FINANCIAL INSTITUTIONS INC
Form 10-K
March 11, 2008

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**UNITED STATES**
**SECURITIES AND EXCHANGE COMMISSION**
**Washington, D.C. 20549**
**FORM 10-K**

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

**For the fiscal year ended December 31, 2007**

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

**Commission file number 0-26481**
**FINANCIAL INSTITUTIONS, INC.**
(Exact name of registrant as specified in its charter)

| New York | 16-0816610 |
|---|---|
| (State of incorporation) | (I.R.S. Employer Identification Number) |
| 220 Liberty Street, Warsaw, NY | 14569 |
| (Address of principal executive offices) | (Zip Code) |

Registrant s telephone number, including area code:
585-786-1100
Securities registered pursuant to Section 12(b) of the Act:

| Title of each class | Name of each exchange on which registered |
|---|---|
| Common stock, par value $0.01 per share | NASDAQ Global Select Market |

Securities registered pursuant to Section 12(g) of the 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 o NO þ

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Exchange Act.
YES o NO þ

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendments to this Form 10-K. o

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

| Large Accelerated filer o | Accelerated filer þ | Non-accelerated filer o | Smaller reporting company o |
|---|---|---|---|

(Do not check if a 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 o NO þ

The aggregate market value of common stock held by non-affiliates of the registrant, as computed by reference to the June 29, 2007 closing price reported by NASDAQ, was $205,984,000.

As of February 29, 2008 there were issued and outstanding, exclusive of treasury shares, 11,012,552 shares of the registrant s common stock.

**DOCUMENTS INCORPORATED BY REFERENCE**

Portions of the Registrant s proxy statement to be filed with the Securities and Exchange Commission in connection with the 2008 Annual Meeting of Shareholders are incorporated by reference in Part III of this Annual Report on Form 10-K.

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**FINANCIAL INSTITUTIONS, INC.**
**2007 ANNUAL REPORT ON FORM 10-K**
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## PART I

## Item 1. Business

### Forward Looking Statements

This Annual Report on Form 10-K, especially in Management s Discussion and Analysis of Financial Condition and Results of Operation, contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. In general, the use of such words as estimate, project, believe, intend, anticipate, plan, seek, expect and similar expressions are intended to identify forward-looking statements and may include:

- Statements regarding our business plans, and prospects;
- Statements of our goals, intentions and expectations;
- Statements regarding our growth and operating strategies;
- Statements regarding the quality of our loan and investment portfolios; and
- Estimates of our risks and future costs and benefits.

The Private Securities Litigation Reform Act of 1995 provides a safe harbor for forward-looking statements. In order to comply with the terms of the safe harbor, the Company notes that a variety of factors could cause the Company s actual results and experience to differ materially from the anticipated results or other expectations expressed in the Company s forward-looking statements. Some of the risks and uncertainties that may affect the operations, performance, development and results of the Company s business, the interest rate sensitivity of its assets and liabilities, and the adequacy of its allowance for loan losses, include but are not limited to those described in Item 1A of this report, which is incorporated herein by reference thereto, and the following:

- Significantly increased competition between depository and other financial institutions;
- Changes in the interest rate environment or yield curve that reduces our margins or the fair value of financial instruments;
- General economic conditions, either nationally or in our market areas, that are worse than expected;
- Declines in the value of real estate, equipment, livestock and other assets serving as collateral for our loans outstanding, which could affect our allowance for loan losses;
- Legislative or regulatory changes that adversely affect our business;
- Changes in consumer spending, borrowing and savings habits;
- Changes in accounting policies and practices, as generally accepted in the United States of America; and
- Actions taken by regulators with jurisdiction over the Company or its subsidiaries.

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

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

### General

Financial Institutions, Inc. ( FII ), a bank holding company organized under the laws of New York State, and its subsidiaries (collectively the Company ) provide deposit, lending and other financial services to individuals and



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businesses in Central and Western New York State. The Company is subject to regulation by certain federal and state agencies.

The Company for many years operated under a decentralized, Super Community Bank business model, with separate and largely autonomous subsidiary banks whose Boards and management had the authority to operate within guidelines set forth in broad corporate policies established at the holding company level. During 2005, FII s Board of Directors decided to implement changes to the Company s business model and governance structure. Effective December 3, 2005, the Company merged three of its bank subsidiaries, Wyoming County Bank, National Bank of Geneva and Bath National Bank into its New York State-chartered bank subsidiary, First Tier Bank & Trust, which was then renamed Five Star Bank ( FSB or the Bank ). The merger was accounted for at historical cost as a combination of entities under common control.

FII formerly qualified as a financial holding company under the Gramm-Leach-Bliley Act, which allowed expansion of business operations to include financial services subsidiaries, namely, Five Star Investment Services, Inc. ( FSIS ), a brokerage subsidiary, and the Burke Group, Inc., an employee benefits and compensation consulting firm that was sold in 2005. FII terminated its financial holding company status and now operates as a bank holding company. The change in status did not affect the non-financial subsidiaries or activities being conducted by the Company, although future acquisitions or expansions of non-financial activities may require prior Federal Reserve Board ( FRB ) approval and will be limited to those that are permissible for bank holding companies.

FII also has a statutory trust, the FISI Statutory Trust I (the Trust ), which was formed to facilitate the private placement of capital securities. The Trust is a variable interest entity as defined by Financial Accounting Standards Board ( FASB ) Interpretation No. 46, Consolidation of Variable Interest Entities, and, as such, the Trust is accounted for as an unconsolidated subsidiary.

**Available Information**

This annual report, including the exhibits and schedules filed as part of the annual report, 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.

The Company also makes available, free of charge through its 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.

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**Executive Officers and Other Significant Employees of the Registrant**

The following table sets forth current information regarding executive officers and other significant employees (ages are as of December 31, 2007).

| Name | Age | Starting In | Positions/Offices |
|---|---|---|---|
| Peter G. Humphrey | 53 | 1983 | President and Chief Executive Officer. |
| James T. Rudgers | 58 | 2004 | Executive Vice President and Chief of Community Banking. From 2002 2004 was Executive Vice President of Retail Banking at Hudson United Bank Corporation. From 1997 2002 was Senior Vice President and Principal of Manchester Humphreys, Inc. |
| Ronald A. Miller | 59 | 1996 | Executive Vice President, Chief Financial Officer and Corporate Secretary. |
| George D. Hagi | 55 | 2006 | Executive Vice President and Chief Risk Officer. From 1997 2005 was Senior Vice President and Director of Risk Management at First National Bankshares of Florida and FNB Corp. |
| John J. Witkowski | 46 | 2005 | Senior Vice President and Regional President/Retail Banking Executive. From 1993 2005 was Senior Vice President and Director of Sales for Business Banking/Client Development Group at Bank of America. |
| Martin K. Birmingham | 42 | 2005 | Senior Vice President and Regional President/Commercial Market Executive. From 1989 2005 was Senior Team Leader and Regional President of the Rochester Market at Bank of America. |
| Kevin B. Klotzbach | 54 | 2001 | Senior Vice President and Treasurer. From 1999 2001 was Chief Investment Officer at Greater Buffalo Savings Bank. |
| Bruce H. Nagle | 59 | 2006 | Senior Vice President and Director of Human Resources. From 2000 2006 was Vice President of Human Resources at University of Pittsburgh Medical Center. |
| Richard J. Harrison | 63 | 2003 | Senior Vice President and Senior Retail Lending Administrator. From 2000 2003 was Executive Vice President and Chief Credit Officer at Savings Bank of the Fingerlakes. |

**Market Area and Competition**

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

The Company s market area is geographically and economically diversified in that it serves both rural markets and the larger more affluent markets of suburban Rochester and suburban Buffalo. Rochester and Buffalo are the two largest cities in New York State outside of New York City, with combined metropolitan area populations of over two million people. The Company anticipates increasing its presence in the markets around these two cities and plans to open two branches in the Rochester suburbs in 2008.

The Company faces significant competition in both making loans and attracting deposits, as Western and Central New York have a high density of financial institutions. The Company s 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. Its most direct competition for deposits has historically come from commercial banks, savings banks and credit unions. The Company faces additional competition for deposits from non-depository competitors such as the mutual fund industry, securities and brokerage firms and insurance companies.

**Employees**

The Company had approximately 621 full-time equivalent employees ( FTEs ) as of December 31, 2007.

**Operating Segments**

The Company s primary operating segment is its subsidiary bank, FSB. The Company s brokerage subsidiary, FSIS, is also deemed an operating segment, however it does not meet the thresholds included in SFAS No. 131 for separation.

**Investing Activities**

*General*. The Bank s investment securities policy is contained within its 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, the Bank considers the ability of an investment to provide earnings consistent with factors of quality, maturity, marketability and risk diversification. The Bank s Treasurer, guided by the ALCO Committee, is responsible for investment portfolio decisions within the established policies.

The Bank s investment securities strategy centers on providing liquidity to meet loan demand and redeeming liabilities, meeting pledging requirements, managing overall interest rate and credit risks and maximizing portfolio yield. The Company s 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 ), the Federal Home Loan Mortgage Corporation ( FHLMC ) and the Small Business Administration ( SBA );

- Mortgage-backed securities ( MBSs ) include mortgage-backed pass-through securities ( pass-throughs ) and collateralized mortgage obligations ( CMOs ) issued by GNMA, FNMA and FHLMC and privately issued whole loan CMOs that contain some exposure to sub-prime loans. See also the section titled Investing Activities in Part II, Item 7, Management s Discussion and Analysis of Financial Condition and Results of Operation;

- Other asset-backed securities ( ABSs ) and other privately issued investment grade quality securities;

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

- Certain creditworthy un-rated securities issued by municipalities; and

- Investment grade corporate debt, certificates of deposit and qualified preferred stock.

**Lending Activities**

*General*. The Bank offers a broad range of loans including commercial and agricultural working capital and revolving lines of credit, commercial and agricultural mortgages, equipment loans, crop and livestock loans, residential mortgage loans and home equity loans and lines of credit, home improvement loans, automobile loans and personal loans. Most newly originated fixed rate residential mortgage loans are sold in the secondary market and servicing rights are retained.

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*Lending Philosophy and Objectives*. The Bank has thoroughly evaluated and updated its lending policy in recent years. The revisions to the loan policy include a renewed focus on lending philosophy and credit objectives.
The key elements of the Bank s lending philosophy include the following:

- To ensure consistent underwriting, all 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.

The Bank s 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.

*Loan Approval Process*. The Bank s loan policy establishes standardized underwriting guidelines, as well as the loan approval process and the committee structures necessary to facilitate and insure 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.

*Loan Review Program*. The Bank s policy includes loan reviews, under the supervision of the Audit Committee of the Board of Directors and directed by the Chief Risk Officer, in order to render an independent and objective evaluation of the Bank s asset quality and credit administration process.

*Risk Assessment Process*. Risk ratings are assigned to loans in the commercial, commercial real estate and agricultural 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 the credit risk profile of the Bank and assesses the overall quality of the loan portfolio and adequacy of the allowance for loan losses.

*Delinquencies and Nonperforming Assets*. The Bank has several procedures in place to assist in maintaining the overall quality of its loan portfolio. Delinquent loan reports are monitored by credit administration to identify adverse levels and trends. Loans are generally placed on nonaccruing status and cease accruing interest when the payment of principal or interest is delinquent for 90 days, or earlier in some cases, unless the loan is in the process of collection and the underlying collateral further supports the carrying value of the loan.

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*Allowance for Loan Losses*. The allowance for loan losses is established through charges or credits to earnings in the form of a provision (credit) 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 charge-off experience;
- Evaluation of the loan portfolio with loan reviews;
- Levels and trends in delinquent and nonaccruing loans;
- Trends in volume and terms;
- Collateral values;
- Effects of changes in lending policy;
- Experience, ability and depth of management;
- National and local economic trends and conditions; and
- Concentrations of credit.

Management presents a quarterly review of the adequacy of the allowance for loan losses to the Company s Board of Directors. In order to determine the adequacy of the allowance for loan losses, the risk rating and delinquency status of loans and other factors are considered, such as collateral value, government guarantees, portfolio composition, trends in economic conditions and the financial strength of borrowers. Specific allocations for individually evaluated loans are established when required. An allowance is also established for groups of loans with similar risk characteristics, based upon average historical charge-off experience taking into account levels and trends in delinquencies, loan volumes, economic and industry trends and concentrations of credit. See also the sections titled Analysis of Allowance for Loan Losses and Allocation of Allowance for Loan Losses in Part II, Item 7, Management s Discussion and Analysis of Financial Condition and Results of Operation.

*Commercial*. The Bank originates commercial loans in its primary market areas and underwrites them based on the borrower s ability to service the loan from operating income. The Bank offers 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. 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, 2007, $48.1 million, or 35.1%, of the aggregate commercial loan portfolio were at fixed rates, while $88.7 million, or 64.9%, were at variable rates. The Bank utilizes government loan guarantee programs where available and appropriate. See Government Guarantee Programs below.

