

FINANCIAL INSTITUTIONS INC

Form 10-Q

November 04, 2016

[Table of Contents](#)

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

Form 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2016

or

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

For the transition period from _____ to _____

Commission File Number: 000-26481

(Exact name of registrant as specified in its charter)

NEW YORK
(State or other jurisdiction of
incorporation or organization)

16-0816610
(I.R.S. Employer
Identification No.)

220 LIBERTY STREET, WARSAW, NEW YORK
(Address of principal executive offices)

14569
(Zip Code)

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports),

and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every

Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

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

Large accelerated filer Accelerated filer

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

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 14,527,719 shares of Common Stock, \$0.01 par value, outstanding as of October 28, 2016.

Table of Contents

FINANCIAL INSTITUTIONS, INC.

Form 10-Q

For the Quarterly Period Ended September 30, 2016

TABLE OF CONTENTS

| | PAGE |
|---|-------------|
| PART I. <u>FINANCIAL INFORMATION</u> | 3 |
| ITEM 1. <u>Financial Statements</u> | 3 |
| <u>Consolidated Statements of Financial Condition - at September 30, 2016 (Unaudited) and December 31, 2015</u> | 3 |
| <u>Consolidated Statements of Income (Unaudited) - Three and nine months ended September 30, 2016 and 2015</u> | 4 |
| <u>Consolidated Statements of Comprehensive Income (Unaudited) - Three and nine months ended September 30, 2016 and 2015</u> | 5 |
| <u>Consolidated Statements of Changes in Shareholders' Equity (Unaudited) - Nine months ended September 30, 2016 and 2015</u> | 6 |
| <u>Consolidated Statements of Cash Flows (Unaudited) - Nine months ended September 30, 2016 and 2015</u> | 7 |
| <u>Notes to Consolidated Financial Statements (Unaudited)</u> | 8 |
| ITEM 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u> | 35 |
| ITEM 3. <u>Quantitative and Qualitative Disclosures About Market Risk</u> | 54 |
| ITEM 4. <u>Controls and Procedures</u> | 55 |
| PART II. <u>OTHER INFORMATION</u> | 56 |
| ITEM 1. <u>Legal Proceedings</u> | 56 |
| ITEM 1A. <u>Risk Factors</u> | 56 |
| ITEM 6. <u>Exhibits</u> | 57 |
| <u>Signatures</u> | 58 |

Table of Contents**PART I. FINANCIAL INFORMATION****ITEM 1. Financial Statements****FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES****Consolidated Statements of Financial Condition (Unaudited)***(Dollars in thousands, except share and per share data)*

| | September 30, 2016 | December 31, 2015 |
|--|-----------------------|----------------------|
| ASSETS | | |
| Cash and due from banks | \$ 110,721 | \$ 60,121 |
| Securities available for sale, at fair value | 559,495 | 544,395 |
| Securities held to maturity, at amortized cost (fair value of \$538,630 and \$490,064, respectively) | 528,708 | 485,717 |
| Loans held for sale | 844 | 1,430 |
| Loans (net of allowance for loan losses of \$29,350 and \$27,085, respectively) | 2,254,644 | 2,056,677 |
| Company owned life insurance | 62,942 | 63,045 |
| Premises and equipment, net | 40,178 | 39,445 |
| Goodwill and other intangible assets, net | 75,943 | 66,946 |
| Other assets | 53,890 | 63,248 |
| Total assets | \$ 3,687,365 | \$ 3,381,024 |
| LIABILITIES AND SHAREHOLDERS EQUITY | | |
| Deposits: | | |
| Noninterest-bearing demand | \$ 657,624 | \$ 641,972 |
| Interest-bearing demand | 629,413 | 523,366 |
| Savings and money market | 1,052,224 | 928,175 |
| Time deposits | 724,096 | 637,018 |
| Total deposits | 3,063,357 | 2,730,531 |
| Short-term borrowings | 230,200 | 293,100 |
| Long-term borrowings, net of issuance costs of \$957 and \$1,010, respectively | 39,043 | 38,990 |
| Other liabilities | 28,494 | 24,559 |
| Total liabilities | 3,361,094 | 3,087,180 |
| Shareholders equity: | | |
| Series A 3% preferred stock, \$100 par value; 1,533 shares authorized; 1,492 shares issued | 149 | 149 |
| Series B-1 8.48% preferred stock, \$100 par value; 200,000 shares authorized; 171,906 shares issued | 17,191 | 17,191 |
| Total preferred equity | 17,340 | 17,340 |

Edgar Filing: FINANCIAL INSTITUTIONS INC - Form 10-Q

| | | |
|---|--------------|--------------|
| Common stock, \$0.01 par value; 50,000,000 shares authorized; 14,692,214 and 14,397,509 shares issued, respectively | 147 | 144 |
| Additional paid-in capital | 81,459 | 72,690 |
| Retained earnings | 232,396 | 218,920 |
| Accumulated other comprehensive loss | (1,961) | (11,327) |
| Treasury stock, at cost 164,495 and 207,317 shares, respectively | (3,110) | (3,923) |
| Total shareholders' equity | 326,271 | 293,844 |
| Total liabilities and shareholders' equity | \$ 3,687,365 | \$ 3,381,024 |

See accompanying notes to the consolidated financial statements.

Table of Contents**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES****Consolidated Statements of Income (Unaudited)***(In thousands, except per share amounts)*

| | Three months ended September 30, | | Nine months ended September 30, | |
|--|---|---------------|--|---------------|
| | 2016 | 2015 | 2016 | 2015 |
| Interest income: | | | | |
| Interest and fees on loans | \$ 23,619 | \$ 21,210 | \$ 68,044 | \$ 61,793 |
| Interest and dividends on investment securities | 5,741 | 5,797 | 17,196 | 16,170 |
| Other interest income | | | 1 | |
| Total interest income | 29,360 | 27,007 | 85,241 | 77,963 |
| Interest expense: | | | | |
| Deposits | 2,192 | 1,917 | 6,237 | 5,364 |
| Short-term borrowings | 500 | 342 | 1,183 | 785 |
| Long-term borrowings | 618 | 617 | 1,853 | 1,132 |
| Total interest expense | 3,310 | 2,876 | 9,273 | 7,281 |
| Net interest income | 26,050 | 24,131 | 75,968 | 70,682 |
| Provision for loan losses | 1,961 | 754 | 6,281 | 4,783 |
| Net interest income after provision for loan losses | 24,089 | 23,377 | 69,687 | 65,899 |
| Noninterest income: | | | | |
| Service charges on deposits | 1,913 | 2,037 | 5,392 | 5,880 |
| Insurance income | 1,407 | 1,265 | 4,262 | 3,930 |
| ATM and debit card | 1,441 | 1,297 | 4,187 | 3,773 |
| Investment advisory | 1,326 | 523 | 3,934 | 1,551 |
| Company owned life insurance | 486 | 488 | 2,340 | 1,448 |
| Investments in limited partnerships | 161 | 336 | 253 | 865 |
| Loan servicing | 104 | 153 | 332 | 416 |
| Net gain on sale of loans held for sale | 46 | 53 | 202 | 161 |
| Net gain on investment securities | 426 | 286 | 2,426 | 1,348 |
| Net gain on other assets | 199 | | 285 | 20 |
| Amortization of tax credit investment | | (390) | | (390) |
| Other | 1,030 | 957 | 3,059 | 2,755 |
| Total noninterest income | 8,539 | 7,005 | 26,672 | 21,757 |
| Noninterest expense: | | | | |
| Salaries and employee benefits | 11,325 | 10,278 | 33,757 | 31,107 |
| Occupancy and equipment | 3,617 | 3,417 | 10,906 | 10,491 |

Edgar Filing: FINANCIAL INSTITUTIONS INC - Form 10-Q

| | | | | |
|--|---------------|---------------|---------------|---------------|
| Professional services | 956 | 1,064 | 5,236 | 2,898 |
| Computer and data processing | 832 | 779 | 2,549 | 2,291 |
| Supplies and postage | 490 | 540 | 1,548 | 1,611 |
| FDIC assessments | 406 | 444 | 1,283 | 1,277 |
| Advertising and promotions | 214 | 312 | 938 | 789 |
| Other | 2,778 | 2,484 | 7,739 | 7,101 |
| Total noninterest expense | 20,618 | 19,318 | 63,956 | 57,565 |
| Income before income taxes | 12,010 | 11,064 | 32,403 | 30,091 |
| Income tax expense | 3,541 | 2,748 | 9,165 | 8,389 |
| Net income | \$ 8,469 | \$ 8,316 | \$ 23,238 | \$ 21,702 |
| Preferred stock dividends | 366 | 366 | 1,097 | 1,097 |
| Net income available to common shareholders | \$ 8,103 | \$ 7,950 | \$ 22,141 | \$ 20,605 |
| Earnings per common share (Note 3): | | | | |
| Basic | \$ 0.56 | \$ 0.56 | \$ 1.53 | \$ 1.46 |
| Diluted | \$ 0.56 | \$ 0.56 | \$ 1.53 | \$ 1.46 |
| Cash dividends declared per common share | \$ 0.20 | \$ 0.20 | \$ 0.60 | \$ 0.60 |
| Weighted average common shares outstanding: | | | | |
| Basic | 14,456 | 14,087 | 14,429 | 14,076 |
| Diluted | 14,500 | 14,139 | 14,485 | 14,124 |

See accompanying notes to the consolidated financial statements.

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

| <i>(Dollars in thousands)</i> | Three months ended | | Nine months ended | |
|--|-------------------------------|-------------|-------------------------------|-------------|
| | September 30, 2016 | 2015 | September 30, 2016 | 2015 |
| Net income | \$ 8,469 | \$ 8,316 | \$ 23,238 | \$ 21,702 |
| Other comprehensive income (loss), net of tax: | | | | |
| Net unrealized (losses) gains on securities available for sale | (1,446) | 5,492 | 8,948 | 2,546 |
| Pension and post-retirement obligations | 139 | 138 | 418 | 413 |
| Total other comprehensive income (loss), net of tax | (1,307) | 5,630 | 9,366 | 2,959 |
| Comprehensive income | \$ 7,162 | \$ 13,946 | \$ 32,604 | \$ 24,661 |

See accompanying notes to the consolidated financial statements.

Table of Contents

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Consolidated Statements of Changes in Shareholders' Equity (Unaudited)

Nine months ended September 30, 2016 and 2015

| <i>(Dollars in thousands, except per share data)</i> | Preferred Equity | Common Stock | Additional Paid-in Capital | Retained Earnings | Accumulated Other Comprehensive Loss | Treasury Stock | Total Shareholders' Equity |
|--|---------------------|-----------------|----------------------------------|----------------------|---|-------------------|----------------------------------|
| Balance at January 1, 2015 | \$ 17,340 | \$ 144 | \$ 72,955 | \$ 203,312 | \$ (9,011) | \$ (5,208) | \$ 279,532 |
| Comprehensive income: | | | | | | | |
| Net income | | | | 21,702 | | | 21,702 |
| Other comprehensive income, net of tax | | | | | 2,959 | | 2,959 |
| Purchases of common stock for treasury | | | | | | (41) | (41) |
| Share-based compensation plans: | | | | | | | |
| Share-based compensation | | | 520 | | | | 520 |
| Stock options exercised | | | 1 | | | 251 | 252 |
| Restricted stock awards issued, net | | | (1,060) | | | 1,060 | |
| Stock awards | | | 11 | | | 43 | 54 |
| Cash dividends declared: | | | | | | | |
| Series A 3% Preferred-\$2.25 per share | | | | (3) | | | (3) |
| Series B-1 8.48% Preferred-\$6.36 per share | | | | (1,094) | | | (1,094) |
| Common-\$0.60 per share | | | | (8,447) | | | (8,447) |
| Balance at September 30, 2015 | \$ 17,340 | \$ 144 | \$ 72,427 | \$ 215,470 | \$ (6,052) | \$ (3,895) | \$ 295,434 |
| Balance at January 1, 2016 | \$ 17,340 | \$ 144 | \$ 72,690 | \$ 218,920 | \$ (11,327) | \$ (3,923) | \$ 293,844 |
| Comprehensive income: | | | | | | | |
| Net income | | | | 23,238 | | | 23,238 |
| Other comprehensive income, net of tax | | | | | 9,366 | | 9,366 |
| Common stock issued | | 3 | 8,097 | | | | 8,100 |
| Share-based compensation plans: | | | | | | | |
| Share-based compensation | | | 597 | | | | 597 |
| Stock options exercised | | | 20 | | | 794 | 814 |
| Restricted stock awards issued, net | | | 24 | | | (24) | |
| Excess tax benefit on share-based compensation | | | 10 | | | | 10 |
| Stock awards | | | 21 | | | 43 | 64 |
| Cash dividends declared: | | | | | | | |
| | | | | (3) | | | (3) |

Edgar Filing: FINANCIAL INSTITUTIONS INC - Form 10-Q

Series A 3% Preferred-\$2.25 per share

Series B-1 8.48% Preferred-\$6.36

per share

(1,094)

(1,094)

Common-\$0.60 per share

(8,665)

(8,665)

Balance at September 30, 2016 \$ 17,340 \$ 147 \$ 81,459 \$ 232,396 \$ (1,961) \$ (3,110) \$ 326,271

See accompanying notes to the consolidated financial statements.

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

| | Nine months ended September 30, | |
|--|--|------------------|
| | 2016 | 2015 |
| Cash flows from operating activities: | | |
| Net income | \$ 23,238 | \$ 21,702 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 4,480 | 4,065 |
| Net amortization of premiums on securities | 2,325 | 2,355 |
| Provision for loan losses | 6,281 | 4,783 |
| Share-based compensation | 597 | 520 |
| Deferred income tax (benefit) expense | (523) | 318 |
| Proceeds from sale of loans held for sale | 9,246 | 10,370 |
| Originations of loans held for sale | (8,458) | (11,022) |
| Income on company owned life insurance | (2,340) | (1,448) |
| Net gain on sale of loans held for sale | (202) | (161) |
| Net gain on investment securities | (2,426) | (1,348) |
| Amortization of tax credit investment | | 390 |
| Net gain on other assets | (285) | (20) |
| Decrease in other assets | 3,548 | 2,830 |
| Increase in other liabilities | 1,943 | 1,819 |
| Net cash provided by operating activities | 37,424 | 35,153 |
| Cash flows from investing activities: | | |
| Purchases of available for sale securities | (192,140) | (271,899) |
| Purchases of held to maturity securities | (90,602) | (53,768) |
| Proceeds from principal payments, maturities and calls on available for sale securities | 107,418 | 118,378 |
| Proceeds from principal payments, maturities and calls on held to maturity securities | 48,424 | 23,826 |
| Proceeds from sales of securities available for sale | 85,772 | 37,620 |
| Net loan originations | (204,691) | (130,485) |
| Proceeds from company owned life insurance, net of purchases | 2,443 | (34) |
| Proceeds from sales of other assets | 602 | 167 |
| Purchases of premises and equipment | (4,242) | (4,957) |
| Cash consideration paid for acquisition, net of cash acquired | (868) | |
| Net cash used in investing activities | (247,884) | (281,152) |
| Cash flows from financing activities: | | |
| Net increase in deposits | 332,826 | 302,973 |
| Net decrease in short-term borrowings | (62,900) | (93,404) |
| Issuance of long-term debt | | 40,000 |
| Debt issuance costs | | (1,060) |

Edgar Filing: FINANCIAL INSTITUTIONS INC - Form 10-Q

| | | |
|--|------------|-----------|
| Purchase of common stock for treasury | | (41) |
| Proceeds from stock options exercised | 814 | 252 |
| Excess tax benefit on share-based compensation, net | 10 | |
| Cash dividends paid to common and preferred shareholders | (9,690) | (9,538) |
| Net cash provided by financing activities | 261,060 | 239,182 |
| Net increase (decrease) in cash and cash equivalents | 50,600 | (6,817) |
| Cash and cash equivalents, beginning of period | 60,121 | 58,151 |
| Cash and cash equivalents, end of period | \$ 110,721 | \$ 51,334 |
| Supplemental information: | | |
| Cash paid for interest | \$ 8,144 | \$ 5,566 |
| Cash paid for income taxes, net of refunds received | 4,708 | 4,257 |
| Noncash investing and financing activities: | | |
| Real estate and other assets acquired in settlement of loans | 443 | 286 |
| Accrued and declared unpaid dividends | 3,257 | 3,183 |
| Increase in net unsettled security purchases | 2,290 | 2,232 |
| Securities transferred from available for sale to held to maturity (at fair value) | | 165,238 |
| Common stock issued for acquisition | 8,100 | |
| Assets acquired and liabilities assumed in business combinations: | | |
| Fair value of assets acquired | 4,848 | |
| Fair value of liabilities assumed | 1,845 | |
| See accompanying notes to the consolidated financial statements. | | |

Table of Contents

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

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

Nature of Operations

Financial Institutions, Inc., (the Company) is a financial holding company organized in 1931 under the laws of New York State. The Company provides diversified financial services through its subsidiaries, Five Star Bank, Scott Danahy Naylor, LLC (Scott Danahy Naylor) and Courier Capital, LLC (Courier Capital). The Company offers a broad array of deposit, lending and other financial services to individuals, municipalities and businesses in Western and Central New York through its wholly-owned New York chartered banking subsidiary, Five Star Bank (the Bank). The Bank also has indirect lending network relationships with franchised automobile dealers in the Capital District of New York and Northern and Central Pennsylvania. Scott Danahy Naylor provides a broad range of insurance services to personal and business clients across 44 states. Acquired on January 5, 2016, Courier Capital provides customized investment management, investment consulting and retirement plan services to individuals, businesses, institutions, foundations and retirement plans across nine states.

Basis of Presentation

The consolidated financial statements include the accounts of Financial Institutions, Inc. and its subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation. The accounting and reporting policies conform to U.S. generally accepted accounting principles (GAAP). Certain information and footnote disclosures normally included in financial statements prepared in conformity with GAAP have been condensed or omitted pursuant to such rules and regulations. However, in the opinion of management, the accompanying consolidated financial statements reflect all adjustments of a normal and recurring nature necessary for a fair presentation of the consolidated statements of financial condition, income, comprehensive income, changes in shareholders' equity and cash flows for the periods indicated, and contain adequate disclosure to make the information presented not misleading. These consolidated financial statements should be read in conjunction with the Company's 2015 Annual Report on Form 10-K for the year ended December 31, 2015. The results of operations for any interim periods are not necessarily indicative of the results which may be expected for the entire year.

Reclassifications

Certain reclassifications of previously reported amounts have been made to conform to the current year presentation. Such reclassifications did not impact net income or shareholders' equity as previously reported.

Subsequent Events

The Company has evaluated events and transactions for potential recognition or disclosure through the day the financial statements were issued and determined there were no material recognizable subsequent events.

Use of Estimates

The preparation of these financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates. Material estimates relate to the determination of the allowance for loan losses, the

carrying value of goodwill and deferred tax assets, and assumptions used in the defined benefit pension plan accounting.

Recent Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*. ASU 2014-09 implements a common revenue standard that clarifies the principles for recognizing revenue. The core principle of ASU 2014-09 is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. To achieve that core principle, an entity should apply the following steps: (i) identify the contract(s) with a customer, (ii) identify the performance obligations in the contract, (iii) determine the transaction price, (iv) allocate the transaction price to the performance obligations in the contract and (v) recognize revenue when (or as) the entity satisfies a performance obligation. The effective date was recently deferred for one year to the interim and annual periods beginning on or after December 15, 2017. Early adoption is permitted as of the original effective date interim and annual periods beginning on or after December 15, 2016. The Company continues to assess the potential impact of ASU 2014-09 on its accounting and disclosures.

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

In January 2016, the FASB issued ASU No. 2016-01, *Financial Instruments – Overall (Subtopic 825-10) Recognition and Measurement of Financial Assets and Financial Liabilities*. ASU 2016-01 is intended to improve the recognition and measurement of financial instruments by requiring equity investments to be measured at fair value with changes in fair value recognized in net income; requiring entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes; requiring separate presentation of financial assets and financial liabilities by measurement category and form of financial asset on the balance sheet or the accompanying notes to the financial statements; eliminating the requirement for entities to disclose the method(s) and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured and amortized at cost on the balance sheet; and requiring an entity to present separately in other comprehensive income the portion of the total change in the fair value of a liability resulting from a change in the instrument-specific credit risk when the entity has elected to measure the liability at fair value in accordance with the fair value option for financial instruments. ASU 2016-01 is effective for annual periods and interim periods within those annual periods, beginning after December 15, 2017. The amendments should be applied by means of a cumulative-effect adjustment to the balance sheet as of the beginning of the fiscal year of adoption. The amendments related to equity securities without readily determinable fair values (including disclosure requirements) should be applied prospectively to equity investments that exist as of the date of adoption. The Company is assessing the impact of ASU 2016-01 on its accounting and disclosures.

