

FINANCIAL INSTITUTIONS INC

Form 10-Q

August 02, 2011

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

**Form 10-Q**

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

**For the quarterly period ended June 30, 2011  
or**

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

**Commission File Number: 000-26481**

(Exact name of registrant as specified in its charter)

**NEW YORK**

(State or other jurisdiction of  
incorporation or organization)

**16-0816610**

(I.R.S. Employer Identification No.)

**220 LIBERTY STREET, WARSAW, NEW YORK**

(Address of principal executive offices)

**14569**

(Zip Code)

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

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

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

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

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

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

The registrant had 13,805,830 shares of Common Stock, \$0.01 par value, outstanding as of July 28, 2011.



**FINANCIAL INSTITUTIONS, INC.**  
**Form 10-Q**  
**For the Quarterly Period Ended June 30, 2011**  
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**Table of Contents****PART I. FINANCIAL INFORMATION****ITEM 1. Financial Statements****FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES****Consolidated Statements of Financial Condition**

| <i>(Dollars in thousands, except share and per share data)</i>  | <b>June 30,<br/>2011<br/>(Unaudited)</b> | <b>December 31,<br/>2010</b> |
|---|--|------------------------------|
| <b>ASSETS</b>   |  |                              |
| Cash and cash equivalents:  |  |                              |
| Cash and due from banks   | \$ 45,990                                | \$ 38,964                    |
| Federal funds sold and interest-bearing deposits in other banks   | 94                                       | 94                           |
| Total cash and cash equivalents   | 46,084                                   | 39,058                       |
| Securities available for sale, at fair value  | 706,958                                  | 666,368                      |
| Securities held to maturity, at amortized cost (fair value of \$24,797 and \$28,849, respectively)                                    | 24,091                                   | 28,162                       |
| Loans held for sale   | 14,511                                   | 3,138                        |
| Loans (net of allowance for loan losses of \$20,632 and \$20,466, respectively)   | 1,347,420                                | 1,325,524                    |
| Company owned life insurance  | 26,632                                   | 26,053                       |
| Premises and equipment, net   | 32,940                                   | 33,263                       |
| Goodwill  | 37,369                                   | 37,369                       |
| Other assets  | 46,939                                   | 55,372                       |
| Total assets  | \$ 2,282,944                             | \$ 2,214,307                 |
| <b>LIABILITIES AND SHAREHOLDERS EQUITY</b>  |  |                              |
| Deposits:   |  |                              |
| Noninterest-bearing demand  | \$ 358,574                               | \$ 350,877                   |
| Interest-bearing demand   | 376,306                                  | 374,900                      |
| Savings and money market  | 438,173                                  | 417,359                      |
| Certificates of deposit   | 699,186                                  | 739,754                      |
| Total deposits  | 1,872,239                                | 1,882,890                    |
| Short-term borrowings   | 132,395                                  | 77,110                       |
| Long-term borrowings  | 26,702                                   | 26,767                       |
| Other liabilities   | 17,875                                   | 15,396                       |
| Total liabilities   | 2,049,211                                | 2,002,163                    |
| Shareholders equity:  |  |                              |
| Series A 3% preferred stock, \$100 par value; 1,533 shares authorized and issued  | 153                                      | 153                          |
| Series A preferred stock, \$5,000 liquidation preference per share, 7,503 shares authorized; 7,503 shares issued at December 31, 2010 |  | 36,210                       |
| Series B-1 8.48% preferred stock, \$100 par value, 200,000 shares authorized, 173,253 and 174,223 shares issued, respectively         | 17,326                                   | 17,422                       |

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|   |              |              |
|---|--------------|--------------|
| Total preferred equity  | 17,479       | 53,785       |
| Common stock, \$0.01 par value, 50,000,000 shares authorized; 14,161,597 and 11,348,122 shares issued, respectively | 142          | 113          |
| Additional paid-in capital  | 66,724       | 26,029       |
| Retained earnings   | 150,971      | 144,599      |
| Accumulated other comprehensive income (loss)   | 5,062        | (4,722)      |
| Treasury stock, at cost 355,767 and 410,616 shares, respectively  | (6,645)      | (7,660)      |
| Total shareholders equity   | 233,733      | 212,144      |
| Total liabilities and shareholders equity   | \$ 2,282,944 | \$ 2,214,307 |

See accompanying notes to the consolidated financial statements.

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

| <i>(Dollars in thousands, except per share amounts)</i>    | <b>Three months ended</b> |               | <b>Six months ended</b> |               |
|--|---------------------------|---------------|-------------------------|---------------|
|  | <b>June 30,</b>           |               | <b>June 30,</b>         |               |
|  | <b>2011</b>               | <b>2010</b>   | <b>2011</b>             | <b>2010</b>   |
| Interest income:   |                           |               |                         |               |
| Interest and fees on loans                                 | \$ 19,071                 | \$ 18,714     | \$ 38,106               | \$ 37,332     |
| Interest and dividends on investment securities            | 4,759                     | 5,485         | 9,363                   | 10,684        |
| Other interest income                                      |                           | 3             |                         | 10            |
| <b>Total interest income</b>                               | <b>23,830</b>             | <b>24,202</b> | <b>47,469</b>           | <b>48,026</b> |
| Interest expense:  |                           |               |                         |               |
| Deposits   | 2,934                     | 3,730         | 6,131                   | 7,514         |
| Short-term borrowings                                      | 110                       | 85            | 182                     | 163           |
| Long-term borrowings                                       | 533                       | 711           | 1,065                   | 1,421         |
| <b>Total interest expense</b>                              | <b>3,577</b>              | <b>4,526</b>  | <b>7,378</b>            | <b>9,098</b>  |
| <b>Net interest income</b>                                 | <b>20,253</b>             | <b>19,676</b> | <b>40,091</b>           | <b>38,928</b> |
| Provision for loan losses                                  | 1,328                     | 2,105         | 2,138                   | 2,523         |
| <b>Net interest income after provision for loan losses</b> | <b>18,925</b>             | <b>17,571</b> | <b>37,953</b>           | <b>36,405</b> |
| Noninterest income:  |                           |               |                         |               |
| Service charges on deposits                                | 2,243                     | 2,502         | 4,348                   | 4,732         |
| ATM and debit card   | 1,123                     | 1,054         | 2,139                   | 1,988         |
| Broker-dealer fees and commissions                         | 402                       | 359           | 788                     | 739           |
| Loan servicing   | 249                       | 140           | 598                     | 420           |
| Company owned life insurance                               | 279                       | 282           | 545                     | 551           |
| Net gain on sale of loans held for sale                    | 117                       | 115           | 341                     | 177           |
| Net gain on disposal of investment securities              | 4                         | 63            | 7                       | 69            |
| Impairment charges on investment securities                |                           |               |                         | (526)         |
| Net (loss) gain on sale and disposal of other assets       | (8)                       |               | 37                      | 2             |
| Other  | 565                       | 451           | 1,319                   | 897           |
| <b>Total noninterest income</b>                            | <b>4,974</b>              | <b>4,966</b>  | <b>10,122</b>           | <b>9,049</b>  |
| Noninterest expense:                                       |                           |               |                         |               |
| Salaries and employee benefits                             | 8,854                     | 8,044         | 17,255                  | 16,291        |
| Occupancy and equipment                                    | 2,644                     | 2,670         | 5,487                   | 5,441         |
| Professional services                                      | 571                       | 478           | 1,253                   | 1,084         |
| Computer and data processing                               | 648                       | 615           | 1,251                   | 1,186         |
| Supplies and postage                                       | 424                       | 431           | 876                     | 876           |
| FDIC assessments   | 168                       | 634           | 775                     | 1,236         |
| Advertising and promotions                                 | 253                       | 352           | 418                     | 539           |
| Other  | 1,591                     | 1,646         | 3,188                   | 2,955         |



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|   |          |          |           |           |
|---|----------|----------|-----------|-----------|
| Total noninterest expense                   | 15,153   | 14,870   | 30,503    | 29,608    |
| Income before income taxes                  | 8,746    | 7,667    | 17,572    | 15,846    |
| Income tax expense                          | 3,027    | 2,469    | 6,033     | 5,320     |
| Net income                                  | \$ 5,719 | \$ 5,198 | \$ 11,539 | \$ 10,526 |
| Preferred stock dividends                   | 370      | 840      | 1,140     | 1,679     |
| Accretion of discount on preferred stock    |          | 91       | 1,305     | 181       |
| Net income available to common shareholders | \$ 5,349 | \$ 4,267 | \$ 9,094  | \$ 8,666  |
| Earnings per common share (Note 2):         |          |          |           |           |
| Basic                                       | \$ 0.39  | \$ 0.39  | \$ 0.73   | \$ 0.80   |
| Diluted                                     | \$ 0.39  | \$ 0.39  | \$ 0.72   | \$ 0.80   |

See accompanying notes to the consolidated financial statements.

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**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**  
**Consolidated Statement of Changes in Shareholders' Equity (Unaudited)**  
**Six months ended June 30, 2011**

| <i>(Dollars in thousands, except per share data)</i> | Preferred Equity | Common Stock | Additional Paid-in Capital | Retained Earnings | Accumulated Other Comprehensive Income (Loss) | Treasury Stock | Total Shareholders' Equity |
|--|------------------|--------------|----------------------------|-------------------|---|----------------|----------------------------|
| <b>Balance at January 1, 2011</b>                    | \$ 53,785        | \$ 113       | \$ 26,029                  | \$ 144,599        | \$ (4,722)                                    | \$ (7,660)     | \$ 212,144                 |
| Comprehensive income:                                |                  |              |                            |                   |   |                |                            |
| Net income   |                  |              |                            | 11,539            |   |                | 11,539                     |
| Other comprehensive income, net of tax               |                  |              |                            |                   | 9,784   |                | 9,784                      |
| Total comprehensive income                           |                  |              |                            |                   |   |                | 21,323                     |
| Issuance of common stock                             |                  | 29           | 43,098                     |                   |   |                | 43,127                     |
| Purchases of treasury stock                          |                  |              |                            |                   |   | (205)          | (205)                      |
| Repurchase of warrant issued to U.S. Treasury        |                  |              |                            | (2,080)           |   |                | (2,080)                    |
| Redemption of Series A preferred stock               | (37,515)         |              | 68                         |                   |   |                | (37,447)                   |
| Repurchase of Series B-1 8.48% preferred stock       | (96)             |              |                            |                   |   |                | (96)                       |
| Share-based compensation plans:                      |                  |              |                            |                   |   |                |                            |
| Share-based compensation                             |                  |              |                            | 576               |   |                | 576                        |
| Stock options exercised                              |                  |              |                            | (28)              |   | 119            | 91                         |
| Restricted stock awards issued, net                  |                  |              |                            | (991)             |   | 991            |                            |
| Excess tax benefit on share-based compensation       |                  |              |                            | 64                |   |                | 64                         |
| Directors' retainer                                  |                  |              |                            | (12)              |   | 110            | 98                         |
| Accretion of discount on Series A preferred stock    | 1,305            |              |                            | (1,305)           |   |                |                            |
| Cash dividends declared:                             |                  |              |                            |                   |   |                |                            |
| Series A 3% preferred-\$1.50 per share               |                  |              |                            | (2)               |   |                | (2)                        |
| Series A preferred-\$53.24 per share                 |                  |              |                            | (399)             |   |                | (399)                      |

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|   |  |  |  |  |  |  |  |  |  |         |         |
|---|--|--|--|--|--|--|--|--|--|---------|---------|
| Series B-1 8.48% preferred-\$4.24 per share |  |  |  |  |  |  |  |  |  | (739)   | (739)   |
| Common-\$0.22 per share                     |  |  |  |  |  |  |  |  |  | (2,722) | (2,722) |

**Balance at June 30, 2011**                    \$ 17,479    \$ 142    \$ 66,724    \$ 150,971    \$ 5,062    \$ (6,645)    \$ 233,733

See accompanying notes to the consolidated financial statements.

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

| <i>(Dollars in thousands)</i>   | <b>Six months ended<br/>June 30,</b> |             |
|---|--------------------------------------|-------------|
|   | <b>2011</b>                          | <b>2010</b> |
| Cash flows from operating activities:   |                                      |             |
| Net income  | \$ 11,539                            | \$ 10,526   |
| Adjustments to reconcile net income to net cash provided by operating activities: |                                      |             |
| Depreciation and amortization   | 1,701                                | 1,776       |
| Net amortization of premiums on securities  | 2,825                                | 1,002       |
| Provision for loan losses   | 2,138                                | 2,523       |
| Share-based compensation  | 576                                  | 542         |
| Deferred income tax expense   | 1,206                                | 828         |
| Proceeds from sale of loans held for sale   | 14,162                               | 14,284      |
| Originations of loans held for sale   | (11,618)                             | (14,594)    |
| Increase in company owned life insurance  | (545)                                | (551)       |
| Net gain on sale of loans held for sale   | (341)                                | (177)       |
| Net gain on disposal of investment securities                                     | (7)                                  | (69)        |
| Impairment charges on investment securities                                       |                                      | 526         |
| Net gain on sale and disposal of other assets                                     | (37)                                 | (2)         |
| Decrease in other assets  | 1,204                                | 294         |
| Increase in other liabilities   | 1,204                                | 1,322       |
| Net cash provided by operating activities   | 24,007                               | 18,230      |
| Cash flows from investing activities:   |                                      |             |
| Purchases of investment securities:   |                                      |             |
| Available for sale  | (124,096)                            | (196,238)   |
| Held to maturity  | (7,428)                              | (8,251)     |
| Proceeds from principal payments, maturities and calls on investment securities:  |                                      |             |
| Available for sale  | 88,512                               | 100,160     |
| Held to maturity  | 11,649                               | 19,979      |
| Proceeds from sales and calls of securities available for sale                    | 8,900                                | 33,090      |
| Net loan originations   | (37,715)                             | (28,178)    |
| Purchases of company owned life insurance   | (34)                                 | (33)        |
| Proceeds from sales of other assets   | 165                                  | 411         |
| Purchases of premises and equipment   | (1,410)                              | (1,250)     |
| Net cash used in investing activities   | (61,457)                             | (80,310)    |
| Cash flows from financing activities:   |                                      |             |
| Net (decrease) increase in deposits   | (10,651)                             | 78,990      |
| Net increase (decrease) in short-term borrowings                                  | 55,285                               | (12,657)    |
| Repayments of long-term borrowings  | (65)                                 | (79)        |
| Proceeds from issuance of common stock, net of issuance costs                     | 43,127                               |             |
| Purchases of common stock for treasury  | (205)                                |             |
| Repurchase of warrant issued to U.S. Treasury                                     | (2,080)                              |             |
| Redemption of Series A preferred stock  | (37,447)                             |             |

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|  |           |         |
|--|-----------|---------|
| Repurchase of Series B-1 8.48% preferred stock | (96)      |         |
| Proceeds from stock options exercised          | 91        | 129     |
| Excess tax benefit on share-based compensation | 64        |         |
| Cash dividends paid to preferred shareholders  | (1,380)   | (1,679) |
| Cash dividends paid to common shareholders     | (2,167)   | (2,164) |
| Net cash provided by financing activities      | 44,476    | 62,540  |
| Net increase in cash and cash equivalents      | 7,026     | 460     |
| Cash and cash equivalents, beginning of period | 39,058    | 42,959  |
| Cash and cash equivalents, end of period       | \$ 46,084 | 43,419  |

See accompanying notes to the consolidated financial statements.

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**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**  
**Notes to Consolidated Financial Statements (Unaudited)**

**(1.) 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 owns all of the capital stock of Five Star Bank, a New York State chartered bank, and Five Star Investment Services, Inc., a broker-dealer subsidiary offering noninsured investment products. The Company also owns 100% of FISIT Statutory Trust I (the Trust ), which was formed in February 2001 for the purpose of issuing trust preferred securities. 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 the Company and its subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation. The accounting and reporting policies conform to U.S. generally accepted accounting principles ( GAAP ). Certain information and footnote disclosures normally included in financial statements prepared in conformity with GAAP have been condensed or omitted pursuant to such rules and regulations. However, in the opinion of management, the accompanying consolidated financial statements reflect all adjustments of a normal and recurring nature necessary to present fairly the consolidated balance sheet, statements of income, 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 2010 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.

