

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

Form 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2021

or

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

For the transition period from _____ to _____

Commission File Number: 000-26481

Financial Institutions, Inc.

(Exact name of registrant as specified in its charter)

NEW YORK

(State or other jurisdiction of
incorporation or organization)

220 LIBERTY STREET, WARSAW, NEW YORK

(Address of principal executive offices)

16-0816610

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

14569

(Zip Code)

(585) 786-1100

(Registrant's telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Securities Exchange Act of 1934:

Title of each class	Trading Symbol(s)	Name of each exchange on which registered
Common stock, par value \$0.01 per share	FISI	Nasdaq Global Select Market

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

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted 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 such files). Yes ☒ No ☐

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

Large accelerated filer	☐	Accelerated filer	☒
Non-accelerated filer	☐	Smaller reporting company	☐
		Emerging growth company	☐

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act. ☐

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

The registrant had 15,841,929 shares of Common Stock, \$0.01 par value, outstanding as of July 31, 2021.

FINANCIAL INSTITUTIONS, INC.
Form 10-Q
For the Quarterly Period Ended June 30, 2021

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PART I. FINANCIAL INFORMATION

ITEM 1. Financial Statements

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES Consolidated Statements of Financial Condition (Unaudited)

<i>(Dollars in thousands, except share and per share data)</i>	June 30, 2021	December 31, 2020
ASSETS		
Cash and due from banks	\$ 206,387	\$ 93,878
Securities available for sale, at fair value	902,845	628,059
Securities held to maturity, at amortized cost (net of allowance for credit losses of \$6 and \$7, respectively) (fair value of \$226,044 and \$282,035, respectively)	218,858	271,966
Loans held for sale	3,929	4,305
Loans (net of allowance for credit losses of \$46,365 and \$52,420, respectively)	3,585,803	3,542,718
Company owned life insurance	102,257	100,895
Premises and equipment, net	43,572	40,610
Goodwill and other intangible assets, net	74,262	73,789
Other assets	157,189	156,086
Total assets	<u>\$ 5,295,102</u>	<u>\$ 4,912,306</u>
LIABILITIES AND SHAREHOLDERS' EQUITY		
Deposits:		
Noninterest-bearing demand	\$ 1,121,827	\$ 1,018,549
Interest-bearing demand	799,299	731,885
Savings and money market	1,796,813	1,642,340
Time deposits	941,282	885,593
Total deposits	4,659,221	4,278,367
Short-term borrowings	—	5,300
Long-term borrowings, net of issuance costs of \$1,244 and \$1,377, respectively	73,756	73,623
Other liabilities	74,999	86,653
Total liabilities	4,807,976	4,443,943
Shareholders' equity:		
Series A 3% preferred stock, \$100 par value; 1,533 shares authorized; 1,435 shares issued	143	143
Series B-1 8.48% preferred stock, \$100 par value; 200,000 shares authorized; 171,486 and 171,847 shares issued, respectively	17,149	17,185
Total preferred equity	17,292	17,328
Common stock, \$0.01 par value; 50,000,000 shares authorized; 16,099,556 shares issued	161	161
Additional paid-in capital	125,253	125,118
Retained earnings	356,485	324,850
Accumulated other comprehensive (loss) income	(5,934)	2,128
Treasury stock, at cost – 257,627 and 57,630 shares, respectively	(6,131)	(1,222)
Total shareholders' equity	487,126	468,363
Total liabilities and shareholders' equity	<u>\$ 5,295,102</u>	<u>\$ 4,912,306</u>

See accompanying notes to the consolidated financial statements.

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
Consolidated Statements of Income (Unaudited)

<i>(In thousands, except per share amounts)</i>	Three months ended		Six months ended	
	June 30,		June 30,	
	2021	2020	2021	2020
Interest income:				
Interest and fees on loans	\$ 36,393	\$ 35,197	\$ 73,452	\$ 72,057
Interest and dividends on investment securities	4,498	4,538	8,685	9,120
Other interest income	61	24	88	235
Total interest income	40,952	39,759	82,225	81,412
Interest expense:				
Deposits	2,165	4,677	4,400	11,696
Short-term borrowings	—	284	119	1,176
Long-term borrowings	1,055	617	2,117	1,235
Total interest expense	3,220	5,578	6,636	14,107
Net interest income	37,732	34,181	75,589	67,305
(Benefit) provision for credit losses	(4,622)	3,746	(6,603)	17,661
Net interest income after (benefit) provision for credit losses	42,354	30,435	82,192	49,644
Noninterest income:				
Service charges on deposits	1,287	480	2,579	2,067
Insurance income	1,147	819	2,543	2,168
Card interchange income	2,194	1,776	4,152	3,378
Investment advisory	2,886	2,251	5,658	4,497
Company owned life insurance	693	462	1,350	927
Investments in limited partnerships	238	(244)	1,093	(31)
Loan servicing	91	50	188	57
(Loss) income from derivative instruments, net	(592)	1,940	1,283	2,686
Net gain on sale of loans held for sale	790	612	1,868	864
Net (loss) gain on investment securities	(3)	674	71	895
Net gain (loss) on other assets	153	(1)	148	63
Net gain (loss) on tax credit investments	276	(40)	191	(80)
Other	1,030	934	2,025	2,132
Total noninterest income	10,190	9,713	23,149	19,623
Noninterest expense:				
Salaries and employee benefits	14,519	15,074	28,984	30,088
Occupancy and equipment	3,286	3,388	6,668	7,144
Professional services	1,603	1,580	3,498	3,732
Computer and data processing	3,460	2,699	6,581	5,372
Supplies and postage	430	517	914	1,070
FDIC assessments	480	539	1,245	911
Advertising and promotions	436	545	760	1,100
Amortization of intangibles	266	287	537	581
Other	2,464	1,946	4,497	4,247
Total noninterest expense	26,944	26,575	53,684	54,245
Income before income taxes	25,600	13,573	51,657	15,022
Income tax expense	5,400	2,441	10,747	2,763
Net income	\$ 20,200	\$ 11,132	\$ 40,910	\$ 12,259
Preferred stock dividends	366	366	731	731
Net income available to common shareholders	\$ 19,834	\$ 10,766	\$ 40,179	\$ 11,528
Earnings per common share (Note 4):				
Basic	\$ 1.25	\$ 0.67	\$ 2.53	\$ 0.72
Diluted	\$ 1.25	\$ 0.67	\$ 2.52	\$ 0.72
Cash dividends declared per common share	\$ 0.27	\$ 0.26	\$ 0.54	\$ 0.52

See accompanying notes to the consolidated financial statements.

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

(Dollars in thousands)

	Three months ended June 30,		Six months ended June 30,	
	2021	2020	2021	2020
Net income	\$ 20,200	\$ 11,132	\$ 40,910	\$ 12,259
Other comprehensive income (loss), net of tax:				
Securities available for sale and transferred securities	5,002	1,741	(9,400)	13,847
Hedging derivative instruments	(501)	(388)	1,063	(297)
Pension and post-retirement obligations	137	233	275	467
Total other comprehensive income (loss), net of tax	4,638	1,586	(8,062)	14,017
Comprehensive income	<u>\$ 24,838</u>	<u>\$ 12,718</u>	<u>\$ 32,848</u>	<u>\$ 26,276</u>

See accompanying notes to the consolidated financial statements.

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
Consolidated Statements of Changes in Shareholders' Equity (Unaudited)
Three and six months ended June 30, 2021 and 2020

<i>(Dollars in thousands, except per share data)</i>	Preferred Equity	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Loss	Treasury Stock	Total Shareholders' Equity
Balance at December 31, 2020	\$ 17,328	\$ 161	\$ 125,118	\$ 324,850	\$ 2,128	\$ (1,222)	\$ 468,363
Comprehensive income:							
Net income	—	—	—	20,710	—	—	20,710
Other comprehensive loss, net of tax	—	—	—	—	(12,700)	—	(12,700)
Common stock issued	—	—	3	—	—	298	301
Purchases of common stock for treasury	—	—	—	—	—	(5,963)	(5,963)
Purchases of 8.48% preferred stock	(6)	—	—	—	—	—	(6)
Share-based compensation plans:							
Share-based compensation	—	—	216	—	—	—	216
Restricted stock units released	—	—	(446)	—	—	446	—
Cash dividends declared:							
Series A 3% Preferred-\$0.75 per share	—	—	—	(1)	—	—	(1)
Series B-1 8.48% Preferred-\$2.12 per share	—	—	—	(364)	—	—	(364)
Common-\$0.27 per share	—	—	—	(4,272)	—	—	(4,272)
Balance at March 31, 2021	\$ 17,322	\$ 161	\$ 124,891	\$ 340,923	\$ (10,572)	\$ (6,441)	\$ 466,284
Comprehensive income:							
Net income	—	—	—	20,200	—	—	20,200
Other comprehensive income, net of tax	—	—	—	—	4,638	—	4,638
Purchases of common stock for treasury	—	—	—	—	—	(1)	(1)
Purchases of 8.48% preferred stock	(30)	—	(7)	—	—	—	(37)
Share-based compensation plans:							
Share-based compensation	—	—	562	—	—	—	562
Restricted stock awards issued	—	—	(223)	—	—	223	—
Stock awards	—	—	30	—	—	88	118
Cash dividends declared:							
Series A 3% Preferred-\$0.75 per share	—	—	—	(1)	—	—	(1)
Series B-1 8.48% Preferred-\$2.12 per share	—	—	—	(365)	—	—	(365)
Common-\$0.27 per share	—	—	—	(4,272)	—	—	(4,272)
Balance at June 30, 2021	\$ 17,292	\$ 161	\$ 125,253	\$ 356,485	\$ (5,934)	\$ (6,131)	\$ 487,126

Continued on next page

See accompanying notes to the consolidated financial statements.

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
Consolidated Statements of Changes in Shareholders' Equity (Unaudited) (Continued)
Three and six months ended June 30, 2021 and 2020

<i>(Dollars in thousands, except per share data)</i>	Preferred Equity	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Loss	Treasury Stock	Total Shareholders' Equity
Balance at December 31, 2019	\$ 17,328	\$ 161	\$ 124,582	\$ 313,364	\$ (14,513)	\$ (1,975)	\$ 438,947
Cumulative-effect adjustment	—	—	—	(8,719)	—	—	(8,719)
Balance at January 1, 2020	\$ 17,328	\$ 161	\$ 124,582	\$ 304,645	\$ (14,513)	\$ (1,975)	\$ 430,228
Comprehensive income:							
Net income	—	—	—	1,127	—	—	1,127
Other comprehensive income, net of tax	—	—	—	—	12,431	—	12,431
Purchases of common stock for treasury	—	—	—	—	—	(196)	(196)
Share-based compensation plans:							
Share-based compensation	—	—	332	—	—	—	332
Restricted stock units released	—	—	(469)	—	—	469	—
Cash dividends declared:							
Series A 3% Preferred-\$0.75 per share	—	—	—	(1)	—	—	(1)
Series B-1 8.48% Preferred-\$2.12 per share	—	—	—	(364)	—	—	(364)
Common-\$0.26 per share	—	—	—	(4,164)	—	—	(4,164)
Balance at March 31, 2020	\$ 17,328	\$ 161	\$ 124,445	\$ 301,243	\$ (2,082)	\$ (1,702)	\$ 439,393
Comprehensive income:							
Net income	—	—	—	11,132	—	—	11,132
Other comprehensive income, net of tax	—	—	—	—	1,586	—	1,586
Share-based compensation plans:							
Share-based compensation	—	—	369	—	—	—	369
Restricted stock awards issued	—	—	(272)	—	—	272	—
Stock awards	—	—	(19)	—	—	114	95
Cash dividends declared:							
Series A 3% Preferred-\$0.75 per share	—	—	—	(1)	—	—	(1)
Series B-1 8.48% Preferred-\$2.12 per share	—	—	—	(365)	—	—	(365)
Common-\$0.26 per share	—	—	—	(4,164)	—	—	(4,164)
Balance at June 30, 2020	\$ 17,328	\$ 161	\$ 124,523	\$ 307,845	\$ (496)	\$ (1,316)	\$ 448,045

See accompanying notes to the consolidated financial statements.