In February 2016, the FASB issued ASU No. 2016-02, *Leases (Topic 842)*. ASU 2016-02 establishes a right of use model that requires a lessee to record a right of use asset and a lease liability for all leases with terms longer than 12 months. Leases will be classified as either finance or operating, with classification affecting the pattern of expense recognition in the income statement. For lessors, the guidance modifies the classification criteria and the accounting for sales-type and direct financing leases. A lease will be treated as a sale if it transfers all of the risks and rewards, as well as control of the underlying asset, to the lessee. If risks and rewards are conveyed without the transfer of control, the lease is treated as a financing. If the lessor doesn't convey risks and rewards or control, an operating lease results. The amendments are effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Entities are required to use a modified retrospective approach for leases that exist or are entered into after the beginning of the earliest comparative period in the financial statements, with certain practical expedients available. Early adoption is permitted. The Company is assessing the impact of ASU 2016-02 on its accounting and disclosures.

In March 2016, the FASB issued ASU No. 2016-09, *Compensation – Stock Compensation (Topic 718) Improvements to Employee Share-Based Payment Accounting*. ASU 2016-09 requires all income tax effects of awards to be recognized in the income statement when the awards vest or are settled. It also allows an employer to repurchase more of an employee's shares than it can today for tax withholding purposes without triggering liability accounting and to make a policy election for forfeitures as they occur. The guidance is effective for fiscal years beginning after December 15, 2016, and interim periods within those years. Early adoption is permitted. The Company is assessing

the impact of ASU 2016-09 on its accounting and disclosures.

In June 2016, the FASB issued ASU No. 2016-13, *Financial Instruments – Credit Losses (Topic 326) – Measurement of Credit Losses on Financial Instruments*. ASU 2016-13 amends guidance on reporting credit losses for financial assets held at amortized cost basis and available for sale debt securities. Topic 326 eliminates the probable initial recognition threshold in current GAAP and instead, requires an entity to reflect its current estimate of all expected credit losses based on historical experience, current conditions and reasonable and supportable forecasts. The allowance for credit losses is a valuation account that is deducted from the amortized cost basis of the financial assets to present the net amount expected to be collected. The guidance is effective for fiscal years beginning after December 15, 2019, and interim periods within those years. Early adoption is permitted beginning after December 15, 2018. The Company is assessing the impact of ASU 2016-13 on its accounting and disclosures.

Table of Contents**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Unaudited)****(2.) BUSINESS COMBINATIONS*****Courier Capital Acquisition***

On January 5, 2016, the Company completed the acquisition of Courier Capital Corporation, a registered investment advisory and wealth management firm with approximately \$1.2 billion in assets under management. Consideration for the acquisition totaled \$9.0 million and included stock of \$8.1 million and \$918 thousand of cash. The acquisition also included up to \$2.8 million of potential future payments of stock and up to \$2.2 million of potential future cash bonuses contingent upon Courier Capital meeting certain EBITDA performance targets through 2018. In addition, the Company purchased two pieces of real property in Buffalo and Jamestown, New York used by Courier Capital for total cash considerations of \$1.3 million. As a result of the acquisition, the Company recorded goodwill of \$6.0 million and other intangible assets of \$3.9 million. The goodwill is not expected to be deductible for income tax purposes. Pro forma results of operations for this acquisition have not been presented because the effect of this acquisition was not material to the Company's consolidated financial statements.

This acquisition was accounted for under the acquisition method in accordance with FASB ASC Topic 805. Accordingly, the assets and liabilities, both tangible and intangible, were recorded at their estimated fair values as of the acquisition date. Due to the timing of the closing of the acquisition, the fair values of other intangibles recorded are subject to adjustment as additional information becomes available to indicate a more accurate or appropriate fair value for the intangibles during the measurement period, which is not to exceed one year from the acquisition date. The following table presents the allocation of acquisition cost to the assets acquired and liabilities assumed, based on their estimated fair values.

| | | |
|--|----|---------|
| Cash | \$ | 50 |
| Identified intangible assets | | 3,928 |
| Premises and equipment, accounts receivable and other assets | | 870 |
| Deferred tax liability | | (1,797) |
| Other liabilities | | (48) |
| Net assets acquired | \$ | 3,003 |

The amounts assigned to goodwill and other intangible assets for the Courier Capital acquisition are as follows:

| | Amount allocated | Useful life (in years) |
|--|---------------------|---------------------------|
| Goodwill | \$ 6,015 | n/a |
| Other intangible assets customer relationships | 3,900 | 20 |
| Other intangible assets other | 28 | 5 |

\$ 9,943

- 10 -

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

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

| | Three months ended September 30, | | Nine months ended September 30, | |
|---|-------------------------------------|----------|------------------------------------|-----------|
| | 2016 | 2015 | 2016 | 2015 |
| Net income available to common shareholders | \$ 8,103 | \$ 7,950 | \$ 22,141 | \$ 20,605 |
| Weighted average common shares outstanding: | | | | |
| Total shares issued | 14,692 | 14,398 | 14,688 | 14,398 |
| Unvested restricted stock awards | (72) | (100) | (76) | (92) |
| Treasury shares | (164) | (211) | (183) | (230) |
| Total basic weighted average common shares outstanding | 14,456 | 14,087 | 14,429 | 14,076 |
| Incremental shares from assumed: | | | | |
| Exercise of stock options | 16 | 23 | 21 | 22 |
| Vesting of restricted stock awards | 28 | 29 | 35 | 26 |
| Total diluted weighted average common shares outstanding | 14,500 | 14,139 | 14,485 | 14,124 |
| Basic earnings per common share | \$ 0.56 | \$ 0.56 | \$ 1.53 | \$ 1.46 |
| Diluted earnings per common share | \$ 0.56 | \$ 0.56 | \$ 1.53 | \$ 1.46 |

For each of the periods presented, average shares subject to the following instruments were excluded from the computation of diluted EPS because the effect would be antidilutive:

| | | | | |
|-------------------------|--|--|---|---|
| Stock options | | | | |
| Restricted stock awards | | | 3 | 1 |
| Total | | | 3 | 1 |

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

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

| | Amortized Cost | Unrealized Gains | Unrealized Losses | Fair Value |
|---|-------------------|---------------------|----------------------|---------------|
| <u>September 30, 2016</u> | | | | |
| Securities available for sale: | | | | |
| U.S. Government agencies and government sponsored enterprises | \$ 175,134 | \$ 5,508 | \$ 5 | \$ 180,637 |
| Mortgage-backed securities: | | | | |
| Federal National Mortgage Association | 312,771 | 7,501 | | 320,272 |
| Federal Home Loan Mortgage Corporation | 39,425 | 773 | 11 | 40,187 |
| Government National Mortgage Association | 16,332 | 672 | 15 | 16,989 |
| Collateralized mortgage obligations: | | | | |
| Federal National Mortgage Association | 328 | | 1 | 327 |
| Federal Home Loan Mortgage Corporation | 73 | | 1 | 72 |
| Privately issued | | 816 | | 816 |
| Total mortgage-backed securities | 368,929 | 9,762 | 28 | 378,663 |
| Asset-backed securities | | 195 | | 195 |
| Total available for sale securities | \$ 544,063 | \$ 15,465 | \$ 33 | \$ 559,495 |
| Securities held to maturity: | | | | |
| State and political subdivisions | 300,922 | 8,136 | 45 | 309,013 |
| Mortgage-backed securities: | | | | |
| Federal National Mortgage Association | 10,422 | 276 | | 10,698 |
| Federal Home Loan Mortgage Corporation | 1,351 | | 1 | 1,350 |
| Government National Mortgage Association | 25,402 | 366 | 1 | 25,767 |
| Collateralized mortgage obligations: | | | | |
| Federal National Mortgage Association | 75,287 | 426 | 105 | 75,608 |
| Federal Home Loan Mortgage Corporation | 98,439 | 942 | 128 | 99,253 |
| Government National Mortgage Association | 16,885 | 72 | 16 | 16,941 |
| Total mortgage-backed securities | 227,786 | 2,082 | 251 | 229,617 |
| Total held to maturity securities | \$ 528,708 | \$ 10,218 | \$ 296 | \$ 538,630 |
| <u>December 31, 2015</u> | | | | |

Securities available for sale:

| | | | | |
|---|------------|----------|----------|------------|
| U.S. Government agencies and government sponsored enterprises | \$ 260,748 | \$ 1,164 | \$ 1,049 | \$ 260,863 |
| Mortgage-backed securities: | | | | |
| Federal National Mortgage Association | 209,671 | 1,092 | 2,333 | 208,430 |
| Federal Home Loan Mortgage Corporation | 24,564 | 282 | 194 | 24,652 |
| Government National Mortgage Association | 26,465 | 943 | 4 | 27,404 |
| Collateralized mortgage obligations: | | | | |
| Federal National Mortgage Association | 16,998 | 90 | 154 | 16,934 |
| Federal Home Loan Mortgage Corporation | 5,175 | 1 | 91 | 5,085 |
| Privately issued | | 809 | | 809 |
| Total mortgage-backed securities | 282,873 | 3,217 | 2,776 | 283,314 |
| Asset-backed securities | | 218 | | 218 |
| Total available for sale securities | \$ 543,621 | \$ 4,599 | \$ 3,825 | \$ 544,395 |

Securities held to maturity:

| | | | | |
|--|------------|----------|----------|------------|
| State and political subdivisions | 294,423 | 6,562 | 4 | 300,981 |
| Mortgage-backed securities: | | | | |
| Federal National Mortgage Association | 9,242 | 14 | 79 | 9,177 |
| Government National Mortgage Association | 25,607 | 33 | 159 | 25,481 |
| Collateralized mortgage obligations: | | | | |
| Federal National Mortgage Association | 56,791 | | 818 | 55,973 |
| Federal Home Loan Mortgage Corporation | 80,570 | | 1,120 | 79,450 |
| Government National Mortgage Association | 19,084 | 19 | 101 | 19,002 |
| Total mortgage-backed securities | 191,294 | 66 | 2,277 | 189,083 |
| Total held to maturity securities | \$ 485,717 | \$ 6,628 | \$ 2,281 | \$ 490,064 |

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

Investment securities with a total fair value of \$939.3 million at September 30, 2016 were pledged and encumbered as collateral to secure public deposits and for other purposes required or permitted by law.

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

| | Three months ended September 30, | | Nine months ended September 30, | |
|-----------------------|---|-------------|--|-------------|
| | 2016 | 2015 | 2016 | 2015 |
| Proceeds from sales | \$ 23,497 | \$ 8,112 | \$ 85,772 | \$ 37,620 |
| Gross realized gains | 426 | 286 | 2,426 | 1,359 |
| Gross realized losses | | | | 11 |

The scheduled maturities of securities available for sale and securities held to maturity at September 30, 2016 are shown below (in thousands). Actual maturities may differ from contractual maturities because issuers may have the right to call or prepay obligations.

| | Amortized Cost | Fair Value |
|--|---------------------------|-----------------------|
| Debt securities available for sale: | | |
| Due in one year or less | \$ 105 | \$ 105 |
| Due from one to five years | 153,605 | 156,094 |
| Due after five years through ten years | 268,354 | 277,631 |
| Due after ten years | 121,999 | 125,665 |
| | \$ 544,063 | \$ 559,495 |
| Debt securities held to maturity: | | |
| Due in one year or less | \$ 42,584 | \$ 42,684 |
| Due from one to five years | 178,401 | 183,536 |
| Due after five years through ten years | 92,745 | 95,657 |
| Due after ten years | 214,978 | 216,753 |
| | \$ 528,708 | \$ 538,630 |

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

Unrealized losses on investment securities and the fair value of the related securities, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, were as follows (in thousands):

| | Less than 12 months | | 12 months or longer | | Total | |
|---|---------------------|-------------------|---------------------|-------------------|------------|-------------------|
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| September 30, 2016 | | | | | | |
| Securities available for sale: | | | | | | |
| U.S. Government agencies and government sponsored enterprises | \$ | \$ | \$ 1,515 | \$ 5 | \$ 1,515 | \$ 5 |
| Mortgage-backed securities: | | | | | | |
| Federal Home Loan Mortgage Corporation | 4,992 | 11 | | | 4,992 | 11 |
| Government National Mortgage Association | 1,171 | 15 | | | 1,171 | 15 |
| Collateralized mortgage obligations: | | | | | | |
| Federal National Mortgage Association | 326 | 1 | | | 326 | 1 |
| Federal Home Loan Mortgage Corporation | 73 | 1 | | | 73 | 1 |
| Total mortgage-backed securities | 6,562 | 28 | | | 6,562 | 28 |
| Total available for sale securities | 6,562 | 28 | 1,515 | 5 | 8,077 | 33 |
| Securities held to maturity: | | | | | | |
| State and political subdivisions | 12,710 | 45 | | | 12,710 | 45 |
| Mortgage-backed securities: | | | | | | |
| Federal Home Loan Mortgage Corporation | 1,349 | 1 | | | 1,349 | 1 |
| Government National Mortgage Association | 1,630 | 1 | | | 1,630 | 1 |
| Collateralized mortgage obligations: | | | | | | |
| Federal National Mortgage Association | 26,315 | 89 | 3,600 | 16 | 29,915 | 105 |
| | 27,838 | 127 | 496 | 1 | 28,334 | 128 |

Edgar Filing: FINANCIAL INSTITUTIONS INC - Form 10-Q

| | | | | | | |
|--|-----------|--------|----------|-------|-----------|--------|
| Federal Home Loan Mortgage Corporation | | | | | | |
| Government National Mortgage Association | 6,677 | 14 | 1,510 | 2 | 8,187 | 16 |
| Total mortgage-backed securities | 63,809 | 232 | 5,606 | 19 | 69,415 | 251 |
| Total held to maturity securities | 76,519 | 277 | 5,606 | 19 | 82,125 | 296 |
| Total temporarily impaired securities | \$ 83,081 | \$ 305 | \$ 7,121 | \$ 24 | \$ 90,202 | \$ 329 |

December 31, 2015

Securities available for sale:

| | | | | | | |
|---|-----------|--------|-----------|--------|------------|----------|
| U.S. Government agencies and government sponsored enterprises | \$ 82,298 | \$ 735 | \$ 26,302 | \$ 314 | \$ 108,600 | \$ 1,049 |
| Mortgage-backed securities: | | | | | | |
| Federal National Mortgage Association | 123,774 | 2,134 | 9,562 | 199 | 133,336 | 2,333 |
| Federal Home Loan Mortgage Corporation | 12,660 | 194 | | | 12,660 | 194 |
| Government National Mortgage Association | 1,405 | 4 | | | 1,405 | 4 |
| Collateralized mortgage obligations: | | | | | | |
| Federal National Mortgage Association | 7,778 | 154 | | | 7,778 | 154 |
| Federal Home Loan Mortgage Corporation | 4,998 | 91 | | | 4,998 | 91 |
| Total mortgage-backed securities | 150,615 | 2,577 | 9,562 | 199 | 160,177 | 2,776 |
| Total available for sale securities | 232,913 | 3,312 | 35,864 | 513 | 268,777 | 3,825 |

Securities held to maturity:

| | | | | | | |
|--|------------|----------|-----------|--------|------------|----------|
| State and political subdivisions | 3,075 | 4 | | | 3,075 | 4 |
| Mortgage-backed securities: | | | | | | |
| Federal National Mortgage Association | 5,666 | 79 | | | 5,666 | 79 |
| Government National Mortgage Association | 8,790 | 159 | | | 8,790 | 159 |
| Collateralized mortgage obligations: | | | | | | |
| Federal National Mortgage Association | 55,973 | 818 | | | 55,973 | 818 |
| Federal Home Loan Mortgage Corporation | 79,323 | 1,120 | | | 79,323 | 1,120 |
| Government National Mortgage Association | 14,559 | 101 | | | 14,559 | 101 |
| Total mortgage-backed securities | 164,311 | 2,277 | | | 164,311 | 2,277 |
| Total held to maturity securities | 167,386 | 2,281 | | | 167,386 | 2,281 |
| Total temporarily impaired securities | \$ 400,299 | \$ 5,593 | \$ 35,864 | \$ 513 | \$ 436,163 | \$ 6,106 |

Table of Contents

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(4.) INVESTMENT SECURITIES (Continued)

The Company had 78 security positions in the investment portfolio in an unrealized loss position at September 30, 2016 compared to 174 at December 31, 2015. At September 30, 2016, the Company had positions in 17 investment securities with a fair value of \$7.1 million and a total unrealized loss of \$24 thousand that have been in a continuous unrealized loss position for more than 12 months. At September 30, 2016, there were a total of 61 securities positions in the Company's investment portfolio with a fair value of \$83.1 million and a total unrealized loss of \$305 thousand that had been in a continuous unrealized loss position for less than 12 months. At December 31, 2015, the Company had positions in 14 investment securities with a fair value of \$35.9 million and a total unrealized loss of \$513 thousand that had been in a continuous unrealized loss position for more than 12 months. At December 31, 2015, there were a total of 160 securities positions in the Company's investment portfolio with a fair value of \$400.3 million and a total unrealized loss of \$5.6 million that had been in a continuous unrealized loss position for less than 12 months. The unrealized loss on investment securities was predominantly caused by changes in market interest rates subsequent to purchase. The fair value of most of the investment securities in the Company's portfolio fluctuates as market interest rates change.

The Company reviews investment securities on an ongoing basis for the presence of other than temporary impairment (OTTI) with formal reviews performed quarterly. When evaluating debt securities for OTTI, management considers many factors, including: (i) the length of time and the extent to which the fair value has been less than cost, (ii) the financial condition and near-term prospects of the issuer, (iii) whether the market decline was affected by macroeconomic conditions and (iv) whether the Company has the intention to sell the debt security or whether it is more likely than not that it will be required to sell the debt security before its anticipated recovery. The assessment of whether OTTI exists involves a high degree of subjectivity and judgment and is based on the information then available to management. There was no impairment recorded during the nine months ended September 30, 2016 and 2015.

Based on management's review and evaluation of the Company's debt securities as of September 30, 2016, the debt securities with unrealized losses were not considered to be other-than-temporarily impaired. As of September 30, 2016, the Company did not intend to sell any of the securities in a loss position and believes that it is not likely that it will be required to sell any such securities before the anticipated recovery of amortized cost. Accordingly, as of September 30, 2016, management has concluded that unrealized losses on its investment securities are temporary and no further impairment loss has been realized in the Company's consolidated statements of income.

Table of Contents

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(5.) LOANS

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

| | Principal Amount Outstanding | Net Deferred Loan (Fees) Costs | Loans, Net |
|----------------------------------|------------------------------------|---|--------------|
| <u>September 30, 2016</u> | | | |
| Commercial business | \$ 350,181 | \$ 407 | \$ 350,588 |
| Commercial mortgage | 637,799 | (1,461) | 636,338 |
| Residential real estate loans | 419,547 | 6,335 | 425,882 |
| Residential real estate lines | 120,901 | 2,762 | 123,663 |
| Consumer indirect | 703,499 | 26,145 | 729,644 |
| Other consumer | 17,700 | 179 | 17,879 |
| Total | \$ 2,249,627 | \$ 34,367 | 2,283,994 |
| Allowance for loan losses | | | (29,350) |
| Total loans, net | | | \$ 2,254,644 |
| <u>December 31, 2015</u> | | | |
| Commercial business | \$ 313,475 | \$ 283 | \$ 313,758 |
| Commercial mortgage | 567,481 | (1,380) | 566,101 |
| Residential real estate loans | 376,023 | 5,051 | 381,074 |
| Residential real estate lines | 124,766 | 2,581 | 127,347 |
| Consumer indirect | 652,494 | 24,446 | 676,940 |
| Other consumer | 18,361 | 181 | 18,542 |
| Total | \$ 2,052,600 | \$ 31,162 | 2,083,762 |
| Allowance for loan losses | | | (27,085) |
| Total loans, net | | | \$ 2,056,677 |

Loans held for sale (not included above) were comprised entirely of residential real estate mortgages and totaled \$844 thousand and \$1.4 million as of September 30, 2016 and December 31, 2015, respectively.

