---|
| **June 30, 2013** | | | | | | | |
| Commercial business | $ 170 | $ | $ | $ 170 | $ 5,043 | $ 252,571 | $ 257,784 |
| Commercial mortgage | 90 | | | 90 | 3,073 | 435,350 | 438,513 |
| Residential mortgage | 791 | | | 791 | 1,423 | 115,725 | 117,939 |
| Home equity | 477 | 30 | | 507 | 699 | 300,223 | 301,429 |
| Consumer indirect | 1,363 | 139 | | 1,502 | 1,035 | 569,813 | 572,350 |
| Other consumer | 134 | 12 | 16 | 162 | 6 | 23,939 | 24,107 |
| Total loans, gross | $ 3,025 | $ 181 | $ 16 | $ 3,222 | $ 11,279 | $ 1,697,621 | $ 1,712,122 |
| **December 31, 2012** | | | | | | | |
| Commercial business | $ 160 | $ | $ | $ 160 | $ 3,413 | $ 255,133 | $ 258,706 |
| Commercial mortgage | 331 | | | 331 | 1,799 | 412,152 | 414,282 |
| Residential mortgage | 376 | | | 376 | 2,040 | 130,925 | 133,341 |
| Home equity | 675 | 10 | | 685 | 939 | 280,879 | 282,503 |
| Consumer indirect | 1,661 | 163 | | 1,824 | 891 | 557,249 | 559,964 |
| Other consumer | 127 | 35 | 18 | 180 | 25 | 26,452 | 26,657 |
| Total loans, gross | $ 3,330 | $ 208 | $ 18 | $ 3,556 | $ 9,107 | $ 1,662,790 | $ 1,675,453 |

There were no loans past due greater than 90 days and still accruing interest as of June 30, 2013 and December 31, 2012. There were $16 thousand and $18 thousand in consumer overdrafts which were past due greater than 90 days as of June 30, 2013 and December 31, 2012, 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. The Company offers various types of concessions when modifying loans, however, forgiveness of principal is rarely granted. Commercial loans modified in a TDR may involve temporary interest-only payments, term extensions, reducing the interest rate for the remaining term of the loan, extending the maturity date at an interest rate lower than the current market rate for new debt with similar risk, requesting additional collateral, releasing collateral for consideration, or substituting or adding a new borrower or guarantor.

The following table presents information related to loans modified in a TDR during the periods indicated (dollars in thousands).

| | Quarter-to-Date | | | Year-to-Date | | |
|---|---|---|---|---|---|---|
| | Number of Contracts | Pre-Modification Outstanding Recorded Investment | Post-Modification Outstanding Recorded Investment | Number of Contracts | Pre-Modification Outstanding Recorded Investment | Post-Modification Outstanding Recorded Investment |
| **June 30, 2013** | | | | | | |
| Commercial business | 1 | $ 1,273 | $ 1,273 | 3 | $ 1,462 | $ 1,453 |
| Commercial mortgage | | | | | | |
| Total | 1 | $ 1,273 | $ 1,273 | 3 | $ 1,462 | $ 1,453 |
| **June 30, 2012** | | | | | | |
| Commercial business | | $ | $ | 2 | $ 433 | $ 433 |
| Commercial mortgage | 3 | 602 | 602 | 4 | 648 | 648 |
| Total | 3 | $ 602 | $ 602 | 6 | $ 1,081 | $ 1,081 |

**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**

**Notes to Consolidated Financial Statements (Unaudited)**

**(5.) LOANS (Continued)**

All of the loans identified as TDRs by the Company were previously on nonaccrual status and reported as impaired loans prior to restructuring. The modifications primarily related to extending the amortization periods of the loans. All loans restructured during the three months ended June 30, 2013 were classified as nonaccrual as of June 30, 2013. Nonaccrual loans that are restructured remain on nonaccrual status, but may move to accrual status after they have performed according to the restructured terms for a period of time. The TDR classification did not have a material impact on the Company s determination of the allowance for loan losses because the modified loans were impaired and evaluated for a specific reserve both before and after restructuring.

There were no loans modified as a TDR within the previous 12 months that defaulted during the three months ended June 30, 2013 or 2012. For purposes of this disclosure, a loan modified as a TDR is considered to have defaulted when the borrower becomes 90 days past due.

**Impaired Loans**

Management has determined that specific commercial loans on nonaccrual status and all loans that have had their terms restructured in a troubled debt restructuring are impaired loans. The following table presents the recorded investment, unpaid principal balance and related allowance of impaired loans as of the dates indicated and average recorded investment and interest income recognized on impaired loans for the three month periods ended as of the dates indicated (in thousands):

| | Recorded Investment[(1)] | Unpaid Principal Balance[(1)] | Related Allowance | Average Recorded Investment | Interest Income Recognized |
|---|---|---|---|---|---|
| **June 30, 2013** | | | | | |
| With no related allowance recorded: | | | | | |
| Commercial business | $ 788 | $ 1,171 | $ | $ 940 | $ |
| Commercial mortgage | 780 | 835 | | 684 | |
| | 1,568 | 2,006 | | 1,624 | |
| With an allowance recorded: | | | | | |
| Commercial business | 4,255 | 4,255 | 956 | 4,419 | |
| Commercial mortgage | 2,293 | 2,293 | 554 | 1,936 | |
| | 6,548 | 6,548 | 1,510 | 6,355 | |
| | $ 8,116 | $ 8,554 | $ 1,510 | $ 7,979 | $ |
| **December 31, 2012** | | | | | |
| With no related allowance recorded: | | | | | |
| Commercial business | $ 963 | $ 1,425 | $ | $ 755 | $ |
| Commercial mortgage | 911 | 1,002 | | 1,310 | |
| | 1,874 | 2,427 | | 2,065 | |
| With an allowance recorded: | | | | | |
| Commercial business | 2,450 | 2,450 | 664 | 2,114 | |
| Commercial mortgage | 888 | 888 | 310 | 1,858 | |

| | | | | | |
|---|---|---|---|---|---|
| | 3,338 | 3,338 | 974 | 3,972 | |
| | $ 5,212 | $ 5,765 | $ 974 | $ 6,037 | $ |

(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, 2013** | | |
| Uncriticized | $ 242,218 | $ 418,395 |
| Special mention | 4,209 | 12,401 |
| Substandard | 11,357 | 7,717 |
| Doubtful | | |
| Total | $ 257,784 | $ 438,513 |
| **December 31, 2012** | | |
| Uncriticized | $ 240,291 | $ 400,576 |
| Special mention | 6,591 | 6,495 |
| Substandard | 11,824 | 7,211 |
| Doubtful | | |
| Total | $ 258,706 | $ 414,282 |

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

| | Residential Mortgage | Home Equity | Consumer Indirect | Other Consumer |
|---|---|---|---|---|
| **June 30, 2013** | | | | |
| Performing | $ 116,516 | $ 300,730 | $ 571,315 | $ 24,085 |
| Non-performing | 1,423 | 699 | 1,035 | 22 |
| Total | $ 117,939 | $ 301,429 | $ 572,350 | $ 24,107 |
| **December 31, 2012** | | | | |
| Performing | $ 131,301 | $ 281,564 | $ 559,073 | $ 26,632 |
| Non-performing | 2,040 | 939 | 891 | 25 |
| Total | $ 133,341 | $ 282,503 | $ 559,964 | $ 26,657 |

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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 Mortgage | Home Equity | Consumer Indirect | Other Consumer | Total |
|---|---|---|---|---|---|---|---|
| **June 30, 2013** | | | | | | | |
| Loans: | | | | | | | |
| Ending balance | $ 257,784 | $ 438,513 | $ 117,939 | $ 301,429 | $ 572,350 | $ 24,107 | $ 1,712,122 |
| Evaluated for impairment: | | | | | | | |
| Individually | $ 5,043 | $ 3,073 | $ | $ | $ | $ | $ 8,116 |
| Collectively | $ 252,741 | $ 435,440 | $ 117,939 | $ 301,429 | $ 572,350 | $ 24,107 | $ 1,704,006 |
| **Allowance for loan losses:** | | | | | | | |
| Ending balance | $ 4,755 | $ 7,125 | $ 701 | $ 1,424 | $ 11,095 | $ 490 | $ 25,590 |
| Evaluated for impairment: | | | | | | | |
| Individually | $ 956 | $ 554 | $ | $ | $ | $ | $ 1,510 |
| Collectively | $ 3,799 | $ 6,571 | $ 701 | $ 1,424 | $ 11,095 | $ 490 | $ 24,080 |
| **June 30, 2012** | | | | | | | |
| **Loans:** | | | | | | | |
| Ending balance | $ 245,513 | $ 414,766 | $ 142,635 | $ 260,855 | $ 507,598 | $ 25,172 | $ 1,596,539 |
| Evaluated for impairment: | | | | | | | |
| Individually | $ 4,150 | $ 3,598 | $ | $ | $ | $ | $ 7,748 |
| Collectively | $ 241,363 | $ 411,168 | $ 142,635 | $ 260,855 | $ 507,598 | $ 25,172 | $ 1,588,791 |
| **Allowance for loan losses:** | | | | | | | |
| Ending balance | $ 4,364 | $ 6,713 | $ 801 | $ 1,164 | $ 10,618 | $ 460 | $ 24,120 |
| Evaluated for impairment: | | | | | | | |
| Individually | $ 863 | $ 691 | $ | $ | $ | $ | $ 1,554 |
| Collectively | $ 3,501 | $ 6,022 | $ 801 | $ 1,164 | $ 10,618 | $ 460 | $ 22,566 |

The following table sets forth the changes in the allowance for loan losses for the three and six month periods ended June 30, 2013 (in thousands):

| | Commercial Business | Commercial Mortgage | Residential Mortgage | Home Equity | Consumer Indirect | Other Consumer | Total |
|---|---|---|---|---|---|---|---|
| **Three months ended June 30, 2013** | | | | | | | |
| Beginning balance | $ 5,167 | $ 6,971 | $ 668 | $ 1,283 | $ 11,312 | $ 426 | $ 25,827 |
| Charge-offs | 292 | 106 | 85 | 53 | 1,929 | 229 | 2,694 |
| Recoveries | 205 | 143 | 13 | 73 | 759 | 71 | 1,264 |
| Provision (credit) | (325) | 117 | 105 | 121 | 953 | 222 | 1,193 |
| Ending balance | $ 4,755 | $ 7,125 | $ 701 | $ 1,424 | $ 11,095 | $ 490 | $ 25,590 |
| **Six months ended June 30, 2013** | | | | | | | |
| Beginning balance | $ 4,884 | $ 6,581 | $ 740 | $ 1,282 | $ 10,715 | $ 512 | $ 24,714 |
| Charge-offs | 531 | 109 | 247 | 322 | 3,647 | 481 | 5,337 |
| Recoveries | 242 | 157 | 30 | 110 | 1,564 | 208 | 2,311 |
| Provision | 160 | 496 | 178 | 354 | 2,463 | 251 | 3,902 |
| Ending balance | $ 4,755 | $ 7,125 | $ 701 | $ 1,424 | $ 11,095 | $ 490 | $ 25,590 |

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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, 2012 (in thousands):

| | Commercial Business | Commercial Mortgage | Residential Mortgage | Home Equity | Consumer Indirect | Other Consumer | Total |
|---|---|---|---|---|---|---|---|
| **Three months ended June 30, 2012** | | | | | | | |
| Beginning balance | $ 4,386 | $ 6,788 | $ 822 | $ 1,281 | $ 9,999 | $ 487 | $ 23,763 |
| Charge-offs | 144 | 227 | 127 | 93 | 1,407 | 90 | 2,088 |
| Recoveries | 155 | 61 | 28 | 11 | 746 | (15) | 986 |
| Provision (credit) | (33) | 91 | 78 | (35) | 1,280 | 78 | 1,459 |
| Ending balance | $ 4,364 | $ 6,713 | $ 801 | $ 1,164 | $ 10,618 | $ 460 | $ 24,120 |
| **Six months ended June 30, 2012** | | | | | | | |
| Beginning balance | $ 4,036 | $ 6,418 | $ 858 | $ 1,242 | $ 10,189 | $ 517 | $ 23,260 |
| Charge-offs | 199 | 347 | 233 | 97 | 2,802 | 404 | 4,082 |
| Recoveries | 232 | 76 | 98 | 20 | 1,473 | 199 | 2,098 |
| Provision (credit) | 295 | 566 | 78 | (1) | 1,758 | 148 | 2,844 |
| Ending balance | $ 4,364 | $ 6,713 | $ 801 | $ 1,164 | $ 10,618 | $ 460 | $ 24,120 |

**Risk Characteristics**

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

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

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

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

likely to be affected by adverse personal circumstances such as job loss, illness or personal bankruptcy. Furthermore, the application of various federal and state laws, including bankruptcy and insolvency laws, may limit the amount which can be recovered on such loans.