*Commercial Real Estate*. In addition to commercial loans secured by real estate, the Bank makes commercial real estate loans to finance the purchase of real property, which generally consists of real estate with completed structures. Commercial real estate 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. As of December 31, 2007, $49.0 million, or 19.9%, of the aggregate commercial real estate loan portfolio were at fixed rates, while $196.8 million, or 80.1%, were at variable rates.

*Agricultural*. Agricultural loans are offered for short-term crop production, farm equipment and livestock financing and agricultural real estate financing, including term loans and lines of credit. Short and medium-term agricultural loans, primarily collateralized, are made available for working capital (crops and livestock), business expansion (including acquisition of real estate, expansion and improvement) and the purchase of equipment. As of December 31, 2007, $13.8 million, or 29.2%, of the agricultural loan portfolio were at fixed rates, while $33.5 million, or 70.8%, were at variable rates. The Bank utilizes government loan guarantee programs where available and appropriate. See Government Guarantee Programs below.

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*Residential Real Estate*. The Bank originates fixed and variable rate one-to-four family residential mortgages collateralized by owner-occupied properties located in its market areas. The Bank offers a variety of real estate loan products, which are generally amortized for periods 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. The Bank sells certain one-to-four family residential mortgages on the secondary mortgage market and typically retains the right to service the mortgages. To assure maximum salability of the residential loan products for possible resale, the Company has formally adopted the underwriting, appraisal, and servicing guidelines of the FHLMC as part of its standard loan policy. As of December 31, 2007, the residential mortgage servicing portfolio totaled $338.1 million, the majority of which have been sold to FHLMC. As of December 31, 2007, $126.2 million, or 75.6%, of residential real estate loans retained in portfolio were at fixed rates, while $40.7 million, or 24.4%, were at variable rates. The Company does not engage in sub-prime or other high-risk residential mortgage lending as a line-of-business.

*Consumer Indirect*. The Bank originates consumer indirect automobile loans, recreational vehicle loans, boat loans and mobile home loans. The consumer indirect loan portfolio was primarily comprised of new and used automobile loans with terms that typically range from 36 to 72 months. The Company has expanded its relationships with franchised new car dealers and has selectively originated a mix of new and used automobile loans from those dealers. As of December 31, 2007, the consumer indirect portfolio totaled $135.0 million, all of which were fixed rate loans.

*Consumer and Home Equity*. The Bank originates 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, 2007, $145.8 million, or 62.7%, of consumer and home equity loans were at fixed rates, while $86.6 million, or 37.3%, were at variable rates.

*Government Guarantee Programs*. The Bank participates in government loan guarantee programs offered by the SBA, United States Department of Agriculture, Rural Economic and Community Development and Farm Service Agency, among others. As of December 31, 2007, the Bank had loans with an aggregate principal balance of $36.0 million that were covered by guarantees under these programs. The guarantees only cover a certain percentage of these loans. By participating in these programs, the Bank is able to broaden its base of borrowers while minimizing credit risk.

**Funding Activities**

*General*. Deposits and borrowed funds are the primary sources of the Bank s funds for use in lending, investing and for other general purposes. In addition, repayments on loans and securities, proceeds from sales of loans and securities, and cash flows from operations provide additional sources of funds.

*Deposits*. The Bank offers 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. The Bank also offers 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. To enhance its deposit product offerings, the Company provides commercial checking accounts for small to moderately sized commercial businesses, as well as a low-cost checking account service for low-income customers. The flow of deposits is influenced significantly by general economic conditions, changes in money market rates, prevailing interest rates and competition. The Bank s deposits are obtained predominantly from the areas in which its branch offices are located. The Bank relies primarily on competitive pricing of its deposit products, customer service and long-standing relationships with customers to attract and retain these deposits. On a secondary basis, the Bank has utilized certificate of deposit sales in the national brokered market ( brokered deposits ) as a wholesale funding source.

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*Borrowings*. The Bank s borrowings consist mainly of advances entered into with the FHLB, federal funds purchased and securities sold under repurchase agreements.

*Junior Subordinated Debentures*. FII formed the Trust to facilitate the private placement of capital securities.

**Supervision and Regulation**

The supervision and regulation of financial and bank holding companies and their subsidiaries is intended primarily for the protection of depositors, the deposit insurance funds regulated by the Federal Deposit Insurance Corporation ( FDIC ) and the banking system as a whole, and not for the protection of shareholders or creditors of bank holding companies. The various bank regulatory agencies have broad enforcement power over bank holding companies and banks, including the power to impose substantial fines, operational restrictions and other penalties for violations of laws and regulations.

The following description summarizes some of the laws to which the Company is subject. References to applicable statutes and regulations are brief summaries and do not claim to be complete. They are qualified in their entirety by reference to such statutes and regulations. Management believes the Company is in compliance in all material respects with these laws and regulations. Changes in the laws, regulations or policies that impact the Company cannot necessarily be predicted, but they may have a material effect on the Company s consolidated financial position, consolidated results of operations, or liquidity.

**The Company**

FII is a bank holding company registered under the Bank Holding Company Act of 1956, as amended, and is subject to supervision, regulation and examination by the FRB. The Bank Holding Company Act and other federal laws subject bank holding companies to particular restrictions on the types of activities in which they may engage, and to a range of supervisory requirements and activities, including regulatory enforcement actions for violations of laws and regulations.

*Regulatory Restrictions on Dividends; Source of Strength*. It is the policy of the FRB that bank holding companies should pay cash dividends on common stock only out of income available over the past year, and only if prospective earnings retention is consistent with the holding company s expected future needs and financial condition. The policy provides that bank holding companies should not maintain a level of cash dividends that undermines the bank holding company s ability to serve as a source of strength to its subsidiaries.

Under FRB policy, a bank holding company is expected to act as a source of financial strength to each of its subsidiaries and commit resources to their support. Such support may be required at times when, absent this FRB policy, a holding company may not be inclined to provide it. As discussed below, a bank holding company in certain circumstances could be required to guarantee the capital plan of an undercapitalized banking subsidiary.

*Safe and Sound Banking Practices*. Bank holding companies are not permitted to engage in unsafe and unsound banking practices. The FRB s Regulation Y, for example, generally requires a holding company to give the FRB prior notice of any redemption or repurchase of its own equity securities, if the consideration to be paid, together with the consideration paid for any repurchases or redemptions in the preceding year, is equal to 10% or more of the company s consolidated net worth. The FRB may oppose the transaction if it believes that the transaction would constitute an unsafe or unsound practice or would violate any law or regulation. Depending upon the circumstances, the FRB could take the position that paying a dividend would constitute an unsafe or unsound banking practice.

The FRB has broad authority to prohibit activities of bank holding companies and their non-banking subsidiaries which represent unsafe and unsound banking practices or which constitute violations of laws or regulations, and can assess civil money penalties for certain activities conducted on a knowing and reckless basis, if those activities caused a substantial loss to a depository institution. The penalties can be as high as $1,000,000 for each day the activity continues.

*Anti-Tying Restrictions*. Bank holding companies and their affiliates are prohibited from tying the provision of certain services, such as extensions of credit, to other services offered by a holding company or its affiliates. In 2002, the FRB adopted Regulation W, a comprehensive synthesis of prior opinions and interpretations under

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Sections 23A and 23B of the Federal Reserve Act. Regulation W contains an extensive discussion of tying arrangements, which could impact the way banks and bank holding companies transact business with affiliates.

*Capital Adequacy Requirements*. The FRB has adopted a system using risk-based capital guidelines to evaluate the capital adequacy of bank holding companies. Under the guidelines, specific categories of assets are assigned different risk weights, based generally on the perceived credit risk of the asset. These risk weights are multiplied by corresponding asset balances to determine a risk-weighted asset base. The guidelines require a minimum total risk-based capital ratio of 8.0% (of which at least 4.0% is required to consist of Tier 1 capital elements). Total capital is the sum of Tier 1 and Tier 2 capital. As of December 31, 2007, the Company s ratio of Tier 1 capital to total risk-weighted assets was 15.74% and the ratio of total capital to total risk-weighted assets was 16.99%. See also the section titled Capital Resources in Part II, Item 7, Management s Discussion and Analysis of Financial Condition and Results of Operation and Note 16 of the notes to consolidated financial statements.

In addition to the risk-based capital guidelines, the FRB uses a leverage ratio as an additional tool to evaluate the capital adequacy of bank holding companies. The leverage ratio is a company s Tier 1 capital divided by quarterly average consolidated assets. Certain highly rated bank holding companies may maintain a minimum leverage ratio of 3.0%, but other bank holding companies may be required to maintain a leverage ratio of up to 200 basis points above the regulatory minimum. As of December 31, 2007, the Company s leverage ratio was 9.35%.

The federal banking agencies risk-based and leverage ratios are minimum supervisory ratios generally applicable to banking organizations that meet certain specified criteria, assuming that they have the highest regulatory rating. Banking organizations not meeting these criteria are expected to operate with capital positions well above the minimum ratios. The federal bank regulatory agencies may set capital requirements for a particular banking organization that are higher than the minimum ratios when circumstances warrant. FRB guidelines also provide that banking organizations experiencing internal growth or making acquisitions will be expected to maintain strong capital positions substantially above the minimum supervisory levels, without significant reliance on intangible assets.

*Imposition of Liability for Undercapitalized Subsidiaries*. Bank regulators are required to take prompt corrective action to resolve problems associated with insured depository institutions whose capital declines below certain levels. In the event an institution becomes undercapitalized, it must submit a capital restoration plan. The capital restoration plan will not be accepted by the regulators unless each company having control of the undercapitalized institution guarantees the subsidiary s compliance with the capital restoration plan up to a certain specified amount. Any such guarantee from a depository institution holding company is entitled to a priority of payment in bankruptcy.

The aggregate liability of the holding company of an undercapitalized bank is limited to the lesser of 5% of the institution s assets at the time it became undercapitalized or the amount necessary to cause the institution to be adequately capitalized. The bank regulators have greater power in situations where an institution becomes significantly or critically undercapitalized or fails to submit a capital restoration plan. For example, a bank holding company controlling such an institution can be required to obtain prior FRB approval of proposed dividends, or might be required to consent to a consolidation or to divest the troubled institution or other affiliates.

*Acquisitions by Bank Holding Companies*. The Bank Holding Company Act requires every bank holding company to obtain the prior approval of the FRB before it may acquire all or substantially all of the assets of any bank, or ownership or control of any voting shares of any bank, if after such acquisition it would own or control, directly or indirectly, more than 5% of the voting shares of such bank. In approving bank acquisitions by bank holding companies, the FRB is required to consider the financial and managerial resources and future prospects of the bank holding company and the banks concerned, the convenience and needs of the communities to be served, and various competitive factors.

*Control Acquisitions*. The Change in Bank Control Act prohibits a person or group of persons from acquiring control of a bank holding company unless the FRB has been notified and has not objected to the transaction. Under a rebuttable presumption established by the FRB, the acquisition of 10% or more of a class of voting stock

of a bank holding company with a class of securities registered under Section 12 of the Exchange Act, would, under the circumstances set forth in the presumption, constitute acquisition of control of the Company.

In addition, any entity is required to obtain the approval of the FRB under the Bank Holding Company Act before acquiring 25% (5% in the case of an acquirer that is a bank holding company) or more of the Company s outstanding common stock, or otherwise obtaining control or a controlling influence over the Company.

**The Bank**

Five Star Bank ( FSB or the Bank ) is a New York State-chartered bank and a member of the Federal Reserve System. The FDIC, through the Bank Insurance Fund, insures deposits of the Bank. The supervision and regulation of FSB subjects the Bank to special restrictions, requirements, potential enforcement actions and periodic examination by the FDIC, the FRB and the New York State Banking Department. Because the FRB regulates the holding company parent, the FRB also has supervisory authority that directly affects FSB.

*Restrictions on Transactions with Affiliates and Insiders*. Transactions between the holding company and its subsidiaries, including the Bank, are subject to Section 23A of the Federal Reserve Act, and to the requirements of Regulation W. In general, Section 23A imposes limits on the amount of such transactions, and also requires certain levels of collateral for loans to affiliated parties. It also limits the amount of advances to third parties, which are collateralized by the securities, or obligations of FII or its subsidiaries.

Affiliate transactions are also subject to Section 23B of the Federal Reserve Act, and to the requirements of Regulation W which generally requires that certain transactions between the holding company and its affiliates be on terms substantially the same, or at least as favorable to the Bank, as those prevailing at the time for comparable transactions with or involving other nonaffiliated persons.

The restrictions on loans to directors, executive officers, principal shareholders and their related interests (collectively referred to herein as insiders ) contained in the Federal Reserve Act and Regulation O apply to all insured institutions and their subsidiaries and holding companies. These restrictions include limits on loans to one borrower and conditions that must be met before such a loan can be made. There is also an aggregate limitation on all loans to insiders and their related interests. These loans cannot exceed the institution s total unimpaired capital and surplus, and the FDIC may determine that a lesser amount is appropriate. Insiders are subject to enforcement actions for knowingly accepting loans in violation of applicable restrictions.

