FINANCIAL INSTITUTIONS INC
Form 10-K
March 18, 2013
Table of Contents

# UNITED STATES

# SECURITIES AND EXCHANGE COMMISSION

**Washington, D.C. 20549**

# Form 10-K

**(Mark One)**

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

**For the fiscal year ended December 31, 2012**

**OR**

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

**For the transition period from _________ to _________**

**Commission file number 000-26481**

# FINANCIAL INSTITUTIONS, INC.

**(Exact name of registrant as specified in its charter)**

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

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

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

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

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

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

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

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

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§ 229.405 of this chapter) is not contained herein, and will not be contained, to the best of the registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this form 10-K or any amendment to this Form 10-K. ¨

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

| | | | |
|---|---|---|---|
| Large accelerated filer | ¨ | Accelerated filer | x |
| Non-accelerated filer | ¨ | Smaller reporting company | ¨ |

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

The aggregate market value of the registrant s common stock, par value $0.01 per share, held by non-affiliates of the registrant, as computed by reference to the June 30, 2012 closing price reported by NASDAQ, was approximately $216,222,000.

As of March 1, 2013, there were outstanding, exclusive of treasury shares, 13,803,158 shares of the registrant s common stock.

**DOCUMENTS INCORPORATED BY REFERENCE**

Portions of the registrant s proxy statement for the 2013 Annual Meeting of Shareholders are incorporated by reference in Part III of this Annual Report on Form 10-K.

## TABLE OF CONTENTS


| | | PAGE |
|---|---|---|
| | **PART I** | |
| Item 1. | Business | 5 |
| Item 1A. | Risk Factors | 18 |
| Item 1B. | Unresolved Staff Comments | 25 |
| Item 2. | Properties | 25 |
| Item 3. | Legal Proceedings | 25 |
| Item 4. | Mine Safety Disclosures | 25 |
| | **PART II** | |
| Item 5. | Market for Registrant s Common Equity, Related Shareholder Matters and Issuer Purchases of Equity Securities | 26 |
| Item 6. | Selected Financial Data | 28 |
| Item 7. | Management s Discussion and Analysis of Financial Condition and Results of Operations | 32 |
| Item 7A. | Quantitative and Qualitative Disclosures About Market Risk | 56 |
| Item 8. | Financial Statements and Supplementary Data | 59 |
| Item 9. | Changes in and Disagreements with Accountants on Accounting and Financial Disclosure | 115 |
| Item 9A. | Controls and Procedures | 115 |
| Item 9B. | Other Information | 115 |
| | **PART III** | |
| Item 10. | Directors, Executive Officers and Corporate Governance | 116 |
| Item 11. | Executive Compensation | 116 |
| Item 12. | Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters | 116 |
| Item 13. | Certain Relationships and Related Transactions, and Director Independence | 116 |
| Item 14. | Principal Accountant Fees and Services | 116 |
| | **PART IV** | |
| Item 15. | Exhibits and Financial Statement Schedules | 117 |
| | Signatures | 120 |

Table of Contents

**PART I**

**FORWARD LOOKING INFORMATION**

Statements in this Annual Report on Form 10-K that are based on other than historical data are forward-looking within the meaning of the Private Securities Litigation Reform Act of 1995. Forward-looking statements provide current expectations or forecasts of future events and include, among others:

- statements with respect to the beliefs, plans, objectives, goals, guidelines, expectations, anticipations, and future financial condition, results of operations and performance of Financial Institutions, Inc. ( the parent or FII ) and its subsidiaries (collectively the Company, we, our, us ); and
- statements preceded by, followed by or that include the words may, could, should, would, believe, anticipate, estimate, ex intend, plan, projects, or similar expressions.

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

- If we experience greater credit losses than anticipated, earnings may be adversely impacted;
- Geographic concentration may unfavorably impact our operations;
- We depend on the accuracy and completeness of information about or from customers and counterparties;
- We are subject to environmental liability risk associated with our lending activities;
- Our indirect lending involves risk elements in addition to normal credit risk;
- We are highly regulated and may be adversely affected by changes in banking laws, regulations and regulatory practices;
- Ongoing financial reform legislation may result in new regulations that could require us to maintain higher capital levels and/or increase our costs of operations or limit certain activities or lines of business;
- New or changing tax, accounting, and regulatory rules and interpretations could significantly impact our strategic initiatives, results of operations, cash flows, and financial condition;
- If our security systems, or those of merchants, merchant acquirers or other third parties containing information about customers, are compromised, we may be subject to liability and damage to our reputation;

We could be subject to losses if we fail to properly safeguard sensitive and confidential information;

Our information systems may experience an interruption or breach in security;

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

We may not be able to attract and retain skilled people and our ongoing leadership transition may be unsuccessful;

The potential for business interruption exists throughout our organization;

Acquisitions may disrupt our business and dilute shareholder value;

We are subject to interest rate risk;

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

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

The soundness of other financial institutions could adversely affect us;

We may be required to recognize an impairment of goodwill:

We operate in a highly competitive industry and market area;

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

Liquidity is essential to our businesses;

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

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

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

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

Table of Contents

- We may not pay dividends on our common stock; and
- Our certificate of incorporation, our bylaws, and certain banking laws contain anti-takeover provisions.

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

Table of Contents

**ITEM 1. BUSINESS**
**GENERAL**

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

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

**Our Business Strategy**

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

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

**MARKET AREAS AND COMPETITION**

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

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

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

Table of Contents

The following table presents the Bank s market share percentage for total deposits as of June 30, 2012, in each county where we have operations. The table also indicates the ranking by deposit size in each market. All information in the table was obtained from SNL Financial of Charlottesville, Virginia, which compiles deposit data published by the FDIC as of June 30, 2012 and updates the information for any bank mergers and acquisitions completed subsequent to the reporting date.

| County | Market Share | Market Rank | Number of Branches |
|---|---|---|---|
| Allegany | 6.6% | 4 | 1 |
| Cattaraugus | 24.0% | 2 | 5 |
| Cayuga | 3.6% | 11 | 1 |
| Chautauqua | 1.2% | 9 | 1 |
| Chemung | 17.1% | 3 | 3 |
| Erie | 0.4% | 12 | 3 |
| Genesee | 20.4% | 3 | 5 |
| Livingston | 30.7% | 1 | 5 |
| Monroe | 1.6% | 9 | 5 |
| Ontario | 13.9% | 3 | 5 |
| Orleans | 23.7% | 2 | 2 |
| Seneca | 20.7% | 2 | 2 |
| Steuben | 28.6% | 1 | 7 |
| Wyoming | 46.8% | 1 | 5 |
| Yates | 38.6% | 1 | 2 |

**INVESTMENT ACTIVITIES**

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

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

U.S. treasury securities;

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

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

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

Certain creditworthy un-rated securities issued by municipalities;

Certificates of deposit;

Equity securities at the holding company level; and

Limited partnership investments in Small Business Investment Companies.

Table of Contents

**LENDING ACTIVITIES**

**General**

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

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

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

**Commercial Business and Commercial Mortgage Lending**

We originate commercial business loans in our primary market areas and underwrite them based on the borrower s ability to service the loan from operating income. We offer a broad range of commercial lending products, including term loans and lines of credit. Short and medium-term commercial loans, primarily collateralized, are made available to businesses for working capital (including inventory and receivables), business expansion (including acquisition of real estate, expansion and improvements) and the purchase of equipment. Commercial business loans are offered to the agricultural industry for short-term crop production, farm equipment and livestock financing. As a general practice, where possible, a collateral lien is placed on any available real estate, equipment or other assets owned by the borrower and a personal guarantee of the owner is obtained. As of December 31, 2012, $84.3 million, or 33%, of our aggregate commercial business loan portfolio were at fixed rates, while $174.4 million, or 67%, were at variable rates.

We also offer commercial mortgage loans to finance the purchase of real property, which generally consists of real estate with completed structures and, to a smaller extent, agricultural real estate financing. Commercial mortgage loans are secured by first liens on the real estate and are typically amortized over a 10 to 20 year period. The underwriting analysis includes credit verification, appraisals and a review of the borrower s financial condition and repayment capacity. As of December 31, 2012, $142.4 million, or 34%, of our aggregate commercial mortgage portfolio were at fixed rates, while $270.9 million, or 66%, were at variable rates.

We utilize government loan guarantee programs where available and appropriate.

**Government Guarantee Programs**

We participate in government loan guarantee programs offered by the SBA, U.S. Department of Agriculture, Rural Economic and Community Development and Farm Service Agency, among others. As of December 31, 2012, we had loans with an aggregate principal balance of $62.8 million that were covered by guarantees under these programs. The guarantees typically only cover a certain percentage of these loans. By participating in these programs, we are able to broaden our base of borrowers while minimizing credit risk.

**Residential Mortgage Lending**

We originate fixed and variable rate one-to-four family residential mortgages collateralized by owner-occupied properties located in our market areas. We offer a variety of real estate loan products, which are generally amortized over periods of up to 30 years. Loans collateralized by one-to-four family residential real estate generally have been originated in amounts of no more than 80% of appraised value or have mortgage insurance. Mortgage title insurance and hazard insurance are normally required. We sell certain one-to-four family residential mortgages to the secondary mortgage market and typically retain the right to service the mortgages. To assure maximum salability of the residential loan products for possible resale, we have formally adopted the underwriting, appraisal, and servicing guidelines of the FHLMC as part of our standard loan policy. As of December 31, 2012, our residential mortgage servicing portfolio totaled $273.3 million, the majority of which has been sold to FHLMC. As of December 31, 2012, our residential mortgage loan portfolio totaled $133.5 million, or 8% of our total loan portfolio. We do not engage in sub-prime or other high-risk residential mortgage lending as a line-of-business.

**Consumer Lending**

We offer a variety of loan products to our consumer customers, including home equity loans and lines of credit, automobile loans, secured installment loans and various other types of secured and unsecured personal loans. At December 31, 2012, outstanding consumer loan balances were concentrated in indirect automobile loans and home equity products.

We originate indirect consumer loans for a mix of new and used vehicles through franchised new car dealers. The consumer indirect loan portfolio is primarily comprised of loans with terms that typically range from 36 to 84 months. We have expanded our relationships with franchised new car dealers in Western, Central and the Capital District of New York, and Northern Pennsylvania. As of December 31, 2012, our consumer indirect portfolio totaled $586.8 million, or 34% of our total loan portfolio. The consumer indirect loan portfolio is primarily fixed rate loans with relatively short durations.

We also originate, independently of the indirect loans described above, consumer automobile loans, recreational vehicle loans, boat loans, 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, 2012, $152.9 million, or 53%, of our home equity portfolio was at fixed rates, while $133.7 million, or 47%, was at variable rates. Approximately 69% of the loans in our home equity portfolio are first lien positions at December 31, 2012. The other consumer portfolio totaled $26.8 million as of December 31, 2012, all but $1.3 million of which were fixed rate loans.

**Credit Administration**

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

Our credit objectives are as follows:

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

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

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

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

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

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

Table of Contents

**Allowance for Loan Losses**

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

- Specific allocations for individually analyzed credits;
- Risk assessment process;
- Historical net charge-off experience;
- Evaluation of the loan portfolio with loan reviews;
- Levels and trends in delinquent and non-accruing loans;
- Trends in volume and terms of loans;
- Effects of changes in lending policy;
- Experience, ability and depth of management;
- National and local economic trends and conditions;
- Concentrations of credit;
- Interest rate environment;
- Customer leverage;
- Information (availability of timely financial information); and
- Collateral values.

Our methodology in the estimation of the allowance for loan losses includes the following:

1. Impaired commercial business and commercial mortgage loans, generally in excess of $50 thousand are reviewed individually and assigned a specific loss allowance, if considered necessary, in accordance with U.S. generally accepted accounting principles ( GAAP ).

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

3. The retail loan portfolio is segmented into the following types of loans: residential real estate, home equity (home equity loans and lines of credit), consumer indirect and other consumer. Allowance allocations for the real estate related loan portfolios (residential and home equity) are based on the average loss experience for the previous eight quarters, supplemented with qualitative factors similar to the elements described above. Allowance allocations for the consumer indirect and other consumer portfolios are based on vintage analyses performed with historical loss experience at 36 months and 24 months aging, respectively. The allocations on these portfolios are also supplemented with qualitative factors.

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

Table of Contents

## SOURCES OF FUNDS

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

### Deposits

We maintain a full range of deposit products and accounts to meet the needs of the residents and businesses in our primary service area. Products include an array of checking and savings account programs for individuals and businesses, including money market accounts, certificates of deposit, sweep investment capabilities as well as Individual Retirement Accounts and other qualified plan accounts. We rely primarily on competitive pricing of our deposit products, customer service and long-standing relationships with customers to attract and retain these deposits and seek to make our services convenient to the community by offering 24-hour ATM access at some of our facilities, access to other ATM networks available at other local financial institutions and retail establishments, and telephone banking services including account inquiry and balance transfers. We also take advantage of the use of technology by allowing our customers banking access via the Internet and various advanced systems for cash management for our business customers.

We had no traditional brokered deposits at December 31, 2012; however, we do participate in the Certificate of Deposit Account Registry Service ( CDARS ) and Insured Cash Sweep ( ICS ) programs, which enable depositors to receive FDIC insurance coverage for deposits otherwise exceeding the maximum insurable amount. Through these programs, deposits in excess of the maximum insurable amount are placed with multiple participating financial institutions. Reciprocal CDARS deposits and ICS deposits totaled $61.0 million and $18.1 million, respectively, at December 31, 2012.

### Borrowings

We have access to a variety of borrowing sources and use both short-term and long-term borrowings to support our asset base. Borrowings from time-to-time include federal funds purchased, securities sold under agreements to repurchase and FHLB advances. We also offer customers a deposit account that sweeps balances in excess of an agreed upon target amount into overnight repurchase agreements.

## OPERATING SEGMENTS

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

## OTHER INFORMATION

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

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

Table of Contents

**SUPERVISION AND REGULATION**

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

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

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

The Bank Holding Company Act generally prohibits a bank holding company from acquiring direct or indirect ownership or control of more than 5% of the voting shares of any company which is not a bank or bank holding company, or from engaging directly or indirectly in activities other than those of banking, managing or controlling banks, or providing services for its subsidiaries. The principal exceptions to these prohibitions involve certain non-bank activities which, by statute or by FRB regulation or order, have been identified as activities closely related to the business of banking or managing or controlling banks. The list of activities permitted by the FRB includes, among other things: lending; operating a savings institution, mortgage company, finance company, credit card company or factoring company; performing certain data processing operations; providing certain investment and financial advice; underwriting and acting as an insurance agent for certain types of credit related insurance; leasing property on a full-payout, non-operating basis; selling money orders, travelers checks and United States Savings Bonds; real estate and personal property appraising; providing tax planning and preparation services; and, subject to certain limitations, providing securities brokerage services for customers. These activities may also be affected by federal legislation.

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

**Broker-Dealer and Related Regulatory Supervision.** FSIS is a member of, and is subject to the regulatory supervision of, the Financial Industry Regulatory Authority. Areas subject to this regulatory review include compliance with trading rules, financial reporting, investment suitability for clients, and compliance with stock exchange rules and regulations. FSIS is also subject to the supervision of the Investor Protection Bureau of the New York Attorney General s Office for its investment advisory business.

**Depository Institution Regulation.** Our bank subsidiary is subject to regulation by the Federal Deposit Insurance Corporation ( FDIC ). This regulatory structure includes:

- Real estate lending standards, which provide guidelines concerning loan-to-value ratios for various types of real estate loans;

Risk-based capital rules, including accounting for interest rate risk, concentration of credit risk and the risks posed by non-traditional activities;

Rules requiring depository institutions to develop and implement internal procedures to evaluate and control credit and settlement exposure to their correspondent banks;

Rules restricting types and amounts of equity investments; and

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

Table of Contents

**The Dodd-Frank Act.** The Dodd-Frank Act, enacted in July 2010, significantly changed the bank regulatory structure and affected the lending, investment, trading and operating activities of financial institutions and their holding companies. The Dodd-Frank Act (as amended) implements far-reaching changes across the financial regulatory landscape, including provisions that, among other things, has or will:

- Centralized responsibility for consumer financial protection by creating a new agency, the Bureau of Consumer Financial Protection, with broad rulemaking, supervision and enforcement authority for a wide range of consumer protection laws that apply to all banks and certain others, including the examination and enforcement powers with respect to any bank with more than $10 billion in assets.
- Require new capital rules and apply the same leverage and risk-based capital requirements that apply to insured depository institutions to most bank holding companies.
- Changed the assessment base for federal deposit insurance from the amount of insured deposits to consolidated average assets less tangible capital. As a result, this change generally imposes more deposit insurance cost on institutions with assets of $10 billion or more.
- Increase the minimum ratio of net worth to insured deposits of the Deposit Insurance Fund from 1.15% to 1.35% and require the FDIC, in setting assessments, to offset the effect of the increase on institutions with assets of less than $10 billion.
- Provide for new disclosure and other requirements relating to executive compensation and corporate governance, including guidelines or regulations on incentive-based compensation and a prohibition on compensation arrangements that encourage inappropriate risks or that could provide excessive compensation.
- Repealed the federal prohibitions on the payment of interest on commercial demand deposits, thereby permitting depository institutions to pay interest on business transaction and other accounts.
- Allow de novo interstate branching by banks.
- Increased the authority of the FRB to examine us and our non-bank subsidiary.
- Required all bank holding companies to serve as a source of financial strength to their depository institution subsidiaries in the event such subsidiaries suffer from financial distress.

Many aspects of the Dodd-Frank Act are subject to rulemaking and will take effect over several years, making it difficult to anticipate the overall financial impact on us and the financial services industry more generally. Provisions in the legislation may require us to maintain higher capital levels and/or increase our cost of operations and limit certain activities or lines of business.

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

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

least 50% of which must consist of Tier 1 capital.

Risk-based capital ratios are calculated by dividing Tier 1 and total capital by risk-weighted assets. Assets and off-balance sheet exposures are assigned to one of four categories of risk-weights, based primarily on relative credit risk. For bank holding companies, generally the minimum Tier 1 risk-based capital ratio is 4% and the minimum total risk-based capital ratio is 8%. Our Tier 1 and total risk-based capital ratios under these guidelines at December 31, 2012 were 10.70% and 11.96%, respectively.

The FRB s leverage capital guidelines establish a minimum leverage ratio determined by dividing Tier 1 capital by adjusted average total assets. The minimum leverage ratio is 3% for bank holding companies that meet certain specified criteria, including having the highest regulatory rating. All other bank holding companies generally are required to maintain a leverage ratio of at least 4%. At December 31, 2012, we had a leverage ratio of 7.70%. See also the section titled Capital Resources in Part II, Item 7, Management s Discussion and Analysis of Financial Condition and Results of Operations and Note 11, Regulatory Matters, of the notes to consolidated financial statements, included in this Annual Report on Form 10-K.

Table of Contents

In June 2012, the U.S. federal banking agencies issued three notices of proposed rulemaking that would revise and replace the current regulatory capital rules. The proposals were initially intended to be effective on January 1, 2013, but the agencies have deferred implementation due to the volume of comments related to the proposed rules. In the Basel III notice of proposed rulemaking, the agencies proposal included the implementation of a new common equity Tier 1 minimum capital requirement and a higher minimum Tier 1 capital requirement. Common equity is the highest quality equity and most loss absorbing form of capital and establishes the base of Tier 1 common equity as adjusted for minority interests and various deductions. The minimum Tier 1 common equity ratio under Basel III is 4.5%. Depending on the final form of the Basel III capital standards, the outcome will likely result in a higher capital requirement, greater volatility in regulatory capital and the elimination of trust preferred instruments in regulatory capital. It is expected that final rules will be issued in 2013.

Future rulemaking and regulatory changes on capital requirements may impact the Company as it continues to grow and evaluate M&A activity.

**Prompt Corrective Action.** The Federal Deposit Insurance Corporation Improvement Act of 1991, among other things, identifies five capital categories for insured depository institutions (well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized and critically undercapitalized) and requires the respective federal bank regulatory agencies to implement systems for prompt corrective action for insured depository institutions that do not meet minimum capital requirements within these categories. This act imposes progressively more restrictive constraints on operations, management and capital distributions, depending on the category in which an institution is classified. Failure to meet the capital guidelines could also subject a banking institution to capital raising requirements. An undercapitalized bank must develop a capital restoration plan and its parent holding company must guarantee that bank s compliance with the plan. The liability of the parent holding company under any such guarantee is limited to the lesser of five percent of the bank s assets at the time it became undercapitalized or the amount needed to comply with the plan. Furthermore, in the event of the bankruptcy of the parent holding company, such guarantee would take priority over the parent s general unsecured creditors. In addition, the Federal Deposit Insurance Corporation Improvement Act requires the various regulatory agencies to prescribe certain non-capital standards for safety and soundness relating generally to operations and management, asset quality and executive compensation and permits regulatory action against a financial institution that does not meet these standards.

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

As of December 31, 2012, our subsidiary bank met the requirements to be classified as well-capitalized .

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

Our primary source for cash dividends is the dividends we receive from our subsidiary bank. Our bank is subject to various regulatory policies and requirements relating to the payment of dividends, including requirements to maintain capital above regulatory minimums. Approval of the New York State Department of Financial Services is required prior to paying a dividend if the dividend declared by the Bank exceeds the sum of the Bank s net profits for that year and its retained net profits for the preceding two calendar years.

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

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

Table of Contents

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

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

DIF-insured institutions pay a Financing Corporation ( FICO ) assessment in order to fund the interest on bonds issued in the 1980s in connection with the failures in the thrift industry. For the fourth quarter of 2012, the FICO assessment was equal to 0.64 basis points computed on assets as required by the Dodd-Frank Act. These assessments will continue until the bonds mature in 2019.

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

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

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

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

**Interstate Branching.** Pursuant to the Dodd-Frank Act, national and state-chartered banks may open an initial branch in a state other than its home state (e.g., a host state) by establishing a de novo branch at any location in such host state at which a bank chartered in such host state could establish a branch. Applications to establish such branches must still be filed with the appropriate primary federal regulator.

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

**Anti-Terrorism Legislation.** The Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act ( USA Patriot Act ), enacted in 2001:

- prohibits banks from providing correspondent accounts directly to foreign shell banks;

- imposes due diligence requirements on banks opening or holding accounts for foreign financial institutions or wealthy foreign individuals;

- requires financial institutions to establish an anti-money-laundering ( AML ) compliance program; and

- generally eliminates civil liability for persons who file suspicious activity reports.