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**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**

**Notes to Consolidated Financial Statements (Unaudited)**

**(6.) GOODWILL AND OTHER INTANGIBLE ASSETS**

The carrying amount of goodwill totaled $48.5 million as of June 30, 2013 and December 31, 2012. The goodwill relates to the Company s primary subsidiary and reporting unit, Five Star Bank. The Company performs a goodwill impairment test on an annual basis or more frequently if events and circumstances warrant.

The Company recorded a core deposit intangible asset of $2.0 million in connection with the 2012 branch acquisitions which will be amortized on an accelerated basis over the remaining estimated average life of the core deposits of approximately 8.8 years. The amortization expense is included in other noninterest expense on the consolidated statements of income and is deductible for tax purposes.

Amortization expense for the core deposit intangible was $98 thousand and $199 thousand for the three and six months ended June 30, 2013, respectively. There was no amortization expense for the three and six months ended June 30, 2012. As of June 30, 2013, estimated core deposit intangible amortization expense for each of the next five years is as follows (in thousands):

| | |
|---|---|
| 2013 (remainder of year) | $ 187 |
| 2014 | 341 |
| 2015 | 296 |
| 2016 | 251 |
| 2017 | 205 |

**(7.) SHAREHOLDERS EQUITY**

**Common Stock**

The changes in shares of common stock were as follows for the six month periods ended June 30, 2013 and 2012:

| | Outstanding | Treasury | Issued |
|---|---|---|---|
| **June 30, 2013** | | | |
| Shares outstanding at December 31, 2012 | 13,787,709 | 373,888 | 14,161,597 |
| Restricted stock awards issued | 42,035 | (42,035) | |
| Restricted stock awards forfeited | (18,977) | 18,977 | |
| Stock options exercised | 3,300 | (3,300) | |
| Treasury stock purchases | (11,349) | 11,349 | |
| Directors retainer | 5,672 | (5,672) | |
| Shares outstanding at June 30, 2013 | 13,808,390 | 353,207 | 14,161,597 |
| **June 30, 2012** | | | |
| Shares outstanding at December 31, 2011 | 13,803,116 | 358,481 | 14,161,597 |
| Restricted stock awards issued | 57,541 | (57,541) | |
| Restricted stock awards forfeited | (25,075) | 25,075 | |
| Stock options exercised | 1,650 | (1,650) | |
| Treasury stock purchases | (31,518) | 31,518 | |
| Directors retainer | 5,816 | (5,816) | |
| Shares outstanding at June 30, 2012 | 13,811,530 | 350,067 | 14,161,597 |

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**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**

**Notes to Consolidated Financial Statements (Unaudited)**

**(8.) ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS)**

The following table presents the components of other comprehensive income (loss) for the six month periods ended June 30, 2013 and 2012 (in thousands):

| | Pre-tax Amount | Tax Effect | Net-of-tax Amount |
|---|---|---|---|
| **June 30, 2013** | | | |
| Net unrealized losses on investment securities: | | | |
| Net unrealized losses arising during the period | $ (26,571) | $ (10,525) | $ (16,046) |
| Reclassification adjustment for gains included in income | (1,224) | (485) | (739) |
| Net unrealized losses on investment securities | (27,795) | (11,010) | (16,785) |
| Pension and post-retirement obligations: | | | |
| Amortization of prior service credit | (24) | (9) | (15) |
| Amortization of actuarial losses | 682 | 269 | 413 |
| Pension and post-retirement obligations, net | 658 | 260 | 398 |
| Other comprehensive loss | $ (27,137) | $ (10,750) | $ (16,387) |
| **June 30, 2012** | | | |
| Net unrealized gains on investment securities: | | | |
| Net unrealized gains arising during the period | $ 2,995 | $ 1,186 | $ 1,809 |
| Reclassification adjustment for gains included in income | (1,568) | (621) | (947) |
| Reclassification adjustment for impairment charges included in income | 91 | 36 | 55 |
| Net unrealized gains on investment securities | 1,518 | 601 | 917 |
| Pension and post-retirement obligations: | | | |
| Amortization of prior service credit | (24) | (9) | (15) |
| Amortization of actuarial losses | 695 | 275 | 420 |
| Pension and post-retirement obligations, net | 671 | 266 | 405 |
| Other comprehensive income | $ 2,189 | $ 867 | $ 1,322 |

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**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**

**Notes to Consolidated Financial Statements (Unaudited)**

**(8.) ACCUMULATED OTHER COMPREHENSIVE INCOME (Continued)**

The following table presents the changes in each component of accumulated other comprehensive income (loss), net of tax, for the six month period ended June 30, 2013 (in thousands):

| | Net Unrealized Gains (Losses) on Investment Securities | Pension and Post-retirement Obligations | Total |
|---|---|---|---|
| Balance at beginning of year | $ 16,060 | $ (12,807) | $ 3,253 |
| Other comprehensive loss before reclassifications | (16,046) | 398 | (15,648) |
| Amounts reclassified from accumulated other comprehensive income | (739) | | (739) |
| Net current period other comprehensive loss | (16,785) | 398 | (16,387) |
| Balance at end of period | $ (725) | $ (12,409) | $ (13,134) |

The following table presents the amounts reclassified out of each component of accumulated other comprehensive income (loss) for the six month period ended June 30, 2013 (in thousands):

| Details About Accumulated Other Comprehensive Income Components | Amount Reclassified from Accumulated Other Comprehensive Income | Affected Line Item in the Consolidated Statement of Income |
|---|---|---|
| Realized gain on sale of investment securities | $ 1,224 | Net gain on disposal of investment securities |
| | (485) | Income tax expense |
| | $ 739 | Net of tax |
| Pension and post-retirement obligations | | |
| Amortization of prior service benefit [1] | $ 24 | Salaries and employee benefits |
| Amortization of actuarial losses [1] | (682) | Salaries and employee benefits |
| | (658) | Total before tax |
| | 260 | Income tax benefit |
| | $ (398) | Net of tax |

[1] These items are included in the computation of net periodic pension cost. See Note 10 Employee Benefit Plans for additional information.

**(9.) SHARE-BASED COMPENSATION PLANS**

The Company maintains certain stock-based compensation plans that were approved by the Company s shareholders and are administered by the Company s Board, or the Management Development and Compensation Committee of the Board. The share-based compensation plans were established to allow for the grant of compensation awards to attract, motivate and retain employees, executive officers and non-employee directors who contribute to the success and profitability of the Company and to give such persons a proprietary interest in the Company, thereby enhancing their personal interest in the Company s success.

The Company awarded grants of 33,035 restricted shares to certain members of management during the six months ended June 30, 2013. Fifty percent of the shares subject to each grant will be earned based upon achievement of an EPS performance requirement for the Company s fiscal year ended December 31, 2013. The remaining fifty percent of the shares will be earned based on the Company s achievement of a relative total shareholder return ( TSR ) performance requirement, on a percentile basis, compared to a defined group of peer companies over a three-year performance period ended December 31, 2015. The shares earned based on the achievement of the EPS and TSR performance requirements, if any, will vest based on the recipient s continuous service to the Company on December 31, 2015.

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**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**

**Notes to Consolidated Financial Statements (Unaudited)**

**(9.) SHARE-BASED COMPENSATION PLANS (Continued)**

The grant-date fair value of the TSR portion of the award granted during the six month period ended June 30, 2013 was determined using the Monte Carlo simulation model on the date of grant, assuming the following (i) expected term of 2.88 years, (ii) risk free interest rate of 0.42%, (iii) expected dividend yield of 3.59% and (iv) expected stock price volatility over the expected term of the TSR award of 37.2%. The grant-date fair value of all other restricted stock awards is equal to the closing market price of our common stock on the date of grant.

During the six months ended June 30, 2013, the Company granted 9,000 restricted shares of common stock to directors, of which 4,500 shares vested immediately and 4,500 shares will vest after completion of a one-year service requirement. The market price of the restricted stock on the date of grant was $19.81.

The restricted stock awards granted to management and directors in 2013 do not have rights to dividends or dividend equivalents.

The following is a summary of restricted stock award activity for the six month period ended June 30, 2013:

| | Number of Shares | Weighted Average Market Price at Grant Date |
|---|---|---|
| Outstanding at beginning of year | 79,580 | $ 16.89 |
| Granted | 42,035 | 16.85 |
| Vested | (38,598) | 17.04 |
| Forfeited | (18,977) | 16.60 |
| Outstanding at end of period | 64,040 | $ 16.86 |

As of June 30, 2013, there was $554 thousand of unrecognized compensation expense related to unvested restricted stock awards that is expected to be recognized over a weighted average period of 1.8 years.

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 2013 or 2012. The following is a summary of stock option activity for the six months ended June 30, 2013 (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 | 319,275 | $ 20.22 | | |
| Exercised | (3,300) | 17.58 | | |
| Expired | (43,790) | 21.38 | | |
| Outstanding and exercisable at end of period | 272,185 | $ 20.07 | 2.4 years | $ 58 |

As of June 30, 2013, all compensation expense related to stock options had been fully recognized in previous periods.

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, 2013 and 2012 was $7 thousand and $2 thousand, respectively. The total cash received as a result of option exercises under stock compensation plans for six months ended June 30, 2013 and 2012 was $59 thousand and $26 thousand, respectively.

The Company amortizes the expense related to restricted stock awards over the vesting period. Share-based compensation expense is recorded as a component of salaries and employee benefits in the consolidated statements of income for awards granted to management and as a component of other noninterest expense for awards granted to directors. The share-based compensation expense included in the consolidated statements of income is as follows (in thousands):

| | Three months ended June 30, | | Six months ended June 30, | |
|---|---|---|---|---|
| | 2013 | 2012 | 2013 | 2012 |
| Salaries and employee benefits | $ (6) | $ 93 | $ 79 | $ 220 |
| Other noninterest expense | 109 | 83 | 126 | 98 |
| Total share-based compensation expense | $ 103 | $ 176 | $ 205 | $ 318 |

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**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**

**Notes to Consolidated Financial Statements (Unaudited)**

**(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, | |
|---|---|---|---|---|
| | 2013 | 2012 | 2013 | 2012 |
| Service cost | $ 516 | $ 509 | $ 1,032 | $ 1,018 |
| Interest cost on projected benefit obligation | 505 | 506 | 1,010 | 1,011 |
| Expected return on plan assets | (921) | (803) | (1,842) | (1,606) |
| Amortization of unrecognized prior service credit | (12) | (12) | (24) | (24) |
| Amortization of unrecognized loss | 341 | 347 | 682 | 694 |
| Net periodic pension cost | $ 429 | $ 547 | $ 858 | $ 1,093 |

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 Internal Revenue Code. The Company has no minimum required contribution for the 2013 fiscal year.

