

FINANCIAL INSTITUTIONS INC

Form 10-K

March 07, 2011

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

Form 10-K

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

For the fiscal year ended December 31, 2010

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

(State or other jurisdiction of incorporation or
organization)

16-0816610

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

220 LIBERTY STREET, WARSAW, NEW YORK

(Address of principal executive offices)

14569

(ZIP Code)

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

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

Title of each class

Common stock, par value \$.01 per share

Name of exchange on which registered

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.

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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 common equity held by non-affiliates of the registrant, as computed by reference to the June 30, 2010 closing price reported by NASDAQ, was approximately \$177,182,000.

As of March 1, 2011, there were issued and outstanding, exclusive of treasury shares, 10,979,715 shares of the registrant's common stock.

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PART I

FORWARD LOOKING INFORMATION

Statements 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, us);
statements preceded by, followed by or that include the words may, could, should, would, believe, 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 Operation. Factors that might cause such differences include, but are not limited to:

If we experience greater credit losses than anticipated, earnings may be adversely impacted;
Geographic concentration may unfavorably impact our operations;
We depend on the accuracy and completeness of information about or from customers and counterparties;
We are subject to environmental liability risk associated with our lending activities;
We are highly regulated and may be adversely affected by changes in banking laws, regulations and regulatory practices;
Recently enacted financial reform legislation will, among other things, tighten capital standards, create a new Consumer Financial Protection Bureau and result in new regulations that are expected to increase our costs of operations;
As a participant in the Troubled Asset Relief Program (TARP), we are subject to certain restrictions on dividends, repurchases of common stock and executive compensation;
New or changing tax, accounting, and regulatory rules and interpretations could significantly impact strategic initiatives, results of operations, cash flows, and financial condition;
If our security systems, or those of merchants, merchant acquirers or other third parties containing information about customers, are compromised, we may be subject to liability and damage to our reputation;
We rely on other companies to provide key components of our business infrastructure;
We may not be able to attract and retain skilled people;
The potential for business interruption exists throughout our organization;
We are subject to interest rate risk;
Our business may be adversely affected by conditions in the financial markets and economic conditions generally;
Our earnings are significantly affected by the fiscal and monetary policies of the federal government and its agencies;
The soundness of other financial institutions could adversely affect us;
We operate in a highly competitive industry and market area;
Our market value could result in an impairment of goodwill;
Liquidity is essential to our businesses;
We may need to raise additional capital in the future and such capital may not be available when needed or at all;
We rely on dividends from our subsidiaries for most of our revenue;
The market price for our common stock varies;
There may be future sales or other dilution of our equity, which may adversely affect the market price of our common stock;

Our shares of common stock are equity and are subordinate to our existing and future indebtedness and our preferred stock, and are effectively subordinated to all the indebtedness and other non-common equity claims against our subsidiaries;

We may not pay dividends on our common stock; and

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

We caution readers not to place undue reliance on any forward-looking statements, which speak only as of the date made, and advises readers that various factors, including those described above, could affect our financial performance and could cause our actual results or circumstances for future periods to differ materially from those anticipated or projected. See also Item 1A, Risk Factors, in this Form 10-K.

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.

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ITEM 1. BUSINESS

GENERAL

Financial Institutions, Inc. is a financial holding company organized in 1931 under the laws of New York State (New York or NYS). Through its subsidiaries, including its wholly-owned, New York State chartered banking subsidiary, Five Star Bank, Financial Institutions, Inc. provides a broad array of deposit, lending and other financial services to retail, commercial, and municipal customers in Western and Central New York. All references in this Annual Report on Form 10-K to the parent company are to Financial Institutions, Inc. (FII). Unless otherwise indicated or unless the context requires otherwise, all references in this Annual Report on Form 10-K to the Company, we, our or us mean Financial Institutions, Inc. and its subsidiaries on a consolidated basis. Five Star Bank is referred to as Five Star Bank, FSB or the Bank . The parent company is a legal entity separate and distinct from its subsidiaries, assisting those subsidiaries by providing financial resources and management. Our executive offices are located at 220 Liberty Street, Warsaw, New York.

We conduct business primarily through our banking subsidiary, Five Star Bank, which adopted its current name in 2005 when we merged three of our bank subsidiaries, Wyoming County Bank, National Bank of Geneva and Bath National Bank into our New York chartered bank subsidiary, First Tier Bank & Trust, which was renamed Five Star Bank. In addition, our business operations include a wholly-owned broker-dealer subsidiary, Five Star Investment Services, Inc. (FSIS).

OTHER INFORMATION

This Annual Report on Form 10-K, including the exhibits and schedules filed as part of the Annual Report on Form 10-K, may be inspected 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. In addition, the SEC maintains a website that contains reports, proxy and information statements and other information regarding registrants, including us, that file electronically with the SEC which can be accessed at www.sec.gov.

We also make available, free of charge through our website at www.fiiwarsaw.com, all reports filed with the SEC, including our Annual Report 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. Information available on our website is not a part of, and is not incorporated into, this Annual Report on Form 10-K.

MARKET AREAS AND COMPETITION

We provide a wide range of consumer and commercial banking and financial services to individuals, municipalities and businesses through a network of over 50 offices and more than 70 ATMs in fourteen contiguous counties of Western and Central New York: Allegany, Cattaraugus, Cayuga, Chautauqua, Chemung, Erie, Genesee, Livingston, Monroe, Ontario, Seneca, Steuben, Wyoming and Yates Counties.

Our market area is economically diversified in that we serve both rural markets and the larger more affluent markets of suburban Rochester and suburban Buffalo. Rochester and Buffalo are the two largest metropolitan areas in New York outside of New York City, with combined metropolitan area populations of over two million people. We anticipate increasing 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 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 service 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.

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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. Commercial business loans are offered to the agricultural industry for short-term crop production, farm equipment and livestock financing. As a general practice, where possible, a 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, 2010, \$70.0 million, or 33%, of the aggregate commercial business loan portfolio were at fixed rates, while \$141.0 million, or 67%, 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, 2010, \$100.0 million, or 28%, of the aggregate commercial mortgage portfolio were at fixed rates, while \$252.9 million, or 72%, were at variable rates.

We utilize government loan guarantee programs where available and appropriate. See Government Guarantee Programs below.

Government Guarantee Programs

We participate in government loan guarantee programs offered by the Small Business Administration (SBA), U.S. Department of Agriculture, Rural Economic and Community Development and Farm Service Agency, among others. As of December 31, 2010, we had loans with an aggregate principal balance of \$55.1 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 Mortgage 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, 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 have formally adopted the underwriting, appraisal, and servicing guidelines of the Federal Home Loan Mortgage Corporation (FHLMC) as part of our standard loan policy. As of December 31, 2010, the residential mortgage servicing portfolio totaled \$328.9 million, the majority of which have been sold to FHLMC. As of December 31, 2010, our residential mortgage loan portfolio totaled \$129.6 million, or

10% of our total loan portfolio. We do not engage in sub-prime or other high-risk residential mortgage lending as a line-of-business.

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Consumer Lending

We offer a variety of loan products to our consumer customers, including home equity loans and lines of credit, automobile loans, secured installment loans and various other types of secured and unsecured personal loans. At December 31, 2010, outstanding consumer loan balances were concentrated in indirect automobile loans and home equity products.

We indirectly originate, through franchised new car dealers, indirect consumer loans. The consumer indirect loan portfolio is primarily comprised of new and used automobile loans with terms that typically range from 36 to 84 months. We have expanded our relationships with franchised new car dealers in Western, Central and, most recently, into the Capital District of New York, and have selectively originated a mix of new and used automobile loans from those dealers. In the latter part of 2010, we began efforts to expand our dealer network into Northern Pennsylvania and anticipate indirectly originating loans there in the first half of 2011. As of December 31, 2010, the consumer indirect portfolio totaled \$418.0 million, or 31% of our total loan portfolio.

We also originate, independently of the indirect loans described above, consumer automobile loans, recreational vehicle loans, boat loans, home improvement loans, closed-end home equity loans, home equity lines of credit, personal loans (collateralized and uncollateralized) and deposit account collateralized loans. The terms of these loans typically range from 12 to 180 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 home or the financed automobile, mobile home, boat or recreational vehicle as collateral. As of December 31, 2010, \$97.2 million, or 47%, of the home equity portfolio was at fixed rates, while \$111.2 million, or 53%, was at variable rates. The other consumer portfolio totaled \$26.1 million as of December 31, 2010, all of which were fixed 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 loan officer 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 as follows:

- 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 and establish a specialization in this area to meet the needs of the small businesses in our communities; and
- Comply with the relevant laws and regulations.

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

Risk ratings are assigned to loans in the commercial business and commercial mortgage portfolios. The risk ratings are specifically used as follows:

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

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.

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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 the loan portfolio with loan reviews;
- Levels and trends in delinquent and non-accruing loans;
- Trends in volume and terms;
- 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 in the estimation of the allowance for loan losses includes the following broad areas:

1. Impaired commercial business and commercial mortgage loans, generally in excess of \$50 thousand are 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 qualitative factors. These qualitative factors include the levels and trends in delinquencies 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 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, home equity (home equity loans and lines of credit), consumer indirect and other consumer. Allowance allocations for the real estate related loan portfolios (residential and home equity) are based on the average loss experience for the previous eight quarters, supplemented with qualitative factors similar to the elements described above. Allowance allocations for the consumer indirect and other consumer portfolios are based on vintage analyses performed with historical loss experience at 36 months and 24 months aging, respectively. The allocations on these portfolios are also supplemented with qualitative factors.

Management presents a quarterly review of the adequacy of the allowance for loan losses to our Board of Directors based on the methodology described above. See also the section titled "Allowance for Loan Losses" Part II, Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations.

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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 of quality, maturity, marketability, pledgeable nature and risk diversification. Our Treasurer, guided by the Asset-Liability Committee (ALCO), is responsible for investment portfolio decisions within the established policies.

Our investment securities strategy centers 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 U.S. government-sponsored enterprise (GSE) 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), FHLMC, SBA and the Federal Farm Credit Bureau);

Mortgage-backed securities (MBS) include mortgage-backed pass-through securities (pass-throughs) and collateralized mortgage obligations (CMO) issued by GNMA, FNMA and FHLMC. See also the section titled Investing Activities in Part II, Item 7, Management s Discussion and Analysis of Financial Condition and Results of Operations;

Investment grade municipal securities, including revenue, tax and bond anticipation notes, statutory installment notes and general obligation bonds;

Certain creditworthy un-rated securities issued by municipalities;

Certificates of deposit;

Equity securities at the holding company level; and

Limited partnership investments in Small Business Investment Companies.

SOURCES OF FUNDS

Our primary sources of funds are deposits, borrowed funds and repurchase agreements, scheduled amortization and prepayments of principal from loans and mortgage-backed securities, maturities and calls of investment securities and funds provided by operations.

We offer a variety of deposit account products with a range of interest rates and terms. The deposit accounts consist of noninterest-bearing demand, interest-bearing demand, savings, money market, club accounts and certificates of deposit. We also offer certificates of deposit with balances in excess of \$100,000 to local municipalities, businesses, and individuals as well as Individual Retirement Accounts and other qualified plan accounts. The flow of deposits is influenced significantly by general economic conditions, prevailing interest rates and competition. Our deposits are obtained predominantly from the areas in which our branch offices are located. We rely primarily on competitive pricing of our deposit products, customer service and long-standing relationships with customers to attract and retain these deposits. We have also utilized certificate of deposit sales in the national brokered market (brokered deposits) as a wholesale funding source; however, we had no brokered deposits at December 31, 2010. Our borrowings consist mainly of advances entered into with the FHLB, federal funds purchased and securities sold under repurchase agreements.

OPERATING SEGMENTS

Our primary operating segment is our subsidiary bank, FSB. Our brokerage subsidiary, FSIS, is also deemed an operating segment; however, it does not meet the applicable thresholds for separation.

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The Company and our subsidiaries are subject to an extensive system of laws and regulations that are intended primarily for the protection of customers and depositors and not for the protection of security holders. These laws and regulations govern such areas as capital, permissible activities, allowance for loan losses, loans and investments, and rates of interest that can be charged on loans. Described below are elements of selected laws and regulations. The descriptions are not intended to be complete and are qualified in their entirety by reference to the full text of the statutes and regulations described.

Holding Company Regulation. As a bank holding company and financial holding company, 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), under the Bank Holding Company 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 on July 21, 2010. 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 Bank Holding Company 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 Bank Holding Company 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 Bank Holding Company 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. During the second quarter of 2008, we received FRB approval for an election to reinstate our status as a financial holding company under the Gramm-Leach-Bliley Act.

Depository Institution Regulation. Our bank subsidiary is subject to regulation by the Federal Deposit Insurance Corporation (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.

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Capital Adequacy Requirements. The FRB and FDIC have issued substantially similar risk-based and leverage capital guidelines applicable to bank holding companies and banks. In addition, these regulatory agencies may from time to time require that a bank holding company or bank maintain capital above the minimum levels, based on its financial condition or actual or anticipated growth.

The FRB's risk-based guidelines establish a two-tier capital framework. Tier 1 capital generally consists of common shareholders' equity, retained earnings, a limited amount of qualifying perpetual preferred stock, qualifying trust preferred securities and non-controlling interests in the equity accounts of consolidated subsidiaries, less goodwill and certain intangibles. Tier 2 capital generally consists of certain hybrid capital instruments and perpetual debt, mandatory convertible debt securities and a limited amount of subordinated debt, qualifying preferred stock, loan loss allowance, and unrealized holding gains on certain equity securities. The sum of Tier 1 and Tier 2 capital represents qualifying total capital, at least 50% of which must consist of Tier 1 capital.

Risk-based capital ratios are calculated by dividing Tier 1 and total capital by risk-weighted assets. Assets and off-balance sheet exposures are assigned to one of four categories of risk-weights, based primarily on relative credit risk. For bank holding companies, generally the minimum Tier 1 risk-based capital ratio is 4% and the minimum total risk-based capital ratio is 8%. Our Tier 1 and total risk-based capital ratios under these guidelines at December 31, 2010 were 12.34% and 13.60%, respectively.

The FRB's leverage capital guidelines establish a minimum leverage ratio determined by dividing Tier 1 capital by adjusted average total assets. The minimum leverage ratio is 3% for bank holding companies that meet certain specified criteria, including having the highest regulatory rating. All other bank holding companies generally are required to maintain a leverage ratio of at least 4%. At December 31, 2010, we had a leverage ratio of 8.31%. See also the section titled "Capital Resources" in Part II, Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations" and Note 10, "Regulatory Matters," of the notes to consolidated financial statements.

The federal regulatory authorities' risk-based capital guidelines are based upon the 1988 capital accord ("Basel I") of the Basel Committee on Banking Supervision (the "Basel Committee"). The Basel Committee is a committee of central banks and bank supervisors/regulators from the major industrialized countries that develops broad policy guidelines for use by each country's supervisors in determining the supervisory policies and regulations to which they apply. Actions of the Committee have no direct effect on banks in participating countries. In 2004, the Basel Committee published a new capital accord ("Basel II") to replace Basel I. Basel II provides two approaches for setting capital standards for credit risk – an internal ratings-based approach tailored to individual institutions' circumstances and a standardized approach that bases risk weightings on external credit assessments to a much greater extent than permitted in existing risk-based capital guidelines. Basel II also would set capital requirements for operational risk and refine the existing capital requirements for market risk exposures.

A final rule implementing the advanced approaches of Basel II in the United States would apply only to certain large or internationally active banking organizations, or "core banks" – defined as those with consolidated total assets of \$250 billion or more or consolidated on-balance sheet foreign exposures of \$10 billion or more, became effective as of April 1, 2008. Certain other U.S. banking organizations would have the option to adopt the requirements of this rule. We are not required to comply with the advanced approaches of Basel II.

In July 2008, the agencies issued a proposed rule that would give banking organizations that do not use the advanced approaches the option to implement a new risk-based capital framework that generally parallels the relevant approaches under Basel II, but recognizes that U.S. markets have unique characteristics and risk profiles, most notably with respect to risk weighting residential mortgage exposures. To date, no final rule has been adopted.

In 2009, the United States Department of Treasury (the "Treasury") issued a policy statement (the "Treasury Policy Statement") entitled "Principles for Reforming the U.S. and International Regulatory Capital Framework for Banking Firms," which contemplates changes to the existing regulatory capital regime involving substantial revisions to major parts of the Basel I and Basel II capital frameworks and affecting all regulated banking organizations and other systemically important institutions. The Treasury Policy Statement calls for, among other things, higher and stronger capital requirements for all banking firms, with changes to the regulatory capital framework to be phased in over a period of several years.