The USA Patriot Act also increases governmental powers to investigate terrorism, including expanded government access to account records. The Department of the Treasury is empowered to administer and make rules to implement the Act, which to some degree, affects our record-keeping and reporting expenses. Should the Bank s AML compliance program be deemed insufficient by federal regulators, we would not be able to grow through acquiring other institutions or opening de novo branches.

Table of Contents

**Volcker Rule.** The Dodd-Frank Act prohibits insured depository institutions and their holding companies from engaging in proprietary trading except in limited circumstances, and prohibits them from owning equity interests in excess of three percent (3%) of Tier 1 Capital in private equity and hedge funds (known as the Volcker Rule ). The Federal Reserve released a final rule on February 9, 2011 (effective on April 1, 2011) which requires a banking entity, a term that is defined to include bank holding companies like the parent, to bring its proprietary trading activities and investments into compliance with the Dodd-Frank Act restrictions no later than two years after the earlier of: (1) July 21, 2012, or (2) 12 months after the date on which interagency final rules are adopted. Pursuant to the compliance date final rule, banking entities are permitted to request an extension of this timeframe from the Federal Reserve. On October 11, 2011, the federal banking agencies released for comment proposed regulations implementing the Volcker Rule. The public comment period closed on February 13, 2012 and a final rule has not yet been published. The parent will be reviewing the implications of the interagency rules on its investments once those rules are issued and will plan for any adjustments of its activities or its holdings in order to be in compliance by the announced compliance date.

**Ability-to-Repay and Qualified Mortgage Rule.** Pursuant to the Dodd Frank Act, the CFPB issued a final rule on January 10, 2013 (effective on January 10, 2014), amending Regulation Z as implemented by the Truth in Lending Act, requiring mortgage lenders to make a reasonable and good faith determination based on verified and documented information that a consumer applying for a mortgage loan has a reasonable ability to repay the loan according to its terms. Mortgage lenders are required to determine consumers ability to repay in one of two ways. The first alternative requires the mortgage lender to consider the following eight underwriting factors when making the credit decision: (1) current or reasonably expected income or assets; (2) current employment status; (3) the monthly payment on the covered transaction; (4) the monthly payment on any simultaneous loan; (5) the monthly payment for mortgage-related obligations; (6) current debt obligations, alimony, and child support; (7) the monthly debt-to-income ratio or residual income; and (8) credit history. Alternatively, the mortgage lender can originate qualified mortgages, which are entitled to a presumption that the creditor making the loan satisfied the ability-to-repay requirements. In general, a qualified mortgage is a mortgage loan without negative amortization, interest-only payments, balloon payments, or terms exceeding 30 years. In addition, to be a qualified mortgage the points and fees paid by a consumer cannot exceed 3% of the total loan amount. Qualified mortgages that are higher-priced (e.g. subprime loans) garner a rebuttable presumption of compliance with the ability-to-repay rules, while qualified mortgages that are not higher-priced (e.g. prime loans) are given a safe harbor of compliance.

**Incentive Compensation Policies and Restrictions.** In July 2010, the federal banking agencies issued guidance that applies to all banking organizations supervised by the agencies (thereby including both the Parent Company and the Bank). Pursuant to the guidance, to be consistent with safety and soundness principles, a banking organization s incentive compensation arrangements should: (1) provide employees with incentives that appropriately balance risk and reward; (2) be compatible with effective controls and risk management; and (3) be supported by strong corporate governance including active and effective oversight by the banking organization s board of directors. Monitoring methods and processes used by a banking organization should be commensurate with the size and complexity of the organization and its use of incentive compensation.

In addition, in March 2011, the federal banking agencies, along with the Federal Housing Finance Agency, and the SEC, released a proposed rule intended to ensure that regulated financial institutions design their incentive compensation arrangements to account for risk. Specifically, the proposed rule would require compensation practices at the Parent Company and at the Bank to be consistent with the following principles: (1) compensation arrangements appropriately balance risk and financial reward; (2) such arrangements are compatible with effective controls and risk management; and (3) such arrangements are supported by strong corporate governance. In addition, financial institutions with $1 billion or more in assets would be required to have policies and procedures to ensure compliance with the rule and would be required to submit annual reports to their primary federal regulator. The comment period has closed but a final rule has not yet been published.

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

- 15 -

**Consumer Laws and Regulations.** In addition to the laws and regulations discussed herein, the Bank is also subject to certain consumer laws and regulations that are designed to protect consumers in transactions with banks. While the list set forth herein is not exhaustive, these laws and regulations include, among others, the Truth in Lending Act, the Truth in Savings Act, the Electronic Funds Transfer Act, the Expedited Funds Availability Act, the Equal Credit Opportunity Act, the Fair Housing Act, the Home Mortgage Disclosure Act and the Real Estate Settlement Procedures Act. These laws and regulations mandate certain disclosure requirements and regulate the manner in which financial institutions must deal with customers when taking deposits or making loans to such customers. The Bank must comply with the applicable provisions of these consumer protection laws and regulations as part of its ongoing customer relations. The Check Clearing for the 21st Century Act (the Check 21 Act ), which became effective on October 28, 2004, creates a new negotiable instrument, called a substitute check , which banks are required to accept as the legal equivalent of a paper check if it meets the requirements of the Check 21 Act. The Check 21 Act is designed to facilitate check truncation, to foster innovation in the check payment system, and to improve the payment system by shortening processing times and reducing the volume of paper checks.

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

**Impact of Inflation and Changing Prices**

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

**Regulatory and Economic Policies**

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

**EMPLOYEES**

At December 31, 2012, we had 662 employees. None of the employees are subject to a collective bargaining agreement and management believes its relations with employees are good.

Table of Contents

**EXECUTIVE OFFICERS OF REGISTRANT**

The following table sets forth current information regarding our executive officers and certain other significant employees (ages are as of May 8, 2013, the date of the 2013 Annual Meeting of Shareholders).

| Name | Age | Started In | Positions/Offices |
|---|---|---|---|
| Martin K. Birmingham | 46 | 2005 | President and Chief Executive Officer since March 2013. Previously, President and Chief of Community Banking of the Company and the Bank from August 2012. Executive Vice President and Regional President/ Commercial Banking Executive Officer of the Bank since 2009. Senior Vice President and Regional President of the Bank since 2005. Senior Team Leader and Regional President of the Rochester Market at Bank of America (formally Fleet Boston Financial) from 2000 to 2005. |
| Richard J. Harrison | 67 | 2003 | Executive Vice President and Chief Operating Officer of the Company and the Bank since August 2012. Executive Vice President and Senior Retail Lending Administrator of the Bank since 2009. Senior Vice President and Senior Retail Lending Administrator of the Bank since 2005. |
| Kevin B. Klotzbach | 60 | 2001 | Senior Vice President and Treasurer of the Bank since 2005. |
| Karl F. Krebs | 57 | 2009 | Executive Vice President and Chief Financial Officer of the Company and the Bank since 2009. Senior Financial Specialist at West Valley Environmental Services, LLC, an environmental remediation services firm, prior to joining the Company in 2009. President of Robar General Funding Corp., a mortgage and construction loan broker, from 2006 to 2008. Senior Vice President and Line-of-Business Finance Director at Five Star Bank from 2005 to 2006. |
| R. Mitchell McLaughlin | 55 | 1981 | Executive Vice President and Chief Information Officer of the Bank since 2009. Senior Vice President and Chief Information Officer of the Bank since 2006. |
| John L. Rizzo | 63 | 2007 | Senior Vice President and Corporate Secretary of the Company and the Bank since 2010. General counsel for the Company and the Bank since 2007. Genesee County (New York) Attorney from 1976 to 2010. |
| Kenneth V. Winn | 55 | 2004 | Executive Vice President and Chief Risk Officer of the Company and the Bank since July 2012. Senior Vice President and Senior Credit Compliance Administrator since 2006. |

Table of Contents

**ITEM 1A. RISK FACTORS**

An investment in our common stock is subject to risks inherent to our business. The material risks and uncertainties that management believes affect us are described below. Before making an investment decision, you should carefully consider the risks and uncertainties described below, together with all of the other information included or incorporated by reference herein. The risks and uncertainties described below are not the only ones facing us. Additional risks and uncertainties that management is not aware of or focused on or that management currently deems immaterial may also impair our business operations. This Annual Report on Form 10-K is qualified in its entirety by these risk factors. Further, to the extent that any of the information contained in this Annual Report on Form 10-K constitutes forward-looking statements, the risk factors set forth below also are cautionary statements identifying important factors that could cause our actual results to differ materially from those expressed in any forward-looking statements made by or on behalf of us.

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

**CREDIT RISKS**

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

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

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

**Geographic concentration may unfavorably impact our operations.**

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

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

Generally, we make loans to small to mid-sized businesses whose success depends on the regional economy. These businesses generally have fewer financial resources in terms of capital or borrowing capacity than larger entities. Adverse economic and business conditions in our market areas could reduce our growth rate, affect our borrowers ability to repay their loans and, consequently, adversely affect our business, financial condition and performance. For example, we place substantial reliance on real estate as collateral for our loan portfolio. A sharp downturn in real

estate values in our market area could leave many of these loans inadequately collateralized. If we are required to liquidate the collateral securing a loan to satisfy the debt during a period of reduced real estate values, the impact on our results of operations could be materially adverse.

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

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

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

A significant portion of our loan portfolio is secured by real property. During the ordinary course of business, we may foreclose on and take title to properties securing certain loans. In doing so, there is a risk that hazardous or toxic substances could be found on these properties. If hazardous or toxic substances are found, we may be liable for remediation costs, as well as for personal injury and property damage regardless of whether we knew, had reason to know of, or caused the release of such substance. Environmental laws may require us to incur substantial expenses and may materially reduce the affected property s value or limit our ability to use or sell the affected property. In addition, future laws or more stringent interpretations or enforcement policies with respect to existing laws may increase our exposure to environmental liability. Although we have policies and procedures to perform an environmental review before initiating any foreclosure action on real property, these reviews may not be sufficient to detect all potential environmental hazards. The remediation costs and any other financial liabilities associated with an environmental hazard could have a material adverse effect on our financial condition and results of operations.

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

A portion of our current lending involves the purchase of consumer automobile installment sales contracts from automobile dealers located in Western, Central and the Capital District of New York, and Northern Pennsylvania. These loans are for the purchase of new or used automobiles. We serve customers that cover a range of creditworthiness, and the required terms and rates are reflective of those risk profiles. While these loans have higher yields than many of our other loans, such loans involve risks elements in addition to normal credit risk. Potential risk elements associated with indirect lending include the limited personal contact with the borrower as a result of indirect lending through dealers, the absence of assured continued employment of the borrower, the varying general creditworthiness of the borrower, changes in the local economy, and difficulty in monitoring collateral. While indirect automobile loans are secured, such loans are secured by depreciating assets and characterized by LTV ratios that could result in us not recovering the full value of an outstanding loan upon default by the borrower. If the economic environment in our primary market area contracts, we may experience higher levels of delinquencies, charge-offs and repossessions.

**REGULATORY/LEGAL/COMPLIANCE RISKS**

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

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

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

**Ongoing financial reform legislation may result in new regulations that could require us to maintain higher capital levels and/or increase our costs of operations or limit certain activities or lines of business.**

The Dodd-Frank Act has significantly changed the current bank regulatory structure and affects the lending, deposit, investment, trading and operating activities of financial institutions and their holding companies. The Dodd-Frank Act requires various federal agencies to adopt a broad range of new implementing rules and regulations, and to prepare numerous studies and reports for Congress. The federal agencies are given significant discretion in drafting the implementing rules and regulations, and consequently, many of the details and much of the rulemaking of the Dodd-Frank Act will not be known for many months or years, making it difficult to anticipate the overall financial impact on us. However, compliance with this new law and its implementing regulations are expected to result in additional operating costs that could have a material adverse effect on our financial condition and results of operations.

The federal banking agencies have proposed rules that would substantially amend the regulatory risk-based capital rules. The proposed rules implement the Basel III regulatory capital reforms and changes required by the Dodd-Frank Act. The proposed rules include new minimum

risk-based capital and leverage ratios, which would be phased in over the next several years and would refine the definition of what constitutes "capital" for purposes of calculating those ratios. While the proposed Basel III changes and other regulatory capital requirements will likely result in generally higher regulatory capital standards, it is difficult at this time to predict when or how any new standards will ultimately be applied to the Company and the Bank.

Table of Contents

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

The financial services industry is extensively regulated. Federal and state banking regulations are designed primarily to protect the deposit insurance funds and consumers, not to benefit a company s stockholders. These regulations may sometimes impose significant limitations on operations. The significant federal and state banking regulations that affect us are described in the section captioned Supervision and Regulation included in Part I, Item 1, Business . These regulations, along with the currently existing tax, accounting, securities, insurance, and monetary laws, regulations, rules, standards, policies, and interpretations control the methods by which financial institutions conduct business, implement strategic initiatives and tax compliance, and govern financial reporting and disclosures. These laws, regulations, rules, standards, policies, and interpretations are constantly evolving and may change significantly over time.

**OPERATIONAL RISKS**

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

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

**We could be subject to losses if we fail to properly safeguard sensitive and confidential information.**

As part of our normal operations, we maintain and transmit confidential information about our clients as well as proprietary information relating to our business operations. We maintain a system of internal controls designed to provide reasonable assurance that fraudulent activity, including misappropriation of assets, fraudulent financial reporting, and unauthorized access to sensitive or confidential data is either prevented or timely detected. Our systems or our third-party service providers systems could be victimized by unauthorized users or corrupted by computer viruses or other malicious software code, or authorized persons could inadvertently or intentionally release confidential or proprietary information. Such disclosure could, among other things:

- seriously damage our reputation,
- allow competitors access to our proprietary business information,
- subject us to liability for a failure to safeguard client data,
- result in the loss of our existing customers,
- subject us to regulatory action, and
- require significant capital and operating expenditures to investigate and remediate the breach.

**Our information systems may experience an interruption or breach in security.**

We rely heavily on communications and information systems to conduct our business. Any failure, interruption or breach in security of these systems could result in failures or disruptions in our customer relationship management, general ledger, deposit, loan and other systems. While we have policies and procedures designed to prevent or limit the effect of the failure, interruption or security breach of our information systems, there can be no assurance that any such failures, interruptions or security breaches will not occur or, if they do occur, that they will be adequately addressed. The occurrence of any failures, interruptions or security breaches of our information systems could damage our reputation, result in a loss of customer business, subject us to additional regulatory scrutiny, or expose us to civil litigation and possible financial liability, any of which could have a material adverse effect on our financial condition and results of operations.

Table of Contents

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

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

**We may not be able to attract and retain skilled people and our ongoing leadership transition may be unsuccessful.**

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

On January 30, 2012, we eliminated the position of Retail Banking Executive previously held by John J. Witkowski, our former Executive Vice President and on June 30, 2012, George D. Hagi, our Executive Vice President and Chief Risk Officer retired and was replaced by Kenneth V. Winn. In August 2012, Peter G. Humphrey retired as our President and Chief Executive Officer. Following Mr. Humphrey s retirement, our Board of Directors appointed John E. Benjamin to serve as Interim Chief Executive Officer in August 2012. At the same time, we also announced the promotion of Richard Harrison as Chief Operating Officer and Martin Birmingham as President and Chief of Community Banking. In March 2013, Mr. Birmingham was appointed to the position of President and Chief Executive Officer. These changes in key management could create uncertainty among our employees, customers, and other third parties with whom we do business and could result in changes to the strategic direction of our business, which could negatively affect our business, financial condition and results of operations. Any failure of our management to work together to effectively manage our operations, our inability to hire other key management, and any failure to effectively integrate new management into our controls, systems and procedures could adversely affect our business, financial condition and results of operations.

**The potential for business interruption exists throughout our organization.**

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

**Acquisitions may disrupt our business and dilute shareholder value.**

A key component of our strategy to grow and improve profitability is to expand our branch network into communities within or adjacent to markets where we currently conduct business. We intend to continue to pursue a growth strategy for our business. As a result, negotiations may take place and future mergers or acquisitions involving cash, debt, or equity securities may occur at any time. We seek merger or acquisition partners that are culturally similar, have experienced management, and possess either significant market presence or have potential for improved profitability through financial management, economies of scale, or expanded services.

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

- difficulty in estimating the value of the target company;

payment of a premium over book and market values that may dilute our tangible book value and earnings per share in the short and long term;

potential exposure to unknown or contingent liabilities of the target company;

exposure to potential asset quality issues of the target company;

there may be volatility in reported income as goodwill impairment losses could occur irregularly and in varying amounts;

challenge and expense of integrating the operations and personnel of the target company;

inability to realize the expected revenue increases, cost savings, increases in geographic or product presence, and / or other projected benefits;

potential disruption to our business;

potential diversion of our management s time and attention;

the possible loss of key employees and customers of the target company; and

potential changes in banking or tax laws or regulations that may affect the target company.

Table of Contents

**EXTERNAL RISKS**

**We are subject to interest rate risk.**

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

Although management believes it has implemented effective asset and liability management strategies to reduce the potential effects of changes in interest rates on our results of operations, any substantial, unexpected or prolonged change in market interest rates could have a material adverse effect on our financial condition and results of operations. Also, our interest rate risk modeling techniques and assumptions likely may not fully predict or capture the impact of actual interest rate changes on our balance sheet.

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

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

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

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

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

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

**The soundness of other financial institutions could adversely affect us.**

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

Table of Contents

**We may be required to recognize an impairment of goodwill.**

Under current accounting standards, goodwill is not amortized but, instead, is subject to impairment tests on at least an annual basis or more frequently if an event occurs or circumstances change that reduce the fair value of a reporting unit below its carrying amount. Significant and sustained declines in our stock price and market capitalization, significant declines in our expected future cash flows, significant adverse changes in the business climate or slower growth rates could result in impairment of goodwill. During 2012, the annual impairment test performed as of September 30 indicated that the fair value of our single reporting unit exceeded the fair value of its assets and liabilities. In the event that we conclude that all or a portion of our goodwill may be impaired, a non-cash charge for the amount of such impairment would be recorded to earnings, which could have a material adverse impact on our results of operations or financial condition. Such a charge would have no impact on tangible capital. At December 31, 2012, we had goodwill of $49.0 million, representing approximately 19% of shareholders equity. For further discussion, see Note 1, Summary of Significant Accounting Policies, and Note 7, Goodwill and Other Intangible Assets, to the Consolidated Financial Statements included in Item 8 of this Annual Report on Form 10-K.

**We operate in a highly competitive industry and market area.**

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

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

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

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

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

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

**LIQUIDITY RISKS**

**Liquidity is essential to our businesses.**

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

Table of Contents

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

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

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

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

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

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

**RISKS RELATED TO AN INVESTMENT IN OUR COMMON STOCK**

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

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

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

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

**We may not pay dividends on our common stock.**

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

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

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

Table of Contents

**ITEM 1B. UNRESOLVED STAFF COMMENTS**

None.

**ITEM 2. PROPERTIES**

We own a 27,400 square foot building in Warsaw, New York that serves as our headquarters, and principal executive and administrative offices. Additionally, we are obligated under a lease commitment through 2017 for a 17,750 square foot regional administrative facility in Pittsford, New York.

We are engaged in the banking business through 52 branch offices, of which 36 are owned and 16 are leased, in fifteen contiguous counties of Western and Central New York: Allegany, Cattaraugus, Cayuga, Chautauqua, Chemung, Erie, Genesee, Livingston, Monroe, Ontario, Orleans, Seneca, Steuben, Wyoming and Yates Counties. The operating leases for our branch offices expire at various dates through the year 2036 and generally include options to renew.

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

**ITEM 3. LEGAL PROCEEDINGS**

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

**ITEM 4. MINE SAFETY DISCLOSURES**

Not applicable.

Table of Contents

PART II

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

Our common stock is traded on the NASDAQ Global Select Market under the ticker symbol FISI. At December 31, 2012, 13,787,709 shares of our common stock were outstanding and held by approximately 1,400 shareholders of record. During 2012, the high sales price of our common stock was $19.52 and the low sales price was $15.22. The closing price per share of common stock on December 31, 2012, the last trading day of our fiscal year, was $18.63. We declared dividends of $0.57 per common share during the year ended December 31, 2012. See additional information regarding the market price and dividends paid in Part II, Item 6, Selected Financial Data .

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

**Equity Compensation Plan Information**

The following table sets forth, as of December 31, 2012, information about our equity compensation plans that have been approved by our shareholders, including the number of shares of our common stock exercisable under all outstanding options, warrants and rights, the weighted average exercise price of all outstanding options, warrants and rights and the number of shares available for future issuance under our equity compensation plans. We have no equity compensation plans that have not been approved by our shareholders.

| Plan Category | Number of securities to be issued upon exercise of outstanding options, warrants and rights (a) | Weighted average exercise price of outstanding options, warrants and rights (b) | Number of securities remaining for future issuance under equity compensation plans (excluding securities reflected in column (a)) (c) |
|---|---|---|---|
| Equity compensation plans approved by shareholders | 398,855[1] | $ 20.22[1] | 651,464[2] |
| Equity compensation plans not approved by shareholders | | $ | |

(1) Includes 79,580 shares of unvested restricted stock awards outstanding as of December 31, 2012. The weighted average exercise price excludes such awards.

(2) Represents the 940,000 aggregate shares approved for issuance under our two active equity compensation plans, reduced by 373,297 shares, which are the 227,623 restricted stock awards issued under these plans to date plus an adjustment of 145,674 shares. Pursuant to the terms of the plans, for purposes of calculating the number of shares available for issuance, each share of common stock granted pursuant to a restricted stock award shall count as 1.64 shares of common stock.