**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.

**Cash Flow Information**

Supplemental cash flow information addressing certain cash payments and noncash investing and financing activities was as follows (in thousands):

|  | <b>Six months ended</b> |             |
|--|-------------------------|-------------|
|  | <b>June 30,</b>         |             |
|  | <b>2011</b>             | <b>2010</b> |
| Cash payments:   |                         |             |
| Interest   | \$ 7,699                | \$ 9,115    |
| Income taxes   | 2,173                   | 4,539       |
| Noncash investing and financing activities:                  |                         |             |
| Real estate and other assets acquired in settlement of loans | \$ 105                  | \$ 70       |
| Accrued and declared unpaid dividends                        | 2,009                   | 1,694       |
| Increase (decrease) in net unsettled security transactions   | 960                     | (441)       |
| Net transfer of loans to held for sale                       | 13,576                  |             |
| Accretion of preferred stock discount                        | 1,305                   | 181         |

**Recent Accounting Pronouncements**

In June 2011, the Financial Accounting Standards Board ( FASB ) issued Accounting Standards Update (ASU) No. 2011-05 *Comprehensive Income (Topic 220) Presentation of Comprehensive Income*. ASU 2011-05

requires that all non-owner changes in stockholders' equity be presented either in a single continuous statement of comprehensive income or in two separate but consecutive statements. In both choices, an entity is required to present each component of net income along with total net income, each component of other comprehensive income along with a total for other comprehensive income, and a total amount for comprehensive income. ASU 2011-05 is effective retrospectively for fiscal years, and interim periods within those years, beginning after December 15, 2011. The Company is assessing the impact of ASU 2011-05 on our comprehensive income presentation.

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

In May 2011, the FASB issued ASU No. 2011-04 *Fair Value Measurement (Topic 820) Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs*. ASU 2011-04 changes the wording used to describe many of the requirements in GAAP for measuring fair value and for disclosing information about fair value measurements. Consequently, the amendments in this update result in common fair value measurement and disclosure requirements in GAAP and IFRSs (International Financial Reporting Standards). ASU 2011-04 is effective prospectively during interim and annual periods beginning on or after December 15, 2011. Early adoption by public entities is not permitted. The Company is currently assessing the impact of ASU 2011-04 on the Company's consolidated financial statements.

In April 2011, the FASB issued ASU No. 2011-03 *Transfers and Servicing (Topic 860) - Reconsideration of Effective Control for Repurchase Agreement*. ASU 2011-03 removes from the assessment of effective control the criterion relating to the transferor's ability to repurchase or redeem financial assets on substantially the agreed terms, even in the event of default by the transferee. ASU 2011-03 is effective for the first interim or annual period beginning on or after December 15, 2011. The guidance should be applied prospectively to transactions or modifications of existing transactions that occur on or after the effective date. Early adoption is not permitted. The Company believes that the adoption of the standard will not have a significant impact on the Company's consolidated financial statements.

In April 2011, the FASB issued ASU 2011-02 *A Creditor's Determination of Whether a Restructuring is a Troubled Debt Restructuring*, which clarifies when creditors should classify loan modifications as troubled debt restructurings. The guidance is effective for interim and annual periods beginning on or after June 15, 2011, and applies retrospectively to restructurings occurring on or after the beginning of the year. The guidance on measuring the impairment of a receivable restructured in a troubled debt restructuring, as clarified, is effective on a prospective basis. The Company believes that the adoption of the standard will not have a significant impact on the Company's consolidated financial statements.

In January 2011, the FASB issued ASU No. 2011-01 *Deferral of the Effective Date of Disclosures about Troubled Debt Restructurings in Update No. 2010-20*. The provisions of ASU No. 2010-20, *Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses* required the disclosure of more granular information on the nature and extent of troubled debt restructurings and their effect on the allowance for loan and lease losses effective for the Company's reporting period ended March 31, 2011. The amendments in ASU No. 2011-01 deferred the effective date related to these disclosures, enabling creditors to provide such disclosures after the FASB completed their project clarifying the guidance for determining what constitutes a troubled debt restructuring. As the provisions of ASU No. 2011-01 only defer the effective date of disclosure requirements related to troubled debt restructurings, the adoption had no impact on the Company's statements of income and condition.

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

The following table presents a reconciliation of the earnings and shares used in calculating basic and diluted EPS for the three and six months ended June 30, 2011 and 2010 (in thousands, except per share amounts).

|  | <b>Three months ended</b> |             | <b>Six months ended</b> |             |
|--|---------------------------|-------------|-------------------------|-------------|
|  | <b>June 30,</b>           |             | <b>June 30,</b>         |             |
|  | <b>2011</b>               | <b>2010</b> | <b>2011</b>             | <b>2010</b> |
| Net income available to common shareholders          | \$ 5,349                  | \$ 4,267    | \$ 9,094                | \$ 8,666    |
| Less: Earnings allocated to participating securities | 10                        | 29          | 20                      | 59          |
| Earnings allocated to common shares outstanding      | \$ 5,339                  | \$ 4,238    | \$ 9,074                | \$ 8,607    |
|  | 13,631                    | 10,761      | 12,489                  | 10,754      |



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|  |    |    |     |    |
|--|----|----|-----|----|
| Weighted average common shares used to calculate basic EPS |    |    |     |    |
| Add: Effect of common stock equivalents                    | 76 | 85 | 104 | 46 |

|  |        |        |        |        |
|--|--------|--------|--------|--------|
| Weighted average common shares used to calculate diluted EPS | 13,707 | 10,846 | 12,593 | 10,800 |
|--|--------|--------|--------|--------|

Earnings per common share:

|         |         |         |         |         |
|---------|---------|---------|---------|---------|
| Basic   | \$ 0.39 | \$ 0.39 | \$ 0.73 | \$ 0.80 |
| Diluted | \$ 0.39 | \$ 0.39 | \$ 0.72 | \$ 0.80 |

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           | 368 | 395 | 360 | 423 |
| Restricted stock awards | 2   | 2   | 7   | 1   |
| Warrant                 |     |     |     | 188 |
|                         | 370 | 397 | 367 | 612 |

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**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**  
**Notes to Consolidated Financial Statements (Unaudited)**

**(3.) INVESTMENT SECURITIES**

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

|   |                           | <b>June 30, 2011</b>        |                              |                       |
|---|---------------------------|-----------------------------|------------------------------|-----------------------|
|   | <b>Amortized<br/>Cost</b> | <b>Unrealized<br/>Gains</b> | <b>Unrealized<br/>Losses</b> | <b>Fair<br/>Value</b> |
| <b>Securities available for sale:</b>                         |                           |                             |                              |                       |
| U.S. Government agencies and government sponsored enterprises | \$ 115,032                | \$ 1,090                    | \$ 1,006                     | \$ 115,116            |
| State and political subdivisions                              | 120,350                   | 2,362                       | 346                          | 122,366               |
| Mortgage-backed securities:                                   |                           |                             |                              |                       |
| Federal National Mortgage Association                         | 118,616                   | 1,482                       | 181                          | 119,917               |
| Federal Home Loan Mortgage Corporation                        | 77,337                    | 591                         | 16                           | 77,912                |
| Government National Mortgage Association                      | 94,380                    | 3,372                       | 7                            | 97,745                |
| Collateralized mortgage obligations:                          |                           |                             |                              |                       |
| Federal National Mortgage Association                         | 31,241                    | 779                         | 11                           | 32,009                |
| Federal Home Loan Mortgage Corporation                        | 27,996                    | 656                         | 1                            | 28,651                |
| Government National Mortgage Association                      | 101,810                   | 2,292                       | 8                            | 104,094               |
| Privately issued  | 633                       | 1,491                       |                              | 2,124                 |
| <br>Total collateralized mortgage obligations                 | <br>161,680               | <br>5,218                   | <br>20                       | <br>166,878           |
| <br>Total mortgage-backed securities                          | <br>452,013               | <br>10,663                  | <br>224                      | <br>462,452           |
| Asset-backed securities                                       | 541                       | 6,483                       |                              | 7,024                 |
| <br>Total available for sale securities                       | <br>\$ 687,936            | <br>\$ 20,598               | <br>\$ 1,576                 | <br>\$ 706,958        |
| <br><b>Securities held to maturity:</b>                       |                           |                             |                              |                       |
| State and political subdivisions                              | \$ 24,091                 | \$ 706                      | \$                           | \$ 24,797             |

|   |                           | <b>December 31, 2010</b>    |                              |                       |
|---|---------------------------|-----------------------------|------------------------------|-----------------------|
|   | <b>Amortized<br/>Cost</b> | <b>Unrealized<br/>Gains</b> | <b>Unrealized<br/>Losses</b> | <b>Fair<br/>Value</b> |
| <b>Securities available for sale:</b>                         |                           |                             |                              |                       |
| U.S. Government agencies and government sponsored enterprises | \$ 141,591                | \$ 1,158                    | \$ 1,965                     | \$ 140,784            |
| State and political subdivisions                              | 105,622                   | 1,516                       | 1,472                        | 105,666               |
| Mortgage-backed securities:                                   |                           |                             |                              |                       |
| Federal National Mortgage Association                         | 96,300                    | 798                         | 1,030                        | 96,068                |
| Federal Home Loan Mortgage Corporation                        | 83,745                    | 321                         | 1,317                        | 82,749                |
| Government National Mortgage Association                      | 102,633                   | 2,422                       | 7                            | 105,048               |
| Collateralized mortgage obligations:                          |                           |                             |                              |                       |
| Federal National Mortgage Association                         | 8,938                     | 231                         | 11                           | 9,158                 |
| Federal Home Loan Mortgage Corporation                        | 15,917                    | 329                         | 1                            | 16,245                |
| Government National Mortgage Association                      | 106,969                   | 1,761                       | 289                          | 108,441               |

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|   |            |          |          |            |
|---|------------|----------|----------|------------|
| Privately issued                          | 981        | 591      |          | 1,572      |
| Total collateralized mortgage obligations | 132,805    | 2,912    | 301      | 135,416    |
| Total mortgage-backed securities          | 415,483    | 6,453    | 2,655    | 419,281    |
| Asset-backed securities                   | 564        | 204      | 131      | 637        |
| Total available for sale securities       | \$ 663,260 | \$ 9,331 | \$ 6,223 | \$ 666,368 |
| <b>Securities held to maturity:</b>       |            |          |          |            |
| State and political subdivisions          | \$ 28,162  | \$ 687   | \$       | \$ 28,849  |

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**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**  
**Notes to Consolidated Financial Statements (Unaudited)**

**(3.) INVESTMENT SECURITIES (Continued)**

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

|                       | <b>Three months ended</b> |             | <b>Six months ended</b> |             |
|-----------------------|---------------------------|-------------|-------------------------|-------------|
|                       | <b>June 30,</b>           |             | <b>June 30,</b>         |             |
|                       | <b>2011</b>               | <b>2010</b> | <b>2011</b>             | <b>2010</b> |
| Proceeds from sales   | \$ 8,900                  | \$ 20,140   | \$ 8,900                | \$ 33,090   |
| Gross realized gains  | 4                         | 67          | 4                       | 73          |
| Gross realized losses |                           | 4           |                         | 4           |

The scheduled maturities of securities available for sale and securities held to maturity at June 30, 2011 are shown below (in thousands). Actual expected maturities may differ from contractual maturities because issuers may have the right to call or prepay obligations.

|  | <b>Amortized<br/>Cost</b> | <b>Fair<br/>Value</b> |
|--|---------------------------|-----------------------|
| <b>Debt securities available for sale:</b> |                           |                       |
| Due in one year or less                    | \$ 27,488                 | \$ 27,775             |
| Due from one to five years                 | 79,163                    | 81,367                |
| Due after five years through ten years     | 237,075                   | 237,170               |
| Due after ten years                        | 344,210                   | 360,646               |
|  | <b>\$ 687,936</b>         | <b>\$ 706,958</b>     |
| <b>Debt securities held to maturity:</b>   |                           |                       |
| Due in one year or less                    | \$ 18,229                 | \$ 18,368             |
| Due from one to five years                 | 4,690                     | 5,050                 |
| Due after five years through ten years     | 994                       | 1,160                 |
| Due after ten years                        | 178                       | 219                   |
|  | <b>\$ 24,091</b>          | <b>\$ 24,797</b>      |

The following tables show the investments gross unrealized losses and fair value, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position at June 30, 2011 and December 31, 2010 (in thousands).

|   | <b>June 30, 2011</b>                          |                              |   |                              | <b>Total<br/>Fair<br/>Value      Unrealized<br/>Losses</b> |          |
|---|---|------------------------------|---|------------------------------|--|----------|
|   | <b>Less than 12 months<br/>Fair<br/>Value</b> | <b>Unrealized<br/>Losses</b> | <b>12 months or longer<br/>Fair<br/>Value</b> | <b>Unrealized<br/>Losses</b> |  |          |
| <b>Securities available for sale:</b>                               |   |                              |   |                              |  |          |
| U.S. Government agencies<br>and government sponsored<br>enterprises | \$ 48,427                                     | \$ 984                       | \$ 7,828                                      | \$ 22                        | \$ 56,255  | \$ 1,006 |
| State and political<br>subdivisions                                 | 30,993  | 346                          |   |                              | 30,993   | 346      |
| Mortgage-backed securities:   | 19,783  | 181                          |   |                              | 19,783   | 181      |

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|  |                   |                 |                 |              |                   |                 |  |
|--|-------------------|-----------------|-----------------|--------------|-------------------|-----------------|--|
| Federal National Mortgage Association        |                   |                 |                 |              |                   |                 |  |
| Federal Home Loan Mortgage Corporation       | 11,662            | 16              |                 |              | 11,662            | 16              |  |
| Government National Mortgage Association     | 4,902             | 7               |                 |              | 4,902             | 7               |  |
| Collateralized mortgage obligations:         |                   |                 |                 |              |                   |                 |  |
| Federal National Mortgage Association        |                   |                 | 2,040           | 11           | 2,040             | 11              |  |
| Federal Home Loan Mortgage Corporation       | 457               | 1               |                 |              | 457               | 1               |  |
| Government National Mortgage Association     | 1,323             | 8               |                 |              | 1,323             | 8               |  |
| Total collateralized mortgage obligations    | 1,780             | 9               | 2,040           | 11           | 3,820             | 20              |  |
| Total mortgage-backed securities             | 38,127            | 213             | 2,040           | 11           | 40,167            | 224             |  |
| <b>Total temporarily impaired securities</b> | <b>\$ 117,547</b> | <b>\$ 1,543</b> | <b>\$ 9,868</b> | <b>\$ 33</b> | <b>\$ 127,415</b> | <b>\$ 1,576</b> |  |

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**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**  
**Notes to Consolidated Financial Statements (Unaudited)**

**(3.) INVESTMENT SECURITIES (Continued)**

|   | Less than 12 months |                      | December 31, 2010                    |                      | Total             |                      |
|---|---------------------|----------------------|--------------------------------------|----------------------|-------------------|----------------------|
|   | Fair<br>Value       | Unrealized<br>Losses | 12 months or longer<br>Fair<br>Value | Unrealized<br>Losses | Fair<br>Value     | Unrealized<br>Losses |
| <b>Securities available for sale:</b>                               |                     |                      |                                      |                      |                   |                      |
| U.S. Government agencies<br>and government sponsored<br>enterprises | \$ 47,752           | \$ 1,911             | \$ 8,821                             | \$ 54                | \$ 56,573         | \$ 1,965             |
| State and political<br>subdivisions                                 | 38,398              | 1,472                |                                      |                      | 38,398            | 1,472                |
| Mortgage-backed securities:   |                     |                      |                                      |                      |                   |                      |
| Federal National Mortgage<br>Association                            | 46,777              | 1,030                |                                      |                      | 46,777            | 1,030                |
| Federal Home Loan Mortgage<br>Corporation                           | 60,707              | 1,317                |                                      |                      | 60,707            | 1,317                |
| Government National<br>Mortgage Association                         | 5,135               | 7                    |                                      |                      | 5,135             | 7                    |
| Collateralized mortgage<br>obligations:                             |                     |                      |                                      |                      |                   |                      |
| Federal National Mortgage<br>Association                            |                     |                      | 2,332                                | 11                   | 2,332             | 11                   |
| Federal Home Loan Mortgage<br>Corporation                           | 612                 | 1                    |                                      |                      | 612               | 1                    |
| Government National<br>Mortgage Association                         | 17,798              | 289                  |                                      |                      | 17,798            | 289                  |
| Total collateralized mortgage<br>obligations                        | 18,410              | 290                  | 2,332                                | 11                   | 20,742            | 301                  |
| Total mortgage-backed<br>securities                                 | 131,029             | 2,644                | 2,332                                | 11                   | 133,361           | 2,655                |
| Asset-backed securities   | 111                 | 61                   | 96                                   | 70                   | 207               | 131                  |
| <b>Total temporarily impaired<br/>securities</b>                    | <b>\$ 217,290</b>   | <b>\$ 6,088</b>      | <b>\$ 11,249</b>                     | <b>\$ 135</b>        | <b>\$ 228,539</b> | <b>\$ 6,223</b>      |

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 available to management at a point in time.

At June 30, 2011, the Company had positions in 11 investment securities with an amortized cost of \$9.9 million and an unrealized loss of \$33 thousand that have been in a continuous unrealized loss position for more than 12 months. There were a total of 99 securities positions in the Company's investment portfolio, with an amortized cost of \$119.1 million and a total unrealized loss of \$1.5 million at June 30, 2011, 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, average life or credit spreads subsequent to purchase. The fair value of most of the investment securities in the Company's portfolio fluctuates as market interest rates change. Based on management's review and evaluation of the Company's debt securities as of June 30, 2011, the debt securities with unrealized losses were not considered to be OTTI. As of June 30, 2011, the Company does not intend to sell any debt securities which have an unrealized loss, it is unlikely the Company will be required to sell these securities before recovery and the Company expects to recover the entire amortized cost of these impaired securities.