*Restrictions on Distribution of Subsidiary Bank Dividends and Assets*. Dividends paid by the Bank provide a substantial part of FII s operating funds and, for the foreseeable future, it is anticipated that dividends paid by the Bank will continue to be its principal source of operating funds. Capital adequacy requirements serve to limit the amount of dividends that may be paid by the subsidiaries. Under federal law, the subsidiaries cannot pay a dividend if, after paying the dividend, a particular subsidiary will be undercapitalized. The FDIC may declare a dividend payment to be unsafe and unsound even though the bank would continue to meet its capital requirements after the dividend.

Because FII is a legal entity separate and distinct from its subsidiaries, FII s right to participate in the distribution of assets of any subsidiary upon the subsidiary s liquidation or reorganization will be subject to the prior claims of the subsidiary s creditors. In the event of a liquidation or other resolution of an insured depository institution, the claims of depositors and other general or subordinated creditors are entitled to a priority of payment over the claims of holders of any obligation of the institution to its shareholders, including any depository bank holding company (such as FII) or any shareholder or creditor thereof.

*Examinations*. The New York State Banking Department, the FRB and the FDIC periodically examine and evaluate the Bank. Based upon such examinations, the appropriate regulator may revalue the assets of the institution and require that it establish specific reserves to compensate for the difference between what the regulator determines the value to be and the book value of such assets.

*Audit Reports*. Insured institutions with total assets of $500 million or more at the beginning of a fiscal year must submit annual audit reports prepared by independent auditors to federal and state regulators. In some instances, the audit report of the institution s holding company can be used to satisfy this requirement. Auditors must receive examination reports, supervisory agreements and reports of enforcement actions. In addition, financial

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statements prepared in accordance with generally accepted accounting principles, management s certifications concerning responsibility for the financial statements, internal controls and compliance with legal requirements designated by the FDIC, and if total assets exceed $1.0 billion, an attestation by the auditor regarding the statements of management relating to the internal controls must be submitted. The FDIC Improvement Act of 1991 requires that independent audit committees be formed, consisting of outside directors only. The committees of institutions with assets of more than $3.0 billion must include members with experience in banking or financial management must have access to outside counsel and must not include representatives of large customers.

*Capital Adequacy Requirements*. The FDIC has adopted regulations establishing minimum requirements for the capital adequacy of insured institutions. The FDIC may establish higher minimum requirements if, for example, a bank has previously received special attention or has a high susceptibility to interest rate risk. The most recent notification from the FDIC categorized the Bank as well capitalized under the regulatory framework for prompt corrective action.

The FDIC s risk-based capital guidelines generally require banks to have a minimum ratio of Tier 1 capital to total risk-weighted assets of 4.0% and a ratio of total capital to total risk-weighted assets of 8.0%. The capital categories have the same definitions for the Company. As of December 31, 2007, the ratio of Tier 1 capital to total risk-weighted assets for the Bank was 14.40% and the ratio of total capital to total risk-weighted assets was 15.65%. See Management s Discussion and Analysis of Financial Condition and Results of Operations-Liquidity and Capital Resources and Note 16 of the notes to consolidated financial statements.

The FDIC s leverage guidelines require banks to maintain Tier 1 capital of no less than 4.0% of average total assets, except in the case of certain highly rated banks for which the requirement is 3.0% of average total assets. As of December 31, 2007, the ratio of Tier 1 capital to quarterly average total assets (leverage ratio) was 8.54% for FSB. See Management s Discussion and Analysis of Financial Condition and Results of Operations-Liquidity and Capital Resources and Note 16 of the notes to consolidated financial statements.

*Corrective Measures for Capital Deficiencies*. The federal banking regulators are required to take prompt corrective action with respect to capital-deficient institutions. Agency regulations define, for each capital category, the levels at which institutions are well-capitalized, adequately capitalized, undercapitalized, significantly undercapitalized and critically undercapitalized. A well-capitalized bank has a total risk-based capital ratio of 10.0% or higher; a Tier 1 risk-based capital ratio of 6.0% or higher; a leverage ratio of 5.0% or higher; and is not subject to any written agreement, order or directive requiring it to maintain a specific capital level for any capital measure. An adequately capitalized bank has a total risk-based capital ratio of 8.0% or higher; a Tier 1 risk-based capital ratio of 4.0% or higher; a leverage ratio of 4.0% or higher (3.0% or higher if the bank was rated a composite 1 in its most recent examination report and is not experiencing significant growth); and does not meet the criteria for a well-capitalized bank. A bank is undercapitalized if it fails to meet any one of the adequately capitalized ratios.

In addition to requiring undercapitalized institutions to submit a capital restoration plan, agency regulations contain broad restrictions on certain activities of undercapitalized institutions including asset growth, acquisitions, branch establishment and expansion into new lines of business. With certain exceptions, an insured depository institution is prohibited from making capital distributions, including dividends, and is prohibited from paying management fees to control persons if the institution would be undercapitalized after any such distribution or payment.

As an institution s capital decreases, the FDIC s enforcement powers become more severe. A significantly undercapitalized institution is subject to mandated capital raising activities, restrictions on interest rates paid and transactions with affiliates, removal of management and other restrictions. The FDIC has only very limited discretion in dealing with a critically undercapitalized institution and is virtually required to appoint a receiver or conservator.

Banks with risk-based capital and leverage ratios below the required minimums may also be subject to certain administrative actions, including the termination of deposit insurance upon notice and hearing, or a temporary suspension of insurance without a hearing in the event the institution has no tangible capital.

*Deposit Insurance Assessments*. The Bank must pay assessments to the FDIC for federal deposit insurance protection that was impacted by legislation enacted during 2006. The Federal Deposit Insurance Reform Act of

2005 and the Federal Deposit Insurance Reform Conforming Amendment Act of 2005 were signed into law in 2006 (collectively the Reform Act ) providing the following changes:

- Merged the Bank Insurance Fund ( BIF ) and the Savings Association Insurance Fund ( SAIF ) into a new fund, the Deposit Insurance Fund ( DIF ).
- Increased the coverage limit for retirement accounts to $250,000.
- Indexed the coverage limit for deposit insurance for inflation.
- Establishing a range of 1.15 percent to 1.50 percent within which the FDIC may set the Designated Reserve Ratio ( DRR ).
- Eliminating the restrictions on premium rates based on the DRR and granting the FDIC the discretion to price deposit insurance according to risk for all insured institutions regardless of the level of the reserve ratio.
- Granting a one-time initial assessment credit to recognize institutions past contributions to the fund.

The Deposit Insurance Fund Act of 1996 contained a comprehensive approach to recapitalizing the Savings Association Insurance Fund and to assuring the payment of the Financing Corporation s ( FICO ) bond obligations. Under this law, banks insured under the Bank Insurance Fund are required to pay a portion of the interest due on bonds that were issued by FICO in 1987 to help shore up the ailing Federal Savings and Loan Insurance Corporation. The FDIC bills and collects this assessment on behalf of FICO.

Prior to the Company s restructuring in December 2005, two of the Company s bank subsidiaries were operating under formal agreements with the Office of the Comptroller of the Currency ( OCC ), which resulted in a higher FDIC risk classification and the Company experienced an increase in FDIC insurance premiums in 2005. As a result of the merger of the Company s subsidiary banks and the lower risk classification for FSB, the FDIC insurance premiums decreased in 2006. As a result of the Reform Act previously described, effective for the FDIC billing period that commenced January 1, 2007, the Company had a $1.3 million assessment credit available to offset future FDIC premium assessments, but not the FICO assessment. The Reform Act had minimal impact on the Company s 2007 consolidated results of operations. Approximately $848,000 in assessment credits were utilized in 2007 and there remains $442,000 in assessment credits that are expected to be utilized in 2008. It is estimated that the FDIC premium assessment for the first half of 2008 will approximate the remaining assessment credit, which will then result in an increase in FDIC insurance expense during the second half of 2008.

*Federal Home Loan Bank System*. FSB is a member of the FHLB System, which consists of 12 regional Federal Home Loan Banks. The FHLB System provides a central credit facility primarily for member institutions. As members of the FHLB of New York, the Bank is required to acquire and hold shares of capital stock in the FHLB. The minimum investment requirement is determined by a membership investment component and an activity-based investment component. Under the membership component, a certain minimum investment in capital stock is required to be maintained as long as the institution remains a member of the FHLB. Under the activity-based component, members are required to purchase capital stock in proportion to the volume of certain transactions with the FLHB. As of December 31, 2007, FSB complied with these requirements.

*Enforcement Powers*. The FDIC, the New York State Banking Department and the FRB have broad enforcement powers, including the power to terminate deposit insurance, impose substantial fines and other civil and criminal penalties and appoint a conservator or receiver. Failure to comply with applicable laws, regulations and supervisory agreements could subject the Company or the Bank, as well as the officers, directors and other institution-affiliated parties of these organizations, to administrative sanctions and potentially substantial civil money penalties.

*Brokered Deposit Restrictions*. Adequately capitalized institutions cannot accept, renew or roll over brokered deposits except with a waiver from the FDIC, and are subject to restrictions on the interest rates that can be paid on such deposits. Undercapitalized institutions may not accept, renew or roll over brokered deposits.

*Cross-Guarantee Provisions*. The Financial Institutions Reform, Recovery and Enforcement Act of 1989 ( FIRREA ) contains a cross-guarantee provision which generally makes commonly controlled insured

depository institutions liable to the FDIC for any losses incurred in connection with the failure of a commonly controlled depository institution.

*Community Reinvestment Act*. The Community Reinvestment Act of 1977 ( CRA ) and the regulations issued hereunder are intended to encourage banks to help meet the credit needs of their service area, including low and moderate income neighborhoods, consistent with the safe and sound operations of the banks. These regulations also provide for regulatory assessment of a bank s record in meeting the needs of its service area when considering applications regarding establishing branches, mergers or other bank or branch acquisitions. FIRREA requires federal banking agencies to make public a rating of a bank s performance under the CRA. In the case of a bank holding company, the CRA performance record of the banks involved in the transaction are reviewed in connection with the filing of an application to acquire ownership or control of shares or assets of a bank or to merge with any other bank holding company. An unsatisfactory record can substantially delay or block the transaction.

*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 their ongoing customer relations. The Check Clearing for the 21st Century Act ( Check 21 Act or the 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 Act. The 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.

**Changing Regulatory Structure**

**Gramm-Leach-Bliley Act**

The Gramm-Leach-Bliley Act ( Gramm-Leach ) was signed into law on November 12, 1999. Gramm-Leach permits, subject to certain conditions, combinations among banks, securities firms and insurance companies. Under Gramm-Leach, bank holding companies are permitted to offer their customers virtually any type of financial service including banking, securities underwriting, insurance (both underwriting and agency), and merchant banking. In order to engage in these additional financial activities, a bank holding company must qualify and register with the Board of Governors of the Federal Reserve System as a financial holding company by demonstrating that each of its subsidiaries is well capitalized, well managed, and has at least a satisfactory rating under the CRA. On May 12, 2000, FII received approval from the Federal Reserve Bank of New York to become a financial holding company resulting in the eventual formation of Five Star Investment Services, Inc. ( FSIS ). During 2003, FII terminated its financial holding company status and now operates as a bank holding company. The change in status did not affect the non-financial subsidiaries or activities being conducted by the Company, although future acquisitions or expansions of non-financial activities may require prior FRB approval and will be limited to those that are permissible for bank holding companies. Gramm-Leach establishes that the federal banking agencies will regulate the banking activities of financial holding companies and banks financial subsidiaries, the SEC will regulate their securities activities and state insurance regulators will regulate their insurance activities. Gramm-Leach also provides new protections against the transfer and use by financial institutions of consumers nonpublic, personal information.

The major provisions of Gramm-Leach are:

*Financial Holding Companies and Financial Activities*. Title I establishes a comprehensive framework to permit affiliations among commercial banks, insurance companies, securities firms, and other financial service providers by revising and expanding the Bank Holding Company Act framework to permit a holding company system to engage in a full range of financial activities through qualification as a new entity known as a financial holding

company. A bank holding company that qualifies as a financial holding company can expand into a wide variety of services that are financial in nature, if its subsidiary depository institutions are well-managed , well-capitalized and have received at least a satisfactory rating on their last CRA examination. Services that have been deemed to be financial in nature include securities underwriting, dealing and market making, sponsoring mutual funds and investment companies, insurance underwriting and agency activities and merchant banking.

*Securities Activities*. Title II narrows the exemptions from the securities laws previously enjoyed by banks, requires the FRB and the SEC to work together to draft rules governing certain securities activities of banks and creates a new, voluntary investment bank holding company.