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
Consolidated Statements of Cash Flows (Unaudited)

	Six months ended June 30,	
	2021	2020
<i>(Dollars in thousands)</i>		
Cash flows from operating activities:		
Net income	\$ 40,910	\$ 12,259
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	3,931	3,950
Net amortization of premiums on securities	2,452	1,378
(Benefit) provision for credit losses	(6,603)	17,661
Share-based compensation	778	701
Deferred income tax expense (benefit)	2,333	(1,663)
Proceeds from sale of loans held for sale	42,767	31,504
Originations of loans held for sale	(40,523)	(33,070)
Income on company owned life insurance	(1,350)	(927)
Net gain on sale of loans held for sale	(1,868)	(864)
Net gain on investment securities	(71)	(895)
Net gain on other assets	(148)	(63)
Noncash restructuring charges against assets	11	—
Decrease (increase) in other assets	2,950	(36,571)
(Decrease) increase in other liabilities	(14,620)	16,772
Net cash provided by operating activities	30,949	10,172
Cash flows from investing activities:		
Purchases of available for sale securities	(411,641)	(121,622)
Purchases of held to maturity securities	(1,830)	(4,761)
Proceeds from principal payments, maturities and calls on available for sale securities	70,596	59,228
Proceeds from principal payments, maturities and calls on held to maturity securities	54,288	53,282
Proceeds from sales of securities available for sale	51,891	29,631
Net loan originations	(37,523)	(276,409)
Purchases of company owned life insurance, net of proceeds received	(12)	(7)
Proceeds from sales of other assets	2,459	482
Purchases of premises and equipment	(6,284)	(2,375)
Cash consideration paid for acquisition, net of cash acquired	(759)	—
Net cash used in investing activities	(278,815)	(262,551)
Cash flows from financing activities:		
Net increase in deposits	380,854	438,333
Net decrease in short-term borrowings	(5,300)	(170,200)
Repurchase of preferred stock	(43)	—
Purchases of common stock for treasury	(5,964)	(196)
Cash dividends paid to common and preferred shareholders	(9,172)	(8,895)
Net cash provided by financing activities	360,375	259,042
Net increase in cash and cash equivalents	112,509	6,663
Cash and cash equivalents, beginning of period	93,878	112,947
Cash and cash equivalents, end of period	\$ 206,387	\$ 119,610

See accompanying notes to the consolidated financial statements.

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements (Unaudited)

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

Nature of Operations

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

Basis of Presentation

The consolidated financial statements include the accounts of the Company and its subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation. The accounting and reporting policies conform to U.S. generally accepted accounting principles (“GAAP”). Certain information and footnote disclosures normally included in financial statements prepared in conformity with GAAP have been condensed or omitted pursuant to such rules and regulations. However, in the opinion of management, the accompanying consolidated financial statements reflect all adjustments of a normal and recurring nature necessary for a fair presentation of the consolidated statements of financial condition, income, comprehensive income, changes in shareholders’ equity and cash flows for the periods indicated and contain adequate disclosure to make the information presented not misleading. These consolidated financial statements should be read in conjunction with the Company’s 2020 Annual Report on Form 10-K for the year ended December 31, 2020. The results of operations for any interim periods are not necessarily indicative of the results which may be expected for the entire year.

Operational, Accounting and Reporting Impacts Related to the COVID-19 Pandemic

The COVID-19 pandemic has negatively impacted the global economy, including our operating footprint of Western and Central New York. In response to this crisis, the Coronavirus Aid, Relief, and Economic Security (“CARES”) Act was passed by Congress and signed into law on March 27, 2020. The CARES Act provided an estimated \$2.2 trillion to fight the COVID-19 pandemic and stimulate the economy by supporting individuals and businesses through loans, grants, tax changes, and other types of relief. Some of the provisions applicable to the Company include, but are not limited to:

- *Accounting for Loan Modifications* - The CARES Act provided that a financial institution may elect to suspend (1) the application of GAAP for certain loan modifications related to COVID-19 that would otherwise be categorized as a troubled debt restructuring (“TDR”) and (2) any determination that such loan modifications would be considered a TDR, including the related impairment for accounting purposes.
- *Paycheck Protection Program* - The CARES Act established the Paycheck Protection Program (“PPP”), an expansion of the Small Business Administration’s (“SBA”) 7(a) loan program and the Economic Injury Disaster Loan Program (“EIDL”), administered directly by the SBA. On December 27, 2020, the Consolidated Appropriations Act, 2021 provided approximately \$284 billion for PPP loans in an additional round of funding under the program and extended the PPP through March 31, 2021. This additional round of PPP loan funding is authorized for first-time borrowers and for second draws by certain borrowers who have previously received PPP loans. On March 30, 2021, the PPP Extension Act of 2021 was signed into law, which extended the program to May 31, 2021.
- *Mortgage Forbearance* - Under the CARES Act, a borrower with a federally backed mortgage loan that is experiencing financial hardship due to COVID-19 may request a forbearance through September 30, 2021.

Also, in response to the COVID-19 pandemic, the Board of Governors of the Federal Reserve System (“FRB”), the Federal Deposit Insurance Corporation (“FDIC”), the National Credit Union Administration (“NCUA”), the Office of the Comptroller of the Currency (“OCC”), and the Consumer Financial Protection Bureau (“CFPB”), in consultation with the state financial regulators (collectively, the “agencies”) issued a joint interagency statement (issued March 22, 2020; revised statement issued April 7, 2020). Some of the provisions applicable to the Company include, but are not limited to:

- *Accounting for Loan Modifications* - Loan modifications that do not meet the conditions of the CARES Act may still qualify as a modification that does not need to be accounted for as a TDR. The agencies confirmed with FASB staff that short-term modifications made on a good faith basis in response to COVID-19 to borrowers who were current prior to any relief are not TDRs. This includes short-term (e.g., six months) modifications such as payment deferrals, fee waivers, extensions of repayment terms, or insignificant delays in payment.

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements (Unaudited)

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

- *Past Due Reporting* - With regard to loans not otherwise reportable as past due, financial institutions are not expected to designate loans with deferrals granted due to COVID-19 as past due because of the deferral. A loan's payment date is governed by the due date stipulated in the legal agreement. If a financial institution agrees to a payment deferral, these loans would not be considered past due during the period of the deferral.
- *Nonaccrual Status and Charge-offs* - During short-term COVID-19 modifications, these loans generally should not be reported as nonaccrual or as classified.

Effective March 23, 2020 through July 9, 2020, for consumer customers, the Bank waived early CD penalty fees for withdrawals up to \$20,000 (limited to one penalty-free withdrawal per CD account); eliminated all insufficient funds (overdrafts) and returned item fees; eliminated all Pay by Phone fees; waived all late fees; offered the opportunity for monthly mortgage, home equity loan or home equity line payment relief; offered the opportunity to defer unsecured consumer loans or lines of credit and secured consumer loans and lines of credit payments; and offered unsecured personal loans up to \$5,000, up to 60 months at 2.95% APR subject to credit approval. ATM access fees were reinitiated on September 19, 2020.

As part of the first round of PPP loans we have helped more than 1,700 customers obtain more than \$270 million in loans as of December 31, 2020. Of those loans, we have helped customers complete the forgiveness process for approximately \$183 million of loans in the first six months of 2021. Also, during the first six months of 2021, we have helped customers obtain approximately \$107 million of new PPP loans under the second round of the PPP. Additionally, as of June 30, 2021, approximately 3% of our commercial loan and mortgage customers, 1% of our residential real estate loans and lines customers and less than 1% of our indirect loans customers have active payment deferrals, in accordance with the previously noted loan modifications under the CARES Act or agencies guidelines.

Reclassifications

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

Use of Estimates

The preparation of these financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates. Material estimates relate to the determination of the allowance for credit losses, the carrying value of goodwill and deferred tax assets, and assumptions used in the defined benefit pension plan accounting.

Cash Flow Reporting

Supplemental cash flow information is summarized as follows for the six months ended June 30 (in thousands):

	2021	2020
Supplemental information:		
Cash paid for interest	\$ 8,148	\$ 18,545
Cash paid for income taxes	7,100	959
Noncash investing and financing activities:		
Real estate and other assets acquired in settlement of loans	—	646
Accrued and declared unpaid dividends	4,638	4,259
Common stock issued for acquisition	301	—
Assets acquired and liabilities assumed in business combinations:		
Fair value of assets acquired	449	—

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements (Unaudited)

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

Recent Accounting Pronouncements

In 2017, the United Kingdom's Financial Conduct Authority ("FCA"), who is responsible for regulating the London Interbank Offered Rate ("LIBOR"), announced its intention that it would no longer be necessary to persuade or compel its panel banks to submit LIBOR rates after December 31, 2021. On March 5, 2021, the ICE Benchmark Administration ("IBA"), the administrator of LIBOR, released the results of its consultation on the cessation timeline for certain LIBOR tenors. In coordination with the IBA, the FCA also confirmed when certain LIBOR tenors will cease to exist. The results of the consultation indicated that certain LIBOR tenors (overnight, one-month, three-month, six-month, and twelve-month USD LIBOR) will be extended to June 30, 2023 to allow some legacy contracts that cannot be easily amended to mature on their current terms. Notwithstanding the extension of certain LIBOR tenors to 2023, banks may no longer offer new LIBOR-based contracts after December 31, 2021. Given that LIBOR is a widely used pricing index for loan and derivative contracts, a Company-wide initiative was introduced to assess all LIBOR exposures through the Company's loan, deposit, borrowing and derivative categories, while developing a plan for the ultimate cessation of the index. In developing the transition plan, the Company has followed best practice recommendations from the Federal Reserve's Alternative Reference Rate Committee, our third-party derivative advisor and the Internal Swaps and Derivatives Association. To date, the Company has identified the portion of loan notes that reference LIBOR, which are primarily representative of commercial relationships. Additionally, the Company has one designated derivative instrument that is utilized to hedge the LIBOR characteristic of a future dated borrowing (i.e. Federal Home Loan Bank Advance). In 2015, the Company issued \$40 million in fixed to floating rate subordinated notes that currently bear a fixed rate of interest at 6.00% until April 2025, when the rate converts to a floating rate equal to three-month LIBOR plus 3.944%; the indenture under which the notes were issued includes language allowing an alternate index to be applied in the event that LIBOR becomes unavailable at the floating rate determination date. At this time, no other borrowing or deposit relationships have been identified that utilize LIBOR as an index.

In March 2020, the FASB issued ASU No. 2020-04, *Reference Rate Reform (Topic 848): Facilitation of the Effects of Reference Rate Reform on Financial Reporting*. The ASU provides temporary optional expedients and exceptions to GAAP guidance on contract modifications and hedge accounting to ease the financial reporting burdens of the expected market transition from LIBOR and other interbank offered rates to alternative rates, such as SOFR. ASU 2020-04 became effective during the first quarter of 2020 and applies to contract modifications and amendments made as of the beginning of the reporting period including the ASU's issuance date, March 12, 2020, through December 31, 2022. The adoption of this guidance in 2020 resulted in the application of certain practical expedients, which did not have a material effect on the Company's consolidated financial statements.

In January 2021, the FASB issued ASU No. 2021-01, *Reference Rate Reform (Topic 848): Scope*. The ASU clarifies that certain optional expedients and exceptions in ASC 848 for contract modifications and hedge accounting apply to derivatives that are affected by the discounting transition. The ASU also amends the expedients and exceptions in ASC 848 to capture the incremental consequences of the scope clarification and to tailor the existing guidance to derivative instruments affected by the discounting transition. ASU 2021-01 was effective upon issuance and applies through December 31, 2022. The Company is in the process of determining which optional expedients to elect, if any, as well as the timing and application of those elections. At this time, the Company does not expect any elections to have a significant impact on its financial statements.

(2.) BUSINESS COMBINATIONS

2021 Activity

On February 1, 2021, SDN completed the acquisition of the assets of Landmark Group ("Landmark"), an independent insurance brokerage firm. Consideration for the acquisition included common shares of Company stock and cash. As a result of the acquisition, SDN recorded goodwill of \$611 thousand and other intangible assets of \$399 thousand. The goodwill and other intangible assets are expected to be deductible for income tax purposes. The allocation of acquisition cost to the assets acquired and liabilities assumed and pro forma results of operations for this acquisition have not been presented because the effect of this acquisition was not material to the Company's consolidated financial statements.

On August 2, 2021, SDN completed the acquisition of the assets of an employee benefits and consulting firm. The consideration for the acquisition, deductibility of acquired assets for income tax purposes, allocation of acquisition cost to the assets acquired and liabilities assumed and pro forma results of operations for this acquisition have not been presented because the effect of this acquisition was not material to the Company's consolidated financial statements.

2020 Activity – No Activity

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements (Unaudited)

(3.) RESTRUCTURING CHARGES

On July 17, 2020, the Bank announced management's decision to adapt to a full-service branch model to streamline retail branches to better align with shifting customer needs and preferences. The transformation resulted in six branch closures and a reduction in staffing. The announcement was the result of a nine-month comprehensive assessment of all lines of business and functional areas, conducted in partnership with a leading process improvement organization. The data-driven analysis identified, among other things, overlapping service areas, automation opportunities and streamlining of processes and operations that would enhance customer experiences and facilitate the long-term sustainability of current and future branches. The announced consolidations represented about ten percent of the branch network and impacted approximately six percent of the total Company workforce. Where possible, those impacted were offered alternative roles or the opportunity to apply for open positions in other areas of the Company. Separated associates received a comprehensive severance package based on tenure.

In October 2020, the Company announced the planned closure of one additional branch that closed in January 2021. This location was not included in the branch consolidations announced in July, as alternative options were being considered and consolidation was not possible given its significant distance from other Bank branches.