On December 17, 2009, the Basel Committee issued a set of proposals (the "2009 Capital Proposals") that would significantly revise the definitions of Tier 1 capital and Tier 2 capital. Among other things, the 2009 Capital Proposals

would re-emphasize that common equity is the predominant component of Tier 1 capital. Concurrently with the release of the 2009 Capital Proposals, the Basel Committee also released a set of proposals related to liquidity risk exposure (the 2009 Liquidity Proposals). The 2009 Liquidity Proposals include the implementation of (i) a liquidity coverage ratio or LCR, designed to ensure that a bank maintains an adequate level of unencumbered, high-quality assets sufficient to meet the bank's liquidity needs over a 30-day time horizon under an acute liquidity stress scenario and (ii) a net stable funding ratio or NSFR, designed to promote more medium and long-term funding of the assets and activities of banks over a one-year time horizon.

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The Dodd-Frank Act includes certain provisions concerning the capital regulations of the U.S. banking regulators, which are often referred to as the Collins Amendment. These provisions are intended to subject bank holding companies to the same capital requirements as their bank subsidiaries and to eliminate or significantly reduce the use of hybrid capital instruments, especially trust preferred securities, as regulatory capital. Under the Collins Amendment, trust preferred securities issued by a company, such as our company, with total consolidated assets of less than \$15 billion before May 19, 2010 and treated as regulatory capital are grandfathered, but any such securities issued later are not eligible as regulatory capital. The banking regulators must develop regulations setting minimum risk-based and leverage capital requirements for holding companies and banks on a consolidated basis that are no less stringent than the generally applicable requirements in effect for depository institutions under the prompt corrective action regulations discussed below. The banking regulators also must seek to make capital standards countercyclical so that the required levels of capital increase in times of economic expansion and decrease in times of economic contraction. The Dodd-Frank Act requires these new capital regulations to be adopted by the FRB in final form 18 months after its date of enactment (July 21, 2010). To date, no proposed regulations have been issued.

In December 2010 and January 2011, the Basel Committee published the final texts of reforms on capital and liquidity generally referred to as Basel III. Although Basel III is intended to be implemented by participating countries for large, internationally active banks, its provisions are likely to be considered by U.S. banking regulators in developing new regulations applicable to other banks in the United States, including Five Star Bank.

For banks in the United States, among the most significant provisions of Basel III concerning capital are the following:

- A minimum ratio of common equity to risk-weighted assets reaching 4.5%, plus an additional 2.5% as a capital conservation buffer, by 2019 after a phase-in period.

- A minimum ratio of Tier 1 capital to risk-weighted assets reaching 6.0% by 2019 after a phase-in period.

- A minimum ratio of total capital to risk-weighted assets, plus the additional 2.5% capital conservation buffer, reaching 10.5% by 2019 after a phase-in period.

- An additional countercyclical capital buffer to be imposed by applicable national banking regulators periodically at their discretion, with advance notice.

- Restrictions on capital distributions and discretionary bonuses applicable when capital ratios fall within the buffer zone.

- Deduction from common equity of deferred tax assets that depend on future profitability to be realized.

- Increased capital requirements for counterparty credit risk relating to OTC derivatives, repos and securities financing activities.

- For capital instruments issued on or after January 13, 2013 (other than common equity), a loss-absorbency requirement such that the instrument must be written off or converted to common equity if a trigger event occurs, either pursuant to applicable law or at the direction of the banking regulator. A trigger event is an event under which the banking entity would become nonviable without the write-off or conversion, or without an injection of capital from the public sector. The issuer must maintain authorization to issue the requisite shares of common equity if conversion were required.

The Basel III provisions on liquidity include complex criteria establishing the LCR and NSFR. The purpose of the LCR is to ensure that a bank maintains adequate unencumbered, high quality liquid assets to meet its liquidity needs for 30 days under a severe liquidity stress scenario. The purpose of the NSFR is to promote more medium and long-term funding of assets and activities, using a one-year horizon. Although Basel III is described as a final text, it is subject to the resolution of certain issues and to further guidance and modification, as well as to adoption by U.S. banking regulators, including decisions as to whether and to what extent it will apply to U.S. banks that are not large, internationally active banks.

Prompt Corrective Action. The Federal Deposit Insurance Corporation Improvement Act of 1991, among other things, identifies five capital categories for insured depository institutions (well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized and critically undercapitalized) and requires the respective federal bank regulatory agencies to implement systems for prompt corrective action for insured depository institutions that do not meet minimum capital requirements within these categories. This act imposes progressively more restrictive

constraints on operations, management and capital distributions, depending on the category in which an institution is classified. Failure to meet the capital guidelines could also subject a banking institution to capital raising requirements. An undercapitalized bank must develop a capital restoration plan and its parent holding company must guarantee that bank's compliance with the plan. The liability of the parent holding company under any such guarantee is limited to the lesser of five percent of the bank's assets at the time it became undercapitalized or the amount needed to comply with the plan. Furthermore, in the event of the bankruptcy of the parent holding company, such guarantee would take priority over the parent's general unsecured creditors. In addition, the Federal Deposit Insurance Corporation Improvement Act requires the various regulatory agencies to prescribe certain non-capital standards for safety and soundness relating generally to operations and management, asset quality and executive compensation and permits regulatory action against a financial institution that does not meet these standards.

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The various federal bank regulatory agencies have adopted substantially similar regulations that define the five capital categories identified by the Federal Deposit Insurance Corporation Improvement Act, using the total risk-based capital, Tier 1 risk-based capital and leverage capital ratios as the relevant capital measures. These regulations establish various degrees of corrective action to be taken when an institution is considered undercapitalized. Under the regulations, a well capitalized institution must have a Tier 1 risk-based capital ratio of at least 6%, a total risk-based capital ratio of at least 10% and a leverage ratio of at least 5% and not be subject to a capital directive or order. An institution is adequately capitalized if it has a Tier 1 risk-based capital ratio of at least 4%, a total risk-based capital ratio of at least 8% and a leverage ratio of at least 4% (3% in certain circumstances). An institution is undercapitalized if it has a Tier 1 risk-based capital ratio of less than 4%, a total risk-based capital ratio of less than 8% or a leverage ratio of less than 4% (3% in certain circumstances). An institution is significantly undercapitalized if it has a Tier 1 risk-based capital ratio of less than 3%, a total risk-based capital ratio of less than 6% or a leverage ratio of less than 3%. An institution is critically undercapitalized if its tangible equity is equal to or less than 2% of total assets. Generally, an institution may be reclassified in a lower capitalization category if it is determined that the institution is in an unsafe or unsound condition or engaged in an unsafe or unsound practice.

As of December 31, 2010, our subsidiary bank met the requirements to be classified as well-capitalized.

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.

On December 23, 2008, as part of the TARP Capital Purchase Program of the Treasury, we sold to the Treasury 7,503 shares of our fixed rate cumulative perpetual preferred stock, Series A preferred stock (Series A), having a liquidation preference amount of \$5,000 per share, for a purchase price of \$37.5 million in cash and issued to Treasury a ten-year warrant to purchase 378,175 shares of the Company's common stock at an exercise price of \$14.88 per share (the Warrant).

We may redeem the Series A preferred stock at any time by repaying the Treasury, without penalty, subject to Treasury's consultation with our appropriate regulatory agency and approval. Additionally, upon redemption of the Series A preferred stock, the Warrant generally may be repurchased from the Treasury at its fair market value as agreed-upon by us and the Treasury. In February 2011, the Company repaid one-third or \$12.5 million of its obligation.

The securities purchase agreement between us and the Treasury provides that prior to the earlier of (i) December 23, 2011 and (ii) the date on which all of the shares of the Series A preferred stock have been redeemed by us or transferred by the Treasury to third parties, we may not, without the consent of the Treasury, (a) pay a quarterly cash dividend on our common stock of more than \$0.10 per share or (b) subject to limited exceptions, redeem, repurchase or otherwise acquire shares of our common stock, preferred stock (other than the Series A preferred stock) or trust preferred securities. In addition, under the terms of the Series A preferred stock, we may not pay dividends on our common stock at any time we are in arrears on the dividends payable on the Series A preferred stock. Dividends on the Series A preferred stock are payable quarterly at a rate of 5% per annum for the first five years and a rate of 9% per annum thereafter if not redeemed prior to that time.

Our primary source for cash dividends is the dividends we receive from our subsidiary bank. Our 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 Banking Department is required prior to paying a dividend if the dividends declared by the Bank exceed the sum of the Bank's net profits for that year and its retained net profits for the preceding two calendar years.

Federal Deposit Insurance Assessments. The Bank's deposits are insured to the maximum extent permitted by the Deposit Insurance Fund (DIF). Upon enactment of the Emergency Economic Stabilization Act of 2008 on October 3, 2008, federal deposit insurance coverage levels under the DIF temporarily increased from \$100,000 to \$250,000 per deposit category, per depositor, per institution, through December 31, 2009. On May 20, 2009, the Helping Families

Save Their Homes Act extended the temporary increase through December 31, 2013. The Dodd-Frank Act permanently increases the maximum amount of deposit insurance to \$250,000 per deposit category, per depositor, per institution retroactive to January 1, 2008, and noninterest-bearing transaction accounts have unlimited deposit insurance through December 31, 2013.

As the insurer, the FDIC is authorized to conduct examinations of, and to require reporting by, FDIC-insured institutions. The FDIC also may prohibit any FDIC-insured institution from engaging in any activity the FDIC determines by regulation or order to pose a serious threat to the DIF. The FDIC also has the authority to initiate enforcement actions against banks. Insurance of deposits may be terminated by the FDIC upon a finding that the institution has engaged or is engaging in unsafe and unsound practices, is in an unsafe or unsound condition to continue operations or has violated any applicable law, regulation, rule, order or condition imposed by the FDIC or written agreement entered into with the FDIC. The management of the Bank does not know of any practice, condition or violation that might lead to termination of deposit insurance.

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The FDIC maintains the DIF by assessing depository institutions an insurance premium on a quarterly basis under a risk-based assessment system. The amount of the assessment is a function of the institution's risk category, of which there are four, and assessment base. An institution's risk category is determined according to its supervisory ratings and capital levels and is used to determine the institution's assessment rate. The assessment rate for risk categories are calculated according to a formula, which relies on supervisory ratings and either certain financial ratios or long-term debt ratings. An insured bank's assessment base is currently determined by its level of deposits. Because the system is risk-based, it allows banks to pay lower assessments to the FDIC as their capital level and supervisory ratings improve. By the same token, if these indicators deteriorate, the institution will have to pay higher assessments to the FDIC.

Under the Federal Deposit Insurance Act, the FDIC Board has the authority to set the annual assessment rate range for the various risk categories within certain regulatory limits and to impose special assessments upon insured depository institutions when deemed necessary by the FDIC's Board. As part of the Deposit Insurance Fund Restoration Plan adopted by the FDIC in October 2008, on February 27, 2009, the FDIC adopted the final rule modifying the risk-based assessment system, which set initial base assessment rates between 12 and 45 basis points, beginning April 1, 2009. The FDIC imposed an emergency special assessment on June 30, 2009, which totaled \$923 thousand for our Bank. In addition, in September 2009, the FDIC extended the Restoration Plan period to eight years. In November 2009, the FDIC adopted a final rule requiring prepayment of 13 quarters of FDIC premiums. The Bank's required prepayment amounted to \$9.9 million and was collected in December 2009.

In October 2010, the FDIC adopted a new Restoration Plan for the DIF to ensure that the fund reserve ratio reaches 1.35% by September 30, 2020, as required by the Dodd-Frank Act. Under the Restoration Plan, the FDIC did not institute the uniform three-basis point increase in assessment rates scheduled to take place on January 1, 2011 and maintained the current schedule of assessment rates for all depository institutions. At least semi-annually, the FDIC will update its loss and income projections for the DIF and, if needed, will increase or decrease assessment rates, following notice-and-comment rulemaking, if required.

In November 2010, the FDIC issued a notice of proposed rulemaking to change the deposit insurance assessment base from total domestic deposits to average total assets minus average tangible equity, as required by the Dodd-Frank Act, effective April 1, 2011. The FDIC also issued a notice of proposed rulemaking to revise the deposit insurance assessment system for large institutions. The FDIC proposed to create a two tier system—one for most large institutions that have more than \$10 billion in assets, and another for highly complex institutions that have over \$50 billion in assets and are fully owned by a parent with over \$500 billion in assets. These proposals did not apply to us or the Bank.

On February 9, 2011, the FDIC adopted a final rule which redefines the deposit insurance assessment base as required by the Dodd-Frank Act. The final rule sets the deposit insurance assessment base as average consolidated total assets minus average tangible equity. It also sets a new assessment rate schedule which reflects assessment rate adjustments including potentially reduced rates tied to unsecured debt and potentially increased rates for brokered deposits. The final rule generally becomes effective on April 1, 2011. Under the new rule, our FDIC insurance premiums are expected to decline in 2011. However, there can be no assurances that such premium reductions will be realized in 2011.

Transactions with Affiliates. FII and FSB 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.

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.

As of its last Community Reinvestment Act examination, Five Star Bank received a rating of outstanding.

Interstate Banking and Branching. The FRB may approve an application of a bank holding company to acquire control of, or acquire all or substantially all of the assets of, a bank located in a state other than the bank holding company's home state, without regard to whether the transaction is prohibited by the laws of any state. The FRB may not approve the acquisition of a bank that has not been in existence for the minimum time period (not exceeding five years) specified by the law of the target bank's home state. The FRB also may not approve an application if the bank holding company (and its bank affiliates) controls or would control more than ten percent of the insured deposits in the U.S. or, generally, 30% or more of the deposits in the target bank's home state or in any state in which the target bank maintains a branch. Individual states may waive the 30% statewide concentration limit. Each state may limit the percentage of total insured deposits in the state that may be held or controlled by a bank or bank holding company to the extent the limitation does not discriminate against out-of-state banks or bank holding companies.

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The federal banking agencies are authorized to approve interstate bank merger transactions without regard to whether these transactions are prohibited by the law of any state, unless the home state of one of the banks opted out of interstate mergers prior to June 1, 1997. Interstate acquisitions of branches are permitted only if the law of the state in which the branch is located permits these acquisitions. Interstate mergers and branch acquisitions are subject to the nationwide and statewide-insured deposit concentration limits described above.

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.

International Money Laundering Abatement and Financial Anti-Terrorism Act of 2001. The President signed the USA Patriot Act of 2001 into law in October 2001. This act contains the International Money Laundering Abatement and Financial Anti-Terrorism Act of 2001 (the IMLAFA). The IMLAFA substantially broadens existing anti-money laundering legislation and the extraterritorial jurisdiction of the U.S., imposes new compliance and due diligence obligations, creates new crimes and penalties, compels the production of documents located both inside and outside the U.S., including those of foreign institutions that have a correspondent relationship in the U.S., and clarifies the safe harbor from civil liability to customers. The Treasury Department has issued a number of regulations implementing the USA Patriot Act that apply certain of its requirements to financial institutions such as our banking and broker-dealer subsidiaries. The regulations impose obligations on financial institutions to maintain appropriate policies, procedures and controls to detect, prevent and report money laundering and terrorist financing. The increased obligations of financial institutions, including us, to identify their customers, watch for and report suspicious transactions, respond to requests for information by regulatory authorities and law enforcement agencies, and share information with other financial institutions, requires the implementation and maintenance of internal procedures, practices and controls which have increased, and may continue to increase, our costs and may subject us to liability. As noted above, enforcement and compliance-related activity by government agencies has increased. Money laundering and anti-terrorism compliance is among the areas receiving a high level of focus in the present environment.

Regulatory Reform. On July 21 2010, the Dodd-Frank Act was signed into law. The Dodd-Frank Act (as amended) implements far-reaching changes across the financial regulatory landscape, including provisions that, among other things, will:

- Centralize responsibility for consumer financial protection by creating a new agency, the Bureau of Consumer Financial Protection, with broad rulemaking, supervision and enforcement authority for a wide range of consumer protection laws that would apply to all banks and certain others, including the examination and enforcement powers with respect to any bank with more than \$10 billion in assets.

- Require new capital rules and apply the same leverage and risk-based capital requirements that apply to insured depository institutions to most bank holding companies.

- Change the assessment base for federal deposit insurance from the amount of insured deposits to consolidated average assets less tangible capital.

- Increase the minimum ratio of net worth to insured deposits of the Deposit Insurance Fund from 1.15% to 1.35% and require the FDIC, in setting assessments, to offset the effect of the increase on institutions with assets of less than \$10 billion. As a result, this increase is generally expected to impose more deposit insurance cost on institutions with assets of \$10 billion or more.

- Provide for new disclosure and other requirements relating to executive compensation and corporate governance, including guidelines or regulations on incentive-based compensation and a prohibition on compensation arrangements that encourage inappropriate risks or that could provide excessive compensation.