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

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

| | 30-59 Days Past Due | 60-89 Days Past Due | Greater Than 90 Days | Total Past Due | Nonaccrual | Current | Total Loans |
|-------------------------------|------------------------------------|------------------------------------|-------------------------------------|---------------------------|-------------------|----------------|------------------------|
| September 30, 2016 | | | | | | | |
| Commercial business | \$ 659 | \$ | \$ | \$ 659 | \$ 2,157 | \$ 347,365 | \$ 350,181 |
| Commercial mortgage | 1,105 | | | 1,105 | 1,345 | 635,349 | 637,799 |
| Residential real estate loans | 846 | | | 846 | 1,239 | 417,462 | 419,547 |
| Residential real estate lines | 122 | 23 | | 145 | 274 | 120,482 | 120,901 |
| Consumer indirect | 1,596 | 311 | | 1,907 | 1,077 | 700,515 | 703,499 |
| Other consumer | 106 | 31 | 8 | 145 | 1 | 17,554 | 17,700 |
| Total loans, gross | \$ 4,434 | \$ 365 | \$ 8 | \$ 4,807 | \$ 6,093 | \$ 2,238,727 | \$ 2,249,627 |
| December 31, 2015 | | | | | | | |
| Commercial business | \$ 321 | \$ 612 | \$ | \$ 933 | \$ 3,922 | \$ 308,620 | \$ 313,475 |
| Commercial mortgage | 68 | 146 | | 214 | 947 | 566,320 | 567,481 |
| Residential real estate loans | 723 | 395 | | 1,118 | 1,848 | 373,057 | 376,023 |
| Residential real estate lines | 199 | 34 | | 233 | 235 | 124,298 | 124,766 |
| Consumer indirect | 1,975 | 286 | | 2,261 | 1,467 | 648,766 | 652,494 |
| Other consumer | 98 | 13 | 8 | 119 | 13 | 18,229 | 18,361 |
| Total loans, gross | \$ 3,384 | \$ 1,486 | \$ 8 | \$ 4,878 | \$ 8,432 | \$ 2,039,290 | \$ 2,052,600 |

There were no loans past due greater than 90 days and still accruing interest as of September 30, 2016 and December 31, 2015. There was \$8 thousand in consumer overdrafts which were past due greater than 90 days as of September 30, 2016 and December 31, 2015. Consumer overdrafts are overdrawn deposit accounts which have been reclassified as loans but by their terms do not accrue interest.

Troubled Debt Restructurings

Edgar Filing: FINANCIAL INSTITUTIONS INC - Form 10-Q

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

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

| | Quarter-to-Date | | Year-to-Date | |
|---------------------------|------------------------------|-------------------------------|------------------------------|-------------------------------|
| | Pre-Modification Outstanding | Post-Modification Outstanding | Pre-Modification Outstanding | Post-Modification Outstanding |
| | Number of Recorded Contracts | Recorded Investment | Number of Recorded Contracts | Recorded Investment |
| September 30, 2016 | | | | |
| Commercial business | | \$ | 3 | \$ 526 |
| Commercial mortgage | | | 1 | 550 |
| Total | | \$ | 4 | \$ 1,076 |
| September 30, 2015 | | | | |
| Commercial business | | \$ | 2 | \$ 1,342 |
| Commercial mortgage | | | 1 | 682 |
| Total | | \$ | 3 | \$ 2,024 |

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

The loans identified as a TDR by the Company during the nine month periods ended September 30, 2016 and 2015 were previously reported as impaired loans prior to restructuring. Each of the loans restructured during the nine months ended September 30, 2016 and 2015 were on nonaccrual status at the end of the respective period. The modifications related to collateral concessions and forbearance agreements. Nonaccrual loans that are restructured remain on nonaccrual status, but may move to accrual status after they have performed according to the restructured terms for a period of time. The TDR classifications did not have a material impact on the Company's determination of the allowance for loan losses because the modified loans were impaired and evaluated for a specific reserve both before and after restructuring.

There were no loans modified as a TDR within the previous 12 months that defaulted during the nine months ended September 30, 2016. There were two commercial business loans with an aggregate pre-default balance of \$1.3 million restructured in the 12 months prior to September 30, 2015 that went into default during the nine months ended September 30, 2015. For purposes of this disclosure, a loan modified as a TDR is considered to have defaulted when the borrower becomes 90 days past due.

Impaired Loans

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

| | Recorded Investment⁽¹⁾ | Unpaid Principal Balance⁽¹⁾ | Related Allowance | Average Recorded Investment | Interest Income Recognized |
|-------------------------------------|--|---|------------------------------|--|---|
| September 30, 2016 | | | | | |
| With no related allowance recorded: | | | | | |
| Commercial business | \$ 1,074 | \$ 1,594 | \$ | \$ 1,149 | \$ |
| Commercial mortgage | 729 | 938 | | 737 | |
| | 1,803 | 2,532 | | 1,886 | |
| With an allowance recorded: | | | | | |
| Commercial business | 1,083 | 1,083 | 460 | 1,058 | |
| Commercial mortgage | 616 | 616 | 124 | 745 | |

Edgar Filing: FINANCIAL INSTITUTIONS INC - Form 10-Q

| | | | | | |
|-------------------------------------|----------|----------|----------|----------|----|
| | 1,699 | 1,699 | 584 | 1,803 | |
| | \$ 3,502 | \$ 4,231 | \$ 584 | \$ 3,689 | \$ |
| December 31, 2015 | | | | | |
| With no related allowance recorded: | | | | | |
| Commercial business | \$ 1,441 | \$ 1,810 | \$ | \$ 1,352 | \$ |
| Commercial mortgage | 937 | 1,285 | | 1,013 | |
| | 2,378 | 3,095 | | 2,365 | |
| With an allowance recorded: | | | | | |
| Commercial business | 2,481 | 2,481 | 996 | 1,946 | |
| Commercial mortgage | 10 | 10 | 10 | 449 | |
| | 2,491 | 2,491 | 1,006 | 2,395 | |
| | \$ 4,869 | \$ 5,586 | \$ 1,006 | \$ 4,760 | \$ |

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

Table of Contents**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Unaudited)****(5.) LOANS (Continued)****Credit Quality Indicators**

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

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

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

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

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

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

| | Commercial Business | Commercial Mortgage |
|----------------------------------|--------------------------------|--------------------------------|
| <u>September 30, 2016</u> | | |
| Uncriticized | \$ 330,433 | \$ 616,955 |
| Special mention | 10,676 | 14,182 |
| Substandard | 9,072 | 6,662 |
| Doubtful | | |

Edgar Filing: FINANCIAL INSTITUTIONS INC - Form 10-Q

| | | |
|---------------------------------|------------|------------|
| Total | \$ 350,181 | \$ 637,799 |
| <u>December 31, 2015</u> | | |
| Uncriticized | \$ 298,413 | \$ 551,603 |
| Special mention | 4,916 | 9,015 |
| Substandard | 10,146 | 6,863 |
| Doubtful | | |
| Total | \$ 313,475 | \$ 567,481 |

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

| | Residential Real Estate Loans | Residential Real Estate Lines | Consumer Indirect | Other Consumer |
|----------------------------------|--|--|------------------------------|---------------------------|
| <u>September 30, 2016</u> | | | | |
| Performing | \$ 418,308 | \$ 120,627 | \$ 702,422 | \$ 17,691 |
| Non-performing | 1,239 | 274 | 1,077 | 9 |
| Total | \$ 419,547 | \$ 120,901 | \$ 703,499 | \$ 17,700 |
| <u>December 31, 2015</u> | | | | |
| Performing | \$ 374,175 | \$ 124,531 | \$ 651,027 | \$ 18,340 |
| Non-performing | 1,848 | 235 | 1,467 | 21 |
| Total | \$ 376,023 | \$ 124,766 | \$ 652,494 | \$ 18,361 |

Table of Contents**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Unaudited)****(5.) LOANS (Continued)****Allowance for Loan Losses**

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

| | Commercial Business | Commercial Mortgage | Residential Real Estate Loans | Residential Real Estate Lines | Consumer Indirect | Other Consumer | Total |
|-----------------------------------|--------------------------------|--------------------------------|--|--|------------------------------|---------------------------|--------------|
| <u>September 30, 2016</u> | | | | | | | |
| Loans: | | | | | | | |
| Ending balance | \$ 350,181 | \$ 637,799 | \$ 419,547 | \$ 120,901 | \$ 703,499 | \$ 17,700 | \$ 2,249,627 |
| Evaluated for impairment: | | | | | | | |
| Individually | \$ 2,081 | \$ 1,334 | \$ | \$ | \$ | \$ | \$ 3,415 |
| Collectively | \$ 348,100 | \$ 636,465 | \$ 419,547 | \$ 120,901 | \$ 703,499 | \$ 17,700 | \$ 2,246,212 |
| Allowance for loan losses: | | | | | | | |
| Ending balance | \$ 6,524 | \$ 9,710 | \$ 1,428 | \$ 315 | \$ 11,041 | \$ 332 | \$ 29,350 |
| Evaluated for impairment: | | | | | | | |
| Individually | \$ 436 | \$ 122 | \$ | \$ | \$ | \$ | \$ 558 |
| Collectively | \$ 6,088 | \$ 9,588 | \$ 1,428 | \$ 315 | \$ 11,041 | \$ 332 | \$ 28,792 |
| <u>September 30, 2015</u> | | | | | | | |
| Loans: | | | | | | | |
| Ending balance | \$ 297,640 | \$ 549,911 | \$ 96,298 | \$ 401,103 | \$ 641,453 | \$ 19,020 | \$ 2,005,425 |
| Evaluated for impairment: | | | | | | | |
| Individually | \$ 3,064 | \$ 1,802 | \$ | \$ | \$ | \$ | \$ 4,866 |
| Collectively | \$ 294,576 | \$ 548,109 | \$ 96,298 | \$ 401,103 | \$ 641,453 | \$ 19,020 | \$ 2,000,559 |
| Allowance for loan losses: | | | | | | | |
| Ending balance | \$ 5,281 | \$ 8,888 | \$ 456 | \$ 1,177 | \$ 10,264 | \$ 389 | \$ 26,455 |

Evaluated for impairment:

| | | | | | | | | |
|--------------|----------|----------|--------|----------|-----------|--------|----|-----------|
| Individually | \$ 806 | \$ 278 | \$ | \$ | \$ | \$ | \$ | \$ 1,084 |
| Collectively | \$ 4,475 | \$ 8,610 | \$ 456 | \$ 1,177 | \$ 10,264 | \$ 389 | \$ | \$ 25,371 |

The following table sets forth the changes in the allowance for loan losses for the three and nine month periods ended September 30, 2016 (in thousands):

| | Commercial Business | Commercial Mortgage | Residential Real Estate Loans | Residential Real Estate Lines | Consumer Indirect | Other Consumer | Total |
|--|------------------------|------------------------|-------------------------------------|-------------------------------------|----------------------|-------------------|-----------|
| Three months ended September 30, 2016 | | | | | | | |
| Beginning balance | \$ 6,197 | \$ 9,496 | \$ 1,444 | \$ 318 | \$ 10,696 | \$ 374 | \$ 28,525 |
| Charge-offs | (44) | (156) | (78) | (8) | (2,056) | (158) | (2,500) |
| Recoveries | 75 | 29 | 17 | 4 | 1,160 | 79 | 1,364 |
| Provision | 296 | 341 | 45 | 1 | 1,241 | 37 | 1,961 |
| Ending balance | \$ 6,524 | \$ 9,710 | \$ 1,428 | \$ 315 | \$ 11,041 | \$ 332 | \$ 29,350 |
| Nine months ended September 30, 2016 | | | | | | | |
| Beginning balance | \$ 5,540 | \$ 9,027 | \$ 1,347 | \$ 345 | \$ 10,458 | \$ 368 | \$ 27,085 |
| Charge-offs | (688) | (168) | (258) | (59) | (6,452) | (434) | (8,059) |
| Recoveries | 244 | 40 | 142 | 11 | 3,324 | 282 | 4,043 |
| Provision | 1,428 | 811 | 197 | 18 | 3,711 | 116 | 6,281 |
| Ending balance | \$ 6,524 | \$ 9,710 | \$ 1,428 | \$ 315 | \$ 11,041 | \$ 332 | \$ 29,350 |

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

The following table sets forth the changes in the allowance for loan losses for the three and nine month periods ended September 30, 2015 (in thousands):

| | Commercial Business | Residential Commercial Mortgage | Residential Real Estate Loans | Residential Real Estate Lines | Consumer Indirect | Other Consumer | Total |
|----------------------------------|------------------------|---------------------------------------|-------------------------------------|-------------------------------------|----------------------|-------------------|-----------|
| <u>Three months ended</u> | | | | | | | |
| <u>September 30, 2015</u> | | | | | | | |
| Beginning balance | \$ 5,334 | \$ 9,358 | \$ 465 | \$ 1,198 | \$ 10,676 | \$ 469 | \$ 27,500 |
| Charge-offs | (106) | (56) | (37) | (98) | (2,380) | (239) | (2,916) |
| Recoveries | 38 | 44 | 34 | 34 | 905 | 62 | 1,117 |
| Provision (credit) | 15 | (458) | (6) | 43 | 1,063 | 97 | 754 |
| Ending balance | \$ 5,281 | \$ 8,888 | \$ 456 | \$ 1,177 | \$ 10,264 | \$ 389 | \$ 26,455 |
| <u>Nine months ended</u> | | | | | | | |
| <u>September 30, 2015</u> | | | | | | | |
| Beginning balance | \$ 5,621 | \$ 8,122 | \$ 570 | \$ 1,485 | \$ 11,383 | \$ 456 | \$ 27,637 |
| Charge-offs | (1,260) | (866) | (114) | (336) | (6,643) | (652) | (9,871) |
| Recoveries | 172 | 140 | 80 | 53 | 3,206 | 255 | 3,906 |
| Provision (credit) | 748 | 1,492 | (80) | (25) | 2,318 | 330 | 4,783 |
| Ending balance | \$ 5,281 | \$ 8,888 | \$ 456 | \$ 1,177 | \$ 10,264 | \$ 389 | \$ 26,455 |

Risk Characteristics

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

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

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

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

Consumer indirect and other consumer loans may entail greater credit risk than residential mortgage loans and home equities, particularly in the case of other consumer loans which are unsecured or, in the case of indirect consumer loans, secured by depreciable assets, such as automobiles or boats. In such cases, any repossessed collateral for a defaulted consumer loan may not provide an adequate source of repayment of the outstanding loan balance. In addition, consumer loan collections are dependent on the borrower's continuing financial stability, and thus are more likely to be affected by adverse personal circumstances such as job loss, illness or personal bankruptcy. Furthermore, the application of various federal and state laws, including bankruptcy and insolvency laws, may limit the amount that can be recovered on such loans.

Table of Contents**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Unaudited)****(6.) GOODWILL AND OTHER INTANGIBLE ASSETS**

The carrying amount of goodwill for the Company totaled \$66.4 and \$60.4 million as of September 30, 2016 and December 31, 2015, respectively. The Company performs a goodwill impairment test on an annual basis as of September 30th or more frequently if events and circumstances warrant.

| | Banking | Non-Banking | Total |
|-----------------------------|----------------|--------------------|--------------|
| Balance, December 31, 2015 | \$ 48,536 | \$ 11,866 | \$ 60,402 |
| Acquisition | | 6,015 | 6,015 |
| Balance, September 30, 2016 | \$ 48,536 | \$ 17,881 | \$ 66,417 |

Goodwill and other intangible assets added during the period relates to the Courier Capital acquisition, which was completed on January 5, 2016. See Note 2 Business Combinations for additional information.

The Company has other intangible assets that are amortized, consisting of core deposit intangibles and other intangibles (primarily related to customer relationships). Changes in the gross carrying amount, accumulated amortization and net book value, were as follows (in thousands):

| | September 30, 2016 | December 31, 2015 |
|----------------------------------|-------------------------------|------------------------------|
| Other intangibles assets: | | |
| Gross carrying amount | \$ 12,610 | \$ 8,682 |
| Accumulated amortization | (3,084) | (2,138) |
| Net book value | \$ 9,526 | \$ 6,544 |

Amortization expense for total other intangible assets was \$309 thousand and \$946 thousand for the three and nine months ended September 30, 2016, \$233 thousand and \$714 thousand for the three and nine months ended September 30, 2015, respectively. As of September 30, 2016, the estimated amortization expense of other intangible assets for the remainder of 2016 and each of the next five years is as follows (in thousands):

| | |
|--------------------------|--------|
| 2016 (remainder of year) | \$ 303 |
| 2017 | 1,144 |
| 2018 | 1,035 |
| 2019 | 937 |

| | |
|------|-----|
| 2020 | 840 |
| 2021 | 738 |

Table of Contents**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Unaudited)****(7.) SHAREHOLDERS EQUITY****Common Stock**

The changes in shares of common stock were as follows for the nine month periods ended September 30, 2016 and 2015:

| | Outstanding | Treasury | Issued |
|--|--------------------|-----------------|---------------|
| <u>September 30, 2016</u> | | | |
| Shares outstanding at December 31, 2015 | 14,190,192 | 207,317 | 14,397,509 |
| Common stock issued for acquisition | 294,705 | | 294,705 |
| Restricted stock awards issued | 8,800 | (8,800) | |
| Restricted stock awards forfeited | (10,183) | 10,183 | |
| Stock options exercised | 41,961 | (41,961) | |
| Stock awards | 2,244 | (2,244) | |
| Shares outstanding at September 30, 2016 | 14,527,719 | 164,495 | 14,692,214 |
| <u>September 30, 2015</u> | | | |
| Shares outstanding at December 31, 2014 | 14,118,048 | 279,461 | 14,397,509 |
| Restricted stock awards issued | 59,834 | (59,834) | |
| Restricted stock awards forfeited | (3,041) | 3,041 | |
| Stock options exercised | 13,422 | (13,422) | |
| Treasury stock purchases | (1,791) | 1,791 | |
| Stock awards | 2,363 | (2,363) | |
| Shares outstanding at September 30, 2015 | 14,188,835 | 208,674 | 14,397,509 |

(8.) ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS)

The following tables present the components of other comprehensive income (loss) for the three and nine month periods ended September 30, 2016 and 2015 (in thousands):

| | Pre-tax Amount | Tax Effect | Net-of-tax Amount |
|---|---------------------------|-------------------|------------------------------|
| <u>Three months ended September 30, 2016</u> | | | |
| Securities available for sale and transferred securities: | | | |
| Change in unrealized gain/loss during the period | \$ (1,922) | \$ (742) | \$ (1,180) |

Edgar Filing: FINANCIAL INSTITUTIONS INC - Form 10-Q

| | | | |
|---|------------|----------|------------|
| Reclassification adjustment for net gains included in net income ⁽¹⁾ | (433) | (167) | (266) |
| Total securities available for sale and transferred securities | (2,355) | (909) | (1,446) |
| Amortization of pension and post-retirement items: | | | |
| Prior service credit | (12) | (5) | (7) |
| Net actuarial losses | 238 | 92 | 146 |
| Total pension and post-retirement obligations | 226 | 87 | 139 |
| Other comprehensive loss | \$ (2,129) | \$ (822) | \$ (1,307) |
| Three months ended September 30, 2015 | | | |
| Securities available for sale and transferred securities: | | | |
| Change in unrealized gain/loss during the period | \$ 9,283 | \$ 3,583 | \$ 5,700 |
| Reclassification adjustment for net gains included in net income ⁽¹⁾ | (338) | (130) | (208) |
| Total securities available for sale and transferred securities | 8,945 | 3,453 | 5,492 |
| Amortization of pension and post-retirement items: | | | |
| Prior service credit | (12) | (5) | (7) |
| Net actuarial losses | 237 | 92 | 145 |
| Total pension and post-retirement obligations | 225 | 87 | 138 |
| Other comprehensive income | \$ 9,170 | \$ 3,540 | \$ 5,630 |

- ⁽¹⁾ Includes amounts related to the amortization/accretion of unrealized net gains and losses related to the Company's reclassification of available for sale investment securities to the held to maturity category. The remaining unrealized net gains/losses will be amortized/accreted over the remaining life of the investment securities as an adjustment of yield.