The Company incurred total pre-tax expense related to the branch closures of approximately \$1.7 million, including approximately \$0.2 million in employee severance, \$0.5 million in lease termination costs and \$1.0 million in valuation adjustments on branch facilities. The Company recognized all of these expenses during 2020. The Company expects \$0.8 million of total costs will result in future cash expenditures. The Company anticipates annual expense savings of approximately \$2.7 million as a result of these branch closures.

The Company incurred no restructuring charges during the six months ended June 30, 2021 and 2020.

The following table represents the changes in the restructuring reserve (in thousands):

	Three months ended June 30,		Six months ended June 30,	
	2021	2020	2021	2020
Balance at beginning of period	\$ 1,161	\$ —	\$ 1,245	\$ —
Restructuring charges	—	—	—	—
Cash payments	(68)	—	(146)	—
Charges against assets	(5)	—	(11)	—
Balance at end of period	<u>\$ 1,088</u>	<u>\$ —</u>	<u>\$ 1,088</u>	<u>\$ —</u>

In contemplation of the transactions noted above, certain long-lived assets have met the held for sale criteria as of June 30, 2021. The Company reclassified \$1.1 million from premises and equipment, net to other assets on the consolidated statement of financial condition as of June 30, 2021. No long-lived assets were reclassified as held for sale as of December 31, 2020.

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements (Unaudited)

(4.) EARNINGS PER COMMON SHARE (“EPS”)

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

	Three months ended June 30,		Six months ended June 30,	
	2021	2020	2021	2020
Net income available to common shareholders	\$ 19,834	\$ 10,766	\$ 40,179	\$ 11,528
Weighted average common shares outstanding:				
Total shares issued	16,100	16,100	16,100	16,100
Unvested restricted stock awards	(6)	(5)	(6)	(4)
Treasury shares	(269)	(77)	(237)	(84)
Total basic weighted average common shares outstanding	15,825	16,018	15,857	16,012
Incremental shares from assumed:				
Exercise of stock options	—	—	—	—
Vesting of restricted stock awards	88	29	86	46
Total diluted weighted average common shares outstanding	15,913	16,047	15,943	16,058
Basic earnings per common share	\$ 1.25	\$ 0.67	\$ 2.53	\$ 0.72
Diluted earnings per common share	\$ 1.25	\$ 0.67	\$ 2.52	\$ 0.72

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

	Three months ended June 30,		Six months ended June 30,	
	2021	2020	2021	2020
Stock options	—	—	—	—
Restricted stock awards	1	74	6	38
Total	1	74	6	38

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements (Unaudited)

(5.) INVESTMENT SECURITIES

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

	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
June 30, 2021				
Securities available for sale:				
U.S. Government agency and government sponsored enterprises	\$ 6,249	\$ 314	\$ —	\$ 6,563
Mortgage-backed securities:				
Federal National Mortgage Association	514,661	10,821	2,400	523,082
Federal Home Loan Mortgage Corporation	301,495	1,563	3,357	299,701
Government National Mortgage Association	45,710	537	224	46,023
Collateralized mortgage obligations:				
Federal National Mortgage Association	20,362	69	79	20,352
Federal Home Loan Mortgage Corporation	6,747	—	47	6,700
Privately issued	—	424	—	424
Total mortgage-backed securities	888,975	13,414	6,107	896,282
Total available for sale securities	<u>\$ 895,224</u>	<u>\$ 13,728</u>	<u>\$ 6,107</u>	<u>\$ 902,845</u>
Securities held to maturity:				
State and political subdivisions	\$ 113,437	\$ 3,383	\$ —	\$ 116,820
Mortgage-backed securities:				
Federal National Mortgage Association	9,649	509	—	10,158
Federal Home Loan Mortgage Corporation	5,099	212	—	5,311
Government National Mortgage Association	31,170	971	—	32,141
Collateralized mortgage obligations:				
Federal National Mortgage Association	24,099	808	—	24,907
Federal Home Loan Mortgage Corporation	28,847	1,092	—	29,939
Government National Mortgage Association	6,563	205	—	6,768
Total mortgage-backed securities	105,427	3,797	—	109,224
Total held to maturity securities	218,864	<u>\$ 7,180</u>	<u>\$ —</u>	<u>\$ 226,044</u>
Allowance for credit losses - securities	(6)			
Total held to maturity securities, net	<u>\$ 218,858</u>			
December 31, 2020				
Securities available for sale:				
U.S. Government agency and government sponsored enterprises	\$ 6,239	\$ 396	\$ —	\$ 6,635
Mortgage-backed securities:				
Federal National Mortgage Association	350,627	15,549	44	366,132
Federal Home Loan Mortgage Corporation	225,645	3,155	24	228,776
Government National Mortgage Association	22,107	830	—	22,937
Collateralized mortgage obligations:				
Federal National Mortgage Association	3,047	97	—	3,144
Federal Home Loan Mortgage Corporation	—	—	—	—
Privately issued	—	435	—	435
Total mortgage-backed securities	601,426	20,066	68	621,424
Total available for sale securities	<u>\$ 607,665</u>	<u>\$ 20,462</u>	<u>\$ 68</u>	<u>\$ 628,059</u>

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements (Unaudited)

(5.) INVESTMENT SECURITIES (Continued)

	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
December 31, 2020 (continued)				
Securities held to maturity:				
State and political subdivisions	\$ 144,506	\$ 4,478	\$ —	\$ 148,984
Mortgage-backed securities:				
Federal National Mortgage Association	10,776	703	—	11,479
Federal Home Loan Mortgage Corporation	5,858	382	—	6,240
Government National Mortgage Association	37,084	1,578	—	38,662
Collateralized mortgage obligations:				
Federal National Mortgage Association	29,988	1,075	—	31,063
Federal Home Loan Mortgage Corporation	35,897	1,581	—	37,478
Government National Mortgage Association	7,864	265	—	8,129
Total mortgage-backed securities	127,467	5,584	—	133,051
Total held to maturity securities	271,973	\$ 10,062	\$ —	\$ 282,035
Allowance for credit losses - securities	(7)			
Total held to maturity securities, net	\$ 271,966			

The Company elected to exclude accrued interest receivable (“AIR”) from the amortized cost basis of debt securities disclosed throughout this footnote. For available for sale (“AFS”) debt securities, AIR totaled \$1.6 million and \$1.2 million as of June 30, 2021 and December 31, 2020. For held to maturity (“HTM”) debt securities, AIR totaled \$751 thousand and \$905 thousand as of June 30, 2021 and December 31, 2020, respectively. AIR is included in other assets on the Company’s consolidated statements of financial condition.

For the three months ended June 30, 2021 and 2020, credit loss expense (credit) for HTM investment securities was \$(1) thousand and \$(5) thousand, respectively. For the six months ended June 30, 2021 and 2020, credit loss expense (credit) for HTM investment securities was \$(1) thousand and \$(6) thousand, respectively.

Investment securities with a total fair value of \$715.3 million and \$567.4 million at June 30, 2021 and December 31, 2020, respectively, were pledged as collateral to secure public deposits and for other purposes required or permitted by law.

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

	Three months ended June 30,		Six months ended June 30,	
	2021	2020	2021	2020
Proceeds from sales	\$ 25,216	\$ 26,474	\$ 51,891	\$ 29,631
Gross realized gains	162	616	251	616
Gross realized losses	165	—	180	9

The scheduled maturities of securities available for sale and securities held to maturity at June 30, 2021 are shown below (in thousands). Actual expected maturities may differ from contractual maturities because issuers may have the right to call or prepay obligations.

	Amortized Cost	Fair Value
Debt securities available for sale:		
Due in one year or less	\$ 4,875	\$ 4,922
Due from one to five years	61,273	64,618
Due after five years through ten years	162,075	168,601
Due after ten years	667,001	664,704
Total available for sale securities	\$ 895,224	\$ 902,845
Debt securities held to maturity:		
Due in one year or less	\$ 39,335	\$ 39,782
Due from one to five years	75,284	78,219
Due after five years through ten years	18,793	19,459
Due after ten years	85,452	88,584
Total held to maturity securities	\$ 218,864	\$ 226,044

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements (Unaudited)

(5.) INVESTMENT SECURITIES (Continued)

Unrealized losses on investment securities for which an allowance for credit losses has not been recorded and the fair value of the related securities, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, were as follows (in thousands):

	Less than 12 months		12 months or longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
June 30, 2021						
Securities available for sale:						
U.S. Government agency and government sponsored enterprises	\$ —	\$ —	\$ —	\$ —	\$ —	\$ —
Mortgage-backed securities:						
Federal National Mortgage Association	212,724	2,400	72	—	212,796	2,400
Federal Home Loan Mortgage Corporation	211,699	3,293	3,565	64	215,264	3,357
Government National Mortgage Association	32,744	224	—	—	32,744	224
Collateralized mortgage obligations:						
Federal National Mortgage Association	8,855	79	—	—	8,855	79
Federal Home Loan Mortgage Corporation	6,700	47	—	—	6,700	47
Privately issued	—	—	—	—	—	—
Total mortgage-backed securities	472,722	6,043	3,637	64	476,359	6,107
Total available for sale securities	472,722	6,043	3,637	64	476,359	6,107
Total temporarily impaired securities	<u>\$ 472,722</u>	<u>\$ 6,043</u>	<u>\$ 3,637</u>	<u>\$ 64</u>	<u>\$ 476,359</u>	<u>\$ 6,107</u>
December 31, 2020						
Securities available for sale:						
U.S. Government agencies and government sponsored enterprises	\$ —	\$ —	\$ —	\$ —	\$ —	\$ —
Mortgage-backed securities:						
Federal National Mortgage Association	18,155	44	—	—	18,155	44
Federal Home Loan Mortgage Corporation	10,932	24	—	—	10,932	24
Government National Mortgage Association	—	—	—	—	—	—
Collateralized mortgage obligations:						
Federal National Mortgage Association	—	—	8	—	8	—
Federal Home Loan Mortgage Corporation	—	—	—	—	—	—
Privately issued	—	—	—	—	—	—
Total mortgage-backed securities	29,087	68	8	—	29,095	68
Total available for sale securities	29,087	68	8	—	29,095	68
Total temporarily impaired securities	<u>\$ 29,087</u>	<u>\$ 68</u>	<u>\$ 8</u>	<u>\$ —</u>	<u>\$ 29,095</u>	<u>\$ 68</u>

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements (Unaudited)

(5.) INVESTMENT SECURITIES (Continued)

The total number of securities positions in the investment portfolio in an unrealized loss position at June 30, 2021 was 65 compared to eight at December 31, 2020. At June 30, 2021, the Company had positions in three investment securities with a fair value of \$3.6 million and a total unrealized loss of \$64 thousand dollars that has been in a continuous unrealized loss position for more than 12 months. At June 30, 2021, there were a total of 62 securities positions in the Company's investment portfolio with a fair value of \$472.7 million and a total unrealized loss of \$6.0 million that had been in a continuous unrealized loss position for less than 12 months. At December 31, 2020, the Company had a position in one investment security with a fair value of eight thousand dollars and a total unrealized loss of less than one thousand dollars that had been in a continuous unrealized loss position for more than 12 months. At December 31, 2020, there were a total of seven securities positions in the Company's investment portfolio with a fair value of \$29.1 million and a total unrealized loss of \$68 thousand that had been in a continuous unrealized loss position for less than 12 months. The unrealized loss on investment securities was predominantly caused by changes in market interest rates subsequent to purchase. The fair value of most of the investment securities in the Company's portfolio fluctuates as market interest rates change.

Securities Available for Sale

As of June 30, 2021 and December 31, 2020, no allowance for credit losses has been recognized on available for sale securities in an unrealized loss position as management does not believe any of the securities were impaired due to reasons of credit quality. This is based upon our analysis of the underlying risk characteristics, including credit ratings, and other qualitative factors related to our available for sale securities and in consideration of our historical credit loss experience and internal forecasts. The issuers of these securities continue to make timely principal and interest payments under the contractual terms of the securities. Furthermore, management does not have the intent to sell any of the securities classified as available for sale in the table above and believes that it is more likely than not that we will not have to sell any such securities before a recovery of cost. The unrealized losses are 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 securities approach their maturity date or repricing date or if market yields for such investments decline.

Securities Held to Maturity

The Company's HTM investment securities include debt securities that are issued by U.S. government agencies or U.S. government-sponsored enterprises. These securities carry the explicit and/or implicit guarantee of the U.S. government, are widely recognized as "risk free," and have a long history of zero credit loss. In addition, the Company's HTM investment securities include debt securities that are issued by state and local government agencies, or municipal bonds.