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**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**  
**Notes to Consolidated Financial Statements (Unaudited)**

**(4.) LOANS**

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

|                           | <b>Loans, Gross</b> | <b>Net Deferred<br/>Loan (Fees)<br/>Costs</b> | <b>Loans, Net</b>   |
|---------------------------|---------------------|---|---------------------|
| <b>June 30, 2011</b>      |                     |   |                     |
| Commercial business       | \$ 217,293          | \$ 137  | \$ 217,430          |
| Commercial mortgage       | 357,989             | (526)   | 357,463             |
| Residential mortgage      | 120,766             | 23  | 120,789             |
| Home equity               | 212,117             | 3,520   | 215,637             |
| Consumer indirect         | 412,332             | 19,279  | 431,611             |
| Other consumer            | 24,953              | 169   | 25,122              |
| <b>Total</b>              | <b>\$ 1,345,450</b> | <b>\$ 22,602</b>                              | <b>1,368,052</b>    |
| Allowance for loan losses |                     |   | (20,632)            |
| <b>Total loans, net</b>   |                     |   | <b>\$ 1,347,420</b> |
| <b>December 31, 2010</b>  |                     |   |                     |
| Commercial business       | \$ 210,948          | \$ 83   | \$ 211,031          |
| Commercial mortgage       | 353,537             | (607)   | 352,930             |
| Residential mortgage      | 129,553             | 27  | 129,580             |
| Home equity               | 205,070             | 3,257   | 208,327             |
| Consumer indirect         | 400,221             | 17,795  | 418,016             |
| Other consumer            | 25,937              | 169   | 26,106              |
| <b>Total</b>              | <b>\$ 1,325,266</b> | <b>\$ 20,724</b>                              | <b>1,345,990</b>    |
| Allowance for loan losses |                     |   | (20,466)            |
| <b>Total loans, net</b>   |                     |   | <b>\$ 1,325,524</b> |

Loans held for sale (not included above) totaled \$14.5 million as of June 30, 2011, comprised of \$935 thousand of residential mortgage loans and \$13.6 million of indirect auto loans. During the second quarter of 2011, the Company reclassified \$13.6 million of indirect auto loans from portfolio to loans held for sale pursuant to a letter of intent to sell the loans under a 90%/10% participation agreement. The Company will continue to service the loans for a fee in accordance with the participation agreement. The loans were subsequently sold in July 2011. Loans held for sale totaled \$3.1 million as of December 31, 2010, all of which were residential mortgage loans.



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**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**  
**Notes to Consolidated Financial Statements (Unaudited)**

**(4.) 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):

|                          | <b>30-59<br/>Days<br/>Past Due</b> | <b>60-89<br/>Days<br/>Past Due</b> | <b>Greater<br/>Than<br/>90<br/>Days</b> | <b>Total<br/>Past<br/>Due</b> | <b>Nonaccrual</b> | <b>Current</b> | <b>Total<br/>Loans</b> |
|--------------------------|------------------------------------|------------------------------------|---|-------------------------------|-------------------|----------------|------------------------|
| <b>June 30, 2011</b>     |                                    |                                    |   |                               |                   |                |                        |
| Commercial business      | \$ 11                              | \$                                 | \$                                      | \$ 11                         | \$ 711            | \$ 216,571     | \$ 217,293             |
| Commercial mortgage      |                                    |                                    |   |                               | 2,863             | 355,126        | 357,989                |
| Residential mortgage     | 248                                |                                    |   | 248                           | 2,262             | 118,256        | 120,766                |
| Home equity              | 299                                | 97                                 |   | 396                           | 472               | 211,249        | 212,117                |
| Consumer indirect        | 349                                | 54                                 |   | 403                           | 667               | 411,262        | 412,332                |
| Other consumer           | 101                                | 3                                  | 4                                       | 108                           |                   | 24,845         | 24,953                 |
| Total loans, gross       | \$ 1,008                           | \$ 154                             | \$ 4                                    | \$ 1,166                      | \$ 6,975          | \$ 1,337,309   | \$ 1,345,450           |
| <b>December 31, 2010</b> |                                    |                                    |   |                               |                   |                |                        |
| Commercial business      | \$ 172                             | \$ 92                              | \$                                      | \$ 264                        | \$ 947            | \$ 209,737     | \$ 210,948             |
| Commercial mortgage      | 163                                |                                    |   | 163                           | 3,100             | 350,274        | 353,537                |
| Residential mortgage     | 492                                | 6                                  |   | 498                           | 2,102             | 126,953        | 129,553                |
| Home equity              | 428                                | 47                                 |   | 475                           | 875               | 203,720        | 205,070                |
| Consumer indirect        | 656                                | 107                                |   | 763                           | 514               | 398,944        | 400,221                |
| Other consumer           | 82                                 | 1                                  | 3                                       | 86                            | 41                | 25,810         | 25,937                 |
| Total loans, gross       | \$ 1,993                           | \$ 253                             | \$ 3                                    | \$ 2,249                      | \$ 7,579          | \$ 1,315,438   | \$ 1,325,266           |

There were no loans past due greater than 90 days and still accruing interest as of June 30, 2011 and December 31, 2010. There were \$4 thousand and \$3 thousand in consumer overdrafts which were past due greater than 90 days as of June 30, 2011 and December 31, 2010, respectively. Consumer overdrafts are overdrawn deposit accounts which have been reclassified as loans but by their terms do not accrue interest.

**Troubled Debt Restructurings**

Troubled debt restructurings ( TDRs ) are loans where the Company, for economic or legal reasons related to the borrower's financial condition, has granted a significant concession to the borrower that it would not otherwise consider. TDRs can be classified as either accrual or nonaccrual loans. The Company had no TDRs on which it continued to accrue interest at June 30, 2011 or December 31, 2010. Included in nonaccrual loans are commercial TDRs of \$760 thousand and \$534 thousand at June 30, 2011 and December 31, 2010, respectively. The Company assigned \$85 thousand and \$137 thousand of specific reserves to loans classified as TDRs as of June 30, 2011 and December 31, 2010, respectively. TDRs typically migrate from the Company's criticized and classified watch list and are assigned specific reserves in accordance with the Company's standard allowance for loan loss methodology.

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**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**  
**Notes to Consolidated Financial Statements (Unaudited)**

**(4.) LOANS (Continued)****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 data on impaired loans as of the dates indicated (in thousands):

|  | <b>Recorded<br/>Investment</b> | <b>Unpaid<br/>Principal<br/>Balance</b> | <b>Related<br/>Allowance</b> | <b>Quarter-to-Date<br/>Average<br/>Recorded<br/>Investment</b> | <b>Interest<br/>Income<br/>Recognized</b> | <b>Year- to-Date<br/>Average<br/>Recorded<br/>Investment</b> | <b>Interest<br/>Income<br/>Recognized</b> |
|--|--------------------------------|---|------------------------------|--|---|--|---|
| <b>June 30, 2011</b>                       |                                |   |                              |  |   |  |   |
| <b>With no related allowance recorded:</b> |                                |   |                              |  |   |  |   |
| <b>Commercial business</b>                 | \$ 157                         | \$ 335                                  | \$                           | \$ 208   | \$  | \$ 283   | \$  |
| Commercial mortgage                        | 703                            | 722                                     |                              | 610  |   | 527  |   |
|  | 860                            | 1,057                                   |                              | 818  |   | 810  |   |
| <b>With an allowance recorded:</b>         |                                |   |                              |  |   |  |   |
| Commercial business                        | 555                            | 555                                     | 199                          | 681  |   | 648  |   |
| Commercial mortgage                        | 2,159                          | 2,159                                   | 483                          | 2,188  |   | 2,399  |   |
|  | 2,714                          | 2,714                                   | 682                          | 2,869  |   | 3,047  |   |
|  | \$ 3,574                       | \$ 3,771                                | \$ 682                       | \$ 3,687   |   | \$ 3,857   | \$  |
| <b>December 31, 2010</b>                   |                                |   |                              |  |   |  |   |
| <b>With no related allowance recorded:</b> |                                |   |                              |  |   |  |   |
| <b>Commercial business</b>                 | \$ 372                         | \$ 524                                  | \$                           |  |   | \$ 275   | \$  |
| Commercial mortgage                        | 187                            | 187                                     |                              |  |   | 481  |   |
|  | 559                            | 711                                     |                              |  |   | 756  |   |
| <b>With an allowance recorded:</b>         |                                |   |                              |  |   |  |   |
| Commercial business                        | 576                            | 576                                     | 149                          |  |   | 1,828  |   |
| Commercial mortgage                        | 2,913                          | 2,921                                   | 883                          |  |   | 1,897  |   |
|  | 3,489                          | 3,497                                   | 1,032                        |  |   | 3,725  |   |
|  | \$ 4,048                       | \$ 4,208                                | \$ 1,032                     |  |   | \$ 4,481   | \$  |

**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 not meeting 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.

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**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**  
**Notes to Consolidated Financial Statements (Unaudited)**

**(4.) LOANS (Continued)**

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

|                          | <b>Commercial<br/>Business</b> | <b>Commercial<br/>Mortgage</b> |
|--------------------------|--------------------------------|--------------------------------|
| <b>June 30, 2011</b>     |                                |                                |
| Uncriticized             | \$ 202,200                     | \$ 344,334                     |
| Special mention          | 8,940                          | 4,816                          |
| Substandard              | 6,153                          | 8,839                          |
| Doubtful                 |                                |                                |
| <b>Total</b>             | <b>\$ 217,293</b>              | <b>\$ 357,989</b>              |
| <b>December 31, 2010</b> |                                |                                |
| Uncriticized             | \$ 194,510                     | \$ 338,061                     |
| Special mention          | 11,479                         | 4,931                          |
| Substandard              | 4,959                          | 10,545                         |
| Doubtful                 |                                |                                |
| <b>Total</b>             | <b>\$ 210,948</b>              | <b>\$ 353,537</b>              |

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):

|                          | <b>Residential<br/>Mortgage</b> | <b>Home<br/>Equity</b> | <b>Consumer<br/>Indirect</b> | <b>Other<br/>Consumer</b> |
|--------------------------|---------------------------------|------------------------|------------------------------|---------------------------|
| <b>June 30, 2011</b>     |                                 |                        |                              |                           |
| Performing               | \$ 118,504                      | \$ 211,645             | \$ 411,665                   | \$ 24,953                 |
| Non-performing           | 2,262                           | 472                    | 667                          |                           |
| <b>Total</b>             | <b>\$ 120,766</b>               | <b>\$ 212,117</b>      | <b>\$ 412,332</b>            | <b>\$ 24,953</b>          |
| <b>December 31, 2010</b> |                                 |                        |                              |                           |
| Performing               | \$ 127,451                      | \$ 204,195             | \$ 399,707                   | \$ 25,896                 |
| Non-performing           | 2,102                           | 875                    | 514                          | 41                        |
| <b>Total</b>             | <b>\$ 129,553</b>               | <b>\$ 205,070</b>      | <b>\$ 400,221</b>            | <b>\$ 25,937</b>          |

**Allowance for Loan Losses**

Loans and the related allowance for loan losses at June 30, 2011, are presented below (in thousands):

| <b>Commercial</b> | <b>Commercial</b> | <b>Residential</b> | <b>Home</b> | <b>Consumer</b> | <b>Other</b> |
|-------------------|-------------------|--------------------|-------------|-----------------|--------------|
|-------------------|-------------------|--------------------|-------------|-----------------|--------------|

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|                                   | <b>Business</b> | <b>Mortgage</b> | <b>Mortgage</b> | <b>Equity</b> | <b>Indirect</b> | <b>Consumer</b> | <b>Total</b> |
|-----------------------------------|-----------------|-----------------|-----------------|---------------|-----------------|-----------------|--------------|
| <b>Loans:</b>                     |                 |                 |                 |               |                 |                 |              |
| Ending balance                    | \$ 217,293      | \$ 357,989      | \$ 120,766      | \$ 212,117    | \$ 412,332      | \$ 24,953       | \$ 1,345,450 |
| Evaluated for impairment:         |                 |                 |                 |               |                 |                 |              |
| Individually                      | \$ 712          | \$ 2,862        | \$              | \$            | \$              | \$              | \$ 3,574     |
| Collectively                      | \$ 216,581      | \$ 355,127      | \$ 120,766      | \$ 212,117    | \$ 412,332      | \$ 24,953       | \$ 1,341,876 |
| <b>Allowance for loan losses:</b> |                 |                 |                 |               |                 |                 |              |
| Ending balance                    | \$ 4,011        | \$ 5,763        | \$ 957          | \$ 1,050      | \$ 8,319        | \$ 532          | \$ 20,632    |
| Evaluated for impairment:         |                 |                 |                 |               |                 |                 |              |
| Individually                      | \$ 199          | \$ 483          | \$              | \$            | \$              | \$              | \$ 682       |
| Collectively                      | \$ 3,812        | \$ 5,280        | \$ 957          | \$ 1,050      | 8,319           | \$ 532          | \$ 19,950    |

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**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**  
**Notes to Consolidated Financial Statements (Unaudited)**

**(4.) LOANS (Continued)**

The changes in the allowance for loan losses for the three and six months ended June 30, 2011 were as follows (in thousands):

|   | <b>Commercial<br/>Business</b> | <b>Commercial<br/>Mortgage</b> | <b>Residential<br/>Mortgage</b> | <b>Home<br/>Equity</b> | <b>Consumer<br/>Indirect</b> | <b>Other<br/>Consumer</b> | <b>Total</b> |
|---|--------------------------------|--------------------------------|---------------------------------|------------------------|------------------------------|---------------------------|--------------|
| <b>Three months ended<br/>June 30, 2011</b> |                                |                                |                                 |                        |                              |                           |              |
| Beginning balance                           | \$ 4,021                       | \$ 5,908                       | \$ 1,016                        | \$ 1,030               | \$ 7,614                     | \$ 530                    | \$ 20,119    |
| Charge-offs                                 | 225                            | 34                             | 10                              | 155                    | 1,055                        | 268                       | 1,747        |
| Recoveries                                  | 110                            | 23                             | 3                               | 7                      | 653                          | 136                       | 932          |
| Provision (credit)                          | 105                            | (134)                          | (52)                            | 168                    | 1,107                        | 134                       | 1,328        |
| Ending balance                              | \$ 4,011                       | \$ 5,763                       | \$ 957                          | \$ 1,050               | \$ 8,319                     | \$ 532                    | \$ 20,632    |
| <b>Six months ended<br/>June 30, 2011</b>   |                                |                                |                                 |                        |                              |                           |              |
| Beginning balance                           | \$ 3,712                       | \$ 6,431                       | \$ 1,013                        | \$ 972                 | \$ 7,754                     | \$ 584                    | \$ 20,466    |
| Charge-offs                                 | 315                            | 378                            | 12                              | 262                    | 2,345                        | 479                       | 3,791        |
| Recoveries                                  | 264                            | 39                             | 30                              | 17                     | 1,205                        | 264                       | 1,819        |
| Provision (credit)                          | 350                            | (329)                          | (74)                            | 323                    | 1,705                        | 163                       | 2,138        |
| Ending balance                              | \$ 4,011                       | \$ 5,763                       | \$ 957                          | \$ 1,050               | \$ 8,319                     | \$ 532                    | \$ 20,632    |

Activity in the allowance for loan losses during the three and six months ended June 30, 2010 was as follows (in thousands):

|                   | <b>Three<br/>months<br/>ended<br/>June 30, 2010</b> | <b>Six months<br/>ended<br/>June 30, 2010</b> |
|-------------------|---|---|
| Beginning balance | \$ 20,586   | \$ 20,741                                     |
| Charge-offs       | 1,476   | 3,089   |
| Recoveries        | 610   | 1,650   |
| Provision         | 2,105   | 2,523   |
| Ending balance    | \$ 21,825   | \$ 21,825                                     |

**Risk Characteristics**

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

Commercial mortgage loans generally have larger balances and involve a greater degree of risk than residential mortgage loans, 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, 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)**

**(5.) SHAREHOLDERS EQUITY****Common Stock**

The changes in shares of common stock were as follows for six months ended June 30, 2011:

|   | <b>Outstanding</b> | <b>Treasury</b> | <b>Issued</b> |
|---|--------------------|-----------------|---------------|
| Shares outstanding at December 31, 2010 | 10,937,506         | 410,616         | 11,348,122    |
| Shares issued in common stock offering  | 2,813,475          |                 | 2,813,475     |
| Restricted stock awards issued          | 53,070             | (53,070)        |               |
| Stock options exercised                 | 6,357              | (6,357)         |               |
| Treasury stock purchases                | (10,467)           | 10,467          |               |
| Directors' retainer                     | 5,889              | (5,889)         |               |
| Shares outstanding at June 30, 2011     | 13,805,830         | 355,767         | 14,161,597    |

**Issuance of Common Stock**

On March 15, 2011, the Company completed the sale of 2,813,475 shares of its common stock through an underwritten public offering at a price of \$16.35 per share. The net proceeds of the offering, after deducting underwriting discounts and commissions and offering expenses, were \$43.1 million. A portion of the proceeds from this offering was used to redeem the Company's Series A preferred stock as described in greater detail below.