*Insurance Activities*. Title III restates the proposition that the states are the functional regulators for all insurance activities, including the insurance activities of federally chartered banks, and bars the states from prohibiting insurance activities by depository institutions. The law encourages the states to develop uniform or reciprocal rules for the licensing of insurance agents.

*Privacy*. Under Title V, federal banking regulators were required to adopt rules that have limited the ability of banks and other financial institutions to disclose non-public information about consumers to nonaffiliated third parties. These limitations require disclosure of privacy policies to consumers and, in some circumstances, allow consumers to prevent disclosure of certain personal information to a nonaffiliated third party. Federal banking regulators issued final rules on May 10, 2000 to implement the privacy provisions of Title V. Under the rules, financial institutions must provide:

- Initial notices to customers about their privacy policies, describing the conditions under which they may disclose nonpublic personal information to nonaffiliated third parties and affiliates;
- Annual notices of their privacy policies to current customers; and
- A reasonable method for customers to opt out of disclosures to nonaffiliated third parties.

The Bank is in full compliance with the rules.

*Safeguarding Confidential Customer Information*. Under Title V, federal banking regulators are required to adopt rules requiring financial institutions to implement a program to protect confidential customer information. In January 2000, the federal banking agencies adopted guidelines requiring financial institutions to establish an information security program to:

- Identify and assess the risks that may threaten customer information;
- Develop a written plan containing policies and procedures to manage and control these risks;
- Implement and test the plan; and
- Adjust the plan on a continuing basis to account for changes in technology, the sensitivity of customer information and internal or external threats to information security.

The Bank approved security programs appropriate to its size and complexity and the nature and scope of its operations prior to the effective date of the regulatory guidelines. The implementation of the programs is an ongoing process.

*Community Reinvestment Act Sunshine Requirements*. In February 2001, the federal banking agencies adopted final regulations implementing Section 711 of Title VII, the CRA Sunshine Requirements. The regulations require nongovernmental entities or persons and insured depository institutions and affiliates that are parties to written agreements made in connection with the fulfillment of the institution s CRA obligations to make available to the public and the federal banking agencies a copy of each agreement. The regulations impose annual reporting requirements concerning the disbursement, receipt and use of funds or other resources under these agreements. The effective date of the regulations was April 1, 2001. Neither FII nor the Bank is a party to any agreement that would be the subject of reporting pursuant to the CRA Sunshine Requirements.

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**USA Patriot Act**

As part of the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 ( USA Patriot Act ), signed into law on October 26, 2001, Congress adopted the International Money Laundering Abatement and Financial Anti-Terrorism Act of 2001 ( IMLAFATA ). IMLAFATA authorizes the Secretary of the Treasury, in consultation with the heads of other government agencies, to adopt special measures applicable to banks, bank holding companies or other financial institutions. During 2002, the Department of Treasury issued a number of regulations relating to enhanced recordkeeping and reporting requirements for certain financial transactions that are of primary money laundering concern, due diligence requirements concerning the beneficial ownership of certain types of accounts, and restrictions or prohibitions on certain types of accounts with foreign financial institutions. Covered financial institutions also are barred from dealing with foreign shell banks. In addition, IMLAFATA expands the circumstances under which funds in a bank account may be forfeited and requires covered financial institutions to respond under certain circumstances to requests for information from federal banking agencies within 120 hours.

Regulations were also adopted during 2002 to implement minimum standards to verify customer identity, to encourage cooperation among financial institutions, federal banking agencies, and law enforcement authorities regarding possible money laundering or terrorist activities, to prohibit the anonymous use of concentration accounts, and to require all covered financial institutions to have in place a Bank Secrecy Act compliance program.

IMLAFATA also amends the Bank Holding Company Act and the Bank Merger Act to require the federal banking agencies to consider the effectiveness of a financial institution s anti-money laundering activities when reviewing an application under these acts.

The Bank has in place a Bank Secrecy Act compliance program, and it engages in very few transactions of any kind with foreign financial institutions or foreign persons.

**Sarbanes-Oxley Act**

On July 30, 2002, the President signed into law the Sarbanes-Oxley Act of 2002 (the Act ) implementing legislative reforms intended to address corporate and accounting fraud. In addition to the establishment of a new accounting oversight board that enforces auditing, quality control and independence standards and is funded by fees from all publicly traded companies, the law restricts accounting firms from providing both auditing and consulting services to the same client. To ensure auditor independence, any non-audit services being provided to an audit client requires pre-approval by the issuer s audit committee members. In addition, the audit partners must be rotated. The Act requires chief executive officers and chief financial officers, or their equivalent, to certify to the accuracy of periodic reports filed with the SEC, subject to civil and criminal penalties if they knowingly or willfully violate this certification requirement. In addition, under the Act, legal counsel is required to report evidence of a material violation of the securities laws or a breach of fiduciary duty by a company to its chief executive officer or its chief legal officer, and, if such officer does not appropriately respond, to report such evidence to the audit committee or other similar committee of the board of directors or the board itself.

Longer prison terms and increased penalties are also applied to corporate executives who violate federal securities laws, the period during which certain types of suits can be brought against a company or its officers has been extended, and bonuses issued to top executives prior to restatement of a company s financial statements are subject to disgorgement if such restatement was due to corporate misconduct. Executives are also prohibited from insider trading during retirement plan blackout periods, and loans to company executives are restricted. The Act accelerates the time frame for disclosures by public companies, as they must immediately disclose any material changes in their financial condition or operations. Directors and executive officers must also provide information for most changes in ownership in a company s securities within two business days of the change.

The Act also prohibits any officer or director of a company or any other person acting under their direction from taking any action to fraudulently influence, coerce, manipulate or mislead any independent public or certified accountant engaged in the audit of the company s financial statements for the purpose of rendering the financial statement s materially misleading. The Act also requires the SEC to prescribe rules requiring inclusion of an internal control report and assessment by management in the annual report to stockholders. In addition, the Act requires that each financial report required to be prepared in accordance with (or reconciled to) accounting

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principles generally accepted in the United States of America and filed with the SEC reflect all material correcting adjustments that are identified by a registered public accounting firm in accordance with accounting principles generally accepted in the United States of America and the rules and regulations of the SEC.

As directed by Section 302(a) of the Act, the Company s chief executive officer and chief financial officer are each required to certify that the Company s quarterly and annual reports do not contain any untrue statement of a material fact. The Act imposes several requirements, including having these officers certify that: they are responsible for establishing, maintaining and regularly evaluating the effectiveness of the Company s internal controls; they have made certain disclosures to the Company s auditors and the Audit Committee of the Board of Directors about the Company s internal controls; and they have included information in the Company s quarterly and annual reports about their evaluation and whether there have been significant changes in the Company s internal controls or in other factors that could significantly affect internal controls during the last quarter.

**Fair Credit Reporting Act and Fair and Accurate Transactions Act**

In 1970, the U. S. Congress enacted the Fair Credit Reporting Act (the FCRA ) in order to ensure the confidentiality, accuracy, relevancy and proper utilization of consumer credit report information. Under the framework of the FCRA, the United States has developed a highly advanced and efficient credit reporting system. The information contained in that broad system is used by financial institutions, retailers and other creditors of every size in making a wide variety of decisions regarding financial transactions. Employers and law enforcement agencies have also made wide use of the information collected and maintained in databases made possible by the FCRA. The FCRA affirmatively preempts state law in a number of areas, including the ability of entities affiliated by common ownership to share and exchange information freely, the requirements on credit bureaus to reinvestigate the contents of reports in response to consumer complaints, among others. By its terms, the preemption provisions of the FCRA were to terminate as of December 31, 2003. With the enactment of the Fair and Accurate Transactions Act (the FACT Act ) in late 2003, the preemption provisions of FCRA were extended, although the FACT Act imposes additional requirements on entities that gather and share consumer credit information. The FACT Act required the FRB and the Federal Trade Commission ( FTC ) to issue final regulations within nine months of the effective date of the Act. A series of regulations and announcements have been promulgated, including a joint FTC/FRB announcement of effective dates for FCRA amendments, the FTC s Free Credit Report rule, revisions to the FTC s FACT Act Rules, the FTC s final rules on identity theft and proof of identity, the FTC s final regulation on consumer information and records disposal, the FTC s final summaries and the final rule on prescreen notices.

**FRB Final Rule on Trust Preferred Securities**

On March 1, 2005, the FRB issued a final rule that allows the continued inclusion of trust preferred securities in the Tier 1 capital of bank holding companies. Trust preferred securities, however, will be subject to stricter quantitative limits. Key components of the final rule are:

- Trust preferred securities, together with other restricted core capital elements , can be included in a bank holding company s Tier 1 capital up to 25% of the sum of core capital elements, including restricted core capital elements ;
- Restricted core capital elements are defined to include:
  - Qualifying trust preferred securities;
  - Qualifying cumulative perpetual preferred stock (and related surplus);
  - Minority interest related to qualifying cumulative perpetual preferred stock directly issued by a consolidated U.S. depository institution or foreign bank subsidiary; and
  - Minority interest related to qualifying common or qualifying perpetual preferred stock issued by a consolidated subsidiary that is neither a U.S. depository institution nor a foreign bank subsidiary.
- The sum of core capital elements will be calculated net of goodwill, less any associated deferred tax liability;

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Internationally active bank holding companies are further limited, and must limit restricted core capital elements to 15% of the sum of core capital elements, including restricted core capital elements, net of goodwill, although they may include qualifying mandatory convertible preferred securities up to the 25% limit;

A five-year transition period for application of quantitative limits, ending March 31, 2009.

**Expanding Enforcement Authority and Enforcement Matters**

The FRB, the New York State Superintendent of Banks and the FDIC possess extensive authority to police unsafe or unsound practices and violations of applicable laws and regulations by depository institutions and their holding companies. For example, the FDIC may terminate the deposit insurance of any institution that it determines has engaged in an unsafe or unsound practice. The agencies can also assess civil money penalties, issue cease and desist or removal orders, seek injunctions, and publicly disclose such actions.

**Effect On Economic Environment**

The policies of regulatory authorities, including the monetary policy of the FRB, have a significant effect on the operating results of bank holding companies and their subsidiaries. Among the means available to the FRB to affect the money supply are open market operations in U.S. Government securities, changes in the discount rate on member bank borrowings and changes in reserve requirements against member bank deposits. These means are used in varying combinations to influence overall growth and distribution of bank loans, investments and deposits, and their use may affect interest rates charged on loans or paid for deposits. FRB monetary policies have materially affected the operating results of commercial banks in the past and are expected to continue to do so in the future.

**Item 1A. Risk Factors**

Our financial results are subject to a number of risks. The factors discussed below are intended to highlight risks that management believes are most relevant to our current operating environment. This listing is not intended to capture all risks associated with our business. Additional risks, including those generally affecting the industry in which we operate, risks that we currently deem immaterial and risks generally applicable to companies that have recently undertaken similar transactions, may also negatively impact our consolidated financial position, consolidated results of operations, or liquidity.

*Asset Quality*. A significant source of risk for the Company arises from the possibility that losses will be sustained because borrowers, guarantors and related parties may fail to perform in accordance with the terms of their loans. Most loans originated by the Company are secured, but loans may be unsecured depending on the nature of the loan. With respect to secured loans, the collateral securing the repayment of these loans includes a wide variety of diverse real and personal property that may be affected by changes in prevailing economic, environmental and other conditions, including declines in the value of real estate, changes in interest rates, changes in monetary and fiscal policies of the federal government, wide-spread disease, terrorist activity, environmental contamination and other external events.

The Company has adopted loan policies with well-defined risk tolerance limits including individual loan officer and committee approval processes. Policies and procedures outline underwriting standards, appraisal requirements, collateral valuations, financial information reviews, and ongoing quality monitoring processes that management believes are appropriate to mitigate the risk of loss within the loan portfolio. Such policies and procedures, however, may not prevent unexpected losses that could have a material adverse effect on the Company s business, financial condition, results of operations, or liquidity.

*Interest Rate Risk*. The banking industry s earnings depend largely on the relationship between the yield on earning assets, primarily loans and investments, and the cost of funds, primarily deposits and borrowings. This relationship, known as the interest rate spread, is subject to fluctuation and is affected by economic and competitive factors which influence interest rates, the volume and mix of interest-earning assets and interest-bearing liabilities and the level of non-performing assets. Fluctuations in interest rates affect the demand of customers for the Company s products and services. The Bank is subject to interest rate risk to the degree that

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interest-bearing liabilities re-price or mature more slowly or more rapidly or on a different basis than interest-earning assets. Significant fluctuations in interest rates could have a material adverse effect on the Company s business, financial condition, results of operations or liquidity. For additional information regarding interest rate risk, see Part II, Item 7A, Quantitative and Qualitative Disclosures About Market Risk.