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

| | Pre-tax Amount | Tax Effect | Net-of-tax Amount |
|---|---------------------------|-------------------|------------------------------|
| <u>Nine months ended September 30, 2016</u> | | | |
| Securities available for sale and transferred securities: | | | |
| Change in unrealized gain/loss during the period | \$ 17,084 | \$ 6,593 | \$ 10,491 |
| Reclassification adjustment for net gains included in net income ⁽¹⁾ | (2,512) | (969) | (1,543) |
| Total securities available for sale and transferred securities | 14,572 | 5,624 | 8,948 |
| Amortization of pension and post-retirement items: | | | |
| Prior service credit | (36) | (14) | (22) |
| Net actuarial losses | 716 | 276 | 440 |
| Total pension and post-retirement obligations | 680 | 262 | 418 |
| Other comprehensive income | \$ 15,252 | \$ 5,886 | \$ 9,366 |
| <u>Nine months ended September 30, 2015</u> | | | |
| Securities available for sale and transferred securities: | | | |
| Change in unrealized gain/loss during the period | \$ 5,693 | \$ 2,197 | \$ 3,496 |
| Reclassification adjustment for net gains included in net income ⁽¹⁾ | (1,546) | (596) | (950) |
| Total securities available for sale and transferred securities | 4,147 | 1,601 | 2,546 |
| Amortization of pension and post-retirement items: | | | |
| Prior service credit | (36) | (14) | (22) |
| Net actuarial losses | 708 | 273 | 435 |
| Total pension and post-retirement obligations | 672 | 259 | 413 |
| Other comprehensive income | \$ 4,819 | \$ 1,860 | \$ 2,959 |

- ⁽¹⁾ Includes amounts related to the amortization/accretion of unrealized net gains and losses related to the Company's reclassification of available for sale investment securities to the held to maturity category. The remaining unrealized net gains/losses will be amortized/accreted over the remaining life of the investment securities as an adjustment of yield.

Edgar Filing: FINANCIAL INSTITUTIONS INC - Form 10-Q

Activity in accumulated other comprehensive income (loss), net of tax, for the three and nine month periods ended September 30, 2016 and 2015 was as follows (in thousands):

| | Securities Available for Sale and Transferred Securities | Pension and Post- retirement Obligations | Accumulated Other Comprehensive Income (Loss) |
|---|---|---|--|
| <u>Three months ended September 30, 2016</u> | | | |
| Balance at beginning of period | \$ 9,698 | \$ (10,352) | \$ (654) |
| Other comprehensive income before reclassifications | (1,180) | | (1,180) |
| Amounts reclassified from accumulated other comprehensive income (loss) | (266) | 139 | (127) |
| Net current period other comprehensive income | (1,446) | 139 | (1,307) |
| Balance at end of period | \$ 8,252 | \$ (10,213) | \$ (1,961) |
| <u>Three months ended September 30, 2015</u> | | | |
| Balance at beginning of period | \$ (1,321) | \$ (10,361) | \$ (11,682) |
| Other comprehensive income before reclassifications | 5,700 | | 5,700 |
| Amounts reclassified from accumulated other comprehensive income (loss) | (208) | 138 | (70) |
| Net current period other comprehensive income | 5,492 | 138 | 5,630 |
| Balance at end of period | \$ 4,171 | \$ (10,223) | \$ (6,052) |

Table of Contents

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

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

| | Securities Available for Sale and Transferred Securities | Pension and Post- retirement Obligations | Accumulated Other Comprehensive Income (Loss) |
|---|--|---|---|
| <u>Nine months ended September 30, 2016</u> | | | |
| Balance at beginning of period | \$ (696) | \$ (10,631) | \$ (11,327) |
| Other comprehensive income before reclassifications | 10,491 | | 10,491 |
| Amounts reclassified from accumulated other comprehensive income (loss) | (1,543) | 418 | (1,125) |
| Net current period other comprehensive income | 8,948 | 418 | 9,366 |
| Balance at end of period | \$ 8,252 | \$ (10,213) | \$ (1,961) |
| <u>Nine months ended September 30, 2015</u> | | | |
| Balance at beginning of period | \$ 1,625 | \$ (10,636) | \$ (9,011) |
| Other comprehensive income before reclassifications | 3,496 | | 3,496 |
| Amounts reclassified from accumulated other comprehensive income (loss) | (950) | 413 | (537) |
| Net current period other comprehensive income | 2,546 | 413 | 2,959 |
| Balance at end of period | \$ 4,171 | \$ (10,223) | \$ (6,052) |

The following tables present the amounts reclassified out of each component of accumulated other comprehensive income (loss) for the three and nine month periods ended September 30, 2016 and 2015 (in thousands):

| Details About Accumulated Other Comprehensive Income (Loss) Components | Amount Reclassified from Accumulated Other Comprehensive | Affected Line Item in the Consolidated Statement of Income |
|---|---|---|
|---|---|---|

| | Income (Loss) | | |
|--|----------------------|-------------|---|
| | Three months | | |
| | ended | | |
| | September 30, | | |
| | 2016 | 2015 | |
| Realized gain on sale of investment securities | \$ 426 | \$ 286 | Net gain on disposal of investment securities |
| Amortization of unrealized holding gains (losses) on investment securities transferred from available for sale to held to maturity | 7 | 52 | Interest income |
| | 433 | 338 | Total before tax |
| | (167) | (130) | Income tax expense |
| | 266 | 208 | Net of tax |
| Amortization of pension and post-retirement items: | | | |
| Prior service credit ⁽¹⁾ | 12 | 12 | Salaries and employee benefits |
| Net actuarial losses ⁽¹⁾ | (238) | (237) | Salaries and employee benefits |
| | (226) | (225) | Total before tax |
| | 87 | 87 | Income tax benefit |
| | (139) | (138) | Net of tax |
| Total reclassified for the period | \$ 127 | \$ 70 | |

⁽¹⁾ These items are included in the computation of net periodic pension expense. See Note 10 Employee Benefit Plans for additional information.

Table of Contents

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

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

| Details About Accumulated Other Comprehensive Income (Loss) Components | Amount Reclassified from Accumulated Other Comprehensive Income (Loss) Nine months ended September 30, | | Affected Line Item in the Consolidated Statement of Income |
|--|--|----------|---|
| | 2016 | 2015 | |
| Realized gain on sale of investment securities | \$ 2,426 | \$ 1,348 | Net gain on disposal of investment securities |
| Amortization of unrealized holding gains (losses) on investment securities transferred from available for sale to held to maturity | 86 | 198 | Interest income |
| | 2,512 | 1,546 | Total before tax |
| | (969) | (596) | Income tax expense |
| | 1,543 | 950 | Net of tax |
| Amortization of pension and post-retirement items: | | | |
| Prior service credit ⁽¹⁾ | 36 | 36 | Salaries and employee benefits |
| Net actuarial losses ⁽¹⁾ | (716) | (708) | Salaries and employee benefits |
| | (680) | (672) | Total before tax |
| | 262 | 259 | Income tax benefit |
| | (418) | (413) | Net of tax |
| Total reclassified for the period | \$ 1,125 | \$ 537 | |

⁽¹⁾ These items are included in the computation of net periodic pension expense. See Note 10 Employee Benefit Plans for additional information.

Table of Contents**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Unaudited)****(9.) SHARE-BASED COMPENSATION PLANS**

The Company maintains certain stock-based compensation plans that were approved by the Company's shareholders and are administered by the Company's Board of Directors or the Management Development and Compensation Committee (the MD&C Committee) of the Board. The share-based compensation plans were established to allow for the grant of compensation awards to attract, motivate and retain employees, executive officers and non-employee directors who contribute to the 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 MD&C Committee approved the grant of restricted stock units (RSUs) and performance share units (PSUs) shown in the table below to certain members of management during the first nine months of 2016.

| | Number of Underlying Shares | Weighted Average Per Share Grant Date Fair Value |
|------|--|---|
| RSUs | 18,500 | \$ 24.17 |
| PSUs | 24,084 | 24.37 |

The grant-date fair value for the RSUs granted during the nine month period ended September 30, 2016 is equal to the closing market price of our common stock on the date of grant reduced by the present value of the dividends expected to be paid on the underlying shares.

The number of PSUs that ultimately vest is contingent on achieving specified EPS targets and specified total shareholder return (TSR) targets relative to the SNL Small Cap Bank & Thrifts Index. Thirty percent of the shares subject to each grant will be earned based upon achievement of an EPS performance requirement for the Company's fiscal year ended December 31, 2016. The remaining seventy percent of the shares will be earned based on the Company's achievement of a relative TSR performance requirement, on a percentile basis, compared to the SNL Small Cap Bank & Thrifts Index over a three-year performance period ended December 31, 2018. The shares earned based on the achievement of the EPS and TSR performance requirements, if any, will vest on February 24, 2019, assuming the recipient's continuous service to the Company.

The grant-date fair value for the EPS portion of the PSUs granted during the nine month period ended September 30, 2016 is equal to the closing market price of our common stock on the date of grant reduced by the present value of the dividends expected to be paid on the underlying shares. The grant-date fair value of the TSR portion of the PSUs granted during the nine month period ended September 30, 2016 was determined using the Monte Carlo simulation model on the date of grant, assuming the following (i) expected term of 2.85 years, (ii) risk free interest rate of 0.88%, (iii) expected dividend yield of 2.99% and (iv) expected stock price volatility over the expected term of the TSR award of 24.3%.

Edgar Filing: FINANCIAL INSTITUTIONS INC - Form 10-Q

During the nine months ended September 30, 2016, the Company issued a total of 2,244 shares of common stock in-lieu of cash for the annual retainer of four non-employee directors and granted a total of 8,800 restricted shares of common stock to non-employee directors, of which 4,400 shares vested immediately and 4,400 shares will vest after completion of a one-year service requirement. The market price of the stock and restricted stock on the date of grant was \$28.38.

The following is a summary of restricted stock awards, RSUs and PSUs activity for the nine month period ended September 30, 2016:

| | Number of Shares | Weighted Average Market Price at Grant Date |
|-------------------------------------|-----------------------------|--|
| Outstanding at beginning of year | 82,908 | \$ 17.23 |
| Granted | 51,384 | 24.98 |
| Vested | (10,770) | 25.11 |
| Forfeited | (14,457) | 21.32 |
| Outstanding at end of period | 109,065 | \$ 19.57 |

At September 30, 2016, the total unrecognized compensation cost related to the nonvested restricted stock awards, RSUs and PSUs granted and expected to vest was \$1.2 million. This cost is expected to be recognized over a weighted-average period of 2.0 years.

Table of Contents**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Unaudited)****(9.) SHARE-BASED COMPENSATION PLANS (Continued)**

The Company uses the Black-Scholes valuation method to estimate the fair value of its stock option awards. There were no stock options awarded during 2016 or 2015. The following is a summary of stock option activity for the nine months ended September 30, 2016 (dollars in thousands, except per share amounts):

| | Number of Options | Weighted Average Exercise Price | Weighted Average Remaining Contractual Term | Aggregate Intrinsic Value |
|--|----------------------|--|---|---------------------------------|
| Outstanding at beginning of year | 102,249 | \$ 19.21 | | |
| Exercised | (41,961) | 19.41 | | |
| Expired | (3,389) | 19.72 | | |
| Outstanding and exercisable at end of period | 56,899 | \$ 19.04 | 1.1 | \$ 459 |

The aggregate intrinsic value (the amount by which the market price of the stock on the date of exercise exceeded the market price of the stock on the date of grant) of option exercises for the nine months ended September 30, 2016 and 2015 was \$342 thousand and \$70 thousand, respectively. The total cash received as a result of option exercises under stock compensation plans for the nine months ended September 30, 2016 and 2015 was \$814 thousand and \$252 thousand, respectively.

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

| | Three months ended September 30, | | Nine months ended September 30, | |
|--|-------------------------------------|--------|------------------------------------|--------|
| | 2016 | 2015 | 2016 | 2015 |
| Salaries and employee benefits | \$ 131 | \$ 118 | \$ 386 | \$ 309 |
| Other noninterest expense | 34 | 32 | 211 | 211 |
| Total share-based compensation expense | \$ 165 | \$ 150 | \$ 597 | \$ 520 |

(10.) EMPLOYEE BENEFIT PLANS

The components of the Company's net periodic benefit expense for its pension and post-retirement obligations were as follows (in thousands):

| | Three months ended September 30, | | Nine months ended September 30, | |
|---|---|-------------|--|-------------|
| | 2016 | 2015 | 2016 | 2015 |
| Service cost | \$ 722 | \$ 581 | \$ 2,164 | \$ 1,743 |
| Interest cost on projected benefit obligation | 601 | 583 | 1,804 | 1,749 |
| Expected return on plan assets | (1,150) | (1,205) | (3,450) | (3,615) |
| Amortization of prior service credit | (12) | (12) | (36) | (36) |
| Amortization of net actuarial losses | 238 | 237 | 716 | 708 |
| Net periodic pension expense | \$ 399 | \$ 184 | \$ 1,198 | \$ 549 |

The net periodic benefit expense is recorded as a component of salaries and employee benefits in the consolidated statements of income. The Company's funding policy is to contribute, at a minimum, an actuarially determined amount that will satisfy the minimum funding requirements determined under the appropriate sections of the Internal Revenue Code. The Company has no minimum required contribution for the 2016 fiscal year.

Table of Contents**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Unaudited)****(11.) COMMITMENTS AND CONTINGENCIES**

The Company has financial instruments with off-balance sheet risk established in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and standby letters of credit. These instruments involve, to varying degrees, elements of credit and interest rate risk extending beyond amounts recognized in the Company's 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):

| | September 30, 2016 | December 31, 2015 |
|------------------------------|-------------------------------|------------------------------|
| Commitments to extend credit | \$ 529,694 | \$ 514,818 |
| Standby letters of credit | 12,474 | 11,746 |

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 which may require payment by the customer of a termination fee. Commitments may expire without being drawn upon; therefore, the total commitment amounts do not necessarily represent future cash requirements. Each customer's creditworthiness is evaluated on a case-by-case basis. The amount of collateral obtained, if any, is based on management's credit evaluation of the borrower. Standby letters of credit are conditional lending commitments issued by the Company to guarantee the performance of a customer to a third party. These standby letters of credit are primarily issued to support private borrowing arrangements. The credit risk involved in issuing standby letters of credit is essentially the same as that involved in extending loan facilities to customers.

The Company also extends rate lock agreements to borrowers related to the origination of residential mortgage loans. To mitigate the interest rate risk inherent in these rate lock agreements, the Company may enter into forward commitments to sell individual residential mortgages. Rate lock agreements and forward commitments are considered derivatives and are recorded at fair value. Forward sales commitments totaled \$806 thousand and \$1.3 million at September 30, 2016 and December 31, 2015, respectively. In addition, the net change in the fair values of these derivatives was recognized as other noninterest income or other noninterest expense in the consolidated statements of income.

(12.) FAIR VALUE MEASUREMENTS**Determination of Fair Value Assets Measured at Fair Value on a Recurring and Nonrecurring Basis**

Valuation Hierarchy

The fair value of an asset or liability is the price that would be received to sell that asset or paid to transfer that liability in an orderly transaction occurring in the principal market (or most advantageous market in the absence of a principal market) for such asset or liability. ASC Topic 820, Fair Value Measurements and Disclosures, establishes a fair value hierarchy for valuation inputs that gives the highest priority to quoted prices in active markets for identical assets or liabilities and the lowest priority to unobservable inputs. There have been no changes in the valuation techniques used during the current period. The fair value hierarchy is as follows:

Level 1 - Unadjusted quoted prices in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date.

Level 2 - Inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly. These might include quoted prices for similar assets or liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets that are not active, inputs other than quoted prices that are observable for the asset or liability (such as interest rates, volatilities, prepayment speeds, credit risks, etc.) or inputs that are derived principally from or corroborated by market data by correlation or other means.

Level 3 - Unobservable inputs for determining the fair values of assets or liabilities that reflect an entity's own assumptions about the assumptions that market participants would use in pricing the assets or liabilities. Transfers between levels of the fair value hierarchy are recorded as of the end of the reporting period.

Table of Contents**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Unaudited)****(12.) FAIR VALUE MEASUREMENTS (Continued)**

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

Securities available for sale: Securities classified as available for sale are reported at fair value utilizing Level 2 inputs. For these securities, the Company obtains fair value measurements from an independent pricing service. The fair value measurements consider observable data that may include dealer quotes, market spreads, cash flows, the U.S. Treasury yield curve, live trading levels, trade execution data, market consensus prepayment speeds, credit information and the bond's terms and conditions, among other things.

Loans held for sale: The fair value of loans held for sale is determined using quoted secondary market prices and investor commitments. Loans held for sale are classified as Level 2 in the fair value hierarchy.

Collateral dependent impaired loans: Fair value of impaired loans with specific allocations of the allowance for loan losses is measured based on the value of the collateral securing these loans and is classified as Level 3 in the fair value hierarchy. Collateral may be real estate and/or business assets including equipment, inventory and/or accounts receivable. Collateral value is determined based on appraisals performed by qualified licensed appraisers hired by the Company. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Appraised and reported values may be discounted based on management's historical knowledge, changes in market conditions from the time of valuation and/or management's expertise and knowledge of the client and the client's business. Such discounts are typically significant and result in a Level 3 classification of the inputs for determining fair value. Impaired loans are reviewed and evaluated on at least a quarterly basis for additional impairment and adjusted accordingly, based on the same factors identified above.

Loan servicing rights: Loan servicing rights do not trade in an active market with readily observable market data. As a result, the Company estimates the fair value of loan servicing rights by using a discounted cash flow model to calculate the present value of estimated future net servicing income. The assumptions used in the discounted cash flow

model are those that the Company believes market participants would use in estimating future net servicing income, including estimates of loan prepayment rates, servicing costs, ancillary income, impound account balances, and discount rates. The significant unobservable inputs used in the fair value measurement of the Company's loan servicing rights are the constant prepayment rates and weighted average discount rate. Significant increases (decreases) in any of those inputs in isolation could result in a significantly lower (higher) fair value measurement. Although the constant prepayment rate and the discount rate are not directly interrelated, they will generally move in opposite directions. Loan servicing rights are classified as Level 3 measurements due to the use of significant unobservable inputs, as well as significant management judgment and estimation.

Other real estate owned (Foreclosed assets): Nonrecurring adjustments to certain commercial and residential real estate properties classified as other real estate owned are measured at the lower of carrying amount or fair value, less costs to sell. Fair values are generally based on third party appraisals of the property, resulting in a Level 3 classification. The appraisals are sometimes further discounted based on management's historical knowledge, changes in market conditions from the time of valuation and/or management's expertise and knowledge of the client and client's business. Such discounts are typically significant and result in a Level 3 classification of the inputs for determining fair value. In cases where the carrying amount exceeds the fair value, less costs to sell, an impairment loss is recognized.

Commitments to extend credit and letters of credit: Commitments to extend credit and fund letters of credit are principally at current interest rates, and therefore, the carrying amount approximates fair value. The fair value of commitments is not material.

Table of Contents**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Unaudited)****(12.) FAIR VALUE MEASUREMENTS (Continued)****Assets Measured at Fair Value**

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

| | Quoted Prices in Active Markets for Identical Assets or Liabilities (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) | Total |
|---|--|--|--|--------------|
| <u>September 30, 2016</u> | | | | |
| Measured on a recurring basis: | | | | |
| Securities available for sale: | | | | |
| U.S. Government agencies and government sponsored enterprises | \$ | \$ 180,637 | \$ | \$ 180,637 |
| Mortgage-backed securities | | 378,663 | | 378,663 |
| Asset-backed securities | | 195 | | 195 |
| | \$ | \$ 559,495 | \$ | \$ 559,495 |
| Measured on a nonrecurring basis: | | | | |
| Loans: | | | | |
| Loans held for sale | \$ | \$ 844 | \$ | \$ 844 |
| Collateral dependent impaired loans | | | 1,055 | 1,055 |
| Other assets: | | | | |
| Loan servicing rights | | | 1,128 | 1,128 |
| Other real estate owned | | | 294 | 294 |
| | \$ | \$ 844 | \$ 2,477 | \$ 3,321 |

December 31, 2015**Measured on a recurring basis:**

Securities available for sale:

Edgar Filing: FINANCIAL INSTITUTIONS INC - Form 10-Q

| | | | | |
|---|----|------------|----------|------------|
| U.S. Government agencies and government sponsored enterprises | \$ | \$ 260,863 | \$ | \$ 260,863 |
| Mortgage-backed securities | | 283,314 | | 283,314 |
| Asset-backed securities | | 218 | | 218 |
| | \$ | \$ 544,395 | \$ | \$ 544,395 |
| Measured on a nonrecurring basis: | | | | |
| Loans: | | | | |
| Loans held for sale | \$ | \$ 1,430 | \$ | \$ 1,430 |
| Collateral dependent impaired loans | | | 1,485 | 1,485 |
| Other assets: | | | | |
| Loan servicing rights | | | 1,241 | 1,241 |
| Other real estate owned | | | 163 | 163 |
| | \$ | \$ 1,430 | \$ 2,889 | \$ 4,319 |

There were no transfers between Levels 1 and 2 during the nine months ended September 30, 2016 and 2015. There were no liabilities measured at fair value on a recurring or nonrecurring basis during the nine month periods ended September 30, 2016 and 2015.