The Company monitors the credit quality of our municipal bonds through the use of a credit rating agency or by ratings that are derived by an internal scoring model. The scoring methodology for the internally derived ratings is based on a series of financial ratios for the municipality being reviewed as compared to typical industry figures. This information is used to determine the financial strengths and weaknesses of the municipality, which is indicated with a numeric rating. This number is then converted into a letter rating to better match the system used by the credit rating agencies. As of June 30, 2021, \$107.1 million of our municipal bonds were rated as an equivalent to Standard & Poor's A/AA/AAA, with \$6.0 million internally rated to be the equivalent of Standard & Poor's A/AA/AAA rating. Additionally, one municipal bond was rated below investment grade, with a BB+ Standard & Poor's equivalent rating. The below investment grade bond represented exposure of \$280 thousand, or 0.25% of the municipal bond portfolio and has been closely monitored for repayment. As of December 31, 2020, \$135.7 million of our municipal bonds were rated as an equivalent to Standard & Poor's A/AA/AAA, with \$8.5 million internally rated to be the equivalent of Standard & Poor's A/AA/AAA rating. Additionally, one municipal bond was rated below investment grade, with a BB+ Standard & Poor's equivalent rating. The below investment grade bond represented exposure of \$279 thousand, or 0.19% of the municipal bond portfolio and has been closely monitored for repayment.

As of June 30, 2021 and December 31, 2020, the Company had no past due or nonaccrual held to maturity investment securities.

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements (Unaudited)

(6.) LOANS

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

	Principal Amount Outstanding	Net Deferred Loan (Fees) Costs	Loans, Net
June 30, 2021			
Commercial business	\$ 735,928	\$ (4,720)	\$ 731,208
Commercial mortgage	1,317,754	(2,350)	1,315,404
Residential real estate loans	576,632	13,671	590,303
Residential real estate lines	77,773	3,008	80,781
Consumer indirect	868,430	30,588	899,018
Other consumer	15,322	132	15,454
Total	<u>\$ 3,591,839</u>	<u>\$ 40,329</u>	3,632,168
Allowance for credit losses - loans			(46,365)
Total loans, net			<u>\$ 3,585,803</u>
December 31, 2020			
Commercial business	\$ 798,409	\$ (4,261)	\$ 794,148
Commercial mortgage	1,256,525	(2,624)	1,253,901
Residential real estate loans	586,537	13,263	599,800
Residential real estate lines	86,708	3,097	89,805
Consumer indirect	812,816	27,605	840,421
Other consumer	16,913	150	17,063
Total	<u>\$ 3,557,908</u>	<u>\$ 37,230</u>	3,595,138
Allowance for credit losses - loans			(52,420)
Total loans, net			<u>\$ 3,542,718</u>

Loans held for sale (not included above) were comprised entirely of residential real estate mortgages and totaled \$3.9 million and \$4.3 million as of June 30, 2021 and December 31, 2020, respectively.

The CARES Act was passed by Congress and signed into law on March 27, 2020. The CARES Act established the PPP, an expansion of the SBA's 7(a) loan program and the EIDL, administered directly by the SBA. The Company had \$177.7 million and \$253.1 million of PPP loans (included in Commercial business above) as of June 30, 2021 and December 31, 2020, respectively. In addition, the CARES Act provides that a financial institution may elect to suspend (1) the application of GAAP for certain loan modifications related to COVID-19 that would otherwise be categorized as a TDR and (2) any determination that such loan modifications would be considered a TDR, including the related impairment for accounting purposes. Accordingly, the Company had \$532.4 million of loans with modifications related to COVID-19 during 2020, with \$69.1 million and \$113.0 million still on deferral as of June 30, 2021 and December 31, 2020, respectively.

The Company elected to exclude AIR from the amortized cost basis of loans disclosed throughout this footnote. As of June 30, 2021 and December 31, 2020, AIR for loans totaled \$12.9 million and \$13.6 million, respectively, and is included in other assets on the Company's consolidated statements of financial condition.

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements (Unaudited)

(6.) LOANS (Continued)

Past Due Loans Aging

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

	30-59 Days Past Due	60-89 Days Past Due	Greater Than 90 Days	Total Past Due	Nonaccrual	Current	Total Loans	Nonaccrual with no allowance
June 30, 2021								
Commercial business	\$ 80	\$ —	\$ —	\$ 80	\$ 1,555	\$ 734,293	\$ 735,928	\$ 899
Commercial mortgage	900	—	—	900	885	1,315,969	1,317,754	355
Residential real estate loans	612	16	—	628	2,615	573,389	576,632	2,615
Residential real estate lines	116	—	—	116	280	77,377	77,773	280
Consumer indirect	2,643	502	—	3,145	1,250	864,035	868,430	1,250
Other consumer	65	24	42	131	8	15,183	15,322	8
Total loans, gross	<u>\$ 4,416</u>	<u>\$ 542</u>	<u>\$ 42</u>	<u>\$ 5,000</u>	<u>\$ 6,593</u>	<u>\$3,580,246</u>	<u>\$3,591,839</u>	<u>\$ 5,407</u>
December 31, 2020								
Commercial business	\$ 264	\$ 87	\$ —	\$ 351	\$ 1,975	\$ 796,083	\$ 798,409	\$ 1,502
Commercial mortgage	822	26	—	848	2,906	1,252,771	1,256,525	2,709
Residential real estate loans	984	60	—	1,044	2,587	582,906	586,537	2,587
Residential real estate lines	40	15	—	55	323	86,330	86,708	323
Consumer indirect	3,966	1,348	—	5,314	1,495	806,007	812,816	1,495
Other consumer	133	18	231	382	—	16,531	16,913	—
Total loans, gross	<u>\$ 6,209</u>	<u>\$ 1,554</u>	<u>\$ 231</u>	<u>\$ 7,994</u>	<u>\$ 9,286</u>	<u>\$3,540,628</u>	<u>\$3,557,908</u>	<u>\$ 8,616</u>

There were no loans past due greater than 90 days and still accruing interest as of June 30, 2021 and December 31, 2020. There were \$42 thousand and \$231 thousand in consumer overdrafts which were past due greater than 90 days as of June 30, 2021 and December 31, 2020, respectively. Consumer overdrafts are overdrawn deposit accounts which have been reclassified as loans but by their terms do not accrue interest.

The Company recognized no interest income on nonaccrual loans during the six months ended June 30, 2021 and 2020.

Troubled Debt Restructurings

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

There were no loans modified as a TDR during the six months ended June 30, 2021 and 2020. There were no loans modified as a TDR within the previous 12 months that defaulted during the six months ended June 30, 2021 and 2020. For purposes of this disclosure, a loan modified as a TDR is considered to have defaulted when the borrower becomes 90 days past due.

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements (Unaudited)

(6.) LOANS (Continued)

Collateral Dependent Loans

Management has determined that specific commercial loans on nonaccrual status, all loans that have had their terms restructured in a troubled debt restructuring and other loans deemed appropriate by management where repayment is expected to be provided substantially through the operation or sale of the collateral to be collateral dependent loans. Collateral dependent loans at June 30, 2021 and December 31, 2020 included certain criticized COVID-19 bridge loans not otherwise classified as nonaccrual. The following table presents the amortized cost basis of collateral dependent loans by collateral type as of June 30, 2021 and December 31, 2020 (in thousands):

	Collateral type		Total	Specific Reserve
	Business assets	Real property		
June 30, 2021				
Commercial business	\$ 910	\$ 1,148	\$ 2,058	\$ 1,409
Commercial mortgage	—	64,499	64,499	11,880
Total	<u>\$ 910</u>	<u>\$ 65,647</u>	<u>\$ 66,557</u>	<u>\$ 13,289</u>
December 31, 2020				
Commercial business	\$ 2,379	\$ —	\$ 2,379	\$ 1,383
Commercial mortgage	—	36,625	36,625	8,187
Total	<u>\$ 2,379</u>	<u>\$ 36,625</u>	<u>\$ 39,004</u>	<u>\$ 9,570</u>

Credit Quality Indicators

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

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

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

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

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

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements (Unaudited)

(6.) LOANS (Continued)

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

	Term Loans Amortized Cost Basis by Origination Year						Revolving Loans Amortized Cost Basis	Revolving Loans Converted to Term	Total
	2021	2020	2019	2018	2017	Prior			
June 30, 2021									
Commercial Business									
Uncriticized	\$ 65,107	\$ 175,374	\$ 97,307	\$ 60,740	\$ 20,000	\$ 21,457	\$ 281,613	\$ —	\$ 721,598
Special mention	27	104	14	129	26	1,083	2,974	—	4,357
Substandard	—	65	173	945	213	133	3,724	—	5,253
Doubtful	—	—	—	—	—	—	—	—	—
Total	\$ 65,134	\$ 175,543	\$ 97,494	\$ 61,814	\$ 20,239	\$ 22,673	\$ 288,311	\$ —	\$ 731,208
Commercial Mortgage									
Uncriticized	\$ 137,070	\$ 340,304	\$ 196,386	\$ 145,712	\$ 145,919	\$ 181,455	\$ 165	\$ —	\$ 1,147,011
Special mention	496	16,636	50,195	9,635	25,426	39,954	—	—	142,342
Substandard	—	327	2,938	11,733	1,276	9,777	—	—	26,051
Doubtful	—	—	—	—	—	—	—	—	—
Total	\$ 137,566	\$ 357,267	\$ 249,519	\$ 167,080	\$ 172,621	\$ 231,186	\$ 165	\$ —	\$ 1,315,404

	Term Loans Amortized Cost Basis by Origination Year						Revolving Loans Amortized Cost Basis	Revolving Loans Converted to Term	Total
	2020	2019	2018	2017	2016	Prior			
December 31, 2020									
Commercial Business									
Uncriticized	\$ 350,992	\$ 112,469	\$ 82,029	\$ 31,990	\$ 8,195	\$ 16,600	\$ 179,770	\$ —	\$ 782,045
Special mention	—	360	21	709	41	1,025	2,995	—	5,151
Substandard	193	211	1,183	464	202	309	4,390	—	6,952
Doubtful	—	—	—	—	—	—	—	—	—
Total	<u>\$ 351,185</u>	<u>\$ 113,040</u>	<u>\$ 83,233</u>	<u>\$ 33,163</u>	<u>\$ 8,438</u>	<u>\$ 17,934</u>	<u>\$ 187,155</u>	<u>\$ —</u>	<u>\$ 794,148</u>
Commercial Mortgage									
Uncriticized	\$ 310,364	\$ 227,406	\$ 163,839	\$ 161,771	\$ 74,915	\$ 154,399	\$ 731	\$ —	\$ 1,093,425
Special mention	14,299	42,305	19,505	27,530	12,256	28,744	43	—	144,682
Substandard	189	2,521	1,890	1,648	3	9,344	199	—	15,794
Doubtful	—	—	—	—	—	—	—	—	—
Total	<u>\$ 324,852</u>	<u>\$ 272,232</u>	<u>\$ 185,234</u>	<u>\$ 190,949</u>	<u>\$ 87,174</u>	<u>\$ 192,487</u>	<u>\$ 973</u>	<u>\$ —</u>	<u>\$ 1,253,901</u>

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements (Unaudited)

(6.) LOANS (Continued)

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

	Term Loans Amortized Cost Basis by Origination Year						Revolving Loans Amortized Cost Basis	Revolving Loans Converted to Term	Total
	2021	2020	2019	2018	2017	Prior			
June 30, 2021									
Residential Real Estate Loans									
Performing	\$ 51,557	\$ 134,889	\$ 92,197	\$ 76,496	\$ 58,061	\$ 174,488	\$ —	\$ —	\$ 587,688
Nonperforming	—	198	245	602	751	819	—	—	2,615
Total	<u>\$ 51,557</u>	<u>\$ 135,087</u>	<u>\$ 92,442</u>	<u>\$ 77,098</u>	<u>\$ 58,812</u>	<u>\$ 175,307</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 590,303</u>
Residential Real Estate Lines									
Performing	\$ —	\$ —	\$ —	\$ —	\$ —	\$ —	\$ 71,762	\$ 8,739	\$ 80,501
Nonperforming	—	—	—	—	—	—	64	216	280
Total	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 71,826</u>	<u>\$ 8,955</u>	<u>\$ 80,781</u>
Consumer Indirect									
Performing	\$ 242,845	\$ 254,491	\$ 160,077	\$ 125,332	\$ 77,625	\$ 37,398	\$ —	\$ —	\$ 897,768
Nonperforming	86	224	419	261	187	73	—	—	1,250
Total	<u>\$ 242,931</u>	<u>\$ 254,715</u>	<u>\$ 160,496</u>	<u>\$ 125,593</u>	<u>\$ 77,812</u>	<u>\$ 37,471</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 899,018</u>
Other Consumer									
Performing	\$ 3,067	\$ 4,805	\$ 2,338	\$ 1,191	\$ 513	\$ 728	\$ 2,804	\$ —	\$ 15,446
Nonperforming	—	—	8	—	—	—	—	—	8
Total	<u>\$ 3,067</u>	<u>\$ 4,805</u>	<u>\$ 2,346</u>	<u>\$ 1,191</u>	<u>\$ 513</u>	<u>\$ 728</u>	<u>\$ 2,804</u>	<u>\$ —</u>	<u>\$ 15,454</u>