**(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, 2013 | December 31, 2012 |
|---|---|---|
| Commitments to extend credit | $ 457,620 | $ 435,948 |
| Standby letters of credit | 9,315 | 9,223 |

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

The Company also extends rate lock agreements to borrowers related to the origination of residential mortgage loans. To mitigate the interest rate risk inherent in these rate lock agreements, the Company may enter into forward commitments to sell individual residential mortgages. Rate lock agreements and forward commitments are considered derivatives and are recorded at fair value. The Company had no forward sales commitments at June 30, 2013. Forward sales commitments totaled $1.8 million at December 31, 2012. In addition, the net change in the fair values of these derivatives was recognized as other noninterest income or other noninterest expense in the consolidated statements of income.

**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**

**Notes to Consolidated Financial Statements (Unaudited)**

**(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.

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.

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**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**

**Notes to Consolidated Financial Statements (Unaudited)**

**(12.) FAIR VALUE MEASUREMENTS (Continued)**

**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.

**Off-balance sheet instruments:** The fair value of off-balance-sheet instruments is based on the current fees that would be charged to enter into or terminate such arrangements, taking into account the remaining terms of the agreements and the counterparties credit standing. The fair value of commitments is not material.

**Assets Measured at Fair Value**

The following tables present for each of the fair-value hierarchy levels the Company s assets that are measured at fair value on a recurring and non-recurring basis as of the dates indicated (in thousands).

| | Quoted Prices in Active Markets for Identical Assets or Liabilities (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) | Total |
|---|---|---|---|---|
| June 30, 2013 | | | | |
| **Measured on a recurring basis:** | | | | |
| Securities available for sale: | | | | |
| U.S. Government agencies and government sponsored enterprises | $ | $ 112,939 | $ | $ 112,939 |
| State and political subdivisions | | 222,706 | | 222,706 |
| Mortgage-backed securities | | 474,427 | | 474,427 |
| Asset-backed securities: | | | | |
| Trust preferred securities | | 207 | | 207 |
| Other | | 270 | | 270 |

| | | | | |
|---|---|---|---|---|
| | $ | $ 810,549 | $ | $ 810,549 |
| **Measured on a nonrecurring basis:** | | | | |
| Loans: | | | | |
| Loans held for sale | $ | $ 3,423 | $ | $ 3,423 |
| Collateral dependent impaired loans | | | 5,038 | 5,038 |
| Other assets: | | | | |
| Loan servicing rights | | | 1,729 | 1,729 |
| Other real estate owned | | | 415 | 415 |
| | $ | $ 3,423 | $ 7,182 | $ 10,605 |

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

**(12.) FAIR VALUE MEASUREMENTS (Continued)**

| | Quoted Prices in Active Markets for Identical Assets or Liabilities (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) | Total |
|---|---|---|---|---|
| **December 31, 2012** | | | | |
| **Measured on a recurring basis:** | | | | |
| Securities available for sale: | | | | |
| U.S. Government agencies and government sponsored enterprises | $ | $ 131,695 | $ | $ 131,695 |
| State and political subdivisions | | 195,210 | | 195,210 |
| Mortgage-backed securities | | 495,868 | | 495,868 |
| Asset-backed securities: | | | | |
| Trust preferred securities | | 754 | | 754 |
| Other | | 269 | | 269 |
| | $ | $ 823,796 | $ | $ 823,796 |
| **Measured on a nonrecurring basis:** | | | | |
| Loans: | | | | |
| Loans held for sale | $ | $ 1,518 | $ | $ 1,518 |
| Collateral dependent impaired loans | | | 2,364 | 2,364 |
| Other assets: | | | | |
| Loan servicing rights | | | 1,719 | 1,719 |
| Other real estate owned | | | 184 | 184 |
| | $ | $ 1,518 | $ 4,267 | $ 5,785 |

There were no transfers between Levels 1 and 2 during the six months ended June 30, 2013. There were no liabilities measured at fair value on a recurring or nonrecurring basis during the six month periods ended June 30, 2013 and 2012.

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 | $5,038 | Appraisal of collateral (1) | Appraisal adjustments (2) | 15% 100% discount |
| | | Discounted cash flow | Discount rate | 4.7% (3) |
| | | | Risk premium rate | 12.0% (3) |
| Loan servicing rights | 1,729 | Discounted cash flow | Discount rate | 4.6% (3) |

| | | | | | |
|---|---|---|---|---|---|
| | | | Constant prepayment rate | 13.2%[3] | |
| Other real estate owned | 415 | Appraisal of collateral [1] | Appraisal adjustments [2] | 6% | 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, 2013. The Company transferred all of the assets classified as Level 3 assets at December 31, 2011 to Level 2 during the six months ended June 30, 2012. The transfers of the $1.5 million of pooled trust preferred securities out of Level 3 was primarily the result of using observable pricing information or a third party pricing quote that appropriately reflects the fair value of those securities, without the need for adjustment based on our own assumptions regarding the characteristics of a specific security or the current liquidity in the market.

**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**

**Notes to Consolidated Financial Statements (Unaudited)**

**(12.) FAIR VALUE MEASUREMENTS (Continued)**

**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.

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, 2013 | | December 31, 2012 | |
|---|---|---|---|---|---|
| | | Carrying Amount | Estimated Fair Value | Carrying Amount | Estimated Fair Value |
| **Financial assets:** | | | | | |
| Cash and cash equivalents | Level 1 | $ 50,927 | $ 50,927 | $ 60,436 | $ 60,436 |
| Securities available for sale | Level 2 | 810,549 | 810,549 | 823,796 | 823,796 |
| Securities held to maturity | Level 2 | 17,348 | 17,821 | 17,905 | 18,478 |
| Loans held for sale | Level 2 | 3,423 | 3,423 | 1,518 | 1,547 |
| Loans | Level 2 | 1,712,786 | 1,713,457 | 1,678,648 | 1,701,419 |
| Loans [(1)] | Level 3 | 5,038 | 5,038 | 2,364 | 2,364 |

| | | | | | |
|---|---|---|---|---|---|
| Accrued interest receivable | Level 1 | 7,894 | 7,894 | 7,843 | 7,843 |
| FHLB and FRB stock | Level 2 | 13,160 | 13,160 | 12,321 | 12,321 |
| **Financial liabilities:** | | | | | |
| Non-maturity deposits | Level 1 | 1,700,709 | 1,700,709 | 1,606,856 | 1,606,856 |
| Time deposits | Level 2 | 623,527 | 624,988 | 654,938 | 658,342 |
| Short-term borrowings | Level 1 | 193,413 | 193,413 | 179,806 | 179,806 |
| Accrued interest payable | Level 1 | 3,819 | 3,819 | 3,819 | 3,819 |

(1) Comprised of collateral dependent impaired loans.

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

*This Quarterly Report on Form 10-Q should be read in conjunction with the more detailed and comprehensive disclosures included in our Annual Report on Form 10-K for the year ended December 31, 2012. In addition, please read this section in conjunction with our Consolidated Financial Statements and Notes to Consolidated Financial Statements contained herein.*

**FORWARD LOOKING INFORMATION**

Statements and financial analysis contained in this document that are not historical facts are forward looking statements made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995 (the Act ). Forward looking statements describe our future plans, strategies and expectations and are based on certain assumptions. Words such as may, could, should, would, believe, anticipate, estimat intend, plan, target, projects, and other similar expressions are intended to identify forward looking statements but are not the exclusive means o identifying such statements.

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 identified under the heading Risk Factors in Item 1A of Part I of our Annual Report on Form 10-K for the year ended December 31, 2012, could affect our financial performance and could cause our actual results or circumstances for future periods to differ materially from those anticipated or projected.

Except as required by law, we do not undertake, and specifically disclaim any obligation to publicly release any revisions to any forward looking statements to reflect the occurrence of anticipated or unanticipated events or circumstances after the date of such statements.

**GENERAL**

Financial Institutions, Inc. is a financial holding company headquartered in New York State that provides banking and nonbanking financial services to individuals and businesses primarily located in our Western and Central New York footprint. We have also expanded our indirect lending network to include relationships with franchised automobile dealers in the Capital District of New York and Northern Pennsylvania. Through our wholly-owned banking subsidiary, Five Star Bank, we provide a wide range of services, including business and consumer loan and depository services, as well as other traditional banking services. Through our nonbanking subsidiary, Five Star Investment Services, Inc., we provide brokerage and investment advisory services to supplement our banking business. References in this report to the Company , we , our or us mean the consolidated reporting entity and references to the Bank mean Five Star Bank.

Our primary sources of revenue are net interest income (predominantly from 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 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 is to maintain a community bank philosophy, which consists of focusing on and understanding the individualized banking needs of the businesses, professionals and other residents of the local communities surrounding our banking centers. 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, and results in long-standing and broad based banking relationships. Our core customers are primarily comprised of households, small- to medium-sized businesses, professionals and community organizations who prefer to build a banking relationship with a community bank that offers and combines high quality, competitively-priced banking products with personalized service. We believe that our level of personal service provides us with 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 and loan products typically found at larger banks, our highly experienced management team and our strategically located banking centers. A central part of our strategy is generating core deposits to support growth of a diversified and high-quality loan portfolio.

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**MANAGEMENT S DISCUSSION AND ANALYSIS**

**RECENT DEVELOPMENTS**

**New Capital Rules**

On July 2, 2013, the Federal Reserve approved final rules that substantially amend the regulatory risk-based capital rules applicable to the Company and the Bank. The FDIC and the OCC have subsequently approved these rules. The final rules were adopted following the issuance of proposed rules by the Federal Reserve in June 2012, and implement the Basel III regulatory capital reforms and changes required by the Dodd-Frank Act. Basel III refers to two consultative documents released by the Basel Committee on Banking Supervision in December 2009, the rules text released in December 2010, and loss absorbency rules issued in January 2011, which include significant changes to bank capital, leverage and liquidity requirements.

The rules include new risk-based capital and leverage ratios, which would be phased in from 2015 to 2019, and would refine the definition of what constitutes capital for purposes of calculating those ratios. The new minimum capital level requirements applicable to the Company and the Bank under the final rules would be: (i) a new common equity Tier 1 capital ratio of 4.5%; (ii) a Tier 1 capital ratio of 6% (increased from 4%); (iii) a total capital ratio of 8% (unchanged from current rules); and (iv) a Tier 1 leverage ratio of 4% for all institutions. The final rules also establish a capital conservation buffer above the new regulatory minimum capital requirements, which must consist entirely of common equity Tier 1 capital. The capital conservation buffer will be phased-in over four years beginning on January 1, 2016, as follows: the maximum buffer will be 0.625% of risk-weighted assets for 2016, 1.25% for 2017, 1.875% for 2018, and 2.5% for 2019 and thereafter. This will result in the following minimum ratios beginning in 2019: (i) a common equity Tier 1 capital ratio of 7.0%; (ii) a Tier 1 capital ratio of 8.5%; and (iii) a total capital ratio of 10.5%. Under the final rules, institutions are subject to limitations on paying dividends, engaging in share repurchases, and paying discretionary bonuses if its capital level falls below the buffer amount. These limitations establish a maximum percentage of eligible retained income that could be utilized for such actions.

Basel III provided discretion for regulators to impose an additional buffer, the countercyclical buffer, of up to 2.5% of common equity Tier 1 capital to take into account the macro-financial environment and periods of excessive credit growth. However, the final rules permit the countercyclical buffer to be applied only to advanced approach banks ( i.e., banks with $250 billion or more in total assets or $10 billion or more in total foreign exposures), which currently excludes the Company and the Bank. The final rules also implement revisions and clarifications consistent with Basel III regarding the various components of Tier 1 capital, including common equity, unrealized gains and losses, as well as certain instruments that will no longer qualify as Tier 1 capital, some of which will be phased out over time. However, the final rules provide that small depository institution holding companies with less than $15 billion in total assets as of December 31, 2009 (which includes the Company) will be able to permanently include non-qualifying instruments that were issued and included in Tier 1 or Tier 2 capital prior to May 19, 2010 in additional Tier 1 or Tier 2 capital until they redeem such instruments or until the instruments mature.