*Changes in the Value of Goodwill and Other Intangible Assets*. Under accounting standards, the Company is not required to amortize goodwill but rather must evaluate goodwill for impairment at least annually. If deemed impaired at any point in the future, an impairment charge representing all or a portion of goodwill will be recorded to current earnings in the period in which the impairment occurred. The capitalized value of other intangible assets is amortized to earnings over their estimated lives. Other intangible assets are also subject to periodic impairment reviews. If these assets are deemed impaired at any point in the future, an impairment charge will be recorded to current earnings in the period in which the impairment occurred. See also Note 7 of the notes to consolidated financial statements.

*Breach of Information Security and Technology Dependence*. The Company depends upon data processing, software, communication and information exchange on a variety of computing platforms and networks and over the internet. Despite instituted safeguards, the Company cannot be certain that all of its systems are entirely free from vulnerability to attack or other technological difficulties or failures. The Company relies on the services of a variety of vendors to meet its data processing and communication needs. If information security is breached or other technology difficulties or failures occur, information may be lost or misappropriated, services and operations may be interrupted and the Company could be exposed to claims from customers. Any of these results could have a material adverse effect on the Company s business, financial condition, results of operations or liquidity.

*Economic Conditions, Limited Geographic Diversification*. The Company s banking operations are located in Western and Central New York State. Because of the geographic concentration of its operations, the Company s results depend largely upon economic conditions in this area, which include volatility in wholesale milk prices, losses of manufacturing jobs in Rochester and Buffalo, and minimal population growth throughout the region. Further deterioration in economic conditions could adversely affect the quality of the Company s loan portfolio and the demand for its products and services, and accordingly, could have a material adverse effect on the Company s business, financial condition, results of operations or liquidity. See also the section titled Market Area and Competition.

*Ability of the Company to Execute Its Business Strategy*. The financial performance and profitability of the Company will depend on its ability to execute its strategic plan and manage its future growth. Failure to execute these plans could have a material adverse effect on the Company s business, financial condition, results of operations or liquidity. Moreover, the Company s future performance is subject to a number of factors beyond its control, including pending and future federal and state banking legislation, regulatory changes, unforeseen litigation outcomes, inflation, lending and deposit rate changes, interest rate fluctuations, increased competition and economic conditions. Accordingly, these issues could have a material adverse effect on the Company s business, financial condition, results of operations or liquidity.

*Dependence on Key Personnel*. The Company s success depends to a significant extent on the management skills of its existing executive officers and directors, many of whom have held officer and director positions with the Company for many years. The loss or unavailability of any of its key personnel, including Erland E. Kailbourne, Chairman of the Board of Directors, Peter G. Humphrey, President and Chief Executive Officer, James T. Rudgers, Executive Vice President and Chief of Community Banking, Ronald A. Miller, Executive Vice President and Chief Financial Officer, George D. Hagi, Executive Vice President and Chief Risk Officer, John J. Witkowski, Senior Vice President and Regional President/Retail Banking Executive, Martin K. Birmingham, Senior Vice President and Regional President/Commercial Market Executive, Kevin B. Klotzbach, Senior Vice President and Treasurer, Bruce H. Nagle, Senior Vice President and Director of Human Resources and Richard J. Harrison, Senior Vice President and Senior Retail Lending Administrator, could have a material adverse effect on the Company s business, financial condition, results of operations or liquidity. See also Part III, Item 10, Directors, Executive Officers and Corporate Governance.

*Competition*. National competitors are much larger in total assets and capitalization, have greater access to financial and capital markets and offer a broader array of financial services than the Company. There can be no

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assurance that the Company will be able to compete effectively in its markets. Furthermore, developments increasing the nature or level of competition, together with changes in our strategic plan and stricter loan underwriting standards, could have a material adverse effect on the Company s business, financial condition, results of operations or liquidity. See also the sections titled Market Area and Competition and Supervision and Regulation.

*Government Regulation and Monetary Policy*. The Company and the banking industry are subject to extensive regulation and supervision under federal and state laws and regulations. The restrictions imposed by such laws and regulations limit the manner in which the Company conducts its banking business, undertakes new investments and activities and obtains financing. These regulations are designed primarily for the protection of the deposit insurance funds and consumers and not to benefit holders of the Company s securities. Financial institution regulation has been the subject of significant legislation in recent years and may be the subject of further significant legislation in the future, none of which is in the control of the Company. Significant new laws or changes in, or repeals of, existing laws could have a material adverse effect on the Company s business, financial condition, results of operations or liquidity. Further, federal monetary policy, particularly as implemented through the Federal Reserve System, significantly affects credit conditions for the Company, and any unfavorable change in these conditions could have a material adverse effect on the Company s business, financial condition, results of operations or liquidity. See also the section titled Supervision and Regulation.

*Real Estate Market Conditions.* If real estate values in the markets the Company serves decline, the Company s business could be adversely affected. Parts of the country have experienced a significant decline in real estate values that has led, in some cases, to the debt on the real estate exceeding the value of the real estate. The markets the Company serves have not generally experienced, to this point, such conditions. Should deterioration in real estate values in the markets we serve occur, the value and liquidity of real estate securing the Company s loans could become impaired. While the Company is not engaged in the business of sub-prime lending, a decline in the value of residential or commercial real estate could have a material adverse effect on the Company s business, financial condition, results of operations or liquidity.

*Financial and Capital Market Liquidity Disruption.* The deteriorating credit quality of assets linked to the sub-prime mortgage market, caused by a decline in general mortgage credit standards, has led to a lack of liquidity and downgrades to certain MBS and other securities in the financial marketplace. This, in turn, has contributed to a broad-based liquidity shortfall in the financial system. The subsequent increase in risk aversion has contributed to a decline in credit availability in the financial and capital markets. A continuation of these credit and liquidity issues may result in reduced liquidity and impairment write-downs on some of our asset holdings. MBS and auction rate preferred equity securities are most affected by and are at most risk for possible future reduced liquidity and impairment write-downs. These financial and capital market disruptions could have a material adverse effect on the Company s business, financial condition, results of operations or liquidity. See also the section titled Investing Activities.

**Item 1B. Unresolved Staff Comments**

Not applicable.

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## Item 2. Properties

| LOCATION | TYPE OF FACILITY | LEASED OR OWNED | EXPIRATION OF LEASE |
|---|---|---|---|
| Allegany | Branch | Owned | |
| Amherst | Branch | Leased | February 2020 |
| Attica | Branch | Owned | |
| Auburn | Branch | Owned | |
| Avoca | Branch | Owned | |
| Batavia | Branch | Leased | December 2016 |
| Batavia (In-Store) | Branch | Leased | July 2009 |
| Bath | Branch | Owned | |
| Bath | Drive-up Branch | Owned | |
| Caledonia | Branch | Leased | July 2012 |
| Canandaigua | Branch | Owned | |
| Cuba | Branch | Owned | |
| Dansville | Branch | Ground Leased | March 2014 |
| Dundee | Branch | Owned | |
| East Aurora | Branch | Leased | January 2013 |
| Ellicottville | Branch | Owned | |
| Elmira | Branch | Owned | |
| Elmira Heights | Branch | Leased | August 2009 |
| Erwin | Branch | Leased | October 2010 |
| Geneseo | Branch | Owned | |
| Geneva | Branch | Owned | |
| Geneva | Drive-up Branch | Owned | |
| Greece * | Branch | Leased | June 2023 |
| Geneva (Plaza) | Branch | Ground Leased | January 2016 |
| Hammondsport | Branch | Owned | |
| Henrietta * | Branch | Leased | June 2023 |
| Honeoye Falls | Branch | Leased | September 2017 |
| Hornell | Branch | Owned | |
| Horseheads | Branch | Leased | September 2012 |
| Lakeville | Branch | Owned | |
| Lakewood | Branch | Owned | |
| Leroy | Branch | Owned | |
| Mount Morris | Branch | Owned | |
| Naples | Branch | Owned | |
| North Chili | Branch | Owned | |
| North Java | Branch | Owned | |
| North Warsaw | Branch | Owned | |
| Olean | Branch | Owned | |
| Olean | Drive-up Branch | Owned | |
| Orchard Park | Branch | Ground Leased | January 2019 |
| Ovid | Branch | Owned | |
| Pavilion | Branch | Owned | |
| Penn Yan | Branch | Owned | |
| Pittsford | Administrative Offices | Leased | April 2017 |

| | | | |
|---|---|---|---|
| Salamanca | Branch | Owned | |
| Strykersville | Branch | Owned | |
| Victor | Branch | Owned | |
| Warsaw (220 Liberty Street) | Headquarters | Owned | |
| Warsaw (31 North Main Street) | Administrative Offices | Owned | |
| Warsaw (55 North Main Street) | Main Branch | Owned | |
| Waterloo | Branch | Owned | |
| Wayland | Branch | Owned | |
| Williamsville | Branch | Leased | August 2009 |
| Wyoming | Branch | Leased | March 2008 |
| Yorkshire | Branch | Ground Leased | November 2012 |

* New branch opening planned for 2008

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**Item 3. Legal Proceedings**

From time to time the Company is 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 the Company, which, if determined adversely, would have a material adverse effect on the Company s business, results of operations or financial condition.

**Item 4. Submission of Matters to a Vote of Security Holders**

Not applicable.

**PART II**

**Item 5. Market for Registrant s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities**

*Market and Dividend Information:* The common stock of FII is traded on the NASDAQ Global Select Market under the symbol of FISI. The following chart lists prices per share of actual sales transactions as reported by NASDAQ, as well as the cash dividends declared.

| | Sales Price Per Share | | | Cash Dividends Per Share |
|---|---|---|---|---|
| | High | Low | Close | Declared |
| **2007** | | | | |
| First Quarter | $23.71 | $19.30 | $20.07 | $0.10 |
| Second Quarter | 20.62 | 18.62 | 20.19 | 0.11 |
| Third Quarter | 20.46 | 16.18 | 17.94 | 0.12 |
| Fourth Quarter | 19.80 | 16.42 | 17.82 | 0.13 |
| **2006** | | | | |
| First Quarter | $21.17 | $18.16 | $18.89 | $0.08 |
| Second Quarter | 20.86 | 17.43 | 20.86 | 0.08 |
| Third Quarter | 25.38 | 19.15 | 23.36 | 0.09 |
| Fourth Quarter | 24.25 | 22.07 | 23.05 | 0.09 |

FII has paid regular quarterly cash dividends on its common stock and its Board of Directors presently intends to continue this practice, subject to the need for those funds for debt service and other purposes. However, because substantially all of the funds available for the payment of dividends are derived from the Bank, future dividends will depend upon the earnings of the Bank, its financial condition and need for funds. Furthermore, there are a number of federal banking policies and regulations that restrict both FII s and the Bank s ability to pay dividends. For further discussion on dividend restrictions, refer to the Part I, Item 1 sections titled Supervision and Regulation , The Company and The Bank , as these restrictions may have the effect of reducing the amount of dividends that FII can declare to its shareholders.

*Shareholders:* As of February 29, 2008, the Company had approximately 1,500 common shareholders and 11,012,552 shares of common stock outstanding (exclusive of treasury shares).

*Recent Sales of Unregistered Securities:* None.

*Purchases of Equity Securities by the Issuer and Affiliated Purchases:* The following table sets forth the information with respect to purchases made by the Company of its common stock during the three months ended December 31, 2007:

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| Period | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | Approximate Dollar Value of Shares that May Yet Be Purchased Under the Plans or Programs (1) |
|---|---|---|---|---|
| 10/01/07 10/31/07 | 18,780 | $19.27 | 18,780 | $ 3,475,000 |
| 11/01/07 11/30/07 | 21,291 | 17.74 | 21,291 | 3,097,000 |
| 12/01/07 12/31/07 | 33,305 | 18.54 | 33,305 | 2,479,000 |
| Total | 73,376 | $18.49 | 73,376 | $ 2,479,000 |

(1) On July 25, 2007, the Company s Board of Directors approved a one-year, $5.0 million common stock repurchase program. Under the program, stock repurchases may be made either in the open market or through privately negotiated transactions.

*Performance Graph:* The Stock Performance Graph compares the cumulative total return on FII s common stock against the cumulative total return of the NASDAQ Composite of U.S. Stocks and the SNL Financial LC ( SNL ) $1 Billion-$5 Billion Bank Index, for the period of December 31, 2002 through December 31, 2007. The graph assumes that $100 was invested on December 31, 2002 in our common stock and the comparison groups and reinvestment of all cash dividends prior to any tax effect.