- Make permanent the \$250 thousand limit for federal deposit insurance and provide unlimited federal deposit insurance until January 1, 2013 for non-interest bearing demand transaction accounts and IOLTA accounts at

all insured depository institutions.

Repeal the federal prohibitions on the payment of interest on demand deposits, thereby permitting depository institutions to pay interest on business transaction and other accounts.

Allow de novo interstate branching by banks.

Increase the authority of the FRB to examine the Company and its non-bank subsidiary.

Require all bank holding companies to serve as a source of financial strength to their depository institution subsidiaries in the event such subsidiaries suffer from financial distress.

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Restrict proprietary trading by banks, bank holding companies and others, and their acquisition and retention of ownership interests in and sponsorship of hedge funds and private equity funds. This restriction is commonly referred to as the Volcker Rule. There is an exception in the Volcker Rule to allow a bank to organize and offer hedge funds and private equity funds to customers if certain conditions are met. These conditions include, among others, requirements that the bank provides *bona fide* investment advisory services; the funds are organized only in connection with such services and to customers of such services; the bank does not have more than a *de minimis* interest in the funds, limited to a 3% ownership interest in any single fund and an aggregated investment in all funds of 3% of Tier 1 capital; the bank does not guarantee the obligations or performance of the funds; and no director or employee of the bank has an ownership interest in the fund unless he or she provides services directly to the funds. Further details on the scope of the Volcker Rule and its exceptions are expected to be defined in regulations due to be issued later in 2011.

Many aspects of the Dodd-Frank Act are subject to rulemaking and will take effect over several years, making it difficult to anticipate the overall financial impact on us and the financial services industry more generally. Provisions in the legislation that affect deposit insurance assessments, and payment of interest on demand deposits could increase the costs associated with deposits. Provisions in the legislation that require revisions to the capital requirements of the Company and Five Star Bank could require the Company and the Bank to seek additional sources of capital in the future.

TARP-Related Compensation and Corporate Governance Requirements. The Emergency Economic Stabilization Act of 2008 (EESA) was signed into law on October 3, 2008 and authorized the Treasury to provide funds to be used to restore liquidity and stability to the U.S. financial system pursuant to the TARP. Under the authority of EESA, Treasury instituted the TARP Capital Purchase Program to encourage U.S. financial institutions to build capital to increase the flow of financing to U.S. businesses and consumers and to support the U.S. economy. As noted above, on December 23, 2008, we participated in this program by issuing 7,503 shares of our Series A preferred stock to the Treasury for a purchase price of \$37.5 million in cash and issued the Warrant to the Treasury. In February 2011, the Company repaid one-third or \$12.5 million of its obligation.

In addition to the restrictions on the Company's ability to pay dividends on and repurchase its stock, as described above under Dividends, participation in the TARP Capital Purchase Program also includes certain requirements and restrictions regarding compensation that were expanded significantly by the American Recovery and Reinvestment Act of 2009 (ARRA), as implemented by the Treasury's Interim Final Rule on TARP Standards for Compensation and Corporate Governance. These requirements and restrictions include, among others, the following: (i) a prohibition on paying or accruing bonuses, retention awards and incentive compensation, other than qualifying long-term restricted stock or pursuant to certain preexisting employment contracts, to our five most highly-compensated employees; (ii) a general prohibition on providing severance benefits, or other benefits due to a change in control of the Company, to our senior executive officers (CEOs) and next five most highly compensated employees; (iii) a requirement to make subject to clawback any bonus, retention award, or incentive compensation paid to any of the CEOs and any of the next twenty most highly compensated employees if such compensation was based on materially inaccurate financial statements or any other materially inaccurate performance metric criteria; (iv) a requirement to establish a policy on luxury or excessive expenditures; (v) a requirement to annually provide shareholders with a non-binding advisory say on pay vote on executive compensation; (vi) a prohibition on deducting more than \$500,000 in annual compensation, including performance-based compensation, to the executives covered under Internal Revenue Code Section 162(m); (vii) a requirement that the compensation committee of the board of directors evaluate and review on a semi-annual basis the risks involved in employee compensation plans; and (viii) a prohibition on providing tax gross-ups to our CEOs and the next 20 most highly compensated employees. These requirements and restrictions will remain applicable to us until we have redeemed the Series A preferred stock in full.

Incentive Compensation. On October 22, 2009, the Federal Reserve issued a comprehensive proposal on incentive compensation policies (the Incentive Compensation Proposal) 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 Incentive Compensation Proposal, 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. Banking organizations are instructed to begin an immediate review of their incentive compensation policies to ensure that they do not encourage excessive risk-taking and implement corrective programs as needed. Where there are deficiencies in the incentive compensation arrangements, they must be immediately addressed.

Additionally, the Incentive Compensation Proposal will require the Federal Reserve to review, as part of the regular, risk-focused examination process, the incentive compensation arrangements of banking organizations, such as us, 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.

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The scope and content of the U.S. banking regulators' policies on executive compensation are continuing to develop and are likely to continue evolving in the near future. It cannot be determined at this time whether compliance with such policies will adversely affect our ability to hire, retain and motivate its key employees.

Sarbanes-Oxley Act of 2002. The Sarbanes-Oxley Act of 2002 implemented a broad range of corporate governance, accounting and reporting measures for companies that have securities registered under the Exchange Act, including publicly-held bank holding companies such as Financial Institutions. Specifically, the Sarbanes-Oxley Act of 2002 and the various regulations promulgated thereunder, established, among other things: (i) requirements for audit committees, including independence, expertise, and responsibilities; (ii) responsibilities regarding financial statements for the Chief Executive Officer and Chief Financial Officer of the reporting company; (iii) the forfeiture of bonuses or other incentive-based compensation and profits from the sale of the reporting company's securities by the Chief Executive Officer and Chief Financial Officer in the twelve-month period following the initial publication of any financial statements that later require restatement; (iv) the creation of an independent accounting oversight board; (v) standards for auditors and regulation of audits, including independence provisions that restrict non-audit services that accountants may provide to their audit clients; (vi) disclosure and reporting obligations for the reporting company and their directors and executive officers, including accelerated reporting of stock transactions and a prohibition on trading during pension blackout periods; (vii) a prohibition on personal loans to directors and officers, except certain loans made by insured financial institutions on non-preferential terms and in compliance with other bank regulatory requirements; and (viii) a range of civil and criminal penalties for fraud and other violations of the securities laws.

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 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 and the Real Estate Settlement Procedures Act. These laws and regulations mandate certain disclosure requirements and regulate the manner in which financial institutions must deal with customers when taking deposits or making loans to such customers. The Bank must comply with the applicable provisions of these consumer protection laws and regulations as part of its ongoing customer relations. The Check Clearing for the 21st Century Act (the Check 21 Act), which became effective on October 28, 2004, creates a new negotiable instrument, called a substitute check, which banks are required to accept as the legal equivalent of a paper check if it meets the requirements of the Check 21 Act. The Check 21 Act is designed to facilitate check truncation, to foster innovation in the check payment system, and to improve the payment system by shortening processing times and reducing the volume of paper checks.

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 the operating environment of the Company 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 the financial condition or results of operations of the Company. A change in statutes, regulations or regulatory policies applicable to the Company or any its subsidiaries could have a material effect on our business.

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. In our view, 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.

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At December 31, 2010, we had 616 employees. None of the employees are subject to a collective bargaining agreement and management believes its relations with employees are good.

EXECUTIVE OFFICERS OF REGISTRANT

The following table sets forth current information regarding our executive officers and certain other significant employees (ages are as of May 4, 2011, the date of the 2011 Annual Meeting of Shareholders).

Name	Age	Started In	Positions/Offices
Peter G. Humphrey	56	1977	President and Chief Executive Officer of the Company and the Bank since 1994.
Karl F. Krebs	55	2009	Executive Vice President and Chief Financial Officer of the Company and the Bank since 2009. Senior Financial Specialist at West Valley Environmental Services, LLC prior to joining FII in 2009. President of Robar General Funding Corp. from 2006 to 2008. Senior Vice President and Line-of-Business Finance Director at Five Star Bank from 2005 to 2006 and Senior Vice President at Wyoming County Bank from 2004 to 2005.
Rita M. Bartol	50	2010	Senior Vice President and Director of Human Resources of the Company and the Bank since late 2010. Senior Vice President and Director of Human Resources at Cardinal Financial Corporation in 2010 and Vice President and Director of Human Resources at Union Bankshares Corporation from 2006 to 2010. Vice President and Human Resources and Organizational Development Manager at M & T Bank Corporation from 1998 to 2005.
Martin K. Birmingham	44	2005	Executive Vice President and Regional President / Commercial Banking Executive Officer of the Bank since 2009. Senior Vice President and Regional President of the Bank since 2005. Senior Team Leader and Regional President of the Rochester Market at Bank of America (formally Fleet Boston Financial) from 2000 to 2005.
George D. Hagi	58	2006	Executive Vice President and Chief Risk Officer of the Company and the Bank since 2006. Senior Vice President and Director of Risk Management at First National Bankshares of Florida and FNB Corp. from 1997 to 2005.
Richard J. Harrison	65	2003	Executive Vice President and Senior Retail Lending Administrator of the Bank since 2009. Senior Vice President and Senior Retail Lending Administrator of the Bank since 2003. Executive Vice President and Chief Credit Officer at Savings Bank of the Finger Lakes from 2000 to 2003.
Kevin B. Klotzbach	58	2001	Senior Vice President and Treasurer of the Bank since 2001.
R. Mitchell McLaughlin	53	1981	

Executive Vice President and Chief Information Officer of the Bank since 2009. Senior Vice President and Chief Information Officer of the Bank since 2006.

John L. Rizzo	61	2010	Senior Vice President and Corporate Secretary of the Company and the Bank since 2010. Counsel (in-house) for the Company and the Bank since 2007. Genesee County (New York) Attorney from 1976 to 2010.
John J. Witkowski	48	2005	Executive Vice President and Regional President / Retail Banking Executive Officer of the Bank since 2009. Senior Vice President and Regional President of the Bank since 2005. Senior Vice President and Director of Sales for Business Banking / Client Development Group at Bank of America from 1993 to 2005.

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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 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. The risks and uncertainties described below are not the only ones facing us. Additional risks and uncertainties that management is not aware of or focused on or that management currently deems immaterial may also impair our business operations. 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.

CREDIT RISKS

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.

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.

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.

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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. In doing so, there is a risk that hazardous or toxic substances could be found on these properties. If hazardous or toxic substances are found, we may be liable for remediation costs, as well as for personal injury and property damage. 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. Although we have policies and procedures to perform an environmental review before initiating any foreclosure action on real property, these reviews may not be sufficient to detect all potential environmental hazards. 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.

REGULATORY/LEGAL/COMPLIANCE RISKS

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, 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.

Recently enacted financial reform legislation will, among other things, tighten capital standards, create a new Consumer Financial Protection Bureau and result in new regulations that are expected to increase our costs of operations.

On July 21, 2010, President Obama signed the Dodd-Frank Act into law. This new law will significantly change the current bank regulatory structure and affect the lending, deposit, investment, trading and operating activities of financial institutions and their holding companies. The Dodd-Frank Act requires various federal agencies to adopt a broad range of new implementing rules and regulations, and to prepare numerous studies and reports for Congress. The federal agencies are given significant discretion in drafting the implementing rules and regulations, and consequently, many of the details and much of the impact of the Dodd-Frank Act may not be known for many months or years.

Among the many requirements in the Dodd-Frank Act for new banking regulations is a requirement for new capital regulations to be adopted within 18 months. These regulations must be at least as stringent as, and may call for higher levels of capital, than current regulations. Generally, trust preferred securities will no longer be eligible as Tier 1 capital, but our currently outstanding trust preferred securities will be grandfathered and our currently outstanding TARP preferred securities will continue to qualify as Tier 1 capital.

Certain provisions of the Dodd-Frank Act are expected to have a near-term impact on us. For example, one year after the date of its enactment, the Dodd-Frank Act eliminates the federal prohibitions on paying interest on demand deposits, thus allowing businesses to have interest bearing checking accounts. Depending on competitive responses, this significant change to existing law could have an adverse impact on our interest expense.

The Dodd-Frank Act also permanently increases the maximum amount of deposit insurance for banks, savings institutions and credit unions to \$250,000 per depositor, retroactive to January 1, 2008, and non-interest bearing transaction accounts and interest on lawyers trust accounts have unlimited deposit insurance through December 31, 2013.

The Dodd-Frank Act creates a new Bureau of Consumer Financial Protection with broad powers to supervise and enforce consumer protection laws. The Bureau will have broad rule-making authority for a wide range of consumer protection laws that apply to all banks, including the authority to prohibit unfair, deceptive or abusive acts and practices.

Many aspects of the Dodd-Frank Act are subject to rulemaking and will take effect over several years, making it difficult to anticipate the overall financial impact on us. However, compliance with this new law and its implementing regulations will result in additional operating costs that could have a material adverse effect on our financial condition and results of operations.

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As a participant in TARP, we are subject to certain restrictions on dividends, repurchases of common stock and executive compensation.

We are subject to restrictions on dividends, repurchases of common stock, and executive compensation as a TARP participant. Compliance with these restrictions and other restrictions may increase our costs, impact our ability to retain executive officers and limit our ability to pursue business opportunities. Additionally, any reduction of, or the elimination of, our common stock dividend in the future could adversely affect the market price of our common stock. The current restrictions, as well as any possible future restrictions, associated with participation in TARP could have a material adverse impact on our business, financial condition, or results of operations.

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

The financial services industry is extensively regulated. Federal and state banking regulations are designed primarily to protect the deposit insurance funds and consumers, not to benefit a company's stockholders. These regulations may sometimes impose significant limitations on operations. The significant federal and state banking regulations that affect us are described in the section captioned "Supervision and Regulation" included in Part I, Item 1, "Business". These regulations, 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.

Proposed changes in New York State banking regulations could adversely affect us.

New York Governor Andrew Cuomo proposed merging the State Departments of Banking, Insurance and Consumer Protection into a single Department of Financial Regulation, or DFR. The bill provides that the Superintendent of the DFR may, beginning April 1, 2012, assess expenses in such proportion as he or she deems just and reasonable against banks and insurers. The bill also establishes a special account called the "consumer protection account," which will consist of fees and penalties received by the department of state and DFR, as well as other monies received in the form of penalties. These monies will be available to the DFR to pay for costs related to its consumer and investor protection activities. If the consumer protection account is insufficient to cover those costs, the balance would be recoverable through assessments against the industry.

The bill makes New York's "wild card" authority (that was set to expire September 10, 2011) permanent. Under this authority, the Banking Board has the power to grant to New York chartered banking organizations, as well as licensed foreign bank branches and agencies, powers possessed by a counterpart federally-chartered banking institution.

If this bill is adopted as proposed, it could adversely affect us.

OPERATIONAL RISKS

If our security systems, or those of merchants, merchant acquirers or other third parties containing information about customers, are compromised, we may be subject to liability and damage to our reputation.

As part of our business, we collect, process and retain sensitive and confidential client and customer information on our behalf and on behalf of other third parties. Customer data also may be stored on systems of third-party service providers and merchants that may have inadequate security systems. Third-party carriers regularly transport customer data, and may lose sensitive customer information. Unauthorized access to our networks or any of our other information systems potentially could jeopardize the security of confidential information stored in our computer systems or transmitted by our customers or others. If our security systems or those of merchants, processors or other third-party service providers are compromised such that this confidential information is disclosed to unauthorized parties, we may be subject to liability. For example, in the event of a security breach, we may incur losses related to fraudulent use of debit cards issued by us as well as the operational costs associated with reissuing cards. Although we take preventive measures to address these factors, such measures are costly and may become more costly in the future. Moreover, these measures may not protect us from liability, which may not be adequately covered by insurance, or from damage to our reputation.

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 their not providing us their services for any reason or their 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.

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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 the best people in most activities engaged in by us 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 difficult 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.

The potential for business interruption exists throughout our organization.

Integral to our performance is the continued efficacy of our technical systems, operational infrastructure, relationships with third parties and the vast array of associates and key executives in our day-to-day and ongoing operations. Failure by any or all of these resources subjects us to risks that may vary in size, scale and scope. This includes, but is not limited to, operational or technical failures, ineffectiveness or exposure due to interruption in third party support as expected, as well as the loss of key individuals or failure on the part of key individuals to perform properly. Although management has established policies and procedures, including implementation and testing of a comprehensive contingency plan, to address such failures, 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.

EXTERNAL RISKS

We are subject to interest rate risk.

Our earnings and cash flows are largely dependent 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 various governmental and regulatory agencies and, in particular, 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.