The final rules also contain revisions to the prompt corrective action framework, which is designed to place restrictions on insured depository institutions, including the Bank, if their capital levels begin to show signs of weakness. These revisions take effect January 1, 2015. Under the prompt corrective action requirements, which are designed to complement the capital conservation buffer, insured depository institutions will be required to meet the following increased capital level requirements in order to qualify as well capitalized: (i) a new common equity Tier 1 capital ratio of 6.5%; (ii) a Tier 1 capital ratio of 8% (increased from 6%); (iii) a total capital ratio of 10% (unchanged from current rules); and (iv) a Tier 1 leverage ratio of 5% (increased from 4%).

The final rules set forth certain changes for the calculation of risk-weighted assets, which we will be required to utilize beginning January 1, 2015. The standardized approach final rule utilizes an increased number of credit risk exposure categories and risk weights, and also addresses: (i) an alternative standard of creditworthiness consistent with Section 939A of the Dodd-Frank Act Act; (ii) revisions to recognition of credit risk mitigation; (iii) rules for risk weighting of equity exposures and past due loans; (iv) revised capital treatment for derivatives and repo-style transactions; and (v) disclosure requirements for top-tier banking organizations with $50 billion or more in total assets that are not subject to the advance approach rules that apply to banks with greater than $250 billion in consolidated assets. Based on our current capital composition and levels, we believe that we would be in compliance with the requirements as set forth in the final rules if they were presently in effect.

**2013 Branch Consolidations**

On July 23, 2013, the Company announced that it will be consolidating its Pavilion and North Java branches into nearby branches. Subject to regulatory approval, the Company expects to transfer customer accounts and employees by October 31, 2013. These branch consolidations are

one component of the Company s long term strategic plan, which provides for the optimal combination of branches and online/mobile banking technologies, supported by highly experienced bankers, to offer customers convenience and high service levels while maintaining an efficient, competitive cost structure. Expenses related to the consolidation of the two branches are not expected to be material.

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**MANAGEMENT S DISCUSSION AND ANALYSIS**

**2012 Branch Acquisitions**

On January 19, 2012, the Bank entered into agreements with First Niagara Bank, National Association ( First Niagara ) to acquire four retail bank branches in Medina, Brockport, Batavia and Waterloo, New York (the First Niagara Branches ) and four retail bank branches previously owned by HSBC Bank USA, National Association ( HSBC ) in Elmira, Elmira Heights, Horseheads and Albion, New York (the HSBC Branches ). First Niagara assigned its rights to the HSBC branches in connection with its acquisition of HSBC s Upstate New York banking franchise. Under the terms of the agreements, the Bank assumed substantially all related deposits and purchased the related branch premises and certain performing loans. The transaction to acquire the First Niagara Branches was completed on June 22, 2012 and the transaction to acquire the HSBC Branches was completed on August 17, 2012. The combined assets acquired and deposits assumed in the two transactions were recorded at their estimated fair values as follows (in thousands):

| | FNFG Branches | HSBC Branches | Total |
|---|---|---|---|
| Cash | $ 63,579 | $ 132,199 | $ 195,778 |
| Loans | 58,245 | 17,390 | 75,635 |
| Bank premises and equipment | 1,504 | 434 | 1,938 |
| Goodwill | 4,690 | 6,477 | 11,167 |
| Core deposit intangible asset | 1,421 | 621 | 2,042 |
| Other assets | 452 | 149 | 601 |
| Total assets acquired | $ 129,891 | $ 157,270 | $ 287,161 |
| Deposits assumed | $ 129,564 | $ 157,255 | $ 286,819 |
| Other liabilities | 327 | 15 | 342 |
| Total liabilities assumed | $ 129,891 | $ 157,270 | $ 287,161 |

The transactions were accounted for using the acquisition method of accounting and accordingly, assets acquired, liabilities assumed and consideration exchanged were recorded at their estimated fair values on the acquisition dates. Fair values are preliminary and in certain cases are subject to refinement for up to one year after the closing date of the acquisition as additional information relative to fair values becomes available. During the three months ended March 31, 2013, the Company recorded a decrease to the estimated fair value of liabilities assumed and an increase to the related deferred income taxes based upon information obtained subsequent to the acquisition. In addition to changes in those assets and liabilities, the revisions resulted in a reduction in goodwill approximating $432 thousand.

The Company acquired the loan portfolios at a fair value discount of $824 thousand. The discount represents expected credit losses, net of market interest rate adjustments. The discount on loans receivable will be amortized to interest income over the estimated remaining life of the acquired loans using the level yield method. The time deposit premium of $335 thousand will be accreted over the estimated remaining life of the related deposits as a reduction of interest expense. The core deposit intangible asset will be amortized on an accelerated basis over the estimated average life of the core deposits.

All goodwill and core deposit intangible assets arising from this acquisition are expected to be deductible for tax purposes.

**RESULTS OF OPERATIONS**

**Summary of Performance**

Net income increased $194 thousand or 3% to $6.9 million for the second quarter of 2013 compared to $6.7 million for the second quarter of 2012. Net income available to common shareholders for the second quarter of 2013 was $6.5 million, or $0.47 per diluted share, compared with $6.3 million, or $0.46 per diluted, for the second quarter of last year. Return on average equity was 10.70% and return on average assets was

0.99% for the second quarter of 2013 compared to 10.94% and 1.08%, respectively, for the second quarter of 2012.

Net income for the three and six months ended June 30, 2012 was reduced by expenses related to the acquisition of the four First Niagara branches. Pre-tax acquisition expenses were approximately $1.0 million for the three months ended June 30, 2012 and $1.1 million for the six months ended June 30, 2012, consisting mainly of professional fees, computer and data processing and supplies and postage expended to facilitate the purchase of the branches.

Net income for the six months ended June 30, 2013 totaled $13.0 million, an increase of $147 thousand or 1% from $12.9 million for the same period in 2012. For the first six months of 2013, net income available to common shareholders was $12.3 million, or $0.89 per diluted share, compared with $12.1 million, or $0.88 per diluted share, for the first six months of 2012. Return on average equity was 10.22% and return on average assets was 0.94% for the six months ended June 30, 2013 compared to 10.65% and 1.07%, respectively, for the same period in 2012.

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MANAGEMENT S DISCUSSION AND ANALYSIS

**Net Interest Income and Net Interest Margin**

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

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

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

| | Three months ended June 30, | | Six months ended June 30, | |
|---|---|---|---|---|
| | 2013 | 2012 | 2013 | 2012 |
| Interest income per consolidated statements of income | $ 24,342 | $ 23,731 | $ 49,090 | $ 47,181 |
| Adjustment to fully taxable equivalent basis | 656 | 568 | 1,284 | 1,075 |
| Interest income adjusted to a fully taxable equivalent basis | 24,998 | 24,299 | 50,374 | 48,256 |
| Interest expense per consolidated statements of income | 1,818 | 2,343 | 3,679 | 4,852 |
| Net interest income on a taxable equivalent basis | $ 23,180 | $ 21,956 | $ 46,695 | $ 43,404 |

***Leverage Strategy***

During the first quarter of 2013, we utilized the proceeds of short-term FHLB advances to purchase high-quality investment securities as part of a leverage strategy of approximately $100 million. Our purchase of investment securities was comprised of mortgage-backed securities, U.S. Government agencies and sponsored enterprise bonds and tax-exempt municipal bonds. All of the securities purchased were of high credit quality with a low to moderate duration. This strategy allowed us to increase net interest income by taking advantage of the positive interest rate spread between the FHLB advances and the newly acquired investment securities. While the underlying leverage strategy contributed to a lower net interest margin, it successfully increased net interest income by approximately $280 thousand and $550 thousand for the second quarter and six months ended June 30, 2013, respectively.

***Analysis of Net Interest Income for the Three Months ended June 30, 2013 and June 30, 2012***

Net interest income on a taxable equivalent basis for the three months ended June 30, 2013, was $23.2 million, an increase of $1.2 million or 6% versus the comparable quarter last year. The increase in taxable equivalent net interest income was primarily attributable to favorable volume variances (as changes in the balances and mix of earning assets and interest-bearing liabilities added $2.9 million to taxable equivalent net interest income), partly offset by unfavorable rate variances (as the impact of changes in the interest rate environment and product pricing reduced taxable equivalent net interest income by $1.7 million).

The net interest margin for the second quarter of 2013 was 3.63%, 26 basis points lower than 3.89% for the same period in 2012. This comparable period decrease was a function of a 24 basis point decrease in interest rate spread, combined with a 2 basis point lower contribution from net free funds (due principally to lower rates on interest-bearing liabilities reducing the value of noninterest-bearing deposits and other net

free funds). The lower interest rate spread was a net result of a 40 basis point decrease in the yield on earning assets and a 16 basis point decrease in the cost of interest-bearing liabilities.

The Federal Reserve has left the targeted Federal funds rate unchanged at zero to 25 basis points since 2010. During 2011, the Federal Reserve disclosed that short-term interest rates would be held near zero through at least the middle of 2013, in anticipation of low growth and little risk of inflation. In April 2012, the Federal Reserve further announced that interest rates will likely remain at exceptionally low levels through late 2014. The Federal Reserve Board continues to indicate there is the potential for these short-term rates to remain unchanged until certain inflation and unemployment rates are achieved.

MANAGEMENT S DISCUSSION AND ANALYSIS

The yield on earning assets was 3.91% for the second quarter of 2013, 40 basis points lower than the second quarter of 2012. Loan yields decreased 41 basis points to 4.65%, also impacted by the lower interest rate environment. Commercial mortgage and consumer indirect loans in particular, down 45 and 68 basis points, respectively, experienced lower yields given the competitive pricing pressures in a low interest rate environment. The yield on investment securities dropped 30 basis points to 2.38%, also impacted by the lower interest rate environment, prepayments of mortgage-related investment securities and the previously mentioned leverage strategy. Overall, earning asset rate changes reduced interest income by $2.2 million.

The cost of average interest-bearing liabilities of 0.36% in the second quarter of 2013 was 16 basis points lower than the second quarter of 2012, reflecting the lower rate environment, mitigated by a focus on product pricing to retain balances. The cost of short-term funding decreased 3 basis points to 0.40% for the second quarter of 2013. The interest-bearing liability rate changes resulted in $485 thousand of lower interest expense.

Average interest-earning assets were $2.56 billion for second quarter 2013, an increase of $297.5 million or 13% from the comparable quarter last year, with average loans up $182.9 million and average securities up $114.5 million. The growth in average loans was comprised of increases in all loan categories, with consumer loans up $135.1 million, commercial loans up $40.2 million and residential mortgage loans up $7.6 million. The growth in average securities was a result of investing excess cash from the branch acquisitions combined with the previously described leverage strategy.

Average interest-bearing liabilities of $2.02 billion in the second quarter of 2013 were $202.3 million or 11% higher than the second quarter of 2012. On average, interest-bearing deposits grew $211.4 million, while noninterest-bearing demand deposits (a principal component of net free funds) were up $103.0 million. The increase in average deposits was primarily attributable to retail deposits assumed in the branch acquisitions. Average short-term borrowings decreased $9.1 million between the second quarter periods.

***Analysis of Net Interest Income for the Six Months ended June 30, 2013 and June 30, 2012***

Net interest income on a taxable equivalent basis for the first six months of 2013 was $46.7 million, an increase of $3.3 million or 8% versus the same period last year. The increase in taxable equivalent net interest income was primarily attributable to a favorable volume variance (as changes in the balances and mix of earning assets and interest-bearing liabilities added $6.8 million to taxable equivalent net interest income), partially offset by an unfavorable rate variance (as the impact of changes in the interest rate environment and product pricing decreased taxable equivalent net interest income by $3.5 million).

