FINANCIAL INSTITUTIONS INC
Form 10-K
March 07, 2017
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

(Mark One) **Form 10-K**

[**X**] ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended **December 31, 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**

FINANCIAL INSTITUTIONS, INC.

(Exact name of registrant as specified in its charter)

NEW YORK	**16-0816610**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
220 LIBERTY STREET, WARSAW, NEW YORK	**14569**
(Address of principal executive offices)	(ZIP Code)

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

Securities registered under Section 12(b) of the Exchange Act:

Title of each class	Name of exchange on which registered
Common stock, par value $.01 per share	**NASDAQ Global Select Market**

Securities registered under Section 12(g) of the Exchange Act: **NONE**

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes No

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 past 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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§ 229.405 of this chapter) is not contained herein, and will not be contained, to the best of the registrant s knowledge, in definitive proxy or information statements

incorporated by reference in Part III of this form 10-K or any amendment to this Form 10-K.

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 definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of
the Exchange Act.

Large accelerated filer	Accelerated filer
Non-accelerated filer	Smaller reporting company

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

The aggregate market value of the registrant s common stock, par value $0.01 per share, held by non-affiliates of the registrant, as computed by reference to the June 30, 2016 closing price reported by NASDAQ, was approximately $358,540,000.

As of February 24, 2017, there were outstanding, exclusive of treasury shares, 14,529,815 shares of the registrant s common stock.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant s proxy statement for the 2017 Annual Meeting of Shareholders are incorporated by reference in Part III of this Annual Report on Form 10-K.

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PART I

FORWARD LOOKING INFORMATION

Statements and financial analysis contained in this Annual Report on Form 10-K that are based on other than historical data are forward-looking 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 or FII) and its subsidiaries (collectively, the Company, we, our or us); and
- statements preceded by, followed by or that include the words may, could, should, would, believe, an 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 Annual Report on Form 10-K, including, but not limited to, those presented in the Management s Discussion and Analysis of Financial Condition and Results of Operations. Factors that might cause such material differences include, but are not limited to:

- If we experience greater credit losses than anticipated, earnings may be adversely impacted;
- Our tax strategies and the value of our deferred tax assets could adversely affect our operating results and regulatory capital ratios;
- Geographic concentration may unfavorably impact our operations;
- We depend on the accuracy and completeness of information about or from customers and counterparties;
- Our insurance brokerage subsidiary is subject to risk related to the insurance industry;
- Our investment advisory and wealth management operations are subject to risks related to the financial services industry;
- We may be unable to successfully implement our growth strategies;
- We are subject to environmental liability risk associated with our lending activities;
- Commercial business and mortgage loans increase our exposure to credit risks;
- Our indirect lending involves risk elements in addition to normal credit risk;
- We accept deposits that do not have a fixed term and which may be withdrawn by the customer at any time for any reason;
- Any future FDIC insurance premium increases may adversely affect our earnings;
- We are highly regulated and may be adversely affected by changes in banking laws, regulations and regulatory practices;
- New or changing tax and accounting rules and interpretations could significantly impact our strategic initiatives, results of operations, cash flows and financial condition;
- Legal and regulatory proceedings and related matters could adversely affect us and 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 policies of the Federal Reserve have a significant impact on our earnings;
The soundness of other financial institutions could adversely affect us;
The value of our goodwill and other intangible assets may decline in the future;
A proxy contest for the election of directors at our annual meeting or proposals arising out of shareholder initiatives could cause us to incur 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;
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;

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- 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, of this Annual Report on 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.

ITEM 1. BUSINESS

GENERAL

The Parent is a financial holding company organized in 1931 under the laws of New York State (New York or NYS). The principal office of the Parent is located at 220 Liberty Street, Warsaw, New York 14569 and its telephone number is (585) 786-1100. The Parent was incorporated on September 15, 1931, but the continuity of the Company s banking business is traced to the organization of the National Bank of Geneva on March 28, 1817. Except as the context otherwise requires, the Parent and its direct and indirect subsidiaries are collectively referred to in this report as the Company. Five Star Bank is referred to as Five Star Bank, FSB or the Bank, Scott Danahy Naylon, LLC is referre as SDN and Courier Capital, LLC is referred to as Courier Capital. The consolidated financial statements include the accounts of the Parent, the Bank, SDN and Courier Capital. The Parent s common stock is traded on the NASDAQ Global Select Market under the ticker symbol FISI.

At December 31, 2016, the Company had consolidated total assets of $3.71 billion, deposits of $3.00 billion and shareholders equity of $320.1 million.

The Parent s primary business is the operation of its subsidiaries. It does not engage in any other substantial business activities. At December 31, 2016, the Parent had three direct wholly-owned subsidiaries: (1) the Bank, which provides a full range of banking services to consumer, commercial and municipal customers in Western and Central New York; (2) SDN, which sells various premium-based insurance policies on a commission basis to commercial and consumer customers; and (3) Courier Capital, which provides customized investment management, investment consulting and retirement plan services to individuals, businesses, institutions, foundations and retirement plans. At December 31, 2016, the Bank represented 99.2%, SDN represented 0.5% and Courier Capital represented 0.3% of the consolidated assets of the Company. Further discussion of our segments is included in Note 20 to the Company s Consolidated Financial Statements included under Item 8 of this Annual Report on Form 10-K.

Five Star Bank

The Bank is a New York chartered bank that has its headquarters at 55 North Main Street, Warsaw, NY, and a total of 52 full-service banking offices in the New York State counties of Allegany, Cattaraugus, Cayuga, Chautauqua, Chemung, Erie, Genesee, Livingston, Monroe, Ontario, Orleans, Seneca, Steuben, Wyoming and Yates counties.

At December 31, 2016, the Bank had total assets of $3.68 billion, investment securities of $1.08 billion, net loans of $2.31 billion, deposits of $3.01 billion and shareholders equity of $318.5 million, compared to total assets of $3.36 billion, investment securities of $1.03 billion, net loans of $2.06 billion, deposits of $2.74 billion and shareholders equity of $302.6 million at December 31, 2015. The Bank offers deposit products, which include checking and NOW accounts, savings accounts, and certificates of deposit, as its principal source of funding. The Bank s deposits are insured up to the maximum permitted by the Bank Insurance Fund (the Insurance Fund) of the Federal Deposit Insurance Corporation (FDIC). The Bank offers a variety of loan products to its customers, including commercial and consumer loans and commercial and residential mortgage loans.

Scott Danahy Naylon, LLC

Acquired in August 2014, SDN is a full-service insurance agency founded in 1923 and headquartered in Amherst, NY. SDN offers personal, commercial and financial services products and serves over 7,000 clients in 45 states. For the year ended December 31, 2016, SDN had total revenue of $5.2 million, compared to total revenue of $5.0 million for the year ended December 31, 2015.

SDN s primary market area is Erie and Niagara counties in New York State. Most lines of personal insurance are provided, including automobile, homeowners, boat, recreational vehicle, landlord, and umbrella coverage. Commercial insurance products are also provided, consisting of property, liability, automobile, inland marine, workers compensation, bonds, crop and umbrella insurance. SDN also provides the following financial services products: life and disability insurance, Medicare supplements, long-term care, annuities, mutual funds, retirement programs and New York State disability.

Courier Capital, LLC

Acquired in January 2016, Courier Capital is an SEC-registered investment advisory and wealth management firm founded in 1967 and based in Western New York, with offices in Buffalo and Jamestown. With $1.33 billion in assets under management, Courier Capital offers customized investment management, investment consulting and retirement plan services to over 1,100 individuals, businesses and institutions across nine states. For the period from date of acquisition through December 31, 2016, Courier Capital had total revenue of $3.4 million.

Other Subsidiaries

In addition to the Bank, SDN and Courier Capital, the Parent had the following indirect wholly-owned subsidiary as of December 31, 2016:

Five Star REIT, Inc. Five Star REIT, Inc. (Five Star REIT), a wholly-owned subsidiary of the Bank, operates as a real estate investment trust that holds residential mortgages and commercial real estate loans. Five Star REIT provides additional flexibility and planning opportunities for the business of the Bank.

Business Strategy

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

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

Acquisition Strategy

We will continue to explore market expansion opportunities in or near our current market areas as opportunities arise. Our primary focus will be on increasing market share within existing markets, while taking advantage of potential growth opportunities within our insurance and wealth management lines of business by acquiring new businesses that can be added to existing operations. We believe our capital position remains strong enough to support an active merger and acquisition strategy, and expansion of our core financial service businesses of banking, insurance and wealth management. Consequently, we continue to explore acquisition opportunities in these activities. In evaluating acquisition opportunities, we will balance the potential for earnings accretion with maintaining adequate capital levels, which could result in our common stock being the predominate form of consideration and/or the need for us to raise capital.

Conversations with potential strategic partners occur on a regular basis. The evaluation of any potential opportunity will favor a transaction that complements our core competencies and strategic intent, with a lesser emphasis being placed on geographic location or size. Additionally, we remain committed to maintaining a diversified revenue stream. Our senior management team has had extensive experience in acquisitions and post-acquisition integration of operations, and is prepared to act quickly should a potential opportunity arise, but will remain disciplined with its approach. We believe this experience positions us to successfully acquire and integrate additional financial services and banking businesses.

MARKET AREAS AND COMPETITION

We provide a wide range of banking and financial services to individuals, municipalities and businesses through a network of over 50 offices and an extensive ATM network throughout Western and Central New York. The region includes the counties of Allegany, Cattaraugus, Cayuga, Chautauqua, Chemung, Erie, Genesee, Livingston, Monroe, Ontario, Orleans, Schuyler, Seneca, Steuben, Wyoming and Yates counties. Our banking activities, though concentrated in the communities where we maintain branches, also extend into neighboring counties. In addition, we have expanded our consumer indirect lending presence to the Capital District of New York and Northern and Central Pennsylvania.

Our market area is economically diversified in that we serve both rural markets and the larger markets in and around Rochester and Buffalo. Rochester and Buffalo are the two largest metropolitan areas in New York outside of New York City, with a combined population of over two million people. We anticipate continuing to increase our presence in and around these metropolitan statistical areas in the coming years.

We face significant competition in both making loans and attracting deposits, as both Western and Central New York have a high density of financial institutions. Our competition for loans comes principally from commercial banks, savings banks, savings and loan associations, mortgage banking companies, credit unions, insurance companies and other financial services companies. Our most direct competition for deposits has historically come from commercial banks, savings banks and credit unions. We face additional competition for deposits from non-depository competitors such as the mutual fund industry, securities and brokerage firms and insurance companies. We generally compete with other financial service providers on factors such as level of customer service, responsiveness to customer needs, availability and pricing of products, and geographic location. Our industry frequently experiences merger activity, which affects competition by eliminating some institutions while potentially strengthening the franchises of others.

The following table presents the Bank s market share percentage for total deposits as of June 30, 2016, in each county where we have operations. The table also indicates the ranking by deposit size in each market. All information in the table was obtained from SNL Financial of Charlottesville, Virginia, which compiles deposit data published by the FDIC as of June 30, 2016 and updates the information for any bank mergers and acquisitions completed subsequent to the reporting date.

County	Market Share	Market Rank	Number of Branches(1)
Allegany	8.4%	3	1
Cattaraugus	28.1%	2	5
Cayuga	3.1%	10	1
Chautauqua	1.4%	8	1
Chemung	13.8%	3	3
Erie	0.4%	10	3
Genesee	22.8%	2	3
Livingston	37.4%	1	5
Monroe	1.6%	10	8
Ontario	13.2%	2	5
Orleans	19.5%	2	2
Seneca	25.8%	2	2
Steuben	29.1%	1	7
Wyoming	55.0%	1	4
Yates	42.2%	1	2

(1) Number of branches current as of December 31, 2016.

INVESTMENT ACTIVITIES

Our investment policy is contained within our overall Asset-Liability Management and Investment Policy. This policy dictates that investment decisions will be made based on the safety of the investment, liquidity requirements, potential returns, cash flow targets, need for collateral and desired risk parameters. In pursuing these objectives, we consider the ability of an investment to provide earnings consistent with factors related to quality, maturity, marketability, pledgeable nature and risk diversification. Our Treasurer, guided by our Asset-Liability Committee (ALCO), is responsible for investment portfolio decisions within the established policies.

Our investment securities strategy is focused on providing liquidity to meet loan demand and redeeming liabilities, meeting pledging requirements, managing credit risks, managing overall interest rate risks and maximizing portfolio yield. Our current policy generally limits security purchases to the following:

- U.S. treasury securities;

- U.S. government agency securities, which are securities issued by official Federal government bodies (e.g., the Government National Mortgage Association (GNMA) and the Small Business Administration (SBA)), and U.S. government-sponsored enterprise securities, which are securities issued by independent organizations that are in part sponsored by the federal government (e.g., the Federal Home Loan Bank (FHLB) system, the Federal National Mortgage Association (FNMA), the Federal Home Loan Mortgage Corporation (FHLMC) and the Federal Farm Credit Bureau);

- Mortgage-backed securities (MBS) include mortgage-backed pass-through securities, collateralized mortgage obligations and multi-family MBS issued by GNMA, FNMA and FHLMC;

- Investment grade municipal securities, including revenue, tax and bond anticipation notes, statutory installment notes and general obligation bonds;
- Certain creditworthy unrated securities issued by municipalities;
- Certificates of deposit;
- Equity securities at the holding company level; and
- Limited partnership investments.

LENDING ACTIVITIES

General

We offer a broad range of loans including commercial business and revolving lines of credit, commercial mortgages, equipment loans, residential mortgage loans and home equity loans and lines of credit, home improvement loans, automobile loans and personal loans. Newly originated and refinanced fixed rate residential mortgage loans are either retained in our portfolio or sold to the secondary market with servicing rights retained.

We continually evaluate and update our lending policy. The key elements of our lending philosophy include the following:

- To ensure consistent underwriting, employees must share a common view of the risks inherent in lending activities as well as the standards to be applied in underwriting and managing credit risk;
- Pricing of credit products should be risk-based;
- The loan portfolio must be diversified to limit the potential impact of negative events; and
- Careful, timely exposure monitoring through dynamic use of our risk rating system is required to provide early warning and assure proactive management of potential problems.

Commercial Business and Commercial Mortgage Lending

We originate commercial business loans in our primary market areas and underwrite them based on the borrower s ability to service the loan from operating income. We offer a broad range of commercial lending products, including term loans and lines of credit. Short and medium-term commercial loans, primarily collateralized, are made available to businesses for working capital (including inventory and receivables), business expansion (including acquisition of real estate, expansion and improvements) and the purchase of equipment. We offer commercial business loans to customers in the agricultural industry for short-term crop production, farm equipment and livestock financing. As a general practice, where possible, a first position collateral lien is placed on any available real estate, equipment or other assets owned by the borrower and a personal guarantee of the owner is obtained. As of December 31, 2016, $108.5 million, or 31%, of our aggregate commercial business loan portfolio were at fixed rates, while $241.0 million, or 69%, were at variable rates.

We also offer commercial mortgage loans to finance the purchase of real property, which generally consists of real estate with completed structures and, to a smaller extent, agricultural real estate financing. Commercial mortgage loans are secured by first liens on the real estate and are typically amortized over a 10 to 20 year period. The underwriting analysis includes credit verification, appraisals and a review of the borrower s financial condition and repayment capacity. As of December 31, 2016, $279.5 million, or 42%, of the loans in our aggregate commercial mortgage portfolio were at fixed rates, while $390.6 million, or 58%, were at variable rates.

We utilize government loan guarantee programs where available and appropriate.

Government Guarantee Programs

We participate in government loan guarantee programs offered by the SBA, U.S. Department of Agriculture, Rural Economic and Community Development and Farm Service Agency, among others. As of December 31, 2016, we had loans with an aggregate principal balance of $50.1 million that were covered by guarantees under these programs. The guarantees typically only cover a certain percentage of these loans. By participating in these programs, we are able to broaden our base of borrowers while minimizing credit risk.

Residential Real Estate Lending

We originate fixed and variable rate one-to-four family residential mortgages collateralized by owner-occupied properties located in our market areas. We offer a variety of real estate loan products, including home improvement loans, closed-end home equity loans, and home equity lines of credit, which are generally amortized over periods of up to 30 years. Loans collateralized by one-to-four family residential real estate generally have been originated in amounts of no more than 80% of appraised value, or have mortgage insurance. Mortgage title insurance and hazard insurance are normally required. We sell certain one-to-four family residential mortgages to the secondary mortgage market and typically retain the right to service the mortgages. To assure maximum salability of the residential loan products for possible resale, we typically follow the underwriting and appraisal guidelines of the secondary market, including the FHLMC and the Federal Housing Administration, and service the loans in a manner that satisfies the secondary market agreements. As of December 31, 2016, our residential mortgage servicing portfolio totaled $173.7 million, the majority of which has been sold to the FHLMC. As of December 31, 2016, our residential real estate loan portfolio totaled $427.9 million, or 18% of our total loan portfolio. As of December 31, 2016, our residential real estate lines portfolio totaled $122.6 million, or 5% of our total loan portfolio. As of December 31, 2016, $392.0 million, or 92%, of the loans in our residential real estate loan portfolio were at fixed rates, while $35.9 million, or 8%, were at variable rates. The residential real estate lines portfolio primarily consists of variable rate lines. Approximately 87% of the loans and lines in our residential real estate portfolios were in first lien positions at December 31, 2016. We do not engage in sub-prime or other high-risk residential mortgage lending as a line-of-business.

Consumer Lending

We offer a variety of loan products to our consumer customers, including automobile loans, secured installment loans and other types of secured and unsecured personal loans. At December 31, 2016, outstanding consumer loan balances were concentrated in indirect automobile loans.

We originate indirect consumer loans for a mix of new and used vehicles through franchised new car dealers. The consumer indirect loan portfolio is primarily comprised of loans with terms that typically range from 36 to 84 months. We have developed relationships with franchised new car dealers in Western, Central and the Capital District of New York, and Northern and Central Pennsylvania. As of December 31, 2016, our consumer indirect portfolio totaled $752.4 million, or 32% of our total loan portfolio. The consumer indirect loan portfolio primarily consists of fixed rate loans with relatively short durations.

We also originate, independently of the indirect loans described above, consumer automobile loans, recreational vehicle loans, boat loans, personal loans (collateralized and uncollateralized) and deposit account collateralized loans. The terms of these loans typically range from 12 to 60 months and vary based upon the nature of the collateral and the size of loan. The majority of the consumer lending program is underwritten on a secured basis using the customer s financed automobile, mobile home, boat or recreational vehicle as collateral. The other loans in our consumer portfolio totaled $17.6 million as of December 31, 2016, all but $839 thousand of which were fixed rate loans.

Credit Administration

Our loan policy establishes standardized underwriting guidelines, as well as the loan approval process and the committee structures necessary to facilitate and ensure the highest possible loan quality decision-making in a timely and businesslike manner. The policy establishes requirements for extending credit based on the size, risk rating and type of credit involved. The policy also sets limits on individual lending authority and various forms of joint lending authority, while designating which loans are required to be approved at the committee level.

Our credit objectives are to:

- Compete effectively and service the legitimate credit needs of our target market;
- Enhance our reputation for superior quality and timely delivery of products and services;
- Provide pricing that reflects the entire relationship and is commensurate with the risk profiles of our borrowers;
- Retain, develop and acquire profitable, multi-product, value added relationships with high quality borrowers;
- Focus on government guaranteed lending to meet the needs of the small businesses in our communities; and
- Comply with all relevant laws and regulations.

Our policy includes loan reviews, under the supervision of our Audit and Risk Oversight committees of the Board of Directors and directed by our Chief Risk Officer, in order to render an independent and objective evaluation of our asset quality and credit administration process.

We assign risk ratings to loans in the commercial business and commercial mortgage portfolios. We use those risk ratings to:

- Profile the risk and exposure in the loan portfolio and identify developing trends and relative levels of risk;
- Identify deteriorating credits;
- Reflect the probability that a given customer may default on its obligations; and
- Assist with risk-based pricing.

Through the loan approval process, loan administration and loan review program, management seeks to continuously monitor our credit risk profile and assesses the overall quality of the loan portfolio and adequacy of the allowance for loan losses.

We have several procedures in place to assist in maintaining the overall quality of our loan portfolio. Delinquent loan reports are monitored by credit administration to identify adverse levels and trends. Loans, including impaired loans, are generally classified as non-accruing if they are past due as to maturity or payment of principal or interest for a period of more than 90 days, unless such loans are well-collateralized and in the process of collection. Loans that are on a current payment status or past due less than 90 days may also be classified as non-accruing if repayment in full of principal and/or interest is uncertain.

Allowance for Loan Losses

The allowance for loan losses is established through charges to earnings in the form of a provision for loan losses. The allowance reflects management s estimate of the amount of probable loan losses in the portfolio, based on factors such as:

- Specific allocations for individually analyzed credits;
- Risk assessment process;
- Historical net charge-off experience;
- Evaluation of loss emergence and look-back periods;
- Evaluation of the loan portfolio with loan reviews;

- Levels and trends in delinquent and non-accruing loans;
- Trends in volume and terms of loans;
- Effects of changes in lending policy;
- Experience, ability and depth of management;
- National and local economic trends and conditions;
- Concentrations of credit;
- Interest rate environment;
- Customer leverage;
- Information (availability of timely financial information); and
- Collateral values.

Our methodology for estimating the allowance for loan losses includes the following:

1. Impaired commercial business and commercial mortgage loans are typically reviewed individually and assigned a specific loss allowance, if considered necessary, in accordance with U.S. generally accepted accounting principles (GAAP).

2. The remaining portfolios of commercial business and commercial mortgage loans are segmented by risk rating into the following loan classification categories: uncriticized or pass, special mention, substandard and doubtful. Uncriticized loans, special mention loans, substandard loans and all doubtful loans not assigned a specific loss allowance are assigned allowance allocations based on historical net loan charge-off experience for each of the respective loan categories, supplemented with additional reserve amounts, if considered necessary, based upon loss emergence periods and qualitative factors. These qualitative factors include the levels and trends in delinquent and non-accruing loans, trends in volume and terms of loans, effects of changes in lending policy, experience, ability, and depth of management, national and local economic trends and conditions, concentrations of credit, interest rate environment, customer leverage, information (availability of timely financial information), and collateral values, among others.

3. The retail loan portfolio is segmented into the following types of loans: residential real estate loans, residential real estate lines, consumer indirect and other consumer. Allowance allocations for the retail loan portfolio are

based on the average loss experience for the previous eight quarters, supplemented with loss emergence periods and qualitative factors similar to the elements described above.

Management presents a quarterly review of the adequacy of the allowance for loan losses to the Audit Committee of our Board of Directors based on the methodology described above. See also the section titled Allowance for Loan Losses in Part II, Item 7, Management s Discussion and Analysis of Financial Condition and Results of Operations of this Annual Report on Form 10-K.

SOURCES OF FUNDS

Our primary sources of funds are deposits and borrowed funds.

Deposits

We maintain a full range of deposit products and accounts to meet the needs of the residents and businesses in our primary service area. Products include an array of checking and savings account programs for individuals and businesses, including money market accounts, certificates of deposit, sweep investment capabilities as well as Individual Retirement Accounts and other qualified plan accounts. We rely primarily on competitive pricing of our deposit products, customer service and long-standing relationships with customers to attract and retain these deposits and seek to make our services convenient to the community by offering a choice of several delivery systems and channels, including telephone, mail, online, automated teller machines (ATMs), debit cards, point-of-sale transactions, automated clearing house transactions (ACH), remote deposit, and mobile banking via telephone or wireless devices. We also take advantage of the use of technology by offering business customers banking access via the Internet and various advanced cash management systems.

We had no traditional brokered deposits at December 31, 2016; however, we do participate in the Certificate of Deposit Account Registry Service (CDARS) and Insured Cash Sweep (ICS) programs, which enable depositors to receive FDIC insurance coverage for deposits otherwise exceeding the maximum insurable amount. 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 $143.2 million and $152.9 million, respectively, at December 31, 2016.

Borrowings

We have access to a variety of borrowing sources and use both short-term and long-term borrowings to support our asset base. Borrowings from time-to-time include federal funds purchased, securities sold under agreements to repurchase, FHLB advances and borrowings from the discount window of the FRB.

Other sources of funds include scheduled amortization and prepayments of principal from loans and mortgage-backed securities, maturities and calls of investment securities and funds provided by operations

OPERATING SEGMENTS

As of December 31, 2016, we have two reportable segments: Banking and Non-Banking. These reportable segments have been identified and organized based on the nature of the underlying products and services applicable to each segment, the type of customers to whom those products and services are offered and the distribution channel through which those products and services are made available.

The Banking segment includes all of the Company s retail and commercial banking operations. The Non-Banking segment includes the activities of SDN, a full service insurance agency that provides a broad range of insurance services to both personal and business clients, and Courier Capital, an investment advisor and wealth management firm that provides customized investment management, investment consulting and retirement plan services to individuals, businesses, institutions, foundations and retirement plans. The Company had operated as one reportable segment until the acquisition of SDN on August 1, 2014, at which time the new Non-Banking segment was created for financial reporting purposes.