Table of Contents

**Stock Performance Graph**

The stock performance graph below compares (a) the cumulative total return on our common stock for the period beginning December 31, 2007 as reported by the NASDAQ Global Select Market, through December 31, 2012, (b) the cumulative total return on stocks included in the NASDAQ Composite Index over the same period, and (c) the cumulative total return, as compiled by SNL Financial L.C., of Major Exchange (NYSE, AMEX and NASDAQ) Banks with $1 billion to $5 billion in assets over the same period. Cumulative return assumes the reinvestment of dividends. The graph was prepared by SNL Financial, LC and is expressed in dollars based on an assumed investment of $100.

| | Period Ending | | | | | |
|---|---|---|---|---|---|---|
| **Index** | **12/31/07** | **12/31/08** | **12/31/09** | **12/31/10** | **12/31/11** | **12/31/12** |
| Financial Institutions, Inc. | 100.00 | 83.16 | 71.33 | 117.63 | 103.06 | 122.99 |
| NASDAQ Composite | 100.00 | 60.02 | 87.24 | 103.08 | 102.26 | 120.42 |
| SNL Bank $1B-$5B Index | 100.00 | 82.94 | 59.45 | 67.39 | 61.46 | 75.75 |

Table of Contents

**ITEM 6. SELECTED FINANCIAL DATA**

| *(Dollars in thousands, except selected ratios and per share data)* | At or for the year ended December 31, 2012 | 2011 | 2010 | 2009 | 2008 |
|---|---|---|---|---|---|
| **Selected financial condition data:** | | | | | |
| Total assets | $ 2,764,034 | $ 2,336,353 | $ 2,214,307 | $ 2,062,389 | $ 1,916,919 |
| Loans, net | 1,681,012 | 1,461,516 | 1,325,524 | 1,243,265 | 1,102,330 |
| Investment securities | 841,701 | 650,815 | 694,530 | 620,074 | 606,038 |
| Deposits | 2,261,794 | 1,931,599 | 1,882,890 | 1,742,955 | 1,633,263 |
| Borrowings | 179,806 | 150,698 | 103,877 | 106,390 | 70,820 |
| Shareholders equity | 253,897 | 237,194 | 212,144 | 198,294 | 190,300 |
| Common shareholders equity [1] | 236,426 | 219,721 | 158,359 | 144,876 | 137,226 |
| Tangible common shareholders equity [2] | 185,606 | 182,352 | 120,990 | 107,507 | 99,577 |
| **Selected operations data:** | | | | | |
| Interest income | $ 97,567 | $ 95,118 | $ 96,509 | $ 94,482 | $ 98,948 |
| Interest expense | 9,051 | 13,255 | 17,720 | 22,217 | 33,617 |
| Net interest income | 88,516 | 81,863 | 78,789 | 72,265 | 65,331 |
| Provision for loan losses | 7,128 | 7,780 | 6,687 | 7,702 | 6,551 |
| Net interest income after provision for loan losses | 81,388 | 74,083 | 72,102 | 64,563 | 58,780 |
| Noninterest income (loss) [3] | 24,777 | 23,925 | 19,454 | 18,795 | (48,778) |
| Noninterest expense | 71,397 | 63,794 | 60,917 | 62,777 | 57,461 |
| Income (loss) before income taxes | 34,768 | 34,214 | 30,639 | 20,581 | (47,459) |
| Income tax expense (benefit) | 11,319 | 11,415 | 9,352 | 6,140 | (21,301) |
| Net income (loss) | $ 23,449 | $ 22,799 | $ 21,287 | $ 14,441 | $ (26,158) |
| Preferred stock dividends and accretion | 1,474 | 3,182 | 3,725 | 3,697 | 1,538 |
| Net income (loss) applicable to common shareholders | $ 21,975 | $ 19,617 | $ 17,562 | $ 10,744 | $ (27,696) |
| **Stock and related per share data:** | | | | | |
| Earnings (loss) per common share: | | | | | |
| Basic | $ 1.60 | $ 1.50 | $ 1.62 | $ 0.99 | $ (2.54) |
| Diluted | 1.60 | 1.49 | 1.61 | 0.99 | (2.54) |
| Cash dividends declared on common stock | 0.57 | 0.47 | 0.40 | 0.40 | 0.54 |
| Common book value per share [1] | 17.15 | 15.92 | 14.48 | 13.39 | 12.71 |
| Tangible common book value per share [2] | 13.46 | 13.21 | 11.06 | 9.94 | 9.22 |
| Market price (NASDAQ: FISI): | | | | | |
| High | 19.52 | 20.36 | 20.74 | 15.99 | 22.50 |
| Low | 15.22 | 12.18 | 10.91 | 3.27 | 10.06 |
| Close | 18.63 | 16.14 | 18.97 | 11.78 | 14.35 |
| **Performance ratios:** | | | | | |
| Net income (loss), returns on: | | | | | |
| Average assets | 0.93% | 1.00% | 0.98% | 0.71% | -1.37% |
| Average equity | 9.46 | 9.82 | 10.07 | 7.43 | -14.30 |
| Average common equity [1] | 9.53 | 9.47 | 11.14 | 7.61 | -16.84 |
| Average tangible common equity [2] | 11.74 | 11.55 | 14.59 | 10.37 | -21.87 |
| Common dividend payout ratio [4] | 35.63 | 31.33 | 24.69 | 40.40 | NA |
| Net interest margin (fully tax-equivalent) | 3.95 | 4.04 | 4.07 | 4.04 | 3.93 |
| Efficiency ratio [5] | 62.87% | 60.55% | 60.36% | 65.52% | 64.07% |

(1) Excludes preferred shareholders equity.

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

(3) The 2012, 2011, 2010, 2009 and 2008 figures include other-than-temporary impairment ( OTTI ) charges of $91 thousand, $18 thousand, $594 thousand, $4.7 million and $68.2 million, respectively.

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

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

Table of Contents

| *(Dollars in thousands, except per share data)* | At or for the year ended December 31, 2012 | 2011 | 2010 | 2009 | 2008 |
|---|---|---|---|---|---|
| **Capital ratios:** | | | | | |
| Leverage ratio | 7.70% | 8.63% | 8.31% | 7.96% | 8.05% |
| Tier 1 capital ratio | 10.70 | 12.20 | 12.34 | 11.95 | 11.83 |
| Total risk-based capital ratio | 11.96 | 13.45 | 13.60 | 13.21 | 13.08 |
| Equity to assets [3] | 9.84 | 10.20 | 9.75 | 9.55 | 9.60 |
| Common equity to assets [1] [3] | 9.15 | 9.10 | 7.28 | 6.94 | 8.63 |
| Tangible common equity to tangible assets [2] [3] | 7.56% | 7.58% | 5.65% | 5.19% | 6.78% |
| **Asset quality:** | | | | | |
| Non-performing loans | $ 9,125 | $ 7,076 | $ 7,582 | $ 8,681 | $ 8,196 |
| Non-performing assets | 10,062 | 9,187 | 8,895 | 10,442 | 9,252 |
| Allowance for loan losses | 24,714 | 23,260 | 20,466 | 20,741 | 18,749 |
| Net loan charge-offs | $ 5,674 | $ 4,986 | $ 6,962 | $ 5,710 | $ 3,323 |
| Non-performing loans to total loans | 0.53% | 0.48% | 0.56% | 0.69% | 0.73% |
| Non-performing assets to total assets | 0.36 | 0.39 | 0.40 | 0.51 | 0.48 |
| Net charge-offs to average loans | 0.36 | 0.36 | 0.54 | 0.47 | 0.32 |
| Allowance for loan losses to total loans | 1.45 | 1.57 | 1.52 | 1.64 | 1.67 |
| Allowance for loan losses to non-performing loans | 271% | 329% | 270% | 239% | 229% |
| **Other data:** | | | | | |
| Number of branches | 52 | 50 | 50 | 50 | 51 |
| Full time equivalent employees | 628 | 575 | 577 | 572 | 600 |

(1) Excludes preferred shareholders equity.

(2) Excludes preferred shareholders equity, goodwill and other intangible assets. Ratios calculated using average balances for the periods shown.

Table of Contents

**SELECTED QUARTERLY DATA**

| *(Dollars in thousands, except per share data)* | Fourth Quarter | Third Quarter | Second Quarter | First Quarter |
|---|---|---|---|---|
| **2012** | | | | |
| Interest income | $ 25,087 | $ 25,299 | $ 23,731 | $ 23,450 |
| Interest expense | 1,999 | 2,200 | 2,343 | 2,509 |
| Net interest income | 23,088 | 23,099 | 21,388 | 20,941 |
| Provision for loan losses | 2,520 | 1,764 | 1,459 | 1,385 |
| Net interest income, after provision for loan losses | 20,568 | 21,335 | 19,929 | 19,556 |
| Noninterest income | 6,283 | 6,353 | 6,690 | 5,451 |
| Noninterest expense | 17,541 | 21,618 | 16,581 | 15,657 |
| Income before income taxes | 9,310 | 6,070 | 10,038 | 9,350 |
| Income tax expense | 2,978 | 1,805 | 3,382 | 3,154 |
| Net income | $ 6,332 | $ 4,265 | $ 6,656 | $ 6,196 |
| Preferred stock dividends | 369 | 368 | 368 | 369 |
| Net income applicable to common shareholders | $ 5,963 | $ 3,897 | $ 6,288 | $ 5,827 |
| Earnings per common share [(1)]: | | | | |
| Basic | $ 0.44 | $ 0.28 | $ 0.46 | $ 0.43 |
| Diluted | 0.43 | 0.28 | 0.46 | 0.42 |
| Market price (NASDAQ: FISI): | | | | |
| High | $ 19.39 | $ 19.52 | $ 17.66 | $ 17.99 |
| Low | 17.61 | 16.50 | 15.51 | 15.22 |
| Close | 18.63 | 18.64 | 16.88 | 16.17 |
| Dividends declared | $ 0.16 | $ 0.14 | $ 0.14 | $ 0.13 |
| **2011** | | | | |
| Interest income | $ 23,875 | $ 23,774 | $ 23,830 | $ 23,639 |
| Interest expense | 2,721 | 3,156 | 3,577 | 3,801 |
| Net interest income | 21,154 | 20,618 | 20,253 | 19,838 |
| Provision for loan losses | 2,162 | 3,480 | 1,328 | 810 |
| Net interest income, after provision for loan losses | 18,992 | 17,138 | 18,925 | 19,028 |
| Noninterest income | 5,767 | 8,036 | 4,974 | 5,148 |
| Noninterest expense | 16,279 | 17,012 | 15,153 | 15,350 |
| Income before income taxes | 8,480 | 8,162 | 8,746 | 8,826 |
| Income tax expense | 2,718 | 2,664 | 3,027 | 3,006 |
| Net income | $ 5,762 | $ 5,498 | $ 5,719 | $ 5,820 |
| Preferred stock dividends | 369 | 368 | 370 | 2,075 |
| Net income applicable to common shareholders | $ 5,393 | $ 5,130 | $ 5,349 | $ 3,745 |

| | | | | |
|---|---|---|---|---|
| Earnings per common share [1]: | | | | |
| Basic | $ 0.39 | $ 0.38 | $ 0.39 | $ 0.33 |
| Diluted | 0.39 | 0.37 | 0.39 | 0.33 |
| Market price (NASDAQ: FISI): | | | | |
| High | $ 17.26 | $ 17.98 | $ 17.93 | $ 20.36 |
| Low | 12.18 | 13.63 | 15.20 | 16.40 |
| Close | 16.14 | 14.26 | 16.42 | 17.52 |
| Dividends declared | $ 0.13 | $ 0.12 | $ 0.12 | $ 0.10 |

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

Table of Contents

**2012 FOURTH QUARTER RESULTS**

Net income was $6.3 million for the fourth quarter of 2012 compared with $5.8 million for the fourth quarter of 2011. After preferred dividends, fourth quarter diluted earnings per share for 2012 was $0.43 compared with $0.39 per share for the fourth quarter of 2011.

Net interest income totaled $23.1 million for the three months ended December 31, 2012, an increase of $1.9 million or 9% over the fourth quarter of 2011. Average earning assets increased $293.1 million during the fourth quarter 2012 compared to the same quarter last year, the result of a $219.6 million increase in average loans combined with a $73.5 million increase in investment securities.

The net interest margin on a tax-equivalent basis was 3.92% in the fourth quarter of 2012, compared with 4.07% in the fourth quarter of 2011. Our yield on earning-assets decreased 33 basis points in the fourth quarter of 2012 compared with the same quarter last year, a result of cash flows being reinvested in the current low interest rate environment, which includes the impact of investing the cash from the branch acquisitions into lower yielding securities. The cost of interest-bearing liabilities decreased 22 basis points compared with the fourth quarter of 2011, primarily a result of the continued downward re-pricing of our certificates of deposit.

The provision for loan losses was $2.5 million for the fourth quarter of 2012 compared with $2.2 million for the fourth quarter of 2011. Net charge-offs for the fourth quarter of 2012 were $2.1 million, or 0.50% annualized, of average loans, compared to $1.9 million, or 0.51% annualized, of average loans in the fourth quarter of 2011. See the sections Allowance for Loan Losses and Non-performing Assets and Potential Problem Loans for additional information on net charge-offs and non-performing loans.

Noninterest income totaled $6.3 million for the fourth quarter of 2012, a 9% increase over the fourth quarter of 2011. The majority of the increase related to a $452 thousand increase in income from service charges on deposit accounts when comparing the fourth quarter 2012 compared with the same quarter last year.

Noninterest expense was $17.5 million for the fourth quarter of 2012, an increase of $1.3 million or 8% from the fourth quarter of 2011. The increases in expenses across all categories for the fourth quarter of 2012 compared to the fourth quarter of 2011 reflect higher infrastructure costs to support the increased number of branches and employees.

Income tax expense for the fourth quarter of 2012 was $3.0 million compared to $2.7 million for the fourth quarter of 2011. The change in income tax expense was primarily due to an $830 thousand increase in pretax income between the periods.

Table of Contents

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

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

## OVERVIEW

### Business Overview

Financial Institutions, Inc. is a financial holding company headquartered in New York State, providing banking and nonbanking financial services to individuals and businesses primarily in our Western and Central New York footprint. We have also expanded our indirect lending network to include relationships with franchised automobile dealers in the Capital District of New York and Northern Pennsylvania. Through our wholly-owned banking subsidiary, Five Star Bank, we provide a wide range of services, including business and consumer loan and depository services, as well as other traditional banking services. Through our nonbanking subsidiary, Five Star Investment Services, we provide brokerage and investment advisory services to supplement our banking business.

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

### 2012 Significant Events

**Branch Acquisitions.** During 2012, we successfully completed the acquisition of eight retail bank branch locations in Upstate New York. Former HSBC Bank USA, N.A. branches located in Albion, Elmira, Elmira Heights, and Horseheads were acquired in August, complementing the former First Niagara Bank, N.A. locations in Batavia, Brockport, Medina, and Seneca Falls acquired in June. Through the acquisition we assumed deposits of $286.8 million and acquired in-market performing loans of $75.6 million. The acquisition of these branch offices was a marked success. We were able to integrate the offices and customer accounts seamlessly. Through detailed planning, we ensured that our sales and support staff members were ready to assist customers with any questions or issues. The feedback we received from our customers was positive and executing on our detailed planning process ultimately resulted in deposit retention rates that were better than expected. We incurred approximately $3.0 million in pre-tax expense during 2012 related to the branch acquisitions.

The combined assets acquired and deposits assumed in the two transactions were recorded at their estimated fair values as follows:

| | |
|---|---:|
| Cash | $ 195,778 |
| Loans | 75,635 |
| Bank premises and equipment | 1,938 |
| Goodwill | 11,599 |
| Core deposit intangible asset | 2,042 |
| Other assets | 339 |
| Total assets acquired | $ 287,331 |
| Deposits assumed | $ 286,819 |
| Other liabilities | 512 |
| Total liabilities assumed | $ 287,331 |

In anticipation of the branch acquisitions, we leveraged our balance sheet through the execution of short-term FHLB advances in order to pre-acquire investment securities. This strategy allowed us to purchase securities over time and carry out a dollar cost averaging strategy. Our purchase of investment securities was comprised of mortgage-backed securities, U.S. Government agencies and sponsored enterprise bonds and

tax-exempt municipal bonds. The cash received at the time of closing the transactions was used to pay down the short-term FHLB advances used to fund the purchase of the investment securities.

For detailed information on the accounting for the branch acquisitions, see Note 2, Branch Acquisitions, of the notes to consolidated financial statements.

Table of Contents

**MANAGEMENT S DISCUSSION AND ANALYSIS**

**Leadership Transition.** In August 2012, Peter G. Humphrey our former President and Chief Executive Officer retired. Mr. Humphrey continues to serve as a member of our Board of Directors. Following Mr. Humphrey s retirement, our Board of Directors appointed John E. Benjamin to serve as our Interim Chief Executive Officer in August 2012. At the same time, we also announced the promotion of Richard Harrison as Chief Operating Officer and Martin Birmingham as President and Chief of Community Banking. Mr. Harrison and Mr. Birmingham were instrumental in the structuring, negotiating and integrating the branch office acquisitions. We incurred approximately $2.6 million in pre-tax expense during 2012 related to the retirement of Mr. Humphrey.

The Board of Directors subsequently appointed Mr. Birmingham as President and Chief Executive Officer, effective March 1, 2013.

**2012 Performance Summary**

Our net income was $23.4 million for the year ended December 31, 2012, compared to a net income of $22.8 million for the year ended December 31, 2011. For 2012, net income available to common shareholders was $22.0 million, or $1.60 per diluted common share, compared to 2011 net income available to common shareholders of $19.6 million, or $1.49 per diluted common share. Cash dividends of $0.57 and $0.47 per common share were declared in 2012 and 2011, respectively.

We had total assets of $2.764 billion at December 31, 2012 compared to $2.336 billion at December 31, 2011. At December 31, 2012, shareholders equity totaled $253.9 million with book value per common share at $17.15, compared to $237.2 million with book value per common share at $15.92 at the end of 2011. The Tier 1 capital ratio was 10.70% as of December 31, 2012 compared to 12.20% at December 31, 2011.

Key factors behind these results are discussed below.

- At December 31, 2012, total loans were $1.706 billion, up $220.9 million or 15% from year-end 2011. At December 31, 2012, total loans included $64.5 million in loans obtained in the branch acquisitions. Total deposits at December 31, 2012, were $2.262 billion, up $330.2 million or 17% from year-end 2011, primarily attributable to $286.8 million in retail deposits assumed from the branch acquisitions. Our deposit mix remains favorably weighted in demand, savings and money market accounts, which comprised 71% of total deposits at the end of 2012 compared to 64% of total deposits at the end of 2011.

- Nonperforming loans were $9.1 million or 0.53% of total loans at December 31, 2012, compared to $7.1 million or 0.48% of total loans at December 31, 2011.

- The provision for loan losses was $7.1 million and $7.8 million, respectively, for 2012 and 2011. Net charge-offs were $5.7 million in 2012 (or 0.36% of average loans) compared to $5.0 million in 2011 (or 0.36% of average loans).

- At year-end 2012, the allowance for loan losses of $24.7 million represented 1.45% of total loans (covering 271% of non-performing loans), compared to $23.3 million or 1.57% (covering 329% of non-performing loans) at year-end 2011. Excluding loans acquired in the branch acquisitions during 2012, the allowance for loan losses was 1.51% of total loans at year-end 2012.

- Taxable equivalent net interest income was $90.8 million for 2012 or 8% higher than $83.9 million in 2011. Taxable equivalent interest income increased $2.7 million, while interest expense decreased by $4.2 million. The increase in taxable equivalent net interest income was a function of a favorable volume variance (increasing taxable equivalent net interest income by $11.7 million), partially offset by an unfavorable rate variance (decreasing taxable equivalent net interest income by $4.8 million).

- The net interest margin for 2012 was 3.95%, 9 basis points lower than 4.04% in 2011.

Noninterest income was $24.8 million for 2012 compared to $23.9 million for 2011. Core fee-based revenues (defined as service charges on deposit accounts, ATM and debit fees, and broker-dealer fees and commissions) totaled $15.4 million for 2012, a $580 thousand or 4% increase from $14.9 million in 2011. Net mortgage banking income was $2.0 million for 2012, an increase of $323 thousand or 19% from $1.7 million in 2011.

Net investment securities gains (defined as net gain on sales and calls of investment securities and impairment charges on investment securities) were $2.6 million for 2012 compared to $3.0 million for 2011.

Noninterest expense for 2012 was $71.4 million, an increase of $7.6 million or 12% over 2011. As previously mentioned, noninterest expense for 2012 includes pre-tax expenses of approximately $3.0 million related to the branch acquisitions and $2.6 million incurred in association with the retirement of our former CEO. Noninterest expense for 2011 includes a loss on extinguishment of debt of $1.1 million, recognized as a result of redeeming our 10.20% junior subordinated debentures. Excluding these expenses, which we consider to be non-recurring in nature, noninterest expense increased $3.1 million or 5% when comparing 2012 to 2011.

**MANAGEMENT S DISCUSSION AND ANALYSIS**

***RESULTS OF OPERATIONS FOR THE YEARS ENDED***

***DECEMBER 31, 2012 AND DECEMBER 31, 2011***

**Net Interest Income and Net Interest Margin**

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

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

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

| | 2012 | 2011 | 2010 |
|---|---|---|---|
| Interest income per consolidated statements of income | $ 97,567 | $ 95,118 | $ 96,509 |
| Adjustment to fully taxable equivalent basis | 2,284 | 2,062 | 1,895 |
| Interest income adjusted to a fully taxable equivalent basis | 99,851 | 97,180 | 98,404 |
| Interest expense per consolidated statement of income | 9,051 | 13,255 | 17,720 |
| Net interest income on a taxable equivalent basis | $ 90,800 | $ 83,925 | $ 80,684 |

Taxable equivalent net interest income of $90.8 million for 2012 was $6.9 million or 8% higher than 2011. The impact of a decline in average yields on our assets was diminished by a $217.4 million or 10% increase in interest-earning assets. The average balance of loans rose $199.6 million or 14% to $1.593 billion, reflecting growth in every loan category. Consistent with our strategic plan, we continue to pursue loan development efforts in the commercial and consumer indirect lending portfolios in accordance with prudent underwriting standards.

The increase in taxable equivalent net interest income was a function of a favorable volume variance as balance sheet changes in both volume and mix increased taxable equivalent net interest income by $11.7 million, partially offset by an unfavorable rate variance that decreased taxable equivalent net interest income by $4.8 million. The change in mix and volume of earning assets increased taxable equivalent interest income by $11.2 million, while the change in volume and composition of interest-bearing liabilities decreased interest expense by $474 thousand, for a net favorable volume impact of $11.7 million on taxable equivalent net interest income. Rate changes on earning assets reduced interest income by $8.5 million, while changes in rates on interest-bearing liabilities lowered interest expense by $3.7 million, for a net unfavorable rate impact of $4.8 million.