**Period Ending**

| **Index** | **12/31/02** | **12/31/03** | **12/31/04** | **12/31/05** | **12/31/06** | **12/31/07** |
|---|---|---|---|---|---|---|
| Financial Institutions, Inc. | 100.00 | 98.79 | 83.65 | 72.08 | 86.04 | 68.12 |
| NASDAQ Composite | 100.00 | 150.01 | 162.89 | 165.13 | 180.85 | 198.60 |
| SNL Bank $1B-$5B Index | 100.00 | 135.99 | 167.83 | 164.97 | 190.90 | 139.06 |

**Source : SNL Financial LC, Charlottesville, VA** **(434) 977-1600**

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## Item 6. Selected Financial Data

| *(Dollars in thousands)* | At December 31: | | | | |
|---|---|---|---|---|---|
| | **2007** | **2006** | **2005** | **2004** | **2003** |
| **Selected Financial Condition Data** | | | | | |
| Total assets | $ 1,857,876 | $ 1,907,552 | $ 2,022,392 | $ 2,156,329 | $ 2,173,732 |
| Loans | 964,173 | 926,482 | 992,321 | 1,252,405 | 1,340,436 |
| Allowance for loan losses | 15,521 | 17,048 | 20,231 | 39,186 | 29,064 |
| Securities available for sale | 695,241 | 735,148 | 790,855 | 727,198 | 604,964 |
| Securities held to maturity | 59,479 | 40,388 | 42,593 | 39,317 | 47,131 |
| Total liabilities | 1,662,554 | 1,725,164 | 1,850,635 | 1,972,042 | 1,990,629 |
| Deposits | 1,575,971 | 1,617,695 | 1,717,261 | 1,818,949 | 1,818,889 |
| Borrowings and junior subordinated debentures | 68,210 | 87,199 | 115,199 | 132,614 | 154,223 |
| Total shareholders equity | 195,322 | 182,388 | 171,757 | 184,287 | 183,103 |

| *(Dollars in thousands)* | For the years ended December 31: | | | | |
|---|---|---|---|---|---|
| | **2007** | **2006** | **2005** | **2004** | **2003** |
| **Selected Results of Operations Data** | | | | | |
| Interest income | $ 105,212 | $ 103,070 | $ 103,887 | $ 106,175 | $ 111,450 |
| Interest expense | 47,139 | 43,604 | 36,395 | 30,768 | 35,947 |
| Net interest income | 58,073 | 59,466 | 67,492 | 75,407 | 75,503 |
| Provision (credit) for loan losses | 116 | (1,842) | 28,532 | 19,676 | 22,526 |
| Net interest income after provision (credit) for loan losses | 57,957 | 61,308 | 38,960 | 55,731 | 52,977 |
| Noninterest income | 20,680 | 21,911 | 29,384 | 22,149 | 22,570 |
| Noninterest expense | 57,428 | 59,612 | 65,492 | 61,767 | 57,283 |
| Income from continuing operations before income taxes | 21,209 | 23,607 | 2,852 | 16,113 | 18,264 |
| Income tax expense (benefit) from continuing operations | 4,800 | 6,245 | (1,766) | 3,170 | 3,923 |
| Income from continuing operations | 16,409 | 17,362 | 4,618 | 12,943 | 14,341 |

| | | | | | |
|---|---|---|---|---|---|
| Loss on discontinued operations, net of tax | | | 2,452 | 450 | 94 |
| Net income | $ 16,409 | $ 17,362 | $ 2,166 | $ 12,493 | $ 14,247 |

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**Item 6. Selected Financial Data (Continued)**

| | At or for the years ended December 31: | | | | |
|---|---|---|---|---|---|
| | **2007** | **2006** | **2005** | **2004** | **2003** |
| **Per Common Share Data** | | | | | |
| Basic: | | | | | |
| Income from continuing operations | $ 1.34 | $ 1.40 | $ 0.28 | $ 1.02 | $ 1.15 |
| Net income | 1.34 | 1.40 | 0.06 | 0.98 | 1.14 |
| Diluted: | | | | | |
| Income from continuing operations | 1.33 | 1.40 | 0.28 | 1.02 | 1.14 |
| Net income | 1.33 | 1.40 | 0.06 | 0.98 | 1.13 |
| Cash dividends declared on common stock | 0.46 | 0.34 | 0.40 | 0.64 | 0.64 |
| Book value | 16.14 | 14.53 | 13.60 | 14.81 | 14.81 |
| Tangible book value | 12.69 | 11.15 | 10.19 | 11.31 | 11.22 |
| Market value | 17.82 | 23.05 | 19.62 | 23.25 | 28.23 |
| **Selected Financial Ratios** | | | | | |
| Performance Ratios: | | | | | |
| Return on average assets | 0.86% | 0.90% | 0.10% | 0.57% | 0.66% |
| Return on average common equity | 8.89 | 10.02 | 0.43 | 6.55 | 7.65 |
| Return on average tangible common equity | 11.50 | 13.23 | 0.56 | 8.57 | 10.12 |
| Common dividend payout (1) | 34.33 | 24.29 | 666.67 | 65.31 | 56.14 |
| Net interest margin (2) | 3.53 | 3.55 | 3.65 | 3.90 | 3.99 |
| Efficiency ratio (3) | 68.77 | 69.78 | 70.18 | 60.41 | 54.26 |
| Capital ratios: | | | | | |
| Period end common equity to total assets | 9.57% | 8.64% | 7.62% | 7.72% | 7.61% |
| Period end tangible common equity to tangible total assets | 7.68 | 6.77 | 5.82 | 6.01 | 5.87 |
| Tier 1 risk-based capital | 15.74 | 15.85 | 13.75 | 11.27 | 10.18 |
| Total risk-based capital | 16.99 | 17.10 | 15.01 | 12.54 | 11.44 |
| Asset Quality Ratios: | | | | | |
| Nonperforming loans to total loans (4) | 0.84% | 1.71% | 1.82% | 4.31% | 3.84% |
| Nonperforming assets to total loans, other real estate and repossessed assets (4) | 0.98 | 1.84 | 1.93 | 4.40 | 3.89 |
| Nonperforming assets to total assets (4) | 0.51 | 0.89 | 0.97 | 2.56 | 2.40 |
| Allowance for loan losses to total loans (4) | 1.61 | 1.84 | 2.04 | 3.13 | 2.17 |
| Allowance for loan losses to nonperforming loans (4) | 192 | 108 | 112 | 73 | 56 |
| Net charge-offs to average total loans (4) | 0.18 | 0.14 | 4.27 | 0.74 | 1.11 |

(1) Cash dividends declared on

common stock divided by basic net income per common share.

(2) Represents net interest income divided by average interest-earning assets. The interest earned from tax-exempt and tax-preferred securities includes a tax-equivalent adjustment.

(3) The efficiency ratio represents noninterest expense less other real estate expense and amortization of intangibles (all from continuing operations), divided by net interest income (tax-equivalent) plus other noninterest income less net gain on sale or call of securities, income associated with the proceeds from corporate owned life insurance, net gain on sale of commercial-related loans held for sale and net gain on sale of trust relationships (all from continuing operations).

(4) Ratios exclude nonaccruing commercial-related loans held for sale

(which amounted to $577,000 as of December 31, 2005 and zero for all other years presented) from nonperforming loans and exclude loans held for sale from total loans.

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**Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operation**
**GENERAL**
The principal objective of this discussion is to provide an overview of the financial condition and results of operations of the Company during the year ended December 31, 2007 and the preceding two years. This discussion and the tabular presentations should be read in conjunction with the accompanying consolidated financial statements and accompanying notes.
Income. The Company s results of operations are dependent primarily on net interest income, which is the difference between the income earned on loans and securities and the interest paid on deposits and borrowings. Results of operations are also affected by the (credit) provision for loan losses, service charges on deposits, financial services group fees and commissions, mortgage banking revenues, gain or loss on the sale of securities, gain or loss on sale of loans and other miscellaneous income.
Expenses. The Company s expenses primarily consist of salaries and employee benefits, occupancy and equipment, supplies and postage, amortization of other intangible assets, computer and data processing, professional fees and services, advertising and promotions and other miscellaneous expense and income tax expense (benefit). Results of operations are also significantly affected by general economic and competitive conditions, particularly changes in interest rates, government policies and the actions of regulatory authorities.
**OVERVIEW**
Net income was $16.4 million ($1.33 per diluted share), $17.4 million ($1.40 per diluted share) and $2.2 million ($0.06 per diluted share) for 2007, 2006 and 2005, respectively. The return on average common equity in 2007 was 8.89%, compared to 10.02% in 2006 and 0.43% in 2005. The return on average assets in 2007 was 0.86%, compared to 0.90% in 2006 and 0.10% in 2005.
Net interest income, the principal source of the Company s earnings, was $58.1 million in 2007, down from $59.5 million in 2006 and $67.5 million in 2005. Net interest margin was 3.53%, 3.55% and 3.65% for the years ended December 31, 2007, 2006 and 2005, respectively. The decline in net interest income resulted from lower earning asset levels along with a narrowed net interest margin. The flat-to-inverted interest rate yield curve, which prevailed throughout the first half of 2007, contributed to a reduced spread on asset transactions and caused nonpublic deposits to shift into higher cost certificates of deposits from lower cost deposit products in comparison to the prior years.
Effective December 3, 2005, the Company merged its subsidiary banks into the New York State-chartered First Tier Bank & Trust, which was then renamed Five Star Bank ( FSB ). The consolidation activities improved operational efficiencies and resulted in lower noninterest expense in 2006. The Company continued to focus on cost reduction initiatives, which resulted in further reductions in noninterest expense in 2007 versus 2006. Over the past several years, the Company has executed its strategic plan, which includes a renewed focus on its core community banking business. As a result, the Company sold the Burke Group, Inc. subsidiary in 2005, therefore its results have been reported separately as discontinued operations in the consolidated statements of income and the loss on discontinued operations, net of tax, was $2.5 million in 2005. In addition, the Company sold its trust relationships during 2006 and recognized a $1.4 million gain on the sale.
**CRITICAL ACCOUNTING POLICIES**
The Company s consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States and are consistent with predominant practices in the financial services industry. Application of critical accounting policies, which are those policies that management believes are the most important to the Company s financial position and results, requires management to make estimates, assumptions, and judgments that affect the amounts reported in the consolidated financial statements and accompanying notes and are based on information available as of the date of the financial statements. Future changes in information may affect these estimates, assumptions and judgments, which, in turn, may affect amounts reported in the financial statements.
The Company has numerous accounting policies, of which the most significant are presented in Note 1 of the notes to consolidated financial statements. These policies, along with the disclosures presented in the other

financial statement notes and in this discussion, provide information on how significant assets, liabilities, revenues and expenses are reported in the consolidated financial statements and how those reported amounts are determined. Based on the sensitivity of financial statement amounts to the methods, assumptions, and estimates underlying those amounts, management has determined that the accounting policies with respect to the allowance for loan losses and goodwill require particularly subjective or complex judgments important to the Company s financial position and results of operations, and, as such, are considered to be critical accounting policies as discussed below.

Allowance for Loan Losses

The allowance for loan losses represents management s estimate of probable credit losses inherent in the loan portfolio. Determining the amount of the allowance for loan losses is considered a critical accounting estimate because it requires significant judgment and the use of subjective measurements including management s assessment of the internal risk classifications of loans, changes in the nature of the loan portfolio, industry concentrations and the impact of current local, regional and national economic factors on the quality of the loan portfolio. Changes in these estimates and assumptions are reasonably possible and may have a material impact on the Company s consolidated financial statements, results of operations or liquidity.

A loan is considered impaired when, based on current information and events, it is probable that a creditor will be unable to collect all amounts of principal and interest under the original terms of the agreement or the loan is restructured in a troubled debt restructuring. Accordingly, the Company evaluates impaired commercial and agricultural loans individually based on the present value of future cash flows discounted at the loan s effective interest rate, or at the loan s observable market price or the net realizable value of the collateral if the loan is collateral dependent. The majority of the Company s impaired loans are collateral dependent.

Loans, including impaired loans, are generally classified as nonaccruing 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 nonaccruing if repayment in full of principal and/or interest is uncertain.

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

Goodwill

Statement of Financial Accounting Standards ( SFAS ) No. 142, Goodwill and Other Intangible Assets prescribes the accounting for goodwill and intangible assets subsequent to initial recognition. The provisions of SFAS No. 142 discontinue the amortization of goodwill and intangible assets with indefinite lives. Instead, these assets are subject to at least an annual impairment review, and more frequently if certain impairment indicators are in evidence. Changes in the estimates and assumptions are reasonably possible and may have a material impact on the Company s consolidated financial statements, results of operations or liquidity. During 2007, 2006 and 2005, the Company evaluated goodwill for impairment using a discounted cash flow analysis and determined no impairment existed. For additional discussion related to the Company s accounting policy for goodwill and other intangible assets, see Note 1 of the notes to consolidated financial statements.

Defined Benefit Pension Plan

Management is required to make various assumptions in valuing its defined benefit pension plan assets and liabilities. These assumptions include, but are not limited to, the expected long-term rate of return on plan assets, the weighted average discount rate used to value certain liabilities and the rate of compensation increase. The Company uses a third-party specialist to assist in making these estimates and assumptions. Changes in these estimates and assumptions are reasonably possible and may have a material impact on the Company s consolidated financial statements, results of operations or liquidity.