The net interest margin for the first six months of 2013 was 3.68%, 29 basis points lower than 3.97% for the same period last year. The interest rate spread was 3.60% during the first six months of 2013 compared to 3.86% during the first six months of 2012.

This comparable period decrease was a function of a 26 basis point decrease in interest rate spread, combined with a 3 basis point lower contribution from net free funds. The lower interest rate spread was a net result of a 45 basis point decrease in the yield on earning assets and a 19 basis point decrease in the cost of interest-bearing liabilities.

The yield on earning assets was 3.97% for the first six months of 2013, 45 basis points lower than the same period last year, attributable to decreases in the yields on the investment security portfolio (down 37 basis points, to 2.38%) and loan portfolio (down 41 basis points to 4.74%).

The cost on interest-bearing liabilities of 0.37% for the first six months of 2013 was 19 basis points lower than the same period in 2012. Rates on interest-bearing deposits were down 20 basis points to 0.36%. The cost of short-term borrowings decreased 4 basis points to 0.40%.

Average interest-earning assets were $2.55 billion for the first six months of 2013, an increase of $359.7 million or 16% from the comparable period last year, with average loans up $196.6 million and average securities up $162.9 million. The growth in average loans was comprised of increases in all loan categories, with consumer loans up $142.9 million, commercial loans up $41.8 million and residential mortgage loans up $11.9 million.

Average interest-bearing liabilities of $2.02 billion in the first six months of 2013 were $264.6 million or 15% higher than the first six months of 2012. On average, interest-bearing deposits grew $222.1 million, while noninterest-bearing demand deposits were up $98.9 million and average short-term borrowings increased $42.5 million. The increase in average deposits was primarily attributable to retail deposits assumed in the

branch acquisitions.

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**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, | | | | | |
|---|---|---|---|---|---|---|
| | 2013 | | | 2012 | | |
| | Average Balance | Interest | Average Rate | Average Balance | Interest | Average Rate |
| **Interest-earning assets:** | | | | | | |
| Federal funds sold and interest-earning deposits | $ 226 | $ | 0.19% | $ 94 | $ | 0.21% |
| Investment securities [1]: | | | | | | |
| Taxable | 599,931 | 3,060 | 2.04 | 542,639 | 3,165 | 2.33 |
| Tax-exempt [2] | 230,022 | 1,874 | 3.26 | 172,792 | 1,622 | 3.75 |
| Total investment securities | 829,953 | 4,934 | 2.38 | 715,431 | 4,787 | 2.68 |
| Loans: | | | | | | |
| Commercial business | 256,332 | 2,854 | 4.47 | 237,936 | 2,732 | 4.62 |
| Commercial mortgage | 433,631 | 5,397 | 4.99 | 411,871 | 5,569 | 5.44 |
| Residential mortgage | 123,263 | 1,558 | 5.05 | 115,621 | 1,523 | 5.27 |
| Home equity | 299,230 | 3,072 | 4.12 | 242,208 | 2,547 | 4.23 |
| Consumer indirect | 595,235 | 6,518 | 4.39 | 517,859 | 6,532 | 5.07 |
| Other consumer | 24,080 | 665 | 11.08 | 23,420 | 609 | 10.46 |
| Total loans | 1,731,771 | 20,064 | 4.65 | 1,548,915 | 19,512 | 5.06 |
| Total interest-earning assets | 2,561,950 | 24,998 | 3.91 | 2,264,440 | 24,299 | 4.31 |
| Allowance for loan losses | (26,282) | | | (24,474) | | |
| Other noninterest-earning assets | 253,436 | | | 233,922 | | |
| Total assets | $ 2,789,104 | | | $ 2,473,888 | | |
| **Interest-bearing liabilities:** | | | | | | |
| Deposits: | | | | | | |
| Interest-bearing demand | $ 489,047 | $ 176 | 0.14% | $ 409,720 | $ 145 | 0.14% |
| Savings and money market | 739,328 | 242 | 0.13 | 553,701 | 251 | 0.18 |
| Time deposits | 635,583 | 1,247 | 0.79 | 689,103 | 1,773 | 1.03 |
| Total interest-bearing deposits | 1,863,958 | 1,665 | 0.36 | 1,652,524 | 2,169 | 0.53 |
| Short-term borrowings | 153,626 | 153 | 0.40 | 162,718 | 174 | 0.43 |
| Total interest-bearing liabilities | 2,017,584 | 1,818 | 0.36 | 1,815,242 | 2,343 | 0.52 |
| Noninterest-bearing demand deposits | 501,354 | | | 398,353 | | |
| Other noninterest-bearing liabilities | 13,259 | | | 15,451 | | |
| Shareholders equity | 256,907 | | | 244,842 | | |
| Total liabilities and shareholders equity | $ 2,789,104 | | | $ 2,473,888 | | |
| Net interest income (tax-equivalent) | | $ 23,180 | | | $ 21,956 | |

| | | | | |
|---|---|---|---|---|
| Interest rate spread | | 3.55% | | 3.79% |
| Net earning assets | $ 544,366 | | $ 449,198 | |
| Net interest margin (tax-equivalent) | | 3.63% | | 3.89% |
| Ratio of average interest-earning assets to average interest-bearing liabilities | | 126.98% | | 124.75% |

(1) Investment securities are shown at amortized cost and include non-performing securities.

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

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**MANAGEMENT S DISCUSSION AND ANALYSIS**

| | Six months ended June 30, | | | | | |
|---|---|---|---|---|---|---|
| | 2013 | | | 2012 | | |
| | Average Balance | Interest | Average Rate | Average Balance | Interest | Average Rate |
| **Interest-earning assets:** | | | | | | |
| Federal funds sold and interest-earning deposits | $ 272 | $ | 0.20% | $ 94 | $ | 0.25% |
| Investment securities [1]: | | | | | | |
| Taxable | 611,364 | 6,262 | 2.05 | 511,101 | 6,137 | 2.40 |
| Tax-exempt [2] | 221,730 | 3,669 | 3.31 | 159,056 | 3,071 | 3.86 |
| Total investment securities | 833,094 | 9,931 | 2.38 | 670,157 | 9,208 | 2.75 |
| Loans: | | | | | | |
| Commercial business | 257,638 | 5,725 | 4.48 | 234,901 | 5,459 | 4.67 |
| Commercial mortgage | 425,982 | 10,682 | 5.06 | 406,939 | 11,071 | 5.47 |
| Residential mortgage | 126,824 | 3,208 | 5.06 | 114,893 | 3,070 | 5.34 |
| Home equity | 294,140 | 6,093 | 4.18 | 237,879 | 5,042 | 4.26 |
| Consumer indirect | 591,671 | 13,370 | 4.56 | 506,360 | 13,182 | 5.24 |
| Other consumer | 24,804 | 1,365 | 11.10 | 23,487 | 1,224 | 10.48 |
| Total loans | 1,721,059 | 40,443 | 4.74 | 1,524,459 | 39,048 | 5.15 |
| Total interest-earning assets | 2,554,425 | 50,374 | 3.97 | 2,194,710 | 48,256 | 4.42 |
| Allowance for loan losses | (25,537) | | | (24,155) | | |
| Other noninterest-earning assets | 255,793 | | | 237,754 | | |
| Total assets | $ 2,784,681 | | | $ 2,408,309 | | |
| **Interest-bearing liabilities:** | | | | | | |
| Deposits: | | | | | | |
| Interest-bearing demand | $ 491,835 | $ 314 | 0.13% | $ 401,037 | $ 291 | 0.15% |
| Savings and money market | 716,632 | 462 | 0.13 | 530,622 | 534 | 0.20 |
| Time deposits | 641,534 | 2,560 | 0.80 | 696,237 | 3,742 | 1.08 |
| Total interest-bearing deposits | 1,850,001 | 3,336 | 0.36 | 1,627,896 | 4,567 | 0.56 |
| Short-term borrowings | 172,415 | 343 | 0.40 | 129,906 | 285 | 0.44 |
| Total interest-bearing liabilities | 2,022,416 | 3,679 | 0.37 | 1,757,802 | 4,852 | 0.56 |
| Noninterest-bearing demand deposits | 491,685 | | | 392,753 | | |
| Other noninterest-bearing liabilities | 14,208 | | | 15,077 | | |
| Shareholders equity | 256,372 | | | 242,677 | | |
| Total liabilities and shareholders equity | $ 2,784,681 | | | $ 2,408,309 | | |
| Net interest income (tax-equivalent) | | $ 46,695 | | | $ 43,404 | |
| Interest rate spread | | | 3.60% | | | 3.86% |
| Net earning assets | $ 532,009 | | | $ 436,908 | | |

| | | |
|---|---|---|
| Net interest margin (tax-equivalent) | 3.68% | 3.97% |
| Ratio of average interest-earning assets to average interest-bearing liabilities | 126.31% | 124.86% |

(1) Investment securities are shown at amortized cost and include non-performing securities.
(2) The interest on tax-exempt securities is calculated on a tax equivalent basis assuming a Federal tax rate of 35%.

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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 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):

| | Three months ended June 30, 2013 vs. 2012 | | | Six months ended June 30, 2013 vs. 2012 | | |
|---|---|---|---|---|---|---|
| | Volume | Rate | Total | Volume | Rate | Total |
| **Increase (decrease) in:** | | | | | | |
| **Interest income:** | | | | | | |
| Federal funds sold and interest-earning deposits | $ | $ | $ | $ | $ | $ |
| Investment securities: | | | | | | |
| Taxable | 315 | (420) | (105) | 1,103 | (978) | 125 |
| Tax-exempt | 486 | (234) | 252 | 1,083 | (485) | 598 |
| Total investment securities | 801 | (654) | 147 | 2,186 | (1,463) | 723 |
| Loans: | | | | | | |
| Commercial business | 207 | (85) | 122 | 512 | (246) | 266 |
| Commercial mortgage | 285 | (457) | (172) | 503 | (892) | (389) |
| Residential mortgage | 99 | (64) | 35 | 308 | (170) | 138 |
| Home equity | 586 | (61) | 525 | 1,167 | (116) | 1,051 |
| Consumer indirect | 907 | (921) | (14) | 2,057 | (1,869) | 188 |
| Other consumer | 17 | 39 | 56 | 71 | 70 | 141 |
| Total loans | 2,101 | (1,549) | 552 | 4,618 | (3,223) | 1,395 |
| **Total interest income** | 2,902 | (2,203) | 699 | 6,804 | (4,686) | 2,118 |
| **Interest expense:** | | | | | | |
| Deposits: | | | | | | |
| Interest-bearing demand | 29 | 2 | 31 | 61 | (38) | 23 |
| Savings and money market | 71 | (80) | (9) | 154 | (226) | (72) |
| Time deposits | (130) | (396) | (526) | (276) | (906) | (1,182) |
| Total interest-bearing deposits | (30) | (474) | (504) | (61) | (1,170) | (1,231) |
| Short-term borrowings | (10) | (11) | (21) | 87 | (29) | 58 |
| **Total interest expense** | (40) | (485) | (525) | 26 | (1,199) | (1,173) |
| **Net interest income** | $ 2,942 | $ (1,718) | $ 1,224 | $ 6,778 | $ (3,487) | $ 3,291 |

**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. There were provisions for loan losses of $1.2 million and $3.9 million for the three and six month periods ended June 30, 2013, compared with provisions of $1.5 million and $2.8 million for the corresponding periods in 2012, respectively. The increase in provision for the six months ended June 30, 2013 is primarily a result of higher net-charge-offs in 2013 versus 2012. 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.