For a discussion of the segments included in our principal activities and certain financial information for each segment, see Note 20, Segment Reporting, of the notes to consolidated financial statements included in this Annual Report on Form 10-K.

OTHER INFORMATION

We also make available, free of charge, through our website, all reports filed with the SEC, including our Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q and Current Reports on Form 8-K, as well as any amendments to those reports, as soon as reasonably practicable after those documents are filed with, or furnished to, the SEC. These filings may be viewed by accessing the *Company Filings* subsection of the *SEC Filings* section under the *Investor Relations* tab on our website (www.fiiwarsaw.com). Information available on our website is not a part of, and is not incorporated into, this Annual Report on Form 10-K.

All of the reports we file with the SEC, including this Annual Report on Form 10-K, Quarterly Reports on Form 10-Q and Current Reports on Form 8-K, as well as any amendments thereto may be accessed at www.sec.gov or at the public reference facility maintained by the SEC at its public reference room at 100 F. Street, N.E., Room 1580, Washington, DC 20549 and copies of all or any part thereof may be obtained from that office upon payment of the prescribed fees. You may call the SEC at 1-800-SEC-0330 for further information on the operation of the public reference room and you can request copies of the documents upon payment of a duplicating fee, by writing to the SEC.

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SUPERVISION AND REGULATION

We are subject to extensive regulation under federal and state laws. The regulatory framework is intended primarily for the protection of depositors, federal deposit insurance funds and the banking system as a whole and not for the protection of shareholders and creditors.

We are also subject to the disclosure and regulatory requirements of the Securities Act of 1933, as amended, and the Securities Exchange Act of 1934, as amended, as administered by the Securities and Exchange Commission (SEC). Our common stock is listed on the NASDAQ Global Select Market (NASDAQ) under the trading symbol FISI and is subject to NASDAQ rules for listed companies.

Significant elements of the laws and regulations applicable to the Company are described below. The description is qualified in its entirety by reference to the full text of the statutes, regulations and policies that are described. Also, such statutes, regulations and policies are continually under review by Congress, state legislatures, and federal and state regulatory agencies. A change in statutes, regulations or regulatory policies applicable to the Company could have a material effect on the business, financial condition and results of operations of the Company.

Holding Company Regulation. We are subject to comprehensive regulation by the Board of Governors of the Federal Reserve System, frequently referred to as the Federal Reserve Board (FRB or Federal Reserve), under the Bank Holding Company Act (the BHC Act), as amended by, among other laws, the Gramm-Leach-Bliley Act of 1999 (the Gramm-Leach-Bliley Act), and by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act), enacted in 2010. We are registered with the Federal Reserve as a bank holding company (BHC). We must file reports with the FRB and such additional information as the FRB may require, and our holding company and non-banking affiliates are subject to examination by the FRB. Under FRB policy, a bank holding company must serve as a source of strength for its subsidiary banks. Under this policy, the FRB may require, and has required in the past, a holding company to contribute additional capital to an undercapitalized subsidiary bank. The BHC Act provides that a bank holding company must obtain FRB approval before:

- Acquiring, directly or indirectly, ownership or control of any voting shares of another bank or bank holding company if, after such acquisition, it would own or control more than 5% of such shares (unless it already owns or controls the majority of such shares);
- Acquiring all or substantially all of the assets of another bank or bank holding company, or
- Merging or consolidating with another bank holding company.

The BHC Act generally prohibits a bank holding company from acquiring direct or indirect ownership or control of more than 5% of the voting shares of any company which is not a bank or bank holding company, or from engaging directly or indirectly in activities other than those of banking, managing or controlling banks, or providing services for its subsidiaries. The principal exceptions to these prohibitions involve certain non-bank activities which, by statute or by FRB regulation or order, have been identified as activities closely related to the business of banking or managing or controlling banks. The list of activities permitted by the FRB includes, among other things: lending; operating a savings institution, mortgage company, finance company, credit card company or factoring company; performing certain data processing operations; providing certain investment and financial advice; underwriting and acting as an insurance agent for certain types of credit related insurance; leasing property on a full-payout, non-operating basis;

selling money orders, travelers checks and United States Savings Bonds; real estate and personal property appraising; providing tax planning and preparation services; and, subject to certain limitations, providing securities brokerage services for customers. These activities may also be affected by federal legislation.

The Gramm-Leach-Bliley Act amended portions of the BHC Act to authorize bank holding companies, such as us, directly or through non-bank subsidiaries to engage in securities, insurance and other activities that are financial in nature or incidental to a financial activity. In order to undertake these activities, a bank holding company must become a financial holding company by submitting to the appropriate Federal Reserve Bank a declaration that the company elects to be a financial holding company and a certification that all of the depository institutions controlled by the company are well capitalized and well managed.

The Dodd-Frank Act. The Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act), which was signed into law in 2010, significantly changes the regulation of financial institutions and the financial services industry. The Dodd-Frank Act includes provisions affecting large and small financial institutions alike, including several provisions that will profoundly affect how community banks, thrifts, and small bank and thrift holding companies will be regulated in the future. Among other things, these provisions abolished the Office of Thrift Supervision and transferred its functions to the other federal banking agencies, relaxed rules regarding interstate branching, allowed financial institutions to pay interest on business checking accounts, and imposed new capital requirements on bank and thrift holding companies. The Dodd-Frank Act also includes several corporate governance provisions that apply to all public companies, not just financial institutions. These include provisions mandating certain disclosures regarding executive compensation and provisions addressing proxy access by shareholders. We have elected to be treated as a financial holding company.

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The Dodd-Frank Act contains numerous other provisions affecting financial institutions of all types, including some that may affect our business in substantial and unpredictable ways. We have incurred higher operating costs in complying with the Dodd-Frank Act, and we expect that these higher costs will continue for the foreseeable future. Our management continues to monitor the ongoing implementation of the Dodd-Frank Act and as new regulations are issued, will assess their effect on our business, financial condition and results of operations.

On February 3, 2017, President Donald J. Trump issued an executive order directing the Secretary of the Treasury to report, within 120 days, on whether current governmental rules and policies either promote or inhibit the Core Principles for Financial Regulation as defined in the executive order (the Executive Order). While the Executive Order did not specifically mention the Dodd-Frank Act, the President has also indicated that he intends to modify if not repeal major provisions of the Dodd-Frank Act, either by further executive order or through legislation. It is too early to predict what impact, if any, the Executive Order or any subsequent presidential or congressional action will have on the existing provisions of the Dodd-Frank Act.

See Item 1A, Risk Factors, for a more extensive discussion of this topic.

The Volcker Rule. The Dodd-Frank Act prohibits banks and their affiliates from engaging in proprietary trading and from investing and sponsoring hedge funds and private equity funds. The statutory provision implementing these restrictions is commonly called the Volcker Rule. To implement the Volcker Rule, federal regulators issued final rules in December 2013 that were to become effective April 2014. The Federal Reserve subsequently issued an order extending the period that institutions have to conform their activities to the requirements of the Volcker Rule to July 21, 2015, and extended the compliance date for banks to conform their investments in certain legacy covered funds until July 21, 2016. These final rules exempt the Bank, as a bank with less than $10 billion in total consolidated assets that does not engage in any covered activities other than trading in certain government, agency, state or municipal obligations, from any significant compliance obligations under the Volcker Rule; therefore, the Volcker Rule will not have a material effect on our business, financial condition and results of operations. It is too early to predict whether President Trump s Executive Order or any subsequent presidential or congressional action will result in a modification, or even the repeal, of the Volcker Rule.

Depository Institution Regulation. The Bank is subject to regulation by the FDIC. This regulatory structure includes:

- Real estate lending standards, which provide guidelines concerning loan-to-value ratios for various types of real estate loans;
- Risk-based capital rules, including accounting for interest rate risk, concentration of credit risk and the risks posed by non-traditional activities;
- Rules requiring depository institutions to develop and implement internal procedures to evaluate and control credit and settlement exposure to their correspondent banks;
- Rules restricting types and amounts of equity investments; and

Rules addressing various safety and soundness issues, including operations and managerial standards, standards for asset quality, earnings and compensation standards.

Capital Requirements. The Company and the Bank are each required to comply with applicable capital adequacy standards established by the Federal Reserve. The current risk-based capital standards applicable to the Company and the Bank, parts of which are currently in the process of being phased in, are based on the final capital framework for strengthening international capital standards, known as Basel III, of the Basel Committee.

Prior to January 1, 2015, the risk-based capital standards applicable to the Company and the Bank (the general risk-based capital rules) were based on the 1988 Capital Accord, known as Basel I, of the Basel Committee. In July 2013, the federal bank regulators approved the final Basel III Rules implementing the Basel III framework as well as certain provisions of the Dodd-Frank Act. The Basel III Rules substantially revised the risk-based capital requirements applicable to BHCs and their depository institution subsidiaries, including the Company and the Bank, as compared to the general risk-based capital rules. The Basel III Rules became effective for the Company and the Bank on January 1, 2015 (subject to a phase-in period for certain provisions).

The Basel III Rules, among other things, (i) introduce a new capital measure called CET1, which consists primarily of retained earnings and common stock, (ii) specify that Tier 1 capital consists of CET1 and Additional Tier 1 capital instruments, such as preferred stock and certain convertible securities, meeting certain revised requirements, (iii) define CET1 narrowly by requiring that most deductions/adjustments to regulatory capital measures be made to CET1 and not to the other components of capital, and (iv) expand the scope of the deductions/adjustments to capital as compared to existing regulations.

Under the Basel III Rules, the minimum capital ratios effective as of January 1, 2015 are:

4.5% CET1 to risk-weighted assets;

6.0% Tier 1 capital (that is, CET1 plus Additional Tier 1 capital) to risk-weighted assets; and

8.0% Total capital (that is, Tier 1 capital plus Tier 2 capital) to risk-weighted assets.

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The Basel III Rules also introduce a new capital conservation buffer designed to absorb losses during periods of economic stress. The capital conservation buffer is an amount in addition to these minimum risk-based capital ratio requirements. The Basel III Rules also provide for a countercyclical capital buffer applicable only to certain covered institutions. We do not expect the countercyclical capital buffer to be applicable to the Company or the Bank. Banking institutions that do not hold capital above the required minimum levels, including the capital conservation buffer, will face constraints on dividends and compensation based on the amount of the shortfall.

When fully phased in on January 1, 2019, the Basel III Rules will require the Company and the Bank to maintain an additional capital conservation buffer of 2.5% of risk-weighted assets, effectively resulting in minimum ratios of (i) CET1 to risk-weighted assets of at least 7%, (ii) Tier 1 capital to risk-weighted assets of at least 8.5%, and (iii) Total capital to risk-weighted assets of at least 10.5%.

The Basel III Rules also provide for a number of deductions from and adjustments to CET1. These include, for example, the requirement that MSRs, certain deferred tax assets and significant investments in non-consolidated financial entities be deducted from CET1 to the extent that any one such category exceeds 10% of CET1 or all such items, in the aggregate, exceed 15% of CET1.

Implementation of the deductions and other adjustments to CET1 began on January 1, 2015 and will be phased in over a 4-year period (beginning at 40% on January 1, 2015 and an additional 20% per year thereafter). The implementation of the capital conservation buffer began on January 1, 2016 at the 0.625% level and will be phased in over a 4-year period (increasing by that amount on each subsequent January 1, until it reaches 2.5% on January 1, 2019).

The Basel III Rules prescribe a new standardized approach for risk weightings that expands the risk-weighting categories from the four Basel I-derived categories (0%, 20%, 50% and 100%) to a much larger and more risk-sensitive number of categories, depending on the nature of the assets, generally ranging from 0% for U.S. government and agency securities, to 600% for certain equity exposures, and resulting in higher risk weights for a variety of asset classes.

Leverage Requirements. BHCs and banks are also required to comply with minimum leverage ratio requirements. These requirements provide for a minimum ratio of Tier 1 capital to total consolidated quarterly average assets (as defined for regulatory purposes), net of the loan loss reserve, goodwill and certain other intangible assets (the leverage ratio), of 4.0%.

Liquidity Regulation. During 2014, the U.S. banking agencies adopted final rules implementing one of the two new standards provided for in the Basel III liquidity framework - its liquidity coverage ratio (LCR), which is designed to ensure that a bank maintains an adequate level of unencumbered high quality liquid assets equal to the bank s expected net cash outflows for a thirty-day time horizon under an acute liquidity stress scenario. The rules as adopted apply in their most comprehensive form only to advanced approaches bank holding companies and depository institution subsidiaries of such bank holding companies and, in a modified form, to banking organizations having $50 billion or more in total consolidated assets. Accordingly they do not apply to either the Company or the Bank. As a result, we do not manage our balance sheet to be compliant with these rules.

The Basel III framework also included a second standard, referred to as the net stable funding ratio (NSFR), which is designed to promote more medium-and long-term funding of the assets and activities of banks over a one-year time horizon. Although the Basel Committee finalized its formulation of the NSFR in 2014, the U.S. banking agencies have not yet proposed an NSFR for application to U.S. banking organizations or addressed the scope of banking organizations to which it will apply. The Basel Committee s final NSFR document states that the NSFR applies to internationally active banks, as did its final LCR document as to that ratio.

Prompt Corrective Action. The Federal Deposit Insurance Act, as amended (FDIA), requires among other things, the federal banking agencies to take prompt corrective action in respect of depository institutions that do not meet minimum capital requirements. The FDIA establishes five capital categories for FDIC-insured banks: well capitalized, adequately capitalized, under-capitalized, significantly under-capitalized and critically under-capitalized. Under rules in effect through December 31, 2014, a depository institution is deemed to be well-capitalized if the institution has a total risk-based capital ratio of 10.0% or greater, a Tier 1 risk-based capital ratio of 6.0% or greater, and a leverage ratio of 5.0% or greater, and the institution is not subject to an order, written agreement, capital directive or prompt corrective action directive to meet and maintain a specific level for any capital measure. As of January 1, 2015, the standards for well-capitalized status under prompt corrective action regulations changed by, among other things, introducing a CET 1 ratio requirement of 6.5% and increasing the Tier 1 risk-based capital ratio requirement from 6.0% to 8.0%. The total risk-based capital ratio and Tier 1 leverage ratio requirements remain at 10.0% and 5.0%, respectively.

The FDIA imposes progressively more restrictive constraints on operations, management and capital distributions, depending on the capital category in which an institution is classified. The current capital rule established by the federal bank regulators, discussed above under Capital Requirements, amend the prompt corrective action requirements in certain respects, including adding a CET1 risk-based capital ratio as one of the metrics (with a minimum 6.5% ratio for well-capitalized status) and increasing the Tier 1 risk-based capital ratio required for each of the five capital categories, including an increase from 6.0% to 8.0% to be well-capitalized.

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For further information regarding the capital ratios and leverage ratio of the Company and the Bank see the section titled Capital Resources in Part II, Item 7, Management s Discussion and Analysis of Financial Condition and Results of Operations, included in this Annual Report on Form 10-K. The current requirements and the actual levels for the Company and the Bank are detailed in Note 11, Regulatory Matters, of the notes to consolidated financial statements, included in this Annual Report on Form 10-K.

Dividends. The FRB policy is that a bank holding company should pay cash dividends only to the extent that its net income for the past year is sufficient to cover both the cash dividends and a rate of earnings retention that is consistent with the holding company s capital needs, asset quality and overall financial condition, and that it is inappropriate for a bank holding company experiencing serious financial problems to borrow funds to pay dividends. Furthermore, a bank that is classified under the prompt corrective action regulations as undercapitalized will be prohibited from paying any dividends.

The primary source of cash for dividends we pay is the dividends we receive from the Bank. The Bank is subject to various regulatory policies and requirements relating to the payment of dividends, including requirements to maintain capital above regulatory minimums. Approval of the New York State Department of Financial Services is required prior to paying a dividend if the dividend declared by the Bank exceeds the sum of the Bank s net profits for that year and its retained net profits for the preceding two calendar years. At January 1, 2017, the Bank could declare dividends of $33.1 million from retained net profits of the preceding two years. The bank declared dividends of $16.0 million in 2016 and $16.0 million in 2015.

Federal Deposit Insurance Assessments. The Bank is a member of the FDIC and pays an insurance premium to the FDIC based upon its assessable assets on a quarterly basis. Deposits are insured up to applicable limits by the FDIC and such insurance is backed by the full faith and credit of the United States Government.

Under the Dodd-Frank Act, a permanent increase in deposit insurance was authorized to $250,000. The coverage limit is per depositor, per insured depository institution for each account ownership category.

The Dodd-Frank Act also set a new minimum Deposit Insurance Fund (DIF) reserve ratio at 1.35% of estimated insured deposits. The FDIC is required to attain this ratio by September 30, 2020. The Dodd-Frank Act also required the FDIC to define the deposit insurance assessment base for an insured depository institution as an amount equal to the institution s average consolidated total assets during the assessment period minus average tangible equity. Premiums for the Bank are now calculated based upon the average balance of total assets minus average tangible equity as of the close of business for each day during the calendar quarter.

The FDIC has the flexibility to adopt actual rates that are higher or lower than the total base assessment rates adopted without notice and comment, if certain conditions are met.

DIF-insured institutions pay a Financing Corporation (FICO) assessment in order to fund the interest on bonds issued in the 1980s in connection with the failures in the thrift industry. For the fourth quarter of 2016, the FICO assessment was equal to 0.56 basis points computed on assets as required by the Dodd-Frank Act. These assessments will continue until the bonds mature in 2019.

The FDIC is authorized to conduct examinations of and require reporting by FDIC-insured institutions. It is also authorized to terminate a depository bank s deposit insurance upon a finding by the FDIC that the bank s financial condition is unsafe or unsound or that the institution has engaged in unsafe or unsound practices or has violated any applicable rule, regulation, order or condition enacted or imposed by the bank s regulatory agency. The termination of deposit insurance for the Bank would have a material adverse effect on our earnings, operations and financial condition.

Consumer Laws and Regulations. In addition to the laws and regulations discussed herein, the Bank is also subject to certain consumer laws and regulations that are designed to protect consumers in transactions with banks. While the list set forth herein is not exhaustive, these laws and regulations include, among others, the Fair Credit Reporting Act, the Truth in Lending Act, the Truth in Savings Act, the Electronic Funds Transfer Act, the Expedited Funds Availability Act, the Equal Credit Opportunity Act, the Fair Housing Act, the Home Mortgage Disclosure Act, the Real Estate Settlement Procedures Act, the Fair Debt Collection Practices Act, the Service Members Civil Relief Act and these laws respective state-law counterparts, as well as state usury laws and laws regarding unfair and deceptive acts and practices. These and other federal laws, among other things, require disclosures of the cost of credit and terms of deposit accounts, provide substantive consumer rights, prohibit discrimination in credit transactions, regulate the use of credit report information, provide financial privacy protections, prohibit unfair, deceptive and abusive practices, restrict the Company s ability to raise interest rates and subject the Company to substantial regulatory oversight. Violations of applicable consumer protection laws can result in significant potential liability from litigation brought by customers, including actual damages, restitution and attorneys fees. Federal bank regulators, state attorneys general and state and local consumer protection agencies may also seek to enforce consumer protection requirements and obtain these and other remedies, including regulatory sanctions, customer rescission rights, action by the state and local attorneys general in each jurisdiction in which we operate and civil money penalties. Failure to comply with consumer protection requirements may also result in our failure to obtain any required bank regulatory approval for merger or acquisition transactions the Company may wish to pursue or our prohibition from engaging in such transactions even if approval is not required.

The Dodd-Frank Act centralized responsibility for consumer financial protection by creating a new agency, the Consumer Financial Protection Bureau (CFPB), and giving it responsibility for implementing, examining and enforcing compliance with federal consumer protection laws. The CFPB focuses on:

Risks to consumers and compliance with the federal consumer financial laws, when it evaluates the policies and practices of a financial institution.

The markets in which firms operate and risks to consumers posed by activities in those markets.

Depository institutions that offer a wide variety of consumer financial products and services; depository institutions with a more specialized focus.

Non-depository companies that offer one or more consumer financial products or services.

The CFPB has broad rulemaking authority for a wide range of consumer financial laws that apply to all banks, including, among other things, the authority to prohibit unfair, deceptive or abusive acts and practices. Abusive acts or practices are defined as those that materially interfere with a consumer s ability to understand a term or condition of a consumer financial product or service or take unreasonable advantage of a consumer s (i) lack of financial savvy, (ii) inability to protect himself in the selection or use of consumer financial products or services, or (iii) reasonable reliance on a covered entity to act in the consumer s interests. The CFPB can issue cease-and-desist orders against banks and other entities that violate consumer financial laws. The CFPB may also institute a civil action against an entity in violation of federal consumer financial law in order to impose a civil penalty or injunction. The CFPB has examination and enforcement authority over all banks with more than $10 billion in assets, as well as their affiliates. It is too early to predict whether President Trump s Executive Order or any subsequent presidential or congressional action will result in a modification of the authority granted to the CFPB by the Dodd-Frank Act or even in the abolishment of the CFPB altogether.

Banking regulators take into account compliance with consumer protection laws when considering approval of a proposed transaction.

Community Reinvestment Act. Under the Community Reinvestment Act, every FDIC-insured institution is obligated, consistent with safe and sound banking practices, to help meet the credit needs of its entire community, including low and moderate income neighborhoods. The Community Reinvestment Act requires the appropriate federal banking regulator, in connection with the examination of an insured institution, to assess the institution s record of meeting the credit needs of its community and to consider this record in its evaluation of certain applications, such as a merger or the establishment of a branch. An unsatisfactory rating may be used as the basis for the denial of an application and will prevent a bank holding company of the institution from making an election to become a financial holding company.

During January 2015 we signed an Assurance of Discontinuance with the NYS Attorney General s office related to an investigation into lending practices for minority residents within the City of Rochester. As part of the agreement, we paid NYS $150 thousand to cover its costs. An additional $750 thousand in dedicated funds spread over three-years has been earmarked for ongoing business efforts consistent with the Bank s growth initiatives in the Rochester market, and throughout Monroe County, including efforts focused on marketing to minority communities, as well as lending discounts and/or subsidies.

Examinations in 2011 by the New York Department of Financial Services and the Federal Reserve Bank of New York under the federal Community Reinvestment Act rated Five Star as outstanding .

Privacy Rules. Federal banking regulators, as required under the Gramm-Leach-Bliley Act, have adopted rules limiting the ability of banks and other financial institutions to disclose nonpublic information about consumers to non-affiliated third parties. The rules require disclosure of privacy policies to consumers and, in some circumstances, allow consumers to prevent disclosure of certain personal information to non-affiliated third parties. The privacy provisions of the Gramm-Leach-Bliley Act affect how consumer information is transmitted through diversified financial services companies and conveyed to outside vendors.

Anti-Money Laundering and the USA Patriot Act. A major focus of governmental policy on financial institutions in recent years has been aimed at combating money laundering and terrorist financing. The USA PATRIOT Act of 2001, or the USA Patriot Act, substantially broadened the scope of United States anti-money laundering laws and regulations by imposing significant new compliance and due diligence obligations, creating new crimes and penalties and expanding the extra-territorial jurisdiction of the United States. Financial institutions are also prohibited from entering into specified financial transactions and account relationships and must use enhanced due diligence procedures in their dealings with certain types of high-risk customers and implement a written customer identification program. Financial institutions must take certain steps to assist government agencies in detecting and preventing money laundering and report certain types of suspicious transactions. Regulatory authorities routinely examine financial institutions for compliance with these obligations, and failure of a financial institution to maintain and implement adequate programs to combat money laundering and terrorist financing, or to comply with all of the relevant laws or regulations, could have serious legal and reputational consequences for the institution, including causing applicable bank regulatory authorities not to approve merger or acquisition transactions when regulatory approval is required or to prohibit such transactions even if approval is not required. Regulatory authorities have imposed cease and desist orders and civil money penalties against institutions found to be violating these obligations.

Interstate Branching. Pursuant to the Dodd-Frank Act, national and state-chartered banks may open an initial branch in a state other than its home state (e.g., a host state) by establishing a de novo branch at any location in such host state at which a bank chartered in such host state could establish a branch. Applications to establish such branches must still be filed with the appropriate primary federal regulator. It is too early to predict whether President Trump s Executive Order or any subsequent presidential or congressional action will result in any change to a bank s ability to establish a de novo branch in a host state.

Transactions with Affiliates. FII, FSB, Five Star REIT, SDN and Courier Capital are affiliates within the meaning of the Federal Reserve Act. The Federal Reserve Act imposes limitations on a bank with respect to extensions of credit to, investments in, and certain other transactions with, its parent bank holding company and the holding company s other subsidiaries. Furthermore, bank loans and extensions of credit to affiliates also are subject to various collateral requirements.