Table of Contents**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Unaudited)****(12.) FAIR VALUE MEASUREMENTS (Continued)**

The following table presents additional quantitative information about assets measured at fair value on a recurring and nonrecurring basis for which the Company has utilized Level 3 inputs to determine fair value (dollars in thousands).

| Asset | Fair Value | Valuation Technique | Unobservable Input | Unobservable Input Value or Range |
|-------------------------------------|-------------------|--|--------------------------------------|--|
| Collateral dependent impaired loans | \$ 1,055 | Appraisal of collateral ⁽¹⁾ | Appraisal adjustments ⁽²⁾ | 45% - 50% discount |
| Loan servicing rights | 1,128 | Discounted cash flow | Discount rate | 4.5% ⁽³⁾ |
| | | | Constant prepayment rate | 16.8% ⁽³⁾ |
| Other real estate owned | 294 | Appraisal of collateral ⁽¹⁾ | Appraisal adjustments ⁽²⁾ | 19% - 72% discount |

(1) Fair value is generally determined through independent appraisals of the underlying collateral, which generally include various Level 3 inputs which are not identifiable.

(2) Appraisals may be adjusted by management for qualitative factors such as economic conditions and estimated liquidation expenses.

(3) Weighted averages.

Changes in Level 3 Fair Value Measurements

There were no assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) as of or during the nine months ended September 30, 2016.

Disclosures about Fair Value of Financial Instruments

The assumptions used below are expected to approximate those that market participants would use in valuing these financial instruments.

Fair value estimates are made at a specific point in time, based on available market information and judgments about the financial instrument, including estimates of timing, amount of expected future cash flows and the credit standing of the issuer. Such estimates do not consider the tax impact of the realization of unrealized gains or losses. In some cases, the fair value estimates cannot be substantiated by comparison to independent markets. In addition, the disclosed fair value may not be realized in the immediate settlement of the financial instrument. Care should be exercised in deriving conclusions about our business, its value or financial position based on the fair value information of financial instruments presented below.

The estimated fair value approximates carrying value for cash and cash equivalents, Federal Home Loan Bank (FHLB) and Federal Reserve Bank (FRB) stock, accrued interest receivable, non-maturity deposits, short-term borrowings and accrued interest payable. Fair value estimates for other financial instruments not included elsewhere in this disclosure are discussed below.

Securities held to maturity: The fair value of the Company's investment securities held to maturity is primarily measured using information from a third-party pricing service. The fair value measurements consider observable data that may include dealer quotes, market spreads, cash flows, the U.S. Treasury yield curve, live trading levels, trade execution data, market consensus prepayment speeds, credit information and the bond's terms and conditions, among other things.

Loans: The fair value of the Company's loans was estimated by discounting the expected future cash flows using the current interest rates at which similar loans would be made for the same remaining maturities. Loans were first segregated by type such as commercial, residential mortgage, and consumer, and were then further segmented into fixed and variable rate and loan quality categories. Expected future cash flows were projected based on contractual cash flows, adjusted for estimated prepayments.

Time deposits: The fair value of time deposits was estimated using a discounted cash flow approach that applies prevailing market interest rates for similar maturity instruments. The fair values of the Company's time deposit liabilities do not take into consideration the value of the Company's long-term relationships with depositors, which may have significant value.

Long-term borrowings: Long-term borrowings consist of \$40 million of subordinated notes issued during the second quarter of 2015. The subordinated notes are publicly traded and are valued based on market prices, which are characterized as Level 2 liabilities in the fair value hierarchy.

Table of Contents**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Unaudited)****(12.) FAIR VALUE MEASUREMENTS (Continued)**

The following presents (in thousands) the carrying amount, estimated fair value and placement in the fair value measurement hierarchy of the Company's financial instruments as of the dates indicated.

| | Level in Fair Value Measurement Hierarchy | September 30, 2016 | | December 31, 2015 | |
|-------------------------------|--|----------------------------|-------------------------------------|----------------------------|-------------------------------------|
| | | Carrying Amount | Estimated Fair Value | Carrying Amount | Estimated Fair Value |
| Financial assets: | | | | | |
| Cash and cash equivalents | Level 1 | \$ 110,721 | \$ 110,721 | \$ 60,121 | \$ 60,121 |
| Securities available for sale | Level 2 | 559,495 | 559,495 | 544,395 | 544,395 |
| Securities held to maturity | Level 2 | 528,708 | 538,630 | 485,717 | 490,064 |
| Loans held for sale | Level 2 | 844 | 865 | 1,430 | 1,430 |
| Loans | Level 2 | 2,253,589 | 2,261,010 | 2,055,192 | 2,046,235 |
| Loans ⁽¹⁾ | Level 3 | 1,055 | 1,055 | 1,485 | 1,485 |
| Accrued interest receivable | Level 1 | 9,792 | 9,792 | 8,609 | 8,609 |
| FHLB and FRB stock | Level 2 | 17,222 | 17,222 | 19,991 | 19,991 |
| Financial liabilities: | | | | | |
| Non-maturity deposits | Level 1 | 2,339,261 | 2,339,261 | 2,093,513 | 2,093,513 |
| Time deposits | Level 2 | 724,096 | 725,418 | 637,018 | 636,159 |
| Short-term borrowings | Level 1 | 230,200 | 230,200 | 293,100 | 293,100 |
| Long-term borrowings | Level 2 | 39,043 | 41,114 | 38,990 | 40,313 |
| Accrued interest payable | Level 1 | 5,805 | 5,805 | 4,676 | 4,676 |

⁽¹⁾ Comprised of collateral dependent impaired loans.

(13.) SEGMENT REPORTING

The Company has two reportable segments: Banking and Non-Banking. These reportable segments have been identified and organized based on the nature of the underlying products and services applicable to each segment, the type of customers to whom those products and services are offered and the distribution channel through which those products and services are made available.

The banking segment includes all of the Company's retail and commercial banking operations. The non-banking segment includes the activities of Scott Danahy Naylon, a full service insurance agency that provides a broad range of insurance services to both personal and business clients, and Courier Capital, an investment advisor and wealth management firm that provides customized investment management, investment consulting and retirement plan

Edgar Filing: FINANCIAL INSTITUTIONS INC - Form 10-Q

services to individuals, businesses, institutions, foundations and retirement plans. The Company operated as two business segments (banking and insurance) until the acquisition of Courier Capital on January 5, 2016, at which time the insurance segment was re-named as the non-banking segment to reflect the inclusion of Courier Capital which has similar products, services and reporting, as noted above. Holding company amounts primarily reflect the differences between segment amounts and consolidated totals and are reflected in the Holding Company and Other column below, along with amounts to eliminate balances and transactions between segments.

The following tables present information regarding our business segments as of and for the periods indicated (in thousands).

| | Banking | Non-Banking | Holding Company and Other | Consolidated Totals |
|----------------------------------|-----------|-------------|---------------------------------|------------------------|
| <u>September 30, 2016</u> | | | | |
| Goodwill | \$ 48,536 | \$ 17,881 | \$ | \$ 66,417 |
| Other intangible assets, net | 637 | 8,889 | | 9,526 |
| Total assets | 3,652,723 | 30,558 | 4,084 | 3,687,365 |
| <u>December 31, 2015</u> | | | | |
| Goodwill | \$ 48,536 | \$ 11,866 | \$ | \$ 60,402 |
| Other intangible assets, net | 829 | 5,715 | | 6,544 |
| Total assets | 3,356,987 | 20,315 | 3,722 | 3,381,024 |

Table of Contents**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Unaudited)****(13.) SEGMENT REPORTING (Continued)**

| | Banking | Non-Banking ⁽¹⁾ | Holding Company and Other | Consolidated Totals |
|--|----------------|-----------------------------------|--|--------------------------------|
| <u>Three months ended September 30,</u> | | | | |
| <u>2016</u> | | | | |
| Net interest income (expense) | \$ 26,667 | \$ | \$ (617) | \$ 26,050 |
| Provision for loan losses | (1,961) | | | (1,961) |
| Noninterest income | 6,579 | 2,086 | (126) | 8,539 |
| Noninterest expense | (18,148) | (1,759) | (711) | (20,618) |
| Income (loss) before income taxes | 13,137 | 327 | (1,454) | 12,010 |
| Income tax (expense) benefit | (3,987) | (129) | 575 | (3,541) |
| Net income (loss) | \$ 9,150 | \$ 198 | \$ (879) | \$ 8,469 |
| <u>Nine months ended September 30,</u> | | | | |
| <u>2016</u> | | | | |
| Net interest income (expense) | \$ 77,820 | \$ | \$ (1,852) | \$ 75,968 |
| Provision for loan losses | (6,281) | | | (6,281) |
| Noninterest income | 20,386 | 6,620 | (334) | 26,672 |
| Noninterest expense | (54,547) | (5,329) | (4,080) | (63,956) |
| Income (loss) before income taxes | 37,378 | 1,291 | (6,266) | 32,403 |
| Income tax (expense) benefit | (10,977) | (505) | 2,317 | (9,165) |
| Net income (loss) | \$ 26,401 | \$ 786 | \$ (3,949) | \$ 23,238 |
| | Banking | Non-Banking | Holding Company and Other | Consolidated Totals |
| <u>Three months ended September 30,</u> | | | | |
| <u>2015</u> | | | | |
| Net interest income (expense) | \$ 24,748 | \$ | \$ (617) | \$ 24,131 |
| Provision for loan losses | (754) | | | (754) |
| Noninterest income | 6,010 | 1,124 | (129) | 7,005 |
| Noninterest expense | (17,679) | (1,152) | (487) | (19,318) |

Edgar Filing: FINANCIAL INSTITUTIONS INC - Form 10-Q

| | | | | |
|-----------------------------------|---------|------|---------|---------|
| Income (loss) before income taxes | 12,325 | (28) | (1,233) | 11,064 |
| Income tax (expense) benefit | (3,361) | 10 | 603 | (2,748) |

Net income (loss) \$ 8,964 \$ (18) \$ (630) \$ 8,316

Nine months ended September 30, 2015

| | | | | |
|-------------------------------|-----------|---------|------------|-----------|
| Net interest income (expense) | \$ 71,814 | \$ | \$ (1,132) | \$ 70,682 |
| Provision for loan losses | (4,783) | | | (4,783) |
| Noninterest income | 18,363 | 3,750 | (356) | 21,757 |
| Noninterest expense | (52,626) | (3,389) | (1,550) | (57,565) |

| | | | | |
|-----------------------------------|---------|-------|---------|---------|
| Income (loss) before income taxes | 32,768 | 361 | (3,038) | 30,091 |
| Income tax (expense) benefit | (9,417) | (144) | 1,172 | (8,389) |

Net income (loss) \$ 23,351 \$ 217 \$ (1,866) \$ 21,702

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

Table of Contents

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

This Quarterly Report on Form 10-Q should be read in conjunction with the more detailed and comprehensive disclosures included in our Annual Report on Form 10-K for the year ended December 31, 2015. In addition, please read this section in conjunction with our Consolidated Financial Statements and Notes to Consolidated Financial Statements contained herein.

FORWARD LOOKING INFORMATION

Statements and financial analysis contained in this document that are based on other than historical data are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995.

Forward-looking statements provide current expectations or forecasts of future events and include, among others:

statements with respect to the beliefs, plans, objectives, goals, guidelines, expectations, anticipations, and future financial condition, results of operations and performance of Financial Institutions, Inc. (the Parent) and our subsidiaries (together, the Company, we, our or us); and

statements preceded by, followed by or that include the words may, could, should, would, believe, and estimate, expect, intend, plan, projects, or similar expressions.

These forward-looking statements are not guarantees of future performance, nor should they be relied upon as representing management's views as of any subsequent date. Forward-looking statements involve significant risks and uncertainties and actual results may differ materially from those presented, either expressed or implied, in this document and our Annual Report on Form 10-K for the fiscal year ended December 31, 2015, which we refer to as the Form 10-K, including, but not limited to, those presented in the Management's Discussion and Analysis of Financial Condition and Results of Operations. Factors that might cause such differences include, but are not limited to:

If we experience greater credit losses than anticipated, earnings may be adversely impacted;

Our tax strategies and the value of our deferred tax assets could adversely affect our operating results and regulatory capital ratios;

Geographic concentration may unfavorably impact our operations;

We depend on the accuracy and completeness of information about or from customers and counterparties;

Our insurance brokerage subsidiary is subject to risk related to the insurance industry;

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

Our inability to successfully implement our growth strategies;

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

Commercial real estate and business loans increase our exposure to credit risks;

Our indirect lending involves risk elements in addition to normal credit risk;

We accept deposits that do not have a fixed term and which may be withdrawn by the customer at any time for any reason;

Any future FDIC insurance premium increases may adversely affect our earnings;

We are highly regulated and may be adversely affected by changes in banking laws, regulations and regulatory practices;

New or changing tax and accounting rules and interpretations could significantly impact our strategic initiatives, results of operations, cash flows, and financial condition;

Legal and regulatory proceedings and related matters could adversely affect us and the banking industry in general;

A breach in security of our or third party information systems, including the occurrence of a cyber incident or a deficiency in cyber security, may subject us to liability, result in a loss of customer business or damage our brand image;

We face competition in staying current with technological changes to compete and meet customer demands;

We rely on other companies to provide key components of our business infrastructure;

We use financial models for business planning purposes that may not adequately predict future results;

We may not be able to attract and retain skilled people;

Acquisitions may disrupt our business and dilute shareholder value;

We are subject to interest rate risk;

Our business may be adversely affected by conditions in the financial markets and economic conditions generally;

The fiscal and monetary policies of the federal government and its agencies have a significant impact on our earnings;

The soundness of other financial institutions could adversely affect us;

The value of our goodwill and other intangible assets may decline in the future;

A future proxy contest for the election of directors at our annual meeting or proposals arising out of shareholder initiatives could cause us to incur additional substantial costs and could negatively affect our business;

We operate in a highly competitive industry and market area;

Severe weather, natural disasters, acts of war or terrorism, and other external events could significantly impact our business;

Table of Contents

MANAGEMENT'S DISCUSSION AND ANALYSIS

Liquidity is essential to our businesses;

We may need to raise additional capital in the future and such capital may not be available on acceptable terms or at all;

We rely on dividends from our subsidiaries for most of our revenue;

We may not pay or may reduce the dividends on our common stock;

We may issue debt and equity securities or securities convertible into equity securities, any of which may be senior to our common stock as to distributions and in liquidation, which could dilute our current shareholders or negatively affect the value of our common stock;

Our certificate of incorporation, our bylaws, and certain banking laws may have an anti-takeover effect; and

The market price of our common stock may fluctuate significantly in response to a number of factors. We caution readers not to place undue reliance on any forward-looking statements, which speak only as of the date made, and advise readers that various factors, including those described above, could affect our financial performance and could cause our actual results or circumstances for future periods to differ materially from those anticipated or projected. See also Item 1A. Risk Factors in the Form 10-K for further information. Except as required by law, we do not undertake, and specifically disclaim any obligation to publicly release any revisions to any forward-looking statements to reflect the occurrence of anticipated or unanticipated events or circumstances after the date of such statements.

GENERAL

The Parent is a financial holding company headquartered in New York State, providing banking and nonbanking financial services to individuals, municipalities and businesses primarily in our Western and Central New York footprint. The Company provides diversified financial services through its subsidiaries, Five Star Bank, Scott Danahy Naylor, LLC (Scott Danahy Naylor) and Courier Capital, LLC (Courier Capital). The Company offers a broad array of deposit, lending and other financial services to individuals, municipalities and businesses in Western and Central New York through its wholly-owned New York chartered banking subsidiary, Five Star Bank (the Bank). The Bank also has indirect lending network relationships with franchised automobile dealers in the Capital District of New York and Northern and Central Pennsylvania. Scott Danahy Naylor provides a broad range of insurance services to personal and business clients across 44 states. Courier Capital, which we acquired on January 5, 2016, provides customized investment management, investment consulting and retirement plan services to individuals, businesses, institutions, foundations and retirement plans across nine states.

Our primary sources of revenue are net interest income (interest earned on our loans and securities, net of interest paid on deposits and other funding sources) and noninterest income, particularly fees and other revenue from insurance and financial services provided to customers or ancillary services tied to loans and deposits. Business volumes and pricing drive revenue potential, and tend to be influenced by overall economic factors, including market interest rates, business spending, consumer confidence, economic growth, and competitive conditions within the marketplace. We are not able to predict market interest rate fluctuations with certainty and our asset/liability management strategy may not prevent interest rate changes from having a material adverse effect on our results of operations and financial condition.

Our business strategy has been to maintain a community bank philosophy, which consists of focusing on and understanding the individualized banking needs of individuals, municipalities and businesses of the local communities surrounding our primary service areas. We believe this focus allows us to be more responsive to our customers' needs and provide a high level of personal service that differentiates us from larger competitors, resulting in long-standing and broad-based banking relationships. Our core customers are primarily small to medium-sized businesses, individuals and community organizations, which prefer to build banking, insurance and wealth management relationships with a community bank that combines high quality, competitively-priced products and services with personalized service. Because of our identity and origin as a locally-operated bank, we believe that our level of personal service provides a competitive advantage over larger banks, which tend to consolidate decision-making authority outside local communities.

A key aspect of our current business strategy is to foster a community-oriented culture where our customers and employees establish long-standing and mutually beneficial relationships. We believe that we are well-positioned to be a strong competitor within our market area because of our focus on community banking needs and customer service, our comprehensive suite of deposit, loan, insurance and wealth management products typically found at larger banks, our highly experienced management team and our strategically located banking centers. We believe that the foregoing factors all help to grow our core deposits, which supports a central element of our business strategy, namely the growth of a diversified and high-quality loan portfolio.

Table of Contents

MANAGEMENT'S DISCUSSION AND ANALYSIS

EXECUTIVE OVERVIEW

Summary of 2016 Third Quarter Results

Net income increased \$153 thousand or 2% to \$8.5 million for the third quarter of 2016 compared to \$8.3 million for the third quarter of 2015. Net income available to common shareholders for the third quarter of 2016 was \$8.1 million, or \$0.56 per diluted share, compared with \$8.0 million, or \$0.56 per diluted share, for the third quarter of last year. Return on average common equity was 10.45% and return on average assets was 0.94% for the third quarter of 2016 compared to 11.60% and 0.99%, respectively, for the third quarter of 2015.

Net interest income totaled \$26.1 million in the third quarter of 2016, up from \$24.1 million in the third quarter of 2015. Average interest-earning assets were up \$224.6 million, led by a \$223.6 million increase in average loans in the third quarter of 2016 compared to the same quarter in 2015. The increase in average loans was attributable to organic commercial, residential real estate and consumer indirect loan growth. Third quarter 2016 net interest margin was 3.23%, a slight increase from 3.20% reported in the third quarter of 2015.

The provision for loans losses was \$2.0 million in the third quarter of 2016 compared to \$754 thousand in the third quarter of 2015. Net charge-offs during the recent quarter were \$1.1 million, a \$663 thousand decrease from the third quarter of 2015. Net charge-offs expressed as an annualized percentage of average loans outstanding were 0.20% during the third quarter of 2016 compared with 0.35% in the third quarter of 2015. See the Allowance for Loan Losses and Non-Performing Assets and Potential Problem Loans sections of this Management's Discussion and Analysis for further discussion regarding the increase in the provision for loan losses and the decrease in net charge-offs.

Noninterest income totaled \$8.5 million in the third quarter of 2016, compared to \$7.0 million in the third quarter of 2015. The higher noninterest income in the third quarter of 2016 compared to the same quarter last year is primarily a result of the investment advisory income from Courier Capital, which we acquired during January 2016. Included in the third quarter of 2016 and 2015 are net gains realized on investment securities totaling \$426 thousand and \$286 thousand, respectively. In addition, the third quarter of 2015 included \$390 thousand of amortization of a tax credit investment. The increases in insurance income and ATM and debit card income were offset by decreases in service charges on deposits and investments in limited partnerships when comparing the third quarter periods of 2016 and 2015.

Noninterest expense in the third quarter of 2016 totaled \$20.6 million compared with \$19.3 million in the third quarter of 2015. The increase in noninterest expense reflects the addition of Courier Capital and our expansion initiatives, including the opening of financial solution centers in the Rochester market.