	Term Loans Amortized Cost Basis by Origination Year						Revolving Loans Amortized Cost Basis	Revolving Loans Converted to Term	Total
	2020	2019	2018	2017	2016	Prior			
December 31, 2020									
Residential Real Estate Loans									
Performing	\$ 137,926	\$ 103,923	\$ 87,153	\$ 66,446	\$ 67,473	\$ 134,292	\$ —	\$ —	\$ 597,213
Nonperforming	—	199	765	665	233	725	—	—	2,587
Total	<u>\$ 137,926</u>	<u>\$ 104,122</u>	<u>\$ 87,918</u>	<u>\$ 67,111</u>	<u>\$ 67,706</u>	<u>\$ 135,017</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 599,800</u>
Residential Real Estate Lines									
Performing	\$ —	\$ —	\$ —	\$ —	\$ —	\$ —	\$ 79,257	\$ 10,225	\$ 89,482
Nonperforming	—	—	—	—	—	—	65	258	323
Total	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 79,322</u>	<u>\$ 10,483</u>	<u>\$ 89,805</u>
Consumer Indirect									
Performing	\$ 295,216	\$ 202,187	\$ 166,773	\$ 111,008	\$ 47,793	\$ 15,949	\$ —	\$ —	\$ 838,926
Nonperforming	70	652	319	287	132	35	—	—	1,495
Total	<u>\$ 295,286</u>	<u>\$ 202,839</u>	<u>\$ 167,092</u>	<u>\$ 111,295</u>	<u>\$ 47,925</u>	<u>\$ 15,984</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 840,421</u>
Other Consumer									
Performing	\$ 6,774	\$ 3,177	\$ 1,765	\$ 907	\$ 369	\$ 508	\$ 3,563	\$ —	\$ 17,063
Nonperforming	—	—	—	—	—	—	—	—	—
Total	<u>\$ 6,774</u>	<u>\$ 3,177</u>	<u>\$ 1,765</u>	<u>\$ 907</u>	<u>\$ 369</u>	<u>\$ 508</u>	<u>\$ 3,563</u>	<u>\$ —</u>	<u>\$ 17,063</u>

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements (Unaudited)

(6.) LOANS (Continued)

Allowance for Credit Losses - Loans

On January 1, 2020, the Company adopted Accounting Standards Update (“ASU”) No. 2016-13, *Financial Instruments – Credit Losses (Topic 326) – Measurement of Credit Losses on Financial Instruments*. ASU 2016-13 amends guidance on reporting credit losses for financial assets held at amortized cost basis and available for sale debt securities. The allowance for credit losses is a valuation account that is deducted from the amortized cost basis of the financial assets to present the net amount expected to be collected. The Company adopted ASU 2016-13 using the modified retrospective approach. Results for the periods beginning after January 1, 2020 are presented under Accounting Standards Codification (“ASC”) 326 while prior period amounts continue to be reported in accordance with previously applicable GAAP. The Company recorded a net reduction of retained earnings of \$8.7 million upon adoption. The transition adjustment includes an increase in credit-related reserves of \$9.6 million, \$14 thousand, and \$2.1 million for loans, held to maturity investment securities and unfunded commitments, respectively, net of the corresponding increase in deferred tax assets of \$3.0 million.

The following table sets forth the changes in the allowance for credit losses - loans for the three- and six-month periods ended as of the dates indicated (in thousands):

	Commercial Business	Commercial Mortgage	Residential Real Estate Loans	Residential Real Estate Lines	Consumer Indirect	Other Consumer	Total
Three months ended June 30, 2021							
Beginning balance	\$ 12,670	\$ 22,672	\$ 3,109	\$ 482	\$ 10,557	\$ 338	\$ 49,828
Charge-offs	(92)	—	(56)	—	(1,157)	(424)	(1,729)
Recoveries	379	7	59	—	1,583	95	2,123
Provision (credit)	(1,952)	(1,017)	(813)	(87)	(235)	247	(3,857)
Ending balance	<u>\$ 11,005</u>	<u>\$ 21,662</u>	<u>\$ 2,299</u>	<u>\$ 395</u>	<u>\$ 10,748</u>	<u>\$ 256</u>	<u>\$ 46,365</u>
Six months ended June 30, 2021							
Beginning balance	\$ 13,580	\$ 21,763	\$ 3,924	\$ 674	\$ 12,165	\$ 314	\$ 52,420
Charge-offs	(178)	(203)	(67)	(70)	(3,570)	(505)	(4,593)
Recoveries	617	7	64	—	3,253	159	4,100
Provision (credit)	(3,014)	95	(1,622)	(209)	(1,100)	288	(5,562)
Ending balance	<u>\$ 11,005</u>	<u>\$ 21,662</u>	<u>\$ 2,299</u>	<u>\$ 395</u>	<u>\$ 10,748</u>	<u>\$ 256</u>	<u>\$ 46,365</u>
	Commercial Business	Commercial Mortgage	Residential Real Estate Loans	Residential Real Estate Lines	Consumer Indirect	Other Consumer	Total
Three months ended June 30, 2020							
Beginning balance	\$ 10,223	\$ 15,154	\$ 6,170	\$ 899	\$ 10,645	\$ 265	\$ 43,356
Charge-offs	(25)	(1,072)	(2)	—	(2,554)	(70)	(3,723)
Recoveries	1,483	—	8	—	1,379	67	2,937
Provision (credit)	718	1,584	(407)	40	1,752	59	3,746
Ending balance	<u>\$ 12,399</u>	<u>\$ 15,666</u>	<u>\$ 5,769</u>	<u>\$ 939</u>	<u>\$ 11,222</u>	<u>\$ 321</u>	<u>\$ 46,316</u>
Six months ended June 30, 2020							
Beginning balance, prior to adoption of ASC 326	\$ 11,358	\$ 5,681	\$ 1,059	\$ 118	\$ 11,852	\$ 414	\$ 30,482
Impact of adopting ASC 326	(246)	7,310	3,290	607	(1,234)	(133)	9,594
Beginning balance, after adoption of ASC 326	11,112	12,991	4,349	725	10,618	281	40,076
Charge-offs	(8,266)	(1,072)	(100)	—	(5,978)	(339)	(15,755)
Recoveries	1,541	—	18	3	3,047	217	4,826
Provision	8,012	3,747	1,502	211	3,535	162	17,169
Ending balance	<u>\$ 12,399</u>	<u>\$ 15,666</u>	<u>\$ 5,769</u>	<u>\$ 939</u>	<u>\$ 11,222</u>	<u>\$ 321</u>	<u>\$ 46,316</u>

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements (Unaudited)

(6.) LOANS (Continued)

Risk Characteristics

Commercial business loans primarily consist of loans to small to mid-sized businesses in our market area in a diverse range of industries. These loans are of higher risk and typically are made on the basis of the borrower's ability to make repayment from the cash flow of the borrower's business. Further, the collateral securing the loans may depreciate over time, may be difficult to appraise and may fluctuate in value. The credit risk related to commercial loans is largely influenced by general economic conditions, including the impact of the COVID-19 pandemic on small to mid-sized business in our market area, and the resulting impact on a borrower's operations or on the value of underlying collateral, if any.

Commercial mortgage loans generally have larger balances and involve a greater degree of risk than residential mortgage loans, potentially resulting in higher potential losses on an individual customer basis. Loan repayment is often dependent on the successful operation and management of the properties, as well as on the collateral securing the loan. Economic events, including the impact of the COVID-19 pandemic on the ability of the tenants to pay rent at these properties, or conditions in the real estate market could have an adverse impact on the cash flows generated by properties securing the Company's commercial real estate loans and on the value of such properties.

Residential real estate loans (comprised of conventional mortgages and home equity loans) and residential real estate lines (comprised of home equity lines) are generally made based on the borrower's ability to make repayment from his or her employment and other income but are secured by real property whose value tends to be more easily ascertainable. Credit risk for these types of loans is generally influenced by general economic conditions, including the impact of the COVID-19 pandemic on the employment income of these borrowers, the characteristics of individual borrowers, and the nature of the loan collateral.

Consumer indirect and other consumer loans may entail greater credit risk than residential mortgage loans and home equities, particularly in the case of other consumer loans which are unsecured or, in the case of indirect consumer loans, secured by depreciable assets, such as automobiles. In such cases, any repossessed collateral for a defaulted consumer loan may not provide an adequate source of repayment of the outstanding loan balance. In addition, consumer loan collections are dependent on the borrower's continuing financial stability, and thus are more likely to be affected by adverse personal circumstances such as job loss, illness or personal bankruptcy, including the heightened risk that such circumstances may arise as a result of the COVID-19 pandemic. Furthermore, the application of various federal and state laws, including bankruptcy and insolvency laws, may limit the amount which can be recovered on such loans.

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements (Unaudited)

(7.) LEASES

ASC 842, Leases (“ASC 842”), establishes a right of use model that requires a lessee to record a right of use asset and a lease liability for all leases with terms longer than 12 months. The Company is obligated under a number of non-cancellable operating lease agreements for land, buildings and equipment with terms, including renewal options reasonably certain to be exercised, extending through 2061. One building lease was subleased for terms extending through June 30, 2021.

The following table represents the consolidated statements of financial condition classification of the Company’s right of use assets and lease liabilities:

	Balance Sheet Location	June 30, 2021	December 31, 2020
Operating Lease Right of Use Assets:			
Gross carrying amount	Other assets	\$ 27,772	\$ 23,697
Accumulated amortization	Other assets	(4,686)	(3,741)
Net book value		<u>\$ 23,086</u>	<u>\$ 19,956</u>
Operating Lease Liabilities:			
Right of use lease obligations	Other liabilities	<u>\$ 24,803</u>	<u>\$ 21,507</u>

The weighted average remaining lease term for operating leases was 23.8 years at June 30, 2021 and the weighted-average discount rate used in the measurement of operating lease liabilities was 3.69%. The Company utilizes its incremental borrowing rate at lease inception, on a collateralized basis, over a similar term for the discount rate.

The following table represents lease costs and other lease information:

	Three months ended June 30,		Six months ended June 30,	
	2021	2020	2021	2020
Lease costs:				
Operating lease costs	\$ 795	\$ 678	\$ 1,475	\$ 1,355
Variable lease costs (1)	90	101	188	202
Sublease income	(12)	(12)	(23)	(23)
Net lease costs	<u>\$ 873</u>	<u>\$ 767</u>	<u>\$ 1,640</u>	<u>\$ 1,534</u>

Other information:

Cash paid for amounts included in the measurement of lease liabilities:

Operating cash flows from operating leases	\$ 1,349	\$ 1,296
Right of use assets obtained in exchange for new operating lease liabilities	\$ 4,178	\$ 405

(1) Variable lease costs primarily represent variable payments such as common area maintenance, insurance, taxes and utilities.

Future minimum payments under non-cancellable operating leases with initial or remaining terms of one year or more, are as follows at June 30, 2021 (in thousands):

Twelve months ended June 30,	
2022	\$ 2,334
2023	2,045
2024	1,507
2025	1,417
2026	1,338
Thereafter	30,217
Total future minimum operating lease payments	38,858
Amounts representing interest	(14,055)
Present value of net future minimum operating lease payments	<u>\$ 24,803</u>

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements (Unaudited)

(8.) GOODWILL AND OTHER INTANGIBLE ASSETS

Goodwill

The carrying amount of goodwill totaled \$66.7 million and \$66.1 million as of both June 30, 2021 and December 31, 2020. The Company performs a goodwill impairment test on an annual basis as of October 1st or more frequently if events and circumstances warrant.

	Banking	All Other (1)	Total
Balance, December 31, 2020	\$ 48,536	\$ 17,526	\$ 66,062
Acquisition	—	611	611
Balance, June 30, 2021	<u>\$ 48,536</u>	<u>\$ 18,137</u>	<u>\$ 66,673</u>

(1) All Other includes the SDN, Courier Capital and HNP Capital reporting units

Goodwill and other intangible assets added during the period relates to the acquisition of assets of Landmark Group, which was completed on February 1, 2021. See Note 2 – Business Combinations for additional information.