Various governmental requirements, including Sections 23A and 23B of the Federal Reserve Act and the FRB s Regulation W, limit borrowings by FII and its nonbank subsidiaries from FSB, and also limit various other transactions between FII and its nonbank subsidiaries, on the one hand, and FSB, on the other. For example, Section 23A of the Federal Reserve Act limits the aggregate outstanding amount of any insured depository institution s loans and other covered transactions with any particular nonbank affiliate to no more than 10% of the institution s total capital and limits the aggregate outstanding amount of any insured depository institution s covered transactions with all of its nonbank affiliates to no more than 20% of its total capital. Covered transactions are defined by statute to include a loan or extension of credit, as well as a purchase of securities issued by an affiliate, a purchase of assets (unless otherwise exempted by the FRB) from the affiliate, the acceptance of securities issued by the affiliate as collateral for a loan, and the issuance of a guarantee, acceptance or letter of credit on behalf of an affiliate. Section 23A of the Federal Reserve Act also generally requires that an insured depository institution s loans to its nonbank affiliates be, at a minimum, 100% secured, and Section 23B of the Federal Reserve Act generally requires that an insured depository institution s transactions with its nonbank affiliates be on terms and under circumstances that are substantially the same or at least as favorable as those prevailing for comparable transactions with non-affiliates. The Dodd-Frank Act significantly expanded the coverage and scope of the limitations on affiliate transactions within a banking organization. For example, commencing in July 2012, the Dodd-Frank Act applies the 10% of capital limit on covered transactions to financial subsidiaries and amends the definition of covered transaction to include (i) securities borrowing or lending transactions with an affiliate, and (ii) all derivatives transactions with an affiliate, to the extent that either causes a bank or its affiliate to have credit exposure to the securities borrowing/lending or derivative counterparty. It is too early to predict whether President Trump s Executive Order or any subsequent presidential or congressional action will result in any changes to, or the repeal of, the limitations imposed on affiliate transactions by the Dodd-Frank Act.

Office of Foreign Assets Control Regulation. The U.S. Treasury Department s Office of Foreign Assets Control, or OFAC, administers and enforces economic and trade sanctions against targeted foreign countries and regimes, under authority of various laws, including designated foreign countries, nationals and others. OFAC publishes lists of specially designated targets and countries. The Company is responsible for, among other things, blocking accounts of, and transactions with, such targets and countries, prohibiting unlicensed trade and financial transactions with them and reporting blocked transactions after their occurrence. Failure to comply with these sanctions could have serious legal and reputational consequences, including causing applicable bank regulatory authorities not to approve merger or acquisition transactions when regulatory approval is required or to prohibit such transactions even if approval is not required.

Insurance Regulation. SDN is required to be licensed or receive regulatory approval in nearly every state in which it does business. In addition, most jurisdictions require individuals who engage in brokerage and certain other insurance service activities to be personally licensed. These licensing laws and regulations vary from jurisdiction to jurisdiction. In most jurisdictions, licensing laws and regulations generally grant broad discretion to supervisory authorities to adopt and amend regulations and to supervise regulated activities.

Investment Advisory Regulation. Courier Capital is a provider of investment consulting and financial planning services and, as such, is considered an investment adviser under the U.S. Investment Advisers Act of 1940, as amended (the Advisers Act). An investment adviser is any person or entity that provides advice to others, or that issues reports or analyses, regarding securities for compensation. While a BHC is generally excluded from regulation under the Advisers Act, the SEC has stated that this exclusion does not apply to investment adviser subsidiaries of BHCs, such as Courier Capital. Since Courier Capital has over $100 million in assets under management it is considered a large advisor, which requires registration with the SEC by filing Form ADV and updating it at least once each year, and more frequently under certain specified circumstances. This registration covers Courier Capital and its employees as well as other persons under its control and supervision, such as independent contractors, provided that their activities are undertaken on behalf of Courier Capital.

In addition to these registration requirements, the Advisers Act contains numerous other provisions that impose obligations on investment advisors. For example, Section 206 includes anti-fraud provisions that courts have interpreted as establishing fiduciary duties extending to all services undertaken on behalf of the client. These duties include, but are not limited to, the disclosure of all material facts to clients, providing only suitable investment advice, and seeking best price execution of trades. Section 206 also has specific rules relating to, among other things, advertising, safeguarding client assets, the engagement of third-parties, the duty to

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supervise persons acting on the investment adviser s behalf, and the establishment of an effective internal compliance program and a code of ethics.

Courier Capital is subject to each of these obligations and, as applicable, restrictions, and is also subject to examination by the SEC s Office of Compliance, Investigations, and Examinations to assess its overall compliance with the Advisers Act and the effectiveness of its internal controls.

Prior to our acquisition of Courier Capital in January 2016, the Bank had provided investment advisory and broker-dealer services to its customers through its subsidiary Five Star Investment Services, Inc. Commencing in October 2013, the Bank entered into a partnership with LPL Financial, one of the nation s largest independent financial services companies (LPL), to provide investment advisory and broker-dealer services to its customers through LPL. This partnership continues and the Bank employs wealth advisors, who are licensed by LPL, to provide investment advisory and broker-dealer services to the Bank s customers. LPL is an investment adviser registered under the Advisers Act and subject to its provisions.

Incentive Compensation. Our compensation practices are subject to oversight by the Federal Reserve. In June 2010, the Federal banking agencies issued comprehensive final guidance on incentive compensation policies intended to ensure that the incentive compensation policies of banking organizations do not undermine the safety and soundness of such organizations by encouraging excessive risk-taking. The guidance, which covers all employees that have the ability to materially affect the risk profile of an organization, either individually or as part of a group, is based upon the key principles that a banking organization s incentive compensation arrangements should (i) provide incentives that do not encourage risk-taking beyond the organization s ability to effectively identify and manage risks, (ii) be compatible with effective internal controls and risk management, and (iii) be supported by strong corporate governance, including active and effective oversight by the organization s board of directors.

The Dodd-Frank Act requires the federal banking agencies to establish joint regulations or guidelines prohibiting incentive-based payment arrangements at specified regulated entities having at least $1 billion in total consolidated assets (which would include the Company and the Bank) that encourage inappropriate risks by providing an executive officer, employee, director or principal shareholder with excessive compensation, fees or benefits or that could lead to material financial loss to the entity. In addition, the agencies must establish regulations or guidelines requiring enhanced disclosure to regulators of incentive-based compensation arrangements. The initial version of these regulations was proposed by agencies in early 2011 but the regulations have not yet been finalized. The proposed regulations include the three key principles from the June 2010 regulatory guidance discussed above. If the regulations are adopted in the form initially proposed, they will impose limitations on the manner in which we may structure compensation for our executives. It is too early to predict whether President Trump s Executive Order or any subsequent presidential or congressional action will result in any reconsideration, up to and including withdrawal, of these proposed regulations.

The FRB will review, as part of the regular, risk-focused examination process, the incentive compensation arrangements of banking organizations, such as the Company, that are not large, complex banking organizations. These reviews will be tailored to each organization based on the scope and complexity of the organization s activities and the prevalence of incentive compensation arrangements. The findings of the supervisory initiatives will be included in reports of examination. Deficiencies will be incorporated into the organization s supervisory ratings, which can affect the organization s ability to make acquisitions and take other actions. Enforcement actions may be taken against a banking organization if its incentive compensation arrangements, or related risk-management control or governance processes, pose a risk to the organization s safety and soundness and the organization is not taking prompt and effective measures to correct the deficiencies.

Other Future Legislation and Changes in Regulations. In addition to the specific proposals described above, from time to time, various legislative and regulatory initiatives are introduced in Congress and state legislatures, as well as by regulatory agencies. Such initiatives may include proposals to expand or contract the powers of bank holding companies and depository institutions or proposals to substantially change the financial institution regulatory system. Such legislation could change banking statutes and/or our operating environment in substantial and unpredictable ways. If enacted, such legislation could increase or decrease the cost of doing business, limit or expand permissible activities or affect the competitive balance among banks, savings associations, credit unions, and other financial institutions. We cannot predict whether any such legislation will be enacted, and, if enacted, the effect that it, or any implementing regulations, would have on our financial condition or results of operations. A change in statutes, regulations or regulatory policies applicable to us or our subsidiaries could have a material effect on our business.

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Impact of Inflation and Changing Prices

Our financial statements included herein have been prepared in accordance with GAAP, which requires us to measure financial position and operating results principally using historic dollars. Changes in the relative value of money due to inflation or recession are generally not considered. The primary effect of inflation on our operations is reflected in increased operating costs. We believe changes in interest rates affect the financial condition of a financial institution to a far greater degree than changes in the inflation rate. While interest rates are generally influenced by changes in the inflation rate, they do not necessarily change at the same rate or in the same magnitude. Interest rates are sensitive to many factors that are beyond our control, including changes in the expected rate of inflation, general and local economic conditions and the monetary and fiscal policies of the United States government, its agencies and various other governmental regulatory authorities.

Regulatory and Economic Policies

Our business and earnings are affected by general and local economic conditions and by the monetary and fiscal policies of the U.S. government, its agencies and various other governmental regulatory authorities. The FRB regulates the supply of money in order to influence general economic conditions. Among the instruments of monetary policy available to the FRB are (i) conducting open market operations in U.S. government obligations, (ii) changing the discount rate on financial institution borrowings, (iii) imposing or changing reserve requirements against financial institution deposits, and (iv) restricting certain borrowings and imposing or changing reserve requirements against certain borrowings by financial institutions and their affiliates. These methods are used in varying degrees and combinations to directly affect the availability of bank loans and deposits, as well as the interest rates charged on loans and paid on deposits. For that reason, the policies of the FRB could have a material effect on our earnings.

EMPLOYEES

At December 31, 2016, we had 654 employees, none of whom are subject to a collective bargaining agreement. Management believes our relations with employees are good.

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ITEM 1A. RISK FACTORS

An investment in our common stock is subject to risks inherent to our business. The material risks and uncertainties that management believes could affect us are described below. Before making an investment decision, you should carefully consider the risks and uncertainties described below, together with all of the other information included or incorporated by reference herein. This Annual Report on Form 10-K is qualified in its entirety by these risk factors. Further, to the extent that any of the information contained in this Annual Report on Form 10-K constitutes forward-looking statements, the risk factors set forth below also are cautionary statements identifying important factors that could cause our actual results to differ materially from those expressed in any forward-looking statements made by or on behalf of us.

If any of the following risks actually occur, our financial condition and results of operations could be materially and adversely affected. If this were to happen, the value of our common stock could decline significantly, and you could lose all or part of your investment.

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

As a lender, we are exposed to the risk that customers will be unable to repay their loans according to their terms and that any collateral securing the payment of their loans may not be sufficient to assure repayment. Credit losses are inherent in the business of making loans and could have a material adverse impact on our results of operations.

We make various assumptions and judgments about the collectability of our loan portfolio, including the creditworthiness of our borrowers and the value of the real estate and other assets serving as collateral, and we provide an allowance for estimated loan losses based on a number of factors. We believe that the allowance for loan losses is adequate. However, if our assumptions or judgments are wrong, the allowance for loan losses may not be sufficient to cover the actual credit losses. We may have to increase the allowance in the future in response to the request of one of our primary banking regulators, to adjust for changing conditions and assumptions, or as a result of any deterioration in the quality of our loan portfolio. The actual amount of future provisions for credit losses may vary from the amount of past provisions.

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

Our tax strategies are dependent upon our ability to generate taxable income in future periods. Our tax strategies will be less effective in the event we fail to generate taxable income. Our deferred tax assets are subject to an evaluation of whether it is more likely than not that they will be realized for financial statement purposes. In making this determination, we consider all positive and negative evidence available including the impact of recent operating results as well as potential carryback of tax to prior years taxable income, reversals of existing taxable temporary differences, tax planning strategies and projected earnings within the statutory tax loss carryover period. If we were to conclude that a significant portion of our deferred tax assets were not more likely than not to be realized, the required valuation allowance could adversely affect our financial position, results of operations and regulatory capital ratios. In addition, the value of our deferred tax assets could be adversely affected by a change in statutory tax rates.

Geographic concentration may unfavorably impact our operations.

Substantially all of our business and operations are concentrated in the Western and Central New York region. As a result of this geographic concentration, our results depend largely on economic conditions in these and surrounding areas. Deterioration in economic conditions in our market could:

- increase loan delinquencies;
- increase problem assets and foreclosures;
- increase claims and lawsuits;
- decrease the demand for our products and services; and
- decrease the value of collateral for loans, especially real estate, in turn reducing customers borrowing power, the value of assets associated with non-performing loans and collateral coverage.

Generally, we make loans to small to mid-sized businesses whose success depends on the regional economy. These businesses generally have fewer financial resources in terms of capital or borrowing capacity than larger entities. Adverse economic and business conditions in our market areas could reduce our growth rate, affect our borrowers ability to repay their loans and, consequently, adversely affect our business, financial condition and performance. For example, we place substantial reliance on real estate as collateral for our loan portfolio. A sharp downturn in real estate values in our market area could leave many of these loans inadequately collateralized. If we are required to liquidate the collateral securing a loan to satisfy the debt during a period of reduced real estate values, the impact on our results of operations could be materially adverse.

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

In deciding whether to extend credit or enter into other transactions, we may rely on information furnished by or on behalf of customers and counterparties, including financial statements, credit reports, and other financial information. We may also rely on representations of those customers, counterparties, or other third parties, such as independent auditors, as to the accuracy and completeness of that information. Reliance on inaccurate or misleading financial statements, credit reports, or other financial information could cause us to enter into unfavorable transactions, which could have a material adverse effect on our financial condition and results of operations.

Our insurance brokerage subsidiary, SDN, is subject to risks related to the insurance industry.

SDN derives the bulk of its revenue from commissions and fees earned from brokerage services. SDN does not determine the insurance premiums on which its commissions are based. Insurance premiums are cyclical in nature and may vary widely based on market conditions. As a result, insurance brokerage revenues and profitability can be volatile. As insurance companies outsource the production of premium revenue to non-affiliated brokers or agents such as SDN, those insurance companies may seek to further minimize their expenses by reducing the commission rates payable to insurance agents or brokers, which could adversely affect SDN s revenues. In addition, there have been and may continue to be various trends in the insurance industry toward alternative insurance markets including, among other things, increased use of self-insurance, captives, and risk retention groups. While SDN has been able to participate in certain of these activities and earn fees for such services, there can be no assurance that we will realize revenues and profitability as favorable as those realized from our traditional brokerage activities.

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 change. The activities of our investment advisory and wealth management operations are subject primarily to provisions of the Advisers Act 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 the percentage of 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.

We may be unable to successfully implement our growth strategies.

Our current growth strategy is multi-faceted. We seek to expand our branch network into nearby areas, make strategic acquisitions of loans, portfolios, other regional banks and non-banking firms whose businesses we feel may be complementary with ours, and to continue to organically grow our core deposits. Any failure by us to effectively implement any one or more of these growth strategies could have several negative effects, including a possible decline in the size or the quality, or both, of our loan portfolio or a decrease in profitability caused by an increase in operating expenses.

In particular, we hope to continue an active merger and acquisition strategy. However, even if we use our common stock as the predominant form of consideration, we may need to raise capital in order to negotiate a transaction on terms acceptable to us and there can be no assurance that we will be able to raise a sufficient amount of capital to enable us to complete an acquisition. It is also possible that even with adequate capital we may still be unable to complete an acquisition on favorable terms, causing us to miss opportunities to increase our earnings and expand or diversify our operations.

Our growth strategy is also dependent upon the successful integration of new businesses, including the recently-acquired SDN and Courier Capital, as well as any future acquisitions, into our existing operations. While our senior management team has had extensive experience in acquisitions and post-acquisition integration, there is no guarantee that our current or future integration efforts will be successful, and if our senior management is forced to spend a disproportionate amount of time on integrating recently-acquired businesses, it may distract their attention from other growth opportunities.

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

A significant portion of our loan portfolio is secured by real property. During the ordinary course of business, we may foreclose on and take title to properties securing certain loans. There is a risk that hazardous or toxic substances could be found on properties we have foreclosed upon. If hazardous or toxic substances are found, we may be liable for remediation costs, as well as for personal injury and property damage regardless of whether we knew, had reason to know of, or caused the release of such substance. Environmental laws may require us to incur substantial expenses and may materially reduce the affected property s value or limit our ability to use or sell the affected property. In addition, future laws or more stringent interpretations or enforcement policies with respect to existing laws may increase our exposure to environmental liability. The remediation costs and any other financial liabilities associated with an environmental hazard could have a material adverse effect on our financial condition and results of operations.

Commercial business and mortgage loans increase our exposure to credit risks.

At December 31, 2016, our portfolio of commercial business and mortgage loans totaled $1,019.6 million, or 43.5% of total loans. We plan to continue to emphasize the origination of these types of loans, which generally expose us to a greater risk of nonpayment and loss than residential real estate or consumer loans because repayment of such loans often depends on the successful operations and income stream of the borrowers. Additionally, such loans typically involve larger loan balances to single borrowers or groups of related borrowers compared to consumer loans or residential real estate loans. A sudden downturn in the economy could result in borrowers being unable to repay their loans, thus exposing us to increased credit risk.

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

A portion of our current lending involves the purchase of consumer automobile installment sales contracts from automobile dealers located in Western, Central and the Capital District of New York, and Northern and Central Pennsylvania. These loans are for the purchase of new or used automobiles. We serve customers that cover a range of creditworthiness, and the required terms and rates are reflective of those risk profiles. While these loans have higher yields than many of our other loans, such loans involve risk elements in addition to normal credit risk. Additional risk elements associated with indirect lending include the limited personal contact with the borrower as a result of indirect lending through non-bank channels, namely automobile dealers. While indirect automobile loans are secured, such loans are secured by depreciating assets and characterized by loan-to-value ratios that could result in us not recovering the full value of an outstanding loan upon default by the borrower. If the losses from our indirect loan portfolio are higher than anticipated, that could have a material adverse effect on our financial condition and results of operations.

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

At December 31, 2016, we had $2.3 billion of deposit liabilities that have no maturity and, therefore, may be withdrawn by the depositor at any time. These deposit liabilities include our checking, savings, and money market deposit accounts.

Market conditions may impact the competitive landscape for deposits in the banking industry. The unprecedented low rate environment and future actions the Federal Reserve may take may impact pricing and demand for deposits in the banking industry. The withdrawal of more deposits than we anticipate could have an adverse impact on our profitability as this source of funding, if not replaced by similar deposit funding, would need to be replaced with wholesale funding, the sale of interest earning assets, or a combination of these two actions. The replacement of deposit funding with wholesale funding could cause our overall cost of funding to increase, which would reduce our net interest income. A loss of interest earning assets could also reduce our net interest income.

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

The amount that is assessed by the FDIC for deposit insurance is set by the FDIC based on a variety of factors. These include the depositor insurance fund s reserve ratio, the Bank s assessment base, which is equal to average consolidated total assets minus average tangible equity, and various inputs into the FDIC s assessment rate calculation.

If there are additional financial institution failures we may be required to pay even higher FDIC premiums than the recently increased levels. Such increases or required prepayments of FDIC insurance premiums may adversely impact our earnings. See Part I, Item 1 Business, Supervision and Regulation-Federal Deposit Insurance Assessments for more information about FDIC insurance premiums.

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

We are subject to extensive supervision, regulation and examination. This regulatory structure gives the regulatory authorities extensive discretion in connection with their supervisory and enforcement activities and examination policies to address not only compliance with applicable laws and regulations (including laws and regulations governing consumer credit, fair lending, and anti-money laundering and anti-terrorism laws), but also capital adequacy, asset quality and risk, management ability and performance, earnings, liquidity, and various other factors. As part of this regulatory structure, we are subject to policies and other guidance developed by the regulatory agencies with respect to capital levels, the timing and amount of dividend payments, the classification of assets and the establishment of adequate loan loss reserves for regulatory purposes. Under this structure the regulatory agencies have broad discretion to impose restrictions and limitations on our operations if they determine, among other things, that our operations are unsafe or unsound, fail to comply with applicable law or are otherwise inconsistent with laws and regulations or with the supervisory policies of these agencies.

This supervisory framework could materially impact the conduct, growth and profitability of our operations. Any failure on our part to comply with current laws, regulations, other regulatory requirements or safe and sound banking practices or concerns about our financial condition, or any related regulatory sanctions or adverse actions against us, could increase our costs or restrict our ability to expand our business and result in damage to our reputation.

We describe the significant federal and state banking regulations that affect us in the section captioned Supervision and Regulation included in Part I, Item 1, Business .

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

Accounting principles generally accepted in the United States, require us to use certain assumptions and estimates in preparing our financial statements, including in determining credit loss reserves and reserves related to litigation, among other items. Certain of our financial instruments, including available-for-sale securities and certain loans, require a determination of their fair value in order to prepare our financial statements. Where quoted market prices are not available, we may make fair value determinations based on internally developed models or other means, which ultimately rely to some degree on management judgment. Some of these and other assets and liabilities may have no direct observable price levels, making their valuation particularly subjective, as they are based on significant estimation and judgment. In addition, sudden illiquidity in markets or declines in prices of certain loans and securities may make it more difficult to value certain balance sheet items, which may lead to the possibility that such valuations will be subject to further change or adjustment. If assumptions or estimates underlying our financial statements are incorrect, we may experience material losses. These risks, along with the currently existing tax, accounting, securities, insurance, and monetary laws, regulations, rules, standards, policies, and interpretations control the methods by which financial institutions conduct business, implement strategic initiatives and tax compliance, and govern financial reporting and disclosures. These laws, regulations, rules, standards, policies, and interpretations are constantly evolving and may change significantly over time.

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

We have been, and may in the future be, subject to various legal and regulatory proceedings. It is inherently difficult to assess the outcome of these matters, and there can be no assurance that we will prevail in any proceeding or litigation. Legal and regulatory matters could result in substantial cost and diversion of our efforts, which by itself could have a material adverse effect on our financial condition and operating results. Further, adverse determinations in such matters could result in actions by our regulators that could materially adversely affect our business, financial condition or results of operations.

We establish reserves for legal claims when payments associated with the claims become probable and the costs can be reasonably estimated. We may still incur legal costs for a matter even if we have not established a reserve. In addition, due to the inherent subjectivity of the assessments and unpredictability of the outcome of legal proceedings, the actual cost of resolving a legal claim may be substantially higher than any amounts reserved for that matter. The ultimate resolution of a pending legal proceeding, depending on the remedy sought and granted, could adversely affect our results of operations and financial condition.

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 rely heavily on communications, information systems (both internal and provided by third parties) and the internet to conduct our business. Our business depends on our ability to process and monitor a large volume of daily transactions in compliance with legal, regulatory and internal standards and specifications. In addition, a significant portion of our operations relies heavily on the secure processing, storage and transmission of personal and confidential information, such as the personal information of our customers and clients. These risks may increase in the future as we continue to increase mobile payments and other internet-based product offerings and expand our internal usage of web-based products and applications.

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In addition, several U.S. financial institutions have experienced significant distributed denial-of-service attacks, some of which involved sophisticated and targeted attacks intended to disable or degrade service, or sabotage systems. Other potential attacks have attempted to obtain unauthorized access to confidential information or destroy data, often through the introduction of computer viruses or malware, cyber-attacks and other means. To date, none of these types of attacks have had a material effect on our business or operations. Such security attacks can originate from a wide variety of sources, including persons who are involved with organized crime or who may be linked to terrorist organizations or hostile foreign governments. Those same parties may also attempt to fraudulently induce employees, customers or other users of our systems to disclose sensitive information in order to gain access to our data or that of our customers or clients. We are also subject to the risk that our employees may intercept and transmit unauthorized confidential or proprietary information. An interception, misuse or mishandling of personal, confidential or proprietary information being sent to or received from a customer or third party could result in legal liability, remediation costs, regulatory action and reputational harm, any of which could adversely affect our results of operations and financial condition.

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

The financial services market, including banking services, faces rapid changes with frequent introductions of new technology-driven products and services. In addition to better serving customers, the effective use of technology increases efficiency and may enable us to reduce costs. Our future success may depend, in part, on our ability to use technology to provide products and services that provide convenience to customers and to create additional efficiencies in our operations. Some of our competitors have substantially greater resources to invest in technological improvements than we currently have. We may not be able to effectively implement new technology-driven products and services or be successful in marketing these products and services to our customers. As a result, our ability to effectively compete to retain or acquire new business may be impaired, and our business, financial condition or results of operations, may be adversely affected.

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

Third party vendors provide key components of our business infrastructure such as internet connections, network access and core application processing. While we have selected these third party vendors carefully, we do not control their actions. Any problems caused by these third parties, including as a result of them not providing us their services for any reason or them performing their services poorly, could adversely affect our ability to deliver products and services to our customers or otherwise conduct our business efficiently and effectively. Replacing these third party vendors could also entail significant delay and expense.

Third parties perform significant operational services on our behalf. These third-party vendors are subject to similar risks as us relating to cybersecurity, breakdowns or failures of their own systems or employees. One or more of our vendors may experience a cybersecurity event or operational disruption and, if any such event does occur, it may not be adequately addressed, either operationally or financially, by the third-party vendor. Certain of our vendors may have limited indemnification obligations or may not have the financial capacity to satisfy their indemnification obligations. Financial or operational difficulties of a vendor could also impair our operations if those difficulties interfere with the vendor s ability to serve us. If a critical vendor is unable to meet our needs in a timely manner or if the services or products provided by such a vendor are terminated or otherwise delayed and if we are not able to develop alternative sources for these services and products quickly and cost-effectively, it could have a material adverse effect on our business. Federal banking regulators recently issued regulatory guidance on how banks select, engage and manage their outside vendors. These regulations may affect the circumstances and conditions under which we work with third parties and the cost of managing such relationships.