The net interest margin for 2012 was 3.95% compared to 4.04% in 2011.

The decrease in net interest margin was attributable to a 7 basis point lower contribution from net free funds (primarily attributable to lower rates on interest-bearing liabilities reducing the value of noninterest-bearing deposits and other net free funds). The interest rate spread decreased by 2 basis points to 3.85% for the year ended December 31, 2012, as a 32 basis point decrease in the yield on earning assets more than offset the 30

basis point decrease in the cost of interest-bearing liabilities.

The Federal Reserve left the Federal funds rate unchanged at 0.25% during 2010 through 2012. During 2011, the Federal Reserve disclosed that short-term interest rates would be held near zero through at least the middle of 2013, in anticipation of low growth and little risk of inflation. In April 2012, the Federal Reserve further announced that interest rates will likely remain at exceptionally low levels through late 2014. As a result of the Federal Reserve s policy, we expect net interest margin and interest rate spread to continue to tighten.

**MANAGEMENT S DISCUSSION AND ANALYSIS**

For 2012, the yield on average earning assets of 4.35% was 32 basis points lower than 2011. Loan yields decreased 44 basis points to 5.09%. Commercial mortgage and consumer indirect loans in particular, down 28 and 84 basis points, respectively, continued to experience lower yields given the competitive pricing pressures and re-pricing of loans in a low interest rate environment. The yield on investment securities dropped 27 basis points to 2.66%, also impacted by the lower interest rate environment, prepayments of mortgage-related investment securities and the impact of investing the excess cash related to our branch acquisitions into low yielding securities. Overall, earning asset rate changes reduced interest income by $8.5 million.

The cost of average interest-bearing liabilities of 0.50% in 2012 was 30 basis points lower than 2011. The average cost of interest-bearing deposits was 0.50% in 2012, 24 basis points lower than 2011, reflecting the sustained low-rate environment. The cost of borrowings decreased 110 basis points to 0.48% for 2012, primarily a result of the redemption of the Company s 10.20% junior subordinated debentures during the third quarter of 2011. The interest-bearing liability rate changes reduced interest expense by $3.7 million during 2012.

Average interest-earning assets of $2.297 billion in 2012 were $217.4 million or 10% higher than 2011. Average investment securities increased $17.9 million while average loans increased $199.6 million or 14%. The growth in average loans was comprised of increases in all loan categories, with consumer loans up $130.5 million, commercial loans up $63.4 million and residential mortgage loans up $5.6 million.

Average interest-bearing liabilities of $1.825 billion in 2012 were up $162.9 million or 10% versus 2011. The impacts of the recent recession continue to positively impact our deposit balances, as consumers tend to save more when consumer confidence is low. On average, interest-bearing deposits grew $156.2 million, while average noninterest-bearing demand deposits (a principal component of net free funds) increased by $62.0 million. Average borrowings increased $6.7 million, representing a $22.6 million increase and $15.9 million decrease in short-term and long-term borrowings, respectively.

**Table of Contents**

**MANAGEMENT S DISCUSSION AND ANALYSIS**

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

| | Years ended December 31, | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | 2012 | | | 2011 | | | 2010 | | |
| | Average Balance | Interest | Average Rate | Average Balance | Interest | Average Rate | Average Balance | Interest | Average Rate |
| **Interest-earning assets:** | | | | | | | | | |
| Federal funds sold and other interest-earning deposits | $ 113 | $ | 0.29% | $ 140 | $ | 0.20% | $ 5,034 | $ 10 | 0.21% |
| Investment securities: | | | | | | | | | |
| Taxable | 525,912 | 12,202 | 2.32 | 545,112 | 14,185 | 2.60 | 571,856 | 17,101 | 2.99 |
| Tax-exempt | 177,731 | 6,526 | 3.67 | 140,657 | 5,890 | 4.19 | 108,900 | 5,416 | 4.97 |
| Total investment securities | 703,643 | 18,728 | 2.66 | 685,769 | 20,075 | 2.93 | 680,756 | 22,517 | 3.31 |
| Loans: | | | | | | | | | |
| Commercial business | 242,100 | 11,263 | 4.65 | 215,598 | 10,311 | 4.78 | 206,167 | 9,939 | 4.82 |
| Commercial mortgage | 407,737 | 22,182 | 5.44 | 370,843 | 21,216 | 5.72 | 338,149 | 20,389 | 6.03 |
| Residential mortgage | 127,363 | 6,637 | 5.21 | 121,742 | 6,868 | 5.64 | 138,954 | 8,157 | 5.87 |
| Home equity | 257,537 | 10,984 | 4.27 | 216,428 | 9,572 | 4.42 | 202,189 | 9,224 | 4.56 |
| Consumer indirect | 533,589 | 27,371 | 5.13 | 444,527 | 26,549 | 5.97 | 382,977 | 25,379 | 6.63 |
| Other consumer | 25,058 | 2,686 | 10.72 | 24,686 | 2,589 | 10.49 | 26,950 | 2,789 | 10.35 |
| Total loans | 1,593,384 | 81,123 | 5.09 | 1,393,824 | 77,105 | 5.53 | 1,295,386 | 75,877 | 5.86 |
| Total interest-earning assets | 2,297,140 | 99,851 | 4.35 | 2,079,733 | 97,180 | 4.67 | 1,981,176 | 98,404 | 4.97 |
| Less: Allowance for loan losses | 24,305 | | | 21,567 | | | 20,883 | | |
| Other noninterest-earning assets | 246,423 | | | 218,983 | | | 206,303 | | |
| Total assets | $ 2,519,258 | | | $ 2,277,149 | | | $ 2,166,596 | | |
| **Interest-bearing liabilities:** | | | | | | | | | |
| Deposits: | | | | | | | | | |
| Interest-bearing demand | $ 423,096 | 598 | 0.14 | $ 383,122 | 614 | 0.16 | $ 382,517 | 705 | 0.18 |
| Savings and money market | 586,329 | 998 | 0.17 | 451,030 | 1,056 | 0.23 | 414,953 | 1,133 | 0.27 |
| Certificates of deposit | 693,353 | 6,866 | 0.99 | 712,411 | 9,764 | 1.37 | 726,330 | 13,015 | 1.79 |
| Total interest-bearing deposits | 1,702,778 | 8,462 | 0.50 | 1,546,563 | 11,434 | 0.74 | 1,523,800 | 14,853 | 0.97 |
| Short-term borrowings | 121,735 | 589 | 0.48 | 99,122 | 500 | 0.50 | 49,104 | 365 | 0.74 |
| Long-term borrowings | | | | 15,905 | 1,321 | 8.31 | 37,043 | 2,502 | 6.75 |
| Total borrowings | 121,735 | 589 | 0.48 | 115,027 | 1,821 | 1.58 | 86,147 | 2,867 | 3.33 |
| Total interest-bearing liabilities | 1,824,513 | 9,051 | 0.50 | 1,661,590 | 13,255 | 0.80 | 1,609,947 | 17,720 | 1.10 |
| Noninterest-bearing deposits | 430,240 | | | 368,268 | | | 329,853 | | |
| Other liabilities | 16,506 | | | 15,041 | | | 15,485 | | |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Shareholders equity | 247,999 | | | 232,250 | | | 211,311 | | |
| Total liabilities and shareholders equity | $ 2,519,258 | | | $ 2,277,149 | | | $ 2,166,596 | | |
| Net interest income (tax-equivalent) | | $ 90,800 | | | $ 83,925 | | | $ 80,684 | |
| Interest rate spread | | | 3.85% | | | 3.87% | | | 3.87% |
| Net earning assets | $ 472,627 | | | $ 418,143 | | | $ 371,229 | | |
| Net interest margin (tax-equivalent) | | | 3.95% | | | 4.04% | | | 4.07% |
| Ratio of average interest-earning assets to average interest-bearing liabilities | 125.90% | | | 125.17% | | | 123.06% | | |

Table of Contents

MANAGEMENT S DISCUSSION AND ANALYSIS

**Rate/Volume Analysis**

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

| | Change from 2012 to 2011 | | | Change from 2011 to 2010 | | |
|---|---|---|---|---|---|---|
| **Increase (decrease) in:** | **Volume** | **Rate** | **Total** | **Volume** | **Rate** | **Total** |
| **Interest income:** | | | | | | |
| Federal funds sold and other interest-earning deposits | $ | $ | $ | $ (5) | $ (5) | $ (10) |
| Investment securities: | | | | | | |
| Taxable | (487) | (1,496) | (1,983) | (772) | (2,144) | (2,916) |
| Tax-exempt | 1,422 | (786) | 636 | 1,418 | (944) | 474 |
| Total investment securities | 935 | (2,282) | (1,347) | 646 | (3,088) | (2,442) |
| Loans: | | | | | | |
| Commercial business | 1,239 | (287) | 952 | 452 | (80) | 372 |
| Commercial mortgage | 2,041 | (1,075) | 966 | 1,905 | (1,078) | 827 |
| Residential mortgage | 308 | (539) | (231) | (980) | (309) | (1,289) |
| Home equity | 1,763 | (351) | 1,412 | 636 | (288) | 348 |
| Consumer indirect | 4,879 | (4,057) | 822 | 3,829 | (2,659) | 1,170 |
| Other consumer | 39 | 58 | 97 | (237) | 37 | (200) |
| Total loans | 10,269 | (6,251) | 4,018 | 5,605 | (4,377) | 1,228 |
| **Total interest income** | **11,204** | **(8,533)** | **2,671** | **6,246** | **(7,470)** | **(1,224)** |
| **Interest expense:** | | | | | | |
| Deposits: | | | | | | |
| Interest-bearing demand | 60 | (76) | (16) | 1 | (92) | (91) |
| Savings and money market | 271 | (329) | (58) | 93 | (170) | (77) |
| Certificates of deposit | (255) | (2,643) | (2,898) | (245) | (3,006) | (3,251) |
| Total interest-bearing deposits | 76 | (3,048) | (2,972) | (151) | (3,268) | (3,419) |
| Short-term borrowings | 110 | (21) | 89 | 281 | (146) | 135 |
| Long-term borrowings | (660) | (661) | (1,321) | (1,662) | 481 | (1,181) |
| Total borrowings | (550) | (682) | (1,232) | (1,381) | 335 | (1,046) |
| **Total interest expense** | **(474)** | **(3,730)** | **(4,204)** | **(1,532)** | **(2,933)** | **(4,465)** |
| **Net interest income** | **$ 11,678** | **$ (4,803)** | **$ 6,875** | **$ 7,778** | **$ (4,537)** | **$ 3,241** |

**Provision for Loan Losses**

The provision for loan losses is based upon credit loss experience, growth or contraction of specific segments of the loan portfolio, and the estimate of losses inherent in the current loan portfolio. The provision for loan losses was $7.1 million for the year ended December 31, 2012 compared with $7.8 million for 2011. See the Allowance for Loan Losses section of this Management s Discussion and Analysis for further discussion.

Table of Contents

MANAGEMENT S DISCUSSION AND ANALYSIS

**Noninterest Income**

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

| | 2012 | 2011 | 2010 |
|---|---|---|---|
| Service charges on deposits | $ 8,627 | $ 8,679 | $ 9,585 |
| ATM and debit card | 4,716 | 4,359 | 3,995 |
| Broker-dealer fees and commissions | 2,104 | 1,829 | 1,283 |
| Company owned life insurance | 1,751 | 1,424 | 1,107 |
| Loan servicing | 617 | 835 | 1,124 |
| Net gain on sale of loans held for sale | 1,421 | 880 | 650 |
| Net gain on disposal of investment securities | 2,651 | 3,003 | 169 |
| Impairment charges on investment securities | (91) | (18) | (594) |
| Net (loss) gain on sale and disposal of other assets | (381) | 67 | (203) |
| Other | 3,362 | 2,867 | 2,338 |
| Total noninterest income | $ 24,777 | $ 23,925 | $ 19,454 |

The components of noninterest income fluctuated as discussed below.

Service charges on deposits decreased slightly during 2012 compared to 2011. An increase in the number of customer accounts, including those added from the branch acquisitions in June and August of 2012, helped offset decreases in service charge income related to changes in customer behavior and regulatory changes that included the requirement that customers opt-in for overdraft coverage for certain types of electronic banking activities.

ATM and debit card income was $4.7 million for 2012, an increase of $357 thousand or 8%, compared to 2011. The increased popularity of electronic banking and transaction processing has resulted in higher ATM and debit card point-of-sale usage income.

Broker-dealer fees and commissions were up $275 thousand or 15%, compared to 2011. Broker-dealer fees and commissions fluctuate mainly due to sales volume, which continued to increase during 2012 as a result of improving market and economic conditions and our renewed focus on this line of business.

During the third quarter of 2011 we purchased an additional $18.0 million of company owned life insurance. The increased amount of insurance was largely responsible for the $327 thousand increase in company owned life insurance income for 2012.

Loan servicing income represents fees earned for servicing mortgage and indirect auto loans sold to third parties, net of amortization expense and impairment losses, if any, associated with capitalized loan servicing assets. Loan servicing income was down $218 thousand or 26% for the year ended December 31, 2012 compared to 2011. Loan servicing income decreased as a result of more rapid amortization of servicing rights due to loans paying off, lower fees collected due to a decrease in the sold and serviced portfolio and write-downs on capitalized mortgage servicing assets.

Net gain on loans held for sale was $1.4 million in 2012, an increase of $541 thousand or 61%, compared to 2011, mainly due to increased origination volume related primarily to refinancing activity, a result of low interest rates.

Net gains from the sales of investment securities were $2.7 million for the year ended December 31, 2012, compared to $3.0 million for the year ended December 31, 2011. During 2012, we recognized gains totaling $2.6 million from the sale of five pooled trust-preferred securities. Net gains for 2011 included $2.3 million from the sale of four pooled trust-preferred securities and $730 thousand from the sale of eight mortgage-backed securities. The amount and timing of our sale of investments securities is dependent on a number of factors, including our prudent efforts to realize gains while managing duration, premium and credit risk.

Due to their proximity to our existing locations, we consolidated four branches as part of the branch acquisitions. The majority of the loss on the disposal of other assets for 2012 was due to write-off of leasehold improvements and other fixed assets for these branches that were closed.

Other noninterest income increased $495 thousand or 17% for the year ended December 31, 2012, compared to 2011. Income from our investment in several limited partnerships and dividends from FHLB stock comprised the majority of the year-over-year increase.

Table of Contents

**MANAGEMENT S DISCUSSION AND ANALYSIS**

**Noninterest Expense**

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

| | 2012 | 2011 | 2010 |
|---|---|---|---|
| Salaries and employee benefits | $ 40,127 | $ 35,743 | $ 32,844 |
| Occupancy and equipment | 11,419 | 10,868 | 10,818 |
| Professional services | 4,133 | 2,617 | 2,197 |
| Computer and data processing | 3,271 | 2,437 | 2,487 |
| Supplies and postage | 2,497 | 1,778 | 1,772 |
| FDIC assessments | 1,300 | 1,513 | 2,507 |
| Advertising and promotions | 929 | 1,259 | 1,121 |
| Loss on extinguishment of debt | | 1,083 | |
| Other | 7,721 | 6,496 | 7,171 |
| Total noninterest expense | $ 71,397 | $ 63,794 | $ 60,917 |

The components of noninterest expense fluctuated as discussed below.

Salaries and employee benefits (which includes salary-related expenses and fringe benefit expenses) was $40.1 million for 2012, up $4.4 million or 12% from 2011. As discussed earlier, salaries and employee benefits for 2012 included pre-tax costs of approximately $2.6 million that were incurred in association with the retirement of our former CEO. After adjusting for these expenses, the increase in salaries and employee benefits for 2012 when compared to the prior year is attributable to higher pension costs along with increased staffing levels. Full time equivalent employees increased by 9% to 628 at December 31, 2012 from 575 at December 31, 2011, primarily due to the branch acquisitions.

Occupancy and equipment increased by $551 thousand or 5% when comparing 2012 to 2011. The increase was primarily related to the growth in the branch network related to the branch acquisitions.

Professional services expense of $4.1 million in 2012 increased $1.5 million or 58% from 2011. Professional fees increased primarily due to legal expenses related to the branch acquisitions. The management transition described earlier also contributed to the increase in professional fees.

Computer and data processing and supplies and postage expense increased, collectively, by $1.6 million when comparing 2012 to 2011. The year-over-year increase was due to expenses related to the branch acquisition transactions.

FDIC assessments decreased $213 thousand for the year ended December 31, 2012, compared to 2011, primarily a result of changes implemented by the FDIC in the method of calculating assessment rates which became effective in the second quarter of 2011.

Advertising and promotions costs were $330 thousand or 26% lower in 2012 compared to 2011 due to the timing of marketing campaigns and promotions, coupled with cost management strategies.

We redeemed all of our 10.20% junior subordinated debentures during the third quarter of 2011. As a result of the redemption, we recognized a loss on extinguishment of debt of $1.1 million, consisting of a redemption premium of $852 thousand and a write-off of the remaining unamortized issuance costs of $231 thousand in 2011.

Other noninterest expense increased $1.2 million or 19% during 2012 compared to 2011. The increases in other noninterest expenses were primarily related to the branch acquisition transactions.

The efficiency ratio for the year ended December 31, 2012 was 62.87% compared with 60.55% for 2011. The higher efficiency ratio is attributable to the additional expenses related to the branch acquisitions and retirement of our former CEO, as previously discussed. The efficiency ratio is calculated by dividing total noninterest expense, excluding other real estate expense and amortization of intangible assets, by net revenue, defined as the sum of tax-equivalent net interest income and noninterest income before net gains and impairment charges on investment securities. Taxes are not part of this calculation. An increase in the efficiency ratio indicates that more resources are being utilized to generate the same volume of income, while a decrease would indicate a more efficient allocation of resources.

**Income Taxes**

We recognized income tax expense of $11.3 million for 2012 compared to $11.4 million for 2011. The lower tax provision was primarily attributable to a decrease in our effective tax rate to 32.6% for 2012 compared to 33.4% for 2011. The lower effective tax rate in 2012 was a result of the greater impact of tax-exempt income on lower taxable income. Effective tax rates are impacted by items of income and expense that are not subject to federal or state taxation. Our effective tax rates reflect the impact of these items, which include, but are not limited to, interest income from tax-exempt securities and earnings on company owned life insurance.

Table of Contents

**MANAGEMENT S DISCUSSION AND ANALYSIS**

***RESULTS OF OPERATIONS FOR THE YEARS ENDED***

***DECEMBER 31, 2011 AND DECEMBER 31, 2010***

**Net Interest Income and Net Interest Margin**

Net interest income in the consolidated statements of income (which excludes the taxable equivalent adjustment) was $81.9 million in 2011, compared to $78.8 million in 2010. The taxable equivalent adjustments (the adjustments to bring tax-exempt interest to a level that would yield the same after-tax income had that income been subject to a taxation using a tax rate of 35%) of $2.1 million and $1.9 million for 2011 and 2010, respectively, resulted in fully taxable equivalent net interest income of $83.9 million in 2011 and $80.7 million in 2010.

Taxable equivalent net interest income of $83.9 million for 2011 was $3.2 million or 4% higher than 2010. The impact of a decline in average yields on our assets was diminished by a 5% increase in interest-earning assets. The average balance of loans rose $98.4 million or 8% to $1.394 billion, reflecting growth in the commercial and consumer indirect loan portfolios, and the average balance of interest-earning assets rose $98.6 million to $2.080 billion.

The increase in taxable equivalent net interest income was a function of a favorable volume variance (as balance sheet changes in both volume and mix increased taxable equivalent net interest income by $7.8 million), partially offset by an unfavorable rate variance (decreasing taxable equivalent net interest income by $4.5 million). The change in mix and volume of earning assets increased taxable equivalent interest income by $6.3 million, while the change in volume and composition of interest-bearing liabilities decreased interest expense by $1.5 million, for a net favorable volume impact of $7.8 million on taxable equivalent net interest income. Rate changes on earning assets reduced interest income by $7.4 million, while changes in rates on interest-bearing liabilities lowered interest expense by $2.9 million, for a net unfavorable rate impact of $4.5 million.

The net interest margin for 2011 was 4.04% compared to 4.07% in 2010. The slight decrease in net interest margin was attributable to a 3 basis point lower contribution from net free funds (primarily attributable to lower rates on interest-bearing liabilities reducing the value of noninterest-bearing deposits and other net free funds). The interest rate spread remained unchanged from the year ended December 31, 2010 at 3.87%, as a 30 basis point decrease in the yield on earning assets offset the 30 basis point decrease in the cost of interest-bearing liabilities.

The Federal Reserve left the Federal funds rate unchanged at 0.25% during 2011 and 2010.

For 2011, the yield on average earning assets of 4.67% was 30 basis points lower than 2010. Loan yields decreased 33 basis points to 5.53%. Commercial mortgage and consumer indirect loans in particular, down 31 and 66 basis points, respectively, experienced lower yields given the competitive pricing pressures and re-pricing of loans in a low interest rate environment. The yield on investment securities dropped 38 basis points to 2.93%, also impacted by the lower interest rate environment and prepayments of mortgage-related investment securities. Overall, earning asset rate changes reduced interest income by $7.5 million.

The cost of average interest-bearing liabilities of 0.80% in 2011 was 30 basis points lower than 2010. The average cost of interest-bearing deposits was 0.74% in 2011, 23 basis points lower than 2010, reflecting the low-rate environment, mitigated by a focus on product pricing to retain balances. The cost of borrowings decreased 175 basis points to 1.58% for 2011, primarily a result of the redemption of the 10.20% junior subordinated debentures. The interest-bearing liability rate changes reduced interest expense by $2.9 million.

Average interest-earning assets of $2.080 billion in 2011 were $98.6 million or 5% higher than 2010. Average investment securities increased $5.0 million while average loans increased $98.4 million or 8%. Commercial loans increased $42.1 million and consumer loans increased $73.5 million, offset by a $17.2 million decrease in residential mortgage loans.

Average interest-bearing liabilities of $1.662 billion in 2011 were up $51.6 million or 3% versus 2010. On average, interest-bearing deposits grew $22.8 million, while average noninterest-bearing demand deposits (a principal component of net free funds) increased by $38.4 million. Average borrowings increased $28.9 million, representing a $50.0 million increase and $21.1 million decrease in short-term and long-term borrowings, respectively.

**Provision for Loan Losses**

The provision for loan losses was $7.8 million for the year ended December 31, 2011 compared with $6.7 million for 2010.