**Redemption of Series A Preferred Stock and Warrant**

In December 2008, under the U.S. Department of the Treasury's (the Treasury) Troubled Asset Relief Program (TARP) Capital Purchase Program, the Company entered into a Securities Purchase Agreement—Standard Terms with the Treasury pursuant to which, among other things, the Company sold to the Treasury for an aggregate purchase price of \$37.5 million, 7,503 shares of fixed rate cumulative perpetual preferred stock, Series A (Series A preferred stock) and a warrant to purchase up to 378,175 shares of common stock, par value \$0.01 per share, at an exercise price of \$14.88 per share (the Warrant), of the Company.

Pursuant to the terms of the Purchase Agreement, the Company's ability to declare or pay dividends on any of its shares was limited. Specifically, the Company was prohibited from paying any dividend with respect to shares of common stock, other junior securities or preferred stock ranking *pari passu* with the Series A preferred stock or repurchasing or redeeming any shares of the Company's common stock, other junior securities or preferred stock ranking *pari passu* with the Series A preferred stock in any quarter unless all accrued and unpaid dividends were paid on the Series A preferred stock for all past dividend periods (including the latest completed dividend period), subject to certain limited exceptions.

The \$37.5 million in proceeds was allocated to the Series A preferred stock and the Warrant based on their relative fair values at issuance (\$35.5 million was allocated to the Series A preferred stock and \$2.0 million to the Warrant). The resulting discount for the Series A preferred stock was to be accreted over five years through retained earnings as a preferred stock dividend. The Warrant was to remain in additional paid-in-capital at its initial book value until it was exercised or expired.

On February 23, 2011, the Company redeemed one-third, or \$12.5 million, of the Series A preferred stock. On March 30, 2011, the remaining \$25.0 million of the Series A preferred stock was redeemed. The unamortized discount related to the Series A preferred stock was charged to retained earnings upon redemption. The complete redemption of the Series A preferred stock removed the TARP restrictions pertaining to the Company's ability to declare and pay dividends and repurchase its common stock, as well as certain restrictions associated with executive compensation.

On May 11, 2011, the Company repurchased the Warrant issued to the Treasury. The repurchase price of \$2.1 million was recorded as a reduction of additional paid-in capital.





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**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**  
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**(5.) SHAREHOLDERS EQUITY (Continued)****Comprehensive Income (Loss)**

Presented below is a reconciliation of net income to comprehensive income including the components of other comprehensive income for the periods indicated (in thousands):

|   | Six months ended June 30, |                                     |                      |                   |                                     |                      |
|---|---------------------------|-------------------------------------|----------------------|-------------------|-------------------------------------|----------------------|
|   | Pre-tax<br>Amount         | 2011<br>Tax<br>Expense<br>(Benefit) | Net-of-tax<br>Amount | Pre-tax<br>Amount | 2010<br>Tax<br>Expense<br>(Benefit) | Net-of-tax<br>Amount |
| Securities available for sale:                  |                           |                                     |                      |                   |                                     |                      |
| Net unrealized gains arising during the period  | \$ 15,921                 | \$ 6,308                            | \$ 9,613             | \$ 9,046          | \$ 3,499                            | \$ 5,547             |
| Reclassification adjustments:                   |                           |                                     |                      |                   |                                     |                      |
| Realized net gains included in income           | (7)                       | (3)                                 | (4)                  | (69)              | (27)                                | (42)                 |
| Impairment charges included in income           |                           |                                     |                      | 526               | 204                                 | 322                  |
|   | 15,914                    | 6,305                               | 9,609                | 9,503             | 3,676                               | 5,827                |
| Pension and post-retirement benefit liabilities | 290                       | 115                                 | 175                  | 211               | 82                                  | 129                  |
| Other comprehensive income                      | \$ 16,204                 | \$ 6,420                            | 9,784                | \$ 9,714          | \$ 3,758                            | 5,956                |
| Net income                                      |                           |                                     | 11,539               |                   |                                     | 10,526               |
| Comprehensive income                            |                           |                                     | \$ 21,323            |                   |                                     | \$ 16,482            |

The components of accumulated other comprehensive income (loss), net of tax, for the periods indicated were as follows (in thousands):

|  | June 30,<br>2011 | December 31,<br>2010 |
|--|------------------|----------------------|
| Net actuarial loss and prior service cost on defined benefit pension and post-retirement plans | \$ (6,424)       | \$ (6,599)           |
| Net unrealized gain on securities available for sale   | 11,486           | 1,877                |
| Accumulated other comprehensive income (loss)  | \$ 5,062         | \$ (4,722)           |

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

The Company maintains certain stock-based compensation plans, approved by the Company's shareholders that are administered by the Board, or the Management Development and Compensation Committee of the Board. The share-based compensation plans were established to allow for the granting 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 45,870 restricted shares of common stock to certain members of management during the six months ended June 30, 2011. The weighted average market price of the restricted stock on the date of grant was \$19.25. Either a service requirement or both service and performance requirements must be satisfied before the participant becomes vested in the shares of common stock. Where applicable, the performance period for the awards is the Company's fiscal year ending on December 31, 2011. The restricted stock awards granted to management in 2011 do not have rights to dividends or dividend equivalents. During the six months ended June 30, 2011, the Company granted 7,200 restricted shares of common stock to directors, of which 3,600 shares vested immediately and 3,600 shares will vest after completion of a one-year service requirement. The market price of the restricted stock on the date of grant was \$16.55. The director awards were granted with nonforfeitable rights to dividends.

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**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**  
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**(6.) SHARE-BASED COMPENSATION PLANS (Continued)**

The following is a summary of restricted stock award activity for the six months ended June 30, 2011:

|                                  | <b>Number of<br/>Shares</b> | <b>Weighted<br/>Average<br/>Market<br/>Price at<br/>Grant Date</b> |
|----------------------------------|-----------------------------|--|
| Outstanding at beginning of year | 150,796                     | \$ 12.76   |
| Granted                          | 53,070                      | 18.88  |
| Released                         | (33,240)                    | 14.63  |
| Outstanding at end of period     | 170,626                     | \$ 14.30   |

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

|                                 | <b>Three months ended<br/>June 30,</b> |             | <b>Six months ended<br/>June 30,</b> |             |
|---------------------------------|--|-------------|--------------------------------------|-------------|
|                                 | <b>2011</b>                            | <b>2010</b> | <b>2011</b>                          | <b>2010</b> |
| Stock options:                  |  |             |                                      |             |
| Management Stock Incentive Plan | \$ 14                                  | \$ 24       | \$ 28                                | \$ 50       |
| Director Stock Incentive Plan   | 4                                      | 11          | 14                                   | 22          |
| Total stock options             | 18                                     | 35          | 42                                   | 72          |
| Restricted stock awards:        |  |             |                                      |             |
| Management Stock Incentive Plan | 253                                    | 212         | 445                                  | 382         |
| Director Stock Incentive Plan   | 74                                     | 74          | 89                                   | 88          |
| Total restricted stock awards   | 327                                    | 286         | 534                                  | 470         |
| Total share-based compensation  | \$ 345                                 | \$ 321      | \$ 576                               | \$ 542      |

**(7.) EMPLOYEE BENEFIT PLANS****Defined Benefit Pension Plan**

The Company participates in The New York State Bankers Retirement System (the System), a defined benefit pension plan covering substantially all employees, subject to the limitations related to the plan closure effective December 31, 2006. The benefits are based on years of service and the employee's highest average compensation during five consecutive years of employment. The defined benefit plan was closed to new participants effective December 31, 2006. Only employees hired on or before December 31, 2006 and who met participation requirements on or before January 1, 2008 are eligible to receive benefits.

The components of the Company's net periodic benefit expense for its pension plan were as follows (in thousands):

|  | <b>Three months ended</b> | <b>Six months ended</b> |
|--|---------------------------|-------------------------|
|--|---------------------------|-------------------------|

|   | <b>June 30,</b> |             | <b>June 30,</b> |             |
|---|-----------------|-------------|-----------------|-------------|
|   | <b>2011</b>     | <b>2010</b> | <b>2011</b>     | <b>2010</b> |
| Service cost                                    | \$ 439          | \$ 408      | \$ 878          | \$ 816      |
| Interest cost on projected benefit obligation   | 506             | 484         | 1,013           | 967         |
| Expected return on plan assets                  | (663)           | (611)       | (1,326)         | (1,222)     |
| Amortization of unrecognized prior service cost | 5               | 3           | 9               | 6           |
| Amortization of unrecognized loss               | 152             | 114         | 304             | 229         |
| Net periodic pension cost                       | \$ 439          | \$ 398      | \$ 878          | \$ 796      |

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. In December 2010, the Company contributed \$4.3 million to the pension plan for fiscal year 2011, which exceeded the minimum required contribution of \$1.5 million.

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**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**  
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**(8.) 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):

|                              | <b>June 30,<br/>2011</b> | <b>December 31,<br/>2010</b> |
|------------------------------|--------------------------|------------------------------|
| Commitments to extend credit | \$ 367,900               | \$ 357,240                   |
| Standby letters of credit    | 17,967                   | 6,524                        |

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 when the Company intends to sell the related loan, once originated, as well as closed residential mortgage loans held for sale, the Company enters into forward commitments to sell individual residential mortgages. Rate lock agreements and forward commitments are considered derivatives and are recorded at fair value. Forward sales commitments totaled \$852 thousand and \$8.0 million at June 30, 2011 and December 31, 2010, respectively.

**(9.) 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. 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.

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**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**  
**Notes to Consolidated Financial Statements (Unaudited)**

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

In general, fair value is based upon quoted market prices, where available. If such quoted market prices are not available, fair value is based upon internally developed models that primarily use, as inputs, observable market-based parameters. Valuation adjustments may be made to ensure that financial instruments are recorded at fair value. These adjustments may include amounts to reflect counterparty credit quality and the company's creditworthiness, among other things, as well as unobservable parameters. Any such valuation adjustments are applied consistently over time. The Company's valuation methodologies may produce a fair value calculation that may not be indicative of net realizable value or reflective of future fair values. While management believes the Company's valuation methodologies are appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different estimate of fair value at the reporting date. Furthermore, the reported fair value amounts have not been comprehensively revalued since the presentation dates, and therefore, estimates of fair value after the balance sheet date may differ significantly from the amounts presented herein. A more detailed description of the valuation methodologies used for assets and liabilities measured at fair value, as well as the general classification of such instruments pursuant to the valuation hierarchy, is set forth below.

**Investment securities available for sale:** Pooled trust preferred securities are reported at fair value utilizing Level 3 inputs. Fair values for these securities are determined through the use of internal valuation methodologies appropriate for the specific asset, which may include the use of a discounted expected cash flow analysis or the use of broker quotes. Other 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:** The fair value of impaired loans with specific allocations of the allowance for loan losses is generally based on recent real estate appraisals. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by the appraisers to adjust for differences between the comparable sales and income data available. Such adjustments are typically significant and result in a Level 3 classification of the inputs for determining fair value.

**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. In cases where the carrying amount exceeds the fair value, less costs to sell, an impairment loss is recognized.

**Mortgage servicing rights:** Mortgage servicing rights do not trade in an active market with readily observable market data. As a result, the Company estimates the fair value of mortgage 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. Significant assumptions in the valuation of mortgage servicing rights include changes in interest rates, estimated loan repayment rates, and the timing of cash flows, among other factors. Mortgage servicing rights are classified as Level 3 measurements due to the use of significant unobservable inputs, as well as significant management judgment and estimation.





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**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**  
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**(9.) FAIR VALUE MEASUREMENTS (Continued)****Assets Measured at Fair Value**

The following table presents 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 June 30, 2011 (in thousands).

|   | <b>Level 1<br/>Inputs</b> | <b>Level 2<br/>Inputs</b> | <b>Level 3<br/>Inputs</b> | <b>Total<br/>Fair Value</b> |
|---|---------------------------|---------------------------|---------------------------|-----------------------------|
| <b>Measured on a recurring basis:</b>                         |                           |                           |                           |                             |
| Securities available for sale:                                |                           |                           |                           |                             |
| U.S. Government agencies and government sponsored enterprises | \$                        | \$ 115,116                | \$                        | \$ 115,116                  |
| State and political subdivisions                              |                           | 122,366                   |                           | 122,366                     |
| Mortgage-backed securities                                    |                           | 462,452                   |                           | 462,452                     |
| Asset-backed securities:                                      |                           |                           |                           |                             |
| Trust preferred securities                                    |                           |                           | 6,963                     | 6,963                       |
| Other   |                           | 61                        |                           | 61                          |
|   | \$                        | \$ 699,995                | \$ 6,963                  | \$ 706,958                  |
| <b>Measured on a nonrecurring basis:</b>                      |                           |                           |                           |                             |
| Loans:  |                           |                           |                           |                             |
| Loans held for sale   | \$                        | \$ 14,511                 | \$                        | \$ 14,511                   |
| Collateral dependent impaired loans                           |                           |                           | 2,032                     | 2,032                       |
| Other assets:   |                           |                           |                           |                             |
| Mortgage servicing rights                                     |                           |                           | 1,573                     | 1,573                       |
| Other real estate owned                                       |                           |                           | 599                       | 599                         |
|   | \$                        | \$ 14,511                 | \$ 4,204                  | \$ 18,715                   |

The following table presents 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 December 31, 2010 (in thousands).

|   | <b>Level 1<br/>Inputs</b> | <b>Level 2<br/>Inputs</b> | <b>Level 3<br/>Inputs</b> | <b>Total<br/>Fair Value</b> |
|---|---------------------------|---------------------------|---------------------------|-----------------------------|
| <b>Measured on a recurring basis:</b>                         |                           |                           |                           |                             |
| Securities available for sale:                                |                           |                           |                           |                             |
| U.S. Government agencies and government sponsored enterprises | \$                        | \$ 140,784                | \$                        | \$ 140,784                  |
| State and political subdivisions                              |                           | 105,666                   |                           | 105,666                     |
| Mortgage-backed securities                                    |                           | 419,281                   |                           | 419,281                     |
| Asset-backed securities:                                      |                           |                           |                           |                             |
| Trust preferred securities                                    |                           |                           | 572                       | 572                         |
| Other   |                           | 65                        |                           | 65                          |
|   | \$                        | \$ 665,796                | \$ 572                    | \$ 666,368                  |

**Measured on a nonrecurring basis:**

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Loans:

|                                     |    |    |       |    |       |          |
|-------------------------------------|----|----|-------|----|-------|----------|
| Loans held for sale                 | \$ | \$ | 3,138 | \$ | \$    | 3,138    |
| Collateral dependent impaired loans |    |    |       |    | 2,457 | 2,457    |
| Other assets:                       |    |    |       |    |       |          |
| Mortgage servicing rights           |    |    |       |    | 1,467 | 1,467    |
| Other real estate owned             |    |    |       |    | 741   | 741      |
|                                     | \$ | \$ | 3,138 | \$ | 4,665 | \$ 7,803 |

There were no liabilities measured at fair value on a recurring or nonrecurring basis during the six month periods ended June 30, 2011 and 2010.

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**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**  
**Notes to Consolidated Financial Statements (Unaudited)**

**(9.) FAIR VALUE MEASUREMENTS (Continued)****Changes in Level 3 Fair Value Measurements**

The reconciliation for all assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) is as follows for the periods indicated (in thousands):

|  | <b>Three months ended</b> |             | <b>Six months ended</b> |             |
|--|---------------------------|-------------|-------------------------|-------------|
|  | <b>June 30,</b>           |             | <b>June 30,</b>         |             |
|  | <b>2011</b>               | <b>2010</b> | <b>2011</b>             | <b>2010</b> |
| Securities available for sale (Level 3), beginning of period | \$ 567                    | \$ 661      | \$ 572                  | \$ 1,015    |
| Transfers into Level 3                                       |                           |             |                         |             |
| Capitalized interest   | 111                       | 114         | 221                     | 200         |
| Coupon payments applied to principal                         | (16)                      | (26)        | (16)                    | (61)        |
| Principal paydowns   | (8)                       |             | (8)                     |             |
| Total gains/losses (realized/unrealized):                    |                           |             |                         |             |
| Included in earnings   |                           |             |                         | (526)       |
| Included in other comprehensive income                       | 6,309                     | (103)       | 6,194                   | 18          |
| Securities available for sale (Level 3), end of period       | \$ 6,963                  | \$ 646      | \$ 6,963                | \$ 646      |

**Fair Value of Financial Instruments**

The Fair Value of Financial Instruments Subsection of the ASC requires disclosure of the fair value of financial assets and financial liabilities, including those financial assets and financial liabilities that are not measured and reported at fair value on a recurring basis or non-recurring basis.

The following discussion describes the valuation methodologies used for assets and liabilities measured or disclosed at fair value. The techniques utilized in estimating the fair values of financial instruments are reliant on the assumptions used, including discount rates and estimates of the amount and timing of future cash flows. 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.