## ANALYSIS OF FINANCIAL CONDITION

### Overview

At December 31, 2007 the Company had total assets of $1.858 billion, a decrease of 2.6% from $1.908 billion as of December 31, 2006. Loans totaled $964.2 million as of December 31, 2007, up $37.7 million, or 4.1%, when compared to $926.5 million as of December 31, 2006. The increase in loans was primarily attributed to the results of our commercial business development program, coupled with expansion of our indirect lending program. Nonperforming assets totaled $9.5 million as of December 31, 2007, a $7.5 million, or 44.3% decline since December 31, 2006. Net loan charge-offs were $1.6 million, or 0.18% of average loans, for the year ended December 31, 2007. Total deposits amounted to $1.576 billion and $1.618 billion as of December 31, 2007 and 2006, respectively. The Company actively managed to lower the level of higher cost deposits during 2007. As of December 31, 2007, total borrowed funds and junior subordinated debentures were $68.2 million compared to $87.2 million as of December 31, 2006. The Company repaid matured borrowings throughout 2007 by using its favorable position of liquidity. Book value per common share was $16.14 and $14.53 as of December 31, 2007 and 2006, respectively. As of December 31, 2007 the Company s total shareholders equity was $195.3 million compared to $182.4 million a year earlier.

### Investing Activities

Investment Portfolio Composition

The Company s total investment security portfolio decreased $20.8 million to $754.7 million as of December 31, 2007 compared to $775.5 million as of December 31, 2006. Further detail regarding the Company s investment portfolio follows.

The deteriorating credit quality of assets linked to the sub-prime mortgage market, caused by a decline in general mortgage credit standards, has led to a lack of liquidity and downgrades to certain MBS and other securities in the financial marketplace. This, in turn, has contributed to a broad-based liquidity shortfall in the financial system. The subsequent increase in risk aversion has contributed to a decline in credit availability in the financial and capital markets. A continuation of these credit and liquidity issues may result in reduced liquidity and impairment write-downs on some of our asset holdings. MBS and auction rate preferred equity securities are most affected by and are at most risk for possible future reduced liquidity and impairment write-downs.

*U.S. Government Agency and U.S. Government-Sponsored Enterprise ( GSE ) Obligations*. The U.S. government agency and GSE obligations portfolio, all of which was classified as available for sale, is comprised of debt obligations issued directly by U.S. government agencies or GSEs and totaled $158.9 million as of December 31, 2007. The portfolio consisted of approximately $78.5 million, or 49%, callable securities. As of December 31, 2007, this category of securities also included $56.6 million of structured notes, the majority of which were step callable debt issues. The step callable bonds step-up in rate at specified intervals and are periodically callable by the issuer. The current average coupon rate for the structured notes was 4.71% as of December 31, 2007, which adjusts on average to 6.39% within three years. However, under current market conditions these notes are likely to be called. As of December 31, 2006, the available for sale U.S. government agency and GSE obligations portfolio totaled $231.9 million.

*Mortgage-Backed Securities ( MBS ).* The MBS portfolio, all of which was classified as available for sale, totaled $295.9 million as of December 31, 2007, which was comprised of $160.0 million of mortgage-backed pass-through securities ( pass-throughs ) and $135.9 million of collateralized mortgage obligations ( CMO ). As of December 31, 2006, the MBS portfolio totaled $296.7 million, which consisted of $189.4 million of pass-throughs and $107.3 million of CMOs.

The pass-throughs were primarily issued by GNMA, FNMA or FHLMC. The majority of the pass-throughs were in fixed rate securities that were most frequently formed with mortgages having an original balloon payment of five or seven years. The remainder of pass-throughs were principally adjustable rate securities indexed to the one-year Treasury bill.

The CMO portfolio consisted of two principal groups, with balances as of December 31, 2007 as follows: (1) $78.2 million of AAA rated fixed and variable rate CMOs issued by either GNMA, FNMA or FHLMC that

carried a full guaranty by the issuing agency of both principal and interest, and (2) $57.7 million of privately issued whole loan CMOs.

The following table details, by risk rating, the privately issued whole loan CMOs as of December 31:

| *(Dollars in millions)* | **2007** |
| --- | --- |
| Risk rating: | |
| AAA | $ 45.4 |
| AAA/AA | 7.8 |
| AA | 3.9 |
| A- | 0.6 |
| Total privately issued whole loan CMOs | $ 57.7 |

As of December 31, 2007, the weighted average percentage (by dollars) of the underlying mortgages that were owner occupied in the privately issued whole loan CMO portfolio was 93%. In addition, 98% of the total privately issued whole loan CMO portfolio was backed by underlying mortgages that were at fixed rates.

All of the bonds rated AAA were issued no later than 2004 and are therefore at least three years seasoned. The bonds rated AAA/AA were issued in 2005, 2006, and 2007 and therefore have mortgages as underlying collateral with relatively short seasoning. The credit support on the AAA/AA classes owned has increased in all cases since the deals were originated. The portfolio included a $1.1 million AAA/AA bond with underlying mortgages where 34% were classified as sub-prime, 100% were at fixed rates and the credit subordination level was 8.53%. In addition, the portfolio included a $3.9 million AA rated bond with underlying mortgages where 44% were classified as sub-prime, 100% were fixed rate, average seasoning was 94 months and the credit subordination level was 1.24%. The portfolio also included a $0.6 million A- rated bond with underlying mortgages where 69% were classified as sub-prime, 100% were variable rate, average seasoning was 52 months, the percentage of delinquencies and foreclosures was relatively high and the credit subordination level was 6.06%.

*Other Asset-Backed Securities ( ABS ).* The ABS portfolio, all of which was classified as available for sale, totaled $33.2 million as of December 31, 2007 and was comprised of positions in 14 different pooled trust preferred securities issues with ratings ranging from A- to AA and one AAA rated Student Loan Marketing Association ( SLMA ) floater or variable rate security backed by student loans. All of the trust preferred securities are backed by preferred debt issued by many different financial institutions and insurance companies. As of December 31, 2006, the ABS portfolio, all of which was classified as available for sale, totaled $7.1 million and was comprised of one pooled trust preferred securities issue and five SLMA securities.

*State and Municipal Obligations.* As of December 31, 2007, the portfolio of state and municipal obligations totaled $232.1 million, of which $172.6 million was classified as available for sale. As of that date, $59.5 million was classified as held to maturity, with a fair value of $59.9 million. As of December 31, 2006, the portfolio of state and municipal obligations totaled $238.7 million, of which $198.3 million was classified as available for sale. As of that date, $40.4 million was classified as held to maturity, with a fair value of $40.4 million.

*Equity Securities.* As of December 31, 2007, the Company had $34.6 million in equity securities that included $33.8 million of auction rate preferred equity securities collateralized by FNMA and FHLMC preferred stock and $780,000 of common equity securities. The auction rate preferred equity securities consisted of three positions collateralized by FNMA preferred stock totaling $13.9 million and four positions collateralized by FHLMC preferred stock totaling $19.9 million. All of the auction rate preferred equity securities are rated AA-. The auction rate preferred equity securities are structured to be tendered at par, at the option of the investor, at auctions occurring every 90 days. The most recent auctions occurred in January of 2008 and the auctions were successful. However, the recent disruption in the financial and capital markets has increased the liquidity risk associated with auction rate preferred

equity securities. The next auctions are scheduled for April of 2008 and it is possible that there might not be any new investors and the Bank will be required to hold these securities. Each of the auction rate preferred equity securities contains provisions to deal with this event. The Bank will continue to receive dividend income and the auctions will continue to take place at future pre-established dates, but the fair value of the securities may become less than their carrying amounts. The dividend income related to both the common and auction rate preferred equity securities qualified for the Federal income tax dividend received deduction. As of December 31, 2007, there were no equity securities that were in a gross unrealized loss position.

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As of December 31, 2006, the Company had $1.1 million in equity securities, all of which were common equity securities.

Security Yields and Maturities Schedule

The following table sets forth certain information regarding the amortized cost, weighted average yields and contractual maturities of the Company s debt securities portfolio as of December 31, 2007. Actual maturities may differ from the contractual maturities presented, because borrowers may have the right to call or prepay certain investments. No tax-equivalent adjustments were made to the weighted average yields.

| | One Year or Less | | More than One Year to Five Years | | More than Five Years to Ten Years | | After Ten Years | | Total | |
|---|---|---|---|---|---|---|---|---|---|---|
| *(Dollars in thousands)* | **Amortized Cost** | **Weighted Average Yield** | **Amortized Cost** | **Weighted Average Yield** | **Amortized Cost** | **Weighted Average Yield** | **Amortized Cost** | **Weighted Average Yield** | **Amortized Cost** | **Weighted Average Yield** |
| Available for sale debt securities: | | | | | | | | | | |
| U.S. Government agency and GSE | $ 52,295 | 4.00% | $ 34,585 | 4.18% | $22,820 | 5.54% | $ 49,220 | 5.12% | $158,920 | 4.61% |
| MBS | 11,091 | 3.96 | 106,344 | 4.36 | 52,882 | 4.26 | 127,481 | 5.15 | 297,798 | 4.67 |
| ABS | | | | | 808 | 5.06 | 33,307 | 5.97 | 34,115 | 5.95 |
| State and municipal | 50,291 | 3.46 | 101,367 | 3.54 | 17,777 | 3.97 | 1,859 | 3.53 | 171,294 | 3.56 |
| Total | $113,677 | 3.76% | $242,296 | 3.99% | $94,287 | 4.52% | $211,867 | 5.26% | $662,127 | 4.43% |
| Held to maturity debt securities: | | | | | | | | | | |
| State and municipal | $ 49,542 | 3.70% | $ 7,285 | 4.35% | $ 1,917 | 4.97% | $ 735 | 5.32% | $ 59,479 | 3.84% |

Other-Than-Temporary Impairment

Management evaluates securities for other-than-temporary impairment on a quarterly basis, or as economic or market concerns warrant such evaluation. Consideration is given to (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, and (3) the intent and ability of the Company to retain its investment in the issuer for a period of time sufficient to allow for recovery in fair value. The net unrealized losses on securities available for sale amounted to $815,000 and $11.1 million as of December 31, 2007 and 2006, respectively. The unrealized losses present do not reflect deterioration in the credit worthiness of the issuing securities and resulted primarily from fluctuations in market interest rates. The Company has the intent and ability to hold these securities until their fair value recovers to their amortized cost; therefore, management has determined that the securities that were in an unrealized loss position as of December 31, 2007 and 2006 represent only temporary declines in fair value.

**Lending Activities**

Loans Held for Sale and Commercial-Related Loan Sale Results

Loans held for sale (not included in the subsequent loan portfolio composition table) totaled $906,000 and $992,000 as of December 31, 2007 and 2006, respectively, all of which were residential real estate loans.

The Company sells 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 $338.1 million as of December 31, 2007 from $355.2 million as of December 31, 2006. During 2007, the Company increased its retention of newly originated residential mortgages, which resulted in a drop in the sold and serviced residential real estate portfolio as run-off outpaced new sold and serviced loan volumes.

During the year ended December 31, 2005, the Company transferred $169.0 million in commercial-related loans to held for sale, at an estimated fair value less costs to sell of $132.3 million. As a result, $36.7 million in commercial-related charge-offs were recorded. In the second half of 2005, the Company realized a net gain of $9.4 million on the ultimate sale or settlement of commercial-related loans held for sale.

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Loan Portfolio Composition

Loans outstanding, excluding loans held for sale and including net unearned income and net deferred fees and costs, are summarized as follows as of December 31:

| *(Dollars in thousands)* | **2007** | **2006** | **2005** | **2004** | **2003** |
|---|---|---|---|---|---|
| Commercial | $ 136,780 | $ 105,806 | $ 116,444 | $ 203,178 | $ 248,313 |
| Commercial real estate | 245,797 | 243,966 | 264,727 | 343,532 | 369,712 |
| Agricultural | 47,367 | 56,808 | 75,018 | 195,185 | 235,199 |
| Residential real estate | 166,863 | 163,243 | 168,498 | 178,282 | 181,479 |
| Consumer indirect | 134,977 | 106,443 | 85,237 | 67,993 | 67,156 |
| Consumer direct and home equity | 232,389 | 250,216 | 282,397 | 264,235 | 238,577 |
| Total loans | 964,173 | 926,482 | 992,321 | 1,252,405 | 1,340,436 |
| Allowance for loan losses | (15,521) | (17,048) | (20,231) | (39,186) | (29,064) |
| Total loans, net | $ 948,652 | $ 909,434 | $ 972,090 | $ 1,213,219 | $ 1,311,372 |

Total loans increased 4.1%, or $37.7 million, to $964.2 million as of December 31, 2007 from $926.5 million as of December 31, 2006, primarily the result of commercial and consumer indirect loan origination efforts, offset by a reduction in agricultural loans and the consumer direct and home equity category.