The regulatory Common equity Tier 1 ratio and Total risk-based capital ratio were 9.58%, and 12.98%, respectively, for the third quarter of 2016. See the Liquidity and Capital Management section of this Management's Discussion and Analysis for further discussion regarding regulatory capital and the Basel III capital rules.

Courier Capital Acquisition

On January 5, 2016, we completed the acquisition of Courier Capital Corporation, a registered investment advisory and wealth management firm with approximately \$1.2 billion in assets under management. Consideration for the

acquisition totaled \$9.0 million and included stock of \$8.1 million and \$918 thousand of cash. The acquisition also included \$2.8 million of potential future payments of stock and \$2.2 million of potential future cash bonuses contingent upon Courier Capital meeting certain EBITDA performance targets through 2018. In addition, the Company purchased two pieces of real property in Buffalo and Jamestown, New York used by Courier Capital for total cash considerations of \$1.3 million. As a result of the acquisition, we recorded goodwill of \$6.0 million and other intangible assets of \$3.9 million. The goodwill is not expected to be deductible for income tax purposes. Courier Capital now operates as a subsidiary of the Parent and an affiliate of Five Star Bank and Scott Danahy Naylor.

Table of Contents

MANAGEMENT'S DISCUSSION AND ANALYSIS

2016 Outlook

We began 2016 in a strong financial condition and with positive momentum. We expect net interest income to increase in 2016. We anticipate an increase in interest-earning assets as we remain focused on loan growth, which will be primarily funded through deposit gathering. However, the benefit to net interest income from increased interest-earning assets is expected to be partially offset by slight downward pressure on net interest margin. We plan to maintain a disciplined approach to loan pricing, but asset yields remain under pressure due to the low interest rate environment and flattening of the yield curve, while the opportunity for deposit repricing remains limited.

We expect our commercial loan portfolio to grow in a manner that is consistent with our strategic initiatives and continued support of middle market small business lending. Automobile loan originations remained strong through the first nine months of 2016, reflecting the positive impact from our investment in building automotive dealer relationships. The residential real estate portfolio, which includes both first and junior lien residential real estate related products, is expected to increase as we remain focused on the customer experience and our convenient application process.

We anticipate the increase in total loans during 2016 will modestly outpace growth in total deposits. This anticipated outcome reflects our continued focus on targeting loyal relationship-based deposit customers rather than those that are more price sensitive. We expect to continue managing our overall cost of funds during 2016 using short-term borrowings, as well as our continued shift in mix of deposits towards low- and no-cost demand deposits and money market deposit accounts.

Noninterest income during 2016 is expected to be higher than 2015, reflecting our continued efforts to increase both account and transaction-based fee income, coupled with the benefit of revenue from our fee-based subsidiaries, Scott Danahy Naylor and Courier Capital. We anticipate that the results of these efforts will further reduce our reliance on traditional spread-based net interest income, as fee-based activities are a relatively stable revenue source during periods of changing interest rates.

Noninterest expense is expected to increase in 2016 with the addition of Courier Capital, coupled with higher operating costs associated with our revenue enhancing initiatives to further accelerate our growth in the communities we serve, including the opening of additional financial solution centers.

We do not expect significant changes in overall asset quality and allowance measurements.

The effective tax rate for 2016 is expected to be slightly higher than it was in 2015, as the lower effective tax rate in 2015 was partly driven by historic tax credits claimed in 2015. However, our 2016 effective tax rate will continue to reflect the positive impacts of tax-exempt income (including the \$911 thousand of non-taxable company owned life death benefit proceeds received in the first quarter of 2016), tax advantaged investments, the formation of our real estate investment trust in early 2014 and benefits from New York State tax law changes that began going into effect during 2015.

Table of Contents**MANAGEMENT'S DISCUSSION AND ANALYSIS****RESULTS OF OPERATIONS****Net Interest Income and Net Interest Margin**

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

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

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

| | Three months ended | | Nine months ended | |
|--|---------------------------|-------------|--------------------------|-------------|
| | September 30, | | September 30, | |
| | 2016 | 2015 | 2016 | 2015 |
| Interest income per consolidated statements of income | \$ 29,360 | \$ 27,007 | \$ 85,241 | \$ 77,963 |
| Adjustment to fully taxable equivalent basis | 789 | 781 | 2,367 | 2,310 |
| Interest income adjusted to a fully taxable equivalent basis | 30,149 | 27,788 | 87,608 | 80,273 |
| Interest expense per consolidated statements of income | 3,310 | 2,876 | 9,273 | 7,281 |
| Net interest income on a taxable equivalent basis | \$ 26,839 | \$ 24,912 | \$ 78,335 | \$ 72,992 |

Analysis of Net Interest Income for the Three Month Periods ended September 30, 2016 and 2015

Net interest income on a taxable equivalent basis for the three months ended September 30, 2016, was \$26.8 million, an increase of \$1.9 million versus the comparable quarter last year. The increase in net interest income was due to an increase in average interest-earning assets of \$224.6 million or 7% compared to the third quarter of 2015.

The net interest margin for the third quarter of 2016 was 3.23%, three basis points higher than 3.20% for the same period in 2015. This comparable period increase was a function of a one basis point increase in interest rate spread and a higher contribution from net free funds of two basis points (due principally to increases in average noninterest-bearing deposits and other net free funds). The higher interest rate spread was a result of a five basis point increase in the yield on interest-earning assets, partially offset by a four basis point increase in the cost of average interest-bearing liabilities.

For the third quarter of 2016, the yield on average interest-earning assets of 3.62% was five basis points higher than the third quarter of 2015. Loan yields increased two basis points to 4.18% when comparing the third quarter of 2016 to the same period in 2015. The yield on investment securities decreased two basis points during the third quarter of 2016 to 2.44%. Overall, the interest-earning asset rate changes decreased interest income by \$3 thousand during the third quarter of 2016.

Average interest-earning assets were \$3.3 billion for the third quarter of 2016, an increase of \$224.6 million or 7% from the comparable quarter last year, with average loans up \$223.6 million and average securities up \$1.0 million. The growth in average loans reflected increases in most loan categories. Commercial loans, in particular, were up \$134.6 million or 16% from the third quarter of 2015. Residential real estate loans increased \$46.5 million or 13% and consumer indirect loans increased \$48.1 million or 7% when comparing the third quarter of 2016 with the same period in 2015. Loans represented 67.8% of average interest-earning assets during the third quarter of 2016 compared to 65.5% during the third quarter of 2015. The increase in the volume of average loans resulted in a \$2.3 million increase in interest income, coupled with a \$64 thousand increase due to the favorable rate variance. Securities represented 32.2% of average interest-earning assets during the third quarter of 2016 compared to 34.5% during the third quarter of 2015. The increase in the volume of average securities resulted in a \$19 thousand increase in interest income, which was more than offset by a \$67 thousand decrease due to the unfavorable rate variance.

The cost of average interest-bearing liabilities of 0.51% in the third quarter of 2016 was four basis points higher than the third quarter of 2015. The cost of average interest-bearing deposits increased two basis points to 0.39% and the cost of short-term borrowings increased 22 basis points to 0.63% in the third quarter of 2016 compared to the same quarter of 2015. The cost of long-term borrowings for the third quarter of 2016 was 6.33% compared to 6.34% for the same quarter of 2015. Overall, interest-bearing liability rate and volume increases resulted in \$434 thousand of higher interest expense.

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

Average interest-bearing liabilities of \$2.6 billion in the third quarter of 2016 were \$197.6 million or 8% higher than the third quarter of 2015. On average, interest-bearing deposits grew \$211.5 million, while noninterest-bearing demand deposits (a principal component of net free funds) were up \$13.3 million. The increase in average deposits was due in part to seasonal inflows of municipal deposits, successful business development efforts in retail banking, and an increase in deposits from our Certificate of Deposit Account Registry Service (CDARS) and Insured Cash Sweep (ICS) programs. For further discussion of the CDARS and ICS programs, refer to the Funding Activities - Deposits section of this Management's Discussion and Analysis. Overall, interest-bearing deposit rate and volume changes resulted in \$275 thousand of higher interest expense during the third quarter of 2016. Average borrowings decreased \$13.9 million compared to the third quarter of 2015. Overall, short and long-term borrowing rates and volume changes resulted in \$159 thousand of higher interest expense during the third quarter of 2016.

Analysis of Net Interest Income for the Nine Months ended September 30, 2016 and 2015

Net interest income on a taxable equivalent basis for the first nine months of 2016 was \$78.3 million compared to \$73.0 million for the same period last year. The increase in net interest income was due to an increase in average interest-earning assets of \$257.5 million or 9% compared to the first nine months of 2015.

The net interest margin for the first nine months of 2016 was 3.24%, four basis points lower than 3.28% for the same period last year. This comparable period decrease was a function of a six basis point decrease in interest rate spread to 3.13% during the first nine months of 2016, partially offset by a two basis point higher contribution from net free funds. The lower interest rate spread was a net result of a seven basis point increase in the cost of interest-bearing liabilities, partially offset by a one basis point increase in the yield on interest-earning assets.

The yield on interest-earning assets was 3.62% for the first nine months of 2016, one basis point higher than the same period last year. A decrease in the yield on the loan portfolio during the period (down one basis point to 4.19%), was offset by an increase in the yield on the investment securities portfolio (up one basis point, to 2.47%). Overall, interest-earning asset rate changes reduced interest income by \$84 thousand during the first nine months of 2016, but that was more than offset by a favorable volume variance that increased interest income by \$7.4 million, which collectively drove a \$7.3 million increase in interest income.

The cost of interest-bearing liabilities of 0.49% for the first nine months of 2016 was seven basis points higher than the same period in 2015. Rates on interest-bearing deposits were up two basis points to 0.37% for the first nine months of 2016 versus the same period in 2015. The cost of short-term borrowings for the first nine months of 2016 was 0.63% or 24 basis points higher than 0.39% for the same period last year. The cost of long-term borrowings for the first nine months of 2016 was 6.33% compared to 6.25% for the first nine months of 2015 due to the issuance of subordinated notes in April 2015. Overall, interest-bearing liability rate and volume increases resulted in \$692 thousand and \$1.3 million of higher interest expense, respectively.

Average interest-earning assets were \$3.2 billion for the first nine months of 2016, an increase of \$257.5 million or 9% from the comparable period last year, with average loans up \$202.6 million and average securities up \$54.9 million. The growth in average loans was comprised of increases in most loan categories. Commercial loans, in particular, were up \$143.7 million or 18% from the first nine months of 2015. Residential real estate loans increased \$35.7 million or 10% and consumer indirect loans increased \$28.0 million or 4% when comparing the first nine months of 2016 with the same period in 2015. Loans represented 67.2% of average interest-earning assets during the

first nine months of 2016 compared to 66.2% during the comparable period last year. The increase in the volume of average loans resulted in a \$6.4 million increase in interest income, which was partially offset by a \$195 thousand decrease due to the unfavorable rate variance. Securities represented 32.8% of average interest-earning assets during the first nine months of 2016 compared to 33.8% during the comparable period last year. The increase in the volume of average securities resulted in a \$972 thousand increase in interest income, coupled with a \$111 thousand increase due to the favorable rate variance.

Average interest-bearing liabilities of \$2.5 billion in the first nine months of 2016 were \$196.9 million or 8% higher than the first nine months of 2015. On average, interest-bearing deposits grew \$201.1 million, while noninterest-bearing demand deposits were up \$33.5 million and average short-term borrowings decreased \$19.1 million. Average long-term borrowings increased \$14.9 million during the first nine months of 2016 due to the issuance of subordinated notes in April 2015.

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

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

| | Three months ended September 30, | | | | | |
|--|----------------------------------|---------------------|-----------------|--------------------|---------------------|-----------------|
| | 2016 | | | 2015 | | |
| | Average Balance | Average Interest | Average Rate | Average Balance | Average Interest | Average Rate |
| Interest-earning assets: | | | | | | |
| Federal funds sold and interest-earning deposits | \$ 1 | \$ | % | \$ | \$ | % |
| Investment securities ⁽¹⁾ : | | | | | | |
| Taxable | 773,037 | 4,276 | 2.21 | 778,380 | 4,347 | 2.23 |
| Tax-exempt ⁽²⁾ | 295,829 | 2,254 | 3.05 | 289,435 | 2,231 | 3.09 |
| Total investment securities | 1,068,866 | 6,530 | 2.44 | 1,067,815 | 6,578 | 2.46 |
| Loans: | | | | | | |
| Commercial business | 352,696 | 3,691 | 4.16 | 297,216 | 3,085 | 4.12 |
| Commercial mortgage | 625,003 | 7,261 | 4.62 | 545,875 | 6,210 | 4.51 |
| Residential real estate loans | 417,854 | 3,987 | 3.82 | 371,318 | 3,756 | 4.05 |
| Residential real estate lines | 123,312 | 1,165 | 3.76 | 127,826 | 1,172 | 3.64 |
| Consumer indirect | 711,948 | 6,987 | 3.90 | 663,884 | 6,436 | 3.85 |
| Other consumer | 17,548 | 528 | 11.97 | 18,680 | 551 | 11.71 |
| Total loans | 2,248,361 | 23,619 | 4.18 | 2,024,799 | 21,210 | 4.16 |
| Total interest-earning assets | 3,317,228 | 30,149 | 3.62 | 3,092,614 | 27,788 | 3.57 |
| Allowance for loan losses | (29,314) | | | (27,836) | | |
| Other noninterest-earning assets | 305,758 | | | 279,024 | | |
| Total assets | \$ 3,593,672 | | | \$ 3,343,802 | | |
| Interest-bearing liabilities: | | | | | | |
| Deposits: | | | | | | |
| Interest-bearing demand | \$ 547,545 | \$ 206 | 0.15% | \$ 516,448 | \$ 199 | 0.15% |
| Savings and money market | 981,207 | 335 | 0.14 | 903,491 | 321 | 0.14 |
| Time deposits | 722,098 | 1,651 | 0.91 | 619,459 | 1,397 | 0.89 |
| Total interest-bearing deposits | 2,250,850 | 2,192 | 0.39 | 2,039,398 | 1,917 | 0.37 |
| Short-term borrowings | 315,122 | 500 | 0.63 | 329,050 | 342 | 0.41 |
| Long-term borrowings | 39,032 | 618 | 6.33 | 38,962 | 617 | 6.34 |

Edgar Filing: FINANCIAL INSTITUTIONS INC - Form 10-Q

| | | | | | | |
|--|--------------|-----------|---------|--------------|-----------|---------|
| Total borrowings | 354,154 | 1,118 | 1.26 | 368,012 | 959 | 1.04 |
| Total interest-bearing liabilities | 2,605,004 | 3,310 | 0.51 | 2,407,410 | 2,876 | 0.47 |
| Noninterest-bearing demand deposits | 638,417 | | | 625,131 | | |
| Other noninterest-bearing liabilities | 24,387 | | | 22,032 | | |
| Shareholders equity | 325,864 | | | 289,229 | | |
| Total liabilities and shareholders equity | \$ 3,593,672 | | | \$ 3,343,802 | | |
| Net interest income (tax-equivalent) | | \$ 26,839 | | | \$ 24,912 | |
| Interest rate spread | | | 3.11% | | | 3.10% |
| Net earning assets | \$ 712,224 | | | \$ 685,204 | | |
| Net interest margin (tax-equivalent) | | | 3.23% | | | 3.20% |
| Ratio of average interest-earning assets to average interest-bearing liabilities | | | 127.34% | | | 128.46% |

(1) Investment securities are shown at amortized cost.

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

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

| | Nine months ended September 30, | | | | | |
|--|---------------------------------|---------------------|-----------------|--------------------|---------------------|-----------------|
| | 2016 | | | 2015 | | |
| | Average Balance | Average Interest | Average Rate | Average Balance | Average Interest | Average Rate |
| Interest-earning assets: | | | | | | |
| Federal funds sold and interest-earning deposits | \$ 129 | \$ 1 | 0.61% | \$ 50 | \$ | 0.30% |
| Investment securities ⁽¹⁾ : | | | | | | |
| Taxable | 763,796 | 12,800 | 2.23 | 717,330 | 11,879 | 2.21 |
| Tax-exempt ⁽²⁾ | 293,476 | 6,763 | 3.07 | 285,031 | 6,601 | 3.09 |
| Total investment securities | 1,057,272 | 19,563 | 2.47 | 1,002,361 | 18,480 | 2.46 |
| Loans: | | | | | | |
| Commercial business | 332,985 | 10,396 | 4.17 | 282,307 | 8,731 | 4.13 |
| Commercial mortgage | 604,577 | 20,846 | 4.61 | 511,545 | 17,584 | 4.60 |
| Residential real estate loans | 397,327 | 11,669 | 3.92 | 361,598 | 11,175 | 4.12 |
| Residential real estate lines | 125,273 | 3,555 | 3.79 | 128,807 | 3,506 | 3.64 |
| Consumer indirect | 691,343 | 20,009 | 3.87 | 663,286 | 19,143 | 3.86 |
| Other consumer | 17,678 | 1,569 | 11.85 | 19,084 | 1,654 | 11.59 |
| Total loans | 2,169,183 | 68,044 | 4.19 | 1,966,627 | 61,793 | 4.20 |
| Total interest-earning assets | 3,226,584 | 87,608 | 3.62 | 2,969,038 | 80,273 | 3.61 |
| Allowance for loan losses | (28,423) | | | (27,881) | | |
| Other noninterest-earning assets | 304,467 | | | 300,489 | | |
| Total assets | \$ 3,502,628 | | | \$ 3,241,646 | | |
| Interest-bearing liabilities: | | | | | | |
| Deposits: | | | | | | |
| Interest-bearing demand | \$ 566,419 | \$ 617 | 0.15% | \$ 543,045 | \$ 552 | 0.14% |
| Savings and money market | 988,224 | 989 | 0.13 | 891,039 | 827 | 0.12 |
| Time deposits | 693,153 | 4,631 | 0.89 | 612,637 | 3,985 | 0.87 |
| Total interest-bearing deposits | 2,247,796 | 6,237 | 0.37 | 2,046,721 | 5,364 | 0.35 |
| Short-term borrowings | 250,329 | 1,183 | 0.63 | 269,415 | 785 | 0.39 |
| Long-term borrowings | 39,015 | 1,853 | 6.33 | 24,148 | 1,132 | 6.25 |
| Total borrowings | 289,344 | 3,036 | 1.40 | 293,563 | 1,917 | 0.87 |
| Total interest-bearing liabilities | 2,537,140 | 9,273 | 0.49 | 2,340,284 | 7,281 | 0.42 |
| Noninterest-bearing demand deposits | 626,018 | | | 592,564 | | |

Edgar Filing: FINANCIAL INSTITUTIONS INC - Form 10-Q

| | | |
|--|--------------|--------------|
| Other noninterest-bearing liabilities | 22,032 | 21,603 |
| Shareholders equity | 317,438 | 287,195 |
| Total liabilities and shareholders equity | \$ 3,502,628 | \$ 3,241,646 |
| Net interest income (tax-equivalent) | \$ 78,335 | \$ 72,992 |
| Interest rate spread | 3.13% | 3.19% |
| Net earning assets | \$ 689,444 | \$ 628,754 |
| Net interest margin (tax-equivalent) | 3.24% | 3.28% |
| Ratio of average interest-earning assets to average interest-bearing liabilities | 127.17% | 126.87% |

(1) Investment securities are shown at amortized cost.