Table of Contents

MANAGEMENT S DISCUSSION AND ANALYSIS

**Noninterest Income**

Service charges on deposits were $8.7 million in 2011, which was $906 thousand or 9% lower than 2010. The decrease was primarily due to changes in customer behavior and regulatory changes that included requirements for customers to opt-in for overdraft coverage for certain types of electronic banking activities.

ATM and debit card income was $4.4 million for 2011, an increase of $364 thousand or 9%, compared to 2010. The increased popularity of electronic banking and transaction processing has resulted in higher ATM and debit card point-of-sale usage income.

Broker-dealer fees and commissions were up $546 thousand or 43%, compared to 2010, as a result of improving market and economic conditions and our renewed focus on this line of business.

Company owned life insurance income was up $317 thousand or 29% for the year ended December 31, 2011 compared to the same period in 2010. The increase was the result of an additional $18.0 million investment in company owned life insurance during the third quarter of 2011.

Loan servicing income was down $289 thousand or 26% for the year ended December 31, 2011 compared to 2010. Loan servicing income decreased as a result of more rapid amortization of servicing rights due to loans paying off, lower fees collected due to a decrease in the sold and serviced portfolio and write-downs on capitalized mortgage servicing assets.

Net gain on loans held for sale was $880 thousand in 2011, an increase of $230 thousand or 35%, compared to 2010, mainly due to the $153 thousand gain relating to the servicing retained sale of $13.0 million of indirect auto loans during the third quarter of 2011.

Net gains from the sales of investment securities were $3.0 million for the year ended December 31, 2011, compared to $169 thousand in 2010. Net gains from the sales of investment securities in 2011 included net gains of $2.3 million from the sale of four pooled trust-preferred securities that had been written down in prior periods and included in non-performing assets. Net gains of $730 thousand from the sale of eight mortgage-backed securities were also recognized during 2011.

Other noninterest income increased $529 thousand or 23% for the year ended December 31, 2011, compared to 2010. Other noninterest income for 2011 includes $152 thousand related to insurance proceeds received for losses relating to an irregular instance of fraudulent debit card activity recorded in the fourth quarter of 2010. Merchant services fees paid by customers for account management and electronic processing of transactions and income from our capital investment in several limited partnerships also contributed to the 2011 increases.

**Noninterest Expense**

Salaries and employee benefits (which includes salary-related expenses and fringe benefit expenses) was $35.7 million for 2011, up $2.9 million or 9% from 2010. Average full-time equivalent employees ( FTEs ) were 576 for 2011, about the same as 577 for 2010. Salary-related expenses increased $2.0 million for the year ended December 31, 2011, compared to 2010, reflecting an increase in estimated incentive compensation, which was previously limited under the TARP Capital Purchase Program. Fringe benefit expenses increased $672 thousand or 9%, primarily attributable to higher medical expenses.

Professional services expense of $2.6 million in 2011 increased $420 thousand or 19% from 2010, primarily due to legal and shareholder expenses related to our common stock offering and redemption of our Series A preferred stock and 10.20% junior subordinated debentures. We also recognized a loss on extinguishment of debt of $1.1 million in connection with the redemption of the 10.20% junior subordinated debentures during 2011.

FDIC assessments decreased $1.0 million for the year ended December 31, 2011, compared to 2010, primarily a result of changes implemented by the FDIC in the method of calculating assessment rates which became effective in the second quarter of 2011.

Advertising and promotions expenses were $138 thousand or 12% higher in 2011 compared to 2010 due to increases in business development expenses and the opening of a new branch in suburban Rochester in the third quarter of 2011.

Other noninterest expense decreased $404 thousand or 6% during 2011 compared to 2010. The 2010 expense includes a loss of approximately $1.0 million relating to irregular instances of fraudulent debit card activity.

The efficiency ratio for the year ended December 31, 2011 was 60.55% compared with 60.36% for 2010.

**Income Taxes**

We recognized income tax expense of $11.4 million for 2011 compared to $9.4 million for 2010. The change was due in part to a $3.6 million increase in pretax income between the years. In addition, during 2010, we recorded non-recurring tax benefits of $1.2 million related to valuation of our deferred tax assets as a result of the NYS repeal of the experience method for determining bad debts and re-valuing at the highest Federal statutory rate of 35%. Our effective tax rates were 33.4% in 2011 and 30.5% in 2010.

Table of Contents

**MANAGEMENT S DISCUSSION AND ANALYSIS**

*ANALYSIS OF FINANCIAL CONDITION*

**OVERVIEW**

At December 31, 2012, we had total assets of $2.764 billion, an increase of 18% from $2.336 billion as of December 31, 2011, largely attributable to the branch acquisitions combined with our continued core business growth in both loans and deposits. Net loans were $1.681 billion as of December 31, 2012, up $219.5 million, or 15%, when compared to $1.462 billion as of December 31, 2011. The increase in net loans was primarily attributed to the continued expansion of the indirect lending program, commercial business development efforts and loans acquired in the branch acquisition. At December 31, 2012, total loans included $64.5 million in loans obtained in the branch acquisitions. Non-performing assets totaled $10.1 million as of December 31, 2012, up $875 thousand from a year ago. Total deposits amounted to $2.262 billion and $1.932 billion as of December 31, 2012 and 2011, respectively. As of December 31, 2012, borrowed funds totaled $179.8 million, compared to $150.7 million as of December 31, 2011. Book value per common share was $17.15 and $15.92 as of December 31, 2012 and 2011, respectively. As of December 31, 2012 our total shareholders equity was $253.9 million compared to $237.2 million a year earlier.

**INVESTING ACTIVITIES**

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

| | Investment Securities Portfolio Composition At December 31, | | | | | |
|---|---|---|---|---|---|---|
| | 2012 | | 2011 | | 2010 | |
| | Amortized Cost | Fair Value | Amortized Cost | Fair Value | Amortized Cost | Fair Value |
| **Securities available for sale:** | | | | | | |
| U.S. Government agency and government-sponsored enterprise securities | $ 128,097 | $ 131,695 | $ 94,947 | $ 97,712 | $ 141,591 | $ 140,784 |
| State and political subdivisions | 188,997 | 195,210 | 119,099 | 124,424 | 105,622 | 105,666 |
| Mortgage-backed securities: | | | | | | |
| Agency mortgage-backed securities | 479,913 | 494,770 | 390,375 | 401,596 | 414,502 | 417,709 |
| Non-Agency mortgage-backed securities | 73 | 1,098 | 327 | 2,089 | 981 | 1,572 |
| Asset-backed securities | 121 | 1,023 | 297 | 1,697 | 564 | 637 |
| Total available for sale securities | 797,201 | 823,796 | 605,045 | 627,518 | 663,260 | 666,368 |
| **Securities held to maturity:** | | | | | | |
| State and political subdivisions | 17,905 | 18,478 | 23,297 | 23,964 | 28,162 | 28,849 |
| Total investment securities | $ 815,106 | $ 842,274 | $ 628,342 | $ 651,482 | $ 691,422 | $ 695,217 |

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

**Impairment Assessment**

We review investment securities on an ongoing basis for the presence of OTTI with formal reviews performed quarterly. Declines in the fair value of held-to-maturity and available-for-sale securities below their cost that are deemed to be other than temporary are reflected in earnings as realized losses to the extent the impairment is related to credit losses or the security is intended to be sold or will be required to be sold. The amount of the impairment related to non-credit related factors is recognized in other comprehensive income. Evaluating whether the impairment

of a debt security is other than temporary involves assessing i.) the intent to sell the debt security or ii.) the likelihood of being required to sell the security before the recovery of its amortized cost basis. In determining whether the other-than-temporary impairment includes a credit loss, we use our best estimate of the present value of cash flows expected to be collected from the debt security considering factors such as: a.) the length of time and the extent to which the fair value has been less than the amortized cost basis, b.) adverse conditions specifically related to the security, an industry, or a geographic area, c.) the historical and implied volatility of the fair value of the security, d.) the payment structure of the debt security and the likelihood of the issuer being able to make payments that increase in the future, e.) failure of the issuer of the security to make scheduled interest or principal payments, f.) any changes to the rating of the security by a rating agency, and g.) recoveries or additional declines in fair value subsequent to the balance sheet date.

MANAGEMENT S DISCUSSION AND ANALYSIS

As of December 31, 2012, management does not have the intent to sell any of the securities in a loss position and believes that it is not likely that it will be required to sell any such securities before the anticipated recovery of amortized cost. The unrealized losses are largely due to increases in market interest rates over the yields available at the time the underlying securities were purchased. The fair value is expected to recover as the bonds approach their maturity date, repricing date or if market yields for such investments decline. Management does not believe any of the securities in a loss position are impaired due to reasons of credit quality. Accordingly, as of December 31, 2012, management has concluded that unrealized losses on its investment securities are temporary and no further impairment loss has been realized in our consolidated statements of income. The following discussion provides further details of our assessment of the securities portfolio by investment category.

**U.S. Government Agencies and Government Sponsored Enterprises ( GSE ).** As of December 31, 2012, there were six securities in an unrealized loss position in the U.S. Government agencies and GSE portfolio with unrealized losses totaling $69 thousand. Of these, three were in an unrealized loss position for 12 months or longer and had an aggregate amortized cost of $3.0 million and unrealized losses of $2 thousand. The decline in fair value is attributable to changes in interest rates, and not credit quality, and because we do not have the intent to sell these securities and it is likely that we will not be required to sell the securities before their anticipated recovery, we do not consider these securities to be other-than-temporarily impaired at December 31, 2012.

**State and Political Subdivisions.** As of December 31, 2012, the state and political subdivisions ( municipals ) portfolio totaled $213.1 million, of which $195.2 million was classified as available for sale. As of that date, $17.9 million was classified as held to maturity with a fair value of $18.5 million. As of December 31, 2012, there were 36 municipals in an unrealized loss position, all of which were available for sale and in an unrealized loss position for less than 12 months. Those 36 securities had an aggregate amortized cost of $8.5 million and unrealized losses totaling $72 thousand.

Because the decline in fair value is attributable to changes in interest rates, and not credit quality, and because we do not have the intent to sell these securities and it is not likely that we will be required to sell the securities before their anticipated recovery, we do not consider these securities to be other-than-temporarily impaired at December 31, 2012.

**Agency Mortgage-backed Securities.** With the exception of the non-Agency mortgage-backed securities ( non-Agency MBS ) discussed below, all of the mortgage-backed securities held by us as of December 31, 2012, were issued by U.S. Government sponsored entities and agencies ( Agency MBS ), primarily FNMA. The contractual cash flows of our Agency MBS are guaranteed by FNMA, FHLMC or GNMA. The GNMA mortgage-backed securities are backed by the full faith and credit of the U.S. Government.

As of December 31, 2012, there were ten securities in the Agency MBS portfolio that were in an unrealized loss position. Of these, three were in an unrealized loss position for 12 months or longer and had an aggregate amortized cost of $1.2 million and unrealized losses of $2 thousand. Given the high credit quality inherent in Agency MBS, we do not consider any of the unrealized losses as of December 31, 2012 on such MBS to be credit related or other-than-temporary. As of December 31, 2012, we did not intend to sell any of Agency MBS that were in an unrealized loss position, all of which were performing in accordance with their terms.

**Non-Agency Mortgage-backed Securities.** Our non-Agency MBS portfolio consists of positions in two privately issued whole loan collateralized mortgage obligations with a fair value of $1.1 million and net unrealized gains of $1.0 million as of December 31, 2012. As of that date, each of the two non-Agency MBS were rated below investment grade. None of these securities were in an unrealized loss position.

**Asset-backed Securities ( ABS ).** As of December 31, 2012, the fair value of our ABS portfolio totaled $1.0 million and consisted of positions in six securities, the majority of which are pooled trust preferred securities ( TPS ) issued primarily by insurance companies and, to a lesser extent, financial institutions located throughout the United States. As a result of some issuers defaulting and others electing to defer interest payments, we considered the TPS to be non-performing and stopped accruing interest on these investments during 2009. As of December 31, 2012, each of the securities in the ABS portfolio was rated below investment grade. None of these securities were in an unrealized loss position.

During 2012, we recognized gains totaling $2.6 million from the sale of five TPS. The five securities had a fair value of $1.1 million at December 31, 2011. We continue to monitor the market for these securities and evaluate the potential for future dispositions.

**Other Investments.** As a member of the FHLB the Bank is required to hold FHLB stock. The amount of required FHLB stock is based on the Bank s asset size and the amount of borrowings from the FHLB. We have assessed the ultimate recoverability of our FHLB stock and believe that no impairment currently exists. As a member of the FRB system, we are required to maintain a specified investment in FRB stock based on

a ratio relative to our capital. At December 31, 2012, our ownership of FHLB and FRB stock totaled $8.4 million and $3.9 million, respectively and is included in other assets and recorded at cost, which approximates fair value.

MANAGEMENT S DISCUSSION AND ANALYSIS

**LENDING ACTIVITIES**

Total loans were $1.706 billion at December 31, 2012, an increase of $220.9 million or 15% from December 31, 2011. Commercial loans increased $44.9 million or 7% and represented 39.4% of total loans at the end of 2012. Residential mortgage loans were $133.5 million, up $19.6 million or 17% and represented 7.8% of total loans at December 31, 2012, while consumer loans increased $156.4 million to represent 52.8% of total loans at December 31, 2012 compared to 50.1% at December 31, 2011. The composition of our loan portfolio, excluding loans held for sale and including net unearned income and net deferred fees and costs, is summarized as follows (in thousands):

**Loan Portfolio Composition**
**At December 31,**

| | 2012 | | 2011 | | 2010 | | 2009 | | 2008 | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Amount | Percent | Amount | Percent | Amount | Percent | Amount | Percent | Amount | Percent |
| Commercial business | $ 258,675 | 15.2% | $ 233,836 | 15.7% | $ 211,031 | 15.7% | $ 206,383 | 16.3% | $ 180,100 | 16.1% |
| Commercial mortgage | 413,324 | 24.2 | 393,244 | 26.5 | 352,930 | 26.2 | 330,748 | 26.2 | 285,383 | 25.5 |
| Total commercial | 671,999 | 39.4 | 627,080 | 42.2 | 563,961 | 41.9 | 537,131 | 42.5 | 465,483 | 41.6 |
| Residential mortgage | 133,520 | 7.8 | 113,911 | 7.7 | 129,580 | 9.6 | 144,215 | 11.4 | 177,683 | 15.8 |
| Home equity | 286,649 | 16.8 | 231,766 | 15.6 | 208,327 | 15.5 | 200,684 | 15.9 | 189,794 | 16.9 |
| Consumer indirect | 586,794 | 34.4 | 487,713 | 32.9 | 418,016 | 31.1 | 352,611 | 27.9 | 255,054 | 22.8 |
| Other consumer | 26,764 | 1.6 | 24,306 | 1.6 | 26,106 | 1.9 | 29,365 | 2.3 | 33,065 | 2.9 |
| Total consumer | 900,207 | 52.8 | 743,785 | 50.1 | 652,449 | 48.5 | 582,660 | 46.1 | 477,913 | 42.6 |
| Total loans | 1,705,726 | 100.0% | 1,484,776 | 100.0% | 1,345,990 | 100.0% | 1,264,006 | 100.0% | 1,121,079 | 100.0% |
| Allowance for loan losses | 24,714 | | 23,260 | | 20,466 | | 20,741 | | 18,749 | |
| Total loans, net | $ 1,681,012 | | $ 1,461,516 | | $ 1,325,524 | | $ 1,243,265 | | $ 1,102,330 | |

As of December 31, 2012, the residential mortgage portfolio consisted of $28.2 million of loans acquired with the branch acquisitions and $105.3 million of organic loans. The decrease in organic residential mortgage loans from $129.6 million to $113.9 million to $105.3 million for the periods ending December 31, 2010, 2011 and 2012, respectively, and the increase in consumer indirect loans from $418.0 million to $487.7 million to $586.8 million for the same periods reflects a strategic shift to increase our consumer indirect loan portfolio, while placing less emphasis on expanding our residential mortgage loan portfolio, coupled with our practice of selling the majority of our fixed-rate residential mortgages in the secondary market with servicing rights retained.

Commercial loans increased during 2012 as we continued our commercial business development efforts. The credit risk related to commercial loans is largely influenced by general economic conditions and the resulting impact on a borrower s operations or on the value of underlying collateral, if any.

The Company participates in various lending programs in which guarantees are supplied by U.S. government agencies, such as the SBA, U.S. Department of Agriculture, Rural Economic and Community Development and Farm Service Agency, among others. As of December 31, 2012, the principal balance of such loans (included in commercial loans) was $62.5 million and the guaranteed portion amounted to $43.1 million. Most of these loans were guaranteed by the SBA.

Commercial business loans were $258.7 million at the end of 2012, up $24.8 million or 11% since year-end 2011, and comprised 15.2% of total loans outstanding at December 31, 2012. We typically originate business loans of up to $15.0 million for small to mid-sized businesses in our market area for working capital, equipment financing, inventory financing, accounts receivable financing, or other general business purposes. Loans of this type are in a diverse range of industries. Within the commercial business classification, loans to finance agricultural production totaled approximately 1% of commercial business loans as of December 31, 2012. As of December 31, 2012, commercial business SBA loans accounted for a total of $38.9 million or 15% of our commercial business loan portfolio.

Commercial mortgage loans totaled $413.3 million at December 31, 2012, up $20.1 million or 5% from December 31, 2011, and comprised 24.2% of total loans, compared to 26.5% at December 31, 2011. Commercial mortgage includes both owner occupied and non-owner occupied commercial real estate loans. Approximately 46% and 45% of the commercial mortgage portfolio at December 31, 2012 and 2011, respectively, was owner occupied commercial real estate. The majority of our commercial real estate loans are secured by office buildings, manufacturing facilities, distribution/warehouse facilities, and retail centers, which are generally located in our local market area. As of December 31, 2012, commercial mortgage SBA loans accounted for a total of $18.1 million or 4% of our commercial mortgage loan portfolio.

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

Table of Contents

**MANAGEMENT S DISCUSSION AND ANALYSIS**

Residential mortgage loans totaled $133.5 million at the end of 2012, up $19.6 million or 17% from the prior year and comprised 7.8% of total loans outstanding at December 31, 2012 and 7.7% at December 31, 2011. Residential mortgage loans include conventional first lien home mortgages and we generally limit the maximum loan to 85% of collateral value without credit enhancement (e.g. PMI insurance). As part of management s historical practice of originating and servicing residential mortgage loans, the majority of our fixed-rate residential mortgage loans are sold in the secondary market with servicing rights retained. Residential mortgage products continue to be underwritten using FHLMC and FNMA secondary marketing guidelines.

Consumer loans totaled $900.2 million at December 31, 2012, up $156.4 million or 21% compared to 2011, and represented 52.8% of the 2012 year-end loan portfolio versus 50.1% at year-end 2011. Loans in this classification include indirect consumer, home equity and other consumer installment loans. Credit risk for these types of loans is generally influenced by general economic conditions, the characteristics of individual borrowers, and the nature of the loan collateral. Risks of loss are generally on smaller average balances per loan spread over many borrowers. Once charged off, there is usually less opportunity for recovery on these smaller retail loans. Credit risk is primarily controlled by reviewing the creditworthiness of the borrowers, monitoring payment histories, and taking appropriate collateral and guaranty positions.

Consumer indirect loans amounted to $586.8 million at December 31, 2012 up $99.1 million or 20% compared to 2011, and represented 34.4% of the 2012 year-end loan portfolio versus 32.9% at year-end 2011. The loans are primarily for the purchase of automobiles (both new and used) and light duty trucks primarily to individuals, but also to corporations and other organizations. The loans are originated through dealerships and assigned to us with terms that typically range from 36 to 84 months. During the year ended December 31, 2012, we originated $324.6 million in indirect loans with a mix of approximately 49% new auto and 51% used vehicles. This compares with $266.7 million in indirect loans with a mix of approximately 46% new auto and 54% used vehicles for the same period in 2011. The increase in loans for new autos reflects changes in market conditions in 2012. We do business with over 400 franchised auto dealers located in Western, Central, and the Capital District of New York, and Northern Pennsylvania.

Home equity consists of home equity lines, as well as home equity loans, some of which are first lien positions. Home equities amounted to $286.6 million at December 31, 2012 up $54.9 million or 24% compared to 2011, and represented 16.8% of the 2012 year-end loan portfolio versus 15.6% at year-end 2011. The increase included home equities acquired in the branch acquisitions, which totaled $26.8 million at December 31, 2012. The portfolio had a weighted average LTV at origination of approximately 54% and 53% at December 31, 2012 and 2011, respectively. Approximately 69% of the loans in the home equity portfolio were first lien positions at December 31, 2012 and 2011.

Our underwriting guidelines for home equity products includes a combination of borrower FICO (credit score), the LTV of the property securing the loan and evidence of the borrower having sufficient income to repay the loan. Currently, for home equity products, the maximum acceptable LTV is 90%. The average FICO score for new home equity production was 758 in 2012 compared to 755 in 2011.

Other consumer loans totaled $26.8 million at December 31, 2012, up $2.5 million or 10% compared to 2011, and represented 1.6% of the loan portfolio at December 31, 2012 and 2011. The increase in other consumer loans is attributed to loans acquired in the branch acquisitions, which totaled $3.4 million at December 31, 2012. Other consumer consists of personal loans (collateralized and uncollateralized) and deposit account collateralized loans.

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

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

The loan portfolio is widely diversified by types of borrowers, industry groups, and market areas within our core footprint. Significant loan concentrations are considered to exist for a financial institution when there are amounts loaned to numerous borrowers engaged in similar activities that would cause them to be similarly impacted by economic or other conditions. At December 31, 2012, no significant concentrations, as defined above, existed in our portfolio in excess of 10% of total loans.

MANAGEMENT S DISCUSSION AND ANALYSIS

**Loans Held for Sale and Loan Servicing Rights.** Loans held for sale (not included in the loan portfolio composition table) were entirely comprised of residential real estate mortgages and totaled $1.5 million and $2.4 million as of December 31, 2012 and 2011, respectively.

We sell certain qualifying newly originated or refinanced residential real estate mortgages on the secondary market. Residential real estate mortgages serviced for others, which are not included in the consolidated statements of financial condition, amounted to $273.3 million and $297.8 million as of December 31, 2012 and 2011, respectively.