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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 June 30, | | Six months ended June 30, | |
|---|---|---|---|---|
| | 2013 | 2012 | 2013 | 2012 |
| Service charges on deposits | 2,568 | 1,974 | 4,709 | 3,809 |
| ATM and debit card | 1,317 | 1,072 | 2,566 | 2,149 |
| Broker-dealer fees and commissions | 650 | 434 | 1,349 | 1,021 |
| Company owned life insurance | 438 | 441 | 853 | 867 |
| Net gain on disposal of investment securities | 332 | 1,237 | 1,224 | 1,568 |
| Loan servicing | 152 | 409 | 225 | 503 |
| Net gain on sale of loans held for sale | 35 | 325 | 235 | 658 |
| Impairment charges on investment securities | | | | (91) |
| Net gain on disposal of other assets | 38 | 29 | 39 | 35 |
| Other | 846 | 769 | 1,729 | 1,622 |
| Total noninterest income | 6,376 | 6,690 | 12,929 | 12,141 |

Service charges on deposit accounts increased $594 thousand or 30% in the second quarter of 2013 and $900 thousand or 24% for the six months ended June 30, 2013, compared to the same periods a year earlier. ATM and debit card income increased $245 thousand or 23% in the second quarter of 2013 and $417 thousand or 19% for the six months ended June 30, 2013, compared to the same periods a year earlier. These increases reflect volume related growth in fees resulting from the 2012 branch acquisitions coupled with the second quarter 2013 retail checking account repositioning that involved simplifying the suite of products offered to customers and modifications to the fee structure for our accounts. The fee waiver process was also reevaluated, which resulted in a reduction in the number of fee waivers which led to an increase in service charges. The Company expects the income from service charges on deposits to gradually stabilize over the longer term as customers determine the optimal mix of our products and services to best suit their banking needs.

Management continues to focus on diversifying its sources of revenue to further reduce the Company s reliance on traditional spread-based interest income, as fee-based activities are a relatively stable revenue source during periods of changing interest rates.

Broker-dealer fees and commissions were up $216 thousand or 50% and $328 thousand or 32%, respectively, in the three and six months ended June 30, 2013, compared to the same periods of 2012. Broker-dealer fees and commissions fluctuate mainly due to sales volume, which increased during the first half of 2013 as a result of favorable market conditions and new business opportunities.

We recognized pre-tax gains on investment securities of $892 thousand and $332 thousand, respectively, during the first and second quarters of 2013, from the sale of pooled trust-preferred securities. Each of the securities had been written down in prior periods and was included in non-performing assets at the end of the quarter preceding its sale. We recognized pre-tax gains on investment securities of $331 thousand and $1.2 million, respectively, during the first and second quarters of 2012, from the sale of pooled trust-preferred securities. The amount and timing of our sale of investments securities is dependent on a number of factors, including our prudent efforts to realize gains while managing duration, premium and credit risk.

Loan servicing income represents fees earned for servicing mortgage and indirect auto loans sold to third parties, net of amortization expense and impairment losses, if any, associated with capitalized loan servicing assets. Loan servicing income was down $257 thousand in the second quarter of 2013 and $278 thousand for the six months ended June 30, 2013, compared to the same periods a year ago. Loan servicing income decreased as a result of more rapid amortization of servicing rights due to loans paying off, lower fees collected due to a decrease in the sold and serviced portfolio and adjustments to the valuation allowance for capitalized mortgage servicing assets.

Gains from the sale of loans held for sale decreased $290 thousand in the second quarter of 2013 and $423 thousand for the six months ended June 30, 2013, compared to the same periods a year earlier. The decrease was primarily due to lower loan origination volume and margins resulting from higher interest rates.

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**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, | |
|---|---|---|---|---|
| | 2013 | 2012 | 2013 | 2012 |
| Salaries and employee benefits | 9,226 | 9,071 | 18,935 | 18,127 |
| Occupancy and equipment | 3,035 | 2,715 | 6,204 | 5,485 |
| Professional services | 1,093 | 1,080 | 2,030 | 1,791 |
| Computer and data processing | 812 | 886 | 1,516 | 1,486 |
| Supplies and postage | 608 | 573 | 1,288 | 1,031 |
| FDIC assessments | 364 | 304 | 725 | 601 |
| Advertising and promotions | 253 | 137 | 467 | 238 |
| Other | 2,071 | 1,815 | 3,881 | 3,479 |
| Total noninterest expense | 17,462 | 16,581 | 35,046 | 32,238 |

During the three and six month periods ended June 30, 2013, salaries and employee benefits increased by $155 thousand or 2% and $808 thousand or 4%, respectively, when compared to the same periods one year earlier. The increase in salaries and employee benefits for the three and six months periods ended June 30, 2013 when compared to the same periods in 2012 are attributable to increased staffing levels, partially offset by lower pension, severance and stock based compensation expense. The number of full time equivalent employees increased by 4% to 617 at June 30, 2013, from 591 at June 30, 2012, primarily due to the branch acquisitions.

Occupancy and equipment and supplies and postage expense increased collectively by $355 thousand in the second quarter of 2013 and $976 thousand for the six months ended June 30, 2013, when compared to the same periods one year earlier. The increases were primarily related to the growth in the branch network related to the 2012 branch acquisitions.

Professional fees were $1.1 million in the second quarter of 2013 and $2.0 million for the six months ended June 30, 2013. Professional fees for the second quarter and six months ended June 30, 2012 include $543 thousand and $604 thousand, respectively, of expenses related to the branch acquisition transactions. Excluding the branch acquisition expenses, professional fees increased $556 thousand in the second quarter of 2013 and $843 thousand for the six months ended June 30, 2013, respectively, from the same periods in 2012, due in part to executive management transitions and other corporate governance initiatives.

FDIC assessments increased $60 thousand or 20% in the second quarter of 2013 and $124 thousand or 21% for the six months ended June 30, 2013, compared to the same periods a year earlier. The increased assessments are a direct result of the growth in our balance sheet.

Advertising and promotions costs were up $116 thousand in the second quarter of 2013 and $229 thousand for the six months ended June 30, 2013, compared to the same periods a year earlier, due to the timing of marketing campaigns and promotions, and new product launches. We proactively market our products but vary the timing based on projected benefits and needs.

Other noninterest expense was $2.1 million in the second quarter of 2013 and $3.9 million for the six months ended June 30, 2013, representing increases of $256 thousand and $402 thousand, respectively, from the same periods in 2012. The three and six month periods ended June 30, 2013, included $98 thousand and $199 thousand, respectively, of core deposit intangible amortization expense related to the 2012 branch acquisitions. There was no amortization expense for the first half of 2012. The second quarter of 2013 also included expenses related to our digital marketing initiatives, including the launch of our new retail checking products.

The efficiency ratio for the second quarter of 2013 was 59.38% compared with 60.41% for the second quarter of 2012, and 59.62% for the six months ended June 30, 2013, compared to 59.52% for the same period a year ago. The efficiency ratio is calculated by dividing total noninterest expense, excluding other real estate expense and amortization of intangible assets, by net revenue, defined as the sum of tax-equivalent net

interest income and noninterest income before net gains and impairment charges 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 would indicate a more efficient allocation of resources.

**Income Taxes**

We recorded income tax expense of $3.4 million in the second quarters of 2013 and 2012. For the six month period ended June 30, 2013, income tax expense totaled $6.4 million compared to $6.5 million in the same period of 2012. The effective tax rates for the three and six month periods ended June 30, 2013 were 33.1% and 33.0%, respectively, in comparison to 33.7% for both the three and six month periods ended June 30, 2012. 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.

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MANAGEMENT S DISCUSSION AND ANALYSIS

*ANALYSIS OF FINANCIAL CONDITION*

**INVESTING ACTIVITIES**

**Investment Securities**

The following table sets forth selected information regarding the composition of our investment securities portfolio as of the dates indicated (in thousands):

| | Investment Securities Portfolio Composition | | | |
|---|---|---|---|---|
| | June 30, 2013 | | December 31, 2012 | |
| | Amortized Cost | Fair Value | Amortized Cost | Fair Value |
| **Securities available for sale:** | | | | |
| U.S. Government agencies and government-sponsored enterprise securities | $ 113,683 | $ 112,939 | $ 128,097 | $ 131,695 |
| State and political subdivisions | 222,726 | 222,706 | 188,997 | 195,210 |
| Mortgage-backed securities: | | | | |
| Agency mortgage-backed securities | 475,322 | 471,823 | 479,913 | 494,770 |
| Non-Agency mortgage-backed securities | | 2,604 | 73 | 1,098 |
| Asset-backed securities [(1)] | 18 | 477 | 121 | 1,023 |
| Total available for sale securities | 811,749 | 810,549 | 797,201 | 823,796 |
| **Securities held to maturity:** | | | | |
| State and political subdivisions | 17,348 | 17,821 | 17,905 | 18,478 |
| Total investment securities | $ 829,097 | $ 828,370 | $ 815,106 | $ 842,274 |

(1) Includes non-performing investment securities. See Non-Performing Assets and Potential Problem Loans under the section titled Lending Activities included herein for additional information.

The available-for-sale ( AFS ) investment securities portfolio decreased $13.2 million or 2%, from $823.8 million at December 31, 2012 to $810.5 million at June 30, 2013. The decrease occurred based on the combination of scheduled principal paydowns on amortizing securities and a change in the net unrealized gain/loss on the AFS portfolio. The AFS portfolio had net unrealized losses totaling $1.2 million at June 30, 2013 compared to net unrealized gains of $26.6 million at December 31, 2012. The unrealized loss on the AFS portfolio was 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.

As previously discussed, we utilized the proceeds from short-term FHLB advances to purchase high-quality investment securities as part of a leverage strategy of approximately $100 million. Our purchase of investment securities was comprised of mortgage-backed securities, U.S. Government agencies and sponsored enterprise bonds and tax-exempt municipal bonds. This strategy allowed us to increase net interest income by taking advantage of the positive interest rate spread between the FHLB advances and the newly acquired investment securities.

**Impairment Assessment**

We review investment securities on an ongoing basis for the presence of 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 the intent to sell the debt security or the likelihood of being required to sell the security before the recovery of its amortized cost basis. In determining whether the other-than-temporary impairment 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: the length of time and the extent to which the fair value has been less than the amortized cost basis, adverse conditions specifically related to the security, an industry, or a geographic area, the historical and implied volatility of the fair value of the security, the payment structure of the debt security and the likelihood of the issuer being able to make payments that increase in the future, failure of the issuer of the security to make scheduled interest or principal payments, any changes to the rating of the security by a rating agency, and 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.

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MANAGEMENT S DISCUSSION AND ANALYSIS

**Securities Deemed to be Other-Than-Temporarily Impaired**

There were no securities deemed to be other-than-temporarily impaired during the six months ended June 30, 2013. During the six months ended June 30, 2012, we recognized an OTTI charge of $91 thousand on a privately issued whole loan CMO that we determined was other-than-temporarily impaired due to credit quality.

**LENDING ACTIVITIES**

The following table sets forth selected information regarding the composition of the Company s loan portfolio as of the dates indicated (in thousands).

| | Loan Portfolio Composition | | | |
|---|---|---|---|---|
| | June 30, 2013 | | December 31, 2012 | |
| | Amount | % of Total | Amount | % of Total |
| Commercial business | $ 257,732 | 14.8% | $ 258,675 | 15.2% |
| Commercial mortgage | 437,515 | 25.1 | 413,324 | 24.2 |
| Total commercial | 695,247 | 39.9 | 671,999 | 39.4 |
| Residential mortgage | 118,117 | 6.8 | 133,520 | 7.8 |
| Home equity | 306,215 | 17.5 | 286,649 | 16.8 |
| Consumer indirect | 599,586 | 34.4 | 586,794 | 34.4 |
| Other consumer | 24,249 | 1.4 | 26,764 | 1.6 |
| Total consumer | 930,050 | 53.3 | 900,207 | 52.8 |
| Total loans | 1,743,414 | 100.0% | 1,705,726 | 100.0% |
| Allowance for loan losses | 25,590 | | 24,714 | |
| Total loans, net | $ 1,717,824 | | $ 1,681,012 | |

Total loans increased $37.7 million to $1.74 billion at June 30, 2013 from $1.71 billion as of December 31, 2012. The increase in loans was attributable to organic growth, primarily in the commercial and consumer loan portfolios, partially offset by a decline in residential mortgages.