Other Intangible Assets

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

	June 30, 2021	December 31, 2020
Other intangibles assets:		
Gross carrying amount	\$ 16,324	\$ 15,925
Accumulated amortization	(8,735)	(8,198)
Net book value	<u>\$ 7,589</u>	<u>\$ 7,727</u>

Amortization expense for total other intangible assets was \$266 thousand and \$537 thousand for the three and six months ended June 30, 2021, respectively, and \$287 thousand and \$581 thousand for the three and six months ended June 30, 2020, respectively. As of June 30, 2021, the estimated amortization expense of other intangible assets for the remainder of 2021 and each of the next five years is as follows (in thousands):

2021 (remainder of year)	\$ 513
2022	960
2023	887
2024	816
2025	745
2026	675

(9.) OTHER ASSETS

A summary of other assets as of the dates indicated are as follows (in thousands):

	June 30, 2021	December 31, 2020
Operating lease right of use assets	\$ 23,086	\$ 19,956
Tax credit investments	44,662	34,370
Derivative instruments	16,443	20,120
Collateral on derivative instruments	8,780	19,630
Other	64,218	62,010
Total other assets	<u>\$ 157,189</u>	<u>\$ 156,086</u>

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements (Unaudited)

(10.) DERIVATIVE INSTRUMENT AND HEDGING ACTIVITIES

Risk Management Objective of Using Derivatives

The Company is exposed to certain risks arising from both its business operations and economic conditions. The Company principally manages its exposures to a wide variety of business and operational risks through management of its core business activities. The Company manages economic risks, including interest rate, liquidity and credit risk, primarily by managing the amount, sources, and duration of its assets and liabilities, and the use of derivative financial instruments. Specifically, the Company enters into derivative financial instruments to manage exposures that arise from business activities that result in the receipt or payment of future known and uncertain cash amounts, the value of which are determined by interest rates. The Company's derivative financial instruments are used to manage differences in the amount, timing, and duration of the Company's known or expected cash receipts and its known or expected cash payments.

Cash Flow Hedges of Interest Rate Risk

The Company's objectives in using interest rate derivatives are to add stability to interest expense and to manage its exposure to interest rate movements. To accomplish this objective, the Company uses interest rate caps and interest rate swaps as part of its interest rate risk management strategy. Interest rate caps designated as cash flow hedges involve the receipt of variable amounts from a counterparty if interest rates rise above the strike rate on the contract in exchange for an up-front premium. During the first six months of 2021 and in 2020, such derivatives were used to hedge the variable cash flows associated with short-term borrowings. Interest rate swaps designated as cash flow hedges involve the receipt of variable amounts from a counterparty in exchange for the Company making fixed-rate payments over the life of the agreements without exchange of the underlying notional amount. The Company is hedging its exposure to the variability in future cash flows for forecasted transactions over a period of approximately 60 months. As of June 30, 2021, the Company had one outstanding forward starting interest rate derivative with a notional value of \$50.0 million that was designated as a cash flow hedge of interest rate risk. The derivative becomes effective in April 2022.

For derivatives designated and that qualify as cash flow hedges of interest rate risk, the gain or loss on the derivative is recorded in accumulated other comprehensive income (loss) and subsequently reclassified into interest expense in the same period(s) during which the hedged transaction affects earnings. Amounts reported in accumulated other comprehensive income (loss) related to derivatives will be reclassified to interest expense as interest payments are made on the Company's borrowings. During the next twelve months, the Company estimates that \$64 thousand will be reclassified into interest expense.

Interest Rate Swaps

The Company executes interest rate swaps with commercial banking customers to facilitate their respective risk management strategies. These interest rate swaps are simultaneously hedged by offsetting interest rate swaps that the Company executes with a third party, such that the Company minimizes its net risk exposure resulting from such transactions. As the interest rate swaps associated with this program do not meet hedge accounting requirements, changes in the fair value of both the customer swaps and the offsetting swaps are recognized directly in earnings.

Credit-risk-related Contingent Features

The Company has agreements with certain of its derivative counterparties that contain one or more of the following provisions: (a) if the Company defaults on any of its indebtedness, including a default where repayment of the indebtedness has not been accelerated by the lender, the Company could also be declared in default on its derivative obligations, and (b) if the Company fails to maintain its status as a well-capitalized institution, the counterparty could terminate the derivative positions and the Company would be required to settle its obligations under the agreements.

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements (Unaudited)

(10.) DERIVATIVE INSTRUMENT AND HEDGING ACTIVITIES (Continued)

Mortgage Banking Derivatives

The Company extends rate lock agreements to borrowers related to the origination of residential mortgage loans. To mitigate the interest rate risk inherent in these rate lock agreements when the Company intends to sell the related loan, once originated, as well as closed residential mortgage loans held for sale, the Company enters into forward commitments to sell individual residential mortgages. Rate lock agreements and forward commitments are considered derivatives and are recorded at fair value.

Fair Values of Derivative Instruments on the Balance Sheet

The table below presents the notional amounts, respective fair values of the Company's derivative financial instruments, as well as their classification on the balance sheet as of June 30, 2021 and December 31, 2020 (in thousands):

	Gross notional amount		Asset derivatives			Liability derivatives		
			Balance sheet line item	Fair value		Balance sheet line item	Fair value	
	June 30, 2021	Dec. 31, 2020		June 30, 2021	Dec. 31, 2020		June 30, 2021	Dec. 31, 2020
Derivatives designated as hedging instruments								
Cash flow hedges	\$ 50,000	\$ 50,000	Other assets	\$ 1,004	\$ —	Other liabilities	\$ —	\$ 311
Total derivatives	<u>\$ 50,000</u>	<u>\$ 50,000</u>		<u>\$ 1,004</u>	<u>\$ —</u>		<u>\$ —</u>	<u>\$ 311</u>
Derivatives not designated as hedging instruments								
Cash flow hedges	\$ —	\$ 100,000	Other assets	\$ —	\$ —	Other liabilities	\$ —	\$ —
Interest rate swaps ⁽¹⁾	716,115	631,907	Other assets	15,108	19,626	Other liabilities	14,972	19,837
Credit contracts	115,833	113,434	Other assets	14	23	Other liabilities	53	86
Mortgage banking	27,730	28,225	Other assets	317	471	Other liabilities	39	1
Total derivatives	<u>\$ 859,678</u>	<u>\$ 873,566</u>		<u>\$ 15,439</u>	<u>\$ 20,120</u>		<u>\$ 15,064</u>	<u>\$ 19,924</u>

(1) The Company secured its obligations under these contracts with \$8.7 million and \$19.6 million in cash at June 30, 2021 and December 31, 2020, respectively.

Effect of Derivative Instruments on the Income Statement

The table below presents the effect of the Company's derivative financial instruments on the income statement for the three and six months ended June 30, 2021 and 2020 (in thousands):

Undesignated derivatives	Line item of gain (loss) recognized in income	Gain (loss) recognized in income		Gain (loss) recognized in income	
		Three months ended		Six months ended	
		June 30, 2021	June 30, 2020	June 30, 2021	June 30, 2020
Cash flow hedges	Income from derivative instruments, net	\$ —	\$ —	\$ —	\$ —
Interest rate swaps	Income from derivative instruments, net	(333)	1,681	1,439	2,405
Credit contracts	Income from derivative instruments, net	(12)	128	36	123
Mortgage banking	Income from derivative instruments, net	(247)	131	(192)	158
Total undesignated		<u>\$ (592)</u>	<u>\$ 1,940</u>	<u>\$ 1,283</u>	<u>\$ 2,686</u>

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements (Unaudited)

(11.) SHAREHOLDERS' EQUITY

Common Stock

The changes in shares of common stock were as follows for the three and six months ended June 30, 2021 and 2020:

	Outstanding	Treasury	Issued
2021			
Shares at December 31, 2020	16,041,926	57,630	16,099,556
Shares issued for Landmark Group acquisition	12,831	(12,831)	—
Restricted stock units released	18,819	(18,819)	—
Treasury stock purchases	(244,677)	244,677	—
Shares at March 31, 2021	15,828,899	270,657	16,099,556
Restricted stock awards issued	9,350	(9,350)	—
Stock awards	3,680	(3,680)	—
Shares at June 30, 2021	<u>15,841,929</u>	<u>257,627</u>	<u>16,099,556</u>
2020			
Shares at December 31, 2019	16,002,899	96,657	16,099,556
Restricted stock units released	22,921	(22,921)	—
Treasury stock purchases	(6,436)	6,436	—
Shares at March 31, 2020	16,019,384	80,172	16,099,556
Restricted stock awards issued	12,798	(12,798)	—
Stock awards	5,403	(5,403)	—
Shares at June 30, 2020	<u>16,037,585</u>	<u>61,971</u>	<u>16,099,556</u>

Share Repurchase Program

In November 2020, the Company's Board of Directors authorized a share repurchase program for up to 801,879 shares of common stock. Repurchased shares are recorded in treasury stock, at cost, which includes any applicable transaction costs. 238,439 shares were repurchased at an average price of \$24.30 during the six months ended June 30, 2021. No shares were repurchased under this program during the three months ended June 30, 2021 and during the year ended December 31, 2020. As of June 30, 2021, the remaining number of shares authorized for repurchase under the repurchase program was 563,440.

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements (Unaudited)

(12.) ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS)

The following tables present the components of other comprehensive income (loss) for the three and six months ended June 30, 2021 and 2020 (in thousands):

	Pre-tax Amount	Tax Effect	Net-of-tax Amount
Three months ended June 30, 2021			
Securities available for sale and transferred securities:			
Change in unrealized gain/loss during the period	\$ 6,661	\$ 1,707	\$ 4,954
Reclassification adjustment for net gains included in net income (1)	64	16	48
Total securities available for sale and transferred securities	6,725	1,723	5,002
Hedging derivative instruments:			
Change in unrealized gain/loss during the period	(674)	(173)	(501)
Pension and post-retirement obligations:			
Amortization of prior service credit included in income	—	—	—
Amortization of net actuarial loss included in income	185	48	137
Total pension and post-retirement obligations	185	48	137
Other comprehensive income	\$ 6,236	\$ 1,598	\$ 4,638
Six months ended June 30, 2021			
Securities available for sale and transferred securities:			
Change in unrealized gain/loss during the period	\$ (12,701)	\$ (3,254)	\$ (9,447)
Reclassification adjustment for net gains included in net income (1)	63	16	47
Total securities available for sale and transferred securities	(12,638)	(3,238)	(9,400)
Hedging derivative instruments:			
Change in unrealized gain/loss during the period	1,429	366	1,063
Pension and post-retirement obligations:			
Amortization of prior service credit included in income	(1)	—	(1)
Amortization of net actuarial loss included in income	371	95	276
Total pension and post-retirement obligations	370	95	275
Other comprehensive loss	\$ (10,839)	\$ (2,777)	\$ (8,062)

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

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements (Unaudited)

(12.) ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS)

	Pre-tax Amount	Tax Effect	Net-of-tax Amount
Three months ended June 30, 2020			
Securities available for sale and transferred securities:			
Change in unrealized gain/loss during the period	\$ 2,912	\$ 746	\$ 2,166
Reclassification adjustment for net gains included in net income ⁽¹⁾	(571)	(146)	(425)
Total securities available for sale and transferred securities	2,341	600	1,741
Hedging derivative instruments:			
Change in unrealized gain/loss during the period	(522)	(134)	(388)
Pension and post-retirement obligations:			
Amortization of prior service credit included in income	(9)	(3)	(6)
Amortization of net actuarial loss included in income	323	84	239
Total pension and post-retirement obligations	314	81	233
Other comprehensive income	\$ 2,133	\$ 547	\$ 1,586
Six months ended June 30, 2020			
Securities available for sale and transferred securities:			
Change in unrealized gain/loss during the period	\$ 19,363	\$ 4,961	\$ 14,402
Reclassification adjustment for net gains included in net income ⁽¹⁾	(746)	(191)	(555)
Total securities available for sale and transferred securities	18,617	4,770	13,847
Hedging derivative instruments:			
Change in unrealized gain/loss during the period	(399)	(102)	(297)
Pension and post-retirement obligations:			
Amortization of prior service credit included in income	(18)	(5)	(13)
Amortization of net actuarial loss included in income	646	166	480
Total pension and post-retirement obligations	628	161	467
Other comprehensive income	\$ 18,846	\$ 4,829	\$ 14,017

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

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements (Unaudited)

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

Activity in accumulated other comprehensive income (loss), net of tax, for the three and six months ended June 30, 2021 and 2020 was as follows (in thousands):

	Hedging Derivative Instruments	Securities Available for Sale and Transferred Securities	Pension and Post- retirement Obligations	Accumulated Other Comprehensive Income (Loss)
Three months ended June 30, 2021				
Balance at beginning of period	\$ 1,248	\$ 341	\$ (12,161)	\$ (10,572)
Other comprehensive income (loss) before reclassifications	(501)	4,954	—	4,453
Amounts reclassified from accumulated other comprehensive income (loss)	—	48	137	185
Net current period other comprehensive income (loss)	(501)	5,002	137	4,638
Balance at end of period	<u>\$ 747</u>	<u>\$ 5,343</u>	<u>\$ (12,024)</u>	<u>\$ (5,934)</u>
Six months ended June 30, 2021				
Balance at beginning of period	\$ (316)	\$ 14,743	\$ (12,299)	\$ 2,128
Other comprehensive income (loss) before reclassifications	1,063	(9,447)	—	(8,384)
Amounts reclassified from accumulated other comprehensive income (loss)	—	47	275	322
Net current period other comprehensive income (loss)	1,063	(9,400)	275	(8,062)
Balance at end of period	<u>\$ 747</u>	<u>\$ 5,343</u>	<u>\$ (12,024)</u>	<u>\$ (5,934)</u>
Three months ended June 30, 2020				
Balance at beginning of period	\$ (427)	\$ 12,979	\$ (14,634)	\$ (2,082)
Other comprehensive income (loss) before reclassifications	(388)	2,166	—	1,778
Amounts reclassified from accumulated other comprehensive income (loss)	—	(425)	233	(192)
Net current period other comprehensive income (loss)	(388)	1,741	233	1,586
Balance at end of period	<u>\$ (815)</u>	<u>\$ 14,720</u>	<u>\$ (14,401)</u>	<u>\$ (496)</u>
Six months ended June 30, 2020				
Balance at beginning of period	\$ (518)	\$ 873	\$ (14,868)	\$ (14,513)
Other comprehensive income (loss) before reclassifications	(297)	14,402	—	14,105
Amounts reclassified from accumulated other comprehensive income (loss)	—	(555)	467	(88)
Net current period other comprehensive income (loss)	(297)	13,847	467	14,017
Balance at end of period	<u>\$ (815)</u>	<u>\$ 14,720</u>	<u>\$ (14,401)</u>	<u>\$ (496)</u>