During 2011, we sold $13.0 million of indirect auto loans, which were reclassified from portfolio to loans held for sale during the second quarter of 2011. The loan servicing asset for the sold and serviced indirect auto loans, included in other assets in the consolidated statements of financial condition, was $250 thousand and $574 thousand as of December 31, 2012 and 2011, respectively.

**Allowance for Loan Losses**

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

| | Loan Loss Analysis Year Ended December 31, | | | | |
|---|---|---|---|---|---|
| | 2012 | 2011 | 2010 | 2009 | 2008 |
| Allowance for loan losses, beginning of year | $ 23,260 | $ 20,466 | $ 20,741 | $ 18,749 | $ 15,521 |
| Charge-offs: | | | | | |
| Commercial business | 729 | 1,346 | 3,426 | 2,360 | 720 |
| Commercial mortgage | 745 | 751 | 263 | 355 | 1,192 |
| Residential mortgage | 326 | 152 | 290 | 225 | 320 |
| Home equity | 305 | 449 | 259 | 195 | 110 |
| Consumer indirect | 6,589 | 4,713 | 4,669 | 3,637 | 2,011 |
| Other consumer | 874 | 877 | 909 | 1,058 | 1,106 |
| Total charge-offs | 9,568 | 8,288 | 9,816 | 7,830 | 5,459 |
| Recoveries: | | | | | |
| Commercial business | 336 | 401 | 326 | 428 | 684 |
| Commercial mortgage | 261 | 245 | 501 | 150 | 315 |
| Residential mortgage | 130 | 90 | 21 | 12 | 26 |
| Home equity | 44 | 44 | 36 | 20 | 19 |
| Consumer indirect | 2,769 | 2,066 | 1,485 | 1,030 | 548 |
| Other consumer | 354 | 456 | 485 | 480 | 544 |
| Total recoveries | 3,894 | 3,302 | 2,854 | 2,120 | 2,136 |
| Net charge-offs | 5,674 | 4,986 | 6,962 | 5,710 | 3,323 |
| Provision for loan losses | 7,128 | 7,780 | 6,687 | 7,702 | 6,551 |
| Allowance for loan losses, end of year | $ 24,714 | $ 23,260 | $ 20,466 | $ 20,741 | $ 18,749 |
| Net charge-offs to average loans | 0.36% | 0.36% | 0.54% | 0.47% | 0.32% |
| Allowance to end of period loans | 1.45% | 1.57% | 1.52% | 1.64% | 1.67% |
| Allowance to end of period non-performing loans | 271% | 329% | 270% | 239% | 229% |

Table of Contents

MANAGEMENT S DISCUSSION AND ANALYSIS

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

| | Allowance for Loan Losses by Loan Category At December 31, | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 2012 | | 2011 | | 2010 | | 2009 | | 2008 | |
| | Loan Loss Allowance | Percentage of loans by category to total loans | Loan Loss Allowance | Percentage of loans by category to total loans | Loan Loss Allowance | Percentage of loans by category to total loans | Loan Loss Allowance | Percentage of loans by category to total loans | Loan Loss Allowance | Percentage of loans by category to total loans |
| Commercial business | $ 4,884 | 15.2% | $ 4,036 | 15.7% | $ 3,712 | 15.7% | $ 4,407 | 16.3% | $ 3,300 | 16.1% |
| Commercial mortgage | 6,581 | 24.2 | 6,418 | 26.5 | 6,431 | 26.2 | 6,638 | 26.2 | 4,635 | 25.5 |
| Residential mortgage | 740 | 7.8 | 858 | 7.7 | 1,013 | 9.6 | 1,251 | 11.4 | 2,516 | 15.8 |
| Home equity | 1,282 | 16.8 | 1,242 | 15.6 | 972 | 15.5 | 1,043 | 15.9 | 2,374 | 16.9 |
| Consumer indirect | 10,715 | 34.4 | 10,189 | 32.9 | 7,754 | 31.1 | 6,837 | 27.9 | 5,152 | 22.8 |
| Other consumer | 512 | 1.6 | 517 | 1.6 | 584 | 1.9 | 565 | 2.3 | 772 | 2.9 |
| Total | $ 24,714 | 100.0% | $ 23,260 | 100.0% | $ 20,466 | 100.0% | $ 20,741 | 100.0% | $ 18,749 | 100.0% |

Management believes that the allowance for loan losses at December 31, 2012 is adequate to cover probable losses in the loan portfolio at that date. Factors beyond our control, however, such as general national and local economic conditions, can adversely impact the adequacy of the allowance for loan losses. As a result, no assurance can be given that adverse economic conditions or other circumstances will not result in increased losses in the portfolio or that the allowance for loan losses will be sufficient to meet actual loan losses. See Part I, Item 1A Risk Factors for the risks impacting this estimate. Management presents a quarterly review of the adequacy of the allowance for loan losses to our Board of Directors based on the methodology that is described in further detail in Part I, Item I Business under the section titled Lending Activities . See also Critical Accounting Estimates for additional information on the allowance for loan losses.

**Non-performing Assets and Potential Problem Loans**

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

| | Non-performing Assets At December 31, | | | | |
|---|---|---|---|---|---|
| | 2012 | 2011 | 2010 | 2009 | 2008 |
| Non-accruing loans: | | | | | |
| Commercial business | $ 3,413 | $ 1,259 | $ 947 | $ 650 | $ 510 |
| Commercial mortgage | 1,799 | 2,928 | 3,100 | 2,288 | 2,670 |
| Residential mortgage | 2,040 | 1,644 | 2,102 | 2,376 | 3,365 |
| Home equity | 939 | 682 | 875 | 880 | 1,143 |
| Consumer indirect | 891 | 558 | 514 | 621 | 445 |
| Other consumer | 25 | | 41 | 7 | 56 |
| Total non-accruing loans | 9,107 | 7,071 | 7,579 | 6,822 | 8,189 |
| Restructured accruing loans | | | | | |
| Accruing loans contractually past due over 90 days | 18 | 5 | 3 | 1,859 | 7 |

| | | | | | |
|---|---|---|---|---|---|
| Total non-performing loans | 9,125 | 7,076 | 7,582 | 8,681 | 8,196 |
| Foreclosed assets | 184 | 475 | 741 | 746 | 1,007 |
| Non-performing investment securities | 753 | 1,636 | 572 | 1,015 | 49 |
| Total non-performing assets | $ 10,062 | $ 9,187 | $ 8,895 | $ 10,442 | $ 9,252 |
| Non-performing loans to total loans | 0.53% | 0.48% | 0.56% | 0.69% | 0.73% |
| Non-performing assets to total assets | 0.36% | 0.39% | 0.40% | 0.51% | 0.48% |

Table of Contents

**MANAGEMENT S DISCUSSION AND ANALYSIS**

Non-performing assets include non-performing loans, foreclosed assets and non-performing investment securities. Non-performing assets at December 31, 2012 were $10.1 million, an increase of $875 thousand from the $9.2 million balance at December 31, 2011. The primary component of non-performing assets is non-performing loans, which were $9.1 million or 0.53% of total loans at December 31, 2012, an increase of $2.0 million from $7.1 million or 0.48% of total loans at December 31, 2011. The Company s ratio of non-performing loans to total loans continues to compare favorably to its peer group average, which was 2.48% of total loans at September 30, 2012, the most recent period for which information is available (Source: Federal Financial Institutions Examination Council Bank Holding Company Performance Report as of September 30, 2012 Top-tier bank holding companies having consolidated assets between $1 billion and $3 billion).

Approximately $4.2 million, or 46%, of the $9.1 million in non-performing loans as of December 31, 2012 were current with respect to payment of principal and interest, but were classified as non-accruing because repayment in full of principal and/or interest was uncertain. For non-accruing loans outstanding as of December 31, 2012, the amount of interest income forgone totaled $555 thousand. Included in nonaccrual loans are troubled debt restructurings ( TDRs ) of $636 thousand at December 31, 2012. We had no TDRs that were accruing interest as of December 31, 2012.

Foreclosed assets consist of real property formerly pledged as collateral to loans, which we have acquired through foreclosure proceedings or acceptance of a deed in lieu of foreclosure. Foreclosed asset holdings represented 5 properties totaling $184 thousand at December 31, 2012 and 8 properties totaling $475 thousand at December 31, 2011.

Non-performing investment securities for which we have stopped accruing interest were $753 thousand at December 31, 2012, compared to $1.6 million at December 31, 2011. Non-performing investment securities are included in non-performing assets at fair value and are comprised of pooled trust preferred securities. There have been no securities transferred to non-performing status since the first quarter of 2009. During 2012, we recognized gains totaling $2.6 million from the sale of five ABS securities. The five securities had a fair value of $1.1 million at December 31, 2011. We continue to monitor the market for these securities and evaluate the potential for future dispositions.

Potential problem loans are loans that are currently performing, but information known about possible credit problems of the borrowers causes management to have concern as to the ability of such borrowers to comply with the present loan payment terms and may result in disclosure of such loans as nonperforming at some time in the future. These loans remain in a performing status due to a variety of factors, including payment history, the value of collateral supporting the credits, and/or personal or government guarantees. Management considers loans classified as substandard, which continue to accrue interest, to be potential problem loans. We identified $13.8 million and $8.6 million in loans that continued to accrue interest which were classified as substandard as of December 31, 2012 and 2011, respectively. Included in potential problem loans at December 31, 2012 is one credit relationship which we internally downgraded to substandard status from special mention during the fourth quarter 2012. The relationship consists of commercial business and commercial mortgage loans with unpaid principal balances totaling $3.4 million. The downgrade necessitated a provision and increase in our allowance for losses of approximately $400 thousand. These loans were performing in accordance with their contractual terms as of December 31, 2012, however, we continue to monitor this relationship closely.

In addition, we currently have a large commercial relationship with an Industrial Development Agency project in our market area. The relationship consists of a $14.1 million first lien mortgage position and $3.5 million second lien mortgage on a manufacturing facility. Recent events with the underlying third party tenant of the project has resulted in our monitoring the credit relationship more closely and including the first mortgage loan as uncriticized watch and the second mortgage loan as special mention in our loan rating system. The loans are current as of December 31, 2012.

Table of Contents

**MANAGEMENT S DISCUSSION AND ANALYSIS**

**FUNDING ACTIVITIES**

**Deposits**

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

| | At December 31, | | | | | |
|---|---|---|---|---|---|---|
| | 2012 | | 2011 | | 2010 | |
| | Amount | Percent | Amount | Percent | Amount | Percent |
| Noninterest-bearing demand | $ 501,514 | 22.2% | $ 393,421 | 20.3% | $ 350,877 | 18.6% |
| Interest-bearing demand | 449,744 | 19.9 | 362,555 | 18.8 | 374,900 | 19.9 |
| Savings and money market | 655,598 | 28.9 | 474,947 | 24.6 | 417,359 | 22.2 |
| Certificates of deposit < $100,000 | 432,506 | 19.2 | 486,496 | 25.2 | 555,840 | 29.5 |
| Certificates of deposit of $100,000 or more | 222,432 | 9.8 | 214,180 | 11.1 | 183,914 | 9.8 |
| Total deposits | $ 2,261,794 | 100.0% | $ 1,931,599 | 100.0% | $ 1,882,890 | 100.0% |

We offer a variety of deposit products designed to attract and retain customers, with the primary focus on building and expanding long-term relationships. At December 31, 2012, total deposits were $2.262 billion, representing an increase of $330.2 million for the year. The increase is largely attributable to $286.8 million in nonpublic (retail) deposits assumed from the branch acquisitions. Certificates of deposit were approximately 29% and 36% of total deposits at December 31, 2012 and 2011, respectively. Depositors remain hesitant to invest in certificates of deposit for long periods due to the low interest rate environment. This has resulted in lower amounts being placed in time deposits for generally shorter terms.

Nonpublic deposits, the largest component of our funding sources, represented 80% of total deposits and totaled $1.789 billion and $1.541 billion as of December 31, 2012 and 2011, respectively. We have managed this segment of funding through a strategy of competitive pricing that minimizes the number of customer relationships that have only a single service high cost deposit account.

We had no traditional brokered deposits at December 31, 2012 or 2011, however, we do participate in the Certificate of Deposit Account Registry Service ( CDARS ) and Insured Cash Sweep ( ICS ) programs, which enables depositors to receive FDIC insurance coverage for deposits otherwise exceeding the maximum insurable amount. Through these programs, deposits in excess of the maximum insurable amount are placed with multiple participating financial institutions. Reciprocal CDARS deposits totaled $61.0 million and $46.5 million at December 31, 2012 and 2011, respectively. ICS deposits totaled $18.1 million at December 31, 2012. There were non ICS deposits outstanding at December 31, 2011.

As an additional source of funding, we offer a variety of public (municipal) deposit products to the many towns, villages, counties and school districts within our market. Public deposits generally range from 20% to 25% of our total deposits. There is a high degree of seasonality in this component of funding, because the level of deposits varies with the seasonal cash flows for these public customers. We maintain the necessary levels of short-term liquid assets to accommodate the seasonality associated with public deposits. Total public deposits were $454.2 million and $390.2 million, as of December 31, 2012 and 2011, respectively, and represented 20% of total deposits as of the end of each period. In general, the number of public relationships remained stable in comparison to the prior year.

**Borrowings**

There were no long-term borrowings outstanding as of December 31, 2012 and 2011. Outstanding short-term borrowings are summarized as follows as of December 31 (in thousands):

| | 2012 | 2011 |
|---|---|---|

| | | |
|---|---|---|
| Short-term borrowings: | | |
| Federal funds purchased | $ | $ 11,597 |
| Repurchase agreements | 40,806 | 36,301 |
| Short-term FHLB borrowings | 139,000 | 102,800 |
| Total short-term borrowings | $ 179,806 | $ 150,698 |

We classify borrowings as short-term or long-term in accordance with the original terms of the agreement.

We have credit capacity with the FHLB and can borrow through facilities that include amortizing and term advances or repurchase agreements. We had approximately $5 million of immediate credit capacity with FHLB as of December 31, 2012. We had approximately $452 million in secured borrowing capacity at the Federal Reserve Bank ( FRB ) Discount Window, none of which was outstanding at December 31, 2012. The FHLB and FRB credit capacity are collateralized by securities from our investment portfolio and certain qualifying loans. We had approximately $120 million of credit available under unsecured federal funds purchased lines with various banks as of December 31, 2012. Additionally, we had approximately $150 million of unencumbered liquid securities available for pledging.

Table of Contents

**MANAGEMENT S DISCUSSION AND ANALYSIS**

Federal funds purchased are short-term borrowings that typically mature within one to ninety days. Short-term repurchase agreements are secured overnight borrowings with customers. Short-term FHLB borrowings have original maturities of less than one year and include overnight borrowings which the Company typically utilizes to address short term funding needs as they arise. Short-term FHLB borrowings at December 31, 2012 consisted of $99.0 million in overnight borrowings and $40.0 million in short-term advances. Short-term FHLB borrowings at December 31, 2011 consisted of $65.0 million in overnight borrowings and $37.8 million in short-term advances.

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

| | At or for the Year Ended December 31, | | |
|---|---|---|---|
| | **2012** | **2011** | **2010** |
| Year-end balance | $ 179,806 | $ 150,698 | $ 77,110 |
| Year-end weighted average interest rate | 0.54% | 0.39% | 0.21% |
| Maximum outstanding at any month-end | $ 229,598 | $ 188,355 | $ 77,110 |
| Average balance during the year | $ 121,735 | $ 99,122 | $ 49,104 |
| Average interest rate for the year | 0.48% | 0.50% | 0.74% |

There were no long-term borrowings outstanding at December 31, 2012 and 2011. In August 2011, the Company redeemed all of the 10.20% junior subordinated debentures at a redemption price equaling 105.1% of the principal amount redeemed, plus all accrued and unpaid interest. As a result of the redemption, the Company recognized a loss on extinguishment of debt of $1.1 million, consisting of the redemption premium of $852 thousand and the write-off of the remaining unamortized issuance costs of $231 thousand.

**Shareholders Equity**

Total shareholders equity was $253.9 million at December 31, 2012, an increase of $16.7 million from $237.2 million at December 31, 2011. Net income for the year increased shareholders equity by $23.4 million, which was partially offset by common and preferred stock dividends declared of $9.3 million. Accumulated other comprehensive income included in shareholders equity increased $2.3 million during the year due primarily to higher net unrealized gains on securities available for sale. For detailed information on shareholders equity, see Note 12, Shareholders Equity, of the notes to consolidated financial statements.

The Company and Bank are subject to various regulatory capital requirements. At December 31, 2012, both the Company and the Bank exceeded all regulatory requirements. For detailed information on regulatory capital, see Note 11, Regulatory Matters, of the notes to consolidated financial statements.

**GOODWILL AND OTHER INTANGIBLE ASSETS**

The carrying value of goodwill totaled $49.0 million and $37.4 million as of December 31, 2012 and 2011, respectively. We performed a qualitative assessment of goodwill at the reporting unit level, Five Star Bank, to determine if it was more likely than not that the fair value of the reporting unit is less than its carrying value. In performing a qualitative analysis, factors considered include, but are not limited to, business strategy, financial performance and market and regulatory dynamics. The results of the qualitative assessment for 2012 indicated that it was not more likely than not that the fair value of the reporting unit is less than its carrying value. Consequently, no additional quantitative two-step impairment test was required, and no impairment was recorded in 2012.

The change in the balance for goodwill during the years ended December 31 was as follows (in thousands):

| | **2012** | **2011** |
|---|---|---|
| Goodwill, beginning of year | $ 37,369 | $ 37,369 |
| Branch acquisitions | 11,599 | |
| Impairment | | |

| | | |
|---|---|---|
| Goodwill, end of year | $ 48,968 | $ 37,369 |

Declines in the market value of our publicly traded stock price or declines in our ability to generate future cash flows may increase the potential that goodwill recorded on our consolidated statements of financial condition be designated as impaired and that we may incur a goodwill write-down in the future.

The Company s other intangible assets consisted entirely of a core deposit intangible asset. The gross carrying amount and accumulated amortization for the core deposit intangible asset was $2.0 million and $190 thousand, respectively, at December 31, 2012. The Company had no other intangible assets as of December 31, 2011. Core deposit intangible amortization expense, included in other noninterest expense on the consolidated statements of income, was $190 thousand for the year ended December 31, 2012. There was no core deposit intangible amortization expense for the years ended December 31, 2011 and 2010. For further discussion, see Note 1, Summary of Significant Accounting Policies, and Note 7, Goodwill and Other Intangible Assets, to the Consolidated Financial Statements included in Item 8 of this Annual Report on Form 10-K.

Table of Contents

MANAGEMENT S DISCUSSION AND ANALYSIS

**LIQUIDITY AND CAPITAL RESOURCES**

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

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

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

Our cash and cash equivalents were $60.4 million as of December 31, 2012, up $2.8 million from $57.6 million as of December 31, 2011. Our net cash provided by operating activities totaled $38.7 million and the principal source of operating activity cash flow was net income adjusted for noncash income and expense items. Net cash used in investing activities totaled $99.1 million, which included outflows of $151.3 million for net loan originations and $138.4 million from net investment securities transactions, substantially offset by $195.8 million in cash received through the branch acquisitions. Net cash provided by financing activities of $63.2 million was attributed to a $43.4 million increase in deposits and a $29.1 million increase in short-term borrowings, partly offset by $8.9 million in dividend payments.

**Contractual Obligations and Other Commitments**

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

| | At December 31, 2012 | | | | |
|---|---|---|---|---|---|
| | Within 1 year | Over 1 to 3 years | Over 3 to 5 Years | Over 5 years | Total |
| **On-Balance sheet:** | | | | | |
| Certificates of deposit [1] | $ 495,423 | $ 127,045 | $ 31,721 | $ 749 | $ 654,938 |
| Supplemental executive retirement plans | 159 | 506 | 618 | 1,402 | 2,685 |
| **Off-Balance sheet:** | | | | | |
| Limited partnership investments [2] | $ 402 | $ 804 | $ 402 | $ | $ 1,608 |
| Commitments to extend credit [3] | 435,948 | | | | 435,948 |
| Standby letters of credit [3] | 4,161 | 4,996 | 66 | | 9,223 |
| Operating leases | 1,433 | 2,689 | 2,023 | 4,347 | 10,492 |

(1) Includes the maturity of certificates of deposit amounting to $100 thousand or more as follows: $58.7 million in three months or less; $39.5 million between three months and six months; $79.5 million between six months and one year; and $44.7 million over one year.

(2) We have committed to capital investments in several limited partnerships of up to $6.3 million, of which we have contributed $4.7 million as of December 31, 2012, including $951 thousand during 2012.

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

**Off-Balance Sheet Arrangements**

With the exception of obligations in connection with our irrevocable loan commitments, operating leases and limited partnership investments, we had no other off-balance sheet arrangements that have or are reasonably likely to have a current or future effect on our financial condition,

changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources that is material to investors. For additional information on off-balance sheet arrangements, see Note 1, Summary of Significant Accounting Policies and Note 10, Commitments and Contingencies, in the notes to the accompanying consolidated financial statements.