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

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

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

| | Three months ended September 30, 2016 vs. 2015 | | | Nine months ended September 30, 2016 vs. 2015 | | |
|--|--|-------|-------|---|-------|-------|
| | Volume | Rate | Total | Volume | Rate | Total |
| Increase (decrease) in: | | | | | | |
| Interest income: | | | | | | |
| Federal funds sold and interest-earning deposits | \$ | \$ | \$ | \$ 1 | \$ | \$ 1 |
| Investment securities: | | | | | | |
| Taxable | (30) | (41) | (71) | 777 | 144 | 921 |
| Tax-exempt | 49 | (26) | 23 | 195 | (33) | 162 |
| Total investment securities | 19 | (67) | (48) | 972 | 111 | 1,083 |
| Loans: | | | | | | |
| Commercial business | 581 | 25 | 606 | 1,581 | 84 | 1,665 |
| Commercial mortgage | 917 | 134 | 1,051 | 3,208 | 54 | 3,262 |
| Residential real estate loans | 452 | (221) | 231 | 1,067 | (573) | 494 |
| Residential real estate lines | (42) | 35 | (7) | (98) | 147 | 49 |
| Consumer indirect | 471 | 80 | 551 | 812 | 54 | 866 |
| Other consumer | (34) | 11 | (23) | (124) | 39 | (85) |
| Total loans | 2,345 | 64 | 2,409 | 6,446 | (195) | 6,251 |
| Total interest income | 2,364 | (3) | 2,361 | 7,419 | (84) | 7,335 |
| Interest expense: | | | | | | |
| Deposits: | | | | | | |
| Interest-bearing demand | 12 | (5) | 7 | 24 | 41 | 65 |
| Savings and money market | 27 | (13) | 14 | 94 | 68 | 162 |
| Time deposits | 235 | 19 | 254 | 536 | 110 | 646 |
| Total interest-bearing deposits | 274 | 1 | 275 | 654 | 219 | 873 |
| Short-term borrowings | (15) | 173 | 158 | (60) | 458 | 398 |
| Long-term borrowings | 1 | | 1 | 706 | 15 | 721 |
| Total borrowings | (14) | 173 | 159 | 646 | 473 | 1,119 |
| Total interest expense | 260 | 174 | 434 | 1,300 | 692 | 1,992 |

| | | | | | | |
|----------------------------|----------|----------|----------|----------|----------|----------|
| Net interest income | \$ 2,104 | \$ (177) | \$ 1,927 | \$ 6,119 | \$ (776) | \$ 5,343 |
|----------------------------|----------|----------|----------|----------|----------|----------|

Provision for Loan Losses

The provision for loan losses is based upon credit loss experience, growth or contraction of specific segments of the loan portfolio, and the estimate of losses inherent in the current loan portfolio. The provision for loan losses for the three and nine month periods ended September 30, 2016 were \$2.0 million and \$6.3 million, respectively, compared to \$754 thousand and \$4.8 million for the corresponding periods in 2015.

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

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

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

| | Three months ended | | Nine months ended | |
|---|--------------------|-----------------|-------------------|------------------|
| | September 30, | | September 30, | |
| | 2016 | 2015 | 2016 | 2015 |
| Service charges on deposits | \$ 1,913 | \$ 2,037 | \$ 5,392 | \$ 5,880 |
| Insurance income | 1,407 | 1,265 | 4,262 | 3,930 |
| ATM and debit card | 1,441 | 1,297 | 4,187 | 3,773 |
| Investment advisory | 1,326 | 523 | 3,934 | 1,551 |
| Company owned life insurance | 486 | 488 | 2,340 | 1,448 |
| Investments in limited partnerships | 161 | 336 | 253 | 865 |
| Loan servicing | 104 | 153 | 332 | 416 |
| Net gain on sale of loans held for sale | 46 | 53 | 202 | 161 |
| Net gain on investment securities | 426 | 286 | 2,426 | 1,348 |
| Net gain on other assets | 199 | | 285 | 20 |
| Amortization of tax credit investment | | (390) | | (390) |
| Other | 1,030 | 957 | 3,059 | 2,755 |
| Total noninterest income | \$ 8,539 | \$ 7,005 | \$ 26,672 | \$ 21,757 |

Service charges on deposit accounts for the nine months ended September 30, 2016 decreased \$488 thousand, or 8%, compared to the same period in 2015. The decrease was primarily due to a decrease in the amount of checking account overdraft activity.

Insurance income increased \$332 thousand, or 8%, to \$4.3 million for the first nine months of 2016 compared to \$3.9 million for the first nine months of 2015, reflecting successful business development efforts.

Investment advisory income increased to \$3.9 million in the first nine months of 2016 compared to \$1.6 million in the first nine months of 2015, reflecting the contribution from Courier Capital which was acquired early in January of 2016 as part of our strategy to diversify our business lines and increase noninterest income through additional fee-based services.

Income from company owned life insurance increased to \$2.3 million in the first nine months of 2016 compared to \$1.4 million in the same period in 2015, as the first quarter of 2016 included \$911 thousand of death benefit proceeds.

We have investments in limited partnerships, primarily small business investment companies, and account for these investments under the equity method. Income from investments in limited partnerships was \$253 thousand and \$865 thousand for the nine months ended September 30, 2016 and 2015, respectively. The income from these equity method investments fluctuates based on the performance of the underlying investments.

During the first nine months of 2016, we recognized net gains on investment securities totaling \$2.4 million from the sale of 24 agency securities and nine mortgage backed securities. The amount and timing of net gains on investment securities is dependent on a number of factors, including our prudent efforts to realize gains while managing duration, premium and credit risk.

During the third quarter of 2015, the Company recognized \$390 thousand of amortization of a historic tax investment in a community-based project. The amortization was included in noninterest income, recorded as contra-income, with an offsetting tax benefit that reduced income tax expense.

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 | | Nine months ended | |
|----------------------------------|--------------------|------------------|-------------------|------------------|
| | September 30, | | September 30, | |
| | 2016 | 2015 | 2016 | 2015 |
| Salaries and employee benefits | \$ 11,325 | \$ 10,278 | \$ 33,757 | \$ 31,107 |
| Occupancy and equipment | 3,617 | 3,417 | 10,906 | 10,491 |
| Professional services | 956 | 1,064 | 5,236 | 2,898 |
| Computer and data processing | 832 | 779 | 2,549 | 2,291 |
| Supplies and postage | 490 | 540 | 1,548 | 1,611 |
| FDIC assessments | 406 | 444 | 1,283 | 1,277 |
| Advertising and promotions | 214 | 312 | 938 | 789 |
| Other | 2,778 | 2,484 | 7,739 | 7,101 |
| Total noninterest expense | \$ 20,618 | \$ 19,318 | \$ 63,956 | \$ 57,565 |

Salaries and employee benefits expense increased by \$2.7 million or 9% in the first nine months of 2016 compared to the same period in 2015, reflecting the addition of Courier Capital as well as additional personnel to support organic growth as part of our expansion initiatives.

Occupancy and equipment expense increased by \$415 thousand to \$10.9 million when comparing the first nine months of 2016 to the same period in 2015. The incremental expenses reflect the addition of Courier Capital and our expansion initiatives, including the opening of financial solution centers in the Rochester market.

Professional services increased \$2.3 million when comparing the first nine months of 2016 to the same period in 2015. The current year includes approximately \$2.1 million of professional services associated with the proxy contest.

Computer and data processing expense increased \$258 thousand, or 11%, when comparing the first nine months of 2016 to the first nine months of 2015. Primarily due to information technology projects to maintain and improve our infrastructure.

Advertising and promotions expense was \$938 thousand for the nine month period ended September 30, 2016 compared to \$789 thousand for the same time period in 2015. The increase was due to advertising campaigns implemented during the current year to build recognition of our brand in the Rochester and Buffalo markets.

Other noninterest expense was \$7.7 million in the first nine months of 2016 compared to \$7.1 million in the first nine months of 2015. Other noninterest expense for the first nine months ended September 30, 2016 included an increase of \$291 thousand in intangible asset amortization associated with the Courier Capital acquisition.

Our efficiency ratio for the nine months ended September 30, 2016 was 61.94% compared with 60.56% for the first nine months of 2015. The increase in the efficiency ratio is primarily a result of the higher level of noninterest expense associated with the aforementioned proxy contest. The efficiency ratio is calculated by dividing total noninterest expense, excluding other real estate expense and amortization of intangible assets, by net revenue, defined as the sum of tax-equivalent net interest income and noninterest income before net gains on investment securities and proceeds from company owned life insurance. An increase in the efficiency ratio indicates that more resources are being utilized to generate the same volume of income, while a decrease indicates a more efficient allocation of resources.

Income Taxes

For the nine months ended September 30, 2016 and 2015, we recorded income tax expense of \$9.2 million and \$8.4 million, respectively. The effective tax rates for the year-to-date periods in 2016 and 2015 were 28.3% and 27.9%, respectively. Effective tax rates are impacted by items of income and expense that are not subject to federal or state taxation. Our effective tax rates reflect the impact of these items, which include, but are not limited to, interest income from tax-exempt securities and earnings on company owned life insurance. In addition, our effective tax rate reflects the New York State tax savings generated by our real estate investment trust.

In March 2014, the New York legislature approved changes in the state tax law that will be phased-in over two years, beginning in 2015. The primary changes that impact us include the repeal of the Article 32 franchise tax on banking corporations (Article 32) for 2015, expanded nexus standards for 2015 and a reduction in the corporate tax rate for 2016. The repeal of Article 32 and the expanded nexus standards lowered our taxable income apportioned to New York to approximately 85% in both 2016 and 2015. In addition, our New York state income tax rate was reduced from 7.1% to 6.5% during the first nine months of 2016.

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

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

| | Investment Securities Portfolio Composition | | | |
|---|--|-----------------------|---------------------------|-----------------------|
| | September 30, 2016 | | December 31, 2015 | |
| | Amortized Cost | Fair Value | Amortized Cost | Fair Value |
| Securities available for sale (AFS): | | | | |
| U.S. Government agencies and government-sponsored enterprise securities | \$ 175,134 | \$ 180,637 | \$ 260,748 | \$ 260,863 |
| Mortgage-backed securities: | | | | |
| Agency mortgage-backed securities | 368,929 | 377,847 | 282,873 | 282,505 |
| Non-Agency mortgage-backed securities | | 816 | | 809 |
| Asset-backed securities | | 195 | | 218 |
| Total AFS securities | 544,063 | 559,495 | 543,621 | 544,395 |
| Securities held to maturity (HTM): | | | | |
| State and political subdivisions | 300,922 | 309,013 | 294,423 | 300,981 |
| Mortgage-backed securities | 227,786 | 229,617 | 191,294 | 189,083 |
| Total HTM securities | 528,708 | 538,630 | 485,717 | 490,064 |
| Total investment securities | \$ 1,072,771 | \$ 1,098,125 | \$ 1,029,338 | \$ 1,034,459 |

The AFS investment securities portfolio increased \$15.1 million or 3%, from \$544.4 million at December 31, 2015 to \$559.5 million at September 30, 2016. The AFS portfolio had net unrealized gains totaling \$15.4 million and \$774 thousand at September 30, 2016 and December 31, 2015, respectively. The unrealized gains in the AFS portfolio were predominantly caused by changes in market interest rates. The fair value of most of the investment securities in the AFS portfolio fluctuates as market interest rates change.

Impairment Assessment

We review investment securities on an ongoing basis for the presence of other than temporary impairment (OTTI) and perform formal reviews quarterly. Declines in the fair value of HTM and AFS below their cost that are deemed to be other than temporary are reflected in earnings as realized losses to the extent the impairment is related to credit losses or the security is intended to be sold or will be required to be sold. The amount of the impairment related to non-credit

related factors is recognized in other comprehensive income. Evaluating whether the impairment of a debt security is other than temporary involves assessing the intent to sell the debt security or the likelihood of being required to sell the security before the recovery of its amortized cost basis. In determining whether the OTTI includes a credit loss, we use our best estimate of the present value of cash flows expected to be collected from the debt security considering factors such as: the length of time and the extent to which the fair value has been less than the amortized cost basis, adverse conditions specifically related to the security, an industry, or a geographic area, the historical and implied volatility of the fair value of the security, the payment structure of the debt security and the likelihood of the issuer being able to make payments that increase in the future, failure of the issuer of the security to make scheduled interest or principal payments, any changes to the rating of the security by a rating agency, and recoveries or additional declines in fair value subsequent to the balance sheet date. The assessment of whether OTTI exists involves a high degree of subjectivity and judgment and is based on the information available to management at a point in time. There were no securities deemed to be other-than-temporarily impaired during the nine month periods ended September 30, 2016 and 2015.

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

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

| | Loan Portfolio Composition | | | |
|---------------------------------|----------------------------|------------|-------------------|------------|
| | September 30, 2016 | | December 31, 2015 | |
| | Amount | % of Total | Amount | % of Total |
| Commercial business | \$ 350,588 | 15.3% | \$ 313,758 | 15.0% |
| Commercial mortgage | 636,338 | 27.9 | 566,101 | 27.2 |
| Total commercial | 986,926 | 43.2 | 879,859 | 42.2 |
| Residential real estate loans | 425,882 | 18.7 | 381,074 | 18.3 |
| Residential real estate lines | 123,663 | 5.4 | 127,347 | 6.1 |
| Consumer indirect | 729,644 | 31.9 | 676,940 | 32.5 |
| Other consumer | 17,879 | 0.8 | 18,542 | 0.9 |
| Total consumer | 1,297,068 | 56.8 | 1,203,903 | 57.8 |
| Total loans | 2,283,994 | 100.0% | 2,083,762 | 100.0% |
| Less: Allowance for loan losses | 29,350 | | 27,085 | |
| Total loans, net | \$ 2,254,644 | | \$ 2,056,677 | |

Total loans increased \$200.2 million to \$2.3 billion at September 30, 2016 from \$2.1 billion at December 31, 2015. The increase in loans was attributable to organic growth, primarily in the commercial, residential real estate and consumer indirect loan portfolios.

Commercial loans increased \$107.1 million and represented 43.2% of total loans as of September 30, 2016, a result of our continued commercial business development efforts.

Residential real estate loans increased \$44.8 million and represented 18.7% of total loans as of September 30, 2016. The growth in 2016 reflects the results of a successful spring loan campaign.

The consumer indirect portfolio totaled \$729.6 million and represented 31.9% of total loans as of September 30, 2016. During the first nine months of 2016, we originated \$265.2 million in indirect auto loans with a mix of approximately 43% new auto and 57% used auto. During the first nine months of 2015, we originated \$218.1 million in indirect auto loans with a mix of approximately 40% new auto and 60% used auto. Our origination volumes and mix of new and used vehicles financed fluctuate depending on general market conditions.

Loans Held for Sale and Loan Servicing Rights

Loans held for sale (not included in the loan portfolio composition table) were entirely comprised of residential real estate mortgages and totaled \$844 thousand and \$1.4 million as of September 30, 2016 and December 31, 2015, respectively.

We sell certain qualifying newly originated or refinanced residential real estate mortgages on the secondary market. Residential real estate mortgages serviced for others, which are not included in the consolidated statements of financial condition, amounted to \$179.3 million and \$196.0 million as of September 30, 2016 and December 31, 2015, respectively.

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).

| | Loan Loss Analysis | | | |
|--|---|--------------|---|--------------|
| | Three months ended September 30, | | Three months ended September 30, | |
| | 2016 | 2015 | 2016 | 2015 |
| Balance as of beginning of period | \$ 28,525 | \$ 27,500 | \$ 27,085 | \$ 27,637 |
| Charge-offs: | | | | |
| Commercial business | 44 | 106 | 688 | 1,260 |
| Commercial mortgage | 156 | 56 | 168 | 866 |
| Residential real estate loans | 78 | 80 | 258 | 277 |
| Residential real estate lines | 8 | 55 | 59 | 173 |
| Consumer indirect | 2,056 | 2,380 | 6,452 | 6,643 |
| Other consumer | 158 | 239 | 434 | 652 |
| Total charge-offs | 2,500 | 2,916 | 8,059 | 9,871 |
| Recoveries: | | | | |
| Commercial business | 75 | 38 | 244 | 172 |
| Commercial mortgage | 29 | 44 | 40 | 140 |
| Residential real estate loans | 17 | 43 | 142 | 104 |
| Residential real estate lines | 4 | 25 | 11 | 29 |
| Consumer indirect | 1,160 | 905 | 3,324 | 3,206 |
| Other consumer | 79 | 62 | 282 | 255 |
| Total recoveries | 1,364 | 1,117 | 4,043 | 3,906 |
| Net charge-offs | 1,136 | 1,799 | 4,016 | 5,965 |
| Provision for loan losses | 1,961 | 754 | 6,281 | 4,783 |
| Balance at end of period | \$ 29,350 | \$ 26,455 | \$ 29,350 | \$ 26,455 |
| Net loan charge-offs to average loans (annualized) | 0.20% | 0.35% | 0.25% | 0.41% |
| Allowance for loan losses to total loans | 1.29% | 1.30% | 1.29% | 1.30% |
| Allowance for loan losses to non-performing loans | 481% | 311% | 481% | 311% |

The allowance for loan losses represents the estimated amount of probable credit losses inherent in our loan portfolio. We perform periodic, systematic reviews of the loan portfolio to estimate probable losses in the respective loan portfolios. In addition, we regularly evaluate prevailing economic and business conditions, industry concentrations, changes in the size and characteristics of the portfolio and other pertinent factors. The process we use to determine the overall allowance for loan losses is based on this analysis. Based on this analysis, we believe the allowance for loan losses is adequate as of September 30, 2016.

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

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

Net charge-offs of \$1.1 million in the third quarter of 2016 represented 0.20% of average loans on an annualized basis compared to \$1.8 million or 0.35% in the third quarter of 2015. For the nine months ended September 30, 2016, net charge-offs of \$4.0 million represented 0.25% of average loans on an annualized basis, compared to \$6.0 million or 0.41% of average loans for the same period in 2015. The first quarter of 2015 included charge-offs for two commercial loan relationships totaling \$1.7 million. The allowance for loan losses was \$29.4 million at September 30, 2016, compared with \$27.1 million at December 31, 2015. The ratio of the allowance for loan losses to total loans was 1.29% at September 30, 2016 and 1.30% at December 31, 2015. The ratio of allowance for loan losses to non-performing loans was 481% at September 30, 2016, compared with 321% at December 31, 2015.

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 our non-performing assets at the dates indicated (in thousands).

| | Non-Performing Assets | |
|--|----------------------------------|------------------------------|
| | September 30, 2016 | December 31, 2015 |
| Nonaccrual loans: | | |
| Commercial business | \$ 2,157 | \$ 3,922 |
| Commercial mortgage | 1,345 | 947 |
| Residential real estate loans | 1,239 | 1,848 |
| Residential real estate lines | 274 | 235 |
| Consumer indirect | 1,077 | 1,467 |
| Other consumer | 1 | 13 |
| Total nonaccrual loans | 6,093 | 8,432 |
| Accruing loans or consumer overdrafts 90 days or more delinquent | 8 | 8 |
| Total non-performing loans | 6,101 | 8,440 |
| Foreclosed assets | 294 | 163 |
| Total non-performing assets | \$ 6,395 | \$ 8,603 |
| Non-performing loans to total loans | 0.27% | 0.41% |
| Non-performing assets to total assets | 0.17% | 0.25% |

Changes in the level of nonaccrual loans typically represent increases for loans that reach a specified past due status, offset by reductions for loans that are charged-off, paid down, sold, transferred to foreclosed real estate, or are no longer classified as nonaccrual because they have returned to accrual status. Activity in nonaccrual loans for the three and nine months ended September 30, 2016 was as follows (in thousands):

| | Three months ended September 30, 2016 | Nine months ended September 30, 2016 |
|---------------------------------------|--|---|
| Nonaccrual loans, beginning of period | \$ 6,545 | \$ 8,432 |
| Additions | 3,547 | 12,903 |
| Payments | (1,247) | (6,031) |
| Charge-offs | (2,401) | (7,824) |

Edgar Filing: FINANCIAL INSTITUTIONS INC - Form 10-Q

| | | |
|--|----------|----------|
| Returned to accruing status | (282) | (944) |
| Transferred to other real estate or repossessed assets | (69) | (443) |
| Nonaccrual loans, end of period | \$ 6,093 | \$ 6,093 |

Non-performing assets include non-performing loans and foreclosed assets. Non-performing assets at September 30, 2016 were \$6.4 million, a decrease of \$2.2 million from \$8.6 million at December 31, 2015. The primary component of non-performing assets is non-performing loans, which were \$6.1 million or 0.27% of total loans at September 30, 2016, compared with \$8.4 million or 0.41% of total loans at December 31, 2015.

Approximately \$2.4 million, or 40%, of the \$6.1 million in non-performing loans as of September 30, 2016 were current with respect to payment of principal and interest, but were classified as non-accruing because repayment in full of principal and/or interest was uncertain. Included in nonaccrual loans are troubled debt restructurings (TDRs) of \$1.9 million and \$2.4 million at September 30, 2016 and December 31, 2015, respectively. We had no TDRs that were accruing interest as of September 30, 2016 or December 31, 2015.

Foreclosed assets consist of real property formerly pledged as collateral for loans, which we have acquired through foreclosure proceedings or acceptance of a deed in lieu of foreclosure. Foreclosed asset holdings represented five properties totaling \$294 thousand at September 30, 2016 and four properties totaling \$163 thousand at December 31, 2015.

Potential problem loans are loans that are currently performing, but information known about possible credit problems of the borrowers causes us to have concern as to the ability of such borrowers to comply with the present loan payment terms and may result in disclosure of such loans as nonperforming at some time in the future. These loans remain in a performing status due to a variety of factors, including payment history, the value of collateral supporting the credits, and/or personal or government guarantees. We consider loans classified as substandard, which continue to accrue interest, to be potential problem loans. We identified \$12.2 million and \$12.1 million in loans that continued to accrue interest which were classified as substandard as of September 30, 2016 and December 31, 2015, respectively.