Although management believes it has implemented effective asset and liability management strategies to reduce the potential effects of changes in interest rates on our results of operations, any substantial, unexpected, 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.

From December 2007 through June 2009, the U.S. economy was in recession. Business activity across a wide range of industries and regions in the U. S. was greatly reduced. Although economic conditions have begun to improve, certain sectors, such as real estate, remain weak and unemployment remains high. Local governments and many businesses are still in serious difficulty due to lower consumer spending and reduced tax collections.

Market conditions also led to the failure or merger of several prominent financial institutions and numerous regional and community-based financial institutions. These failures, as well as projected future failures, have had a significant negative impact on the capitalization level of the deposit insurance fund of the FDIC, which, in turn, has led to past increases in deposit insurance premiums paid by financial institutions.

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.

Approximately 20% of our investment securities portfolio at December 31, 2010 is comprised of municipal securities issued by or on behalf of New York and its political subdivisions, agencies or instrumentalities, the interest on which is exempt from regular federal income tax. Risks associated with investing in municipal securities include political, economic and regulatory factors which may affect the issuers. The concerns facing the State of New York may lead nationally recognized rating agencies to downgrade its debt obligations. It is uncertain how the financial markets may react to any potential future ratings downgrade in New York's debt obligations. However, the fallout from continued budgetary concerns and a possible ratings downgrade could adversely affect the value of New York's obligations and those of its political subdivisions, agencies and instrumentalities.

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Overall, during 2010, the business environment has been adverse for many households and businesses in the United States and worldwide. While economic conditions in the State of New York, the United States and worldwide have begun to improve, there can be no assurance that this improvement will continue. Such conditions could adversely affect our financial condition and results of operations.

Our earnings are significantly affected by the fiscal and monetary policies of the federal government and its agencies.

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. 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 operation.

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.

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 various markets in which we operate. We also face competition from many other types of financial institutions, including, without limitation, savings and loans, 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. Many of our 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.

Our market value could result in an impairment of goodwill.

Our goodwill is evaluated for impairment on an annual basis or when triggering events or circumstances indicate impairment may exist. 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 could result in impairment of goodwill. At December 31, 2010, we had goodwill of \$37.4 million, representing approximately 18% of shareholders' equity. If impairment of goodwill was determined to exist, we would be required to write down our goodwill as a charge to earnings, which could have a material adverse impact on our results of operations or financial condition. For further discussion, see Note 1, Summary of Significant Accounting Policies, and Note 6, Goodwill and Other Intangible Assets, to the Consolidated Financial Statements included in Item 8 of this Annual Report on Form 10-K.

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LIQUIDITY RISKS

Liquidity is essential to our businesses.

Our liquidity could be impaired by an inability to access the capital markets or unforeseen outflows of cash. This situation 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 revenue, or we may need to sell a portion of our investment and/or loan portfolio, which, depending upon market conditions, could result in our realizing a loss.

We may need to raise additional capital in the future and such capital may not be available when needed 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, among other things, conditions in the capital markets at that time, which are outside of our control, and our financial performance.

In addition, we are highly regulated, and our regulators could require us to raise additional common equity in the future. Both 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 such 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 to pay dividends on our common and preferred stock, and to pay interest and principal on our debt. Various federal and/or state laws and regulations limit the amount of dividends that our Bank subsidiary and nonbank 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.

RISKS RELATED TO AN INVESTMENT IN OUR COMMON STOCK

The market price for our common stock varies, and you should purchase common stock for long-term investment only.

Although our common stock is currently traded on the NASDAQ Global Select Market, we cannot assure you that there will, at any time in the future, be an active trading market for our common stock. Even if there is an active trading market for our common stock, we cannot assure you that you will be able to sell all of your shares of common stock at one time or at a favorable price, if at all. As a result, you should purchase shares of common stock described herein only if you are capable of, and seeking, to make a long-term investment in our common stock.

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There may be future sales or other dilution of our equity, which may adversely affect the market price of our common stock.

We are not restricted from issuing additional shares of common stock, including any securities that are convertible into or exchangeable for, or that represent the right to receive, common stock. We are currently authorized to issue up to 50,000,000 shares of common stock and up to 210,000 shares of preferred stock, par value \$100 per share, which is designated into two classes, Class A of which 10,000 shares are authorized, and Class B of which 200,000 shares are authorized.

As of December 31, 2010, 10,937,506 shares of common stock and 183,259 shares of our preferred stock were issued and outstanding including (i) 7,503 shares of our fixed rate cumulative perpetual Series A preferred stock, par value \$100 per share, having a liquidation preference of \$5,000 per share, which we refer to as the TARP preferred stock, (ii) 1,533 shares of our Series A 3% cumulative preferred stock, which we refer to as the 3% preferred stock, and (iii) 174,223 shares of Series B-1 8.48% cumulative preferred stock, which we refer to as the 8.48% preferred stock. We refer to our TARP preferred stock, our 3% preferred stock and our 8.48% preferred stock collectively as the preferred stock. Our Board of Directors has authority, without action or vote of the shareholders, to issue all or part of the authorized but unissued shares. These authorized but unissued shares could be issued on terms or in circumstances that could dilute the interests of the holders of our common stock.

Pursuant to the Letter Agreement, dated December 23, 2008, and the Securities Purchase Agreement - Standard Terms attached thereto, which we refer to collectively as the Securities Purchase Agreement, that we entered into with the Treasury, in connection with our participation in TARP, the Treasury received a warrant to purchase up to 378,175 shares of our common stock, which we refer to as the warrant, at an exercise price of \$14.88 per share, and we have provided the Treasury with registration rights covering the warrant and the underlying shares of common stock. We may seek the approval of our regulators to repurchase the warrant with the proceeds from any offering. The issuance of additional shares of common stock as a result of exercise of the warrant or otherwise or the issuance of securities convertible or exercisable into shares of common stock would dilute the ownership interest of existing holders of our common stock. Although the Treasury has agreed to not vote any of the shares of common stock it receives upon exercise of the warrant, a transferee of any portion of the warrant or of any shares of common stock acquired upon exercise of the warrant is not bound by this restriction. The market price of our common stock could decline as a result of any offering as well as other sales of a large block of common stock in the market after an offering, or the perception that such sales could occur.

The terms of the warrant include an anti-dilution adjustment, which provides that (except in certain permitted transactions, including registered offerings), if we issue shares of common stock at a price that is less than 90% of the market price of such shares on the last trading day preceding the date of the agreement to sell such shares, the number of shares of common stock to be issued under the warrant would increase and the per share price of common stock to be purchased pursuant to the warrant would decrease.

Our shares of common stock are equity and are subordinate to our existing and future indebtedness and our preferred stock, and are effectively subordinated to all the indebtedness and other non-common equity claims against our subsidiaries.

Our shares of common stock are equity interests in us and do not constitute indebtedness. Accordingly, our common stock will rank junior to all of our indebtedness and to other non-equity claims on us with respect to assets available to satisfy claims on us. Additionally, holders of our common stock are subject to the prior dividend and liquidation rights of holders of our outstanding preferred stock. See Note 11, Shareholders' Equity, in the accompanying consolidated financial statements. The terms of our preferred stock currently prohibit us from paying dividends with respect to our common stock unless all accrued and unpaid dividends for all completed dividend periods with respect to the preferred stock have been paid with our TARP preferred stock and 3% preferred stock receiving payments first.

In addition, our right to participate in any distribution of assets of any of our subsidiaries upon the subsidiary's liquidation or otherwise, and thus your ability as a holder of our common stock to benefit indirectly from such distribution, will be subject to the prior claims of creditors of that subsidiary and holders of any of that subsidiary's preferred stock, except to the extent that any of our claims as a creditor of such subsidiary may be recognized. As a result, our common stock will effectively be subordinated to all existing and future liabilities and obligations of our

subsidiaries.

We may not pay 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. Also, participation in TARP limits our ability to increase our dividend or to repurchase our common stock, for so long as any securities issued under such program remain outstanding, as discussed in greater detail below.

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.

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ITEM 1B. UNRESOLVED STAFF COMMENTS

Not applicable.

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. Additionally, we are obligated under a lease commitment through 2017 for a regional administrative facility in Pittsford, New York.

We are engaged in the banking business through 50 branch offices, of which 34 are owned and 16 are leased, in fourteen contiguous counties of Western and Central New York: Allegany, Cattaraugus, Cayuga, Chautauqua, Chemung, Erie, Genesee, Livingston, Monroe, Ontario, Seneca, Steuben, Wyoming and Yates Counties. The operating leases for our branch offices expire at various dates through the year 2023 and generally include options to renew.

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 5, Premises and Equipment, Net, and Note 9, Commitments and Contingencies, 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.

ITEM 3. LEGAL PROCEEDINGS

From time to time we are a party to or otherwise involved in legal proceedings arising in 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. RESERVED

Table of Contents**PART II****ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED SHAREHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES**

Our common stock is traded on the NASDAQ Global Select Market under the ticker symbol FISI. At December 31, 2010, 10,937,506 shares of our common stock were outstanding and held by approximately 1,300 shareholders of record. During 2010, the high sales price of our common stock was \$20.74 and the low sales price was \$10.91. The closing price per share of common stock on December 31, 2010, the last trading day of the Company's fiscal year, was \$18.97. We declared dividends of \$0.40 per common share during the year ended December 31, 2010. 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. However, the payment of dividends is subject to continued compliance with minimum regulatory capital requirements and TARP restrictions. 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 10, 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.

Equity Compensation Plan Information

The following table sets forth, as of December 31, 2010, information about our equity compensation plans that have been approved by our shareholders, including the number of shares of our common stock exercisable under all outstanding options, warrants and rights, the weighted average exercise price of all outstanding options, warrants and rights and the number of shares available for future issuance under our equity compensation plans. We have no equity compensation plans that have not been approved by our shareholders.

Plan Category	Number of securities to be issued upon exercise of outstanding options, warrants and rights (a)	Weighted average exercise price of outstanding options, warrants and rights (b)	Number of securities remaining for future issuance under equity compensation plans (excluding securities reflected in column (a)) (c)
Equity compensation plans approved by shareholders	560,689 ⁽¹⁾	\$ 20.64 ⁽¹⁾	748,101 ⁽²⁾
Equity compensation plans not approved by shareholders		\$	

(1) Includes 150,796 shares of unvested restricted stock awards outstanding as of December 31, 2010. The weighted average exercise price excludes such awards.

(2)

Represents the 940,000 aggregate shares approved for issuance under our two active equity compensation plans, reduced by 191,899 shares, which are the 117,012 restricted stock awards issued under these plans to date plus an adjustment of 74,887 shares. Pursuant to the terms of the plans, for purposes of calculating the number of shares available for issuance, each share of common stock granted pursuant to a restricted stock award shall count as 1.64 shares of common stock.

Sales of Unregistered Securities

2009 Management Incentive Plan

On May 6, 2009, our shareholders approved our 2009 Management Stock Incentive Plan. Pursuant to the terms of the 2009 Management Stock Incentive Plan, we have the ability to grant incentive stock options, non-qualified stock options and restricted stock to members of our management team. Between May 6, 2009 and December 31, 2010, we granted shares of restricted stock to members of our management team under the 2009 Management Stock Incentive Plan as described in the table below.

Date	Number of shares issued	Number of individuals receiving awards
October 1, 2009	1,972	1
January 13, 2010	40,188	5
February 23, 2010	59,152	23
December 15, 2010	500	1

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These shares of restricted stock were issued without registration under the Securities Act of 1933, as amended (the Securities Act) in reliance on the exemption from registration in Section 4(2) of the Securities Act. These shares of restricted stock are subject to the resale prohibitions under the Securities Act and may not be sold or transferred without registration except in accordance with Rule 144 of the Securities Act.

2009 Directors' Stock Incentive Plan

On May 6, 2009, our shareholders approved our 2009 Directors' Stock Incentive Plan. Pursuant to the terms of the 2009 Directors' Stock Incentive Plan, we have the ability to grant non-qualified stock options and restricted stock to our non-employee directors. On May 6, 2009, we granted a total of 8,000 shares of restricted stock to ten of our non-employee directors and on May 6, 2010, we granted a total of 7,200 shares of restricted stock to nine of our non-employee directors.

These shares of restricted stock were issued without registration under the Securities Act in reliance on the exemption from registration in Section 4(2) of the Securities Act. These shares of restricted stock are subject to the resale prohibitions under the Securities Act and may not be sold or transferred without registration except in accordance with Rule 144 of the Securities Act.

Stock Performance Graph

The stock performance graph below compares (a) the cumulative total return on our common stock for the period beginning December 31, 2005 as reported by the NASDAQ Global Select Market, through December 31, 2010, (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 L.C., of Major Exchange (NYSE, AMEX 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 Financial, LC and is expressed in dollars based on an assumed investment of \$100.

Total Return Performance

Index	Period Ending					
	12/31/05	12/31/06	12/31/07	12/31/08	12/31/09	12/31/10
Financial Institutions, Inc.	100.00	119.37	94.50	78.59	67.41	111.16
NASDAQ Composite	100.00	110.39	122.15	73.32	106.57	125.91
SNL Bank \$1B-\$5B Index	100.00	115.72	84.29	69.91	50.11	56.81

Table of Contents**ITEM 6. SELECTED FINANCIAL DATA**

<i>(Dollars in thousands, except selected ratios and per share data)</i>	At or for the year ended December 31,				
	2010	2009	2008	2007	2006
Selected financial condition data:					
Total assets	\$ 2,214,307	\$ 2,062,389	\$ 1,916,919	\$ 1,857,876	\$ 1,907,552
Loans, net	1,325,524	1,243,265	1,102,330	948,652	909,434
Investment securities	694,530	620,074	606,038	754,720	775,536
Deposits	1,882,890	1,742,955	1,633,263	1,575,971	1,617,695
Borrowings	103,877	106,390	70,820	68,210	87,199
Shareholders equity	212,144	198,294	190,300	195,322	182,388
Common shareholders equity ⁽¹⁾	158,359	144,876	137,226	177,741	164,765
Tangible common shareholders equity ⁽²⁾	120,990	107,507	99,577	139,786	126,502
Selected operations data:					
Interest income	\$ 96,509	\$ 94,482	\$ 98,948	\$ 105,212	\$ 103,070
Interest expense	17,720	22,217	33,617	47,139	43,604
Net interest income	78,789	72,265	65,331	58,073	59,466
Provision (credit) for loan losses	6,687	7,702	6,551	116	(1,842)
Net interest income after provision (credit) for loan losses	72,102	64,563	58,780	57,957	61,308
Noninterest income (loss) ⁽³⁾	19,454	18,795	(48,778)	20,680	21,911
Noninterest expense	60,917	62,777	57,461	57,428	59,612
Income (loss) before income taxes	30,639	20,581	(47,459)	21,209	23,607
Income tax expense (benefit)	9,352	6,140	(21,301)	4,800	6,245
Net income (loss)	\$ 21,287	\$ 14,441	\$ (26,158)	\$ 16,409	\$ 17,362
Preferred stock dividends and accretion	3,725	3,697	1,538	1,483	1,486
Net income (loss) applicable to common shareholders	\$ 17,562	\$ 10,744	\$ (27,696)	\$ 14,926	\$ 15,876
Stock and related per share data:					
Earnings (loss) per common share:					
Basic	\$ 1.62	\$ 0.99	\$ (2.54)	\$ 1.34	\$ 1.40
Diluted	1.61	0.99	(2.54)	1.33	1.40
Cash dividends declared on common stock	0.40	0.40	0.54	0.46	0.34
Common book value per share ⁽¹⁾	14.48	13.39	12.71	16.14	14.53
Tangible common book value per share ⁽²⁾	11.06	9.94	9.22	12.69	11.15
Market price (NASDAQ: FISL):					
High	20.74	15.99	22.50	23.71	25.38
Low	10.91	3.27	10.06	16.18	17.43
Close	18.97	11.78	14.35	17.82	23.05

⁽¹⁾ Excludes preferred shareholders equity.

- (2) Excludes preferred shareholders' equity, goodwill and other intangible assets.
- (3) The 2010, 2009 and 2008 figures include other-than-temporary impairment (OTTI) charges of \$594 thousand, \$4.7 million and \$68.2 million, respectively. There were no OTTI charges in the other years presented.