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.

The estimated fair value approximates carrying value for cash and cash equivalents, FHLB and FRB stock, company owned life insurance, accrued interest receivable, short-term borrowings and accrued interest payable. Fair value estimates for other financial instruments are discussed below.

**Loans held for sale.** The fair value is based on estimates, quoted market prices and investor commitments.

**Loans.** For variable rate loans that re-price frequently, fair value approximates carrying amount. The fair value for fixed rate loans is estimated through discounted cash flow analysis using interest rates currently being offered on loans with similar terms and credit quality. For criticized and classified loans, fair value is estimated by discounting expected cash flows at a rate commensurate with the risk associated with the estimated cash flows, or estimates of fair value discounts based on observable market information.

**Deposits.** The fair values for demand accounts, money market and savings deposits are equal to their carrying amounts. The fair values of certificates of deposit are estimated using a discounted cash flow approach that applies prevailing market interest rates for similar maturity instruments.

***Long-term borrowings and junior subordinated debentures.*** The fair value for long-term borrowings and junior subordinated debentures are estimated using a discounted cash flow approach that applies prevailing market interest rates for similar maturity instruments.

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**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**  
**Notes to Consolidated Financial Statements (Unaudited)**

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

The fair value of a financial instrument is the current amount that would be exchanged between willing parties, other than in a forced liquidation. Fair value is best determined based upon quoted market prices. However, in many instances, there are no quoted market prices for the Company's various financial instruments. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. Accordingly, the fair value estimates may not be realized in an immediate settlement of the instrument. The accounting guidelines exclude certain financial instruments and all non-financial instruments from its disclosure requirements. Accordingly, the aggregate fair value amounts presented at June 30, 2011 and December 31, 2010 may not necessarily represent the underlying fair value of the Company.

The estimated fair values of financial instruments were as follows (in thousands):

|   | <b>June 30, 2011</b> |                  | <b>December 31, 2010</b> |                  |
|---|----------------------|------------------|--------------------------|------------------|
|   | <b>Carrying</b>      | <b>Estimated</b> | <b>Carrying</b>          | <b>Estimated</b> |
|   | <b>Amount</b>        | <b>Fair</b>      | <b>Amount</b>            | <b>Fair</b>      |
|   |                      | <b>Value</b>     |                          | <b>Value</b>     |
| <b>Financial assets:</b>  |                      |                  |                          |                  |
| Cash and cash equivalents                                       | \$ 46,084            | \$ 46,084        | \$ 39,058                | \$ 39,058        |
| Securities available for sale                                   | 706,958              | 706,958          | 666,368                  | 666,368          |
| Securities held to maturity                                     | 24,091               | 24,797           | 28,162                   | 28,849           |
| Loans held for sale   | 14,511               | 14,523           | 3,138                    | 3,138            |
| Loans   | 1,347,420            | 1,417,663        | 1,325,524                | 1,388,787        |
| Accrued interest receivable                                     | 7,845                | 7,845            | 7,613                    | 7,613            |
| FHLB and FRB stock  | 8,298                | 8,298            | 6,353                    | 6,353            |
| <b>Financial liabilities:</b>                                   |                      |                  |                          |                  |
| Demand, savings and money market deposits                       | 1,173,053            | 1,173,053        | 1,143,136                | 1,143,136        |
| Certificate of deposit  | 699,186              | 700,234          | 739,754                  | 740,440          |
| Short-term borrowings   | 132,395              | 132,395          | 77,110                   | 77,110           |
| Long-term borrowings (excluding junior subordinated debentures) | 10,000               | 10,010           | 10,065                   | 10,244           |
| Junior subordinated debentures                                  | 16,702               | 10,550           | 16,702                   | 10,564           |
| Accrued interest payable  | 7,299                | 7,299            | 7,620                    | 7,620            |

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**ITEM 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**  
**FORWARD LOOKING INFORMATION**

*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, 2010. In addition, please read this section in conjunction with our Consolidated Financial Statements and Notes to Consolidated Financial Statements contained herein.*

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). In addition, certain statements may be contained in our future filings with SEC, in press releases, and in oral and written statements made by or with our approval that are not statements of historical fact and constitute forward-looking statement within the meaning of 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, be anticipated, estimate, expect, intend, plan, target, plan, projects, and other similar expressions are intended to identify forward-looking statements but are not the exclusive means of identifying such statements.

The Company cautions readers not to place undue reliance on any forward-looking statements, which speak only as of the date made, and advises readers that various factors, including those identified by the Company 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, 2010, could affect the Company's financial performance and could cause the Company's actual results or circumstances for future periods to differ materially from those anticipated or projected.

Except as required by law, the Company does not undertake, and specifically disclaims 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.

**SIGNIFICANT EVENTS**

**Common Stock Offering**

On March 15, 2011, we completed the sale of 2,813,475 shares of our common stock through an underwritten public offering at a price of \$16.35 per share. The net proceeds of the offering, after deducting underwriting discounts and commissions and offering expenses, amounted to \$43.1 million. A portion of the proceeds from this offering was used to redeem the Company's Series A preferred stock as described in greater detail below. The Company also plans during the third quarter of 2011 to redeem the \$16.7 million of 10.20% junior subordinated debentures related to the trust preferred securities issued by an unconsolidated subsidiary, as discussed in greater detail below. The remaining proceeds of this offering were used for general working capital purposes.

**Redemption of Series A Preferred Stock**

In the first quarter of 2011, the Company fully redeemed \$37.5 million of its fixed rate cumulative perpetual preferred stock, Series A (Series A preferred stock) issued in connection with the U.S. Department of the Treasury's (the Treasury) Troubled Asset Relief Program's (TARP) Capital Purchase Program (the Capital Purchase Program). The redemption was funded, in part, by the proceeds of the common stock offering discussed above and from excess liquidity at the parent company. The redemption resulted in a one-time, non-cash redemption charge of \$1.2 million, reflecting the accelerated accretion of the remaining discount on the preferred stock, which reduced 2011 year-to-date diluted earnings per common share by \$0.10.

The complete redemption of the Series A preferred stock removed the TARP restrictions pertaining to the Company's ability to declare and pay dividends and repurchase its common stock, as well as certain restrictions associated with executive compensation.

During the second quarter of 2011, the Company repurchased the Warrant issued to the Treasury. The repurchase price of \$2.1 million was recorded as a reduction of additional paid-in capital.

**Redemption of Subordinated Debentures**

On July 1, 2011, the Company notified the trustee of FISI Statutory Trust I (the Trust), a wholly-owned subsidiary of the Company, that it will redeem all of its 10.20% junior subordinated debentures due 2031 on August 22, 2011 (the Redemption Date). The redemption price will be 105.1% of the principal amount redeemed, plus all accrued and unpaid interest as of the Redemption Date. As a result of the redemption, the Company anticipates that it will

recognize a pre-tax charge of \$1.1 million during the third quarter of 2011.

Consequent to repayment of the junior subordinated debentures, the Trust will redeem all of its fixed rate trust preferred securities (the Securities ). The Securities are subject to mandatory redemption, in whole or in part, upon repayment of the junior subordinated debentures. See the section titled Liquidity and Capital Resources included herein for additional information regarding the impact of this transaction on regulatory capital.



Table of Contents**MANAGEMENT'S DISCUSSION AND ANALYSIS****RESULTS OF OPERATIONS****Summary of Performance**

Net income increased \$521 thousand or 10% to \$5.7 million for the second quarter of 2011 compared to \$5.2 million for the second quarter of 2010. The increase during the second quarter of 2011 was primarily the result of an increase of \$577 thousand in net interest income and a \$777 thousand decrease in the provision for loan losses, offset by increases of \$283 thousand in noninterest expense and \$558 thousand in income tax expense. Net income available to common shareholders for the second quarter of 2011 was \$5.3 million, or \$0.39 per diluted share, compared with \$4.3 million, or \$0.39 per diluted share, for the second quarter of last year. Return on average equity was 10.03% and return on average assets was 1.01% for the second quarter of 2011 compared to 10.04% and 0.97%, respectively, for the second quarter of 2010.

Net income for the six months ended June 30, 2011 totaled \$11.5 million, an increase of \$1.0 million or 10% from \$10.5 million for the same period in 2010. The increase in year-to-date net income for 2011 was driven by a \$1.2 million increase in net interest income, a \$385 thousand decrease in the provision for loan losses and a \$1.1 million increase in noninterest income, offset by increases of \$895 thousand in noninterest expense and \$713 thousand in income tax expense. For the first six months of 2011 net income available to common shareholders was \$9.1 million, or \$0.72 per diluted share, compared with \$8.7 million, or \$0.80 per diluted share, for the first six months of 2010. Return on average equity was 10.43% and return on average assets was 1.04% for the six months ended June 30, 2011 compared to 10.35% and 0.99%, respectively, for the same period in 2010.

The 2011 second quarter and year-to-date earnings per share amounts were impacted by the 2,813,475 additional shares of common stock issued in conjunction with our public stock offering that occurred late in the first quarter of 2011. In addition, year-to-date earnings for 2011 were reduced by \$1.2 million, or \$0.10 per common share, for the accelerated discount accretion related to the Company's redemption of the Series A preferred stock issued pursuant to the Capital Purchase Program.

**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:

|   | <b>Three months ended June 30,</b> |             | <b>Six months ended June 30,</b> |             |
|---|------------------------------------|-------------|----------------------------------|-------------|
|   | <b>2011</b>                        | <b>2010</b> | <b>2011</b>                      | <b>2010</b> |
| Interest income per consolidated statements of income | \$ 23,830                          | \$ 24,202   | \$ 47,469                        | \$ 48,026   |
| Adjustment to fully taxable equivalent basis          | 534                                | 465         | 1,048                            | 972         |
|   | 24,364                             | 24,667      | 48,517                           | 48,998      |

|  |           |           |           |           |
|--|-----------|-----------|-----------|-----------|
| Interest income adjusted to a fully taxable equivalent basis |           |           |           |           |
| Interest expense per consolidated statements of income       | 3,577     | 4,526     | 7,378     | 9,098     |
| Net interest income on a taxable equivalent basis            | \$ 20,787 | \$ 20,141 | \$ 41,139 | \$ 39,900 |

***Analysis of Net Interest Income for the Three Months ended June 30, 2011 and June 30, 2010***

Net interest income on a taxable equivalent basis for the three months ended June 30, 2011, was \$20.8 million, an increase of \$646 thousand or 3% 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 \$1.9 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 \$1.3 million).

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

The net interest margin for the second quarter of 2011 was 4.00%, 9 basis points lower than 4.09% for the same period in 2010. This comparable period decrease was a function of a 5 basis point decrease in interest rate spread, combined with a 4 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 32 basis point decrease in the yield on earning assets and a 27 basis point decrease in the cost of interest-bearing liabilities.

The yield on earning assets was 4.69% for the second quarter of 2011, 32 basis points lower than the second quarter of 2010. Loan yields decreased 28 basis points to 5.60%, also impacted by the lower interest rate environment. Commercial mortgage and consumer indirect loans in particular, down 37 and 59 basis points, respectively, experienced lower yields given the competitive pricing pressures in a low interest rate environment. The yield on investment securities dropped 48 basis points to 2.96%, also impacted by the lower interest rate environment and prepayments of mortgage-related investment securities. Overall, earning asset rate changes reduced interest income by \$1.9 million.

The cost of average interest-bearing liabilities of 0.86% in the second quarter of 2011 was 27 basis points lower than the second quarter of 2010. The average cost of interest-bearing deposits was 0.75% in 2011, 23 basis points lower than 2010, reflecting the lower rate environment, mitigated by a focus on product pricing to retain balances. The cost of short-term funding decreased 17 basis points to 0.62%, while the cost of long-term borrowings increased by 189 basis points to 7.98%. The cost of long-term borrowings has increased as the Company has repaid lower priced debt, leaving the higher fixed rate 10.20% junior subordinated debentures as a larger percentage of total outstanding long-term debt. As previously discussed, the Company intends to repay the junior subordinated debentures in full during the third quarter of 2011. The interest-bearing liability rate changes resulted in \$635 thousand of lower interest expense.

Average interest-earning assets were \$2.080 billion for the second quarter of 2011, an increase of \$108.4 million or 5% from the comparable quarter last year, with average loans up \$90.4 million and average securities up \$22.3 million. The growth in average loans was comprised of increases in consumer loans (up \$77.2 million, primarily indirect loans) and commercial loans (up \$30.9 million), while residential mortgages declined (down \$17.7 million).

Average interest-bearing liabilities of \$1.665 billion in the second quarter of 2011 were \$53.0 million or 3% higher than the second quarter of 2010. On average, interest-bearing deposits grew \$45.0 million (primarily attributable to \$33.0 million higher municipal deposits), while noninterest-bearing demand deposits (a principal component of net free funds) were up \$33.6 million. Average borrowings increased \$8.0 million between the second quarter periods, with short-term borrowings higher by \$28.1 million and long-term funding lower by \$20.1 million.

***Analysis of Net Interest Income for the Six Months ended June 30, 2011 and June 30, 2010***

Net interest income on a taxable equivalent basis for the first six months of 2011 was \$41.1 million, an increase of \$1.2 million or 3% 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 \$3.6 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 \$2.4 million).

The net interest margin for the first six months of 2011 was 4.02%, 9 basis points lower than 4.11% for the same period last year. This comparable period decrease was a function of a 4 basis point decrease in interest rate spread, combined with a 5 basis point lower contribution from net free funds. The decline in the interest rate spread was a net result of a 29 basis point decrease in the yield on earning assets, largely offset by a 25 basis point reduction in the cost of interest-bearing liabilities.

The yield on earning assets was 4.75% for the first six months of 2011, 29 basis points lower than the same period last year, attributable to decreases in the yields on the investment security portfolio (down 47 basis points, to 2.98%) and loan portfolio (down 27 basis points to 5.66%).

The rate on interest-bearing liabilities of 0.90% for the first six months of 2011 was 25 basis points lower than the same period in 2010. Rates on interest-bearing deposits were down 22 basis points to 0.79%. The cost of short-term

borrowings decreased 12 basis points to 0.60%, while the cost of long-term funding increased by 189 basis points. As previously discussed, the cost of long-term borrowings has increased due to a change in the mix of outstanding long-term debt.

Average interest-earning assets were \$2.056 billion for the first six months of 2011, an increase of \$101.9 million or 5% from the comparable period last year, with average loans up \$88.3 million and average securities up \$22.9 million. The growth in average loans was comprised of increases in consumer loans (up \$74.0 million, primarily indirect loans) and commercial loans (up \$30.7 million), while residential mortgages declined (down \$16.4 million).

Average interest-bearing liabilities of \$1.653 billion in the first six months of 2011 were \$57.7 million or 4% higher than the first six months of 2010. On average, interest-bearing deposits grew \$62.1 million (primarily attributable to \$42.8 million higher retail deposits), while noninterest-bearing demand deposits were up \$35.2 million. Average borrowings decreased \$4.4 million between the first six months of 2011 and the same period in 2010 due to repayment of long-term borrowings upon maturity.