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

We use financial models to aid in planning for various purposes including our capital and liquidity needs, interest rate risk, potential charge- offs, reserves, and other purposes. The models used may not accurately account for all variables that could affect future results, may fail to predict outcomes accurately and/or may overstate or understate certain effects. As a result of these potential failures, we may not adequately prepare for future events and may suffer losses or other setbacks due to these failures.

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

Our success depends, in large part, on our ability to attract and retain skilled people. Competition for highly talented people can be intense, and we may not be able to hire sufficiently skilled people or to retain them. Further, the rural location of our principal executive offices and many of our bank branches make it challenging for us to attract skilled people to such locations. The unexpected loss of services of one or more of our key personnel could have a material adverse impact on our business because of their skills, knowledge of our markets, years of industry experience, and the difficulty of promptly finding qualified replacement personnel.

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Acquisitions may disrupt our business and dilute shareholder value.

We intend to continue to pursue a growth strategy for our business by expanding our branch network into communities within or adjacent to markets where we currently conduct business. We may consider acquisitions of loans or securities portfolios, lending or leasing firms, commercial and small business lenders, residential lenders, direct banks, banks or bank branches, wealth and investment management firms, securities brokerage firms, specialty finance or other financial services-related companies. We also intend to expand our SDN and Courier subsidiaries by acquiring smaller insurance agencies and wealth management firms in areas which complement our current footprint. We may be unsuccessful in expanding our SDN and Courier subsidiaries through acquisition because of the growing interest in acquiring insurance brokers and wealth management firms, which could make it more difficult for us to identify appropriate targets and could make such acquisitions more expensive. Even if we are able to identify appropriate acquisition targets, we may not have sufficient capital to fund acquisitions or be able to execute transactions on favorable terms. If we are unable to expand our SDN and Courier operations through smaller acquisitions, we may not be able to achieve all of the expected benefits of the SDN and Courier acquisitions, which could adversely affect our results of operations and financial condition.

Acquiring other banks, businesses, or branches involves potential adverse impact to our financial results and various other risks commonly associated with acquisitions, including, among other things:

- difficulty in estimating the value of the target company;
- payment of a premium over book and market values that may dilute our tangible book value and earnings per share in the short and long term;
- potential exposure to unknown or contingent liabilities of the target company;
- exposure to potential asset quality issues of the target company;
- volatility in reported income as goodwill impairment losses could occur irregularly and in varying amounts;
- challenge and expense of integrating the operations and personnel of the target company;
- inability to realize the expected revenue increases, cost savings, increases in geographic or product presence, and / or other projected benefits;
- potential disruption to our business;
- potential diversion of our management s time and attention;
- the possible loss of key employees and customers of the target company;
- potential changes in banking or tax laws or regulations that may affect the target company; and
- additional regulatory burdens associated with new lines of business.

We are subject to interest rate risk.

Our earnings and cash flows depend largely upon our net interest income. Interest rates are highly sensitive to many factors that are beyond our control, including general economic conditions and policies of governmental and regulatory agencies, particularly the Federal Reserve. Changes in monetary policy, including changes in interest rates, could influence not only the interest we receive on loans and investments and the amount of interest we pay on deposits and borrowings, but such changes could also affect (i) our ability to originate loans and obtain deposits; (ii) the fair value of our financial assets and liabilities; and (iii) the average duration of our mortgage-backed securities portfolio and other interest-earning assets. If the interest rates paid on deposits and other borrowings increase at a faster rate than the interest rates received on loans and other investments, our net interest income, and therefore earnings, could be adversely affected. Earnings could also be adversely affected if the interest rates received on loans and other investments fall more quickly than the interest rates paid on deposits and other borrowings.

Any substantial, unexpected or prolonged change in market interest rates could have a material adverse effect on our financial condition and results of operations. Also, our interest rate risk modeling techniques and assumptions likely may not fully predict or capture the impact of actual interest rate changes on our balance sheet.

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

Our financial performance generally, and in particular the ability of borrowers to pay interest on and repay principal of outstanding loans and the value of collateral securing those loans, as well as demand for loans and other products and services we offer, is highly dependent on the business environment in the markets where we operate, in the State of New York and in the United States as a whole. A favorable business environment is generally characterized by, among other factors, economic growth, efficient capital markets, low inflation, low unemployment, high business and investor confidence, and strong business earnings. Unfavorable or uncertain economic and market conditions can be caused by declines in economic growth, business activity or investor or business confidence; limitations on the availability or increases in the cost of credit and capital; increases in inflation or interest rates; high unemployment, natural disasters; or a combination of these or other factors.

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The policies of the Federal Reserve have a significant impact on our earnings.

The policies of the Federal Reserve impact us significantly. The Federal Reserve regulates the supply of money and credit in the United States. Its policies directly and indirectly influence the rate of interest earned on loans and paid on borrowings and interest-bearing deposits and can also affect the value of financial instruments we hold. Those policies determine to a significant extent our cost of funds for lending and investing and impact our net interest income, our primary source of revenue. Changes in those policies are beyond our control and are difficult to predict. Federal Reserve policies can also affect our borrowers, potentially increasing the risk that they may fail to repay their loans. For example, a tightening of the money supply by the Federal Reserve could reduce the demand for a borrower s products and services. This could adversely affect the borrower s earnings and ability to repay its loan, which could have a material adverse effect on our financial condition and results of operations.

The soundness of other financial institutions could adversely affect us.

Financial services institutions are interrelated as a result of trading, clearing, counterparty, or other relationships. We have exposure to many different industries and counterparties, and we routinely execute transactions with counterparties in the financial services industry, including commercial banks, brokers and dealers, investment banks, and other institutional clients. Many of these transactions expose us to credit risk in the event of a default by our counterparty or client. In addition, our credit risk may be exacerbated when the collateral held by us cannot be realized or is liquidated at prices not sufficient to recover the full amount of the credit or derivative exposure due us. Any such losses could have a material adverse effect on our financial condition and results of operations.

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

As of December 31, 2016, we had $66.4 million of goodwill and $9.2 million of other intangible assets. Significant and sustained declines in our stock price and market capitalization, significant declines in our expected future cash flows, significant adverse changes in the business climate or slower growth rates, any or all of which could be materially impacted by many of the risk factors discussed herein, may necessitate our taking charges in the future related to the impairment of our goodwill. Future regulatory actions could also have a material impact on assessments of goodwill for impairment. If the fair value of our net assets improves at a faster rate than the market value of our reporting units, or if we were to experience increases in book values of a reporting unit in excess of the increase in fair value of equity, we may also have to take charges related to the impairment of our goodwill. If we were to conclude that a future write-down of our goodwill is necessary, we would record the appropriate charge, which could have a material adverse effect on our results of operations.

Identifiable intangible assets other than goodwill consist of core deposit intangibles and other intangible assets (primarily customer relationships). Adverse events or circumstances could impact the recoverability of these intangible assets including loss of core deposits, significant losses of customer accounts and/or balances, increased competition or adverse changes in the economy. To the extent these intangible assets are deemed unrecoverable, a non-cash impairment charge would be recorded which could have a material adverse effect on our results of operations.

During the fourth quarter of 2015, we determined that the carrying value of our SDN reporting unit exceeded its fair value and recorded a $751 thousand impairment charge. For further discussion, see Note 1, Summary of Significant Accounting Policies, and Note 7, Goodwill and Other Intangible Assets, to the Consolidated Financial Statements included in Item 8 of this Annual Report on Form 10-K.

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

Over the last few years, proxy contests and other forms of shareholder activism have been directed against numerous publicly-traded community banks. In the event that any significant investor makes proposals concerning our operations, governance or other matters, or seeks to change our Board of Directors, our review and consideration of such proposals may require the devotion of a significant amount of time by our management and employees and could require us to expend significant resources. Further, if our Board of Directors, in exercising its fiduciary duties, disagrees with or determines not to pursue the strategic direction suggested by an activist shareholder, our business could be adversely affected by responding to a costly and time-consuming proxy contest or other actions from an activist shareholder that will divert the attention of our management and employees, interfere with our ability to execute our strategic plan, result in the loss of business opportunities and customers, and make it more difficult for us to attract and retain qualified personnel and business partners.

In 2016, the Company nominated and recommended a slate of four individuals for election to our Board of Directors at our 2016 Annual Meeting. Clover Partners, L.P., an activist hedge fund based in Dallas, Texas, launched a proxy contest in which it nominated and advocated for the election of two individuals in opposition to our director nominees. While each of our director nominees was elected by a wide margin at our Annual Meeting on June 3, 2016, our professional services expenses in 2016 were $1.7 million, or 37%, higher than in 2015, primarily due to this proxy contest. Any future proxy contest could command a comparable, if not greater, amount of time and resources and there can be no assurance that we would again be successful.

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We operate in a highly competitive industry and market area.

We face substantial competition in all areas of our operations from a variety of different competitors, many of which are larger and may have more financial resources. Such competitors primarily include national, regional and internet banks within the markets in which we operate. We also face competition from many other types of financial institutions, including, without limitation, savings and loan associations, credit unions, finance companies, brokerage firms, insurance companies and other financial intermediaries. The financial services industry could become even more competitive as a result of legislative, regulatory and technological changes and continued consolidation. Banks, securities firms and insurance companies can merge under the umbrella of a financial holding company, which can offer virtually any type of financial service, including banking, securities underwriting, insurance (both agency and underwriting), and merchant banking. Also, technology has lowered barriers to entry and made it possible for nonbanks to offer products and services traditionally provided by banks, such as automatic transfer and automatic payment systems. More recently, peer to peer lending has emerged as an alternative borrowing source for our customers and many other non-banks offer lending and payment services in competition with banks. Many of these competitors have fewer regulatory constraints and may have lower cost structures. Additionally, due to their size, many competitors may be able to achieve economies of scale and, as a result, may offer a broader range of products and services as well as better pricing for those products and services than we can.

Our ability to compete successfully depends on a number of factors, including, among other things:

- the ability to develop, maintain and build upon long-term customer relationships based on top quality service, high ethical standards and safe, sound assets;
- the ability to expand our market position;
- the scope, relevance and pricing of products and services offered to meet customer needs and demands;
- the rate at which we introduce new products and services relative to our competitors;
- customer satisfaction with our level of service; and
- industry and general economic trends.

Failure to perform in any of these areas could significantly weaken our competitive position, which could adversely affect our growth and profitability, which, in turn, could have a material adverse effect on our financial condition and results of operations.

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

Severe weather, natural disasters, acts of war or terrorism, and other adverse external events could have a significant impact on our ability to conduct business. Such events could affect the stability of our deposit base, impair the ability of borrowers to repay outstanding loans, impair the value of collateral securing loans, cause significant property damage, result in loss of revenue, and/or cause us to incur additional expenses. The occurrence of any such event could have a material adverse effect on our business, which, in turn, could have a material adverse effect on our financial condition and results of operations.

Liquidity is essential to our businesses.

Our liquidity could be impaired by an inability to access the capital markets or unforeseen outflows of cash. Reduced liquidity may arise due to circumstances that we may be unable to control, such as a general market disruption or an operational problem that affects third parties or us. Our efforts to monitor and manage liquidity risk may not be successful or sufficient to deal with dramatic or unanticipated reductions in our liquidity. In such events, our cost of funds may increase, thereby reducing our net interest income, or we may need to sell a portion of our investment and/or loan portfolio, which, depending upon market conditions, could result in us realizing a loss.

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

We may need to raise additional capital in the future to provide sufficient capital resources and liquidity to meet our commitments and business needs. Our ability to raise additional capital, if needed, will depend on our financial performance and, among other things, conditions in the capital markets at that time which is outside of our control.

In addition, we are highly regulated, and our regulators could require us to raise additional common equity in the future. We and our regulators perform a variety of analyses of our assets, including the preparation of stress case scenarios, and as a result of those assessments we could determine, or our regulators could require us, to raise additional capital.

We cannot assure that required capital will be available on acceptable terms or at all. Any occurrence that may limit our access to the capital markets, such as a decline in the confidence of debt purchasers, depositors of the Bank or counterparties participating in the capital markets, or a downgrade of our debt rating, may adversely affect our capital costs and ability to raise capital and, in turn, our liquidity. An inability to raise additional capital on acceptable terms when needed could have a material adverse impact on our business, financial condition, results of operations or liquidity.

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

We are a separate and distinct legal entity from our subsidiaries. A substantial portion of our revenue comes from dividends from our Bank subsidiary. These dividends are the principal source of funds we use to pay dividends on our common and preferred stock, and to pay interest and principal on our debt. Federal and/or state laws and regulations limit the amount of dividends that our Bank subsidiary may pay to us. Also, our right to participate in a distribution of assets upon a subsidiary s liquidation or reorganization is subject to the prior claims of the subsidiary s creditors. In the event our Bank subsidiary is unable to pay dividends to us, we may not be able to service debt, pay obligations, or pay dividends on our common and preferred stock. The inability to receive dividends from our Bank subsidiary could have a material adverse effect on our business, financial condition, and results of operations.

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

Holders of our common stock are only entitled to receive such dividends as our Board of Directors may declare out of funds legally available for such payments. Although we have historically declared cash dividends on our common stock, we are not required to do so and may reduce or eliminate our common stock dividend in the future. This could adversely affect the market price of 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.

In the future, we may attempt to increase our capital resources by entering into debt or debt-like financing that is unsecured or secured by all or up to all of our assets, or by issuing additional debt or equity securities, which could include issuances of secured or unsecured commercial paper, medium-term notes, senior notes, subordinated notes, preferred stock or securities convertible into or exchangeable for equity securities. In the event of our liquidation, our lenders and holders of our debt and preferred securities would receive a distribution of our available assets before distributions to the holders of our common stock. Because our decision to incur debt and issue securities in our future offerings will depend on market conditions and other factors beyond our control, we cannot predict or estimate the amount, timing or nature of our future offerings and debt financings. Further, market conditions could require us to accept less favorable terms for the issuance of our securities in the future. We may also issue additional shares of our common stock or securities convertible into or exchangeable for our common stock that could dilute our current shareholders and effect the value of our common stock.

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

Provisions of our certificate of incorporation, our bylaws, and federal and state banking laws, including regulatory approval requirements, could make it more difficult for a third party to acquire us, even if doing so would be perceived to be beneficial to our shareholders. The combination of these provisions may discourage others from initiating a potential merger, takeover or other change of control transaction, which, in turn, could adversely affect the market price of our common stock.

The market price of our common stock may fluctuate significantly in response to a number of factors.

Our quarterly and annual operating results have varied in the past and could vary significantly in the future, which makes it difficult for us to predict our future operating results. Our operating results may fluctuate due to a variety of factors, many of which are outside of our control, including the changing U.S. economic environment and changes in the commercial and residential real estate market, any of which may cause our stock price to fluctuate. If our operating results fall below the expectations of investors or securities analysts, the price of our common stock could decline substantially. Our stock price can fluctuate significantly in response to a variety of factors including, among other things:

- volatility of stock market prices and volumes in general;
- changes in market valuations of similar companies;
- changes in conditions in credit markets;
- changes in accounting policies or procedures as required by the Financial Accounting Standards Board, or FASB, or other regulatory agencies;
- legislative and regulatory actions (including the impact of the Dodd-Frank Act and related regulations) subjecting us to additional regulatory oversight which may result in increased compliance costs and/or require us to change our business model;
- government intervention in the U.S. financial system and the effects of and changes in trade and monetary and fiscal policies and laws, including the interest rate policies of the Federal Reserve Board;
- additions or departures of key members of management;
- fluctuations in our quarterly or annual operating results; and
- changes in analysts estimates of our financial performance.

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ITEM 1B. UNRESOLVED STAFF COMMENTS

None.

ITEM 2. PROPERTIES

We own a 27,400 square foot building in Warsaw, New York that serves as our headquarters, and principal executive and administrative offices. We lease a 22,200 square foot regional administrative facility located in Pittsford, New York. This lease expires in April 2017 and we do not expect to renew the lease.

In April 2016, we entered into a 52,300 square foot lease in Rochester, New York, to relocate our regional administrative facility from Pittsford, New York. Monthly lease payments will commence in phases after completion of agreed-upon renovations to the facility, starting in February 2017 and continuing through April 2017, with full monthly lease payments starting in September 2017. This lease has an initial expiration of date of August 2027, with options for two additional ten-year extensions.

We are engaged in the banking business through 52 branch offices, of which 35 are owned and 17 are leased, in the following fifteen contiguous counties of Western and Central New York: Allegany, Cattaraugus, Cayuga, Chautauqua, Chemung, Erie, Genesee, Livingston, Monroe, Ontario, Orleans, Seneca, Steuben, Wyoming and Yates Counties. The operating leases for our branch offices expire at various dates through the year 2047 and generally include options to renew.

SDN operates from a leased 14,400 square foot office located in Williamsville, New York. The lease for such space, which is used by SDN and several of our Bank s commercial lenders, extends through September 2021. SDN also leases one retail location.

Courier Capital operates from an owned 11,000 square foot office, located in Buffalo, New York. Courier Capital also has operations at an owned facility in Jamestown, New York.

We believe that our properties have been adequately maintained, are in good operating condition and are suitable for our business as presently conducted, including meeting the prescribed security requirements. For additional information, see Note 6, Premises and Equipment, Net, and Note 10, Commitments and Contingencies, in the accompanying financial statements included in Part II, Item 8, of this Annual Report on Form 10-K.

ITEM 3. LEGAL PROCEEDINGS

From time to time we are a party to or otherwise involved in legal proceedings arising out of the normal course of business. Management does not believe that there is any pending or threatened proceeding against us, which, if determined adversely, would have a material adverse effect on our business, results of operations or financial condition.

ITEM 4. MINE SAFETY DISCLOSURES

Not applicable.

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PART II

ITEM 5. MARKET FOR REGISTRANT S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

Our common stock is traded on the NASDAQ Global Select Market under the ticker symbol FISI. At February 24, 2017, 14,529,815 shares of our common stock were outstanding and held by approximately 4,200 shareholders of record. During 2016, the high sales price of our common stock was $34.55 and the low sales price was $24.56. The closing price per share of our common stock on December 30, 2016, the last trading day of our fiscal year, was $34.20. We declared dividends of $0.81 per common share during the year ended December 31, 2016. See additional information regarding the market price and dividends paid in Part II, Item 6, Selected Financial Data .

We have paid regular quarterly cash dividends on our common stock and our Board of Directors presently intends to continue this practice, subject to our results of operations and the need for those funds for debt service and other purposes. See the discussions in the section captioned Supervision and Regulation included in Part I, Item 1, Business, in the section captioned Liquidity and Capital Resources included in Part II, Item 7, in Management s Discussion and Analysis of Financial Condition and Results of Operations and in Note 11, Regulatory Matters, in the accompanying financial statements included in Part II, Item 8, Financial Statements and Supplementary Data, all of which are included elsewhere in this report and incorporated herein by reference thereto.

Stock Performance Graph

The stock performance graph below compares (a) the cumulative total return on our common stock for the period beginning December 31, 2011 as reported by the NASDAQ Global Select Market, through December 31, 2016, (b) the cumulative total return on stocks included in the NASDAQ Composite Index over the same period, and (c) the cumulative total return, as compiled by SNL Financial LC (SNL), of Major Exchange (NYSE, NYSE MKT and NASDAQ) Banks with $1 billion to $5 billion in assets over the same period. Cumulative return assumes the reinvestment of dividends. The graph was prepared by SNL and is expressed in dollars based on an assumed investment of $100.

	Period Ending					
Index	**12/31/11**	**12/31/12**	**12/31/13**	**12/31/14**	**12/31/15**	**12/31/16**
Financial Institutions, Inc.	100.00	119.33	164.11	172.60	198.55	249.40
NASDAQ Composite	100.00	117.45	164.57	188.84	201.98	219.89
SNL Bank $1B-$5B Index	100.00	123.31	179.31	187.48	209.86	301.92

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ITEM 6. SELECTED FINANCIAL DATA

(Dollars in thousands, except per share data)	At or for the year ended December 31,				
	2016	**2015**	**2014**	**2013**	**2012**
Selected financial condition data:					
Total assets	$ 3,710,340	$ 3,381,024	$ 3,089,521	$ 2,928,636	$ 2,763,865
Loans, net	2,309,227	2,056,677	1,884,365	1,806,883	1,681,012
Investment securities	1,083,264	1,030,112	916,932	859,185	841,701
Deposits	2,995,222	2,730,531	2,450,527	2,320,056	2,261,794
Borrowings	370,561	332,090	334,804	337,042	179,806
Shareholders equity	320,054	293,844	279,532	254,839	253,897
Common shareholders equity	302,714	276,504	262,192	237,497	236,426
Tangible common shareholders equity[(1)]	227,074	209,558	193,553	187,495	186,037
Selected operations data:					
Interest income	$ 115,231	$ 105,450	$ 101,055	$ 98,931	$ 97,567
Interest expense	12,541	10,137	7,281	7,337	9,051
Net interest income	102,690	95,313	93,774	91,594	88,516
Provision for loan losses	9,638	7,381	7,789	9,079	7,128
Net interest income after provision for loan losses	93,052	87,932	85,985	82,515	81,388
Noninterest income	35,760	30,337	25,350	24,833	24,777
Noninterest expense	84,671	79,393	72,355	69,441	71,397
Income before income taxes	44,141	38,876	38,980	37,907	34,768
Income tax expense	12,210	10,539	9,625	12,377	11,319
Net income	$ 31,931	$ 28,337	$ 29,355	$ 25,530	$ 23,449
Preferred stock dividends and accretion	1,462	1,462	1,462	1,466	1,474
Net income available to common shareholders	$ 30,469	$ 26,875	$ 27,893	$ 24,064	$ 21,975
Stock and related per share data:					
Earnings per common share:					

Basic	$	2.11	$	1.91	$	2.01	$	1.75	$	1.60
Diluted	$	2.10	$	1.90	$	2.00	$	1.75	$	1.60
Cash dividends declared on common stock	$	0.81	$	0.80	$	0.77	$	0.74	$	0.57
Common book value per share	$	20.82	$	19.49	$	18.57	$	17.17	$	17.15
Tangible common book value per share(1)	$	15.62	$	14.77	$	13.71	$	13.56	$	13.49
Market price (NASDAQ: FISI):										
High	$	34.55	$	29.04	$	27.02	$	26.59	$	19.52
Low	$	25.98	$	21.67	$	19.72	$	17.92	$	15.22
Close	$	34.20	$	28.00	$	25.15	$	24.71	$	18.63

(1) This is a non-GAAP measure that we believe is useful in understanding our financial performance and condition. Refer to the GAAP to Non-GAAP Reconciliation for further information.

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(Dollars in thousands)	At or for the year ended December 31,				
	2016	**2015**	**2014**	**2013**	**2012**
Performance ratios:					
Net income, returns on:					
Average assets	0.90%	0.87%	0.98%	0.91%	0.93%
Average equity	10.01%	9.78%	10.80%	10.10%	9.46%
Average common equity	10.10%	9.87%	10.96%	10.23%	9.53%
Average tangible common equity(1)	13.51%	13.16%	14.12%	13.00%	11.74%
Average tangible assets(1)	0.88%	0.84%	0.95%	0.87%	0.89%
Common dividend payout ratio	38.39%	41.88%	38.31%	42.29%	35.63%
Net interest margin (fully tax-equivalent)	3.24%	3.28%	3.50%	3.64%	3.95%
Effective tax rate	27.7%	27.1%	24.7%	32.7%	32.6%
Efficiency ratio(2)	60.92%	61.58%	58.59%	58.48%	62.87%
Capital ratios:					
Leverage ratio(3)	7.36%	7.41%	7.35%	7.63%	7.71%
Common equity Tier 1 ratio(3)	9.59%	9.77%	n/a	n/a	n/a
Tier 1 capital ratio(3)	10.26%	10.50%	10.47%	10.82%	10.73%
Total risk-based capital ratio(3)	12.97%	13.35%	11.72%	12.08%	11.98%
Average equity to average assets	8.99%	8.86%	9.08%	9.01%	9.84%
Common equity to assets	8.16%	8.18%	8.49%	8.11%	8.55%
Tangible common equity to tangible assets(1)	6.25%	6.32%	6.41%	6.51%	6.86%
Asset quality:					
Non-performing loans	$ 6,326	$ 8,440	$ 10,153	$ 16,622	$ 9,125
Non-performing assets	$ 6,433	$ 8,603	$ 10,347	$ 17,083	$ 10,062
Allowance for loan losses	$ 30,934	$ 27,085	$ 27,637	$ 26,736	$ 24,714
Net loan charge-offs	$ 5,789	$ 7,933	$ 6,888	$ 7,057	$ 5,674
Non-performing loans to total loans	0.27%	0.41%	0.53%	0.91%	0.53%
Non-performing assets to total assets	0.17%	0.25%	0.33%	0.58%	0.36%
Net charge-offs to average loans	0.26%	0.40%	0.37%	0.40%	0.36%
Allowance for loan losses to total loans	1.32%	1.30%	1.45%	1.46%	1.45%
Allowance for loan losses to non-performing loans	489%	321%	272%	161%	271%
Other data:					
Number of branches	52	50	49	50	52
Full time equivalent employees	631	660	622	608	628

(1) This is a non-GAAP measure that we believe is useful in understanding our financial performance and condition. Refer to the GAAP to Non-GAAP Reconciliation for further information.