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<i>(Dollars in thousands, except per share data)</i>	At or for the year ended December 31,				
	2010	2009	2008	2007	2006
Selected financial ratios and other data:					
Performance ratios:					
Net income (loss), returns on:					
Average assets	0.98%	0.71%	-1.37%	0.86%	0.90%
Average equity	10.07	7.43	-14.30	8.84	9.86
Average common equity ⁽¹⁾	11.14	7.61	-16.84	8.89	10.02
Average tangible common equity ⁽²⁾	14.59	10.37	-21.87	11.50	13.23
Common dividend payout ratio ⁽³⁾	24.69	40.40	NA	34.33	24.29
Net interest margin (fully tax-equivalent)	4.07	4.04	3.93	3.53	3.55
Efficiency ratio ⁽⁴⁾	60.36%	65.52%	64.07%	68.77%	69.78%
Capital ratios:					
Leverage ratio	8.31%	7.96%	8.05%	9.35%	8.91%
Tier 1 risk-based capital	12.34	11.95	11.83	15.74	15.85
Total risk-based capital	13.60	13.21	13.08	16.99	17.10
Equity to assets ⁽⁵⁾	9.75	9.55	9.60	9.73	9.08
Common equity to assets ^{(1) (5)}	7.28	6.94	8.63	8.81	8.17
Tangible common equity to tangible assets ⁽²⁾ ⁽⁵⁾	5.65%	5.19%	6.78%	6.95%	6.32%
Asset quality:					
Non-performing loans	\$ 7,582	\$ 8,681	\$ 8,196	\$ 8,077	\$ 15,840
Non-performing assets	8,895	10,442	9,252	9,498	17,043
Allowance for loan losses	20,466	20,741	18,749	15,521	17,048
Net loan charge-offs	\$ 6,962	\$ 5,710	\$ 3,323	\$ 1,643	\$ 1,341
Total non-performing loans to total loans	0.56%	0.69%	0.73%	0.84%	1.71%
Total non-performing assets to total assets	0.40	0.51	0.48	0.51	0.89
Net charge-offs to average loans	0.54	0.47	0.32	0.18	0.14
Allowance for loan losses to total loans	1.52	1.64	1.67	1.61	1.84
Allowance for loan losses to non-performing loans	270%	239%	229%	192%	108%
Other data:					
Number of branches	50	50	51	50	50
Full time equivalent employees	577	572	600	621	640

(1) Excludes preferred shareholders equity.

(2) Excludes preferred shareholders equity, goodwill and other intangible assets.

(3) Common dividend payout ratio equals dividends declared during the year divided by earnings per share for the year. There is no ratio shown for years where we both declared a dividend and incurred a loss because the ratio would result in a negative payout since the dividend declared (paid out) will always be greater than 100% of earnings.

- (4) Efficiency ratio equals noninterest expense less other real estate expense and amortization of intangible assets as a percentage of net revenue, defined as the sum of tax-equivalent net interest income and noninterest income before net gains and impairment charges on investment securities, proceeds from company owned life insurance included in income, and net gains from the sale of trust relationships (all from continuing operations).
- (5) Ratios calculated using average balances for the periods shown.

Table of Contents**SELECTED QUARTERLY DATA**

<i>(Dollars in thousands, except per share data)</i>	2010			
	Fourth Quarter	Third Quarter	Second Quarter	First Quarter
Interest income	\$ 24,297	\$ 24,186	\$ 24,202	\$ 23,824
Interest expense	4,229	4,393	4,526	4,572
Net interest income	20,068	19,793	19,676	19,252
Provision for loan losses	1,980	2,184	2,105	418
Net interest income, after provision for loan losses	18,088	17,609	17,571	18,834
Noninterest income	5,274	5,131	4,966	4,083
Noninterest expense	16,373	14,936	14,870	14,738
Income before income taxes	6,989	7,804	7,667	8,179
Income tax expense	1,891	2,141	2,469	2,851
Net income	\$ 5,098	\$ 5,663	\$ 5,198	\$ 5,328
Preferred stock dividends	933	932	931	929
Net income applicable to common shareholders	\$ 4,165	\$ 4,731	\$ 4,267	\$ 4,399
Earnings per common share ⁽¹⁾ :				
Basic	\$ 0.38	\$ 0.44	\$ 0.39	\$ 0.41
Diluted	0.38	0.43	0.39	0.40
Market price (NASDAQ: FISI):				
High	\$ 20.74	\$ 19.94	\$ 19.48	\$ 15.40
Low	16.80	14.14	14.07	10.91
Close	18.97	17.66	17.76	14.62
Dividends declared	\$ 0.10	\$ 0.10	\$ 0.10	\$ 0.10

<i>(Dollars in thousands, except per share data)</i>	2009			
	Fourth Quarter	Third Quarter	Second Quarter	First Quarter
Interest income	\$ 24,390	\$ 23,697	\$ 23,302	\$ 23,093
Interest expense	5,175	5,619	5,657	5,766
Net interest income	19,215	18,078	17,645	17,327
Provision for loan losses	1,088	2,620	2,088	1,906
Net interest income, after provision for loan losses	18,127	15,458	15,557	15,421
Noninterest income	5,183	4,406	4,515	4,691
Noninterest expense	15,117	15,142	16,440	16,078
Income before income taxes	8,193	4,722	3,632	4,034
Income tax expense	2,756	1,313	1,004	1,067

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Net income	\$	5,437	\$	3,409	\$	2,628	\$	2,967
Preferred stock dividends		927		927		925		918
Net income applicable to common shareholders	\$	4,510	\$	2,482	\$	1,703	\$	2,049
Earnings per common share ⁽¹⁾ :								
Basic	\$	0.42	\$	0.23	\$	0.16	\$	0.19
Diluted		0.42		0.23		0.16		0.19
Market price (NASDAQ: FISI):								
High	\$	12.25	\$	15.00	\$	15.99	\$	14.95
Low		9.71		9.90		6.98		3.27
Close		11.78		9.97		13.66		7.62
Dividends declared	\$	0.10	\$	0.10	\$	0.10	\$	0.10

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

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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 report.

OVERVIEW AND OUTLOOK

Business Overview

Financial Institutions, Inc. is a financial holding company headquartered in New York State, providing banking and nonbanking financial services to individuals and businesses primarily in our Western and Central New York footprint. Through our wholly-owned banking subsidiary, Five Star Bank, we provide a wide range of services, including business and consumer loan and depository services, as well as other traditional banking services. Through our nonbanking subsidiary, Five Star Investment Services, we provide brokerage services to supplement our banking business.

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

Outlook

The general state of the U.S. economy and, in particular, economic and market conditions in Western and Central New York have a significant impact on loan demand, the ability of borrowers to repay loans and the value of any collateral securing loans and may also affect deposit levels. Accordingly, future general economic conditions and the impact on credit risk are key uncertainties that may materially affect our results of operations.

Approximately 20% of our investment securities portfolio at December 31, 2010 is comprised of municipal securities issued by or on behalf of New York and its political subdivisions, agencies or instrumentalities, the interest on which is exempt from federal income tax. Risks associated with investing in municipal securities include political, economic and regulatory factors which may affect the issuers. The concerns facing the State of New York may lead nationally recognized rating agencies to downgrade its debt obligations. It is uncertain how the financial markets may react to any potential future ratings downgrade in New York's debt obligations. However, the fallout from continued budgetary concerns and a possible ratings downgrade could adversely affect the value of New York's obligations.

Our interest rate spread affects our profitability. Our interest rate spread is the difference between the interest rate we receive on interest-earning assets, such as loans and investment securities, and the interest rate we pay on deposits and other borrowings. If the interest rates we pay on our deposits and other borrowings were to increase at a faster rate than the interest rates we receive on our loans and investments securities, our interest rate spread will decline, which could adversely affect our profitability.

Legislative and regulatory reforms continue to be adopted which impose additional restrictions on current business practices including passage of the Dodd-Frank Act. The Dodd-Frank Act is complex and we continue to assess how this legislation and subsequent rule-making will affect us. As hundreds of regulations are promulgated, we will continue to evaluate impacts such as changes in regulatory costs and fees, modifications to consumer products or disclosures required by the Consumer Financial Protection Bureau and the requirements of the enhanced supervision provisions, among others.

Recent Developments

On February 23, 2011, the Company was granted approval from the Treasury and redeemed \$12.5 million of the \$37.5 million in Series A preferred stock issued by the Company in December 2008. The redemption will result in a reduction of the associated Series A preferred stock dividends and Tier 1 Capital in future periods. Upon issuance in

December 2008, the discount associated with the Series A preferred stock was \$2.0 million, which is being accreted to retained earnings as an adjustment to dividends using the effective yield method. At December 31, 2010, the Series A preferred stock discount totaled \$1.3 million. As a result of the redemption, the Company will accelerate the accretion of the remaining discount in proportion to the Series A preferred stock redeemed in the first quarter of 2011. This transaction has no effect on the outstanding warrant to purchase common stock issued to the Treasury as part of the original issuance of the Series A preferred stock. The Company may apply for approval to repay the remaining balance of the Series A preferred stock in future periods.

Table of Contents**MANAGEMENT'S DISCUSSION AND ANALYSIS****2010 Performance Summary**

Our reported net income was \$21.3 million for the year ended December 31, 2010, compared to a net income of \$14.4 million for the year ended December 31, 2009. For 2010, net income available to common shareholders was \$17.6 million, or \$1.61 per diluted common share. Net income available to common shareholders was \$10.7 million for 2009, or \$0.99 per diluted common share. Cash dividends of \$0.40 per common share were paid in 2010 and 2009. We had total assets of \$2.214 billion at December 31, 2010 compared to \$2.062 billion at December 31, 2009. At December 31, 2010, shareholders' equity totaled \$212.1 million with book value per common share at \$14.48, compared to \$198.3 million with book value per share at \$13.39 at the end of 2009. Tangible common equity to tangible common assets improved to 5.65% during 2010 from 5.19% in 2009. The Tier 1 capital ratio was 12.34% as of December 31, 2010 compared to 11.95% at December 31, 2009.

Key factors behind these results are discussed below.

At December 31, 2010, total gross loans (includes loans held for sale) were \$1.349 billion, up 7% from year-end 2009, primarily in commercial mortgage and consumer indirect loans, as we have focused our business development efforts in these areas in accordance with our strategic objectives. Total deposits at December 31, 2010, were \$1.883 billion, up 8% from year-end 2009, primarily attributable to a \$113.6 million increase in retail deposits. Our deposit mix remains favorably weighted in lower cost demand, savings and money market accounts, which comprised 60.7% of total deposits at the end of 2010. Nonperforming loans were \$7.6 million at December 31, 2010, compared to \$8.7 million at December 31, 2009, as our loan portfolio continues to benefit from responsible underwriting and lending practices. Net charge-offs were \$7.0 million in 2010 (or 0.54% of average loans) compared to \$5.7 million in 2009 (or 0.47% of average loans). We had a \$5.0 million participation interest in one commercial business loan, which was sold during the third quarter of 2010 for \$1.9 million, resulting in a charge-off of \$3.1 million. The provision for loan losses was \$6.7 million and \$7.7 million, respectively, for 2010 and 2009. At year-end 2010, the allowance for loan losses of \$20.5 million represented 1.52% of total loans (covering 270% of non-performing loans), compared to \$20.7 million or 1.64% (covering 239% of non-performing loans) at year-end 2009. See also sections, Allowance for Loan Losses and Non-performing Assets and Potential Problem Loans for additional information on net charge-offs and non-performing loans. Taxable equivalent net interest income was \$80.7 million for 2010 or 8% higher than \$75.0 million in 2009. Taxable equivalent interest income increased \$1.2 million, while interest expense decreased by \$4.5 million. The increase in taxable equivalent net interest income was a function of a favorable volume variance (increasing taxable equivalent net interest income by \$6.3 million), partially offset by an unfavorable rate variance (decreasing taxable equivalent net interest income by \$573 thousand). See also section, Net Interest Income and Net Interest Margin for additional information on taxable equivalent net interest income and net interest margin.

The net interest margin for 2010 was 4.07%, 3 basis points higher than 4.04% in 2009. The increase in net interest margin was attributable to a 10 basis point increase in interest rate spread (the net of a 36 basis point decrease in the cost of interest-bearing liabilities and a 26 basis decrease in the yield on earning assets), partially offset by a 7 basis point lower contribution from net free funds (primarily attributable to lower rates on interest-bearing liabilities reducing the value of noninterest-bearing deposits and other net free funds). See also section, Net Interest Income and Net Interest Margin for additional information on taxable equivalent net interest income and net interest margin.

Noninterest income was \$19.5 million for 2010 compared to \$18.8 million for 2009. Core fee-based revenues (defined as service charges on deposit accounts, ATM and debit fees, and broker-dealer fees and commissions) totaled \$14.9 million for 2010, up \$166 thousand from \$14.7 million for 2009. Net mortgage banking income was \$1.8 million for 2010, compared to \$2.0 million in 2009, a decrease of \$233 thousand from 2009, primarily attributable to lower secondary mortgage production experienced during 2010 and a decrease in our loan serviced for others portfolio. For additional discussion concerning noninterest income see section, Noninterest Income.

Net investment securities losses (defined as impairment charges on investment securities and net gain on disposal of investment securities) were \$425 thousand for 2010, compared to net investment securities losses of \$1.2 million for 2009, primarily attributable to other-than-temporary write-downs on investment securities.

Noninterest expense for 2010 was \$60.9 million, a decrease of \$1.9 million or 3% over 2009. FDIC assessments decreased \$1.1 million, salaries and employee benefits decreased \$823 thousand, and collectively all remaining noninterest expense categories were up \$107 thousand or less than half a percent compared to 2009. Other noninterest expense for 2010 includes \$1.0 million of losses relating to irregular instance of fraudulent debit card activity. The efficiency ratio (as defined under Part II, Item 6, Selected Financial Data) was 60.36% for 2010 and 65.52% for 2009. For additional discussion regarding noninterest expense see section, Noninterest Expense.

Income tax expense for 2010 was \$9.4 million compared to \$6.1 million for 2009. The change in income tax expense was primarily due to a \$10.1 million increase in pretax income between the years. For additional discussion concerning income tax see section, Income Taxes.

Table of Contents**MANAGEMENT'S DISCUSSION AND ANALYSIS****RESULTS OF OPERATIONS FOR THE YEARS ENDED DECEMBER 31, 2010 AND DECEMBER 31, 2009****Net Interest Income and Net Interest Margin**

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

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

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

	2010	2009	2008
Interest income per consolidated statements of operations	\$ 96,509	\$ 94,482	\$ 98,948
Adjustment to fully taxable equivalent basis	1,895	2,692	4,292
Interest income adjusted to a fully taxable equivalent basis	98,404	97,174	103,240
Interest expense per consolidated statement of operations	17,720	22,217	33,617
Net interest income on a taxable equivalent basis	\$ 80,684	\$ 74,957	\$ 69,623

Taxable equivalent net interest income of \$80.7 million for 2010 was \$5.7 million or 8% higher than 2009. While the average yields on our loans and assets declined, the impact was far exceeded by the benefit of substantial loan production and asset growth. The average balance of loans rose \$85.4 million to \$1.295 billion, reflecting growth in the commercial and consumer indirect loan portfolios, as we have focused business development efforts in those areas, and the average balance of interest-earning assets rose \$124.3 million to \$1.981 billion, both increases of 7%. We will continue to pursue loan development efforts in the commercial and consumer indirect lending portfolios in accordance with our prudent underwriting standards.

The increase in taxable equivalent net interest income was a function of a favorable volume variance (as balance sheet changes in both volume and mix increased taxable equivalent net interest income by \$6.3 million), partially offset by an unfavorable rate variance (decreasing taxable equivalent net interest income by \$573 thousand). The change in mix and volume of earning assets increased taxable equivalent interest income by \$6.8 million, while the change in volume and composition of interest-bearing liabilities increased interest expense by \$499 thousand, for a net favorable volume impact of \$6.3 million on taxable equivalent net interest income. Rate changes on earning assets reduced interest income by \$5.6 million, while changes in rates on interest-bearing liabilities lowered interest expense by \$5.0 million, for a net unfavorable rate impact of \$573 thousand.

The net interest margin for 2010 was 4.07% compared to 4.04% in 2009. The 3 basis point improvement in net interest margin was attributable to a 10 basis point increase in interest rate spread (the net of a 36 basis point decrease in the cost of interest-bearing liabilities and a 26 basis decrease in the yield on earning assets), partially offset by a 7 basis point lower contribution from net free funds (primarily attributable to lower rates on interest-bearing liabilities reducing the relative value of noninterest-bearing deposits and other net free funds).

The Federal Reserve left the Federal funds rate unchanged at 0.25% during 2010 and 2009.

For 2010, the yield on average earning assets of 4.97% was 26 basis points lower than 2009. Loan yields decreased 15 basis points to 5.86%. Commercial mortgage and consumer indirect loans in particular, down 26 and 34 basis points, respectively, experienced lower yields given the competitive pricing pressures in a low interest rate environment. The yield on investment securities dropped 69 basis points to 3.31%, also impacted by the lower interest rate environment and prepayments of mortgage-related investment securities. Overall, earning asset rate changes reduced interest income by \$5.6 million.