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

The following tables 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, |          |                 |                    |          |                 |
|--|-----------------------------|----------|-----------------|--------------------|----------|-----------------|
|  | 2011                        |          | 2010            |                    |          |                 |
|  | Average<br>Balance          | Interest | Average<br>Rate | Average<br>Balance | Interest | Average<br>Rate |
| <b>Interest-earning assets:</b>                  |                             |          |                 |                    |          |                 |
| Federal funds sold and interest-earning deposits | \$ 116                      | \$       | 0.22%           | \$ 4,479           | \$ 3     | 0.20%           |
| Investment securities <sup>(1)</sup> :           |                             |          |                 |                    |          |                 |
| Taxable  | 570,945                     | 3,767    | 2.64            | 585,300            | 4,584    | 3.13            |
| Tax-exempt <sup>(2)</sup>                        | 143,545                     | 1,526    | 4.25            | 106,862            | 1,366    | 5.11            |
| Total investment securities                      | 714,490                     | 5,293    | 2.96            | 692,162            | 5,950    | 3.44            |
| Loans:   |                             |          |                 |                    |          |                 |
| Commercial business                              | 212,260                     | 2,553    | 4.82            | 208,327            | 2,500    | 4.81            |
| Commercial mortgage                              | 361,265                     | 5,216    | 5.79            | 334,253            | 5,137    | 6.16            |
| Residential mortgage                             | 123,293                     | 1,737    | 5.63            | 140,946            | 2,032    | 5.77            |
| Home equity                                      | 212,439                     | 2,376    | 4.49            | 199,865            | 2,277    | 4.57            |
| Consumer indirect                                | 431,728                     | 6,544    | 6.08            | 364,801            | 6,069    | 6.67            |
| Other consumer                                   | 24,717                      | 645      | 10.46           | 27,060             | 699      | 10.37           |
| Total loans                                      | 1,365,702                   | 19,071   | 5.60            | 1,275,252          | 18,714   | 5.88            |
| Total interest-earning assets                    | 2,080,308                   | 24,364   | 4.69            | 1,971,893          | 24,667   | 5.01            |
| Allowance for loan losses                        | (20,739)                    |          |                 | (21,052)           |          |                 |
| Other noninterest-earning assets                 | 208,790                     |          |                 | 208,071            |          |                 |
| Total assets                                     | \$ 2,268,359                |          |                 | \$ 2,158,912       |          |                 |
| <b>Interest-bearing liabilities:</b>             |                             |          |                 |                    |          |                 |
| Deposits:  |                             |          |                 |                    |          |                 |
| Interest-bearing demand                          | \$ 391,899                  | \$ 161   | 0.16%           | \$ 386,703         | \$ 179   | 0.19%           |
| Savings and money market                         | 468,130                     | 275      | 0.24            | 420,774            | 294      | 0.28            |
| Certificates of deposit                          | 707,608                     | 2,498    | 1.42            | 715,168            | 3,257    | 1.83            |
| Total interest-bearing deposits                  | 1,567,637                   | 2,934    | 0.75            | 1,522,645          | 3,730    | 0.98            |
| Short-term borrowings                            | 71,092                      | 110      | 0.62            | 42,946             | 85       | 0.79            |
| Long-term borrowings                             | 26,702                      | 533      | 7.98            | 46,807             | 711      | 6.09            |
| Total borrowings                                 | 97,794                      | 643      | 2.63            | 89,753             | 796      | 3.55            |
|  | 1,665,431                   | 3,577    | 0.86            | 1,612,398          | 4,526    | 1.13            |

|  |              |           |              |
|--|--------------|-----------|--------------|
| Total interest-bearing liabilities   |              |           |              |
| Noninterest-bearing demand deposits  | 358,349      |           | 324,790      |
| Other noninterest-bearing liabilities  | 15,970       |           | 14,053       |
| Shareholders' equity   | 228,609      |           | 207,671      |
| Total liabilities and shareholders' equity                                       | \$ 2,268,359 |           | \$ 2,158,912 |
| Net interest income (tax-equivalent)   |              | \$ 20,787 | \$ 20,141    |
| Interest rate spread   |              | 3.83%     | 3.88%        |
| Net earning assets   | \$ 414,877   |           | \$ 359,495   |
| Net interest margin (tax-equivalent)   |              | 4.00%     | 4.09%        |
| Ratio of average interest-earning assets to average interest-bearing liabilities |              | 124.91%   | 122.30%      |

(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% and 34% for the three months ended June 30, 2011 and 2010, respectively.

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

|  | Six months ended June 30, |                  |                 |                    |                  |                 |
|--|---------------------------|------------------|-----------------|--------------------|------------------|-----------------|
|  | Average<br>Balance        | 2011<br>Interest | Average<br>Rate | Average<br>Balance | 2010<br>Interest | Average<br>Rate |
| <b>Interest-earning assets:</b>                  |                           |                  |                 |                    |                  |                 |
| Federal funds sold and interest-earning deposits | \$ 186                    | \$               | 0.22%           | \$ 9,395           | \$ 10            | 0.20%           |
| Investment securities <sup>(1)</sup> :           |                           |                  |                 |                    |                  |                 |
| Taxable  | 558,084                   | 7,416            | 2.66            | 563,723            | 8,797            | 3.12            |
| Tax-exempt <sup>(2)</sup>                        | 140,054                   | 2,995            | 4.28            | 111,542            | 2,859            | 5.13            |
| Total investment securities                      | 698,138                   | 10,411           | 2.98            | 675,265            | 11,656           | 3.45            |
| Loans:   |                           |                  |                 |                    |                  |                 |
| Commercial business                              | 209,977                   | 5,027            | 4.83            | 206,626            | 4,964            | 4.84            |
| Commercial mortgage                              | 361,247                   | 10,447           | 5.83            | 333,918            | 10,113           | 6.11            |
| Residential mortgage                             | 125,915                   | 3,572            | 5.67            | 142,355            | 4,254            | 5.98            |
| Home equity                                      | 210,558                   | 4,699            | 4.50            | 199,884            | 4,554            | 4.59            |
| Consumer indirect                                | 424,818                   | 13,069           | 6.20            | 358,823            | 12,035           | 6.76            |
| Other consumer                                   | 24,971                    | 1,292            | 10.44           | 27,599             | 1,412            | 10.32           |
| Total loans                                      | 1,357,486                 | 38,106           | 5.66            | 1,269,205          | 37,332           | 5.93            |
| Total interest-earning assets                    | 2,055,810                 | 48,517           | 4.75            | 1,953,865          | 48,998           | 5.04            |
| Allowance for loan losses                        | (20,807)                  |                  |                 | (21,036)           |                  |                 |
| Other noninterest-earning assets                 | 210,194                   |                  |                 | 202,852            |                  |                 |
| Total assets                                     | \$ 2,245,197              |                  |                 | \$ 2,135,681       |                  |                 |
| <b>Interest-bearing liabilities:</b>             |                           |                  |                 |                    |                  |                 |
| Deposits:  |                           |                  |                 |                    |                  |                 |
| Interest-bearing demand                          | \$ 393,842                | \$ 323           | 0.17%           | \$ 389,783         | \$ 368           | 0.19%           |
| Savings and money market                         | 451,447                   | 537              | 0.24            | 411,088            | 570              | 0.28            |
| Certificates of deposit                          | 719,943                   | 5,271            | 1.48            | 702,297            | 6,576            | 1.89            |
| Total interest-bearing deposits                  | 1,565,232                 | 6,131            | 0.79            | 1,503,168          | 7,514            | 1.01            |
| Short-term borrowings                            | 61,165                    | 182              | 0.60            | 45,441             | 163              | 0.72            |
| Long-term borrowings                             | 26,723                    | 1,065            | 7.98            | 46,827             | 1,421            | 6.09            |
| Total borrowings                                 | 87,888                    | 1,247            | 2.85            | 92,268             | 1,584            | 3.45            |
| Total interest-bearing liabilities               | 1,653,120                 | 7,378            | 0.90            | 1,595,436          | 9,098            | 1.15            |
|  | 354,213                   |                  |                 | 319,040            |                  |                 |

|  |              |              |         |
|--|--------------|--------------|---------|
| Noninterest-bearing demand deposits  |              |              |         |
| Other noninterest-bearing liabilities  | 14,765       | 16,090       |         |
| Shareholders' equity   | 223,099      | 205,115      |         |
| Total liabilities and shareholders' equity                                       | \$ 2,245,197 | \$ 2,135,681 |         |
| Net interest income (tax-equivalent)   | \$ 41,139    | \$ 39,900    |         |
| Interest rate spread   |              | 3.85%        | 3.89%   |
| Net earning assets   | \$ 402,690   | \$ 358,429   |         |
| Net interest margin (tax-equivalent)   |              | 4.02%        | 4.11%   |
| Ratio of average interest-earning assets to average interest-bearing liabilities |              | 124.36%      | 122.47% |

(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% and 34% for the six months ended June 30, 2011 and 2010, respectively.



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

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

| Increase (decrease) in:                          | Three months ended<br>June 30, 2011 vs. 2010 |            |        | Six months ended<br>June 30, 2011 vs. 2010 |            |          |
|--|--|------------|--------|--|------------|----------|
|  | Volume                                       | Rate       | Total  | Volume                                     | Rate       | Total    |
| <b>Interest income:</b>                          |  |            |        |  |            |          |
| Federal funds sold and interest-earning deposits | \$ (3)                                       | \$         | \$ (3) | \$ (10)                                    | \$         | \$ (10)  |
| Investment securities:                           |  |            |        |  |            |          |
| Taxable  | (110)  | (707)      | (817)  | (87)                                       | (1,294)    | (1,381)  |
| Tax-exempt                                       | 416  | (256)      | 160    | 658  | (522)      | 136      |
| Total investment securities                      | 306  | (963)      | (657)  | 571  | (1,816)    | (1,245)  |
| Loans:   |  |            |        |  |            |          |
| Commercial business                              | 47   | 6          | 53     | 80   | (17)       | 63       |
| Commercial mortgage                              | 401  | (322)      | 79     | 803  | (469)      | 334      |
| Residential mortgage                             | (250)  | (45)       | (295)  | (474)                                      | (208)      | (682)    |
| Home equity                                      | 141  | (42)       | 99     | 239  | (94)       | 145      |
| Consumer indirect                                | 1,046  | (571)      | 475    | 2,087                                      | (1,053)    | 1,034    |
| Other consumer                                   | (61)   | 7          | (54)   | (136)                                      | 16         | (120)    |
| Total loans                                      | 1,324  | (967)      | 357    | 2,599                                      | (1,825)    | 774      |
| <b>Total interest income</b>                     | 1,627  | (1,930)    | (303)  | 3,160                                      | (3,641)    | (481)    |
| <b>Interest expense:</b>                         |  |            |        |  |            |          |
| Deposits:  |  |            |        |  |            |          |
| Interest-bearing demand                          | 2  | (20)       | (18)   | 4  | (49)       | (45)     |
| Savings and money market                         | 31   | (50)       | (19)   | 53   | (86)       | (33)     |
| Certificates of deposit                          | (34)   | (725)      | (759)  | 161  | (1,466)    | (1,305)  |
| Total interest-bearing deposits                  | (1)  | (795)      | (796)  | 218  | (1,601)    | (1,383)  |
| Short-term borrowings                            | 47   | (22)       | 25     | 50   | (31)       | 19       |
| Long-term borrowings                             | (360)  | 182        | (178)  | (720)                                      | 364        | (356)    |
| Total borrowings                                 | (313)  | 160        | (153)  | (670)                                      | 333        | (337)    |
| <b>Total interest expense</b>                    | (314)  | (635)      | (949)  | (452)                                      | (1,268)    | (1,720)  |
| <b>Net interest income</b>                       | \$ 1,941                                     | \$ (1,295) | \$ 646 | \$ 3,612                                   | \$ (2,373) | \$ 1,239 |

**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 \$1.3 million and \$2.1 million for the three and six month periods ended June 30, 2011, compared with provisions of \$2.1 million and \$2.5 million for the corresponding periods in 2010, respectively. See Allowance for Loan Losses

under the section titled Lending Activities included herein for additional information.

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

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

|  | Three months ended |          | Six months ended |          |
|--|--------------------|----------|------------------|----------|
|  | June 30,           |          | June 30,         |          |
|  | 2011               | 2010     | 2011             | 2010     |
| Service charges on deposits                          | \$ 2,243           | \$ 2,502 | \$ 4,348         | \$ 4,732 |
| ATM and debit card                                   | 1,123              | 1,054    | 2,139            | 1,988    |
| Broker-dealer fees and commissions                   | 402                | 359      | 788              | 739      |
| Loan servicing                                       | 249                | 140      | 598              | 420      |
| Company owned life insurance                         | 279                | 282      | 545              | 551      |
| Net gain on sale of loans held for sale              | 117                | 115      | 341              | 177      |
| Net gain on disposal of investment securities        | 4                  | 63       | 7                | 69       |
| Impairment charges on investment securities          |                    |          |                  | (526)    |
| Net (loss) gain on sale and disposal of other assets | (8)                |          | 37               | 2        |
| Other  | 565                | 451      | 1,319            | 897      |
| Total noninterest income                             | \$ 4,974           | \$ 4,966 | \$ 10,122        | \$ 9,049 |

The components of noninterest income fluctuated as discussed below.

Service charges on deposit accounts were down \$259 thousand or 10% in the second quarter of 2011 and \$384 thousand or 8% for the six months ended June 30, 2011, compared to the same periods a year earlier. Substantially the entire decline was due to a reduction in non-sufficient funds transactions.

ATM and debit card income was up \$69 thousand or 7% and \$151 thousand or 8%, respectively, in the three and six months ended June 30, 2011, compared to the same periods of 2010. The increased popularity of electronic banking and transaction processing has resulted in higher ATM and debit card point-of-sale usage income.

Broker-dealer fees and commissions were up \$43 thousand or 12% and \$151 thousand or 7%, respectively, in the three and six months ended June 30, 2011, compared to the same periods of 2010, mainly due to increased sales volume.

Loan servicing income was up \$109 thousand or 78% in the second quarter of 2011 and \$178 thousand or 42% for the six months ended June 30, 2011, compared to the same periods a year ago, mainly due to a decrease in the mortgage servicing asset valuation allowance.

Net gain in loans held for sale increased \$164 thousand or 93% for the six months ended June 30, 2011, compared to the same period a year ago, primarily due to a decrease in the valuation allowance for loans held for sale.

Other noninterest income increased \$114 thousand or 25% in the second quarter of 2011 and \$422 thousand or 47% for the six months ended June 30, 2011, compared to the same periods a year earlier. Income from the Company's capital investment in several limited partnerships accounted for the majority of the 2011 increases.

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

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

|                                | Three months ended |           | Six months ended |           |
|--------------------------------|--------------------|-----------|------------------|-----------|
|                                | June 30,           |           | June 30,         |           |
|                                | 2011               | 2010      | 2011             | 2010      |
| Salaries and employee benefits | \$ 8,854           | \$ 8,044  | \$ 17,255        | \$ 16,291 |
| Occupancy and equipment        | 2,644              | 2,670     | 5,487            | 5,441     |
| Professional services          | 571                | 478       | 1,253            | 1,084     |
| Computer and data processing   | 648                | 615       | 1,251            | 1,186     |
| Supplies and postage           | 424                | 431       | 876              | 876       |
| FDIC assessments               | 168                | 634       | 775              | 1,236     |
| Advertising and promotions     | 253                | 352       | 418              | 539       |
| Other                          | 1,591              | 1,646     | 3,188            | 2,955     |
| Total noninterest expense      | \$ 15,153          | \$ 14,870 | \$ 30,503        | \$ 29,608 |

The components of noninterest expense fluctuated as discussed below.

The largest noninterest expense increase in the three and six month periods ended June 30, 2011 was in salaries and employee benefits, which increased by \$810 thousand or 10% and \$964 thousand or 6%, respectively, over the same periods one year earlier. The increases reflect higher employee benefit costs and increased accruals for incentive compensation, which were previously limited under the Capital Purchase Program. In addition, the Company has increased its staffing levels modestly as full time equivalent employees totaled 581 and 573 at June 30, 2011 and 2010, respectively.

Professional services expenses increased \$93 thousand or 19% and \$169 thousand or 16%, respectively, in the three and six months ended June 30, 2011, compared to the same periods of 2010. Professional fees increased primarily due to legal and shareholder expenses related to the transactions identified earlier as significant events.

FDIC assessments for the second quarter and first six months of 2011 are down considerably compared to the same periods of 2010, primarily a result of changes made by the FDIC in the method of calculating assessment rates.

Advertising and promotions costs were down \$99 thousand or 28% in the second quarter of 2011 and \$121 thousand or 22% for the six months ended June 30, 2011, compared to the same periods a year earlier due to fewer marketing campaigns and promotions.

The efficiency ratio for the second quarter of 2011 was 58.68% compared with 59.16% for the second quarter of 2010, and 59.32% for the six months ended June 30, 2011, compared to 59.73% for the same period a year ago. The efficiency ratio equals noninterest expense less other real estate expense as a percentage of net revenue, defined as the sum of tax-equivalent net interest income and noninterest income before net gains and impairment charges on investment securities.

**Income Taxes**

The Company recorded income tax expense of \$3.0 million in the second quarter of 2011, compared to income tax expense of \$2.5 million in the second quarter of 2010. For the six month period ended June 30, 2011, income tax expense totaled \$6.0 million compared to \$5.3 million in the same period of 2010. These changes were due in part to increases of \$1.1 million and \$1.7 million in pre-tax income for the three and six month periods of 2011, respectively, compared to the prior year. The effective tax rates recorded for 2011 on a quarter-to-date and year-to-date basis were 34.6% and 34.3%, respectively, in comparison to the June 30, 2010 quarter-to-date and year-to-date effective tax rates of 32.2% and 33.6%, respectively. Effective tax rates are impacted by items of income and expense that are not subject to federal or state taxation. The Company's 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.



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

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

|   | <b>Investment Securities Portfolio Composition</b> |                   |                          |                   |
|---|--|-------------------|--------------------------|-------------------|
|   | <b>June 30, 2011</b>                               |                   | <b>December 31, 2010</b> |                   |
|   | <b>Amortized Cost</b>                              | <b>Fair Value</b> | <b>Amortized Cost</b>    | <b>Fair Value</b> |
| <b>Securities available for sale:</b>                                 |  |                   |                          |                   |
| U.S. Government agency and government-sponsored enterprise securities | \$ 115,032   | \$ 115,116        | \$ 141,591               | \$ 140,784        |
| State and political subdivisions                                      | 120,350  | 122,366           | 105,622                  | 105,666           |
| Mortgage-backed securities:   |  |                   |                          |                   |
| Agency mortgage-backed securities                                     | 451,380  | 460,328           | 414,502                  | 417,709           |
| Non-Agency mortgage-backed securities                                 | 633  | 2,124             | 981                      | 1,572             |
| Asset-backed securities   | 541  | 7,024             | 564                      | 637               |
| Total available for sale securities                                   | 687,936  | 706,958           | 663,260                  | 666,368           |
| <b>Securities held to maturity:</b>                                   |  |                   |                          |                   |
| State and political subdivisions                                      | 24,091   | 24,797            | 28,162                   | 28,849            |
| Total investment securities   | \$ 712,027   | \$ 731,755        | \$ 691,422               | \$ 695,217        |

**Impairment Assessment**

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 available to management at a point in time.