(2)

Efficiency ratio provides a ratio of operating expenses to operating income. Efficiency ratio equals noninterest expense less other real estate expense and amortization and impairment of goodwill and other intangible assets as a percentage of net revenue, defined as the sum of tax-equivalent net interest income and noninterest income before net gains on investment securities, proceeds from company owned life insurance, adjustments to contingent liabilities and amortizations of tax credit investment. The efficiency ratio is not a financial measurement required by GAAP. However, the efficiency ratio is used by management in its assessment of financial performance specifically as it relates to noninterest expense control. Management also believes such information is useful to investors in evaluating Company performance.

(3) 2016 and 2015 ratios calculated under Basel III rules, which became effective January 1, 2015.

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GAAP to Non-GAAP Reconciliation

(In thousands, except per share data)	At or for the year ended December 31,				
	2016	**2015**	**2014**	**2013**	**2012**
Computation of ending tangible common equity:					
Common shareholders equity	$ 302,714	$ 276,504	$ 262,192	$ 237,497	$ 236,426
Less: goodwill and other intangible assets, net	75,640	66,946	68,639	50,002	50,389
Tangible common equity	$ 227,074	$ 209,558	$ 193,553	$ 187,495	$ 186,037
Computation of ending tangible assets:					
Total assets	$ 3,710,340	$ 3,381,024	$ 3,089,521	$ 2,928,636	$ 2,763,865
Less: goodwill and other intangible assets, net	75,640	66,946	68,639	50,002	50,389
Tangible assets	$ 3,634,700	$ 3,314,078	$ 3,020,882	$ 2,878,634	$ 2,713,476
Tangible common equity to tangible assets(1)	6.25%	6.32%	6.41%	6.51%	6.86%
Common shares outstanding	14,538	14,191	14,118	13,829	13,788
Tangible common book value per share(2)	$ 15.62	$ 14.77	$ 13.71	$ 13.56	$ 13.49
Computation of average tangible common equity:					
Average common equity	$ 301,666	$ 272,367	$ 254,533	$ 235,290	$ 230,527
Average goodwill and other intangible assets, net	76,170	68,138	57,039	50,201	43,399
Average tangible common equity	$ 225,496	$ 204,229	$ 197,494	$ 185,089	$ 187,128
Computation of average tangible assets:					
Average assets	$ 3,547,105	$ 3,269,890	$ 2,994,604	$ 2,803,825	$ 2,519,258
	76,170	68,138	57,039	50,201	43,399

Average goodwill and other intangible assets, net					
Average tangible assets	$ 3,470,935	$ 3,210,752	$ 2,937,565	$ 2,753,624	$ 2,475,859
Net income available to common shareholders	$ 30,469	$ 26,875	$ 27,893	$ 24,064	$ 21,975
Return on average tangible common equity(3)	13.51%	13.16%	14.12%	13.00%	11.74%
Return on average tangible assets(4)	0.88%	0.84%	0.95%	0.87%	0.89%

(1) Tangible common equity divided by tangible assets.
(2) Tangible common equity divided by common shares outstanding.
(3) Net income available to common shareholders divided by average tangible common equity.
(4) Net income available to common shareholders divided by average tangible assets.

This table contains disclosure regarding tangible common equity, tangible assets, tangible common equity to tangible assets, tangible common book value per share, average tangible common equity, average tangible assets, return on average tangible common equity and return on average tangible assets, which are determined by methods other than in accordance with GAAP. We believe that these non-GAAP measures are useful to our investors as measures of the strength of our capital and ability to generate earnings on tangible common equity invested by our shareholders. These non-GAAP measures provide supplemental information that may help investors to analyze our capital position without regard to the effects of intangible assets. Non-GAAP financial measures have inherent limitations and are not uniformly applied by issuers. Therefore, these non-GAAP financial measures should not be considered in isolation, or as a substitute for comparable measures prepared in accordance with GAAP.

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SELECTED QUARTERLY DATA

(Dollars in thousands, except per share data)	Fourth Quarter	Third Quarter	Second Quarter	First Quarter
2016				
Interest income	$ 29,990	29,360	28,246	27,635
Interest expense	3,268	3,310	3,047	2,916
Net interest income	26,722	26,050	25,199	24,719
Provision for loan losses	3,357	1,961	1,952	2,368
Net interest income, after provision for loan losses	23,365	24,089	23,247	22,351
Noninterest income	9,088	8,539	8,916	9,217
Noninterest expense	20,715	20,618	22,120	21,218
Income before income taxes	11,738	12,010	10,043	10,350
Income tax expense	3,045	3,541	2,892	2,732
Net income	$ 8,693	8,469	7,151	7,618
Preferred stock dividends	365	366	366	365
Net income applicable to common shareholders	$ 8,328	8,103	6,785	7,253
Earnings per common share [1]:				
Basic	$ 0.58	0.56	0.47	0.50
Diluted	0.57	0.56	0.47	0.50
Market price (NASDAQ: FISI):				
High	$ 34.55	27.63	29.49	29.53
Low	25.98	25.16	24.56	25.38
Close	34.20	27.11	26.07	29.07
Dividends declared	$ 0.21	0.20	0.20	0.20
2015				
Interest income	$ 27,487	27,007	25,959	24,997
Interest expense	2,856	2,876	2,555	1,850
Net interest income	24,631	24,131	23,404	23,147
Provision for loan losses	2,598	754	1,288	2,741
Net interest income, after provision for loan losses	22,033	23,377	22,116	20,406
Noninterest income	8,580	7,005	6,455	8,297
Noninterest expense	21,828	19,318	19,236	19,011

Income before income taxes		8,785	11,064	9,335	9,692
Income tax expense		2,150	2,748	2,750	2,891
Net income	$	6,635	8,316	6,585	6,801
Preferred stock dividends		365	366	366	365
Net income applicable to common shareholders	$	6,270	7,950	6,219	6,436
Earnings per common share [1]:					
Basic	$	0.44	0.56	0.44	0.46
Diluted		0.44	0.56	0.44	0.46
Market price (NASDAQ: FISI):					
High	$	29.04	25.21	25.50	25.38
Low		24.05	23.54	22.50	21.67
Close		28.00	24.78	24.84	22.93
Dividends declared	$	0.20	0.20	0.20	0.20

(1) Earnings per share data is computed independently for each of the quarters presented. Therefore, the sum of the quarterly earnings per common share amounts may not equal the total for the year.

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2016 FOURTH QUARTER RESULTS

Net income was $8.7 million for the fourth quarter of 2016 compared with $6.6 million for the fourth quarter of 2015. After preferred dividends, net income available to common shareholders for the fourth quarter of 2016 was $8.3 million or $0.57 per diluted share, compared to $6.3 million or $0.44 per share in the fourth quarter of 2015.

Net interest income was $26.7 million for the fourth quarter of 2016 compared with $24.6 million for the fourth quarter of 2015. The increase was primarily related to an increase in average interest-earning assets of $309.7 million, led by a $265.9 million increase in loans. The increase was partially offset by a lower net interest margin, which decreased five basis points from the fourth quarter of 2015 to the fourth quarter of 2016.

The provision for loan losses was $3.4 million for the fourth quarter of 2016 compared with $2.6 million for the fourth quarter of 2015. Net charge-offs for the fourth quarter of 2016 were $1.8 million, or 0.30% annualized, of average loans, compared to $2.0 million, or 0.38% annualized, of average loans in the fourth quarter of 2015.

Noninterest income was $9.1 million for the fourth quarter of 2016 compared to $8.6 million in the fourth quarter of 2015. The increase was primarily the result of a $632 thousand increase in investment advisory income, reflecting the contribution from Courier Capital.

Noninterest expense was $20.7 million for the fourth quarter of 2016 compared to $21.8 million in the fourth quarter of 2015. The decrease was primarily the result of $751 thousand of goodwill impairment related to the SDN reporting unit and $540 thousand of professional service fees attributable to the acquisition of Courier Capital, both of which were recognized in 2015.

Income tax expense was $3.0 million in the fourth quarter of 2016, representing an effective tax rate of 25.9%, compared to $2.2 million in the fourth quarter of 2015, representing an effective tax rate of 24.5%. Effective tax rates are impacted by items of income and expense that are not subject to federal or state taxation. Our effective tax rates differ from the statutory rates primarily due to the effect of interest income from tax-exempt securities, earnings on company owned life insurance and the non-cash fair value adjustment of the contingent consideration liability associated with the SDN acquisition.

ITEM 7. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following is a discussion and analysis of our financial position and results of operations and should be read in conjunction with the information set forth under Part I, Item 1A, Risks Factors , and our consolidated financial statements and notes thereto appearing under Part II, Item 8, Financial Statements and Supplementary Data of this Annual Report on Form 10-K.

INTRODUCTION

Financial Institutions, Inc. (the Parent and together with all its subsidiaries, we, our, or us), is a financial hold company headquartered in New York State. We offer a broad array of deposit, lending, and other financial services to individuals, municipalities and businesses in Western and Central New York through our wholly-owned New York chartered banking subsidiary, Five Star Bank (the Bank). Our indirect lending network includes relationships with franchised automobile dealers in Western and Central New York, the Capital District of New York and Northern and Central Pennsylvania. We also offer insurance services through our wholly-owned subsidiary, Scott Danahy Naylon, LLC (SDN), a full service insurance agency. In addition, we also offer customized investment management, investment consulting and retirement plan services through our wholly-owned subsidiary Courier Capital, LLC (Courier Capital), a SEC-registered investment advisory and wealth management firm.

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

EXECUTIVE OVERVIEW

2016 Financial Performance Review

During 2016 we continued to execute on our growth and diversification strategy and we progressed in growing our core banking franchise. We delivered year-over-year increases in both total loans and total deposits of 12% and 10%, respectively, which drove our

MANAGEMENT S DISCUSSION AND ANALYSIS

revenue higher. We have focused on integrating the SDN insurance and Courier Capital wealth management platforms into our overall sales process to diversify our revenue.

Net income for 2016 was $31.9 million, compared to $28.3 million for 2015. This resulted in a 0.90% return on average assets and a 10.01% return on average equity. Net income available to common shareholders was $30.5 million or $2.10 per diluted share for 2016, compared to $26.9 million or $1.90 per diluted share for 2015. We declared cash dividends of $0.81 during 2016, an increase of $0.01 per common share or 1% compared to the prior year.

Fully-taxable equivalent net interest income was $105.9 million in 2016, an increase of $7.5 million, or 8%, compared with 2015. This reflected the impact of 9% growth in average interest-earning assets, partially offset by a 4 basis point decline in the net interest margin to 3.24%.

The provision for loan losses increased $2.3 million, or 31%, from 2015 as our allowance for loan losses reflects growth in our loan portfolio. During the fourth quarter of 2016, the Company internally downgraded to substandard status one commercial business credit relationship with unpaid principal balances totaling $3.5 million. The downgrade necessitated a provision and increase in our allowance for losses of approximately $1.1 million. These loans were current with respect to principal and interest payments as of December 31, 2016; however, we continue to monitor this relationship closely. Net charge-offs decreased $2.1 million from the prior year to $5.8 million in 2016. Net charge-offs were an annualized 0.26% of average loans in the current year compared to 0.40% in 2015. In addition, non-performing loans decreased $2.1 million compared to a year ago to $6.3 million, or 0.27% of total loans.

Noninterest income totaled $35.8 million for the full year 2016, an increase of $5.4 million or 18% when compared to the prior year. Investment advisory income increased by $3.0 million to $5.2 million during the current year as 2016 reflects the benefit of revenue associated with the January 2016 Courier Capital acquisition. Income from company owned life insurance increased to $2.8 million in 2016 from $2.0 million in the prior year, as the first quarter of 2016 included $911 thousand of death benefit proceeds. In addition, increases in ATM and debit card income and net gain on investment securities, $603 thousand and $707 thousand, respectively, contributed to the increase. During both 2016 and 2015, we recognized non-cash fair value adjustments of the contingent consideration liability related to the SDN acquisition that resulted in noninterest income of $1.2 million and $1.1 million, respectively. The fair value of the contingent consideration liability was recorded at the time of the SDN acquisition as a component of the purchase price.

Noninterest expense for the full year 2016 totaled $84.7 million, a $5.3 million increase compared to $79.4 million in the prior year. Salaries and benefits expense increased $2.8 million year-over-year, reflecting the impact of the addition of Courier Capital employees and increased staffing associated with the Company s growth initiatives. Professional services increased $1.7 million year-over-year, primarily in connection with the Company s 2016 proxy contest. Also contributing to the increase were higher occupancy and equipment expense, computer and data processing expense and advertising and promotions expense, partially offset by a goodwill impairment charge related to the SDN acquisition that was recognized in 2015.

Income tax expense for the year was $12.2 million, representing an effective tax rate of 27.7% compared with an effective tax rate of 27.1% in 2015.

Total assets were $3.7 billion at December 31, 2016, up $329.3 million from $3.4 billion at December 31, 2015. The increase was largely the result of loan growth funded by deposit growth. Total loans were $2.3 billion at

December 31, 2016, up $256.4 million, or 12%, from December 31, 2015.

- Commercial mortgage loans totaled $670.1 million, up $104.0 million, or 18%, from December 31, 2015.
- Commercial business loans totaled $349.5 million, up $35.8 million, or 11%, from December 31, 2015.
- Residential real estate loans totaled $427.9 million, up $46.9 million, or 12%, from December 31, 2015.
- Consumer indirect loans totaled $752.4 million, up $75.5 million, or 11%, from December 31, 2015.

Total deposits were $3.0 billion at December 31, 2016, an increase of $264.7 million from December 31, 2015, which was primarily the result of successful business development efforts in both municipal and retail banking. Short-term borrowings were $331.5 million at December 31, 2016, up $38.4 million from December 31, 2015.

Shareholders equity was $320.1 million at December 31, 2016, compared to $293.8 million at December 31, 2015. Common book value per share was $20.82 at December 31, 2016, an increase of $1.33 or 7% from $19.49 at December 31, 2015. The increases in shareholders equity and common book value per share as compared to December 31, 2015, are attributable to net income and stock issued for the acquisition of Courier Capital, with partial offsets from dividends and net unrealized losses on securities available for sale, a component of accumulated other comprehensive loss.

The Company s leverage ratio was 7.36% at December 31, 2016 compared to 7.41% at December 31, 2015. The decrease in the leverage ratio was due to strong loan growth and higher asset levels. The Bank s leverage ratio and total risk-based capital ratio were 7.92% and 12.26%, respectively, at December 31, 2016.

MANAGEMENT S DISCUSSION AND ANALYSIS

RESULTS OF OPERATIONS FOR THE YEARS ENDED

DECEMBER 31, 2016 AND DECEMBER 31, 2015

Net Interest Income and Net Interest Margin

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

We use interest rate spread and net interest margin to measure and explain changes in net interest income. Interest rate spread is the difference between the yield on earning assets and the rate paid for interest-bearing liabilities that fund those assets. The net interest margin is expressed as the percentage of net interest income to average earning assets. The net interest margin exceeds the interest rate spread because noninterest-bearing sources of funds (net free funds), principally noninterest-bearing demand deposits and shareholders 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 Federal Reserve influences the general market rates of interest, which impacts the deposit and loan rates offered by many financial institutions. The intended federal funds rate, which is the cost of immediately available overnight funds, was increased by 25 basis points to a range of 0.50% to 0.75% in December 2016. The Federal Reserve had earlier increased the intended federal funds rate by 25 basis points to a range of 0.25% to 0.50% in December 2015. Prior to that, the intended federal funds rate had remained at a range of zero to 0.25% since 2008. Our loan portfolio is significantly affected by changes in the prime interest rate and changes in the prime interest rate generally follow changes in the federal funds rate. The prime interest rate, which is the rate offered on loans to borrowers with strong credit, increased by 25 basis points to 3.75% in December 2016 after the previous 25 basis point increase to 3.50% in December 2015. Prior to that, the prime interest rate had remained at 3.25% since 2008.

Net Interest Income and Net Interest Margin

The following table reconciles interest income per the consolidated statements of income to interest income adjusted to a fully taxable equivalent basis for the years ended December 31 (in thousands):

	2016	2015	2014
Interest income per consolidated statements of income	$ 115,231	$ 105,450	$ 101,055
Adjustment to fully taxable equivalent basis	3,172	3,097	2,853
Interest income adjusted to a fully taxable equivalent basis	118,403	108,547	103,908

Interest expense per consolidated statements of income		12,541		10,137		7,281
Net interest income on a taxable equivalent basis	$	105,862	$	98,410	$	96,627

Net interest income on a taxable equivalent basis for 2016 increased $7.5 million or 8%, compared to 2015. The increase was due to an increase in average interest-earning assets of $270.6 million or 9% compared to 2015. The net interest margin of 3.24% for 2016 declined compared to 3.28% in 2015. This decrease was a function of a six basis point decrease in interest rate spread to 3.13% during 2016, partially offset by a two basis point higher contribution from net free funds. The lower interest rate spread was a net result of no change in the yield on earning assets and a six basis point increase in the cost of interest-bearing liabilities.

For the year ended December 31, 2016, the yield on average earning assets of 3.62% was unchanged from 2015. Loan yields decreased 3 basis points during 2016 to 4.18%. The yield on investment securities decreased 1 basis point during 2016 to 2.45%. Overall, the earning asset rate changes reduced interest income by $577 thousand during 2016, but that was more than offset by a favorable volume variance that increased interest income by $10.4 million, which collectively drove a $9.8 million increase in interest income.

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MANAGEMENT S DISCUSSION AND ANALYSIS

Average interest-earning assets were $3.27 billion for 2016, an increase of $270.6 million or 9% from the prior year, with average loans up $218.4 million, average securities up $49.1 million and average federal funds sold and other interest-earning deposits up $3.1 million. Average loans were $2.21 billion for 2016, an increase of $218.4 million or 11% from the prior year. The growth in average loans reflected increases in most loan categories reflecting the impact of our growth strategy, with commercial loans up $146.7 million, residential real estate loans up $38.4 million, and consumer loans up $37.2 million, partially offset by a $3.9 million decrease in residential real estate lines. Loans made up 67.4% of average interest-earning assets during 2016 compared to 66.2% during 2015. Loans generally have significantly higher yields compared to securities and federal funds sold and interest-bearing deposits and, as such, have a more positive effect on the net interest margin. The yield on average loans was 4.18% for 2016, a decrease of 3 basis points compared to 4.21% for 2015. The yield on average loans was negatively impacted by lower average spreads due to increased competition in loan pricing during 2016 compared to 2015. The increase in the volume of average loans resulted in a $9.2 million increase in interest income, partially offset by a $528 thousand decrease due to the unfavorable rate variance. Average securities were $1.06 billion for 2016, an increase of $49.1 million or 5% from the prior year. Securities made up 32.5% of average interest-earning assets in 2016 compared to 33.8% in 2015. The taxable equivalent yield on average securities was 2.45% in 2016 compared to 2.46% in 2015. The increase in the volume of average securities resulted in a $1.2 million increase in interest income, partially offset by a $49 thousand decrease due to the unfavorable rate variance.

For the year ended December 31, 2016, the cost of average interest-bearing liabilities of 0.49% was 6 basis points higher than 2015. The cost of average interest-bearing deposits increased two basis points to 0.37%, the cost of short-term borrowings increased 24 basis points to 0.65% in 2016 compared to 2015 and the cost of long-term borrowings increased five basis points to 6.33%. Overall, interest-bearing liability rate and volume increases resulted in $2.4 million of higher interest expense.

Average interest-bearing liabilities of $2.57 billion in 2016 were $212.7 million or 9% higher than 2015. On average, interest-bearing deposits grew $215.2 million, while noninterest-bearing demand deposits (a principal component of net free funds) were up $34.1 million. The increase in average deposits was due to successful business development efforts. Overall, interest-bearing deposit rate and volume changes resulted in $1.2 million of higher interest expense during 2016. Average short-term and long-term borrowings were $288.0 million in 2016, $2.4 million lower than in 2015. Overall, short and long-term borrowing rate and volume changes resulted in $1.2 million of higher interest expense during 2016.

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MANAGEMENT S DISCUSSION AND ANALYSIS

The following tables present, for the periods indicated, information regarding: (i) the average balance sheet; (ii) the amount of interest income from interest-earning assets and the resulting annualized yields (tax-exempt yields have been adjusted to a tax-equivalent basis using the applicable Federal tax rate in each year); (iii) the amount of interest expense on interest-bearing liabilities and the resulting annualized rates; (iv) net interest income; (v) net interest rate spread; (vi) net interest income as a percentage of average interest-earning assets (net interest margin); and (vii) the ratio of average interest-earning assets to average interest-bearing liabilities. Investment securities are at amortized cost for both held to maturity and available for sale securities. Loans include net unearned income, net deferred loan fees and costs and non-accruing loans. Dollar amounts are shown in thousands.

	Years ended December 31,								
	2016			2015			2014		
	Average Balance	Interest	Average Rate	Average Balance	Interest	Average Rate	Average Balance	Interest	Average Rate
Interest-earning assets:									
Federal funds sold and other interest-earning deposits	$ 3,116	$ 18	0.56%	$ 37	$ -	0.40%	$ 114	$ -	0.14%
Investment securities:									
Taxable	767,371	17,025	2.22	727,564	16,123	2.22	617,738	13,304	2.15
Tax-exempt	295,850	9,064	3.06	286,607	8,849	3.09	259,935	8,151	3.14
Total investment securities	1,063,221	26,089	2.45	1,014,171	24,972	2.46	877,673	21,455	2.44
Loans:									
Commercial business	336,633	14,091	4.19	286,019	11,774	4.12	269,877	11,471	4.25
Commercial mortgage	618,436	28,465	4.60	522,328	24,136	4.62	473,372	23,345	4.93
Residential real estate loans	404,456	15,722	3.89	366,032	15,053	4.11	338,603	14,580	4.31
Residential real estate lines	124,635	4,734	3.80	128,525	4,669	3.63	128,162	4,691	3.66
Consumer indirect	703,975	27,190	3.86	665,454	25,746	3.87	651,279	25,970	3.99
Other consumer	17,620	2,094	11.89	18,969	2,197	11.58	21,094	2,396	11.36
Total loans	2,205,755	92,296	4.18	1,987,327	83,575	4.21	1,882,387	82,453	4.38
Total interest-earning	3,272,092	118,403	3.62	3,001,535	108,547	3.62	2,760,174	103,908	3.76

assets									
Less: Allowance for loan losses	(28,791)			(27,599)			(27,455)		
Other noninterest-earning assets	303,804			295,954			261,885		
Total assets	$ 3,547,105			$ 3,269,890			$ 2,994,604		
Interest-bearing liabilities:									
Deposits:									
Interest-bearing demand	$ 576,046	833	0.14	$ 543,690	754	0.14	$ 504,584	607	0.12
Savings and money market	1,010,510	1,339	0.13	908,614	1,166	0.13	783,784	913	0.12
Time deposits	697,654	6,286	0.90	616,747	5,386	0.87	624,299	4,846	0.78
Total interest-bearing deposits	2,284,210	8,458	0.37	2,069,051	7,306	0.35	1,912,667	6,366	0.33
Short-term borrowings	248,938	1,612	0.65	262,494	1,081	0.41	247,956	915	0.37
Long-term borrowings	39,023	2,471	6.33	27,886	1,750	6.28	-	-	-
Total borrowings	287,961	4,083	1.42	290,380	2,831	0.98	247,956	915	0.37
Total interest-bearing liabilities	2,572,171	12,541	0.49	2,359,431	10,137	0.43	2,160,623	7,281	0.34
Noninterest-bearing deposits	633,416			599,334			545,904		
Other liabilities	22,512			21,418			16,203		
Shareholders equity	319,006			289,707			271,874		
Total liabilities and shareholders equity	$ 3,547,105			$ 3,269,890			$ 2,994,604		
Net interest income (tax-equivalent)		$ 105,862			$ 98,410			$ 96,627	
Interest rate spread			3.13%			3.19%			3.42%
Net earning assets	$ 699,921			$ 642,104			$ 599,551		
Net interest margin (tax-equivalent)			3.24%			3.28%			3.50%

Ratio of average interest-earning assets to average interest-bearing liabilities	127.21%	127.21%	127.75%

The net interest spread, as well as the net interest margin, will be impacted by future changes in short-term and long-term interest rate levels, as well as the impact from the competitive environment. A discussion of the effects of changing interest rates on net interest income is set forth in Item 7A. Quantitative and Qualitative Disclosures About Market Risk included elsewhere in this report.