The cost of average interest-bearing liabilities of 1.10% in 2010 was 36 basis points lower than 2009. The average cost of interest-bearing deposits was 0.97% in 2010, 36 basis points lower than 2009, reflecting the lower rate environment, mitigated by a focus on product pricing to retain balances. The cost of wholesale funding (comprised of short-term borrowings and long-term borrowings) decreased 14 basis points to 3.33% for 2010. The interest-bearing liability rate changes resulted in \$5.0 million lower interest expense.

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MANAGEMENT'S DISCUSSION AND ANALYSIS

Average interest-earning assets of \$1.981 billion in 2010 were \$124.3 million or 7% higher than 2009. Average investment securities increased \$71.2 million, mostly in high quality U.S. Government agency securities. Average loans increased \$85.4 million or 7%, with a \$33.3 million increase in commercial loans and a \$74.2 million increase in consumer loans, offset by a \$22.1 million decrease in residential mortgage loans.

Average interest-bearing liabilities of \$1.610 billion in 2010 were up \$85.1 million or 6% versus 2009, mainly attributable to higher average retail deposit balances. The impacts of the recent recession have had a positive impact on our deposit balances, as consumers tend to save more conservatively when consumer confidence is low. On average, interest-bearing deposits grew \$89.0 million, while average noninterest-bearing demand deposits (a principal component of net free funds) increased by \$36.0 million. Average wholesale funding decreased \$3.9 million, net of the \$6.0 million increase and \$9.9 million decrease in short-term and long-term borrowings, respectively.

The recently enacted Dodd-Frank Act repealed the federal prohibitions on the payment of interest on demand deposits for commercial accounts, thereby permitting depository institutions to pay interest on business transaction and other accounts beginning July 21, 2011. Although the ultimate impact of this legislation on us has not yet been determined, we expect interest costs associated with demand deposits to increase as a result of competitor responses to this change. See Part I, Item 1, Section Supervision and Regulation for a detailed discussion of this legislation.

Table of Contents**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,								
	2010			2009			2008		
	Average Balance	Average Interest	Average Rate	Average Balance	Average Interest	Average Rate	Average Balance	Average Interest	Average Rate
Interest-earning assets:									
Federal funds sold and other interest-earning deposits	\$ 5,034	\$ 10	0.21%	\$ 37,214	\$ 82	0.22%	\$ 26,568	\$ 619	2.33%
Investment securities:									
Taxable	571,856	17,101	2.99	454,552	16,466	3.62	487,687	21,882	4.49
Tax-exempt	108,900	5,416	4.97	155,054	7,920	5.11	233,864	13,065	5.59
Total investment securities	680,756	22,517	3.31	609,606	24,386	4.00	721,551	34,947	4.84
Loans:									
Commercial business	206,167	9,939	4.82	204,235	9,612	4.71	167,760	10,476	6.24
Commercial mortgage	338,149	20,389	6.03	306,763	19,309	6.29	274,677	18,877	6.87
Residential mortgage	138,954	8,157	5.87	161,055	9,701	6.02	172,083	10,761	6.25
Home equity	202,189	9,224	4.56	193,929	9,121	4.70	189,448	11,041	5.83
Consumer indirect	382,977	25,379	6.63	313,239	21,838	6.97	185,197	13,098	7.07
Other consumer	26,950	2,789	10.35	30,791	3,125	10.15	34,895	3,421	9.80
Total loans	1,295,386	75,877	5.86	1,210,012	72,706	6.01	1,024,060	67,674	6.61
Total interest-earning assets	1,981,176	98,404	4.97	1,856,832	97,174	5.23	1,772,179	103,240	5.83
Less: Allowance for loan losses	20,883			20,355			16,287		
Other noninterest-earning assets	206,303			197,439			149,453		

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Total assets	\$ 2,166,596			\$ 2,033,916			\$ 1,905,345		
Interest-bearing liabilities:									
Deposits:									
Interest-bearing demand	\$ 382,517	705	0.18	\$ 365,873	772	0.21	\$ 347,702	3,246	0.93
Savings and money market	414,953	1,133	0.27	383,697	1,090	0.28	369,926	3,773	1.02
Certificates of deposit	726,330	13,015	1.79	685,259	17,228	2.51	617,381	22,330	3.62
Total interest-bearing deposits	1,523,800	14,853	0.97	1,434,829	19,090	1.33	1,335,009	29,349	2.20
Short-term borrowings	49,104	365	0.74	43,092	270	0.63	38,028	721	1.90
Long-term borrowings	37,043	2,502	6.75	46,913	2,857	6.09	53,687	3,547	6.61
Total borrowings	86,147	2,867	3.33	90,005	3,127	3.47	91,715	4,268	4.65
Total interest-bearing liabilities	1,609,947	17,720	1.10	1,524,834	22,217	1.46	1,426,724	33,617	2.36
Noninterest-bearing deposits	329,853			293,852			280,467		
Other liabilities	15,485			20,890			15,249		
Shareholders equity	211,311			194,340			182,905		
Total liabilities and shareholders equity	\$ 2,166,596			\$ 2,033,916			\$ 1,905,345		
Net interest income (tax-equivalent)		\$ 80,684			\$ 74,957			\$ 69,623	
Interest rate spread			3.87%			3.77%			3.47%
Net earning assets	\$ 371,229			\$ 331,998			\$ 345,455		
Net interest margin (tax-equivalent)			4.07%			4.04%			3.93%
Ratio of average interest-earning assets to average interest-bearing liabilities	123.06%			121.77%			124.21%		

Table of Contents**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):

Increase (decrease) in:	Change from 2010 to 2009			Change from 2009 to 2008		
	Volume	Rate	Total	Volume	Rate	Total
Interest income:						
Federal funds sold and other interest-earning deposits	\$ (65)	\$ (7)	\$ (72)	\$ 179	\$ (716)	\$ (537)
Investment securities:						
Taxable	3,807	(3,172)	635	(1,412)	(4,004)	(5,416)
Tax-exempt	(2,300)	(204)	(2,504)	(4,102)	(1,043)	(5,145)
Total investment securities	1,507	(3,376)	(1,869)	(5,514)	(5,047)	(10,561)
Loans:						
Commercial business	92	235	327	2,015	(2,879)	(864)
Commercial mortgage	1,916	(836)	1,080	2,097	(1,665)	432
Residential mortgage	(1,302)	(242)	(1,544)	(673)	(387)	(1,060)
Home equity	382	(279)	103	256	(2,176)	(1,920)
Consumer indirect	4,665	(1,124)	3,541	8,930	(190)	8,740
Other consumer	(396)	60	(336)	(414)	118	(296)
Total loans	5,357	(2,186)	3,171	12,211	(7,179)	5,032
Total interest income	6,799	(5,569)	1,230	6,876	(12,942)	(6,066)
Interest expense:						
Deposits:						
Interest-bearing demand	34	(101)	(67)	162	(2,636)	(2,474)
Savings and money market	86	(43)	43	135	(2,818)	(2,683)
Certificates of deposit	982	(5,195)	(4,213)	2,257	(7,359)	(5,102)
Total interest-bearing deposits	1,102	(5,339)	(4,237)	2,554	(12,813)	(10,259)
Short-term borrowings	41	54	95	85	(536)	(451)
Long-term borrowings	(644)	289	(355)	(426)	(264)	(690)
Total borrowings	(603)	343	(260)	(341)	(800)	(1,141)
Total interest expense	499	(4,996)	(4,497)	2,213	(13,613)	(11,400)
Net interest income	\$ 6,300	\$ (573)	\$ 5,727	\$ 4,663	\$ 671	\$ 5,334

Table of Contents**MANAGEMENT'S DISCUSSION AND ANALYSIS****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 \$6.7 million for the year ended December 31, 2010 compared with \$7.7 million for 2009. See the Allowance for Loan Losses section for further discussion.

Noninterest Income (Loss)

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

	2010	2009	2008
Service charges on deposits	\$ 9,585	\$ 10,065	\$ 10,497
ATM and debit card	3,995	3,610	3,313
Broker-dealer fees and commissions	1,283	1,022	1,458
Company owned life insurance	1,107	1,096	563
Loan servicing	1,124	1,308	664
Net gain on sale of loans held for sale	650	699	339
Net gain on disposal of investment securities	169	3,429	288
Impairment charges on investment securities	(594)	(4,666)	(68,215)
Net (loss) gain on sale and disposal of other assets	(203)	180	305
Other	2,338	2,052	2,010
Total noninterest income (loss)	\$ 19,454	\$ 18,795	\$ (48,778)

Service charges on deposits were \$9.6 million in 2010, which was \$480 thousand or 5% lower than 2009. The decrease was primarily attributable to lower nonsufficient funds fees in 2010, which were down \$407 thousand to \$7.9 million. In November 2009, the FRB issued a final rule that, effective July 1, 2010, prohibits financial institutions from charging consumers fees for paying overdrafts on automated teller machine and one-time debit card transactions, unless a consumer consents, or opts in, to the overdraft service for those types of transactions, commonly referred to as Reg.-E. Consumers must be provided a notice that explains the financial institution's overdraft services, including the fees associated with the service, and the consumer's choices. We implemented the provisions of Reg.-E in the third quarter of 2010 and the number of customers that have chosen to opt-in has exceeded our original expectations; however the extent of the adverse impacts of Reg.-E on our future service charge revenue is uncertain. ATM and debit card income was \$4.0 million for 2010, an increase of \$385 thousand or 11%, compared to 2009, due to higher interchange fees resulting from an increase in the number of cardholders and an increase in customer transactions.

Broker-dealer fees and commissions were up \$261 thousand or 26%, compared to 2009. Broker-dealer fees and commissions fluctuate mainly due to sales volume, which increased during 2010 as a result of improving market and economic conditions.

Loan servicing income represents fees earned for servicing mortgage loans sold to third parties, net of amortization expense and impairment losses, if any, associated with capitalized mortgage servicing assets. Loan servicing income decreased \$184 thousand for the year ended December 31, 2010 compared to 2009, mainly as a result of more rapid amortization of servicing rights due to loans paying off prior to maturity and lower fees collected due to a decrease in the sold and serviced portfolio.

We recognized \$425 thousand in net losses on investment securities during the year ended December 31, 2010 as compared to \$1.2 million of net losses during the same period in 2009. The investment security net losses for 2010 resulted from other-than-temporary impairment charges of \$594 thousand, partly offset by \$169 thousand of gains on the disposal of securities. The 2010 OTTI charges primarily relate to pooled trust preferred securities that were designated as impaired in the first quarter due to credit quality. The \$1.2 million of investment security losses for 2009 are a result of \$4.7 million of other-than-temporary impairment charges, partly offset by \$3.4 million of gains on the

sale of securities.

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

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

	2010	2009	2008
Salaries and employee benefits	\$ 32,811	\$ 33,634	\$ 31,437
Occupancy and equipment	10,818	11,062	10,502
FDIC assessments	2,507	3,651	674
Computer and data processing	2,487	2,340	2,433
Professional services	2,197	2,524	2,141
Supplies and postage	1,772	1,846	1,800
Advertising and promotions	1,121	949	1,453
Other	7,204	6,771	7,021
Total noninterest expense	\$ 60,917	\$ 62,777	\$ 57,461

Salaries and employee benefits (which includes salary-related expenses and fringe benefit expenses) was \$32.8 million for 2010, down \$823 thousand or 2% from 2009. Average full-time equivalent employees (FTEs) were 577 for 2010, down 2% from 586 for 2009. Salary-related expenses were relatively unchanged at \$25.3 million for 2010 and \$25.2 million for 2009. Fringe benefit expenses decreased \$876 thousand or 10%, primarily attributable to lower pension costs.

FDIC assessments, comprised mostly of deposit insurance paid to the FDIC, decreased \$1.1 million for the year ended December 31, 2010, due primarily to the one-time special assessment of \$923 thousand incurred in the second quarter of 2009. FDIC assessment rates have also declined as a result of our improved financial ratios, upon which the assessment rate is based

Professional services expense of \$2.2 million in 2010 decreased \$327 thousand or 13% from 2009, primarily due to lower legal costs associated with loan workouts and other corporate activities.

Advertising and promotions expenses were \$172 thousand or 18% higher in 2010 compared to 2009 due to increases in business development expenses.

Other noninterest expense increased \$433 thousand or 6% during 2010 compared to 2009. This increase was primarily due to a loss of approximately \$1.0 million relating to irregular instances of fraudulent debit card activity that we recorded in the fourth quarter of 2010. We have taken actions to limit our exposure to such fraudulent activity and we are reviewing the remedies that may be available. Any recoveries or other remedies received will be separate from the \$1.0 million loss recorded in 2010 and will be recorded if and when received.

The efficiency ratio for the year ended December 31, 2010 improved to 60.36% compared with 65.52% for 2009. The efficiency ratio is a supplemental financial measure utilized in management's internal evaluations and is not defined under generally accepted accounting principles. The efficiency ratio is calculated by dividing total noninterest expense, excluding other real estate expense and amortization of intangible assets, by net revenue, defined as the sum of tax-equivalent net interest income and noninterest income before net gains and impairment charges on investment securities. Taxes are not part of this calculation. An increase in the efficiency ratio indicates that more resources are being utilized to generate the same volume of income, while a decrease would indicate a more efficient allocation of resources.

Income Taxes

We recognized income tax expense of \$9.4 million for 2010 compared to \$6.1 million for 2009. The change in income tax expense was primarily due to a \$10.1 million increase in pretax income between the years. We also recorded non-recurring tax benefits during 2010 of \$1.2 million related to valuation of our deferred tax assets as a result of the NYS repeal of the experience method for determining bad debts and re-valuing at the highest Federal statutory rate of 35%. Our effective tax rates were 30.5% in 2010 and 29.8% in 2009. Effective tax rates are affected by income and expense items that are not subject to Federal or state taxation. Our income tax provision reflects the impact of such

items, including tax-exempt interest income from municipal securities, tax-exempt earnings on bank-owned life insurance and the effect of certain state tax credits.

Table of Contents**MANAGEMENT'S DISCUSSION AND ANALYSIS*****RESULTS OF OPERATIONS FOR THE YEARS ENDED DECEMBER 31, 2009 AND DECEMBER 31, 2008*****Net Interest Income and Net Interest Margin**

Net interest income in the consolidated statements of operations (which excludes the taxable equivalent adjustment) was \$72.3 million in 2009 compared to \$65.3 million in 2008. The taxable equivalent adjustments (the adjustments to bring tax-exempt interest to a level that would yield the same after-tax income had that income been subject to a taxation using a 34% tax rate) of \$2.7 million and \$4.3 million for 2009 and 2008, respectively, resulted in fully taxable equivalent net interest income of \$75.0 million in 2009 and \$69.6 million in 2008.

Taxable equivalent net interest income of \$75.0 million for 2009 was \$5.3 million or 8% higher than 2008. The increase in taxable equivalent net interest income was a combination of favorable volume variances (as balance sheet changes in both volume and mix increased taxable equivalent net interest income by \$4.7 million) and favorable interest rate changes (as the impact of changes in the interest rate environment and product pricing increased taxable equivalent net interest income by \$671 thousand). The change in mix and volume of earning assets increased taxable equivalent interest income by \$6.9 million, while the change in volume and composition of interest-bearing liabilities decreased interest expense by \$2.2 million, for a net favorable volume impact of \$4.7 million on taxable equivalent net interest income. Rate changes on earning assets reduced interest income by \$12.9 million, while changes in rates on interest-bearing liabilities lowered interest expense by \$13.6 million, for a net favorable rate impact of \$671 thousand.

The net interest margin for 2009 was 4.04%, compared to 3.93% in 2008. The 11 basis point improvement in net interest margin was attributable to a 30 basis point increase in interest rate spread (the net of a 90 basis point decrease in the cost of interest-bearing liabilities and a 60 basis decrease in the yield on earning assets), partially offset by a 19 basis point lower contribution from net free funds (primarily attributable to lower rates on interest-bearing liabilities reducing the relative value of noninterest-bearing deposits and other net free funds).

For 2009, the yield on average earning assets of 5.23% was 60 basis points lower than 2008. Loan yields also decreased 60 basis points (to 6.01%). Commercial loans in particular, down 97 basis points, experienced lower yields given the repricing of adjustable rate loans and competitive pricing pressures in a low interest rate environment. The yield on securities and short-term investments was down 84 basis points to 4.00%, also impacted by the lower interest rate environment and prepayment speeds of mortgage-related investment securities purchased at a premium. Overall, earning asset rate changes reduced interest income by \$12.9 million.