The table below summarizes unrealized losses in each category of the securities portfolio at the end of the periods indicated (in thousands).

|   | <b>Unrealized Losses on Investment Securities</b> |                   |                          |                   |
|---|---|-------------------|--------------------------|-------------------|
|   | <b>June 30, 2011</b>                              |                   | <b>December 31, 2010</b> |                   |
|   | <b>Unrealized Losses</b>                          | <b>% of Total</b> | <b>Unrealized Losses</b> | <b>% of Total</b> |
| <b>Securities available for sale:</b>                         |   |                   |                          |                   |
| U.S. Government agencies and government sponsored enterprises | \$ 1,006  | 63.8%             | \$ 1,965                 | 31.6%             |
| State and political subdivisions                              | 346   | 22.0              | 1,472                    | 23.6              |
| Mortgage-backed securities:                                   |   |                   |                          |                   |
| Agency mortgage-backed securities                             | 224   | 14.2              | 2,655                    | 42.7              |
| Non-Agency mortgage-backed securities                         |   |                   |                          |                   |
| Asset-backed securities                                       |   |                   | 131                      | 2.1               |

|                                     |    |       |        |    |       |        |
|-------------------------------------|----|-------|--------|----|-------|--------|
| Total available for sale securities | \$ | 1,576 | 100.0  | \$ | 6,223 | 100.0  |
| <b>Securities held to maturity:</b> |    |       |        |    |       |        |
| State and political subdivisions    |    |       |        |    |       |        |
| Total investment securities         | \$ | 1,576 | 100.0% | \$ | 6,223 | 100.0% |

**U.S. Government Agencies and Government Sponsored Enterprises ( GSE ).** As of June 30, 2011, there were 14 securities in the U.S. Government agencies and GSE portfolio that were in an unrealized loss position. Of these, 7 were in an unrealized loss position for 12 months or longer and had an aggregate amortized cost of \$7.8 million and unrealized losses of \$22 thousand. Because the decline in fair value is attributable to changes in interest rates, and not credit quality, and because we do not have the intent to sell these securities and it is likely that we will not be required to sell the securities before their anticipated recovery, we do not consider these securities to be other-than-temporarily impaired at June 30, 2011.

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

**State and Political Subdivisions.** As of June 30, 2011, the state and political subdivisions portfolio ( municipals ) totaled \$146.5 million, of which \$122.4 million was classified as available for sale. As of that date, \$24.1 million was classified as held to maturity with a fair value of \$24.8 million. As of June 30, 2011, there were 81 municipals in an unrealized loss position, all of which were available for sale. These securities had an aggregate amortized cost of \$31.3 million and unrealized losses of \$346 thousand.

Although there has been a considerable amount of negative information regarding municipal bond insurers, and several of the municipal bond insurers have been downgraded, there is no indication to date that the underlying credit issuers (counties, towns, villages, cities, schools, etc.) are likely to default on their debt. There have also been some highly publicized concerns over the New York State budget problems as well as reductions in the amounts and delays in funding by New York State to its municipalities and political subdivisions. At this time, management does not believe that the New York State budget problems will culminate in local municipalities defaulting on debt obligations. Additionally, most of the available for sale bonds are General Obligation issues which require the taxing authority to increase taxes as needed to repay the bond holders.

Because the decline in fair value is attributable to changes in interest rates, and not credit quality, and because we do not have the intent to sell these securities and it is likely that we will not be required to sell the securities before their anticipated recovery, we do not consider these securities to be other-than-temporarily impaired at June 30, 2011.

**Agency Mortgage-backed Securities.** With the exception of the non-Agency mortgage-backed securities ( non-Agency MBS ) discussed below, all of the mortgage-backed securities held by us as of June 30, 2011, were issued by U.S. Government sponsored entities and agencies ( Agency MBS ), primarily GNMA. The contractual cash flows of our Agency MBS are guaranteed by FNMA, FHLMC or GNMA. The GNMA mortgage-backed securities are backed by the full faith and credit of the U.S. Government.

As of June 30, 2011, there were 15 securities in the Agency MBS portfolio that were in an unrealized loss position. Of these, only four securities with an aggregate amortized cost of \$2.1 million and unrealized losses of \$11 thousand were in an unrealized loss position for 12 months or longer. Given the high credit quality inherent in Agency MBS, we do not consider any of the unrealized losses on such MBS to be credit related or other-than-temporary as of June 30, 2011. Furthermore, as of June 30, 2011, we did not intend to sell any of Agency MBS that were in an unrealized loss position, all of which were performing in accordance with their terms.

**Non-Agency Mortgage-backed Securities.** Our non-Agency MBS portfolio consists of positions in three privately issued whole loan collateralized mortgage obligations with a fair value of \$2.1 million and net unrealized gains of \$1.5 million as of June 30, 2011. As of that date, each of the three non-Agency MBS were rated below investment grade. None of these securities were in an unrealized loss position. To date, we have recognized aggregate OTTI charges of \$6.0 million due to reasons of credit quality against these securities, all of which was recorded prior to 2010.

**Asset-backed Securities ( ABS ).** As of June 30, 2011, the fair value of the ABS portfolio totaled \$7.0 million and consisted of positions in 15 securities, the majority of which are pooled trust preferred securities ( TPS ) issued primarily by financial institutions and, to a lesser extent, insurance companies located throughout the United States. As a result of some issuers defaulting and others electing to defer interest payments, we considered all but one of the ABS securities to be non-performing and stopped accruing interest on the investments during 2009.

Since the second quarter of 2008, we have written down each of the securities in the ABS portfolio, resulting in aggregate OTTI charges of \$32.9 million through December 31, 2010. We expect to recover the remaining amortized cost of \$541 thousand on the securities. As of June 30, 2011, each of the securities in the ABS portfolio was rated below investment grade. None of these securities were in an unrealized loss position.

The market for these securities greatly improved during the second quarter of 2011, resulting in the \$6.4 million increase in fair value from December 31, 2010. During that time, there were no additions to the portfolio as the increase relates solely to an increase in the fair value of each of the 15 securities in the portfolio. During July 2011, the Company sold one of the ABS securities and will recognize a gain of approximately \$1 million during the third quarter. The security had a fair value of \$752 thousand at June 30, 2011. The Company continues to monitor the market for these securities and evaluate the potential for future dispositions.



**Other Investments.** As a member of the FHLB the Bank is required to hold FHLB stock. The amount of required FHLB stock is based on the Bank's asset size and the amount of borrowings from the FHLB. We have assessed the ultimate recoverability of our FHLB stock and believe that no impairment currently exists. As a member of the FRB system, we are required to maintain a specified investment in FRB stock based on a ratio relative to our capital. The FHLB stock and FRB stock are recorded at cost and included in other assets. Our ownership of FHLB stock totaled \$4.4 million and \$2.5 million at June 30, 2011 and December 31, 2010, respectively. The increase in FHLB stock was required due to an increased level of borrowings.

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

|                           | <b>Loan Portfolio Composition</b> |                       |                          |                       |
|---------------------------|-----------------------------------|-----------------------|--------------------------|-----------------------|
|                           | <b>June 30, 2011</b>              |                       | <b>December 31, 2010</b> |                       |
|                           | <b>Amount</b>                     | <b>% of<br/>Total</b> | <b>Amount</b>            | <b>% of<br/>Total</b> |
| Commercial business       | \$ 217,430                        | 15.9%                 | \$ 211,031               | 15.7%                 |
| Commercial mortgage       | 357,463                           | 26.1                  | 352,930                  | 26.2                  |
| Total commercial          | 574,893                           | 42.0                  | 563,961                  | 41.9                  |
| Residential mortgage      | 120,789                           | 8.8                   | 129,580                  | 9.6                   |
| Home equity               | 215,637                           | 15.8                  | 208,327                  | 15.5                  |
| Consumer indirect         | 431,611                           | 31.6                  | 418,016                  | 31.1                  |
| Other consumer            | 25,122                            | 1.8                   | 26,106                   | 1.9                   |
| Total consumer            | 672,370                           | 49.2                  | 652,449                  | 48.5                  |
| Total loans               | 1,368,052                         | 100.0%                | 1,345,990                | 100.0%                |
| Allowance for loan losses | 20,632                            |                       | 20,466                   |                       |
| Total loans, net          | \$ 1,347,420                      |                       | \$ 1,325,524             |                       |

Total loans increased by 2% to \$1.368 billion as of June 30, 2011 from \$1.346 billion as of December 31, 2010. Commercial loans increased \$10.9 million from December 31, 2010 and represented 42.0% of total loans as of June 30, 2011, a result of the Company's continued focus on commercial business development programs. Residential mortgage loans decreased \$8.8 million to \$120.8 million as of June 30, 2011 in comparison to \$129.6 million as of December 31, 2010. This category of loans decreased as the majority of newly originated and refinanced residential mortgages were sold in the secondary market rather than being added to the portfolio. The Company does not engage in sub-prime or other high-risk residential mortgage lending as a line-of-business. Consumer loans totaled \$672.4 million as of June 30, 2011, an increase of \$19.9 million or 3% from December 31, 2010. The consumer indirect portfolio increased \$13.6 million to \$431.6 million as of June 30, 2011, from \$418.0 million as of December 31, 2010. During the first half of 2011, the Company originated \$111.6 million in indirect auto loans with a mix of approximately 44% new auto and 56% used auto. During the second quarter of 2011, the Company reclassified \$13.6 million of auto loans from the consumer indirect portfolio to loans held for sale.

**Loans Held for Sale and Mortgage Servicing Rights.** Loans held for sale (not included above) totaled \$14.5 million as of June 30, 2011, comprised of \$935 thousand of residential mortgage loans and \$13.6 million of indirect auto loans. During the second quarter of 2011, the Company reclassified \$13.6 million of indirect auto loans from portfolio to loans held for sale pursuant to a letter of intent to sell the loans under a 90%/10% participation agreement. The Company will continue to service the loans for a fee in accordance with the participation agreement. The loans were subsequently sold in July 2011 and we expect to recognize a gain on the sale of \$153 thousand during the third quarter. Loans held for sale totaled \$3.1 million as of December 31, 2010, all of which were residential mortgage loans.

We sell certain qualifying newly originated and refinanced residential real estate mortgages in the secondary market. The sold and serviced residential real estate loan portfolio decreased to \$314.6 million as of June 30, 2011 from \$328.9 million as of December 31, 2010. The decrease in the sold and serviced portfolio resulted from payments and payoffs on existing loans outpacing new loan origination and refinancing volumes.

**Table of Contents****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).

|  | <b>Loan Loss Analysis</b>          |             |                                  |             |
|--|------------------------------------|-------------|----------------------------------|-------------|
|  | <b>Three months ended June 30,</b> |             | <b>Six months ended June 30,</b> |             |
|  | <b>2011</b>                        | <b>2010</b> | <b>2011</b>                      | <b>2010</b> |
| Balance as of beginning of period                  | \$ 20,119                          | \$ 20,586   | \$ 20,466                        | \$ 20,741   |
| Charge-offs:                                       |                                    |             |                                  |             |
| Commercial business                                | 225                                | 121         | 315                              | 190         |
| Commercial mortgage                                | 34                                 | 164         | 378                              | 209         |
| Residential mortgage                               | 10                                 | 42          | 12                               | 54          |
| Home equity  | 155                                | 41          | 262                              | 88          |
| Consumer indirect                                  | 1,055                              | 932         | 2,345                            | 2,160       |
| Other consumer                                     | 268                                | 176         | 479                              | 388         |
| Total charge-offs                                  | 1,747                              | 1,476       | 3,791                            | 3,089       |
| Recoveries:  |                                    |             |                                  |             |
| Commercial business                                | 110                                | 92          | 264                              | 184         |
| Commercial mortgage                                | 23                                 | 18          | 39                               | 450         |
| Residential mortgage                               | 3                                  | 12          | 30                               | 16          |
| Home equity  | 7                                  | 25          | 17                               | 27          |
| Consumer indirect                                  | 653                                | 359         | 1,205                            | 699         |
| Other consumer                                     | 136                                | 104         | 264                              | 274         |
| Total recoveries                                   | 932                                | 610         | 1,819                            | 1,650       |
| Net charge-offs                                    | 815                                | 866         | 1,972                            | 1,439       |
| Provision for loan losses                          | 1,328                              | 2,105       | 2,138                            | 2,523       |
| Balance at end of period                           | \$ 20,632                          | \$ 21,825   | \$ 20,632                        | \$ 21,825   |
| Net loan charge-offs to average loans (annualized) | 0.24%                              | 0.27%       | 0.29%                            | 0.23%       |
| Allowance for loan losses to total loans           | 1.51%                              | 1.69%       | 1.51%                            | 1.69%       |
| Allowance for loan losses to non-performing loans  | 296%                               | 192%        | 296%                             | 192%        |

The allowance for loan losses represents the estimated amount of probable credit losses inherent in the Company's loan portfolio. The Company performs periodic, systematic reviews of the loan portfolio to estimate probable losses in the respective loan portfolios. In addition, the Company regularly evaluates prevailing economic and business conditions, industry concentrations, changes in the size and characteristics of the portfolio and other pertinent factors. The process used by the Company to determine the overall allowance for loan losses is based on this analysis. Based on this analysis the Company believes the allowance for loan losses is adequate as of June 30, 2011.

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 the Company's loan products and customers. The Company does not

engage in sub-prime or other high-risk residential mortgage lending as a line-of-business. The Company primarily originates fixed and variable rate one-to-four family residential mortgages collateralized by owner-occupied properties located within its central and western New York marketplace, which has been relatively stable in recent years. Residential mortgages collateralized by one-to-four family residential real estate generally have been originated in amounts of no more than 85% of appraised value or have mortgage insurance.

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.

The provision for loan losses for the three and six months ended June 30, 2011 was \$1.3 million and \$2.1 million, respectively, compared to a provision for loan losses of \$2.1 million and \$2.5 million for the three and six months ended June 30, 2010, respectively. Net charge-offs of \$815 thousand were recorded for the second quarter of 2011, compared to \$866 thousand for the same quarter a year ago. Year-to-date net charge-offs of \$2.0 million have been recorded in 2011, compared to \$1.4 million through June 30, 2010. The provision for loan losses and net charge-offs for the first six months of 2010 were favorably impacted by a \$354 thousand recovery in the first quarter of 2010 on one commercial real estate relationship that was charged-off during 2008 and 2009.

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

|   | <b>Delinquent and Non-Performing Assets</b> |                                  |                          |
|---|---|----------------------------------|--------------------------|
|   | <b>June 30,<br/>2011</b>                    | <b>December<br/>31,<br/>2010</b> | <b>June 30,<br/>2010</b> |
| Nonaccrual loans:                         |   |                                  |                          |
| Commercial business                       | \$ 712                                      | \$ 947                           | \$ 5,889                 |
| Commercial mortgage                       | 2,862                                       | 3,100                            | 1,380                    |
| Residential mortgage                      | 2,262                                       | 2,102                            | 2,480                    |
| Home equity                               | 472   | 875                              | 1,072                    |
| Consumer indirect                         | 667   | 514                              | 464                      |
| Other consumer                            |   | 41                               | 19                       |
| Total nonaccrual loans                    | 6,975                                       | 7,579                            | 11,304                   |
| Accruing loans 90 days or more delinquent | 4   | 3                                | 61                       |
| Total non-performing loans                | 6,979                                       | 7,582                            | 11,365                   |
| Foreclosed assets                         | 599   | 741                              | 500                      |
| Non-performing investment securities      | 6,963                                       | 572                              | 646                      |
| Total non-performing assets               | \$ 14,541                                   | \$ 8,895                         | \$ 12,511                |
| Non-performing loans to total loans       | 0.51%                                       | 0.56%                            | 0.88%                    |
| Non-performing assets to total assets     | 0.64%                                       | 0.40%                            | 0.58%                    |

Activity in nonaccrual loans for periods indicated was as follows (in thousands).

|  | <b>Three<br/>months<br/>ended</b> | <b>Six months<br/>ended</b> |
|--|-----------------------------------|-----------------------------|
|  | <b>June 30, 2011</b>              | <b>June 30, 2011</b>        |
| Nonaccrual loans, beginning of period                  | \$ 7,315                          | \$ 7,579                    |
| Additions  | 2,846                             | 6,011                       |
| Payments   | (1,260)                           | (2,684)                     |
| Charge-offs  | (1,603)                           | (3,519)                     |
| Returned to accruing status                            | (218)                             | (307)                       |
| Transferred to other real estate or repossessed assets | (105)                             | (105)                       |
| Nonaccrual loans, end of period                        | \$ 6,975                          | \$ 6,975                    |

Non-performing assets include non-performing loans, foreclosed assets and non-performing investment securities. Non-performing assets at June 30, 2011 were \$14.5 million or 0.64% of total assets, an increase of \$5.6 million from the \$8.9 million or 0.40% of total assets at December 31, 2010.