Table of Contents

MANAGEMENT S DISCUSSION AND ANALYSIS

**Security Yields and Maturities Schedule**

The following table sets forth certain information regarding the amortized cost ( Cost ), weighted average yields ( Yield ) and contractual maturities of our debt securities portfolio as of December 31, 2012. Mortgage-backed securities are included in maturity categories based on their stated maturity date. Actual maturities may differ from the contractual maturities presented because borrowers may have the right to call or prepay certain investments. We have stopped accruing interest on our asset-backed securities. No tax-equivalent adjustments were made to the weighted average yields (in thousands).

| | Due in one year or less | | Due from one to five years | | Due after five years through ten years | | Due after ten years | | Total | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Cost | Yield | Cost | Yield | Cost | Yield | Cost | Yield | Cost | Yield |
| **Available for sale debt securities:** | | | | | | | | | | |
| U.S. Government agencies and government-sponsored enterprises | $ 18,557 | 1.89% | $ 23,973 | 2.20% | $ 72,633 | 1.77% | $ 12,934 | 0.87% | $ 128,097 | 1.78% |
| State and political subdivisions | 10,064 | 3.64 | 68,677 | 2.21 | 110,256 | 2.06 | | | 188,997 | 2.20 |
| Mortgage-backed securities | 346 | 3.76 | 1,829 | 3.65 | 135,235 | 1.82 | 342,576 | 2.33 | 479,986 | 2.19 |
| Asset-backed securities | | | | | | | 121 | | 121 | |
| | 28,967 | 2.52 | 94,479 | 2.24 | 318,124 | 1.89 | 355,631 | 2.27 | 797,201 | 2.13 |
| **Held to maturity debt securities:** | | | | | | | | | | |
| State and political subdivisions | 12,886 | 2.24 | 4,164 | 3.69 | 768 | 4.78 | 87 | 5.53 | 17,905 | 2.70 |
| | $ 41,853 | 2.43% | $ 98,643 | 2.30% | $ 318,892 | 1.90% | $ 355,718 | 2.28% | $ 815,106 | 2.14% |

**Contractual Loan Maturity Schedule**

The following table summarizes the contractual maturities of our loan portfolio at December 31, 2012. Loans, net of deferred loan origination costs, include principal amortization and non-accruing loans. Demand loans having no stated schedule of repayment or maturity and overdrafts are reported as due in one year or less (in thousands).

| | Due in less than one year | Due from one to five years | Due after five years | Total |
|---|---|---|---|---|
| Commercial business | $ 158,620 | $ 87,051 | $ 13,004 | $ 258,675 |
| Commercial mortgage | 134,797 | 212,004 | 66,523 | 413,324 |
| Residential mortgage | 28,496 | 64,013 | 41,011 | 133,520 |
| Home equity | 49,190 | 129,284 | 108,175 | 286,649 |
| Consumer indirect | 204,831 | 362,478 | 19,485 | 586,794 |
| Other consumer | 10,647 | 13,874 | 2,243 | 26,764 |
| Total loans | $ 586,581 | $ 868,704 | $ 250,441 | $ 1,705,726 |
| Loans maturing after one year: | | | | |
| With a predetermined interest rate | | $ 249,428 | $ 131,385 | $ 380,813 |
| With a floating or adjustable rate | | 619,276 | 119,056 | 738,332 |
| Total loans maturing after one year | | $ 868,704 | $ 250,441 | $ 1,119,145 |

Table of Contents

**MANAGEMENT S DISCUSSION AND ANALYSIS**

**Capital Resources**

The FRB has adopted a system using risk-based capital guidelines to evaluate the capital adequacy of bank holding companies on a consolidated basis. The guidelines require a minimum Tier 1 leverage ratio of 4.00%, a minimum Tier 1 capital ratio of 4.00% and a minimum total risk-based capital ratio of 8.00%. The following table reflects the ratios and their components (in thousands):

| | 2012 | 2011 |
|---|---|---|
| Total shareholders equity | $ 253,897 | $ 237,194 |
| Less: Unrealized gain on securities available for sale, net of tax | 16,060 | 13,570 |
| Unrecognized net periodic pension & postretirement benefits (costs), net of tax | (12,807) | (12,625) |
| Disallowed goodwill and other intangible assets | 50,820 | 37,369 |
| Disallowed deferred tax assets | | 1,794 |
| Tier 1 capital | $ 199,824 | $ 197,086 |
| Adjusted average total assets (for leverage capital purposes) | $ 2,595,691 | $ 2,282,755 |
| Tier 1 leverage ratio (Tier 1 capital to adjusted average total assets) | 7.70% | 8.63% |
| Total Tier 1 capital | $ 199,824 | $ 197,086 |
| Plus: Qualifying allowance for loan losses | 23,352 | 20,239 |
| Total risk-based capital | $ 223,176 | $ 217,325 |
| Net risk-weighted assets | $ 1,866,764 | $ 1,616,119 |
| Tier 1 capital ratio (Tier 1 capital to net risk-weighted assets) | 10.70% | 12.20% |
| Total risk-based capital ratio (Total risk-based capital to net risk-weighted assets) | 11.96% | 13.45% |

**CRITICAL ACCOUNTING ESTIMATES**

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

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

Table of Contents

MANAGEMENT S DISCUSSION AND ANALYSIS

**Adequacy of the Allowance for Loan Losses**

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

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

**Valuation of Goodwill**

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

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

**Valuation of Deferred Tax Assets**

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

Table of Contents

MANAGEMENT S DISCUSSION AND ANALYSIS

**Valuation and Other Than Temporary Impairment of Securities**

We record all of our securities that are classified as available for sale at fair value. The fair value of equity securities are determined using public quotations, when available. Where quoted market prices are not available, fair values are estimated based on dealer quotes, pricing models, discounted cash flow methodologies, or similar techniques for which the determination of fair value may require significant judgment or estimation. Fair values of public bonds and those private securities that are actively traded in the secondary market have been determined through the use of third-party pricing services using market observable inputs. Private placement securities and other corporate fixed maturities for which we do not receive a public quotation are valued using a variety of acceptable valuation methods. Market rates used are applicable to the yield, credit quality and average maturity of each security. Private equity securities may also utilize internal valuation methodologies appropriate for the specific asset. Fair values might also be determined using broker quotes or through the use of internal models or analysis.

Securities are evaluated quarterly to determine whether a decline in their fair value is other than temporary. Management utilizes criteria such as, the current intent or requirement to hold or sell the security, the magnitude and duration of the decline and, when appropriate, consideration of negative changes in expected cash flows, creditworthiness, near term prospects of issuers, the level of credit subordination, estimated loss severity, and delinquencies, to determine whether a loss in value is other than temporary. The term other than temporary is not intended to indicate that the decline is permanent, but indicates that the prospect for a near-term recovery of value is not necessarily favorable. Declines in the fair value of investment securities below their cost that are deemed to be other than temporary are reflected in earnings as realized losses to the extent the impairment is related to credit issues or concerns, or the security is intended to be sold. The amount of impairment related to non-credit related factors on securities not intended to be sold is recognized in other comprehensive income.

**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. We use 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 our consolidated financial statements, results of income or liquidity.

**RECENT ACCOUNTING PRONOUNCEMENTS**

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

Table of Contents

**ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**
**Asset-Liability Management**

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

**Portfolio Composition**

Our balance sheet assets are a mix of fixed and variable rate assets with consumer indirect loans, commercial loans, and MBSs comprising a significant portion of our assets. Our consumer indirect loan portfolio comprised 21% of assets and is primarily fixed rate loans with relatively short durations. Our commercial loan portfolio totaled 24% of assets and is a combination of fixed and variable rate loans, lines and mortgages. The MBS portfolio, including collateralized mortgages obligations, totaled 18% of assets with durations averaging three to five years.

Our liabilities are made up primarily of deposits, which account for approximately 90% of total liabilities. Of these deposits, the majority, or 53%, is in nonpublic variable rate and noninterest bearing products including demand (both noninterest and interest- bearing), savings and money market accounts. In addition, fixed rate nonpublic certificate of deposit products make up 27% of total deposits. The bank also has a significant amount of public deposits, which represented 20% of total deposits as of December 31, 2012.

**Net Interest Income at Risk**

A primary tool used to manage interest rate risk is rate shock simulation to measure the rate sensitivity. Rate shock simulation is a modeling technique used to estimate the impact of changes in rates on net interest income as well as economic value of equity. At December 31, 2012, the Company is generally asset sensitive, meaning that, in most cases, net interest income tends to rise as interest rates rise and decline as interest rates fall. The following table sets forth the results of the modeling analysis as of December 31, 2012 (dollars in thousands):

| | Changes in Interest Rate | | | |
|---|---|---|---|---|
| | -100 bp | +100 bp | +200 bp | +300 bp |
| Change in net interest income | $ (106) | $ 2,611 | $ 5,492 | $ 6,565 |
| % Change | (0.12)% | 2.85% | 5.99% | 7.16% |

Net interest income at risk is measured by estimating the changes in net interest income resulting from instantaneous and sustained parallel shifts in interest rates of different magnitudes over a period of 12 months. As of December 31, 2012, a 300 basis point increase in rates would increase net interest income by $6.6 million, or 7.2%, over the following twelve-month period. A 100 basis point decrease in rates would decrease net interest income by $106 thousand, or 0.1%, over the following twelve-month period.

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

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

**Economic Value of Equity At Risk**

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

equal book value and do not vary with interest rate fluctuations. An economic value simulation is a static measure for balance sheet accounts at a given point in time, but this measurement can change substantially over time as the characteristics of our balance sheet evolve and as interest rate and yield curve assumptions are updated.

Table of Contents

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

The table below shows estimated changes in our EVE under different interest rate scenarios relative to a base case of current interest rates.

| | Changes in Interest Rate | | | |
|---|---|---|---|---|
| | **-100 bp** | **+100 bp** | **+200 bp** | **+300 bp** |
| Change in EVE | $ 27,739 | $ 3,684 | $ 172 | $ (15,721) |
| % Change | 7.06% | 0.94% | 0.04% | (4.00)% |

As of December 31, 2012, a 300 basis point increase in rates would decrease the economic value of equity by $15.7 million, or 4.0%. A 100 basis point decrease in rates would increase the economic value of equity by $27.7 million, or 7.0%. Embedded options within the current balance sheet such as caps, floors, and calls as well as changes in prepayment speeds and a decompression of deposit rates in rising interest rate scenarios are affecting the results, particularly as market rates begin to rise with rates increasing 100 and 200 basis points. Embedded optionality sometimes outweighs impacts of the movement in the direction of interest rates. This is evidenced in the results under the plus 100 and plus 200 basis point scenarios.

Table of Contents

**Interest Rate Sensitivity Gap**

The following table presents an analysis of our interest rate sensitivity gap position at December 31, 2012. All interest-earning assets and interest-bearing liabilities are shown based on the earlier of their contractual maturity or re-pricing date. The expected maturities are presented on a contractual basis or, if more relevant, based on projected call dates. Investment securities are at amortized cost for both securities available for sale and securities held to maturity. Loans, net of deferred loan origination costs, include principal amortization adjusted for estimated prepayments (principal payments in excess of contractual amounts) and non-accruing loans. Because the interest rate sensitivity levels shown in the table could be changed by external factors such as loan prepayments and liability decay rates or by factors controllable by us, such as asset sales, it is not an absolute reflection of our potential interest rate risk profile (in thousands).

| | At December 31, 2012 | | | | |
|---|---|---|---|---|---|
| | **Three Months or Less** | **Over Three Months Through One Year** | **Over One Year Through Five Years** | **Over Five Years** | **Total** |
| INTEREST-EARNING ASSETS: | | | | | |
| Federal funds sold and interest-earning deposits in other banks | $ | $ 94 | $ | $ | $ 94 |
| Investment securities | 98,857 | 137,633 | 344,016 | 234,600 | 815,106 |
| Loans | 521,041 | 306,079 | 749,167 | 130,957 | 1,707,244 |
| Total interest-earning assets | $ 619,898 | $ 443,806 | $ 1,093,183 | $ 365,557 | 2,522,444 |
| Cash and due from banks | | | | | 60,342 |
| Other assets [1] | | | | | 181,248 |
| Total assets | | | | | $ 2,764,034 |
| INTEREST-BEARING LIABILITIES: | | | | | |
| Interest-bearing demand, savings and money market | $ 1,105,342 | $ | $ | $ | $ 1,105,342 |
| Certificates of deposit | 154,826 | 340,379 | 158,984 | 749 | 654,938 |
| Borrowings | 139,806 | 40,000 | | | 179,806 |
| Total interest-bearing liabilities | $ 1,399,974 | $ 380,379 | $ 158,984 | $ 749 | 1,940,086 |
| Noninterest-bearing deposits | | | | | 501,514 |
| Other liabilities | | | | | 68,537 |
| Total liabilities | | | | | 2,510,137 |
| Shareholders equity | | | | | 253,897 |
| Total liabilities and shareholders equity | | | | | $ 2,764,034 |
| Interest sensitivity gap | $ (780,076) | $ 63,427 | $ 934,199 | $ 364,808 | $ 582,358 |
| Cumulative gap | $ (780,076) | $ (716,649) | $ 217,550 | $ 582,358 | |
| Cumulative gap ratio [2] | 44.3% | 59.7% | 111.2% | 130.0% | |
| Cumulative gap as a percentage of total assets | (28.2)% | (25.9)% | 7.9% | 21.1% | |

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

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

**ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA**

**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**

**Index to Consolidated Financial Statements**


| | **Page** |
|---|---|
| Management s Report on Internal Control over Financial Reporting | 60 |
| Report of Independent Registered Public Accounting Firm (on Internal Control over Financial Reporting) | 61 |
| Report of Independent Registered Public Accounting Firm (on the Consolidated Financial Statements) | 62 |
| Consolidated Statements of Financial Condition at December 31, 2012 and 2011 | 63 |
| Consolidated Statements of Income for the years ended December 31, 2012, 2011 and 2010 | 64 |
| Consolidated Statements of Comprehensive Income for the years ended December 31, 2012, 2011 and 2010 | 65 |
| Consolidated Statements of Changes in Shareholders Equity for the years ended December 31, 2012, 2011 and 2010 | 66 |
| Consolidated Statements of Cash Flows for the years ended December 31, 2012, 2011 and 2010 | 68 |
| Notes to Consolidated Financial Statements | 69 |

Table of Contents

**Management s Report on Internal Control over Financial Reporting**

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

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

The Company s management has assessed the effectiveness of the Company s internal control over financial reporting as of December 31, 2012. To make this assessment, we used the criteria for effective internal control over financial reporting described in *Internal Control Integrated Framework*, issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on our assessment and based on such criteria, we believe that, as of December 31, 2012, the Company s internal control over financial reporting was effective.

The Company s independent registered public accounting firm that audited the Company s consolidated financial statements has issued an attestation report on internal control over financial reporting as of December 31, 2012. That report appears herein.

*/s/ Martin K. Birmingham*
President and Chief Executive Officer
March 18, 2013

*/s/ Karl F. Krebs*
Executive Vice President and Chief Financial Officer
March 18, 2013

Table of Contents

**Report of Independent Registered Public Accounting Firm**

The Board of Directors and Shareholders

Financial Institutions, Inc.:

We have audited Financial Institutions, Inc. and subsidiaries   (the Company) internal control over financial reporting as of December 31, 2012, based on criteria established in *Internal Control  Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management s Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the Company s internal control over financial reporting based on our audit.

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

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

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

In our opinion, Financial Institutions, Inc. and subsidiaries maintained, in all material respects, effective internal control over financial reporting as of December 31, 2012, based on criteria established in *Internal Control  Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated statements of financial condition of Financial Institutions, Inc. and subsidiaries as of December 31, 2012 and 2011, and the related consolidated statements of income, comprehensive income, changes in shareholders  equity, and cash flows for each of the years in the three-year period ended December 31, 2012, and our report dated March 18, 2013 expressed an unqualified opinion on those consolidated financial statements.

*/s/ KPMG LLP*

Rochester, New York

March 18, 2013

**Table of Contents**

**Report of Independent Registered Public Accounting Firm**

The Board of Directors and Shareholders

Financial Institutions, Inc.:

We have audited the accompanying consolidated statements of financial condition of Financial Institutions, Inc. and subsidiaries (the Company) as of December 31, 2012 and 2011, and the related consolidated statements of income, comprehensive income, changes in shareholders equity, and cash flows for each of the years in the three-year period ended December 31, 2012. These consolidated financial statements are the responsibility of the Company s management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Financial Institutions, Inc. and subsidiaries as of December 31, 2012 and 2011, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2012, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the Company s internal control over financial reporting as of December 31, 2012, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated March 18, 2013 expressed an unqualified opinion on the effectiveness of the Company s internal control over financial reporting.

***/s/ KPMG LLP***

Rochester, New York

March 18, 2013

Table of Contents

**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**

**Consolidated Statements of Financial Condition**

| *(Dollars in thousands, except share and per share data)* | December 31, 2012 | December 31, 2011 |
|---|---|---|
| **ASSETS** | | |
| Cash and cash equivalents: | | |
| Cash and due from banks | $ 60,342 | $ 57,489 |
| Federal funds sold and interest-bearing deposits in other banks | 94 | 94 |
| Total cash and cash equivalents | 60,436 | 57,583 |
| Securities available for sale, at fair value | 823,796 | 627,518 |
| Securities held to maturity, at amortized cost (fair value of $18,478 and $23,964, respectively) | 17,905 | 23,297 |
| Loans held for sale | 1,518 | 2,410 |
| Loans (net of allowance for loan losses of $24,714 and $23,260, respectively) | 1,681,012 | 1,461,516 |
| Company owned life insurance | 47,386 | 45,556 |
| Premises and equipment, net | 36,618 | 33,085 |
| Goodwill and other intangible assets, net | 50,820 | 37,369 |
| Other assets | 44,543 | 48,019 |
| Total assets | $ 2,764,034 | $ 2,336,353 |
| **LIABILITIES AND SHAREHOLDERS EQUITY** | | |
| Deposits: | | |
| Noninterest-bearing demand | $ 501,514 | $ 393,421 |
| Interest-bearing demand | 449,744 | 362,555 |
| Savings and money market | 655,598 | 474,947 |
| Certificates of deposit | 654,938 | 700,676 |
| Total deposits | 2,261,794 | 1,931,599 |
| Short-term borrowings | 179,806 | 150,698 |
| Other liabilities | 68,537 | 16,862 |
| Total liabilities | 2,510,137 | 2,099,159 |
| Commitments and contingencies (Note 10) | | |
| Shareholders equity: | | |
| Series A 3% preferred stock, $100 par value; 1,533 shares authorized; 1,499 and 1,500 shares issued, respectively | 150 | 150 |
| Series B-1 8.48% preferred stock, $100 par value, 200,000 shares authorized; 173,210 and 173,235 shares issued, respectively | 17,321 | 17,323 |
| Total preferred equity | 17,471 | 17,473 |
| Common stock, $0.01 par value, 50,000,000 shares authorized and 14,161,597 shares issued | 142 | 142 |
| Additional paid-in capital | 67,710 | 67,247 |
| Retained earnings | 172,244 | 158,079 |
| Accumulated other comprehensive income | 3,253 | 945 |
| Treasury stock, at cost 373,888 and 358,481 shares, respectively | (6,923) | (6,692) |
| Total shareholders equity | 253,897 | 237,194 |
| Total liabilities and shareholders equity | $ 2,764,034 | $ 2,336,353 |

See accompanying notes to the consolidated financial statements.

Table of Contents

**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**

**Consolidated Statements of Income**

| *(Dollars in thousands, except per share amounts)* | **Years ended December 31, 2012** | **2011** | **2010** |
|---|---|---|---|
| Interest income: | | | |
| Interest and fees on loans | $ 81,123 | $ 77,105 | $ 75,877 |
| Interest and dividends on investment securities | 16,444 | 18,013 | 20,622 |
| Other interest income | | | 10 |
| Total interest income | 97,567 | 95,118 | 96,509 |
| Interest expense: | | | |
| Deposits | 8,462 | 11,434 | 14,853 |
| Short-term borrowings | 589 | 500 | 365 |
| Long-term borrowings | | 1,321 | 2,502 |
| Total interest expense | 9,051 | 13,255 | 17,720 |
| Net interest income | 88,516 | 81,863 | 78,789 |
| Provision for loan losses | 7,128 | 7,780 | 6,687 |
| Net interest income after provision for loan losses | 81,388 | 74,083 | 72,102 |
| Noninterest income: | | | |
| Service charges on deposits | 8,627 | 8,679 | 9,585 |
| ATM and debit card | 4,716 | 4,359 | 3,995 |
| Broker-dealer fees and commissions | 2,104 | 1,829 | 1,283 |
| Company owned life insurance | 1,751 | 1,424 | 1,107 |
| Loan servicing | 617 | 835 | 1,124 |
| Net gain on sale of loans held for sale | 1,421 | 880 | 650 |
| Net gain on disposal of investment securities | 2,651 | 3,003 | 169 |
| Impairment charges on investment securities | (91) | (18) | (594) |
| Net (loss) gain on sale and disposal of other assets | (381) | 67 | (203) |
| Other | 3,362 | 2,867 | 2,338 |
| Total noninterest income | 24,777 | 23,925 | 19,454 |
| Noninterest expense: | | | |
| Salaries and employee benefits | 40,127 | 35,743 | 32,844 |
| Occupancy and equipment | 11,419 | 10,868 | 10,818 |
| Professional services | 4,133 | 2,617 | 2,197 |
| Computer and data processing | 3,271 | 2,437 | 2,487 |
| Supplies and postage | 2,497 | 1,778 | 1,772 |
| FDIC assessments | 1,300 | 1,513 | 2,507 |
| Advertising and promotions | 929 | 1,259 | 1,121 |
| Loss on extinguishment of debt | | 1,083 | |
| Other | 7,721 | 6,496 | 7,171 |
| Total noninterest expense | 71,397 | 63,794 | 60,917 |
| Income before income taxes | 34,768 | 34,214 | 30,639 |

| | | | |
|---|---|---|---|
| Income tax expense | 11,319 | 11,415 | 9,352 |
| Net income | $ 23,449 | $ 22,799 | $ 21,287 |
| Preferred stock dividends | 1,474 | 1,877 | 3,358 |
| Accretion of discount on Series A preferred stock | | 1,305 | 367 |
| Net income available to common shareholders | $ 21,975 | $ 19,617 | $ 17,562 |
| Earnings per common share (Note 16): | | | |
| Basic | $ 1.60 | $ 1.50 | $ 1.62 |
| Diluted | $ 1.60 | $ 1.49 | $ 1.61 |
| Cash dividends declared per common share | $ 0.57 | $ 0.47 | $ 0.40 |
| Weighted average common shares outstanding: | | | |
| Basic | 13,696 | 13,067 | 10,767 |
| Diluted | 13,751 | 13,157 | 10,845 |

See accompanying notes to the consolidated financial statements.

Table of Contents

**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**

**Consolidated Statements of Comprehensive Income**

| | Years ended December 31, | | |
|---|---|---|---|
| *(Dollars in thousands)* | **2012** | **2011** | **2010** |
| Net income | $ 23,449 | $ 22,799 | $ 21,287 |
| Other comprehensive income: | | | |
| Unrealized gains on securities: | | | |
| Change in net unrealized securities gains arising during period | 6,682 | 22,350 | (16) |
| Deferred tax expense | (2,646) | (8,855) | (19) |
| Reclassification adjustment for gains included in income before income taxes | (2,560) | (2,985) | 425 |
| Related tax expense (benefit) | 1,014 | 1,183 | (168) |
| Change in net unrealized gains on securities, net of tax | 2,490 | 11,693 | 222 |
| Change in pension and post-retirement obligations: | | | |
| Change in net actuarial gain\loss | (300) | (9,979) | (2,192) |
| Related tax expense | 118 | 3,953 | 950 |
| Change in pension and post-retirement obligations, net of tax | (182) | (6,026) | (1,242) |
| Other comprehensive income (loss) | 2,308 | 5,667 | (1,020) |
| Comprehensive income | $ 25,757 | $ 28,466 | $ 20,267 |

See accompanying notes to the consolidated financial statements.