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

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

| | Deposit Composition | | | |
|------------------------------------|----------------------------|-------------------|--------------------------|-------------------|
| | September 30, 2016 | | December 31, 2015 | |
| | Amount | % of Total | Amount | % of Total |
| Noninterest-bearing demand | \$ 657,624 | 21.5% | \$ 641,972 | 23.5% |
| Interest-bearing demand | 629,413 | 20.5 | 523,366 | 19.2 |
| Savings and money market | 1,052,224 | 34.4 | 928,175 | 34.0 |
| Time deposits < \$250,000 | 606,129 | 19.7 | 545,044 | 19.9 |
| Time deposits of \$250,000 or more | 117,967 | 3.9 | 91,974 | 3.4 |
| Total deposits | \$ 3,063,357 | 100.0% | \$ 2,730,531 | 100.0% |

We offer a variety of deposit products designed to attract and retain customers, with the primary focus on building and expanding long-term relationships. At September 30, 2016, total deposits were \$3.1 billion, representing an increase of \$332.8 million for the year. Time deposits were approximately 24% of total deposits at September 30, 2016 and 23% at December 31, 2015.

Nonpublic deposits, the largest component of our funding sources, totaled \$1.9 billion and \$1.8 billion at September 30, 2016 and December 31, 2015, respectively, and represented 61% and 66% of total deposits as of the end of each period, respectively. We have managed this segment of funding through a strategy of competitive pricing that minimizes the number of customer relationships that have only a single service high cost deposit account.

As an additional source of funding, we offer a variety of public (municipal) deposit products to various public entities, including the towns, villages, counties and school districts within our market. Public deposits generally range from 20% to 30% of our total deposits. There is a high degree of seasonality in this component of funding, because the level of deposits varies with the seasonal cash flows for these public customers. We maintain the necessary levels of short-term liquid assets to accommodate the seasonality associated with public deposits. Total public deposits were \$892.0 million and \$675.7 million at September 30, 2016 and December 31, 2015, respectively, and represented 29% and 25% of total deposits as of the end of each period, respectively. The increase in public deposits during 2016 was due to a combination of seasonality and successful business development efforts.

We had no traditional brokered deposits at September 30, 2016 or December 31, 2015; however, we do participate in the CDARS and ICS programs, which enable depositors to receive FDIC insurance coverage for deposits otherwise exceeding the maximum insurable amount. CDARS and ICS deposits are considered brokered deposits for regulatory reporting purposes. Through these programs, deposits in excess of the maximum insurable amount are placed with multiple participating financial institutions. Reciprocal CDARS deposits and ICS deposits totaled \$160.2 million and

\$145.8 million, respectively, at September 30, 2016, compared to \$92.9 million and \$146.6, respectively, at December 31, 2015.

Borrowings

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

| | September 30, 2016 | December 31, 2015 |
|--|-------------------------------|------------------------------|
| Short-term borrowings - Short-term FHLB borrowings | \$ 230,200 | \$ 293,100 |
| Long-term borrowings - Subordinated notes | 39,043 | 38,990 |
| Total borrowings | \$ 269,243 | \$ 332,090 |

Short-term Borrowings

We have credit capacity with the FHLB and can borrow through facilities that include amortizing and term advances or repurchase agreements. We had approximately \$125 million of immediate credit capacity with the FHLB as of September 30, 2016. We had approximately \$523 million in secured borrowing capacity at the Federal Reserve Bank (FRB) discount window, none of which was outstanding at September 30, 2016. The FHLB and FRB credit capacity are collateralized by securities from our investment portfolio and certain qualifying loans. We had approximately \$140 million of credit available under unsecured federal funds purchased lines with various banks as of September 30, 2016. Additionally, we had approximately \$138 million of unencumbered liquid securities available for pledging.

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

Federal funds purchased are short-term borrowings that typically mature within one to ninety days. Short-term repurchase agreements are secured overnight borrowings with customers. Short-term FHLB borrowings have original maturities of up to one year and include overnight borrowings which we typically utilize to address short-term funding needs as they arise. Short-term FHLB borrowings at September 30, 2016 consisted of \$70.2 million in overnight borrowings and \$160.0 million in short-term advances. Short-term FHLB borrowings at December 31, 2015 consisted of \$116.8 million in overnight borrowings and \$176.3 million in short-term advances.

The Parent has a revolving line of credit with a commercial bank allowing borrowings up to \$20.0 million in total as an additional source of working capital. At September 30, 2016, no amounts have been drawn on the line of credit.

Long-term Borrowings

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

LIQUIDITY AND CAPITAL MANAGEMENT**Liquidity**

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

We manage liquidity for the Bank by the monitoring of anticipated changes in loans, the investment portfolio, core deposits and wholesale funds. The strength of the Bank's liquidity position is a result of its base of core customer deposits. These core deposits are supplemented by wholesale funding sources that include credit lines with the other banking institutions, the FHLB and the FRB. The primary source of our non-deposit borrowings is FHLB advances, of which we had \$230.2 million outstanding at September 30, 2016. In addition to this amount, we have additional collateralized wholesale borrowing capacity of approximately \$788 million from various funding sources which include the FHLB, Federal Reserve Bank, and commercial banks that we can use to fund lending activities, liquidity needs, and/or to adjust and manage our asset and liability position.

The Parent's funding requirements consist primarily of dividends to shareholders, debt service, income taxes, operating expenses, funding of nonbank subsidiaries, repurchases of our stock, and acquisitions. The Parent obtains funding to meet obligations from dividends received from the Bank, net taxes collected from subsidiaries included in the federal consolidated tax return, and the issuance of debt and equity securities. In addition, the Parent maintains a revolving line of credit with a commercial bank for an aggregate amount of up to \$20.0 million, all of which was available at

September 30, 2016. The line of credit has a one year term and matures in May 2017. Funds drawn would be used for general corporate purposes and backup liquidity.

Cash and cash equivalents were \$110.7 million as of September 30, 2016, up \$50.6 million from \$60.1 million as of December 31, 2015. Net cash provided by operating activities totaled \$37.4 million and the principal source of operating activity cash flow was net income adjusted for noncash income and expense items. Net cash used in investing activities totaled \$247.9 million, which included outflows of \$204.7 million for net loan originations and \$41.1 million from net investment securities transactions. Net cash provided by financing activities of \$261.1 million was attributed to a \$332.8 million increase in deposits, partially offset by a \$62.9 million decrease in short-term borrowings and \$9.7 million in dividend payments.

Capital Management

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

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

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

Shareholders' equity was \$326.3 million at September 30, 2016, an increase of \$32.5 million from \$293.8 million at December 31, 2015. Net income for the year and stock issued for the acquisition of Courier Capital increased shareholders' equity by \$23.2 million and \$8.1 million, respectively, which were partially offset by common and preferred stock dividends declared of \$9.8 million. Accumulated other comprehensive loss included in shareholders' equity decreased \$9.4 million during the first nine months of 2016 due primarily to higher net unrealized gains on securities available for sale.

The FRB and FDIC have adopted a system using risk-based capital guidelines to evaluate the capital adequacy of banks and bank holding companies. The final rules implementing the Basel Committee on Banking Supervision's (BCBS) capital guidelines for U.S. banks became effective for the Company on January 1, 2015, with full compliance with all of the final requirements phased in over a multi-year schedule, to be fully phased-in by January 1, 2019. As of September 30, 2016, the Company's capital levels remained characterized as well-capitalized under the new rules.

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

| | September 30, 2016 | December 31, 2015 |
|---|-------------------------------|------------------------------|
| Common shareholders' equity | \$ 308,931 | \$ 276,504 |
| Less: Goodwill and other intangible assets, net of deferred tax liabilities | 68,954 | 61,217 |
| Net unrealized gain (loss) on investment securities ⁽¹⁾ | 8,252 | (696) |
| Net periodic pension & postretirement benefits plan adjustments | (10,213) | (10,631) |
| Other | | 201 |
| Common equity Tier 1 (CET1) capital | 241,938 | 226,413 |
| Plus: Preferred stock | 17,340 | 17,340 |
| Less: Other | | 301 |
| Tier 1 Capital | 259,278 | 243,452 |
| Plus: Qualifying allowance for loan losses | 29,350 | 27,085 |
| Subordinated Notes | 39,043 | 38,990 |
| Total regulatory capital | \$ 327,671 | \$ 309,527 |
| Adjusted average total assets (for leverage capital purposes) | \$ 3,507,511 | \$ 3,287,646 |
| Total risk-weighted assets | \$ 2,524,622 | \$ 2,318,536 |
| Regulatory Capital Ratios | | |
| | 7.39% | 7.41% |

| | | |
|---|-------|-------|
| Tier 1 leverage (Tier 1 capital to adjusted average assets) | | |
| CET1 capital (CET1 capital to total risk-weighted assets) | 9.58 | 9.77 |
| Tier 1 capital (Tier 1 capital to total risk-weighted assets) | 10.27 | 10.50 |
| Total risk-based capital (Total regulatory capital to total risk-weighted assets) | 12.98 | 13.35 |

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

Basel III Capital Rules

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

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

The following table presents actual and required capital ratios as of September 30, 2016 and December 31, 2015 for the Company and the Bank under the Basel III Capital Rules. The minimum required capital amounts presented include the minimum required capital levels as of those dates based on the phase-in provisions of the Basel III Capital Rules and the minimum required capital levels as of January 1, 2019 when the Basel III Capital Rules have been fully phased-in. Capital levels required to be considered well capitalized are based upon prompt corrective action regulations, as amended to reflect the changes under the Basel III Capital Rules (in thousands):

| | Actual | | Minimum Capital Required Phase-in Schedule | | Minimum Capital Required Basel III Fully Phased-in | | Required to be Considered Well Capitalized | |
|---------------------------|------------|-------|--|-------|--|-------|--|-------|
| | Amount | Ratio | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| September 30, 2016 | | | | | | | | |
| Tier 1 leverage: | | | | | | | | |
| Company | \$ 259,277 | 7.39% | \$ 140,300 | 4.00% | \$ 140,300 | 4.00% | \$ 175,376 | 5.00% |
| Bank | 280,547 | 8.01 | 140,088 | 4.00 | 140,088 | 4.00 | 175,110 | 5.00 |
| CET1 capital: | | | | | | | | |
| Company | 241,937 | 9.58 | 129,387 | 5.13 | 176,724 | 7.00 | 164,100 | 6.50 |
| Bank | 280,547 | 11.16 | 128,831 | 5.13 | 175,965 | 7.00 | 163,396 | 6.50 |
| Tier 1 capital: | | | | | | | | |
| Company | 259,277 | 10.27 | 167,256 | 6.63 | 214,593 | 8.50 | 201,970 | 8.00 |
| Bank | 280,547 | 11.16 | 166,538 | 6.63 | 213,671 | 8.50 | 201,102 | 8.00 |
| Total capital: | | | | | | | | |
| Company | 327,670 | 12.98 | 217,749 | 8.63 | 265,085 | 10.50 | 252,462 | 10.00 |
| Bank | 309,897 | 12.33 | 216,813 | 8.63 | 263,947 | 10.50 | 251,378 | 10.00 |
| December 31, 2015 | | | | | | | | |
| Tier 1 leverage: | | | | | | | | |
| Company | \$ 243,452 | 7.41% | \$ 131,506 | 4.00% | \$ 131,506 | 4.00% | \$ 164,382 | 5.00% |
| Bank | 265,487 | 8.09 | 131,188 | 4.00 | 131,188 | 4.00 | 163,985 | 5.00 |
| CET1 capital: | | | | | | | | |
| Company | 226,413 | 9.77 | 104,334 | 4.50 | 162,297 | 7.00 | 150,705 | 6.50 |
| Bank | 265,487 | 11.49 | 103,971 | 4.50 | 161,733 | 7.00 | 150,180 | 6.50 |
| Tier 1 capital: | | | | | | | | |
| Company | 243,452 | 10.50 | 139,112 | 6.00 | 197,076 | 8.50 | 185,483 | 8.00 |
| Bank | 265,487 | 11.49 | 138,628 | 6.00 | 196,389 | 8.50 | 184,837 | 8.00 |
| Total capital: | | | | | | | | |
| Company | 309,527 | 13.35 | 185,483 | 8.00 | 243,446 | 10.50 | 231,854 | 10.00 |
| Bank | 292,572 | 12.66 | 184,837 | 8.00 | 242,599 | 10.50 | 231,046 | 10.00 |

Dividend Restrictions

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

Off-Balance Sheet Arrangements

With the exception of obligations in connection with our irrevocable loan commitments, operating leases and limited partnership investments as of September 30, 2016, we had no other off-balance sheet arrangements that have or are reasonably likely to have a current or future effect on our financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources that is material to investors. For additional information on off-balance sheet arrangements, see Note 11, Commitments and Contingencies, in the notes to the accompanying consolidated financial statements.

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

Quantitative and qualitative disclosures about market risk were presented at December 31, 2015 in Item 7A of the Company's Annual Report on Form 10-K for the year ended December 31, 2015, as filed with the Securities and Exchange Commission on March 8, 2016. The following is an update of the discussion provided therein.

Portfolio Composition

There was no material change in the composition of assets, deposit liabilities or borrowings from December 31, 2015 to September 30, 2016. See the section titled "Analysis of Financial Condition" in Part I, Item 2, "Management's Discussion and Analysis of Financial Condition and Results of Operations" for a discussion of asset, deposit and borrowing activity during the period.

Net Interest Income at Risk

A primary tool used to manage interest rate risk is "rate shock" simulation to measure the rate sensitivity. Rate shock simulation is a modeling technique used to estimate the impact of changes in rates on net interest income as well as economic value of equity. At September 30, 2016, the Company was slightly asset sensitive, meaning that net interest income increases in rising rate conditions.

Net interest income at risk is measured by estimating the changes in net interest income resulting from instantaneous and sustained parallel shifts in interest rates of different magnitudes over a period of 12 months. The following table sets forth the estimated changes to net interest income over the 12-month period ending September 30, 2017 assuming instantaneous changes in interest rates for the given rate shock scenarios (dollars in thousands):

| | Changes in Interest Rate | | | |
|-------------------------------|--------------------------|----------|----------|----------|
| | -100 bp | +100 bp | +200 bp | +300 bp |
| Change in net interest income | \$ (1,376) | \$ 1,725 | \$ 3,697 | \$ 2,726 |
| % Change | (1.31)% | 1.64% | 3.51% | 2.59% |

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

The simulations referenced above are 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 future results, does not measure the effect of changing interest rates on noninterest income and is based on many assumptions that, if changed, could cause a different outcome.

Economic Value of Equity At Risk

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

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

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

Table of Contents

The analysis that follows presents the estimated EVE resulting from market interest rates prevailing at a given quarter-end (Pre-Shock Scenario), and under other interest rate scenarios (each a Rate Shock Scenario) represented by immediate, permanent, parallel shifts in interest rates from those observed at September 30, 2016 and December 31, 2015. The analysis additionally presents a measurement of the interest rate sensitivity at September 30, 2016 and December 31, 2015. EVE amounts are computed under each respective Pre- Shock Scenario and Rate Shock Scenario. An increase in the EVE amount is considered favorable, while a decline is considered unfavorable.

| | September 30, 2016 | | | December 31, 2015 | | |
|-----------------------------|--------------------|-----------|-------------------|-------------------|-----------|-------------------|
| | EVE | Change | Percentage Change | EVE | Change | Percentage Change |
| Rate Shock Scenario: | | | | | | |
| Pre-Shock Scenario | \$ 498,865 | | | \$ 497,349 | | |
| - 100 Basis Points | 544,027 | \$ 45,162 | 9.05% | 508,973 | \$ 11,624 | 2.34% |
| + 100 Basis Points | 487,905 | (10,960) | (2.20) | 480,888 | (16,461) | (3.31) |
| + 200 Basis Points | 472,571 | (26,294) | (5.27) | 460,567 | (36,782) | (7.40) |
| + 300 Basis Points | 441,642 | (57,223) | (11.47) | 429,381 | (67,968) | (13.67) |

The Pre-Shock Scenario EVE was \$498.9 million at September 30, 2016, compared to \$497.3 million at December 31, 2015. The increase in the Pre-Shock Scenario EVE at September 30, 2016, compared to December 31, 2015 resulted primarily from a more favorable valuation of non-maturity deposits that reflected alternative funding rate changes used for discounting future cash flows.

The +200 basis point Rate Shock Scenario EVE increased from \$460.6 million at December 31, 2015 to \$472.6 million at September 30, 2016, reflecting the more favorable valuation of non-maturity deposits. The percentage change in the EVE amount from the Pre-Shock Scenario to the +200 basis point Rate Shock Scenario decreased from (7.40)% at December 31, 2015 to (5.27)% at September 30, 2016. The decrease in sensitivity resulted from an increased benefit in the valuation of non-maturity deposits in the +200 basis point Rate Shock Scenario EVE as of September 30, 2016, compared to December 31, 2015.

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

As of September 30, 2016, 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 under the Exchange Act is accumulated and

communicated to management, including the Company's Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

Changes in internal control over financial reporting

The acquisition of Courier Capital Corporation was consummated on January 5, 2016, at which time Courier Capital, LLC (Courier Capital) became a consolidated subsidiary of the Company. In the quarter ended September 30, 2016, the Company completed its review of the internal control structure of Courier Capital and made appropriate changes to integrate Courier Capital into the Company's overall internal control over financial reporting process. In connection with the foregoing evaluation by the Company's Chief Executive Officer and Chief Financial Officer, other than as noted above, no changes in the Company's internal control over financial reporting have occurred during the quarter ended September 30, 2016 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

Table of Contents

PART II. OTHER INFORMATION

ITEM 1. Legal Proceedings

The Company has experienced no material developments in its legal proceedings from the disclosure included in the Company's Annual Report on Form 10-K for the year ended December 31, 2015, dated March 8, 2016, as filed with the Securities and Exchange Commission (SEC).

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, 2015, dated March 8, 2016, as filed with the SEC, as updated by the factor 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.

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

The financial services industry is subject to extensive regulation at the federal and state levels. It is very difficult to predict the future impact of the legislative and regulatory requirements affecting our business. The securities laws and other laws that govern the activities of our registered investment advisor are complex and subject to rapid change. The activities of our investment advisory and wealth management operations are subject primarily to provisions of the Investment Advisers Act of 1940, as amended and the Employee Retirement Income Act of 1940, as amended (ERISA). We are a fiduciary under ERISA. Our investment advisory services are also subject to state laws including anti-fraud laws and regulations. Any claim of noncompliance, regardless of merit or ultimate outcome, could subject us to investigation by the SEC or other regulatory authorities. Our compliance processes may not be sufficient to prevent assertions that we failed to comply with any applicable law, rule or regulation. If our investment advisory and wealth management operations are subject to investigation by the SEC or other regulatory authorities or if litigation is brought by clients based on our failure to comply with applicable regulations, our results of operations could be materially adversely effected.

In addition, the majority of our investment advisory revenue is from fees based on assets under management. The value of the assets under management is determined, in part by market conditions that can be volatile. As a result, investment advisory revenues and profitability can fluctuate with market conditions.

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:

Exhibit

| Number | Description | Location |
|---------------|---|-----------------|
| 31.1 | Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 Principal Executive Officer | Filed Herewith |
| 31.2 | Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 Principal Financial Officer | Filed Herewith |
| 32 | Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 | Filed Herewith |
| 101.INS | XBRL Instance Document | |
| 101.SCH | XBRL Taxonomy Extension Schema Document | |
| 101.CAL | XBRL Taxonomy Extension Calculation Linkbase Document | |
| 101.LAB | XBRL Taxonomy Extension Label Linkbase Document | |
| 101.PRE | XBRL Taxonomy Extension Presentation Linkbase Document | |
| 101.DEF | XBRL Taxonomy Extension Definition Linkbase Document | |

Table of Contents

SIGNATURES

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

FINANCIAL INSTITUTIONS, INC.

/s/ Martin K. Birmingham , November 4, 2016
Martin K. Birmingham
President and Chief Executive Officer
(Principal Executive Officer)

/s/ Kevin B. Klotzbach , November 4, 2016
Kevin B. Klotzbach
Executive Vice President, Chief Financial Officer and
Treasurer
(Principal Financial Officer)

/s/ Michael D. Grover , November 4, 2016
Michael D. Grover
Senior Vice President and Chief Accounting Officer
(Principal Accounting Officer)