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MANAGEMENT S DISCUSSION AND ANALYSIS

Rate /Volume Analysis

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

	Change from 2016 to 2015			Change from 2015 to 2014		
Increase (decrease) in:	**Volume**	**Rate**	**Total**	**Volume**	**Rate**	**Total**
Interest income:						
Federal funds sold and interest-earning deposits	$ 18	$ -	$ 18	$ -	$ -	$ -
Investment securities:						
Taxable	883	19	902	2,424	395	2,819
Tax-exempt	283	(68)	215	825	(127)	698
Total investment securities	1,166	(49)	1,117	3,249	268	3,517
Loans:						
Commercial business	2,116	201	2,317	672	(369)	303
Commercial mortgage	4,424	(95)	4,329	2,320	(1,529)	791
Residential real estate loans	1,524	(855)	669	1,147	(674)	473
Residential real estate lines	(144)	209	65	13	(35)	(22)
Consumer indirect	1,488	(44)	1,444	558	(782)	(224)
Other consumer	(159)	56	(103)	(245)	46	(199)
Total loans	9,249	(528)	8,721	4,465	(3,343)	1,122
Total interest income	**10,433**	**(577)**	**9,856**	**7,714**	**(3,075)**	**4,639**
Interest expense:						
Deposits:						
Interest-bearing demand	46	33	79	49	98	147
Savings and money market	134	39	173	154	99	253
Time deposits	725	175	900	(60)	600	540
Total interest-bearing deposits	905	247	1,152	143	797	940
Short-term borrowings	(59)	590	531	56	110	166
Long-term borrowings	705	16	721	875	875	1,750
Total borrowings	646	606	1,252	931	985	1,916
Total interest expense	**1,551**	**853**	**2,404**	**1,074**	**1,782**	**2,856**

Net interest income	**$ 8,882**	**$ (1,430)**	**$ 7,452**	**$ 6,640**	**$ (4,857)**	**$ 1,783**

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 was $9.6 million for the year ended December 31, 2016 compared with $7.4 million for 2015. See the Allowance for Loan Losses section of this Management s Discussion and Analysis for further discussion.

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MANAGEMENT S DISCUSSION AND ANALYSIS

Noninterest Income

The following table summarizes our noninterest income for the years ended December 31 (in thousands):

	2016	2015	2014
Service charges on deposits	$ 7,280	$ 7,742	$ 8,954
Insurance income	5,396	5,166	2,399
ATM and debit card	5,687	5,084	4,963
Investment advisory	5,208	2,193	2,138
Company owned life insurance	2,808	1,962	1,753
Investments in limited partnerships	300	895	1,103
Loan servicing	436	503	568
Net gain on sale of loans held for sale	240	249	313
Net gain on investment securities	2,695	1,988	2,041
Net gain on other assets	313	27	69
Amortization of tax credit investment	-	(390)	(2,323)
Contingent consideration liability adjustment	1,170	1,093	-
Other	4,227	3,825	3,372
Total noninterest income	$ 35,760	$ 30,337	$ 25,350

Service charges on deposits were $7.3 million for 2016, a decrease of $462 thousand or 6%, compared to 2015. The decrease was primarily due to a decrease in the amount of checking account overdraft activity, primarily due to changes in customer behavior.

Insurance income increased by $230 thousand, or 4%, to $5.4 million during 2016, reflecting successful business development efforts, including cross-selling of SDN products and services to our FSB customers.

ATM and debit card income was $5.7 million for 2016, an increase of $603 thousand or 12%, compared to 2015. The increase was primarily attributable to more favorable contract terms with a new card vendor and higher transaction volumes.

Investment advisory income increased to $5.2 million in 2016, compared to $2.2 million in 2015, reflecting the contribution from Courier Capital which was acquired in January 2016 as part of our strategy to diversify our business lines and increase noninterest income through additional fee-based services.

Company owned life insurance increased by $846 thousand or 43% in 2016. The increase was primarily due to $911 thousand of death benefit proceeds received by the Company in first quarter of 2016.

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 $300 thousand and $895 thousand for the years ended December 31, 2016 and 2015, respectively. The income from these equity method investments fluctuates based on the maturity and performance of the underlying investments.

During the year ended December 31, 2016 we recognized net gains of $2.7 million from the sale of available for sale (AFS) securities with an amortized cost totaling $92.6 million. The securities sold were comprised of 25 agency securities and 22 mortgage backed securities. During the year ended December 31, 2015 we recognized gains of $2.0 million from the sale of AFS securities with an amortized cost totaling $52.3 million. The securities sold were comprised of 5 agency securities and 13 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.

We recognized $390 thousand for the year ended December 31, 2015, 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. These types of investments are, for the most part, fully amortized in the first year the project is placed in service.

For the years ended December 31, 2016 and 2015, we recognized a $1.2 million and $1.1 million, respectively, non-cash fair value adjustment of the contingent consideration liability related to the SDN acquisition. For additional discussion related to the fair value adjustment of the contingent consideration liability see Note 2, Business Combinations, of the notes to consolidated financial statements.

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MANAGEMENT S DISCUSSION AND ANALYSIS

Noninterest Expense

The following table summarizes our noninterest expense for the years ended December 31 (in thousands):

	2016	2015	2014
Salaries and employee benefits	$ 45,215	$ 42,439	$ 38,595
Occupancy and equipment	14,529	13,856	12,829
Professional services	6,184	4,502	4,760
Computer and data processing	3,402	3,186	3,016
Supplies and postage	2,047	2,155	2,053
FDIC assessments	1,735	1,719	1,592
Advertising and promotions	1,695	1,165	972
Goodwill impairment	-	751	-
Other	9,864	9,620	8,538
Total noninterest expense	$ 84,671	$ 79,393	$ 72,355

Salaries and employee benefits increased by $2.8 million or 7% when comparing 2016 to 2015. The increase was primarily due to the addition of Courier Capital as well as additional personnel to support organic growth as part of our expansion initiatives.

Occupancy and equipment increased by $673 thousand or 5% when comparing 2016 to 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 expense of $6.2 million in 2016 increased $1.7 million or 37% from 2015. The increase was primarily due to the Company s 2016 proxy contest.

Computer and data processing increased by $216 thousand or 7% when comparing 2016 to 2015. We continue to invest in information technology to both maintain and improve our infrastructure.

Advertising and promotions expense increased by $530 thousand or 45% when comparing 2016 to 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, coupled with deposit campaigns in our new branches.

We recognized $751 thousand of goodwill impairment in the fourth quarter of 2015 related to the SDN acquisition. For additional discussion related to the goodwill impairment see Note 7, Goodwill and Other Intangible Assets, of the notes to consolidated financial statements.

Other noninterest expense increased $244 thousand or 3% when comparing 2016 to 2015. The increase was primarily due to higher intangible asset amortization associated with the Courier Capital acquisition.

The efficiency ratio for the year ended December 31, 2016 was 60.92% compared with 61.58% for 2015. The efficiency ratio provides a ratio of operating expenses to operating income. The efficiency ratio is calculated by dividing total noninterest expense, excluding other real estate expense and amortization and impairment of goodwill and other intangible assets, by net revenue, defined as the sum of tax-equivalent net interest income and noninterest income before net gains on investment securities, proceeds from company owned life insurance, adjustments to contingent liabilities and amortizations of tax credit investment. The efficiency ratio is not a financial measurement required by GAAP. However, the efficiency ratio is used by management in its assessment of financial performance specifically as it relates to noninterest expense control. Management also believes such information is useful to investors in evaluating Company performance

Income Taxes

We recorded income tax expense of $12.2 million for 2016, compared to $10.5 million for 2015. Our effective tax rate was 27.7% for 2016 compared to 27.1% for 2015. Effective tax rates are impacted by items of income and expense that are not subject to federal or state taxation. Our effective tax rates differ from the statutory rates primarily due to the effect of interest income from tax-exempt securities, earnings on company owned life insurance and the non-cash fair value adjustment of the contingent consideration liability associated with the SDN acquisition.

In March 2014, the New York legislature approved changes in the state tax law to be phased-in over two years, beginning in 2015. The primary changes that impact us included 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 from 7.1% to 6.5% for 2016. The repeal of Article 32 and the expanded nexus standards lowered our taxable income apportioned to New York in 2016 and 2015 compared to 2014.

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MANAGEMENT S DISCUSSION AND ANALYSIS

RESULTS OF OPERATIONS FOR THE YEARS ENDED

DECEMBER 31, 2015 AND DECEMBER 31, 2014

Net Interest Income and Net Interest Margin

Net interest income was $95.3 million in 2015, compared to $93.8 million in 2014. The taxable equivalent adjustments of $3.1 million and $2.8 million for 2015 and 2014, respectively, resulted in fully taxable equivalent net interest income of $98.4 million in 2015 and $96.6 million in 2014.

During the second quarter of 2015, we used the proceeds of short-term Federal Home Loan Bank (FHLB) advances to purchase high-quality investment securities of approximately $50 million. Our purchase of investment securities was comprised of mortgage-backed securities, U.S. Government agencies and sponsored enterprise bonds and tax-exempt municipal bonds. All of the securities purchased were of high credit quality with a low to moderate duration. This strategy allowed us to increase net interest income by taking advantage of the positive interest rate spread between the FHLB advances and the newly acquired investment securities.

Net interest income on a taxable equivalent basis for 2015 increased $1.8 million or 2%, compared to 2014. The increase was due to an increase in average interest-earning assets of $241.4 million or 9% compared to 2014. The net interest margin was 3.28% for 2015, compared to 3.50% in 2014. This decrease was a function of a 23 basis point decrease in interest rate spread to 3.19% during 2015, partially offset by a 1 basis point higher contribution from net free funds. The lower interest rate spread was a net result of a 14 basis point decrease in the yield on earning assets and a 9 basis point increase in the cost of interest-bearing liabilities.

For the year ended December 31, 2015, the yield on average earning assets of 3.62% was 14 basis points lower than 2014. Loan yields decreased 17 basis points during 2015 to 4.21%. Commercial mortgage loan yields in particular, down 31 basis points, experienced lower yields because of competitive pricing pressures in a low interest rate environment. The yield on investment securities increased 2 basis points during 2015 to 2.46%. Overall, the earning asset rate changes reduced interest income by $2.9 million during 2015, but that was more than offset by a favorable volume variance that increased interest income by $7.5 million, which collectively drove a $4.6 million increase in interest income.

Average interest-earning assets were $3.00 billion for 2015, an increase of $241.4 million or 9% from the prior year, with average loans up $104.9 million and average securities up $136.5 million. Average loans were $1.99 billion for 2015, an increase of $104.9 million or 6% from the prior year. The growth in average loans reflected increases in most loan categories, with commercial and consumer loans up $65.1 million and $49.4 million, respectively, partially offset by a $9.6 million decrease in residential mortgage loans. Loans made up 66.2% of average interest-earning assets during 2015 compared to 68.2% during 2014. Loans generally have significantly higher yields compared to securities and federal funds sold and interest-bearing deposits and, as such, have a more positive effect on the net interest margin. The yield on average loans was 4.21% for 2015, a decrease of 17 basis points compared to 4.38% for 2014. The yield on average loans was negatively impacted by lower average spreads due to increased competition in loan pricing during 2015 compared to 2014. The increase in the volume of average loans resulted in a $4.3 million increase in interest income, partially offset by a $3.2 million decrease due to the unfavorable rate variance. Average securities were $1.01 billion for 2015, an increase of $136.5 million or 16% from the prior year. The growth in average securities was primarily a result of securities purchased with proceeds from our previously described leverage strategy and issuance of the Subordinated Notes. Securities made up 33.8% of average interest-earning assets in 2015 compared to 31.8% in 2014. The yield on average securities was 2.46% in 2015 compared to 2.44% in 2014. The increase in the volume of average securities resulted in a $3.2 million increase in interest income, coupled with a $268 thousand increase due to the favorable rate variance.

For the year ended December 31, 2015, the cost of average interest-bearing liabilities of 0.43% was 9 basis points higher than 2014. The cost of average interest-bearing deposits increased 2 basis points to 0.35% and the cost of short-term borrowings increased 4 basis points to 0.41% in 2015 compared to 2014. The cost of long-term borrowings for 2015 was 6.28% due to the issuance of the Subordinated Notes in April. Overall, interest-bearing liability rate and volume increases resulted in $2.9 million of higher interest expense.

Average interest-bearing liabilities of $2.36 billion in 2015 were $198.8 million or 9% higher than 2014. On average, interest-bearing deposits grew $156.4 million, while noninterest-bearing demand deposits (a principal component of net free funds) were up $53.4 million. The increase in average deposits was due in part to successful business development efforts 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 $940 thousand of higher interest expense during 2015. Average short-term and long-term borrowings were $290.4 million in 2015, $42.4 million higher than in 2014, with the majority of the increase related to the issuance of the previously mentioned Subordinated Notes. Overall, short and long-term borrowing rate and volume changes resulted in $1.9 million of higher interest expense during 2015.

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MANAGEMENT S DISCUSSION AND ANALYSIS

Provision for Loan Losses

The provision for loan losses was $7.4 million for the year ended December 31, 2015 compared with $7.8 million for 2014.

Noninterest Income

Service charges on deposits were $7.7 million for 2015, a decrease of $1.2 million or 14%, compared to 2014. The decrease was primarily due to a decrease in the amount of checking account overdraft activity.

Insurance income increased by $2.8 million to $5.2 million during 2015. The increase reflects the contributions from SDN, which was acquired at the beginning of August last year as part of our strategy to diversify business lines and increase noninterest income through additional fee-based services.

Company owned life insurance increased by $209 thousand or 12% in 2015. The increase was primarily due to new policies purchased during the third and fourth quarters of 2014.

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 $895 thousand and $1.1 million for the years ended December 31, 2015 and 2014, respectively. The income from these equity method investments fluctuates based on the performance of the underlying investments.

During the year ended December 31, 2015 we recognized gains of $2.0 million from the sale of AFS securities with an amortized cost totaling $52.3 million. The securities sold were comprised of 5 agency securities and 13 mortgage backed securities. During the year ended December 31, 2014 we recognized gains of $2.0 million from the sale of AFS securities with an amortized cost totaling $79.6 million. The amount and timing of our sale of investment securities is dependent on a number of factors, including our efforts to realize gains while prudently managing duration, premium and credit risk.

We recognized $390 thousand and $2.3 million for the years ended December 31, 2015 and 2014, respectively, 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. These types of investments are, for the most part, fully amortized in the first year the project is placed in service.

Other noninterest income increased $1.5 million for the year ended December 31, 2015, compared to 2014. Included in other noninterest income is a $1.1 million non-cash fair value adjustment of the contingent consideration liability related to the SDN acquisition. For additional discussion related to the fair value adjustment of the contingent consideration liability see Note 2, Business Combinations, of the notes to consolidated financial statements.

Noninterest Expense

Salaries and employee benefits increased by $3.8 million or 10% when comparing 2015 to 2014. An increase of $3.1 million in salaries expense was primarily due to the full year impact of the addition of employees from SDN and increased staffing associated with our expansion initiatives. An increase of $757 thousand in employee benefits was primarily due to higher expense related to our defined benefit plans and payroll-related taxes. We recognized a combined net periodic pension and post-retirement expense of $731 thousand during 2015 compared to $222 thousand during 2014. The number of full time equivalent employees increased to 660 at December 31, 2015 from 622 at December 31, 2014.

Occupancy and equipment increased by $1.0 million or 8% when comparing 2015 to 2014. The increase was primarily related to higher contractual service expenses and incremental expenses from the SDN facility.

Professional services expense of $4.5 million in 2015 decreased $258 thousand or 5% from 2014. The prior year included additional expense for professional services associated with the acquisition of SDN.

Computer and data processing increased by $170 thousand or 6% when comparing 2015 to 2014. We continue to see an increase in this area due to ongoing regulatory compliance and information technology projects.

Advertising and promotions expense increased by $193 thousand when comparing 2015 to 2014. The increase is primarily attributable to additional marketing services, including branding initiatives and the opening of our new CityGate branch in Rochester, NY. We proactively market our products but vary the timing based on projected benefits and needs.

FDIC assessments increased $127 thousand or 8% for the year ended December 31, 2015 compared to 2014. The increase in assessments is a direct result of the growth in our balance sheet.

We recognized $751 thousand of goodwill impairment in the fourth quarter of 2015 related to the SDN acquisition. For additional discussion related to the goodwill impairment see Note 7, Goodwill and Other Intangible Assets, of the notes to consolidated financial statements.

MANAGEMENT S DISCUSSION AND ANALYSIS

Other noninterest expense increased $1.1 million or 31% when comparing 2015 to 2014. The increase was largely due to higher intangible asset amortization and other incremental expenses due to the full year impact of SDN.

The efficiency ratio for the year ended December 31, 2015 was 61.58% compared with 58.59% for 2014.

Income Taxes

We recorded income tax expense of $10.5 million for 2015, compared to $9.6 million for 2014. Our effective tax rate was 27.1% for 2015 compared to 24.7% for 2014. 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, the lower effective tax rate in 2014 reflects the previously mentioned historic tax credit benefit.

In March 2014, the New York legislature approved changes in the state tax law to be phased-in over two years, beginning in 2015. The primary changes that impacted 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 from 7.1% to 6.5% for 2016. The repeal of Article 32 and the expanded nexus standards lowered our taxable income apportioned to New York in 2015 compared to 2014.

ANALYSIS OF FINANCIAL CONDITION

OVERVIEW

At December 31, 2016, we had total assets of $3.71 billion, an increase of 10% from $3.38 billion as of December 31, 2015, largely attributable to our continued loan growth and higher investment security balances. Net loans were $2.31 billion as of December 31, 2016, up $252.6 million or 12%, when compared to $2.06 billion as of December 31, 2015. The increase in net loans was primarily attributable to organic growth in the commercial, residential real estate loans and consumer indirect portfolios. Non-performing assets totaled $6.4 million as of December 31, 2016, down $2.2 million from a year ago. Total deposits amounted to $3.00 billion as of December 31, 2016, up $264.7 million or 10%, compared to December 31, 2015. As of December 31, 2016, borrowed funds totaled $370.6 million, compared to $332.1 million as of December 31, 2015. Common book value per common share was $20.82 and $19.49 as of December 31, 2016 and 2015, respectively. As of December 31, 2016 our total shareholders equity was $320.1 million compared to $293.8 million a year earlier.

INVESTING ACTIVITIES

The following table summarizes the composition of our available for sale and held to maturity security portfolios (in thousands).

Investment Securities Portfolio Composition
At December 31,

	2016	2015	2014

	Amortized Cost	Fair Value	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Securities available for sale:						
U.S. Government agency and government-sponsored enterprise securities	$ 187,325	$ 186,268	$ 260,748	$ 260,863	$ 160,334	$ 160,475
Mortgage-backed securities:						
Agency mortgage-backed securities	356,667	352,643	282,873	282,505	458,959	460,570
Non-Agency mortgage-backed securities	-	824	-	809	-	1,218
Asset-backed securities	-	191	-	218	-	231
Total available for sale securities	543,992	539,926	543,621	544,395	619,293	622,494
Securities held to maturity:						
State and political subdivisions	305,248	305,759	294,423	300,981	277,273	281,384
Mortgage-backed securities	238,090	234,232	191,294	189,083	17,165	17,311
Total held to maturity securities	543,338	539,991	485,717	490,064	294,438	298,695
Total investment securities	$ 1,087,330	$ 1,079,917	$ 1,029,338	$ 1,034,459	$ 913,731	$ 921,189

Our investment policy is contained within our overall Asset-Liability Management and Investment Policy. This policy dictates that investment decisions will be made based on the safety of the investment, liquidity requirements, potential returns, cash flow targets, need for collateral and desired risk parameters. In pursuing these objectives, we consider the ability of an investment to provide earnings consistent with factors of quality, maturity, marketability, pledgeable nature and risk diversification. Our Treasurer, guided by ALCO, is responsible for investment portfolio decisions within the established policies.

MANAGEMENT S DISCUSSION AND ANALYSIS

Our AFS investment securities portfolio decreased $4.5 million to $539.9 million at December 31, 2016 from $544.4 million at December 31, 2015. Our AFS portfolio had a net unrealized loss totaling $4.1 million at December 31, 2016 compared to a net unrealized gain of $774 thousand at December 31, 2015. The fair value of most of the investment securities in the AFS portfolio fluctuates as market interest rates change.

During the year ended December 31, 2016, we recognized gains of $2.7 million from the sale of AFS securities with an amortized cost totaling $92.6 million. The securities sold were comprised of 25 agency securities and 22 mortgage backed securities.

During the year ended December 31, 2015, we transferred $165.2 million of AFS mortgage backed securities to the held to maturity (HTM) category, reflecting our intent to hold those securities to maturity. Transfers of investment securities into the HTM category from the AFS category are made at fair value at the date of transfer. The related $1.1 million of unrealized holding losses that were included in the transfer during the year ended December 31, 2015 are retained in accumulated other comprehensive income and in the carrying value of the HTM securities. These amounts will be amortized as an adjustment to interest income over the remaining life of the securities. This will offset the impact of amortization of the net premium created in the transfer. There were no gains or losses recognized as a result of this transfer. The transfers of securities from AFS to HTM are expected to reduce the fair value fluctuations in the available for sale portfolio.

Impairment Assessment

We review investment securities on an ongoing basis for the presence of other-than-temporary impairment (OTTI) with formal reviews performed quarterly. Declines in the fair value of held to maturity and available for sale securities below their cost that are deemed to be other than temporary are reflected in earnings as realized losses to the extent the impairment is related to credit losses or the security is intended to be sold or will be required to be sold. The amount of the impairment related to non-credit related factors is recognized in other comprehensive income. Evaluating whether the impairment of a debt security is other than temporary involves assessing i.) the intent to sell the debt security or ii.) the likelihood of being required to sell the security before the recovery of its amortized cost basis. In determining whether the OTTI includes a credit loss, we use our best estimate of the present value of cash flows expected to be collected from the debt security considering factors such as: a.) the length of time and the extent to which the fair value has been less than the amortized cost basis, b.) adverse conditions specifically related to the security, an industry, or a geographic area, c.) the historical and implied volatility of the fair value of the security, d.) the payment structure of the debt security and the likelihood of the issuer being able to make payments that increase in the future, e.) failure of the issuer of the security to make scheduled interest or principal payments, f.) any changes to the rating of the security by a rating agency, and g.) recoveries or additional declines in fair value subsequent to the balance sheet date.

As of December 31, 2016, we do not have the intent to sell any of our securities in a loss position and we believe that it is not likely that we will be required to sell any such securities before the anticipated recovery of amortized cost. The unrealized losses are largely due to increases in market interest rates over the yields available at the time the underlying securities were purchased. The fair value is expected to recover as the bonds approach their maturity date, repricing date or if market yields for such investments decline. We do not believe any of the securities in a loss position are impaired due to reasons of credit quality. Accordingly, as of December 31, 2016, we concluded that unrealized losses on our investment securities are temporary and no further impairment loss has been realized in our consolidated statements of income. The following discussion provides further details of our assessment of the securities portfolio by investment category.

U.S. Government Agencies and Government Sponsored Enterprises (GSE). As of December 31, 2016, there were 32 securities in an unrealized loss position in the U.S. Government agencies and GSE portfolio with unrealized losses totaling $1.6 million. Of these, 3 were in an unrealized loss position for 12 months or longer and had an aggregate fair value of $1.4 million and unrealized losses of $3 thousand. The decline in fair value is attributable to changes in interest rates, and not credit quality, and because we do not have the intent to sell these securities and it is likely that we will not be required to sell the securities before their anticipated recovery, we do not consider these securities to be other-than-temporarily impaired at December 31, 2016.

State and Political Subdivisions. As of December 31, 2016, the state and political subdivisions (municipal securities) portfolio totaled $305.2 million, all of which was classified as HTM. As of that date, each of the 267 municipal securities in an unrealized loss position had been in an unrealized loss position for less than 12 months. Those securities had an aggregate fair value of $82.6 million and unrealized losses totaling $1.6 million.

The decline in fair value is attributable to changes in interest rates, and not credit quality, and because we do not have the intent to sell these securities and it is not likely that we will be required to sell the securities before their anticipated recovery, we do not consider these securities to be other-than-temporarily impaired at December 31, 2016.

Agency Mortgage-backed Securities. With the exception of the non-Agency mortgage-backed securities (non-Agency MBS) discussed below, all of the mortgage-backed securities held by us as of December 31, 2016, were issued by U.S. Government sponsored entities and agencies (Agency MBS), primarily FNMA and FHLMC. The contractual cash flows of our Agency MBS are guaranteed by FNMA, FHLMC or GNMA. The GNMA mortgage-backed securities are backed by the full faith and credit of the U.S. Government.