Commercial loans increased $23.2 million and represented 40% of total loans as of June 30, 2013, a result of our continued commercial business development efforts.

Residential mortgage loans decreased $15.4 million to $118.1 million as of June 30, 2013 in comparison to $133.5 million as of December 31, 2012. This category of loans decreased as the majority of newly originated and refinanced residential mortgages were sold to the secondary market rather than being added to our portfolio, coupled with our focus in home equity lending.

Our home equity portfolio, which consists of home equity loans and lines, totaled $306.2 million as of June 30, 2013, up $19.6 million or 7% compared to December 31, 2012. We continue to grow our home equity portfolio as the lower origination cost and convenience to customers has made these products an increasingly attractive alternative to conventional residential mortgage loans. As of June 30, 2013, approximately 73% of the loans in the home equity portfolio were first lien positions.

The consumer indirect portfolio increased $12.8 million to $599.6 million as of June 30, 2013, from $586.8 million as of December 31, 2012. During the first six months of 2013 we originated $141.9 million in indirect auto loans with an equal mix of new and used auto. This compares

with $153.5 million in indirect auto loans originated with a mix of approximately 48% new auto and 52% used auto for the same period in 2012.

**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 mortgages and totaled $3.4 million and $1.5 million at June 30, 2013 and December 31, 2012, respectively.

We sell certain qualifying newly originated or refinanced residential real estate mortgages on the secondary market. Residential real estate mortgages serviced for others, which are not included in the consolidated statements of financial condition, amounted to $256.8 million as of June 30, 2013 and $273.3 million as of December 31, 2012.

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MANAGEMENT S DISCUSSION AND ANALYSIS

**Allowance for Loan Losses**

The following table sets forth an analysis of 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, | |
| | 2013 | 2012 | 2013 | 2012 |
| Balance as of beginning of period | $ 25,827 | $ 23,763 | $ 24,714 | $ 23,260 |
| Charge-offs: | | | | |
| Commercial business | 292 | 144 | 531 | 199 |
| Commercial mortgage | 106 | 227 | 109 | 347 |
| Residential mortgage | 85 | 127 | 247 | 233 |
| Home equity | 53 | 93 | 322 | 97 |
| Consumer indirect | 1,929 | 1,407 | 3,647 | 2,802 |
| Other consumer | 229 | 90 | 481 | 404 |
| Total charge-offs | 2,694 | 2,088 | 5,337 | 4,082 |
| Recoveries: | | | | |
| Commercial business | 205 | 155 | 242 | 232 |
| Commercial mortgage | 143 | 61 | 157 | 76 |
| Residential mortgage | 13 | 28 | 30 | 98 |
| Home equity | 73 | 11 | 110 | 20 |
| Consumer indirect | 759 | 746 | 1,564 | 1,473 |
| Other consumer | 71 | (15) | 208 | 199 |
| Total recoveries | 1,264 | 986 | 2,311 | 2,098 |
| Net charge-offs | 1,430 | 1,102 | 3,026 | 1,984 |
| Provision for loan losses | 1,193 | 1,459 | 3,902 | 2,844 |
| Balance at end of period | $ 25,590 | $ 24,120 | $ 25,590 | $ 24,120 |
| Net loan charge-offs to average loans (annualized) | 0.33% | 0.29% | 0.35% | 0.26% |
| Allowance for loan losses to total loans | 1.47% | 1.49% | 1.47% | 1.49% |
| Allowance for loan losses to non-performing loans | 227% | 213% | 227% | 213% |

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, 2013.

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 recognize additions to

the allowance based on their judgments about information available to them at the time of their examination.

Net charge-offs of $1.4 million in the second quarter of 2013 represented 0.33% of average loans on an annualized basis compared to $1.1 million or 0.29% in the second quarter of 2012. For the six months ended June 30, 2013 net charge-offs of $3.0 million represented 0.35% of average loans compared to $2.0 million or 0.26% of average loans for same period in 2012. See the Non-Performing Assets and Potential Problem Loans section for further discussion.

The allowance for loan losses was $25.6 million at June 30, 2013, compared with $24.7 million at December 31, 2012. The ratio of the allowance for loan losses to total loans was 1.47% at June 30, 2013, compared with 1.45% at December 31, 2012. The ratio of allowance for loan losses to non-performing loans was 227% at June 30, 2013, compared with 271% at December 31, 2012.

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**Non-Performing Assets and Potential Problem Loans**

The table below sets forth the amounts and categories of the Company s non-performing assets at the dates indicated (in thousands).

| | Non-Performing Assets | |
|---|---|---|
| | June 30, 2013 | December 31, 2012 |
| Nonaccrual loans: | | |
| Commercial business | $ 5,043 | $ 3,413 |
| Commercial mortgage | 3,073 | 1,799 |
| Residential mortgage | 1,423 | 2,040 |
| Home equity | 699 | 939 |
| Consumer indirect | 1,035 | 891 |
| Other consumer | 6 | 25 |
| Total nonaccrual loans | 11,279 | 9,107 |
| Accruing loans 90 days or more delinquent | 16 | 18 |
| Total non-performing loans | 11,295 | 9,125 |
| Foreclosed assets | 415 | 184 |
| Non-performing investment securities | 207 | 753 |
| Total non-performing assets | $ 11,917 | $ 10,062 |
| Non-performing loans to total loans | 0.65% | 0.53% |
| Non-performing assets to total assets | 0.43% | 0.36% |

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 month periods ended June 30, 2013 was as follows (in thousands):

| | Three months ended June 30, 2013 | Six months ended June 30, 2013 |
|---|---|---|
| Nonaccrual loans, beginning of period | $ 11,761 | $ 9,107 |
| Additions | 4,513 | 12,065 |
| Payments | (1,947) | (3,586) |
| Charge-offs | (2,552) | (5,028) |
| Returned to accruing status | (280) | (653) |
| Transferred to other real estate or repossessed assets | (216) | (626) |
| Nonaccrual loans, end of period | $ 11,279 | $ 11,279 |

Non-performing assets include non-performing loans, foreclosed assets and non-performing investment securities. Non-performing assets at June 30, 2013 were $11.9 million, an increase of $1.9 million from the $10.1 million balance at December 31, 2012. The primary component of non-performing assets is non-performing loans, which were $11.3 million or 0.65% of total loans at June 30, 2013, an increase of $2.2 million from $9.1 million or 0.53% of total loans at December 31, 2012. The Company s ratio of non-performing loans to total loans continues to compare favorably to its peer group average, which was 2.02% of total loans at March 31, 2013, the most recent period for which information is

available (Source: Federal Financial Institutions Examination Council Bank Holding Company Performance Report as of March 31, 2013 Top-tier bank holding companies having consolidated assets between $1 billion and $3 billion).

The increase in non-performing loans during the first half of 2013 was due to the addition of one credit relationship consisting of commercial business and commercial mortgage loans with unpaid principal balances totaling $3.0 million at June 30, 2013.

Approximately $7.0 million, or 62%, of the $11.3 million in non-performing loans as of June 30, 2013 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 $2.0 million and $636 thousand at June 30, 2013 and December 31, 2012, respectively. We had no TDRs that were accruing interest as of June 30, 2013 or December 31, 2012.

Foreclosed assets consist of real property formerly pledged as collateral to loans, which we have acquired through foreclosure proceedings or acceptance of a deed in lieu of foreclosure. Foreclosed asset holdings represented 4 properties totaling $415 thousand at June 30, 2013 and 5 properties totaling $184 thousand at December 31, 2012.

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**MANAGEMENT S DISCUSSION AND ANALYSIS**

Non-performing investment securities for which we have stopped accruing interest were $207 thousand at June 30, 2013, compared to $753 thousand at December 31, 2012. Non-performing investment securities are included in non-performing assets at fair value and is comprised of one pooled trust preferred security at June 30, 2013. There have been no securities transferred to non-performing status since the first quarter of 2009. During the first six months of 2013, we recognized gains totaling $1.2 million from the sale of four pooled trust-preferred securities. The four securities had a fair value of $550 thousand at December 31, 2012. We continue to monitor the market for the security and evaluate the potential for a future disposition.

Potential problem loans are loans that are currently performing, but information known about possible credit problems of the borrowers causes management 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. Management considers loans classified as substandard, which continue to accrue interest, to be potential problem loans. We identified $11.0 million and $13.8 million in loans that continued to accrue interest which were classified as substandard as of June 30, 2013 and December 31, 2012, respectively. The decrease in potential problems relates to the $3.0 million credit relationship discussed above which migrated to non-performing classification during the first six months of 2013.

In addition, we currently have a large commercial relationship with an Industrial Development Agency project in our market area. The relationship consists of a $13.7 million first lien mortgage position and $3.4 million second lien mortgage on a manufacturing facility. Events with the underlying third party tenant of the project resulted in our monitoring the credit relationship more closely and including the first mortgage loan as uncriticized watch in our loan rating system during the fourth quarter of 2012. The second mortgage loan was upgraded from special mention to uncriticized watch as of June 30, 2013. The loans are current as of June 30, 2013.

**FUNDING ACTIVITIES**

**Deposits**

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

| | Deposit Composition | | | |
|---|---|---|---|---|
| | June 30, 2013 | | December 31, 2012 | |
| | Amount | % of Total | Amount | % of Total |
| Noninterest-bearing demand | $ 511,802 | 22.0% | $ 501,514 | 22.2% |
| Interest-bearing demand | 475,448 | 20.5 | 449,744 | 19.9 |
| Savings and money market | 713,459 | 30.7 | 655,598 | 28.9 |
| Time deposits < $100,000 | 392,968 | 16.9 | 432,506 | 19.2 |
| Time deposits of $100,000 or more | 230,559 | 9.9 | 222,432 | 9.8 |
| Total deposits | $ 2,324,236 | 100.0% | $ 2,261,794 | 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, 2013, total deposits were $2.32 billion, an increase of $62.4 million in comparison to $2.26 billion as of December 31, 2012. Public deposit balances increased $86.9 million during the first half of 2013 due largely to the seasonality of municipal cash flows and successful business development efforts in our newly acquired branches. Time deposits were approximately 27% and 29% of total deposits at June 30, 2013 and December 31, 2012, respectively. Depositors remain hesitant to invest in time deposits, such as certificates of deposit, for long periods due to the low interest rate environment. This has resulted in lower amounts being placed in time deposits for generally shorter terms.

Nonpublic deposits, the largest component of our funding sources, represented 77% of total deposits and totaled $1.78 billion and $1.81 billion at June 30, 2013 and December 31, 2012, respectively. 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.

We had no traditional brokered deposits at June 30, 2013 or December 31, 2012, however, we do participate in the Certificate of Deposit Account Registry Service ( CDARS ) and Insured Cash Sweep ( ICS ) programs, which enable depositors to receive FDIC insurance coverage for deposits otherwise exceeding the maximum insurable amount. CDARS 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 totaled $53.8 million and $61.0 million at June 30, 2013 and December 31, 2012, respectively. ICS deposits totaled $49.0 million and $18.1 million at June 30, 2013 and December 31, 2012, respectively.

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As an additional source of funding, we offer a variety of public (municipal) deposit products to the many towns, villages, counties and school districts within our market. Public deposits generally range from 20% to 27% 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 $541.2 million and $454.2 million at June 30, 2013 and December 31, 2012, respectively, and represented 23% and 20% of total deposits as of the end of each period, respectively.