The cost of average interest-bearing liabilities of 1.46% in 2009 was 90 basis points lower than 2008. The average cost of interest-bearing deposits was 1.33% in 2009, 87 basis points lower than 2008, reflecting the lower rate environment, mitigated by a focus on product pricing to retain balances. The cost of wholesale funding (comprised of short-term borrowings and long-term borrowings) decreased 118 basis points to 3.47% for 2009, with short-term borrowings down 127 basis points and long-term borrowings down 52 basis points. The interest-bearing liability rate changes resulted in \$13.6 million lower interest expense.

Average interest-earning assets of \$1.857 billion in 2009 were \$84.7 million or 5% higher than 2008. Average investment securities decreased \$111.9 million as a result of mortgage-related investment securities sales and maturities. Average loans increased \$186.0 million or 18%, with a \$68.6 million increase in commercial loans and a \$128.4 million increase in consumer loans, offset by a \$11.0 million decrease in residential real-estate loans.

Average interest-bearing liabilities of \$1.525 billion in 2009 were up \$98.1 million or 7% versus 2008, attributable to higher average deposit balances. On average, interest-bearing deposits grew \$99.8 million, while average noninterest-bearing demand deposits (a principal component of net free funds) increased by \$13.4 million. Average wholesale funding decreased \$1.7 million, the net of \$5.1 million increase and \$6.8 million decrease in short-term and long-term borrowings, respectively.

Provision for Loan Losses

The provision for loan losses totaled \$7.7 million for the year ended December 31, 2009, versus \$6.6 million for 2008. The increase in the provision was due to increased net charge-offs and increases in loan portfolio outstandings during 2009. See the Allowance for Loan Losses section for further discussion.

Noninterest Income

Service charges on deposits were \$10.1 million in 2009, which was \$432 thousand or 4% lower than 2008. The decrease was primarily attributable to lower nonsufficient fund fees in 2009, which were down \$505 thousand to \$8.3 million, offset by an increase in other service charges, which increased by \$73 thousand to \$1.8 million in 2009. ATM and debit card income was \$3.6 million for 2009, an increase of \$297 thousand or 9%, compared to 2008, as the increased popularity of electronic banking and transaction processing has resulted in higher ATM and debit card point-of-sale usage fees.

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

Loan servicing income represents fees earned for servicing mortgage loans sold to third parties, net of amortization expense and impairment losses, if any, associated with capitalized mortgage servicing assets. Loan servicing income increased \$644 thousand for the year ended December 31, 2009 compared to 2008, mainly from an increase in the sold and serviced residential real estate portfolio and a recovery in the fair value of capitalized mortgage servicing assets.

We invested \$20.0 million in company owned life insurance during the third quarter of 2008, resulting in the \$533 thousand increase when comparing company owned life insurance income for the year ended December 31, 2009 to 2008.

Broker-dealer fees and commissions were down \$436 thousand or 30%, compared to 2008. Broker-dealer fees and commissions fluctuate mainly due to sales volume, which has declined during 2009 as a result of current market and economic conditions.

Net gain on sale of loans held for sale increased \$360 thousand compared to the prior year, due primarily to higher gains on sales and related income resulting from increased volumes. Secondary mortgage production was \$89.0 million for 2009, compared to \$28.5 million for 2008. In addition, the 2008 income includes \$104 thousand in net gains from the sale of student loans. We exited the student loan business in 2008.

The \$3.4 million net gain on disposal of investment securities for 2009 is comprised of \$6.8 million in gross gains, primarily from securities issued by U.S. government sponsored agencies, and \$3.4 million in gross losses on sales of privately issued whole loan CMOs and auction rate securities. The \$288 thousand net gain on disposal of investment securities for 2008 is comprised of \$291 thousand in gross gains and \$3 thousand in gross losses.

The \$4.7 million of impairment charges on investment securities for 2009 is comprised of valuation write-downs of \$2.4 million on pooled trust preferred securities and \$2.3 million on privately issued whole loan CMOs. The \$68.2 million of impairment charges on investment securities for 2008 is comprised of valuation write-downs of \$30.0 million on pooled TPS, \$5.9 million on privately issued whole loan CMOs and \$32.3 million on auction-rate securities.

Noninterest Expense

Salaries and employee benefits (which includes salary-related expenses and fringe benefit expenses) was \$33.6 million for 2009, up \$2.2 million or 7% from 2008. Average FTEs were 586 for 2009, down 4% from 610 for 2008. Salary-related expenses were relatively unchanged at \$25.2 million for 2009 and \$25.1 million for 2008, a result of fewer FTEs offset by higher incentives and commissions. Fringe benefit expenses increased \$2.1 million or 34%, primarily from higher pension and post-retirement benefit costs.

Compared to 2008, occupancy and equipment expenses of \$11.1 million were up \$560 thousand or 5%, primarily a result of additional expenses related to the opening of two new branches at the end of 2008, combined with increased software maintenance costs.

FDIC assessments, comprised mostly of deposit insurance paid to the FDIC, increased \$3.0 million for the year ended December 31, 2009. The increases resulted from a combination of an increase in deposit levels subject to insurance premiums, higher FDIC insurance premium rates during 2009 and a \$923 thousand special assessment during the second quarter of 2009, coupled with utilization of approximately \$451 thousand in carryforward credits that reduced expense during the first nine months of 2008.

Professional services expense of \$2.5 million in 2009 increased \$383 thousand or 18% from 2008, primarily due to higher legal and other professional consultant costs associated with loan workouts and other corporate activities and projects.

Advertising and promotions expense of \$949 thousand and other noninterest expense of \$6.8 million, collectively, were down \$754 thousand or 9%, reflecting efforts to control selected discretionary expenses.

The efficiency ratio for the year ended December 31, 2009 was 65.52% compared with 64.07% for 2008. The diminished efficiency ratio is reflective of noninterest expense increasing by larger margin than the higher level of net interest income. The efficiency ratio equals noninterest expense less other real estate expense and amortization of intangible assets as a percentage of net revenue, defined as the sum of tax-equivalent net interest income and noninterest income before net gains and impairment charges on investment securities and proceeds from company

owned life insurance included in income.

Income Taxes

We recognized income tax expense of \$6.1 million for 2009 compared to an income tax benefit of \$21.3 million for 2008. The change in income tax was primarily due to us having pre-tax income for 2009 versus a pre-tax loss for 2008. Our effective tax rates were 29.8% in 2009 and (44.9%) in 2008. Effective tax rates are affected by income and expense items that are not subject to Federal or state taxation. Our income tax provision reflects the impact of such items, including tax-exempt interest income from municipal securities, tax-exempt earnings on bank-owned life insurance and the effect of certain state tax credits. The unusual 2008 effective tax benefit rate results from the relationship between the size of the favorable permanent differences and pre-tax loss.

Table of Contents**MANAGEMENT'S DISCUSSION AND ANALYSIS****2010 FOURTH QUARTER RESULTS**

Net income was \$5.1 million for the fourth quarter of 2010 compared with \$5.4 million for the fourth quarter of 2009. After preferred dividends, fourth quarter diluted earnings per share for 2010 was \$0.38 compared with \$0.42 per share for the fourth quarter of 2009.

Net interest income totaled \$20.1 million for the three months ended December 31, 2010, an increase of \$853 thousand or 4% over the fourth quarter of 2009. The increase in net interest income compared to the fourth quarter of 2009 resulted primarily from lower funding costs, a result of continued re-pricing of our certificates of deposit in the low rate environment. Average earning assets increased \$102.2 million or 5% in the fourth quarter of 2010 compared with the fourth quarter last year, with most of the growth in the investment securities portfolio, and the indirect consumer and commercial mortgage loan portfolios. The increase in average indirect consumer loans reflected our continued expansion, including expansion of our dealer network into the Capital District of New York State.

The net interest margin on a tax-equivalent basis was 4.01% in the fourth quarter of 2010, compared with 4.06% in the fourth quarter of 2009. Our yield on earning-assets decreased 29 basis points in the fourth quarter of 2010 compared with the same quarter last year. This was due to the effect of reinvesting cash flows in the low interest rate environment and a substantial portion of earning asset growth being concentrated in lower yielding mortgage-backed securities. The cost of interest-bearing liabilities decreased 27 basis points compared with the fourth quarter of 2009 due to continued downward changes in our interest-bearing deposit rates, a result of the continued re-pricing of certificates of deposit.

Noninterest income totaled \$5.3 million for the fourth quarter of 2010, a 2% increase over the fourth quarter of 2009. Noninterest expense was \$16.4 million for the fourth quarter of 2010, an increase of \$1.3 million or 8% from the fourth quarter of 2009. This increase was primarily due to a loss of approximately \$1.0 million relating to irregular instances of fraudulent debit card activity that we recorded in the fourth quarter of 2010.

Total assets at December 31, 2010 were \$2.214 billion, down \$35.2 million from \$2.250 billion at September 30, 2010. Total gross loans (includes loans held for sale) were \$1.349 billion and represented 61% of total assets at December 31, 2010, compared to \$1.326 billion and 59% of total assets at September 30, 2010. Total investment securities were \$694.5 million at December 31, 2010, down \$25.1 million or 3% from September 30, 2010. Total deposits decreased \$63.5 million to \$1.883 billion at December 31, 2010, compared to \$1.946 billion at September 30, 2010, due to seasonal reductions in public deposits. Lower cost demand, savings and money market accounts comprised 60.7% of total deposits at the end of 2010.

Total shareholders' equity was \$212.1 million at December 31, 2010, a \$4.0 million decrease from September 30, 2010, due to a \$7.5 million decrease in accumulated other comprehensive income, partially offset by a net increase of \$3.1 million in our retained earnings. The decrease in accumulated comprehensive income was primarily related to a decrease in unrealized gains on investment securities from \$13.0 million to \$3.1 million driven by an increase in interest rates. Our tangible common equity as a percent of tangible assets was 5.56% as of December 31, 2010, with a tangible common book value per share of \$11.06.

Non-performing assets were \$8.9 million or 0.40% of total assets at December 31, 2010, up from \$8.5 million at September 30, 2010. The ratio of non-performing loans to total loans was 0.56% at the end of the third and fourth quarters of 2010. The provision for loan losses was \$2.0 million for the fourth quarter of 2010, compared to \$2.2 million for the third quarter of 2010. Net charge-offs were \$1.2 million, or 0.37% annualized, of average loans, down from \$4.3 million, or 1.30% annualized, of average loans in the third quarter of 2010. The third quarter of 2010 included a \$3.1 million charge-off related to one commercial business loan.

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

At December 31, 2010, we had total assets of \$2.214 billion, an increase of 7% from \$2.062 billion as of December 31, 2009, primarily a result of the continued core business growth in both loans and deposits. Total gross loans (includes loans held for sale) were \$1.349 billion as of December 31, 2010, up \$84.7 million, or 7%, when compared to \$1.264 billion as of December 31, 2009. The increase in loans was primarily attributed to the continued expansion of the indirect lending program in existing and new markets and commercial business development efforts. Non-performing assets totaled \$8.9 million as of December 31, 2010, down \$1.5 million from a year ago, due to decreases in both non-performing loans and investment securities for which we have stopped accruing interest. Total deposits amounted to \$1.883 billion and \$1.743 billion as of December 31, 2010 and 2009, respectively. The impacts of the recent recession have had a positive impact on our deposit balances, as consumers tend to save more conservatively when consumer confidence is low. As of December 31, 2010, total borrowed funds were \$103.9 million, compared to \$106.4 million as of December 31, 2009. Book value per common share was \$14.48 and \$13.39 as of December 31, 2010 and 2009, respectively. As of December 31, 2010 our total shareholders' equity was \$212.1 million compared to \$198.3 million a year earlier.

INVESTING ACTIVITIES

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

	Investment Securities Portfolio Composition					
	At December 31,					
	2010		2009		2008	
	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	\$ 141,591	\$ 140,784	\$ 134,564	\$ 134,105	\$ 67,871	\$ 68,173
State and political subdivisions	105,622	105,666	80,812	83,659	129,572	131,711
Mortgage-backed securities:						
Agency mortgage-backed securities	414,502	417,709	356,044	356,355	297,278	303,105
Non-Agency mortgage-backed securities	981	1,572	5,087	5,160	42,296	39,447
Asset-backed securities	564	637	1,295	1,222	3,918	3,918
Equity securities					923	1,152
Total available for sale securities	663,260	666,368	577,802	580,501	541,858	547,506
Securities held to maturity:						
State and political subdivisions	28,162	28,849	39,573	40,629	58,532	59,147
Total investment securities	\$ 691,422	\$ 695,217	\$ 617,375	\$ 621,130	\$ 600,390	\$ 606,653

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.

Impairment Assessment

We review investment securities on an ongoing basis for the presence of OTTI with formal reviews performed quarterly. Declines in the fair value of held-to-maturity and available-for-sale securities below their cost that are deemed to be other than temporary are reflected in earnings as realized losses to the extent the impairment is related to credit losses or the security is intended to be sold or will be required to be sold. The amount of the impairment related to non-credit related factors is recognized in other comprehensive income. Evaluating whether the impairment of a debt security is other than temporary involves assessing 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 other-than-temporary impairment includes a credit loss, we use our best estimate of the present value of cash flows expected to be collected from the debt security considering factors such as: 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.

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

As of December 31, 2010, management does not have the intent to sell any of the securities in a loss position and believes that it is likely that it will not 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. Management does not believe any of the securities in a loss position are impaired due to reasons of credit quality. Accordingly, as of December 31, 2010, management has concluded that unrealized losses on its investment securities are temporary and no further impairment loss has been realized in our consolidated statements of operations. The following discussion provides further details of our assessment of the securities portfolio by investment category.

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

	Unrealized Losses on Investment Securities					
	At December 31,					
	2010		2009		2008	
	Unrealized Losses	% of Total	Unrealized Losses	% of Total	Unrealized Losses	% of Total
Securities available for sale:						
U.S. Government agency and government-sponsored enterprise securities	\$ 1,965	31.6%	\$ 545	19.8%	\$ 307	7.3%
State and political subdivisions	1,472	23.6	3	0.1	42	1.0
Mortgage-backed securities:						
Agency mortgage-backed securities	2,655	42.7	1,638	59.3	981	23.1
Non-Agency mortgage-backed securities			330	12.0	2,854	67.3
Asset-backed securities	131	2.1	244	8.8		
Equity securities					52	1.2
Total available for sale securities	6,223	100.0	2,760	100.0	4,236	99.9
Securities held to maturity:						
State and political subdivisions					4	0.1
Total investment securities	\$ 6,223	100.0%	\$ 2,760	100.0%	\$ 4,240	100.0%

U.S. Government Agencies and Government Sponsored Enterprises (GSE). As of December 31, 2010, there were 14 securities in the U.S. Government agencies and GSE portfolio that were in an unrealized loss position. Of these, 7 were in an unrealized loss position for 12 months or longer and had an aggregate amortized cost of \$8.9 million and unrealized losses of \$54 thousand. Because the decline in fair value is attributable to changes in interest rates, and not credit quality, and because we do not have the intent to sell these securities and it is likely that we will not be required to sell the securities before their anticipated recovery, we do not consider these securities to be other-than-temporarily impaired at December 31, 2010.

State and Political Subdivisions. As of December 31, 2010, the state and political subdivisions portfolio (municipals) totaled \$133.9 million, of which \$105.7 million was classified as available for sale. As of that date, \$28.2 million was classified as held to maturity, with a fair value of \$28.8 million. As of December 31, 2010, there were 95 municipals in an unrealized loss position, all of which were available for sale. These securities had an

aggregate amortized cost of \$39.9 million and unrealized losses of \$1.5 million. There were no municipals in an unrealized loss position for 12 months or longer as of December 31, 2010. Because the decline in fair value is attributable to changes in interest rates, and not credit quality, and because we do not have the intent to sell these securities and it is likely that we will not be required to sell the securities before their anticipated recovery, we do not consider these securities to be other-than-temporarily impaired at December 31, 2010.

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, 2010, were issued by U.S. Government sponsored entities and agencies (Agency MBS), primarily GNMA. The contractual cash flows of our Agency MBS are guaranteed by FNMA, FHLMC or GNMA. The GNMA mortgage-backed securities are backed by the full faith and credit of the U.S. Government.

As of December 31, 2010, there were 36 securities in the U.S. Government agencies and GSE portfolio that were in an unrealized loss position. Of these, only 4 were in an unrealized loss position for 12 months or longer and had an aggregate amortized cost of \$2.3 million and unrealized losses of \$11 thousand. Given the high credit quality inherent in Agency MBS, we do not consider any of the unrealized losses as of December 31, 2010, on such MBS to be credit related or other-than-temporary. As of December 31, 2010, we did not intend to sell any of Agency MBS that were in an unrealized loss position, all of which were performing in accordance with their terms.