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements (Unaudited)

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

The following table presents the amounts reclassified out of each component of accumulated other comprehensive income (loss) for the three and six months ended June 30, 2021 and 2020 (in thousands):

Details About Accumulated Other Comprehensive Income (Loss) Components	Amount Reclassified from Accumulated Other Comprehensive Income (Loss)		Affected Line Item in the Consolidated Statement of Income
	Three months ended June 30,		
	2021	2020	
Realized gain (loss) on sale of investment securities	\$ (3)	\$ 674	Net gain (loss) on investment securities
Amortization of unrealized holding losses on investment securities transferred from available for sale to held to maturity	(61)	(103)	Interest income
	(64)	571	Total before tax
	16	(146)	Income tax expense
	(48)	425	Net of tax
Amortization of pension and post-retirement items:			
Prior service credit (1)	—	9	Salaries and employee benefits
Net actuarial losses (1)	(185)	(323)	Salaries and employee benefits
	(185)	(314)	Total before tax
	48	81	Income tax benefit
	(137)	(233)	Net of tax
Total reclassified for the period	\$ (185)	\$ 192	
	Six months ended June 30,		
	2021	2020	
Realized gain on sale of investment securities	\$ 71	\$ 895	Net gain (loss) on investment securities
Amortization of unrealized holding losses on investment securities transferred from available for sale to held to maturity	(134)	(149)	Interest income
	(63)	746	Total before tax
	16	(191)	Income tax (expense) benefit
	(47)	555	Net of tax
Amortization of pension and post-retirement items:			
Prior service credit (1)	1	18	Salaries and employee benefits
Net actuarial losses (1)	(371)	(646)	Salaries and employee benefits
	(370)	(628)	Total before tax
	95	161	Income tax benefit
	(275)	(467)	Net of tax
Total reclassified for the period	\$ (322)	\$ 88	

(1) These items are included in the computation of net periodic pension expense. See Note 14 – Employee Benefit Plans for additional information.

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements (Unaudited)

(13.) SHARE-BASED COMPENSATION PLANS

The Company maintains certain share-based compensation plans, approved by the Company's shareholders, that are administered by the Management Development and Compensation Committee (the "MD&C Committee") of the Board. The share-based compensation plans were established to allow for the grant of compensation awards to attract, motivate and retain employees, executive officers and non-employee directors who contribute to the long-term growth and profitability of the Company and to give such persons a proprietary interest in the Company, thereby enhancing their personal interest in the Company's success.

The MD&C Committee approved the grant of restricted stock units ("RSUs") and performance share units ("PSUs") shown in the table below to certain members of management during the six months ended June 30, 2021.

	Number of Underlying Shares	Weighted Average Per Share Grant Date Fair Value
RSUs	59,998	\$ 27.50
PSUs	22,178	27.58

The grant-date fair value for the RSUs granted during the six months ended June 30, 2021 is equal to the closing market price of our common stock on the date of grant reduced by the present value of the dividends expected to be paid on the underlying shares.

Fifty percent of the PSUs that ultimately vest is contingent on achieving specified return on average equity ("ROAE") targets relative to the SNL Small Cap Bank & Thrift Index, a market index the MD&C Committee has selected as a peer group for this purpose. These shares will be earned based on the Company's achievement of a relative ROAE performance requirement, on a percentile basis, compared to the SNL Small Cap Bank & Thrift Index over a three-year performance period ended December 31, 2023. The shares earned based on the achievement of the ROAE performance requirement, if any, will vest on the third anniversary of the grant date assuming the recipient's continuous service to the Company. The remaining fifty percent of the PSUs that ultimately vest is contingent upon achievement of an average return on average assets ("ROAA") performance requirement over a three-year performance period ended December 31, 2023. The shares earned based on the achievement of the ROAA performance requirement, if any, will vest on the third anniversary of the grant date assuming the recipient's continuous service to the Company.

The grant-date fair values for both the ROAE and the ROAA portions of PSUs granted during the six months ended June 30, 2021 are equal to the closing market price of our common stock on the date of grant reduced by the present value of the dividends expected to be paid on the underlying shares.

During the six months ended June 30, 2021, the Company issued a total of 3,680 shares of common stock in lieu of cash for the annual retainer of six non-employee directors and granted a total of 9,350 restricted shares of common stock to non-employee directors, of which 4,670 shares vested immediately and 4,680 shares will vest after completion of a one-year service requirement. The market value of the stock and restricted stock at the close of the Nasdaq Global Select Market on the date of grant was \$32.06.

The following is a summary of restricted stock awards and restricted stock units activity for the six months ended June 30, 2021:

	Number of Shares	Weighted Average Market Price at Grant Date
Outstanding at beginning of year	168,513	\$ 25.65
Granted	91,526	27.99
Vested	(29,888)	26.64
Forfeited	(25,977)	26.68
Outstanding at end of period	204,174	\$ 26.42

At June 30, 2021, there was \$3.4 million of unrecognized compensation expense related to unvested restricted stock awards and restricted stock units that is expected to be recognized over a weighted average period of 2.15 years.

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements (Unaudited)

(13.) SHARE-BASED COMPENSATION PLANS (Continued)

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

	Three months ended June 30,		Six months ended June 30,	
	2021	2020	2021	2020
Salaries and employee benefits	\$ 383	\$ 228	\$ 571	\$ 532
Other noninterest expense	179	141	207	169
Total share-based compensation expense	<u>\$ 562</u>	<u>\$ 369</u>	<u>\$ 778</u>	<u>\$ 701</u>

(14.) EMPLOYEE BENEFIT PLANS

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

	Three months ended June 30,		Six months ended June 30,	
	2021	2020	2021	2020
Service cost	\$ 1,049	\$ 923	\$ 2,098	\$ 1,846
Interest cost on projected benefit obligation	551	635	1,102	1,270
Expected return on plan assets	(1,307)	(1,284)	(2,613)	(2,568)
Amortization of unrecognized prior service credit	(1)	(9)	(1)	(18)
Amortization of unrecognized net actuarial loss	186	323	371	646
Net periodic benefit expense	<u>\$ 478</u>	<u>\$ 588</u>	<u>\$ 957</u>	<u>\$ 1,176</u>

The net periodic benefit expense is recorded as a component of salaries and employee benefits in the consolidated statements of income. The Company's funding policy is to contribute, at a minimum, an actuarially determined amount that will satisfy the minimum funding requirements determined under the appropriate sections of the Internal Revenue Code. The Company has no minimum required contribution for the 2021 fiscal year.

(15.) COMMITMENTS AND CONTINGENCIES

Financial Instruments with Off-Balance Sheet Risk

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

The Company's exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit and standby letters of credit is essentially the same as that involved with extending loans to customers. The Company uses the same credit underwriting policies in making commitments and conditional obligations as for on-balance sheet instruments.

Off-balance sheet commitments consist of the following (in thousands):

	June 30, 2021	December 31, 2020
Commitments to extend credit	\$ 936,937	\$ 1,012,810
Standby letters of credit	24,526	22,393

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements (Unaudited)

(15.) COMMITMENTS AND CONTINGENCIES (Continued)

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the agreement. Commitments generally have fixed expiration dates or other termination clauses which may require payment of a fee. Commitments may expire without being drawn upon; therefore, the total commitment amounts do not necessarily represent future cash requirements. Each customer's creditworthiness is evaluated on a case-by-case basis. The amount of collateral obtained, if any, is based on management's credit evaluation of the borrower. Standby letters of credit are conditional lending commitments issued by the Company to guarantee the performance of a customer to a third party. These standby letters of credit are primarily issued to support private borrowing arrangements. The credit risk involved in issuing standby letters of credit is essentially the same as that involved in extending loan facilities to customers.

Unfunded Commitments

At June 30, 2021 and December 31, 2020, the allowance for credit losses for unfunded commitments totaled \$2.1 million and \$3.1 million, respectively, and was included in other liabilities on the Company's consolidated statements of financial condition. For the three months ended June 30, 2021 and 2020, credit loss (benefit) expense for unfunded commitments was \$(764) thousand and \$5 thousand, respectively. For the six months ended June 30, 2021 and 2020, credit loss (benefit) expense for unfunded commitments was \$(1.0) million and \$498 thousand, respectively.

Contingent Liabilities and Litigation

In the ordinary course of business, there are various threatened and pending legal proceedings against the Company. Management believes that the aggregate liability, if any, arising from such litigation, except for the matter described below, would not have a material adverse effect on the Company's consolidated financial statements.

As previously disclosed in the Company's Annual Report on Form 10-K for the year ended December 31, 2020 as filed with the SEC on March 15, 2021 and as disclosed in Part II, Item 1 of this Quarterly Report on Form 10-Q, we are party to an action filed against us on May 16, 2017 by Matthew L. Chipeco, Charlene Mowry, Constance C. Churchill and Joseph W. Ewing in the Court of Common Pleas in Philadelphia, Pennsylvania. Plaintiffs seek class certification to represent classes of consumers in New York and Pennsylvania along with statutory damages, interest and declaratory relief. The plaintiffs seek to represent a putative class of consumers who are alleged to have obtained direct or indirect financing from us for the purchase of vehicles that we later repossessed. The plaintiffs specifically claim that the notices the Bank sent to defaulting consumers after their vehicles were repossessed did not comply with the relevant portions of the Uniform Commercial Code in New York and Pennsylvania. We dispute and believe we have meritorious defenses against these claims and plan to vigorously defend ourselves.

In February 2020, we agreed to engage in mediation with the plaintiffs and the mediation commenced in May 2021. On October 19, 2020, the Court granted plaintiffs' motion for judgment on the pleadings dismissing our affirmative defense against one named New York plaintiff that his claim was time-barred under New York law, applying a six-year statute of limitations rather than the three years limitation period we had argued. The plaintiff's motion for class certification was argued on June 16, 2021 and the motion remains pending.

If we settle these claims or the action is not resolved in our favor, we may suffer reputational damage and incur legal costs, settlements or judgments that exceed the amounts covered by our existing insurance policies. We can provide no assurances that our insurer will insure the legal costs, settlements or judgments we incur in excess of our deductible. If we are unsuccessful in defending ourselves from these claims or if our insurer does not insure us against legal costs we incur in excess of our deductible, the result may materially adversely affect our business, results of operations and financial condition.

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements (Unaudited)

(16.) FAIR VALUE MEASUREMENTS

Determination of Fair Value – Assets Measured at Fair Value on a Recurring and Nonrecurring Basis

Valuation Hierarchy

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

- **Level 1** - Unadjusted quoted prices in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date.
- **Level 2** - Inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly. These might include quoted prices for similar assets or liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets that are not active, inputs other than quoted prices that are observable for the asset or liability (such as interest rates, volatilities, prepayment speeds, credit risks, etc.) or inputs that are derived principally from or corroborated by market data by correlation or other means.
- **Level 3** - Unobservable inputs for determining the fair values of assets or liabilities that reflect an entity’s own assumptions about the assumptions that market participants would use in pricing the assets or liabilities.

Transfers between levels of the fair value hierarchy are recorded as of the end of the reporting period.

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements (Unaudited)

(16.) FAIR VALUE MEASUREMENTS (Continued)

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

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

Derivative instruments: The fair value of derivative instruments is determined using quoted secondary market prices for similar financial instruments and are classified as Level 2 in the fair value hierarchy.

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

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

Long-lived assets held for sale: The fair value of the long-lived assets held for sale was based on estimated market prices from independently prepared current appraisals and are classified as Level 2 in the fair value hierarchy.