Commercial loans increased $31.0 million, or 29.3% in 2007, while commercial real estate loans remained relatively flat on a year-over-year basis when 2007 is compared to 2006 As of December 31, 2007, commercial loans totaled $136.8 million, representing 14.2% of total loans, and commercial real estate loans totaled $245.8 million, representing 25.5% of total loans. As of December 31, 2007, agricultural loans, which include agricultural real estate loans, totaled $47.4 million or 4.9% of the total loan portfolio, down $9.4 million from 2006. Collectively, commercial-related loans comprised $23.4 million or 62.0% of the increase in total loans.

As of December 31, 2007, residential real estate loans totaled $166.9 million, a $3.6 million or 2.2% increase from $163.2 million as of December 31, 2006. Residential real estate loans represented 17.3% of the total loan portfolio as of year-end 2007 compared to 17.6% as of year-end 2006. This category of loans increased as certain residential mortgages were added to the portfolio rather than being sold to the secondary market. The Company does not engage in sub-prime or other high-risk residential mortgage lending as a line-of-business.

The consumer indirect portfolio increased $28.6 million to $135.0 million, or 14.0% of total loans, as of December 31, 2007 from $106.4 million as of December 31, 2006. During 2007, the Company expanded its relationships with franchised new car dealers and selectively originated a mix of approximately 41% new and 59% used automobile indirect loans.

The consumer direct and home equity category totaled $232.4 and $250.2 million as of December 31, 2007 and 2006, respectively. Consumer direct and home equity products represented 24.1% of the total loan portfolio as of year-end 2007. A firm pricing and underwriting discipline was maintained on direct consumer and home equity products, which led to slower loan originations and run-off outpacing growth in these product categories.

Parts of the country have experienced a significant decline in real estate values that has led, in some cases, to the debt on the real estate exceeding the value of the real estate. The Western and Central New York State markets the Company serves have not generally experienced, to this point, such conditions. Should deterioration in real estate values in the markets we serve occur, the value and liquidity of real estate securing the Company s loans could become impaired. While the Company is not engaged in the business of sub-prime lending, a decline in the value of residential or commercial real estate could have a material adverse effect on the value of property used as collateral for our loans.

Adverse changes in the economy may have a negative effect on the ability of our borrowers to make timely loan payments, which could have a negative impact on our earnings.

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Nonperforming Assets

The following table sets forth information regarding nonperforming assets as of December 31:

| *(Dollars in thousands)* | **2007** | **2006** | **2005** | **2004** | **2003** |
|---|---|---|---|---|---|
| Nonaccruing loans (1) | | | | | |
| Commercial | $ 827 | $ 2,205 | $ 4,389 | $ 20,576 | $ 12,983 |
| Commercial real estate | 2,825 | 4,661 | 6,985 | 15,954 | 11,745 |
| Agricultural | 481 | 4,836 | 2,786 | 13,165 | 18,870 |
| Residential real estate | 2,987 | 3,127 | 2,615 | 1,473 | 2,138 |
| Consumer indirect | 278 | 166 | 63 | 74 | 186 |
| Consumer and home equity | 677 | 842 | 923 | 704 | 750 |
| Total nonaccruing loans | 8,075 | 15,837 | 17,761 | 51,946 | 46,672 |
| Restructured loans | | | | | 3,069 |
| Accruing loans 90 days or more delinquent | 2 | 3 | 276 | 2,018 | 1,709 |
| Total nonperforming loans | 8,077 | 15,840 | 18,037 | 53,964 | 51,450 |
| Other real estate owned ( ORE ) | 1,421 | 1,203 | 1,099 | 1,196 | 653 |
| Total nonperforming loans and other real estate owned | 9,498 | 17,043 | 19,136 | 55,160 | 52,103 |
| Nonaccruing commercial-related loans held for sale | | | 577 | | |
| Total nonperforming assets | $ 9,498 | $ 17,043 | $ 19,713 | $ 55,160 | $ 52,103 |
| Total nonperforming loans to total loans (2) | 0.84% | 1.71% | 1.82% | 4.31% | 3.84% |
| Total nonperforming loans and ORE to total loans and ORE (2) | 0.98% | 1.84% | 1.93% | 4.40% | 3.89% |
| Total nonperforming assets to total assets | 0.51% | 0.89% | 0.97% | 2.56% | 2.40% |

(1) Although loans are generally placed on nonaccruing status

when they become 90 days or more past due they may be placed on nonaccruing status earlier if they have been identified by the Company as presenting uncertainty with respect to the collectibility of interest or principal. Loans past due 90 days or more may remain on accruing status if they are both well secured and in the process of collection.

(2) Ratios exclude nonaccruing commercial-related loans held for sale from nonperforming loans and exclude loans held for sale from total loans.

Nonperforming loans totaled $8.1 million as of December 31, 2007, down from $15.8 million as of December 31, 2006. The majority of the decline was from a reduction in nonaccruing commercial-related loans, which was offset by a $218,000 increase in ORE to $1.4 million as of December 31, 2007, compared to $1.2 million as of December 31, 2006.

The following table details nonaccruing loan activity for the year ended December 31:

| *(Dollars in thousands)* | **2007** | **2006** |
|---|---|---|
| Nonaccruing loans as of beginning of year | $ 15,837 | $ 17,761 |
| Additions | 9,554 | 16,856 |
| Payments | (5,166) | (10,193) |
| Charge-offs | (3,173) | (3,497) |
| Returned to accruing status | (6,534) | (2,588) |
| Transferred to other real estate or repossessed assets | (2,443) | (2,502) |
| Nonaccruing loans as of end of year | $ 8,075 | $ 15,837 |

During 2007, the Company received $5.2 million in payments on nonaccruing loans and $6.5 million of nonaccruing loans were returned to accruing status, including a single $3.1 million agricultural relationship that returned to accruing status during the second quarter of 2007 as a result of improved cash flow from the increase

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in the price of milk. In addition, the Company charged-off $3.2 million in nonaccruing loans during 2007 and transferred $2.4 million in loans to other real estate or repossessed assets.

Approximately $2.3 million, or 27.9%, of the $8.1 million in nonaccruing loans as of December 31, 2007 were current with respect to payment of principal and interest, but were classified as nonaccruing because reasonable doubt existed with respect to the future collectibility of principal and interest in accordance with the original contractual terms. For nonaccruing loans outstanding as of December 31, 2007, the amount of interest income forgone on nonaccruing loans totaled $713,000 for the year ended December 31, 2007.

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. The Company identified $16.6 million and $16.2 million in loans that continued to accrue interest which were classified as substandard as of December 31, 2007 and 2006, respectively.

The following table summarizes loan delinquencies (excluding past due nonaccruing loans) as of December 31:

| *(Dollars in thousands)* | **2007** | | **2006** | |
|---|---|---|---|---|
| | **60-89 Days** | **Accruing Loans 90 Days or More** | **60-89 Days** | **Accruing Loans 90 Days or More** |
| Commercial | $ | $ | $ 7 | $ |
| Commercial real estate | | | 30 | |
| Consumer indirect | 83 | | 50 | |
| Consumer and home equity | 172 | 2 | 98 | 3 |
| | $ 255 | $ 2 | $ 185 | $ 3 |

Analysis of Allowance for Loan Losses

The allowance for loan losses represents the estimated amount of probable credit losses inherent in the Company s loan portfolio. The Company performs periodic, systematic reviews of the Bank s loan portfolio to estimate probable losses in the respective loan portfolios. In addition, the Company regularly evaluates prevailing economic and business conditions, industry concentrations, changes in the size and characteristics of the portfolio and other pertinent factors. The process used by the Company to determine the overall allowance for loan losses is based on this analysis. Based on this analysis the Company believes the allowance for loan losses is adequate as of December 31, 2007.

Assessing the adequacy of the allowance for loan losses involves substantial uncertainties and is based upon management s evaluation of the amounts required to meet estimated charge-offs in the loan portfolio after weighing various factors. The adequacy of the allowance for loan losses is subject to ongoing management review. While management evaluates currently available information in establishing the allowance for loan losses, future adjustments to the allowance may be necessary if conditions differ substantially from the assumptions used in making the evaluations. In addition, various regulatory agencies, as an integral part of their examination process, periodically review a financial institution s allowance for loan losses and carrying amounts of other real estate owned. Such agencies may require the financial institution to recognize additions to the allowance based on their judgments about information available to them at the time of their examination.

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The following table sets forth an analysis of the activity in the allowance for loan losses for the years ended December 31:

| *(Dollars in thousands)* | **2007** | **2006** | **2005** | **2004** | **2003** |
|---|---|---|---|---|---|
| Allowance for loan losses as of beginning of year | $ 17,048 | $ 20,231 | $ 39,186 | $ 29,064 | $ 21,660 |
| Charge-offs (1): | | | | | |
| Commercial | 562 | 1,195 | 12,980 | 4,486 | 8,891 |
| Commercial real estate | 439 | 501 | 15,397 | 1,779 | 2,953 |
| Agricultural | 56 | 379 | 18,543 | 2,519 | 1,876 |
| Residential real estate | 319 | 278 | 56 | 227 | 150 |
| Consumer indirect | 988 | 532 | 775 | 759 | 759 |
| Consumer and home equity | 1,531 | 1,314 | 1,535 | 1,027 | 1,413 |
| Total charge-offs | 3,895 | 4,199 | 49,286 | 10,797 | 16,042 |
| Recoveries: | | | | | |
| Commercial | 972 | 1,417 | 864 | 598 | 525 |
| Commercial real estate | 216 | 132 | 280 | 103 | 35 |
| Agricultural | 168 | 389 | 57 | 39 | 3 |
| Residential real estate | 50 | 71 | 5 | 43 | 7 |
| Consumer indirect | 235 | 224 | 261 | 212 | 111 |
| Consumer and home equity | 611 | 625 | 332 | 248 | 239 |
| Total recoveries | 2,252 | 2,858 | 1,799 | 1,243 | 920 |
| Net charge-offs | 1,643 | 1,341 | 47,487 | 9,554 | 15,122 |
| (Credit) provision for loan losses | 116 | (1,842) | 28,532 | 19,676 | 22,526 |
| Allowance for loan losses as of end of year | $ 15,521 | $ 17,048 | $ 20,231 | $ 39,186 | $ 29,064 |
| Ratio of net charge-offs to total average loans | 0.18% | 0.14% | 4.27% | 0.74% | 1.11% |
| Ratio of allowance for loan losses to total loans (2) | 1.61% | 1.84% | 2.04% | 3.13% | 2.17% |
| Ratio of allowance for loans losses to nonperforming loans (2) | 192% | 108% | 112% | 73% | 56% |

(1) Included in charge-offs for the

year ended December 31, 2005 are $36.7 million in write-downs on commercial-related loans.

(2) Ratios exclude nonaccruing loans held for sale from nonperforming loans and loans held for sale from total loans.

Net charge-offs were $1.6 million and $1.3 million for the years ended December 31, 2007 and 2006, respectively. The ratio of net loan charge-offs to total average loans was 0.18% for the year ended December 31, 2007, compared to 0.14% for the same 2006 period. The Company s net charge-off experience increased in 2007 compared to 2006, due in part to the combination of an increase in charge-offs in the consumer-related portfolios (residential real estate, indirect, direct and home equity) and a decrease in commercial and agricultural recoveries. As of December 31, 2007, the Company s allowance for loan losses totaled $15.5 million, down $1.5 million from $17.0 million as of December 31, 2006. The allowance for loan losses represents the estimated probable losses inherent in the loan portfolio based on the Company s comprehensive assessment. This assessment resulted in a provision for loan losses of $116,000 for the year ended December 31, 2007. The allowance for loan losses as a percentage of total loans was 1.61% and 1.84% as of December 31, 2007 and 2006, respectively. The ratio of allowance for loan losses to nonperforming loans increased to 192% as of December 31, 2007 versus 108% as of December 31, 2006.

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Allocation of Allowance for Loan Losses

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.

| | **At December 31:** | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| *(Dollars in thousands)* | **2007** | | **2006** | | **2005** | | **2004** | | **2003** | |
| | Amount of Allowance for Loan Losses | Percent of Loans in Each Category to Total Loans | Amount of Allowance for Loan Losses | Percent of Loans in Each Category to Total Loans | Amount of Allowance for Loan Losses | Percent of Loans in Each Category to Total Loans | Amount of Allowance for Loan Losses | Percent of Loans in Each Category to Total Loans | Amount of Allowance for Loan Losses | Percent of Loans in Each Category to Total Loans |
| Commercial | $1,878 | 14.2% | $2,443 | 11.4% | $4,098 | 11.7% | $11,420 | 16.2% | $7,739 | 18.5% |
| Commercial real estate | 3,751 | 25.5 | 4,458 | 26.4 | 6,564 | 26.7 | 9,297 | 27.4 | 5,354 | 27.6 |
| Agricultural | 1,516 | 4.9 | 1,887 | 6.1 | 2,187 | 7.5 | 8,197 | 15.6 | 6,078 | 17.6 |
| Residential real estate | | | | | | | | | | |