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As of December 31, 2016, each of the 79 securities in the AFS Agency MBS portfolio that were in an unrealized loss position had been in an unrealized loss position for less than 12 months. As of December 31, 2016, there were 85 securities in the HTM Agency MBS portfolio that were in an unrealized loss position. Of these, 6 were in an unrealized loss position for 12 months or longer and had an aggregate fair value of $4.1 million and unrealized losses of $16 thousand.

Given the high credit quality inherent in Agency MBS, we do not consider any of the unrealized losses as of December 31, 2016 on such MBS to be credit related or other-than-temporary. As of December 31, 2016, we did not intend to sell any Agency MBS that were in an unrealized loss position, all of which were performing in accordance with their terms.

Non-Agency Mortgage-backed Securities. Our non-Agency MBS portfolio consists of positions in two privately issued whole loan collateralized mortgage obligations with a fair value and net unrealized gains of $824 thousand as of December 31, 2016. As of that date, each of the two non-Agency MBS were rated below investment grade. None of these securities were in an unrealized loss position.

Asset-backed Securities (ABS). Our ABS portfolio consisted of one security with a fair value and unrealized gain of $191 thousand as of December 31, 2016. As of December 31, 2016, the ABS security was rated below investment grade.

Other Investments. As a member of the FHLB, the Bank is required to hold FHLB stock. The amount of required FHLB stock is based on the Bank s asset size and the amount of borrowings from the FHLB. We have assessed the ultimate recoverability of our FHLB stock and believe that no impairment currently exists. As a member of the FRB system, we are required to maintain a specified investment in FRB stock based on a ratio relative to our capital. At December 31, 2016, our ownership of FHLB and FRB stock totaled $16.9 million and $4.9 million, respectively and is included in other assets and recorded at cost, which approximates fair value.

LENDING ACTIVITIES

Total loans were $2.34 billion at December 31, 2016, an increase of $256.4 million or 12% from December 31, 2015. Commercial loans increased $139.7 million and represented 43.5% of total loans at the end of 2016. Consumer loans increased $116.7 million to represent 56.5% of total loans at December 31, 2016. The composition of our loan portfolio, excluding loans held for sale and including net unearned income and net deferred fees and costs, is summarized as follows (in thousands):

Loan Portfolio Composition
At December 31,

	2016		2015		2014		2013		2012
	Amount	**Percent**	**Amount**	**Percent**	**Amount**	**Percent**	**Amount**	**Percent**	**Amount**
cial business	$ 349,547	14.9%	$ 313,758	15.0%	$ 267,409	14.0%	$ 265,766	14.5%	$ 258,675
cial mortgage	670,058	28.6	566,101	27.2	475,092	24.8	469,284	25.6	413,324

mmercial	1,019,605	43.5	879,859	42.2	742,501	38.8	735,050	40.1	671,999
ial real estate	427,937	18.3	381,074	18.3	357,187	18.7	310,394	16.9	285,068
ial real estate	122,555	5.2	127,347	6.1	129,529	6.8	128,737	7.0	135,101
er indirect	752,421	32.2	676,940	32.5	661,673	34.6	636,368	34.7	586,794
nsumer	17,643	0.8	18,542	0.9	21,112	1.1	23,070	1.3	26,764
nsumer	1,320,556	56.5	1,203,903	57.8	1,169,501	61.2	1,098,569	59.9	1,033,727
ns	2,340,161	100.0%	2,083,762	100.0%	1,912,002	100.0%	1,833,619	100.0%	1,705,726
ce for loan	30,934		27,085		27,637		26,736		24,714
ns, net	$ 2,309,227		$ 2,056,677		$ 1,884,365		$ 1,806,883		$ 1,681,012

Commercial loans increased during 2016 as we continued our commercial business development efforts. 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.

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MANAGEMENT S DISCUSSION AND ANALYSIS

Factors that are important to managing overall credit quality are sound loan underwriting and administration, systematic monitoring of existing loans and commitments, effective loan review on an ongoing basis, early identification of potential problems, an appropriate allowance for loan losses, and sound nonaccrual and charge off policies.

An active credit risk management process is used for commercial loans to further ensure that sound and consistent credit decisions are made. Credit risk is controlled by detailed underwriting procedures, comprehensive loan administration, and periodic review of borrowers outstanding loans and commitments. Borrower relationships are formally reviewed and graded on an ongoing basis for early identification of potential problems. Further analyses by customer, industry, and geographic location are performed to monitor trends, financial performance, and concentrations.

We participate in various lending programs in which guarantees are supplied by U.S. government agencies, such as the SBA, U.S. Department of Agriculture, Rural Economic and Community Development and Farm Service Agency, among others. As of December 31, 2016, the principal balance of such loans (included in commercial loans) was $50.1 million and the guaranteed portion amounted to $32.0 million. Most of these loans were guaranteed by the SBA.

Commercial business loans were $349.5 million at the end of 2016, up $35.7 million or 11% since the end of 2015, and comprised 14.9% of total loans outstanding at December 31, 2016, compared to 15.0% at December 31, 2015. We typically originate business loans of up to $15.0 million for small to mid-sized businesses in our market area for working capital, equipment financing, inventory financing, accounts receivable financing, or other general business purposes. Loans of this type are in a diverse range of industries. As of December 31, 2016, commercial business SBA loans accounted for a total of $34.4 million or 10% of our commercial business loan portfolio.

Commercial mortgage loans totaled $670.1 million at December 31, 2016, up $104.0 million or 18% from December 31, 2015, and comprised 28.6% of total loans, compared to 27.2% at December 31, 2015. Commercial mortgage loans include both owner occupied and non-owner occupied commercial real estate loans. Approximately 39% and 41% of our commercial mortgage portfolio at December 31, 2016 and 2015, respectively, was owner occupied commercial real estate. The majority of our commercial real estate loans are secured by office buildings, manufacturing facilities, distribution/warehouse facilities, and retail centers, which are generally located in our local market area. As of December 31, 2016, commercial mortgage SBA loans accounted for a total of $11.2 million or 2% of our commercial mortgage loan portfolio.

We determine our current lending standards for commercial real estate and real estate construction lending by property type and specifically address many criteria, including: maximum loan amounts, maximum loan-to-value (LTV), requirements for pre-leasing or pre-sales, minimum debt-service coverage ratios, minimum borrower equity, and maximum loan to cost. Currently, the maximum standard for LTV is 85%, with lower limits established for certain higher risk types, such as raw land which has a 65% LTV maximum.

Consumer loans totaled $1.32 billion at December 31, 2016, up $116.6 million or 10% compared to 2015, and represented 56.5% of the 2016 year-end loan portfolio versus 57.8% at year-end 2015. Loans in this classification include residential real estate loans, residential real estate lines, indirect consumer and other consumer installment loans. 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. Risks of loss are generally on smaller average balances per loan spread over many borrowers. Once charged off, there is usually less opportunity for recovery on these smaller retail loans. Credit risk is primarily controlled by reviewing the creditworthiness of the borrowers, monitoring payment histories, and taking appropriate collateral and guaranty positions.

Residential real estate loans include conventional first lien mortgages and home equity loans and lines of credit. For conventional first lien mortgages, we generally limit the maximum loan to 85% of collateral value without credit enhancement (e.g. personal mortgage insurance). The majority of our fixed-rate conventional mortgage loans are sold in the secondary market with servicing rights retained. Our conventional mortgage products continue to be underwritten using FHLMC secondary marketing guidelines. Our underwriting guidelines for home equity products include a combination of borrower FICO (credit score), the LTV of the property securing the loan and evidence of the borrower having sufficient income to repay the loan. Currently, for home equity products, the maximum acceptable LTV is 90%. The average FICO score for new home equity production was 763 and 753 during the years ended December 31, 2016 and 2015, respectively.

Residential real estate loans totaled $427.9 million at the end of 2016, up $46.9 million or 12% from the end of the prior year and comprised 18.3% of total loans outstanding at December 31, 2016 and 2015. As of December 31, 2016 and 2015, our residential real estate loan portfolio included $11.3 million and $12.8 million, respectively, of loans acquired during the 2012 branch acquisitions. The residential real estate line portfolio amounted to $122.6 million at December 31, 2016 down $4.8 million or 4% compared to 2015, and represented 5.2% of the 2016 year-end loan portfolio versus 6.1% at year-end 2015. As of December 31, 2016 and 2015, our residential real estate line portfolio included $11.5 million and $15.0 million, respectively, of loans acquired during the 2012 branch acquisitions.

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The residential real estate loans and lines portfolios had a weighted average LTV at origination of approximately 63% and 61% at December 31, 2016 and 2015, respectively. Approximately 87% and 85% of the loans and lines were first lien positions at December 31, 2016 and 2015, respectively. We continue to grow our home equity portfolio as the lower origination cost and convenience to customers has made these products an attractive alternative to conventional residential mortgage loans.

Consumer indirect loans amounted to $752.4 million at December 31, 2016 up $75.5 million or 11% compared to 2015, and represented 32.2% of the 2016 year-end loan portfolio versus 32.5% at year-end 2015. The loans are primarily for the purchase of automobiles (both new and used) and light duty trucks primarily by individuals, but also by corporations and other organizations. The loans are originated through dealerships and assigned to us with terms that typically range from 36 to 84 months. During the year ended December 31, 2016, we originated $356.4 million in indirect loans with a mix of approximately 43% new vehicles and 57% used vehicles. This compares with $296.9 million in indirect loans with a mix of approximately 40% new vehicles and 60% used vehicles for the same period in 2015. We do business with over 450 franchised auto dealers located in Western, Central, and the Capital District of New York, and Northern and Central Pennsylvania. The average FICO score for indirect loan production was 731 and 728 during the years ended December 31, 2016 and 2015, respectively. Other consumer loans totaled $17.6 million at December 31, 2016, down $899 thousand or 5% compared to 2015, and represented less than one percent of the 2016 and 2015 year-end loan portfolio. Other consumer loans consist of personal loans (collateralized and uncollateralized) and deposit account collateralized loans.

Our loan portfolio is widely diversified by types of borrowers, industry groups, and market areas within our core footprint. Significant loan concentrations are considered to exist for a financial institution when there are amounts loaned to numerous borrowers engaged in similar activities that would cause them to be similarly impacted by economic or other conditions. At December 31, 2016, no significant concentrations, as defined above, existed in our portfolio in excess of 10% of total loans.

Loans Held for Sale and Loan Servicing Rights. Loans held for sale (not included in the loan portfolio composition table) were entirely comprised of residential real estate loans and totaled $1.1 million and $1.4 million as of December 31, 2016 and 2015, respectively.

We sell certain qualifying newly originated or refinanced residential real estate loans on the secondary market. Residential real estate loans serviced for others, which are not included in the consolidated statements of financial condition, amounted to $173.7 million and $196.0 million as of December 31, 2016 and 2015, respectively.

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Allowance for Loan Losses

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

Loan Loss Analysis Year Ended December 31,	2016	2015	2014	2013	2012
Allowance for loan losses, beginning of year	$ 27,085	$ 27,637	$ 26,736	$ 24,714	$ 23,260
Charge-offs:					
Commercial business	943	1,433	204	1,070	729
Commercial mortgage	385	895	304	553	745
Residential real estate loans	289	397	382	748	520
Residential real estate lines	104	199	148	54	111
Consumer indirect	8,748	9,156	10,004	8,125	6,589
Other consumer	607	878	972	928	874
Total charge-offs	11,076	12,958	12,014	11,478	9,568
Recoveries:					
Commercial business	447	212	201	349	336
Commercial mortgage	45	146	143	319	261
Residential real estate loans	174	114	76	169	157
Residential real estate lines	15	31	19	42	17
Consumer indirect	4,259	4,200	4,321	3,161	2,769
Other consumer	347	322	366	381	354
Total recoveries	5,287	5,025	5,126	4,421	3,894
Net charge-offs	5,789	7,933	6,888	7,057	5,674
Provision for loan losses	9,638	7,381	7,789	9,079	7,128
Allowance for loan losses, end of year	$ 30,934	$ 27,085	$ 27,637	$ 26,736	$ 24,714
Net charge-offs to average loans	0.26%	0.40%	0.37%	0.40%	0.36%
Allowance to end of period loans	1.32%	1.30%	1.45%	1.46%	1.45%
Allowance to end of period non-performing loans	489%	321%	272%	161%	271%

The following table sets forth the allocation of the allowance for loan losses by loan category as of the dates indicated. The allocation is made for analytical purposes and is not necessarily indicative of the categories in which actual losses may occur. The total allowance is available to absorb losses from any segment of the loan portfolio (in thousands).

Allowance for Loan Losses by Loan Category
At December 31,

	2016		2015		2014		2013		2012	
	Loan Loss Allowance	Percentage of loans by category to total loans	Loan Loss Allowance	Percentage of loans by category to total loans	Loan Loss Allowance	Percentage of loans by category to total loans	Loan Loss Allowance	Percentage of loans by category to total loans	Loan Loss Allowance	Percentage of loans by category to total loans
Commercial business	$ 7,225	14.9%	$ 5,540	15.0%	$ 5,621	14.0%	$ 4,273	14.5%	$ 4,884	15.2%
Commercial mortgage	10,315	28.6	9,027	27.2	8,122	24.8	7,743	25.6	6,581	24.2
Residential real estate loans	1,478	18.3	1,347	18.3	1,620	18.7	1,607	16.9	1,485	16.7
Residential real estate lines	303	5.2	345	6.1	435	6.8	436	7.0	537	7.9
Consumer indirect	11,311	32.2	10,458	32.5	11,383	34.6	12,230	34.7	10,715	34.4
Other consumer	302	0.8	368	0.9	456	1.1	447	1.3	512	1.6
Total	$ 30,934	100.0%	$ 27,085	100.0%	$ 27,637	100.0%	$ 26,736	100.0%	$ 24,714	100.0%

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Management believes that the allowance for loan losses at December 31, 2016 is adequate to cover probable losses in the loan portfolio at that date. Factors beyond our control, however, such as general national and local economic conditions, can adversely impact the adequacy of the allowance for loan losses. As a result, no assurance can be given that adverse economic conditions or other circumstances will not result in increased losses in the portfolio or that the allowance for loan losses will be sufficient to meet actual loan losses. See Part I, Item 1A Risk Factors for the risks impacting this estimate. Management presents a quarterly review of the adequacy of the allowance for loan losses to the Audit Committee of our Board of Directors based on the methodology that is described in further detail in Part I, Item I Business under the section titled Lending Activities . See also Critical Accounting Estimates for additiona information on the allowance for loan losses.

Non-performing Assets and Potential Problem Loans

The following table sets forth information regarding non-performing assets (in thousands):

	Non-performing Assets At December 31,				
	2016	2015	2014	2013	2012
Non-accruing loans:					
Commercial business	$ 2,151	$ 3,922	$ 4,288	$ 3,474	$ 3,413
Commercial mortgage	1,025	947	3,020	9,663	1,799
Residential real estate loans	1,236	1,848	1,451	1,723	2,878
Residential real estate lines	372	235	206	280	101
Consumer indirect	1,526	1,467	1,169	1,471	891
Other consumer	7	13	11	5	25
Total non-accruing loans	6,317	8,432	10,145	16,616	9,107
Restructured accruing loans	-	-	-	-	-
Accruing loans contractually past due over 90 days	9	8	8	6	18
Total non-performing loans	6,326	8,440	10,153	16,622	9,125
Foreclosed assets	107	163	194	333	184
Non-performing investment securities	-	-	-	128	753
Total non-performing assets	$ 6,433	$ 8,603	$ 10,347	$ 17,083	$ 10,062
Non-performing loans to total loans	0.27%	0.41%	0.53%	0.91%	0.53%
Non-performing assets to total assets	0.17%	0.25%	0.33%	0.58%	0.36%

Non-performing assets include non-performing loans, foreclosed assets and non-performing investment securities. Non-performing assets at December 31, 2016 were $6.4 million, a decrease of $2.2 million from the $8.6 million balance at December 31, 2015. The primary component of non-performing assets is non-performing loans, which were $6.3 million or 0.27% of total loans at December 31, 2016, a decrease of $2.1 million from $8.4 million or 0.41% of total loans at December 31, 2015.

Approximately $2.0 million, or 31%, of the $6.3 million in non-performing loans as of December 31, 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. The amount of interest income forgone totaled $234 thousand and $432 thousand for non-accruing loans outstanding as of December 31, 2016 and 2015, respectively. Included in nonaccrual loans are troubled debt restructurings (TDRs) of $1.4 million and $2.4 million at December 31, 2016 and 2015, respectively. We had no TDRs that were accruing interest as of December 31, 2016 or 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 four properties totaling $107 thousand at December 31, 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 $15.6 million and $12.1 million in loans that continued to accrue interest which were classified as substandard as of December 31, 2016 and 2015, respectively.

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FUNDING ACTIVITIES

Deposits

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

	At December 31,					
	2016		2015		2014	
	Amount	Percent	Amount	Percent	Amount	Percent
Noninterest-bearing demand	$ 677,076	22.6 %	$ 641,972	23.5 %	$ 571,260	23.3 %
Interest-bearing demand	581,436	19.4	523,366	19.2	490,190	20.0
Savings and money market	1,034,194	34.5	928,175	34.0	795,835	32.5
Time deposits < $250,000	602,715	20.2	545,044	19.9	526,782	21.5
Time deposits of $250,000 or more	99,801	3.3	91,974	3.4	66,460	2.7
Total deposits	$ 2,995,222	100.0 %	$ 2,730,531	100.0 %	$ 2,450,527	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 December 31, 2016, total deposits were $3.00 billion, representing an increase of $264.7 million for the year.

Nonpublic deposits, the largest component of our funding sources, totaled $2.19 billion and $2.05 billion at December 31, 2016 and 2015, respectively, and represented 73% and 75% 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 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 $803.6 million and $675.7 million at December 31, 2016 and December 31, 2015, respectively, and represented 27% and 25% of total deposits as of the end of each period, respectively. The increase in public deposits during 2016 was due largely to successful business development efforts.

We had no traditional brokered deposits at December 31, 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 $143.2 million and

$152.9 million, respectively, at December 31, 2016, compared to $92.9 million and $146.6 million, respectively, at December 31, 2015.

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Borrowings

The Company classifies borrowings as short-term or long-term in accordance with the original terms of the agreement. Outstanding borrowings are summarized as follows as of December 31 (in thousands):

	2016	2015
Short-term borrowings:		
Short-term FHLB borrowings	$ 331,500	$ 293,100
Long-term borrowings:		
Subordinated notes, net	39,061	38,990
Total borrowings	$ 370,561	$ 332,090

Short-term borrowings

Short-term FHLB borrowings have original maturities of less than one year and include overnight borrowings which we typically utilize to address short term funding needs as they arise. Short-term FHLB borrowings at December 31, 2016 consisted of $171.5 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 FHLB borrowings are collateralized by securities from the Company s investment portfolio and certain qualifying loans. At December 31, 2016 and 2015, the Company s borrowings had a weighted average rate of 0.76% and 0.53%, respectively.

We have credit capacity with the FHLB and can borrow through facilities that include amortizing and term advances or repurchase agreements. We had approximately $50 million of immediate credit capacity with the FHLB as of December 31, 2016. We had approximately $535 million in secured borrowing capacity at the Federal Reserve Bank (FRB) discount window, none of which was outstanding at December 31, 2016. The FHLB and FRB credit capacity are collateralized by securities from our investment portfolio and certain qualifying loans. We had $140 million of credit available under unsecured federal funds purchased lines with various banks as of December 31, 2016. Additionally, we had approximately $154 million of unencumbered liquid securities available for pledging.

The Parent has a revolving line of credit with a commercial bank allowing borrowings up to $20.0 million in total as an additional source of working capital. At December 31, 2016, no amounts have been drawn on the line of credit.

The following table summarizes information relating to our short-term borrowings (dollars in thousands).

	At or for the Year Ended December 31,		
	2016	2015	2014
Year-end balance	$ 331,500	$ 293,100	$ 334,804
Year-end weighted average interest rate	0.76 %	0.53 %	0.35 %

Maximum outstanding at any month-end	$ 358,700	$ 351,600	$ 334,804
Average balance during the year	$ 248,938	$ 262,494	$ 247,956
Average interest rate for the year	0.65 %	0.41 %	0.37 %

<u>Long-term borrowings</u>

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 net proceeds from this offering were used for general corporate purposes, including but not limited to, contribution of capital to the Bank to support both organic growth and opportunistic acquisitions. The Subordinated Notes qualify as Tier 2 capital for regulatory purposes.

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Shareholders Equity

Total shareholders equity was $320.0 million at December 31, 2016, an increase of $26.2 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 $31.9 million and $8.1 million, respectively, which were partially offset by common and preferred stock dividends declared of $13.2 million. Accumulated other comprehensive loss included in shareholders equity increased $2.6 million during the year due primarily to higher net unrealized losses on securities available for sale. The decrease of $1.0 million in treasury stock during 2016 was primarily due to the exercise of stock options with an aggregate exercise value of $964 thousand. For detailed information on shareholders equity, see Note 12, Shareholders Equity, of the notes to consolidated financial statements. FII and the Bank are subject to various regulatory capital requirements. At December 31, 2016 both FII and the Bank exceeded all regulatory requirements. For detailed information on regulatory capital requirements, see Note 11, Regulatory Matters, of the notes to consolidated financial statements.

LIQUIDITY AND CAPITAL RESOURCES

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.

Liquidity for the Bank is managed through the monitoring of anticipated changes in loans, the investment portfolio, core deposits and wholesale funds. The strength of the Bank s liquidity position is a result of its base of core customer deposits. These core deposits are supplemented by wholesale funding sources that include credit lines with the other banking institutions, the FHLB and the FRB.

The primary sources of liquidity for FII are dividends from the Bank and access to financial and capital markets. Dividends from the Bank are limited by various regulatory requirements related to capital adequacy and earnings trends. The Bank relies on cash flows from operations, core deposits, borrowings and short-term liquid assets.

Cash and cash equivalents were $71.3 million as of December 31, 2016, an increase of $11.2 million from $60.1 million as of December 31, 2016. Net cash provided by operating activities totaled $46.7 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 $326.7 million, which included outflows of $262.7 million for net loan originations and $58.8 million from net investment securities transactions. Net cash provided by financing activities of $291.1 million was attributed to a $264.7 million increase in deposits and a $38.4 million increase in short-term borrowings, partly offset by $12.9 million in dividend payments.

Contractual Obligations and Other Commitments

The following table summarizes the maturities of various contractual obligations and other commitments (in thousands):

	At December 31, 2016				
	Within 1 year	Over 1 to 3 years	Over 3 to 5 Years	Over 5 years	Total
On-Balance sheet:					
Time deposits [1]	$ 471,494	$ 181,947	$ 49,075	$ -	$ 702,516
Supplemental executive retirement plans	360	752	507	765	2,384
Earn-out liabilities	1,200	450	-	-	1,650
Subordinated notes	-	-	-	40,000	40,000
Off-Balance sheet:					
Limited partnership investments [2]	$ 792	$ 1,584	$ 792	$ -	$ 3,168
Commitments to extend credit [3]	555,713	-	-	-	555,713
Standby letters of credit [3]	7,487	4,805	397	-	12,689
Operating leases	2,173	4,326	3,822	30,885	41,206

(1) Includes the maturity of time deposits amounting to $100 thousand or more as follows: $185.7 million in three months or less; $31.1 million between three months and six months; $61.1 million between six months and one year; and $87.5 million over one year.

(2) We have committed to capital investments in several limited partnerships of up to $9.0 million, of which we have contributed $5.9 million as of December 31, 2016, including $897 thousand during 2016.

(3) We do not expect all of the commitments to extend credit and standby letters of credit to be funded. Thus, the total commitment amounts do not necessarily represent our future cash requirements.

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Off-Balance Sheet Arrangements

With the exception of obligations in connection with our irrevocable loan commitments, operating leases and limited partnership investments as of December 31, 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 1, Summary of Significant Accounting Policies and Note 10, Commitments and Contingencies, in the notes to the accompanying consolidated financial statements.

Security Yields and Maturities Schedule

The following table sets forth certain information regarding the amortized cost (Cost), weighted average yields (Yield) and contractual maturities of our debt securities portfolio as of December 31, 2016. Mortgage-backed securities are included in maturity categories based on their stated maturity date. Actual maturities may differ from the contractual maturities presented because borrowers may have the right to call or prepay certain investments. No tax-equivalent adjustments were made to the weighted average yields (dollars in thousands).

	Due in one year or less		Due from one to five years		Due after five years through ten years		Due after ten years		Total	
	Cost	Yield	Cost	Yield	Cost	Yield	Cost	Yield	Cost	Yield
vailable for sale ebt securities:										
.S. Government gencies and overnment-sponsored nterprises	$ 127	0.95%	$ 32,684	1.57%	$ 148,956	2.33%	$ 5,558	1.24%	$ 187,325	2.16%
ortgage-backed ecurities	-	-	116,565	1.90	128,191	2.54	111,911	2.15	356,667	2.22
	127	0.95	149,249	1.83	277,147	2.42	117,469	2.16	543,992	2.20
eld to maturity debt ecurities:										
tate and political ubdivisions	48,132	1.50	176,150	2.12	80,966	1.88	-	-	305,248	1.96
ortgage-backed ecurities	-	-	-	-	12,883	1.35	225,207	2.07	238,090	2.03
	48,132	1.50	176,150	2.12	93,849	1.81	225,207	2.07	543,338	1.99
otal investment ecurities	$ 48,259	1.50%	$ 325,399	1.99%	$ 370,996	2.26%	$ 342,676	2.10%	$ 1,087,330	2.10%

Contractual Loan Maturity Schedule

The following table summarizes the contractual maturities of our loan portfolio at December 31, 2016. Loans, net of deferred loan origination costs, include principal amortization and non-accruing loans. Demand loans having no stated schedule of repayment or maturity and overdrafts are reported as due in one year or less (in thousands).