Table of Contents

**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**

**Consolidated Statements of Changes in Shareholders Equity**

**Years ended December 31, 2012, 2011 and 2010**

| *(Dollars in thousands, except per share data)* | Preferred Equity | Common Stock | Additional Paid-in Capital | Retained Earnings | Accumulated Other Comprehensive Income (Loss) | Treasury Stock | Total Shareholders Equity |
|---|---|---|---|---|---|---|---|
| **Balance at January 1, 2010** | **$ 53,418** | **$ 113** | **$ 26,940** | **$ 131,371** | **$ (3,702)** | **$ (9,846)** | **$ 198,294** |
| Comprehensive income: | | | | | | | |
| Net income | | | | 21,287 | | | 21,287 |
| Other comprehensive loss, net of tax | | | | | (1,020) | | (1,020) |
| Total comprehensive income | | | | | | | 20,267 |
| Purchases of common stock for treasury | | | | | | (69) | (69) |
| Share-based compensation plans: | | | | | | | |
| Share-based compensation | | | 1,031 | | | | 1,031 |
| Stock options exercised | | | (74) | | | 290 | 216 |
| Restricted stock awards issued, net | | | (1,853) | | | 1,853 | |
| Directors retainer | | | (15) | | | 112 | 97 |
| Accrued undeclared cumulative dividend on Series A preferred stock, net of accretion | 367 | | | (367) | | | |
| Cash dividends declared: | | | | | | | |
| Series A 3% preferred-$3.00 per share | | | | (5) | | | (5) |
| Series A preferred-$250.00 per share | | | | (1,876) | | | (1,876) |
| Series B-1 8.48% preferred-$8.48 per share | | | | (1,477) | | | (1,477) |
| Common-$0.40 per share | | | | (4,334) | | | (4,334) |
| **Balance at December 31, 2010** | **$ 53,785** | **$ 113** | **$ 26,029** | **$ 144,599** | **$ (4,722)** | **$ (7,660)** | **$ 212,144** |
| Comprehensive income: | | | | | | | |
| Net income | | | | 22,799 | | | 22,799 |
| Other comprehensive income, net of tax | | | | | 5,667 | | 5,667 |
| Total comprehensive income | | | | | | | 28,466 |
| Issuance of common stock | | 29 | 43,098 | | | | 43,127 |
| Purchases of common stock for treasury | | | | | | (215) | (215) |
| Repurchase of Series A 3% preferred stock | (3) | | | | | | (3) |
| Repurchase of warrant issued to U.S. Treasury | | | (2,080) | | | | (2,080) |
| Redemption of Series A preferred stock | (37,515) | | 68 | | | | (37,447) |
| Repurchase of Series B-1 8.48% preferred stock | (99) | | | | | | (99) |
| Share-based compensation plans: | | | | | | | |
| Share-based compensation | | | 1,105 | | | | 1,105 |
| Stock options exercised | | | (28) | | | 119 | 91 |
| Restricted stock awards issued, net | | | (954) | | | 954 | |
| Excess tax benefit on share-based compensation | | | 21 | | | | 21 |
| Directors retainer | | | (12) | | | 110 | 98 |
| Accretion of discount on Series A preferred stock | 1,305 | | | (1,305) | | | |
| Cash dividends declared: | | | | | | | |
| Series A 3% preferred-$3.00 per share | | | | (5) | | | (5) |
| Series A preferred-$53.24 per share | | | | (399) | | | (399) |
| Series B-1 8.48% preferred-$8.48 per share | | | | (1,473) | | | (1,473) |

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| Common-$0.47 per share | | | | (6,137) | | | (6,137) |
| **Balance at December 31, 2011** | **$ 17,473** | **$ 142** | **$ 67,247** | **$ 158,079** | **$ 945** | **$ (6,692)** | **$ 237,194** |

***Continued on next page***

See accompanying notes to the consolidated financial statements.

Table of Contents

**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**

**Consolidated Statements of Changes in Shareholders Equity (Continued)**

**Years ended December 31, 2012, 2011 and 2010**

| *(Dollars in thousands, except per share data)* | Preferred Equity | Common Stock | Additional Paid-in Capital | Retained Earnings | Accumulated Other Comprehensive Income (Loss) | Treasury Stock | Total Shareholders Equity |
|---|---|---|---|---|---|---|---|
| **Balance at December 31, 2011** | **$ 17,473** | **$ 142** | **$ 67,247** | **$ 158,079** | **$ 945** | **$ (6,692)** | **$ 237,194** |
| ***Balance carried forward*** | | | | | | | |
| Comprehensive income: | | | | | | | |
| Net income | | | | 23,449 | | | 23,449 |
| Other comprehensive income, net of tax | | | | | 2,308 | | 2,308 |
| Total comprehensive income | | | | | | | 25,757 |
| Purchases of common stock for treasury | | | | | | (557) | (557) |
| Repurchase of Series B-1 8.48% preferred stock | (2) | | | | | | (2) |
| Share-based compensation plans: | | | | | | | |
| Share-based compensation | | | 526 | | | | 526 |
| Stock options exercised | | | (10) | | | 79 | 69 |
| Restricted stock awards issued, net | | | (140) | | | 140 | |
| Excess tax benefit on share-based compensation | | | 97 | | | | 97 |
| Directors retainer | | | (10) | | | 107 | 97 |
| Cash dividends declared: | | | | | | | |
| Series A 3% Preferred-$3.00 per share | | | | (5) | | | (5) |
| Series B-1 8.48% Preferred-$8.48 per share | | | | (1,469) | | | (1,469) |
| Common-$0.57 per share | | | | (7,810) | | | (7,810) |
| **Balance at December 31, 2012** | **$ 17,471** | **$ 142** | **$ 67,710** | **$ 172,244** | **$ 3,253** | **$ (6,923)** | **$ 253,897** |

See accompanying notes to the consolidated financial statements.

Table of Contents

**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**

**Consolidated Statements of Cash Flows**

| *(Dollars in thousands)* | Years ended December 31, 2012 | 2011 | 2010 |
|---|---|---|---|
| Cash flows from operating activities: | | | |
| Net income | $ 23,449 | $ 22,799 | $ 21,287 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | | |
| Depreciation and amortization | 3,828 | 3,466 | 3,537 |
| Net amortization of premiums on securities | 5,284 | 5,722 | 3,005 |
| Provision for loan losses | 7,128 | 7,780 | 6,687 |
| Share-based compensation | 526 | 1,105 | 1,031 |
| Deferred income tax expense | 6,343 | 6,510 | 2,468 |
| Proceeds from sale of loans held for sale | 55,067 | 32,839 | 42,195 |
| Originations of loans held for sale | (52,754) | (31,231) | (44,262) |
| Increase in company owned life insurance | (1,751) | (1,424) | (1,107) |
| Net gain on sale of loans held for sale | (1,421) | (880) | (650) |
| Net gain on disposal of investment securities | (2,651) | (3,003) | (169) |
| Impairment charges on investment securities | 91 | 18 | 594 |
| Net loss (gain) on sale and disposal of other assets | 381 | (67) | 203 |
| Contributions to defined benefit pension plan | (8,000) | (10,000) | (4,300) |
| Loss on extinguishment of debt | | 1,083 | |
| Increase in other assets | (4,249) | (7,756) | (353) |
| Increase in other liabilities | 7,429 | 5,057 | 5,261 |
| Net cash provided by operating activities | 38,700 | 32,018 | 35,427 |
| Cash flows from investing activities: | | | |
| Purchases of investment securities: | | | |
| Available for sale | (322,191) | (158,013) | (430,952) |
| Held to maturity | (15,484) | (17,188) | (19,791) |
| Proceeds from principal payments, maturities and calls on investment securities: | | | |
| Available for sale | 175,679 | 168,976 | 219,974 |
| Held to maturity | 20,819 | 21,986 | 30,885 |
| Proceeds from sales of securities available for sale | 2,823 | 44,514 | 122,090 |
| Net increase in loans, excluding sales | (151,311) | (157,110) | (89,507) |
| Loans sold or participated to others | | 13,033 | |
| Purchases of company owned life insurance | (79) | (18,079) | (79) |
| Proceeds from sales of other assets | 734 | 705 | 611 |
| Purchases of premises and equipment | (5,840) | (3,678) | (2,438) |
| Net cash received in branch acquisitions | 195,778 | | |
| Net cash used in investing activities | (99,072) | (104,854) | (169,207) |
| Cash flows from financing activities: | | | |
| Net increase in deposits | 43,376 | 48,709 | 139,935 |
| Net increase in short-term borrowings | 29,108 | 73,588 | 17,567 |
| Repayments of long-term borrowings | | (26,767) | (20,080) |
| Proceeds from issuance of common stock, net of issuance costs | | 43,127 | |
| Purchases of common stock for treasury | (557) | (215) | (69) |
| Repurchase of preferred stock | (2) | (37,549) | |
| Repurchase of warrant issued to U.S. Treasury | | (2,080) | |
| Proceeds from stock options exercised | 69 | 91 | 216 |

| | | | |
|---|---|---|---|
| Excess tax benefit on share-based compensation | 97 | 21 | |
| Cash dividends paid to preferred shareholders | (1,474) | (2,118) | (3,358) |
| Cash dividends paid to common shareholders | (7,392) | (5,446) | (4,332) |
| Net cash provided by financing activities | 63,225 | 91,361 | 129,879 |
| Net increase (decrease) in cash and cash equivalents | 2,853 | 18,525 | (3,901) |
| Cash and cash equivalents, beginning of period | 57,583 | 39,058 | 42,959 |
| Cash and cash equivalents, end of period | $ 60,436 | $ 57,583 | $ 39,058 |

See accompanying notes to the consolidated financial statements.

Table of Contents

**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**December 31, 2012, 2011 and 2010**

**(1.) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

Financial Institutions, Inc., a financial holding company organized under the laws of New York State ( New York or NYS ), and its subsidiaries provide deposit, lending and other financial services to individuals and businesses in Central and Western New York. The Company has also expanded its indirect lending network to include relationships with franchised automobile dealers in the Capital District of New York and Northern Pennsylvania. Financial Institutions, Inc. owns all of the capital stock of Five Star Bank, a New York State chartered bank, and Five Star Investment Services, Inc., a financial services subsidiary offering noninsured investment products and investment advisory services. References to the Company mean the consolidated reporting entities and references to the Bank mean Five Star Bank.

The accounting and reporting policies conform to general practices within the banking industry and to U.S. generally accepted accounting principles ( GAAP ). Prior years consolidated financial statements are re-classified whenever necessary to conform to the current year s presentation.

The Company has evaluated events and transactions for potential recognition or disclosure through the day the financial statements were issued.

The following is a description of the Company s significant accounting policies.

***(a.) Principles of Consolidation***

The consolidated financial statements include the accounts of the Company and its subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation.

***(b.) Use of Estimates***

In preparing the consolidated financial statements in conformity with GAAP, management is required to make estimates and assumptions that affect the reported amount of assets and liabilities as of the date of the statement of financial condition and reported amounts of revenue and expenses during the reporting period. Material estimates relate to the determination of the allowance for loan losses, the carrying value of goodwill and deferred tax assets, the valuation and other than temporary impairment ( OTTI ) considerations related to the securities portfolio, and assumptions used in the defined benefit pension plan accounting. These estimates and assumptions are based on management s best estimates and judgment and are evaluated on an ongoing basis using historical experience and other factors, including the current economic environment. The Company adjusts these estimates and assumptions when facts and circumstances dictate. As future events cannot be determined with precision, actual results could differ significantly from the Company s estimates.

***(c.) Cash Flow Reporting***

Cash and cash equivalents include cash and due from banks, federal funds sold and interest-bearing deposits in other banks. Net cash flows are reported for loans, deposit transactions and short-term borrowings.

Supplemental cash flow information is summarized as follows for the years ended December 31 (in thousands):

| | 2012 | 2011 | 2010 |
|---|---|---|---|
| Cash payments: | | | |
| Interest expense | $ 10,438 | $ 15,668 | $ 17,676 |
| Income taxes | 4,014 | 5,191 | 6,923 |
| Noncash investing and financing activities: | | | |
| Real estate and other assets acquired in settlement of loans | $ 322 | $ 305 | $ 561 |
| Accrued and declared unpaid dividends | 2,562 | 2,144 | 1,694 |

| | | | |
|---|---|---|---|
| Accretion of preferred stock discount | | 1,305 | 367 |
| Increase (decrease) in net unsettled security purchases | 51,135 | (67) | (317) |
| Net transfer of portfolio loans to held for sale | | 13,576 | |
| Assets acquired and liabilities assumed in branch acquisition: | | | |
| Loans and other non-cash assets, excluding goodwill and core deposit intangible asset | 77,912 | | |
| Deposits and other liabilities | 287,331 | | |

Table of Contents

**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**December 31, 2012, 2011 and 2010**

**(1.) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

***(d.) Investment Securities***

Investment securities are classified as either available for sale or held to maturity. Debt securities that management has the positive intent and ability to hold to maturity are classified as held to maturity and are recorded at amortized cost. Other investment securities are classified as available for sale and recorded at fair value, with unrealized gains and losses excluded from earnings and reported as a component of comprehensive income and shareholders equity.

Purchase premiums and discounts are recognized in interest income using the interest method over the terms of the securities. Securities are evaluated periodically to determine whether a decline in their fair value is other than temporary. Management utilizes criteria such as, the current intent to hold or sell the security, the magnitude and duration of the decline and, when appropriate, consideration of negative changes in expected cash flows, creditworthiness, near term prospects of issuers, the level of credit subordination, estimated loss severity, and delinquencies, to determine whether a loss in value is other than temporary. The term other than temporary is not intended to indicate that the decline is permanent, but indicates that the prospect for a near-term recovery of value is not necessarily favorable. Declines in the fair value of investment securities below their cost that are deemed to be other than temporary are reflected in earnings as realized losses to the extent the impairment is related to credit issues or concerns, or the security is intended to be sold. The amount of impairment related to non-credit related factors is recognized in other comprehensive income. Gains and losses on the sale of securities are recorded on the trade date and are determined using the specific identification method.

***(e.) Loans Held for Sale and Loan Servicing Rights***

The Company generally makes the determination of whether to identify a mortgage as held for sale at the time the loan is closed based on the Company s intent and ability to hold the loan. Loans held for sale are recorded at the lower of cost or market computed on the aggregate portfolio basis. The amount, by which cost exceeds market value, if any, is accounted for as a valuation allowance with changes included in the determination of results of operations for the period in which the change occurs. The amount of loan origination cost and fees are deferred at origination of the loans and recognized as part of the gain or loss on sale of the loans, determined using the specific identification method, in the consolidated statements of income.

The Company originates and sells certain residential real estate loans in the secondary market. The Company typically retains the right to service the mortgages upon sale. Mortgage-servicing rights ( MSRs ) represent the cost of acquiring the contractual rights to service loans for others. MSRs are recorded at their fair value at the time a loan is sold and servicing rights are retained. MSRs are reported in other assets in the consolidated statements of financial position and are amortized to noninterest income in the consolidated statements of income in proportion to and over the period of estimated net servicing income. The Company uses a valuation model that calculates the present value of future cash flows to determine the fair value of servicing rights. In using this valuation method, the Company incorporates assumptions to estimate future net servicing income, which include estimates of the cost to service the loan, the discount rate, an inflation rate and prepayment speeds. On a quarterly basis, the Company evaluates its MSRs for impairment and charges any such impairment to current period earnings. In order to evaluate its MSRs the Company stratifies the related mortgage loans on the basis of their predominant risk characteristics, such as interest rates, year of origination and term, using discounted cash flows and market-based assumptions. Impairment of MSRs is recognized through a valuation allowance, determined by estimating the fair value of each stratum and comparing it to its carrying value. Subsequent increases in fair value are adjusted through the valuation allowance, but only to the extent of the valuation allowance. No impairment loss related to the MSRs was recognized during the years ended December 31, 2012 or 2010. The Company recognized an impairment loss related to the MSRs of $35 thousand during the year ended December 31, 2011.

Mortgage loan servicing includes collecting monthly mortgagor payments, forwarding payments and related accounting reports to investors, collecting escrow deposits for the payment of mortgagor property taxes and insurance, and paying taxes and insurance from escrow funds when due. Loan servicing income (a component of noninterest income in the consolidated statements of income) consists of fees earned for servicing

mortgage loans sold to third parties, net of amortization expense and impairment losses associated with capitalized mortgage servicing assets.

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2012, 2011 and 2010

**(1.) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

Automobile loan servicing rights are accounted for using the amortization method. A servicing asset is established at fair value at the time of the sale. The servicing asset is reported in other assets in the consolidated statements of financial position and amortized to noninterest income in the consolidated statements of income in proportion to and over the period of estimated net servicing income. Impairment, if any, is recognized when carrying value exceeds the fair value as determined by calculating the present value of expected net future cash flows. The primary risk characteristic for measuring servicing assets is payoff rates of the underlying loan pools. Valuation calculations rely on the predicted payoff assumption and, if actual payoff is quicker than expected, then future value would be impaired. Management reviewed the servicing asset related to the automobile loan servicing rights for impairment as of December 31, 2012 and determined that no valuation allowance was necessary.

***(f.) Loans***

Loans are classified as held for investment when management has both the intent and ability to hold the loan for the foreseeable future, or until maturity or payoff. Loans are carried at the principal amount outstanding, net of any unearned income and unamortized deferred fees and costs on originated loans. Loan origination fees and certain direct loan origination costs are deferred, and the net amount is amortized into net interest income over the contractual life of the related loans or over the commitment period as an adjustment of yield. Interest income on loans is based on the principal balance outstanding computed using the effective interest method.

A loan is considered delinquent when a payment has not been received in accordance with the contractual terms. The accrual of interest income for commercial loans is discontinued when there is a clear indication that the borrower s cash flow may not be sufficient to meet payments as they become due, while the accrual of interest income for retail loans is discontinued when loans reach specific delinquency levels. Loans are generally placed on nonaccrual status when contractually past due 90 days or more as to interest or principal payments, unless the loan is well secured and in the process of collection. Additionally, if management becomes aware of facts or circumstances that may adversely impact the collectability of principal or interest on loans, it is management s practice to place such loans on a nonaccrual status immediately, rather than delaying such action until the loans become 90 days past due. When a loan is placed on nonaccrual status, previously accrued and uncollected interest is reversed, amortization of related deferred loan fees or costs is suspended, and income is recorded only to the extent that interest payments are subsequently received in cash and a determination has been made that the principal balance of the loan is collectible. If collectability of the principal is in doubt, payments received are applied to loan principal. A nonaccrual loan may be returned to accrual status when all delinquent principal and interest payments become current in accordance with the terms of the loan agreement, the borrower has demonstrated a period of sustained performance (generally a minimum of six months) and the ultimate collectability of the total contractual principal and interest is no longer in doubt.

The Company s loan policy dictates the guidelines to be followed in determining when a loan is charged-off. All charge offs are approved by the Bank s senior loan officers or loan committees, depending on the amount of the charge off, and are reported in aggregate to the Bank s Board of Directors. Commercial business and commercial mortgage loans are charged-off when a determination is made that the financial condition of the borrower indicates that the loan will not be collectible in the ordinary course of business. Residential mortgage loans and home equities are generally charged-off or written down when the credit becomes severely delinquent and the balance exceeds the fair value of the property less costs to sell. Indirect and other consumer loans, both secured and unsecured, are generally charged-off in full during the month in which the loan becomes 120 days past due, unless the collateral is in the process of repossession in accordance with the Company s policy.

A loan is accounted for as a troubled debt restructuring if the Company, for economic or legal reasons related to the borrower s financial condition, grants a significant concession to the borrower that it would not otherwise consider. A troubled debt restructuring may involve the receipt of assets from the debtor in partial or full satisfaction of the loan, or a modification of terms such as a reduction of the stated interest rate or face amount of the loan, a reduction of accrued interest, an extension of the maturity date at a stated interest rate lower than the current market rate for a new loan with similar risk, or some combination of these concessions. Troubled debt restructurings generally remain on nonaccrual status until there is a sustained period of payment performance (usually six months or longer) and there is a reasonable assurance that the payments will continue. See Allowance for Loan Losses below for further policy discussion and see Note 5 Loans for additional information.

**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**December 31, 2012, 2011 and 2010**

**(1.) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

***(g.) Off-Balance Sheet Financial Instruments***

In the ordinary course of business, the Company enters into off-balance sheet financial instruments consisting of commitments to extend credit, standby letters of credit and financial guarantees. Such financial instruments are recorded in the consolidated financial statements when they are funded or when related fees are incurred or received. The Company periodically evaluates the credit risks inherent in these commitments and establishes loss allowances for such risks if and when these are deemed necessary.

The Company recognizes as liabilities the fair value of the obligations undertaken in issuing the guarantees under the standby letters of credit, net of the related amortization at inception. The fair value approximates the unamortized fees received from the customers for issuing the standby letters of credit. The fees are deferred and recognized on a straight-line basis over the commitment period. Standby letters of credit outstanding at December 31, 2012 had original terms ranging from one to five years.

Fees received for providing loan commitments and letters of credit that result in loans are typically deferred and amortized to interest income over the life of the related loan, beginning with the initial borrowing. Fees on commitments and letters of credit are amortized to other income as banking fees and commissions over the commitment period when funding is not expected.

***(h.) Allowance for Loan Losses***

The allowance for loan losses is established through charges to earnings in the form of a provision for loan losses. When a loan or portion of a loan is determined to be uncollectible, the portion deemed uncollectible is charged against the allowance and subsequent recoveries, if any, are credited to the allowance.

The allowance for loan losses is evaluated on a regular basis and is based upon periodic review of the collectability of the loans in light of historical experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower s ability to repay, estimated value of any underlying collateral, and prevailing economic conditions. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available.

The allowance consists of specific and general components. Specific allowances are established for impaired loans. Impaired commercial business and commercial mortgage loans are individually evaluated and measured for impairmen