Non-performing investment securities are included in non-performing assets at fair value and represent securities on which the Company has stopped accruing interest. These non-performing investment securities totaled \$7.0 million at

June 30, 2011, compared to \$572 thousand at December 31, 2010. There were no new securities transferred to non-performing status during the quarter. The increase relates solely to an increase in the fair value of each of the 14 securities classified as non-performing. The market for these securities improved dramatically during the second quarter of 2011, resulting in the \$6.4 million increase in fair value from December 31, 2010.

During July 2011, the Company sold one of the 14 securities classified as non-performing and will recognize a gain of approximately \$1 million during the third quarter. The security had a fair value of \$752 thousand at June 30, 2011. The Company continues to monitor the market for these securities and evaluate the potential for future dispositions.

Non-performing loans totaled \$7.0 million or 0.51% of total loans at June 30, 2011, a decrease of \$603 thousand from the \$7.6 million or 0.56% of total loans at December 31, 2010. The ratio of non-performing loans to total loans continues to compare favorably to the average of our peer group, which was 3.43% of total loans at March 31, 2011, the most recent period for which information is available (Source: Federal Financial Institutions Examination Council Bank Holding Company Performance Report as of March 31, 2011 - Top-tier bank holding companies having consolidated assets between \$1 billion and \$3 billion). Included in nonaccrual loans are troubled debt restructurings ( TDRs ) of \$760 thousand and \$534 thousand at June 30, 2011 and December 31, 2010, respectively.

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

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 consisted of 10 properties (2 commercial properties and 8 residential properties) totaling \$599 thousand at June 30, 2011 and 13 properties (5 commercial properties and 8 residential properties) totaling \$741 thousand at December 31, 2010.

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 \$11.4 million and \$11.5 million in loans that continued to accrue interest which were classified as substandard as of June 30, 2011 and December 31, 2010, respectively.

**FUNDING ACTIVITIES****Deposits**

The Company offers a broad array of deposit products including noninterest-bearing demand, interest-bearing demand, savings and money market accounts and certificates of deposit. We rely primarily on providing excellent customer service and long-standing relationships with customers to attract and retain deposits. We continuously evaluate our branch network to determine how to best serve our customers efficiently and to improve our profitability. In July 2011, we upgraded our presence in the Rochester market by relocating a branch from North Chili to Chili Center. We intend to continue to pursue expansion in our market area by growing and enhancing our branch network and anticipate additional expansion in the coming years.

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

|  | <b>Deposit Composition</b> |                   |                          |                   |
|--|----------------------------|-------------------|--------------------------|-------------------|
|  | <b>June 30, 2011</b>       |                   | <b>December 31, 2010</b> |                   |
|  | <b>Amount</b>              | <b>% of Total</b> | <b>Amount</b>            | <b>% of Total</b> |
| Noninterest-bearing demand                   | \$ 358,574                 | 19.2%             | \$ 350,877               | 18.6%             |
| Interest-bearing demand                      | 376,306                    | 20.1              | 374,900                  | 19.9              |
| Savings and money market                     | 438,173                    | 23.4              | 417,359                  | 22.2              |
| Certificates of deposit less than \$100,000  | 500,123                    | 26.7              | 555,840                  | 29.5              |
| Certificates of deposit of \$100,000 or more | 199,063                    | 10.6              | 183,914                  | 9.8               |
| <b>Total deposits</b>                        | <b>\$ 1,872,239</b>        | <b>100.0%</b>     | <b>\$ 1,882,890</b>      | <b>100.0%</b>     |

Nonpublic deposits represent the largest component of the Company's funding. Total nonpublic deposits were \$1.469 billion and \$1.501 billion as of June 30, 2011 and December 31, 2010, respectively. The Company continues to manage this segment of funding through a strategy of competitive pricing and relationship-based sales and marketing that minimizes the number of customer relationships that have only a single high-cost deposit account.

The Company offers a variety of public deposit products to the many towns, villages, counties, school districts and other public entities within our market. Public deposits generally range from 20 to 25% of the Company's total deposits. As of June 30, 2011, total public deposits were \$403.2 million in comparison to \$382.2 million as of December 31, 2010. There is a high degree of seasonality in this component of funding, as the level of deposits varies with the seasonal cash flows for these public customers. The Company maintains the necessary levels of short-term liquid assets and alternative liquidity sources to accommodate the seasonality associated with public deposits.





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

The following table summarizes the Company's borrowings as of the dates indicated (in thousands).

|                                | <b>June 30,<br/>2011</b> | <b>December 31,<br/>2010</b> |
|--------------------------------|--------------------------|------------------------------|
| Customer repurchase agreements | \$ 45,015                | \$ 38,910                    |
| Federal funds purchased        | 47,380                   | 38,200                       |
| FHLB borrowings                | 50,000                   | 10,065                       |
| Junior subordinated debentures | 16,702                   | 16,702                       |
| <br>Total borrowings           | <br>\$ 159,097           | <br>\$ 103,877               |

The Company has credit capacity with the FHLB and can borrow through facilities that include amortizing and term advances. The Company had approximately \$108 million of immediate credit capacity with FHLB as of June 30, 2011. The Company had approximately \$359 million in secured borrowing capacity at the Federal Reserve Bank (FRB) Discount Window, none of which was outstanding at June 30, 2011. The FHLB and FRB credit capacity are collateralized by securities from the Company's investment portfolio and certain qualifying loans. FHLB borrowings increased by approximately \$40 million during 2011 due primarily to the purchase of municipal and agency mortgage-backed securities as part of a leverage strategy implemented during the second quarter of 2011 to take advantage of a steep yield curve.

Funds are borrowed on an overnight basis through retail repurchase agreements with bank customers and federal funds purchased from other financial institutions. Retail repurchase agreement borrowings are collateralized by securities of the U.S. Treasury and U.S. Government agencies and corporations. The Company had approximately \$52 million of credit available under unsecured federal funds purchased lines with various banks as of June 30, 2011.

**Equity Activities**

Total shareholders' equity was \$233.7 million at June 30, 2011, an increase of \$21.6 million from \$212.1 million at December 31, 2010. During February 2011, the Company redeemed \$12.5 million of Series A preferred stock issued to the U.S. Treasury. During March 2011, the Company successfully completed a follow-on common equity offering, issuing 2,813,475 shares of common stock at a price of \$16.35 per share before associated offering expenses. After deducting underwriting and other offering costs, the Company received net proceeds of approximately \$43.1 million. Prior to the end of the first quarter of 2011, the Company utilized a portion of the net proceeds to redeem the remaining \$25.0 million in Series A preferred stock. During the second quarter of 2011, the Company repurchased the Warrant issued to the Treasury. The repurchase price of \$2.1 million was recorded as a reduction of additional paid-in capital.

**Table of Contents****MANAGEMENT'S DISCUSSION AND ANALYSIS****LIQUIDITY AND CAPITAL RESOURCES****Liquidity**

The objective of maintaining adequate liquidity is to assure the ability of the Company to meet its 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. The Company achieves liquidity by maintaining a strong base of core customer funds, maturing short-term assets, its ability to sell 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. 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 FII 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 FII when necessary.

The Company's cash and cash equivalents were \$46.1 million as of June 30, 2011, an increase of \$7.0 million from \$39.1 million as of December 31, 2010. The Company's net cash provided by operating activities totaled \$24.0 million. Net cash used in investing activities totaled \$61.5 million, which included cash outflows of \$37.7 million for net loan originations and \$22.5 million from investment securities transactions. Net cash provided by financing activities of \$44.5 million was attributed to a \$55.2 million increase in net borrowings and \$43.1 million in net proceeds from the issuance of common stock, partly offset by the \$37.5 million payment to redeem the Series A preferred stock, a \$10.7 million decrease in deposits and \$3.5 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 the Company's 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, \$16.2 million of trust preferred securities issued by FISI Statutory Trust I and \$17.5 million of preferred stock. 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.

As previously discussed, on July 1, 2011, the Company notified the trustee of FISI Statutory Trust I that the Company will be redeeming all of its 10.20% junior subordinated debentures on August 22, 2011. Consequent to repayment of the junior subordinated debentures, the Trust will redeem its \$16.2 million of trust preferred securities. The trust preferred securities are subject to mandatory redemption, in whole or in part, upon repayment of the junior subordinated debentures. Under applicable regulatory capital guidelines issued by bank regulatory agencies, upon notice of redemption, the trust preferred securities will no longer qualify as Tier 1 capital for the Company. Had the trust preferred securities not qualified as Tier 1 capital as of June 30, 2011, the Company's Tier 1 capital would have been reduced by \$16.2 million and resulted in a Tier 1 leverage ratio of 8.57%, Tier 1 capital ratio of 12.64% and

Total risk-based capital ratio of 13.89%. The redemption of the trust preferred securities will not have a significant impact on the Bank's capital.

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 securities more than one level below investment grade that are subject to the low level exposure rules). 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.

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

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

|   | <b>June 30,<br/>2011</b> | <b>December 31,<br/>2010</b> |
|---|--------------------------|------------------------------|
| Total shareholders' equity  | \$ 233,733               | \$ 212,144                   |
| Less: Unrealized gain on securities available for sale, net of tax                        | 11,486                   | 1,877                        |
| Unrecognized net periodic pension & postretirement benefits (costs), net of tax           | (6,424)                  | (6,599)                      |
| Disallowed goodwill and other intangible assets   | 37,369                   | 37,369                       |
| Disallowed deferred tax assets  |                          | 14,608                       |
| Plus: Qualifying trust preferred securities   | 16,200                   | 16,200                       |
| <br>Tier 1 capital  | <br>\$ 207,502           | <br>\$ 181,089               |
| <br>Adjusted average total assets (for leverage capital purposes)                         | <br>\$ 2,231,185         | <br>\$ 2,177,911             |
| <br>Tier 1 leverage ratio (Tier 1 capital to adjusted average total assets)               | <br>9.30%                | <br>8.31%                    |
| <br>Total Tier 1 capital  | <br>\$ 207,502           | <br>\$ 181,089               |
| Plus: Qualifying allowance for loan losses  | 18,947                   | 18,363                       |
| <br>Total risk-based capital  | <br>\$ 226,449           | <br>\$ 199,452               |
| <br>Net risk-weighted assets  | <br>\$ 1,514,057         | <br>\$ 1,466,957             |
| <br>Tier 1 capital ratio (Tier 1 capital to net risk-weighted assets)                     | <br>13.71%               | <br>12.34%                   |
| <br>Total risk-based capital ratio (Total risk-based capital to net risk-weighted assets) | <br>14.96%               | <br>13.60%                   |

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

|                           |         | <b>Actual</b> |              | <b>For Capital Adequacy Purposes</b> |              | <b>Well Capitalized</b> |              |
|---------------------------|---------|---------------|--------------|--------------------------------------|--------------|-------------------------|--------------|
|                           |         | <b>Amount</b> | <b>Ratio</b> | <b>Amount</b>                        | <b>Ratio</b> | <b>Amount</b>           | <b>Ratio</b> |
| <b>June 30, 2011:</b>     |         |               |              |                                      |              |                         |              |
| Tier 1 leverage:          | Company | \$ 207,502    | 9.30%        | \$ 89,247                            | 4.00%        | \$ 111,559              | 5.00%        |
|                           | Bank    | 174,411       | 7.84         | 88,986                               | 4.00         | 111,233                 | 5.00         |
| Tier 1 capital:           | Company | 207,502       | 13.71        | 60,562                               | 4.00         | 90,843                  | 6.00         |
|                           | Bank    | 174,411       | 11.55        | 60,376                               | 4.00         | 90,564                  | 6.00         |
| Total risk-based capital: | Company | 226,449       | 14.96        | 121,125                              | 8.00         | 151,406                 | 10.00        |
|                           | Bank    | 193,300       | 12.81        | 120,752                              | 8.00         | 150,940                 | 10.00        |
| <b>December 31, 2010:</b> |         |               |              |                                      |              |                         |              |
| Tier 1 leverage:          | Company | \$ 181,089    | 8.31%        | \$ 87,116                            | 4.00%        | \$ 108,896              | 5.00%        |
|                           | Bank    | 156,957       | 7.22         | 86,958                               | 4.00         | 108,697                 | 5.00         |

|                           |         |         |       |         |      |         |       |
|---------------------------|---------|---------|-------|---------|------|---------|-------|
| Tier 1 capital:           | Company | 181,089 | 12.34 | 58,678  | 4.00 | 88,017  | 6.00  |
|                           | Bank    | 156,957 | 10.74 | 58,450  | 4.00 | 87,674  | 6.00  |
| Total risk-based capital: | Company | 199,452 | 13.60 | 117,357 | 8.00 | 146,696 | 10.00 |
|                           | Bank    | 175,250 | 11.99 | 116,899 | 8.00 | 146,124 | 10.00 |

**Dividend Restrictions**

In the ordinary course of business, the Company is dependent upon dividends from Five Star Bank to provide funds for the payment of interest expense on the junior subordinated debentures, 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.

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

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 the net interest margin, 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 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 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 material 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, 2010, dated March 7, 2011, as filed with the Securities and Exchange Commission.

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

As of June 30, 2011, 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 Company's Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures were effective as of the end of the period covered by this report.

Disclosure controls and procedures are the controls and other procedures that are designed to ensure that information required to be disclosed in the reports that the Company files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed in the reports that the Company files or submits to the SEC 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, 2011 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, 2010, dated March 7, 2011, as filed with the Securities and Exchange Commission.

**ITEM 1A. Risk Factors**

In addition to the other information set forth in this report, you should carefully consider the factors discussed under Part I, Item 1A, "Risk Factors" in the Company's Annual Report on Form 10-K for the year ended December 31, 2010, as supplemented and updated by the discussion below. These factors could materially adversely affect our business, financial condition, liquidity, results of operations and capital position, and could cause our actual results to differ materially from our historical results or the results contemplated by the forward-looking statements contained in this report.

**Implications of U.S. Government Credit Downgrade**

We have significant exposure to U.S. Government agency and instrumentality debt in our investment securities portfolio. These investments are backed by the explicit or implied guarantee of the U.S. Government. If the credit rating of U.S. Government debt obligations is downgraded, we would expect there would be a similar impact on the ratings for U.S. Government agency and instrumentality debt backed by these guarantees. Additionally, we hold other assets that rely, to varying degrees, on direct U.S. Government guarantees, insurance, or defeasance to enhance credit levels. A downgrade in the U.S. Government debt rating would likely have a negative impact on the rating of these assets as well. Such downgrades could adversely affect the value of our investment securities and other assets, which could result in a material adverse impact on the Company's business, financial condition, results of operations or liquidity.

**Liquidity Implications of Selective Payments by the U.S. Government on its Debt**

In the event that the U.S. Government has to prioritize which debt payments it is able to pay and not pay (selective defaults), the possibility of a short-term liquidity crisis may arise. We believe we have access to sufficient amounts and a variety of types of liquidity sources to withstand interruption in normal liquidity patterns, however, in the event of a catastrophic liquidity crisis, we may not be able to immediately access sufficient liquidity to satisfy our obligations.



**Table of Contents****ITEM 6. Exhibits**

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

| <b>Exhibit Number</b> | <b>Description</b>   | <b>Location</b>  |
|-----------------------|--|--|
| 11.1                  | Statement of Computation of Per Share Earnings   | Incorporated by reference to Note 2 of the Registrant's unaudited consolidated financial statements under Item 1 filed herewith. |
| 31.1                  | Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 Principal Executive Officer                    | Filed Herewith   |
| 31.2                  | Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 Principal Financial Officer                    | Filed Herewith   |
| 32                    | Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 | Filed Herewith   |
| *101.INS              | XBRL Instance Document   |  |
| *101.SCH              | XBRL Taxonomy Extension Schema Document  |  |
| *101.CAL              | XBRL Taxonomy Extension Calculation Linkbase Document  |  |
| *101.LAB              | XBRL Taxonomy Extension Label Linkbase Document  |  |
| *101.PRE              | XBRL Taxonomy Extension Presentation Linkbase Document   |  |
| *101.DEF              | XBRL Taxonomy Extension Definition Linkbase Document   |  |

\* Pursuant to Rule 406T of Regulation S-T, the information in this exhibit shall not be deemed to be filed for purposes of Section 18 of the Securities Exchange Act of 1934, or otherwise subject to the liability of that section, and shall not be incorporated by reference into any registration statement, prospectus or other document filed under the Securities Act of 1933, or the Securities Exchange Act of 1934, except as shall be expressly set forth by specific reference in such filings.

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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/ Peter G. Humphrey* , August 2, 2011

Peter G. Humphrey  
President and Chief Executive Officer  
(Principal Executive Officer)

*/s/ Karl F. Krebs* , August 2, 2011

Karl F. Krebs  
Executive Vice President and Chief  
Financial Officer  
(Principal Financial and Principal  
Accounting Officer)