**Borrowings**

The following table summarizes our borrowings as of the dates indicated (in thousands):

| | June 30, 2013 | December 31, 2012 |
|---|---|---|
| Short-term borrowings: | | |
| Customer repurchase agreements | $ 39,913 | $ 40,806 |
| Short-term FHLB borrowings | 153,500 | 139,000 |
| Total short-term borrowings | $ 193,413 | $ 179,806 |

We classify borrowings as short-term or long-term in accordance with the original terms of the agreement. There were no long-term borrowings outstanding as of June 30, 2013 or December 31, 2012.

We have credit capacity with the FHLB and can borrow through facilities that include amortizing and term advances or repurchase agreements. We had approximately $53 million of immediate credit capacity with FHLB as of June 30, 2013. We had approximately $456 million in secured borrowing capacity at the Federal Reserve Bank ( FRB ) Discount Window, none of which was outstanding at June 30, 2013. The FHLB and FRB credit capacity are collateralized by securities from our investment portfolio and certain qualifying loans. We had approximately $120 million of credit available under unsecured federal funds purchased lines with various banks at June 30, 2013. Additionally, we had approximately $74 million of unencumbered liquid securities available for pledging.

Federal funds purchased are overnight borrowings with correspondent banks. Short-term repurchase agreements are secured overnight borrowings with customers. 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, 2013 consisted of $53.5 million in overnight borrowings and $100.0 million in short-term advances. Short-term FHLB borrowings at December 31, 2012 consisted of $99.0 million in overnight borrowings and $40.0 million in short-term advances.

As previously discussed, during the first quarter of 2013 we leveraged our balance sheet through the execution of short-term FHLB advances in order to acquire investment securities to take advantage of the positive interest rate spread and increase net interest income.

**Shareholders Equity**

Shareholders equity was $244.9 million at June 30, 2013, a decrease of $9.0 million from $253.9 million at December 31, 2012. Net income for the first six months of 2013 increased shareholders equity by $13.0 million, which was partially offset by common and preferred stock dividends declared of $5.7 million. Accumulated other comprehensive income included in shareholders equity decreased $16.4 million due primarily to net unrealized losses on securities available for sale that arose during the first six months of 2013.

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**MANAGEMENT S DISCUSSION AND ANALYSIS**

**LIQUIDITY AND CAPITAL RESOURCES**

**Liquidity**

The objective of maintaining adequate liquidity is to assure our ability to meet our financial obligations. These obligations include the withdrawal of deposits on demand or at their contractual maturity, the servicing and repayment of debt and preferred equity obligations, the ability to fund new and existing loan commitments, to take advantage of new business opportunities and to satisfy other operating requirements. We achieve liquidity by maintaining a strong base of core customer funds, maturing short-term assets, the ability to sell or pledge securities, lines of credit, and 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, as well as the results of its operations and capital expenditures. 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 sources of liquidity for the parent company are dividends from the Bank and access to financial and capital markets. Dividends from the Bank are limited by various regulatory requirements related to capital adequacy and earnings trends. The Bank relies on cash flows from operations, core deposits, borrowings and short-term liquid assets. Five Star Investment Services relies on cash flows from operations and funds from the parent company when necessary. As a secondary source of liquidity, the Company also has the ability to draw up to $20.0 million on a revolving credit line with a correspondent bank.

The Company s cash and cash equivalents were $50.9 million as of June 30, 2013, down $9.5 million from $60.4 million as of December 31, 2012. Net cash provided by operating activities totaled $26.6 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 $106.5 million, which included cash outflows of $41.3 million for net loan originations and $63.3 million from investment securities transactions. Net cash provided by financing activities of $70.4 million was attributed to increase of $62.4 million and $13.6 million in deposits and short-term borrowings, respectively, partly offset by $5.4 million in dividend payments.

**Capital Resources**

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.

Quantitative measures established by regulation to ensure capital adequacy require the Company and the Bank to maintain minimum amounts and ratios of Total and Tier 1 capital to risk-weighted assets and of Tier 1 capital to average assets (all as defined in the regulations). These minimum amounts and ratios are included in the table below.

The Company s and the Bank s Tier 1 capital consists of shareholders equity excluding unrealized gains and losses on securities available for sale (except for unrealized losses which have been determined to be other than temporary and recognized as expense in the consolidated statements of income), goodwill and other intangible assets and disallowed portions of deferred tax assets. Tier 1 capital for the Company includes, subject to limitation, $17.4 million and $17.5 million of preferred stock at June 30, 2013 and December 31, 2012, respectively. The Company and the Bank s total capital are comprised of Tier 1 capital for each entity plus a permissible portion of the allowance for loan losses.

The Tier 1 and total capital ratios are calculated by dividing the respective capital amounts by risk-weighted assets. Risk-weighted assets are calculated based on regulatory requirements and include total assets, excluding goodwill and other intangible assets and disallowed portions of deferred tax assets, allocated by risk weight category and certain off-balance-sheet items (primarily loan commitments and standby letters of credit). The leverage ratio is calculated by dividing Tier 1 capital by adjusted quarterly average total assets, which exclude goodwill and other intangible assets and disallowed portions of deferred tax assets.

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**MANAGEMENT S DISCUSSION AND ANALYSIS**

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

| | June 30, 2013 | December 31, 2012 |
|---|---|---|
| Total shareholders equity | $ 244,888 | $ 253,897 |
| Less: Unrealized (loss) gain on securities available for sale, net of tax | (725) | 16,060 |
| Unrecognized net periodic pension & postretirement benefits (costs), net of tax | (12,409) | (12,807) |
| Disallowed goodwill and other intangible assets | 50,190 | 50,389 |
| Tier 1 capital | $ 207,832 | $ 200,255 |
| Adjusted average total assets (for leverage capital purposes) | $ 2,739,444 | $ 2,596,122 |
| Tier 1 leverage ratio (Tier 1 capital to adjusted average total assets) | 7.59% | 7.71% |
| Total Tier 1 capital | $ 207,832 | $ 200,255 |
| Plus: Qualifying allowance for loan losses | 23,723 | 23,355 |
| Total risk-based capital | $ 231,555 | $ 223,610 |
| Net risk-weighted assets | $ 1,895,966 | $ 1,867,032 |
| Tier 1 capital ratio (Tier 1 capital to net risk-weighted assets) | 10.96% | 10.73% |
| Total risk-based capital ratio (Total risk-based capital to net risk-weighted assets) | 12.21% | 11.98% |

The Company s and the Bank s actual and required regulatory capital ratios were as follows (dollars in thousands):

| | | Actual | | For Capital Adequacy Purposes | | Well Capitalized | |
|---|---|---|---|---|---|---|---|
| | | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| **June 30, 2013** | | | | | | | |
| Tier 1 leverage: | Company | $ 207,832 | 7.59% | $ 109,578 | 4.00% | $ 136,972 | 5.00% |
| | Bank | 199,017 | 7.28 | 109,382 | 4.00 | 136,727 | 5.00 |
| Tier 1 capital: | Company | 207,832 | 10.96 | 75,839 | 4.00 | 113,758 | 6.00 |
| | Bank | 199,017 | 10.52 | 75,687 | 4.00 | 113,531 | 6.00 |
| Total risk-based capital: | Company | 231,555 | 12.21 | 151,677 | 8.00 | 189,597 | 10.00 |
| | Bank | 222,693 | 11.77 | 151,374 | 8.00 | 189,218 | 10.00 |
| **December 31, 2012** | | | | | | | |
| Tier 1 leverage: | Company | $ 200,255 | 7.71% | $ 103,845 | 4.00% | $ 129,806 | 5.00% |
| | Bank | 192,136 | 7.41 | 103,681 | 4.00 | 129,601 | 5.00 |
| Tier 1 capital: | Company | 200,255 | 10.73 | 74,681 | 4.00 | 112,022 | 6.00 |
| | Bank | 192,136 | 10.31 | 74,526 | 4.00 | 111,789 | 6.00 |
| Total risk-based capital: | Company | 223,610 | 11.98 | 149,363 | 8.00 | 186,703 | 10.00 |
| | Bank | 215,443 | 11.56 | 149,052 | 8.00 | 186,315 | 10.00 |

The leverage ratio decreased as of June 30, 2013 when compared to December 31, 2012 primarily as a result an increase in average assets. See the Recent Developments New Capital Rules section of this Management s Discussion and Analysis for a description of the new capital ratios that will be phased-in beginning in 2015.

**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.

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**ITEM 3. Quantitative and Qualitative Disclosures About Market Risk**

Our primary market risk is interest rate risk, which is defined as the potential variability of our earnings that arises from changes in market interest rates and the magnitude of the change at varying points along the yield curve. Changes in market interest rates, whether they are increases or decreases, can trigger repricings and changes in the pace of payments for both assets and liabilities, which individually or in combination may affect our net income, net interest income and net interest margin, either positively or negatively.

The principal objective of the Company s interest rate risk management is to evaluate the interest rate risk inherent in certain assets and liabilities, determine the appropriate level of risk to the Company given its business strategy, operating environment, capital and liquidity requirements and performance objectives, and manage the risk consistent with the guidelines approved by the Company s Board of Directors. The Company s management is responsible for reviewing with the Board its activities and strategies, the effect of those strategies on net interest income, the fair value of the portfolio and the effect that changes in interest rates will have on the portfolio and exposure limits. Management develops an Asset-Liability Policy that meets strategic objectives and regularly reviews the activities of the Bank.

The primary tool the Company uses to manage interest rate risk is a rate shock simulation to measure the rate sensitivity of the balance sheet. Rate shock simulation is a modeling technique used to estimate the impact of changes in rates on net interest income and the economic value of equity. The Company measures net interest income at risk 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 twelve and twenty four months. This simulation is based on management s 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 the future results and is based on many assumptions that, if changed, could cause a different outcome.

In addition to the changes in interest rate scenarios listed above, the Company typically runs other scenarios to measure interest rate risk, which vary depending on the economic and interest rate environments.

The Company has experienced no significant changes in market risk due to changes in interest rates since the Company s Annual Report on Form 10-K for the year ended December 31, 2012, dated March 18, 2013, as filed with the Securities and Exchange Commission.

**ITEM 4. Controls and Procedures**

***Evaluation of disclosure controls and procedures***

As of June 30, 2013, 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 ( Exchange Act ). Based upon that evaluation, the 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 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, 2013 that have materially affected, or are reasonably likely to materially affect, the Company s internal control over financial reporting.

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## 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, 2012, dated March 18, 2013, as filed with the Securities and Exchange Commission.

### ITEM 1A. Risk Factors

The Company has experienced no material changes in its risk factors from the disclosure included in the Company s Annual Report on Form 10-K for the year ended December 31, 2012, dated March 18, 2013, as filed with the Securities and Exchange Commission.

### 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 between Financial Institutions, Inc. and Martin K. Birmingham | Incorporated by reference to Exhibit 10.1 of the Form 8-K, dated May 23, 2013 |
| 10.2 | Executive Agreement between Financial Institutions, Inc. and Kevin B. Klotzbach | Incorporated by reference to Exhibit 10.2 of the Form 8-K, dated May 23, 2013 |
| 10.3 | Executive Agreement between Financial Institutions, Inc. and Richard J. Harrison | Incorporated by reference to Exhibit 10.3 of the Form 8-K, dated May 23, 2013 |
| 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 to18 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 | |

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## 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 6, 2013
Martin K. Birmingham
President and Chief Executive Officer
(Principal Executive Officer)

***/s/ Kevin B. Klotzbach*** , August 6, 2013
Kevin B. Klotzbach
Executive Vice President, Chief Financial Officer and Treasurer
(Principal Financial Officer)

***/s/ Michael D. Grover*** , August 6, 2013
Michael D. Grover
Senior Vice President and Chief Accounting Officer
(Principal Accounting Officer)