	Due in less than one year	Due from one to five years	Due after five years	Total
Commercial business	$ 119,114	$ 172,953	$ 57,480	$ 349,547
Commercial mortgage	184,712	335,331	150,015	670,058
Residential real estate loans	64,150	178,438	185,349	427,937
Residential real estate lines	19,416	47,084	56,055	122,555
Consumer indirect	280,820	456,219	15,382	752,421
Other consumer	7,747	8,875	1,021	17,643
Total loans	$ 675,959	$ 1,198,900	$ 465,302	$ 2,340,161
Loans maturing after one year:				
With a predetermined interest rate		$ 853,661	$ 245,352	$ 1,099,013
With a floating or adjustable rate		345,239	219,950	565,189
Total loans maturing after one year		$ 1,198,900	$ 465,302	$ 1,664,202

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Capital Resources

The FRB has adopted a system using risk-based capital guidelines to evaluate the capital adequacy of bank holding companies on a consolidated basis. 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 December 31, 2016, the Company s capital levels remained characterized as well-capitalized under the new rules. We continue to evaluate the potential impact that regulatory rules may have on our liquidity and capital management strategies, including Basel III and those required under the Dodd-Frank Act. See Note 11, Regulatory Matters of the notes to consolidated financial statements and the Basel III Capital Rules section below for further discussion. The following table reflects the Company s ratios and their components as of December 31 (in thousands):

	2016	2015
Common shareholders equity	$ 302,714	$ 276,504
Less: Goodwill and other intangible assets	68,759	61,217
Net unrealized (loss) gain on investment securities [1]	(3,729)	(696)
Net periodic pension & postretirement benefits plan adjustments	(10,222)	(10,631)
Other	-	201
Common equity Tier 1 (CET1) capital	247,906	226,413
Plus: Preferred stock	17,340	17,340
Less: Other	-	301
Tier 1 Capital	265,246	243,452
Plus: Qualifying allowance for loan losses	30,934	27,085
Subordinated Notes	39,061	38,990
Total regulatory capital	$ 335,241	$ 309,527
Adjusted average total assets (for leverage capital purposes)	$ 3,602,377	$ 3,287,646
Total risk-weighted assets	$ 2,584,161	$ 2,318,536
Regulatory Capital Ratios		
Tier 1 leverage (Tier 1 capital to adjusted average assets)	7.36%	7.41%
CET1 capital (CET1 capital to total risk-weighted assets)	9.59	9.77
Tier 1 capital (Tier 1 capital to total risk-weighted assets)	10.26	10.50
Total risk-based capital (Total regulatory capital to total risk-weighted assets)	12.97	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

In July 2013, the FRB and the FDIC approved the final rules implementing the BCBS s capital guidelines for U.S. banks. Under the final rules, minimum requirements will increase for both the quantity and quality of capital held by the Company. The rules include a new common equity Tier 1 capital to risk-weighted assets minimum ratio of 4.5%, raise the minimum ratio of Tier 1 capital to risk-weighted assets from 4.0% to 6.0%, require a minimum ratio of total capital to risk-weighted assets 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. This capital conservation buffer will be phased in beginning 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. Strict eligibility criteria for regulatory capital instruments were also implemented under the final rules. The final rules also revise the definition and calculation of Tier 1 capital, total capital, and risk-weighted assets.

The phase-in period for the final rules became effective for the Company on January 1, 2015, with full compliance with all of the final rules requirements phased in over a multi-year schedule, to be fully phased-in by January 1, 2019. As of December 31, 2016, the Company s capital levels remained characterized as well-capitalized under the new rules.

MANAGEMENT S DISCUSSION AND ANALYSIS

CRITICAL ACCOUNTING ESTIMATES

Our consolidated financial statements are prepared in accordance with GAAP and are consistent with predominant practices in the financial services industry. Application of critical accounting policies, which are those policies that management believes are the most important to our financial position and results, requires management to make estimates, assumptions, and judgments that affect the amounts reported in the consolidated financial statements and accompanying notes and are based on information available as of the date of the financial statements. Future changes in information may affect these estimates, assumptions and judgments, which, in turn, may affect amounts reported in the financial statements.

We have numerous accounting policies, of which the most significant are presented in Note 1, Summary of Significant Accounting Policies, of the notes to consolidated financial statements. These policies, along with the disclosures presented in the other financial statement notes and in this discussion, provide information on how significant assets, liabilities, revenues and expenses are reported in the consolidated financial statements and how those reported amounts are determined. Based on the sensitivity of financial statement amounts to the methods, assumptions, and estimates underlying those amounts, management has determined that the accounting policies with respect to the allowance for loan losses, valuation of goodwill and deferred tax assets, and accounting for defined benefit plans require particularly subjective or complex judgments important to our financial position and results of operations, and, as such, are considered to be critical accounting policies as discussed below. These estimates and assumptions are based on management s best estimates and judgment and are evaluated on an ongoing basis using historical experience and other factors, including the current economic environment. We adjust these estimates and assumptions when facts and circumstances dictate. Illiquid credit markets and volatile equity have combined with declines in consumer spending to increase the uncertainty inherent in these estimates and assumptions. As future events cannot be determined with precision, actual results could differ significantly from our estimates.

Adequacy of the Allowance for Loan Losses

The allowance for loan losses represents management s estimate of probable credit losses inherent in the loan portfolio. Determining the amount of the allowance for loan losses is considered a critical accounting estimate because it requires significant judgment and the use of subjective measurements including management s assessment of the internal risk classifications of loans, changes in the nature of the loan portfolio, industry concentrations, existing economic conditions, the fair value of underlying collateral, and other qualitative and quantitative factors which could affect probable credit losses. Because current economic conditions and borrower strength can change and future events are inherently difficult to predict, the anticipated amount of estimated loan losses, and therefore the appropriateness of the allowance for loan losses, could change significantly. As an integral part of their examination process, various regulatory agencies also review the allowance for loan losses. Such agencies may require additions to the allowance for loan losses or may require that certain loan balances be charged off or downgraded into criticized loan categories when their credit evaluations differ from those of management, based on their judgments about information available to them at the time of their examination. We believe the level of the allowance for loan losses is appropriate as recorded in the consolidated financial statements.

For additional discussion related to our accounting policies for the allowance for loan losses, see the sections titled Allowance for Loan Losses in Part II, Item 7, Management s Discussion and Analysis of Financial Condition and Results of Operations and Note 1, Summary of Significant Accounting Policies, of the notes to consolidated financial statements.

Valuation of Goodwill

Goodwill represents the excess of the purchase price over the fair value of net assets acquired in accordance with the purchase method of accounting for business combinations. Goodwill has an indefinite useful life and is not amortized, but is tested for impairment. GAAP requires goodwill to be tested for impairment at our reporting unit level on an annual basis and more frequently if events or circumstances indicate that there may be impairment. We test goodwill for impairment as of September 30 of each year.

Impairment exists when a reporting unit s carrying value of goodwill exceeds its implied fair value. In testing goodwill for impairment, GAAP permits us to first assess qualitative factors to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying value (Step 0). If, after assessing the totality of events and circumstances, we determine it is not more likely than not that the fair value of a reporting unit is less than its carrying value, then performing the two-step impairment test would be unnecessary. However, if we conclude otherwise, we would then be required to perform the first step (Step 1) of the goodwill impairment test, and continue to the second step (Step 2), if necessary. Step 1 compares the fair value of a reporting unit with its carrying value, including goodwill. If the carrying value of the reporting unit exceeds its fair value, Step 2 of the goodwill impairment test is performed to measure the value of impairment loss, if any.

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Valuation of Deferred Tax Assets

The determination of deferred tax expense or benefit is based on changes in the carrying amounts of assets and liabilities that generate temporary differences. The carrying value of our net deferred tax assets assumes that we will be able to generate sufficient future taxable income based on estimates and assumptions (after consideration of historical taxable income as well as tax planning strategies). If these estimates and related assumptions change, we may be required to record valuation allowances against our deferred tax assets resulting in additional income tax expense in the consolidated statements of income. We evaluate deferred tax assets on a quarterly basis and assess the need for a valuation allowance, if any. A valuation allowance is established when management believes that it is more likely than not that some portion of its deferred tax assets will not be realized. Changes in valuation allowance from period to period are included in our tax provision in the period of change. For additional discussion related to our accounting policy for income taxes see Note 15, Income Taxes, of the notes to consolidated financial statements.

Defined Benefit Pension Plan

We have a defined benefit pension plan covering substantially all employees. For employees hired prior to December, 31, 2006, who met participation requirements on or before January 1, 2008 (Tier 1 Participant), the benefits are generally based on years of service and the employee s highest average compensation during five consecutive years of employment. For eligible employees who were hired on and after January 1, 2007 (Tier 2 Participant), the benefits are generally based on a cash balance benefit formula. Assumptions are made concerning future events that will determine the amount and timing of required benefit payments, funding requirements and defined benefit pension expense. The major assumptions are the weighted average discount rate used in determining the current benefit obligation, the weighted average expected long-term rate of return on plan assets, the rate of compensation increase and the estimated mortality rate. The weighted average discount rate was based upon the projected benefit cash flows and the market yields of high grade corporate bonds that are available to pay such cash flows as of the measurement date, December 31. The weighted average expected long-term rate of return is estimated based on current trends experienced by the assets in the plan as well as projected future rates of return on those assets and reasonable actuarial assumptions for long term inflation, and the real and nominal rate of investment return for a specific mix of asset classes. The current target asset allocation model for the plans is detailed in Note 17 to the consolidated financial statements. The expected returns on these various asset categories are blended to derive one long-term return assumption. The assets are invested in certain collective investment and mutual funds, common stocks, U.S. Treasury and other U.S. government agency securities, and corporate and municipal bonds and notes. The rate of compensation increase is based on reviewing the compensation increase practices of other plan sponsors in similar industries and geographic areas as well as the expectation of future increases. Mortality rate assumptions are based on mortality tables published by third-parties such as the Society of Actuaries (SOA), considering other available information including historical data as well as studies and publications from reputable sources. We review the pension plan assumptions on an annual basis with our actuarial consultants to determine if the assumptions are reasonable and adjust the assumptions to reflect changes in future expectations.

The assumptions used to calculate 2016 expense for the defined benefit pension plan were a weighted average discount rate of 4.21%, a weighted average long-term rate of return on plan assets of 6.50% and a rate of compensation increase of 3.00%. Defined benefit pension expense in 2017 is expected to increase to $2.0 million from the $1.6 million recorded in 2016, primarily driven by an increase in the number of plan participants and an increase in the discount rate assumption.

Due to the long-term nature of pension plan assumptions, actual results may differ significantly from the actuarial-based estimates. Differences resulting in actuarial gains or losses are required to be recorded in shareholders equity as part of accumulated other comprehensive loss and amortized to defined benefit pension expense in future years. For 2016, the actual return on plan assets in the qualified defined benefit pension plan was a gain of $5.6 million, compared to an expected return on plan assets of $4.6 million. Total pretax losses recognized in accumulated other comprehensive loss at December 31, 2016 were $17.0 million for the defined benefit pension plan. Actuarial pretax net losses recognized in other comprehensive income for the year ended December 31, 2016 were $189 thousand for the defined benefit pension plan.

Defined benefit pension expense is recorded in Salaries and employee benefits expense on the consolidated statements of income.

RECENT ACCOUNTING PRONOUNCEMENTS

See Note 1, Summary of Significant Accounting Policies - Recent Accounting Pronouncements, in the notes to consolidated financial statements for a discussion of recent accounting pronouncements.

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ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Asset-Liability Management

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

Portfolio Composition

Our balance sheet assets are a mix of fixed and variable rate assets with consumer indirect loans, commercial loans, and MBSs comprising a significant portion of our assets. Our consumer indirect loan portfolio comprised 20% of assets and is primarily fixed rate loans with relatively short durations. Our commercial loan portfolio totaled 27% of assets and is a combination of fixed and variable rate loans, lines and mortgages. The MBS portfolio, including collateralized mortgages obligations, totaled 16% of assets with durations averaging three to five years.

Our liabilities are made up primarily of deposits, which account for 88% of total liabilities. Of these deposits, the majority, or 53%, is in nonpublic variable rate and noninterest bearing products including demand (both noninterest and interest-bearing), savings and money market accounts. In addition, fixed rate nonpublic certificate of deposit products make up 20% of total deposits. The bank also has a significant amount of public deposits, which represented 27% of total deposits as of December 31, 2016.

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 December 31, 2016, we were 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 December 31, 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**
	$ (1,479)	$ 274	$ 907	$ (947)

Estimated change in net interest income				
% Change	(1.33)%	0.25%	0.82%	(0.85)%

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

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

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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).

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 December 31, 2016 and 2015. The analysis additionally presents a measurement of the interest rate sensitivity at December 31, 2016 and 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.

	December 31, 2016			December 31, 2015		
Rate Shock Scenario:	**EVE**	**Change**	**Percentage Change**	**EVE**	**Change**	**Percentage Change**
Pre-Shock Scenario	$ 532,744			$ 497,349		
- 100 Basis Points	543,506	$ 10,762	2.02%	508,973	$ 11,624	2.34%
+ 100 Basis Points	507,924	(24,820)	(4.66)	480,888	(16,461)	(3.31)
+ 200 Basis Points	481,692	(51,052)	(9.58)	460,567	(36,782)	(7.40)
+ 300 Basis Points	445,207	(87,537)	(16.43)	429,381	(67,968)	(13.67)

The Pre-Shock Scenario EVE was $532.7 million at December 31, 2016, compared to $497.3 million at December 31, 2015. The increase in the Pre-Shock Scenario EVE at December 31, 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 $481.7 million at December 31, 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 increased from (7.40)% at December 31, 2015 to (9.58)% at December 31, 2016. The increase in sensitivity resulted from a decreased benefit in the valuation of non-maturity deposits and certain fixed rate assets in the +200 basis point Rate Shock Scenario EVE as of December 31, 2016, compared to December 31, 2015.

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Interest Rate Sensitivity Gap

The following table presents an analysis of our interest rate sensitivity gap position at December 31, 2016. All interest-earning assets and interest-bearing liabilities are shown based on the earlier of their contractual maturity or re-pricing date. The expected maturities are presented on a contractual basis or, if more relevant, based on projected call dates. Investment securities are at amortized cost for both securities available for sale and securities held to maturity. Loans, net of deferred loan origination costs, include principal amortization adjusted for estimated prepayments (principal payments in excess of contractual amounts) and non-accruing loans. Because the interest rate sensitivity levels shown in the table could be changed by external factors such as loan prepayments and liability decay rates or by factors controllable by us, such as asset sales, it is not an absolute reflection of our potential interest rate risk profile (in thousands).

	At December 31, 2016				
	Three Months or Less	Over Three Months Through One Year	Over One Year Through Five Years	Over Five Years	Total
INTEREST-EARNING ASSETS:					
Investment securities	$ 46,049	$ 111,447	$ 463,514	$ 466,320	$ 1,087,330
Loans	671,446	373,216	1,019,181	277,368	2,341,211
Total interest-earning assets	$ 717,495	$ 484,663	$ 1,482,695	$ 743,688	3,428,541
Cash and due from banks					71,277
Other assets (1)					210,522
Total assets					$ 3,710,340
INTEREST-BEARING LIABILITIES:					
Interest-bearing demand, savings and money market	$ 1,615,630	$ -	$ -	$ -	$ 1,615,630
Time deposits	236,197	235,297	231,022	-	702,516
Borrowings	303,300	28,200	-	39,061	370,561
Total interest-bearing liabilities	$ 2,155,127	$ 263,497	$ 231,022	$ 39,061	2,688,707
Noninterest-bearing deposits					677,076
Other liabilities					24,503

Total liabilities					3,390,286
Shareholders equity					320,054
Total liabilities and shareholders equity					$ 3,710,340
Interest sensitivity gap	$ (1,437,632)	$ 221,166	$ 1,251,673	$ 704,627	$ 739,834
Cumulative gap	$ (1,437,632)	$ (1,216,466)	$ 35,207	$ 739,834	
Cumulative gap ratio [2]	33.3 %	49.7 %	101.3 %	127.5 %	
Cumulative gap as a percentage of total assets	(38.7) %	(32.8) %	0.9 %	19.9 %	

[1] Includes net unrealized loss on securities available for sale and allowance for loan losses.
[2] Cumulative total interest-earning assets divided by cumulative total interest-bearing liabilities.

For purposes of interest rate risk management, we direct more attention on simulation modeling, such as net interest income at risk as previously discussed, rather than gap analysis. We consider the net interest income at risk simulation modeling to be more informative in forecasting future income at risk.

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ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Index to Consolidated Financial Statements

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Management s Report on Internal Control over Financial Reporting

Management is responsible for establishing and maintaining adequate internal control over financial reporting for Financial Institutions, Inc. and its subsidiaries (the Company), as such term is defined in Exchange Act Rule 13a-15(f). The Company s system of internal control over financial reporting has been designed to provide reasonable assurance to the Company s management and board of directors regarding the reliability of financial reporting and the preparation and fair presentation of financial statements for external purposes in accordance with U.S. generally accepted accounting principles.

Any system of internal control over financial reporting, no matter how well designed, has inherent limitations, including the possibility that a control can be circumvented or overridden and misstatements due to error or fraud may occur and not be detected. Also, because of changes in conditions, internal control effectiveness may vary over time. Accordingly, even an effective system of internal control will provide only reasonable assurance with respect to financial statement preparation and presentation.

The Company s management has, including the Company s principal executive officer and principal financial officer as identified below, assessed the effectiveness of the Company s internal control over financial reporting as of December 31, 2016. To make this assessment, we used the criteria for effective internal control over financial reporting described in *Internal Control Integrated Framework (2013)*, issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on our assessment and based on such criteria, we believe that, as of December 31, 2016, the Company s internal control over financial reporting was effective.

KPMG LLP, the Company s independent registered public accounting firm that audited the Company s consolidated financial statements has issued an attestation report on internal control over financial reporting as of December 31, 2016. That report appears herein.

/s/ Martin K. Birmingham
President and Chief Executive Officer
March 7, 2017

/s/ Kevin B. Klotzbach
Executive Vice President and Chief Financial Officer
March 7, 2017

Report of Independent Registered Public Accounting Firm

The Board of Directors and Shareholders

Financial Institutions, Inc.:

We have audited Financial Institutions, Inc. and subsidiaries (the Company) internal control over financial reporting as of December 31, 2016, based on criteria established in *Internal Control Integrated Framework (2013)* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management s Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the Company s internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company s internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company s assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, Financial Institutions, Inc. and subsidiaries maintained, in all material respects, effective internal control over financial reporting as of December 31, 2016, based on criteria established in *Internal Control Integrated Framework (2013)* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated statements of financial condition of Financial Institutions, Inc. and subsidiaries as of December 31, 2016 and 2015, and the related consolidated statements of income, comprehensive income, changes in shareholders equity, and cash flows for each of the years in the three-year period ended December 31, 2016, and our report dated March 7, 2017 expressed an unqualified opinion on those consolidated financial statements.

/s/ KPMG LLP

Rochester, New York

March 7, 2017

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Report of Independent Registered Public Accounting Firm

The Board of Directors and Shareholders

Financial Institutions, Inc.:

We have audited the accompanying consolidated statements of financial condition of Financial Institutions, Inc. and subsidiaries (the Company) as of December 31, 2016 and 2015, and the related consolidated statements of income, comprehensive income, changes in shareholders equity, and cash flows for each of the years in the three-year period ended December 31, 2016. These consolidated financial statements are the responsibility of the Company s management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Financial Institutions, Inc. and subsidiaries as of December 31, 2016 and 2015, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2016, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), Financial Institutions, Inc. s internal control over financial reporting as of December 31, 2016, based on criteria established in *Internal Control - Integrated Framework (2013)* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated March 7, 2017 expressed an unqualified opinion on the effectiveness of the Company s internal control over financial reporting.

/s/ KPMG LLP

Rochester, New York

March 7, 2017

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Consolidated Statements of Financial Condition

(Dollars in thousands, except share and per share data)	**December 31,**	
	2016	**2015**
ASSETS		
Cash and due from banks	$ 71,277	$ 60,121
Securities available for sale, at fair value	539,926	544,395
Securities held to maturity, at amortized cost (fair value of $539,991 and $490,064, respectively)	543,338	485,717
Loans held for sale	1,050	1,430
Loans (net of allowance for loan losses of $30,934 and $27,085, respectively)	2,309,227	2,056,677
Company owned life insurance	63,455	63,045
Premises and equipment, net	42,398	39,445
Goodwill and other intangible assets, net	75,640	66,946
Other assets	64,029	63,248
Total assets	$ 3,710,340	$ 3,381,024
LIABILITIES AND SHAREHOLDERS EQUITY		
Deposits:		
Noninterest-bearing demand	$ 677,076	$ 641,972
Interest-bearing demand	581,436	523,366
Savings and money market	1,034,194	928,175
Time deposits	702,516	637,018
Total deposits	2,995,222	2,730,531
Short-term borrowings	331,500	293,100
Long-term borrowings, net of issuance costs of $939 and $1,010, respectively	39,061	38,990
Other liabilities	24,503	24,559
Total liabilities	3,390,286	3,087,180
Commitments and contingencies (Note 10)		
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
Common stock, $0.01 par value; 50,000,000 shares authorized; 14,692,214 and 14,397,509 shares issued	147	144
Additional paid-in capital	81,755	72,690

Retained earnings	237,687	218,920
Accumulated other comprehensive loss	(13,951)	(11,327)
Treasury stock, at cost 154,617 and 207,317 shares, respectively	(2,924)	(3,923)
Total shareholders equity	320,054	293,844
Total liabilities and shareholders equity	$ 3,710,340	$ 3,381,024

See accompanying notes to the consolidated financial statements.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Consolidated Statements of Income

(Dollars in thousands, except per share amounts)	Years ended December 31, 2016	2015	2014
Interest income:			
Interest and fees on loans	$ 92,296	$ 83,575	$ 82,453
Interest and dividends on investment securities	22,917	21,875	18,602
Other interest income	18	-	-
Total interest income	115,231	105,450	101,055
Interest expense:			
Deposits	8,458	7,306	6,366
Short-term borrowings	1,612	1,081	915
Long-term borrowings	2,471	1,750	-
Total interest expense	12,541	10,137	7,281
Net interest income	102,690	95,313	93,774
Provision for loan losses	9,638	7,381	7,789
Net interest income after provision for loan losses	93,052	87,932	85,985
Noninterest income:			
Service charges on deposits	7,280	7,742	8,954
Insurance income	5,396	5,166	2,399
ATM and debit card	5,687	5,084	4,963
Investment advisory	5,208	2,193	2,138
Company owned life insurance	2,808	1,962	1,753
Investments in limited partnerships	300	895	1,103
Loan servicing	436	503	568
Net gain on sale of loans held for sale	240	249	313
Net gain on investment securities	2,695	1,988	2,041
Net gain (loss) on other assets	313	27	69
Amortization of tax credit investment	-	(390)	(2,323)
Contingent consideration liability adjustment	1,170	1,093	-
Other	4,227	3,825	3,372
Total noninterest income	35,760	30,337	25,350
Noninterest expense:			
Salaries and employee benefits	45,215	42,439	38,595
Occupancy and equipment	14,529	13,856	12,829
Professional services	6,184	4,502	4,760

Computer and data processing		3,402		3,186		3,016
Supplies and postage		2,047		2,155		2,053
FDIC assessments		1,735		1,719		1,592
Advertising and promotions		1,695		1,165		972
Goodwill impairment		-		751		-
Other		9,864		9,620		8,538
Total noninterest expense		84,671		79,393		72,355
Income before income taxes		44,141		38,876		38,980
Income tax expense		12,210		10,539		9,625
Net income	$	31,931	$	28,337	$	29,355
Preferred stock dividends		1,462		1,462		1,462
Net income available to common shareholders	$	30,469	$	26,875	$	27,893
Earnings per common share (Note 16):						
Basic	$	2.11	$	1.91	$	2.01
Diluted	$	2.10	$	1.90	$	2.00
Cash dividends declared per common share	$	0.81	$	0.80	$	0.77
Weighted average common shares outstanding:						
Basic		14,436		14,081		13,893
Diluted		14,491		14,135		13,946

See accompanying notes to the consolidated financial statements.

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Consolidated Statements of Comprehensive Income