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

Non-Agency Mortgage-backed Securities. Our non-Agency MBS portfolio consists of positions in three privately issued whole loan collateralized mortgage obligations with a fair value of \$1.6 million and net unrealized gains of \$591 thousand as of December 31, 2010. As of that date, each of the 3 non-Agency MBS were rated below investment grade. None of these securities were in an unrealized loss position. To date, we have recognized aggregate OTTI charges of \$6.0 million due to reasons of credit quality against these securities, all of which was recorded prior to 2010.

Asset-backed Securities (ABS). As of December 31, 2010, the fair value of the ABS portfolio totaled \$637 thousand and consisted of positions in 15 securities, the majority of which are pooled trust preferred securities (TPS) issued primarily by financial institutions and, to a lesser extent, insurance companies located throughout the United States. As a result of some issuers defaulting and others electing to defer interest payments, we considered the TPS to be non-performing and stopped accruing interest on the investments during 2009.

During 2010, we recognized OTTI charges totaling \$594 thousand against 5 ABSs. Since the second quarter of 2008, we have written down each of the securities in the ABS portfolio, resulting in aggregate OTTI charges of \$32.9 million through December 31, 2010. We expect to recover the remaining amortized cost of \$564 thousand on the securities. As of December 31, 2010, each of the securities in the ABS portfolio was rated below investment grade. There were 8 ABS in a loss position with an aggregate amortized cost of \$338 thousand and unrealized losses totaling \$131 thousand as of December 31, 2010. Of these, 6 were in an unrealized loss position for 12 months or longer and had an aggregate amortized cost of \$166 thousand and unrealized losses of \$70 thousand. We determined at December 31, 2010 that the unrealized losses in the ABS portfolio are temporary.

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. Our ownership of FHLB stock, which totaled \$2.5 million at December 31, 2010, is included in other assets and recorded at cost.

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. FRB stock totaled \$3.9 million at December 31, 2010, is included in other assets and recorded at cost.

LENDING ACTIVITIES

Total loans were \$1.346 billion at December 31, 2010, an increase \$82.0 million or 6% from December 31, 2009. Commercial loans increased \$26.9 million or 5% and represented 41.9% of total loans at the end of 2010, compared to 42.5% at December 31, 2009. Residential mortgage loans were \$129.6 million, down \$14.6 million or 10% and represented 9.6% of total loans compared to 11.4% at December 31, 2009, while consumer loans increased \$69.8 million to represent 48.5% of total loans at December 31, 2010 and 46.1% at December 31, 2009. 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,									
	2010		2009		2008		2007		2006	
	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent
Commercial business	\$ 211,031	15.7%	\$ 206,383	16.3%	\$ 180,100	16.1%	\$ 157,550	16.3%	\$ 130,695	14.1%
Commercial mortgage	352,930	26.2	330,748	26.2	285,383	25.5	272,394	28.3	275,884	29.8
Total commercial	563,961	41.9	537,131	42.5	465,483	41.6	429,944	44.6	406,579	43.9
	129,580	9.6	144,215	11.4	177,683	15.8	166,863	17.3	163,244	17.6

Residential
mortgage

Home equity	208,327	15.5	200,684	15.9	189,794	16.9	194,144	20.1	203,426	22.0
Consumer indirect	418,016	31.1	352,611	27.9	255,054	22.8	134,977	14.0	106,445	11.5
Other consumer	26,106	1.9	29,365	2.3	33,065	2.9	38,245	4.0	46,788	5.0
Total consumer	652,449	48.5	582,660	46.1	477,913	42.6	367,366	38.1	356,659	38.5
Total loans	1,345,990	100.0%	1,264,006	100.0%	1,121,079	100.0%	964,173	100.0%	926,482	100.0%
Allowance for loan losses	20,466		20,741		18,749		15,521		17,048	
Total loans, net	\$ 1,325,524		\$ 1,243,265		\$ 1,102,330		\$ 948,652		\$ 909,434	

The decrease in residential mortgage loans from \$177.7 million to \$144.2 million to \$129.6 million for the periods ending December 31, 2008, 2009 and 2010, respectively, and the increase in consumer indirect loans from \$255.1 million to \$352.6 million to \$418.0 million for the same periods reflects a strategic shift to increase our consumer indirect loan portfolio, while placing less emphasis on expanding our residential mortgage loan portfolio, coupled with our practice of selling the majority of our fixed-rate residential mortgages in the secondary market with servicing rights retained.

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

Commercial loans are generally viewed as having more inherent risk of default than residential mortgage or consumer loans. Also, the commercial loan balance per borrower is typically larger than that for residential mortgage and consumer loans, inferring higher potential losses on an individual customer basis. Commercial loans increased during 2010 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, if any.

Commercial business loans were \$211.0 million at the end of 2010, up \$4.6 million or 2% since year-end 2009, and comprised 15.7% of total loans outstanding at December 31, 2010 compared to 16.3% at December 31, 2009. 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. Within the commercial business classification, loans to finance agricultural production totaled approximately 1% of total loans as of December 31, 2010.

Commercial mortgage loans totaled \$352.9 million at December 31, 2010, up \$22.2 million or 7% from December 31, 2009, and comprised 26.2% of total loans, unchanged from year-end 2009. Commercial mortgage includes both owner occupied and non-owner occupied commercial real estate loans. Approximately 51% of the commercial mortgage portfolio at December 31, 2010 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.

Our current lending standards for commercial real estate and real estate construction lending are determined by property type and specifically address many criteria, including: maximum loan amounts, maximum loan-to-value (LTV), requirements for pre-leasing and / or pre-sales, minimum debt-service coverage ratios, minimum borrower equity, and maximum loan to cost. Currently, the maximum standard for LTV is 80%, with lower limits established for certain higher risk types, such as raw land which has a 65% LTV maximum. Our LTV guidelines are in compliance with regulatory supervisory limits.

Residential mortgage loans totaled \$129.6 million at the end of 2010, down \$14.6 million or 10% from the prior year and comprised 9.6% of total loans outstanding at December 31, 2010 and 11.4% at December 31, 2009. Residential mortgage loans include conventional first lien home mortgages and we generally limit the maximum loan to 85% of collateral value without credit enhancement (e.g. PMI insurance). As part of management's historical practice of originating and servicing residential mortgage loans, the majority of our fixed-rate residential mortgage loans are sold in the secondary market with servicing rights retained.

Our underwriting and risk-based pricing guidelines for consumer-related real estate loans consist of a combination of borrower FICO (credit score) and the LTV of the property securing the loan. Currently, for home equity products, the maximum acceptable LTV is 90%. The average FICO score for new home equity production in 2010 was 759 compared to 763 in 2009. Residential mortgage products continue to be underwritten using FHLMC and FNMA secondary marketing guidelines.

Consumer loans totaled \$652.4 million at December 31, 2010, up \$69.8 million or 12% compared to 2009, and represented 48.5% of the 2010 year-end loan portfolio versus 46.1% at year-end 2009. Loans in this classification include indirect consumer, home equity 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.

Consumer indirect loans amounted to \$418.0 million at December 31, 2010 up \$65.4 million or 19% compared to 2009, and represented 31.1% of the 2010 year-end loan portfolio versus 27.9% at year-end 2009. The loans are primarily for the purchase of automobiles (both new and used) and light duty trucks primarily to individuals, but also to 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, 2010, we originated \$204.4 million in

indirect loans with a mix of approximately 33% new auto and 67% used vehicles. This compares with \$199.1 million in indirect loans with a mix of approximately 32% new auto and 68% used vehicles for the same period in 2009. We do business with over 300 franchised auto dealers, primarily in Western and Central New York. During 2010, we continued to grow our indirect lending network by establishing relationships with dealerships in the Capital District of New York. In the latter part of 2010, we began efforts to expand our dealer network into Northern Pennsylvania and anticipate indirectly originating loans there in the first half of 2011.

Home equity consists of home equity lines, as well as home equity loans, some of which are first lien positions. Home equities amounted to \$208.3 million at December 31, 2010 up \$7.6 million or 4% compared to 2009, and represented 15.5% of the 2010 year-end loan portfolio versus 15.9% at year-end 2009. The portfolio had a weighted average LTV at origination of approximately 52% at December 31, 2010. Approximately 37% of the loans in the home equity portfolio are second lien positions at December 31, 2010.

Other consumer loans totaled \$26.1 million at December 31, 2010, down \$3.3 million or 11% compared to 2009, and represented 1.9% of the 2010 year-end loan portfolio versus 2.3% at year-end 2009. Other consumer consists of personal loans (collateralized and uncollateralized) and deposit account collateralized loans.

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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.

The 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, 2010, no significant concentrations, as defined above, existed in the Company's portfolio in excess of 10% of total loans.

Loans Held for Sale and Mortgage Servicing Rights. Loans held for sale (not included in the loan portfolio composition table) totaled \$3.1 million and \$421 thousand as of December 31, 2010 and 2009, respectively, all of which were residential real estate loans.

We sell certain qualifying newly originated and refinanced residential real estate mortgages on the secondary market. The sold and serviced residential real estate loan portfolio decreased to \$328.9 million as of December 31, 2010 from \$349.8 million as of December 31, 2009. The decrease in the sold and serviced portfolio resulted from a decrease in residential loan origination and refinancing volumes associated with the interest rate environment during 2010 compared to 2009.

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,				
	2010	2009	2008	2007	2006
Allowance for loan losses, beginning of year	\$ 20,741	\$ 18,749	\$ 15,521	\$ 17,048	\$ 20,231
Charge-offs:					
Commercial business	3,426	2,360	720	618	1,472
Commercial mortgage	263	355	1,192	439	603
Residential mortgage	290	225	320	319	278
Home equity	259	195	110	255	108
Consumer indirect	4,669	3,637	2,011	988	532
Other consumer	909	1,058	1,106	1,276	1,206
Total charge-offs	9,816	7,830	5,459	3,895	4,199
Recoveries:					
Commercial business	326	428	684	1,140	1,777
Commercial mortgage	501	150	315	216	161
Residential mortgage	21	12	26	50	71
Home equity	36	20	19	12	22
Consumer indirect	1,485	1,030	548	235	224
Other consumer	485	480	544	599	603

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Total recoveries	2,854	2,120	2,136	2,252	2,858
Net charge-offs	6,962	5,710	3,323	1,643	1,341
Provision (credit) for loan losses	6,687	7,702	6,551	116	(1,842)
Allowance for loan losses, end of year	\$ 20,466	\$ 20,741	\$ 18,749	\$ 15,521	\$ 17,048
Net charge-offs to average loans	0.54%	0.47%	0.32%	0.18%	0.14%
Allowance to end of period loans	1.52%	1.64%	1.67%	1.61%	1.84%
Allowance to end of period non-performing loans	270%	239%	229%	192%	108%

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

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,									
	2010		2009		2008		2007		2006	
	Percentage	Percentage	Percentage	Percentage	Percentage	Percentage	Percentage	Percentage	Percentage	Percentage
	of	of	of	of	of	of	of	of	of	of
	loans	loans	loans	loans	loans	loans	loans	loans	loans	loans
Loan	by	Loan	by	Loan	by	Loan	by	Loan	by	Loan
category	category	category	category	category	category	category	category	category	category	category
Loss	to	Loss	to	Loss	to	Loss	to	Loss	to	Loss
Allowance	total	Allowance	total	Allowance	total	Allowance	total	Allowance	total	Allowance
	loans		loans		loans		loans		loans	
Commercial business	\$ 3,712	15.7%	\$ 4,407	16.3%	\$ 3,300	16.1%	\$ 2,505	16.3%	\$ 3,294	14.1%
Commercial mortgage	6,431	26.2	6,638	26.2	4,635	25.5	4,640	28.3	5,494	29.8
Residential mortgage	1,013	9.6	1,251	11.4	2,516	15.8	1,763	17.3	1,748	17.6
Home equity	972	15.5	1,043	15.9	2,374	16.9	1,869	20.1	2,082	22.0
Consumer indirect	7,754	31.1	6,837	27.9	5,152	22.8	2,284	14.0	1,749	11.5
Other consumer	584	1.9	565	2.3	772	2.9	798	4.0	751	5.0
Unallocated ⁽¹⁾							1,662		1,930	
Total	\$ 20,466	100.0%	\$ 20,741	100.0%	\$ 18,749	100.0%	\$ 15,521	100.0%	\$ 17,048	100.0%

⁽¹⁾ During 2008 management revised estimation techniques related to allocation of the allowance to specific loan segments. The result was the elimination of the unallocated portion of the allowance for loan losses and allocation of the entire balance to specific loan segments.

Management believes that the allowance for loan losses at December 31, 2010 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. Management presents a quarterly review of the adequacy of the allowance for loan losses to 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 additional 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,					
2010	2009	2008	2007	2006	

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Non-accruing loans:					
Commercial business	\$ 947	\$ 650	\$ 510	\$ 839	\$ 4,031
Commercial mortgage	3,100	2,288	2,670	3,294	7,671
Residential mortgage	2,102	2,376	3,365	2,987	3,127
Home equity	875	880	1,143	661	712
Consumer indirect	514	621	445	278	166
Other consumer	41	7	56	16	130
Total non-accruing loans	7,579	6,822	8,189	8,075	15,837
Restructured accruing loans					
Accruing loans contractually past due over 90 days	3	1,859	7	2	3
Total non-performing loans	7,582	8,681	8,196	8,077	15,840
Foreclosed assets	741	746	1,007	1,421	1,203
Non-performing investment securities	572	1,015	49		
Total non-performing assets	\$ 8,895	\$ 10,442	\$ 9,252	\$ 9,498	\$ 17,043
Non-performing loans to total loans	0.56%	0.69%	0.73%	0.84%	1.71%
Non-performing assets to total assets	0.40%	0.51%	0.48%	0.51%	0.89%

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

Non-performing assets include non-performing loans, foreclosed assets and non-performing investment securities. Non-performing assets at December 31, 2010 were \$8.9 million, a decrease of \$1.5 million from the \$10.4 million balance at December 31, 2009. The primary component of non-performing assets is non-performing loans, which were \$7.6 million at December 31, 2010, a decrease of \$1.1 million from the \$8.7 million balance at December 31, 2009. The decrease in non-performing loans was attributable to a commercial relationship included in accruing loans past due 90 days or more at December 31, 2009 on which we collected substantially all of the \$1.9 million balance during the first quarter of 2010, partially offset by a \$757 thousand increase in non-accruing loans.

The ratio of non-performing loans to total loans was 0.56% at December 31, 2010, compared to 0.69% at December 31, 2009. This ratio continues to compare favorably to the average of our peer group, which was 3.53% of total loans at December 31, 2010, the most recent period for which information is available (Source: Federal Financial Institutions Examination Council Bank Holding Company Performance Report as of December 31, 2010 Top-tier bank holding companies having consolidated assets between \$1 billion and \$3 billion).

Non-accruing loans at December 31, 2010 were \$7.6 million compared to \$6.8 million at December 31, 2009. Approximately \$3.3 million, or 43%, of the \$7.6 million in non-accruing loans as of December 31, 2010 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. For non-accruing loans outstanding as of December 31, 2010, the amount of interest income forgone totaled \$474 thousand. Included in nonaccrual loans are troubled debt restructurings (TDRs) of \$534 thousand at December 31, 2010. We had no TDRs which were accruing interest as of December 31, 2010.

Foreclosed assets consist of real property formerly pledged as collateral to loans, which we have acquired through foreclosure proceedings or acceptance of a deed in lieu of foreclosure. Foreclosed asset holdings represented 13 properties totaling \$741 thousand at December 31, 2010 and 14 properties totaling \$746 thousand at December 31, 2009.

Non-performing investment securities for which we have stopped accruing interest were \$572 thousand at December 31, 2010, a decrease of \$443 thousand from the \$1.0 million balance at December 31, 2009. The decrease in non-performing investment securities reflects net losses, both realized and unrealized, in our asset backed securities portfolio.

Potential problem loans are loans that are currently performing, but information known about possible credit problems of the borrowers causes management to have concern as to the ability of such borrowers to comply with the present loan payment terms and may result in disclosure of such loans as nonperforming at some time in the future. These loans remain in a performing status due to a variety of factors, including payment history, the value of collateral supporting the credits, and/or personal or government guarantees. Management considers loans classified as substandard, which continue to accrue interest, to be potential problem loans. We identified \$11.5 million and \$18.4 million in loans that continued to accrue interest which were classified as substandard as of December 31, 2010 and 2009, respectively.

FUNDING ACTIVITIES**Deposits**

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

	2010		At December 31, 2009		2008	
	Amount	Percent	Amount	Percent	Amount	Percent
Noninterest-bearing demand	\$ 350,877	18.6%	\$ 324,303	18.6%	\$ 292,586	