Loan servicing rights: Loan servicing rights do not trade in an active market with readily observable market data. As a result, the Company estimates the fair value of loan servicing rights by using a discounted cash flow model to calculate the present value of estimated future net servicing income. The assumptions used in the discounted cash flow model are those that we believe market participants would use in estimating future net servicing income, including estimates of loan prepayment rates, servicing costs, ancillary income, impound account balances, and discount rates. The significant unobservable inputs used in the fair value measurement of the Company's loan servicing rights are the constant prepayment rates and weighted average discount rate. Significant increases (decreases) in any of those inputs in isolation could result in a significantly lower (higher) fair value measurement. Although the constant prepayment rate and the discount rate are not directly interrelated, they will generally move in opposite directions. Loan servicing rights are classified as Level 3 measurements due to the use of significant unobservable inputs, as well as significant management judgment and estimation.

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

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

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements (Unaudited)

(16.) FAIR VALUE MEASUREMENTS (Continued)

Assets Measured at Fair Value

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

	Quoted Prices in Active Markets for Identical Assets or Liabilities (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
June 30, 2021				
Measured on a recurring basis:				
Securities available for sale:				
U.S. Government agency and government sponsored enterprises	\$ —	\$ 6,563	\$ —	\$ 6,563
Mortgage-backed securities	—	896,282	—	896,282
Other assets:				
Hedging derivative instruments	—	1,004	—	1,004
Fair value adjusted through comprehensive income	<u>\$ —</u>	<u>\$ 903,849</u>	<u>\$ —</u>	<u>\$ 903,849</u>
Other assets:				
Derivative instruments - interest rate swaps	—	15,108	—	15,108
Derivative instruments - credit contracts	—	14	—	14
Derivative instruments - mortgage banking	—	317	—	317
Other liabilities:				
Derivative instruments - interest rate swaps	—	(14,972)	—	(14,972)
Derivative instruments - credit contracts	—	(53)	—	(53)
Derivative instruments - mortgage banking	—	(39)	—	(39)
Fair value adjusted through net income	<u>\$ —</u>	<u>\$ 375</u>	<u>\$ —</u>	<u>\$ 375</u>
Measured on a nonrecurring basis:				
Loans:				
Loans held for sale	\$ —	\$ 3,929	\$ —	\$ 3,929
Collateral dependent loans	—	—	53,268	53,268
Other assets:				
Long-lived assets held for sale	—	1,118	—	1,118
Loan servicing rights	—	—	1,433	1,433
Other real estate owned	—	—	646	646
Total	<u>\$ —</u>	<u>\$ 5,047</u>	<u>\$ 55,347</u>	<u>\$ 60,394</u>

There were no transfers between Levels 1 and 2 during the six months ended June 30, 2021. There were no liabilities measured at fair value on a nonrecurring basis during the six months ended June 30, 2021.

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements (Unaudited)

(16.) FAIR VALUE MEASUREMENTS (Continued)

	Quoted Prices in Active Markets for Identical Assets or Liabilities (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
December 31, 2020				
Measured on a recurring basis:				
Securities available for sale:				
U.S. Government agency and government sponsored enterprises	\$ —	\$ 6,635	\$ —	\$ 6,635
Mortgage-backed securities	—	621,424	—	621,424
Other liabilities:				
Hedging derivative instruments	—	(311)	—	(311)
Fair value adjusted through comprehensive income	<u>\$ —</u>	<u>\$ 627,748</u>	<u>\$ —</u>	<u>\$ 627,748</u>
Other assets:				
Derivative instruments - cash flow hedges	\$ —	\$ —	\$ —	\$ -
Derivative instruments - interest rate swaps	—	19,626	—	19,626
Derivative instruments - credit contracts	—	23	—	23
Derivative instruments - mortgage banking	—	471	—	471
Other liabilities:				
Derivative instruments - interest rate swaps	—	(19,837)	—	(19,837)
Derivative instruments - credit contracts	—	(86)	—	(86)
Derivative instruments - mortgage banking	—	(1)	—	(1)
Fair value adjusted through net income	<u>\$ —</u>	<u>\$ 196</u>	<u>\$ —</u>	<u>\$ 196</u>
Measured on a nonrecurring basis:				
Loans:				
Loans held for sale	\$ —	\$ 4,305	\$ —	\$ 4,305
Collateral dependent loans	—	—	29,434	29,434
Other assets:				
Loan servicing rights	—	—	1,320	1,320
Other real estate owned	—	—	2,966	2,966
Total	<u>\$ —</u>	<u>\$ 4,305</u>	<u>\$ 33,720</u>	<u>\$ 38,025</u>

There were no transfers between Levels 1 and 2 during the six months ended June 30, 2020. There were no liabilities measured at fair value on a nonrecurring basis during the six months ended June 30, 2020.

The following table presents additional quantitative information about assets measured at fair value on a recurring and nonrecurring basis for which the Company has utilized Level 3 inputs to determine fair value as of June 30, 2021 (dollars in thousands).

Asset	Fair Value	Valuation Technique	Unobservable Input	Unobservable Input Value or Range
Collateral dependent loans	\$ 53,268	Appraisal of collateral ⁽¹⁾	Appraisal adjustments ⁽²⁾	22.4% ⁽³⁾ / 0 - 35%
Loan servicing rights	1,433	Discounted cash flow	Discount rate	10.3% ⁽³⁾
			Constant prepayment rate	14.2% ⁽³⁾
Other real estate owned	646	Appraisal of collateral ⁽¹⁾	Appraisal adjustments ⁽²⁾	46.2% ⁽³⁾

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

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

(3) Weighted averages.

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements (Unaudited)

(16.) FAIR VALUE MEASUREMENTS (Continued)

Changes in Level 3 Fair Value Measurements

There were no assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) as of or during the six months ended June 30, 2021 and 2020.

Disclosures about Fair Value of Financial Instruments

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

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

The estimated fair value approximates carrying value for cash and cash equivalents, Federal Home Loan Bank (“FHLB”) and Federal Reserve Bank (“FRB”) stock, accrued interest receivable, non-maturity deposits, short-term borrowings and accrued interest payable.

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

	Level in Fair Value Measurement Hierarchy	June 30, 2021		December 31, 2020	
		Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
Financial assets:					
Cash and cash equivalents	Level 1	\$ 206,387	\$ 206,387	\$ 93,878	\$ 93,878
Securities available for sale	Level 2	902,845	902,845	628,059	628,059
Securities held to maturity, net	Level 2	218,858	226,044	271,973	282,035
Loans held for sale	Level 2	3,929	3,929	4,305	4,305
Loans	Level 2	3,532,535	3,564,623	3,513,284	3,549,770
Loans (1)	Level 3	53,268	53,268	29,434	29,434
Long-lived assets held for sale	Level 2	1,118	1,118	—	—
Accrued interest receivable	Level 1	15,431	15,431	15,635	15,635
Derivative instruments – cash flow hedges	Level 2	1,004	1,004	—	—
Derivative instruments – interest rate products	Level 2	15,108	15,108	19,626	19,626
Derivative instruments – credit contracts	Level 2	14	14	23	23
Derivative instruments – mortgage banking	Level 2	317	317	471	471
FHLB and FRB stock	Level 2	9,154	9,154	8,619	8,619
Financial liabilities:					
Non-maturity deposits	Level 1	3,717,939	3,717,939	3,392,774	3,392,774
Time deposits	Level 2	941,282	941,649	885,593	887,113
Short-term borrowings	Level 1	—	—	5,300	5,300
Long-term borrowings	Level 2	73,756	78,286	73,623	83,953
Accrued interest payable	Level 1	2,868	2,868	4,381	4,381
Derivative instruments – cash flow hedges	Level 2	—	—	311	311
Derivative instruments – interest rate products	Level 2	14,972	14,972	19,837	19,837
Derivative instruments – credit contracts	Level 2	53	53	86	86
Derivative instruments – mortgage banking	Level 2	39	39	1	1

(1) Comprised of collateral dependent loans.

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements (Unaudited)

(17.) SEGMENT REPORTING

The Company has one reportable segment, Banking, which includes all of the company's retail and commercial banking operations. This reportable segment has been identified and organized based on the nature of the underlying products and services applicable to the segment, the type of customers to whom those products and services are offered and the distribution channel through which those products and services are made available.

All other segments that do not meet the quantitative threshold for separate reporting have been grouped as "All Other." This "All Other" grouping includes the activities of SDN, a full-service insurance agency that provides a broad range of insurance services to both personal and business clients, and Courier Capital and HNP Capital, our investment advisor and wealth management firms that provide customized investment management, investment consulting and retirement plan services to individuals, businesses, institutions, foundations and retirement plans, and Holding Company amounts, which are the primary differences between segment amounts and consolidated totals, along with amounts to eliminate balances and transactions between segments.

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

	Banking	All Other	Consolidated Totals
June 30, 2021			
Goodwill	\$ 48,536	\$ 18,137	\$ 66,673
Other intangible assets, net	10	7,579	7,589
Total assets	5,257,795	37,307	5,295,102
December 31, 2020			
Goodwill	\$ 48,536	\$ 17,526	\$ 66,062
Other intangible assets, net	28	7,699	7,727
Total assets	4,875,673	36,633	4,912,306
	Banking	All Other (1)	Consolidated Totals
Three months ended June 30, 2021			
Net interest income (expense)	\$ 38,788	\$ (1,056)	\$ 37,732
Benefit (provision) for credit losses	4,622	—	4,622
Noninterest income	6,603	3,587	10,190
Noninterest expense	(23,199)	(3,745)	(26,944)
Income (loss) before income taxes	26,814	(1,214)	25,600
Income tax (expense) benefit	(5,780)	380	(5,400)
Net income (loss)	<u>\$ 21,034</u>	<u>\$ (834)</u>	<u>\$ 20,200</u>
Six months ended June 30, 2021			
Net interest income (expense)	\$ 77,706	\$ (2,117)	\$ 75,589
Benefit (provision) for credit losses	6,603	—	6,603
Noninterest income	15,878	7,271	23,149
Noninterest expense	(45,832)	(7,852)	(53,684)
Income (loss) before income taxes	54,355	(2,698)	51,657
Income tax (expense) benefit	(11,815)	1,068	(10,747)
Net income (loss)	<u>\$ 42,540</u>	<u>\$ (1,630)</u>	<u>\$ 40,910</u>

(1) Reflects activity from the acquisition of assets of Landmark Group since February 1, 2021 (the date of acquisition).

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements (Unaudited)

(17.) SEGMENT REPORTING (Continued)

	Banking	All Other	Consolidated Totals
Three months ended June 30, 2020			
Net interest income (expense)	\$ 34,798	\$ (617)	\$ 34,181
Provision for credit losses	(3,746)	—	(3,746)
Noninterest income	7,082	2,631	9,713
Noninterest expense	(23,607)	(2,968)	(26,575)
Income (loss) before income taxes	14,527	(954)	13,573
Income tax (expense) benefit	(2,860)	419	(2,441)
Net income (loss)	<u>\$ 11,667</u>	<u>\$ (535)</u>	<u>\$ 11,132</u>
Six months ended June 30, 2020			
Net interest income (expense)	\$ 68,540	\$ (1,235)	\$ 67,305
Provision for credit losses	(17,661)	—	(17,661)
Noninterest income	13,897	5,726	19,623
Noninterest expense	(47,333)	(6,912)	(54,245)
Income (loss) before income taxes	17,443	(2,421)	15,022
Income tax (expense) benefit	(2,719)	(44)	(2,763)
Net income (loss)	<u>\$ 14,724</u>	<u>\$ (2,465)</u>	<u>\$ 12,259</u>

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

This Quarterly Report on Form 10-Q should be read in conjunction with the more detailed and comprehensive disclosures included in our Annual Report on Form 10-K for the year ended December 31, 2020. In addition, please read this section in conjunction with our Consolidated Financial Statements and Notes to Consolidated Financial Statements contained herein.

FORWARD LOOKING INFORMATION

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

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

These forward-looking statements are not guarantees of future performance, nor should they be relied upon as representing management's views as of any subsequent date. Forward-looking statements involve significant risks and uncertainties and actual results may differ materially from those presented, either expressed or implied, in this Quarterly Report on Form 10-Q and our Annual Report on Form 10-K for the fiscal year ended December 31, 2020 (the "Form 10-K"), including, but not limited to, those presented in the Management's Discussion and Analysis of Financial Condition and Results of Operations. Factors that might cause such material differences include, but are not limited to:

- The COVID-19 pandemic, and governmental and individual efforts to contain the pandemic, have had a significant negative impact on the U.S. and global economy which has and will continue to adversely affect our business, financial condition and results of operations;
- If we experience greater credit losses than anticipated, earnings may be adversely impacted;
- Geographic concentration may unfavorably impact our operations;
- Our commercial business and mortgage loans increase our exposure to credit risks;
- Our indirect and consumer lending involves risk elements in addition to normal credit risk;
- Lack of seasoning in portions of our loan portfolio could increase risk of credit defaults in the future;
- We accept deposits that do not have a fixed term, and which may be withdrawn by the customer at any time for any reason;
- We are subject to environmental liability risk associated with our lending activities;
- We operate in a highly competitive industry and market area;
- Changes to and replacement of the LIBOR Benchmark Interest Rate may adversely affect our business, financial condition, and results of operations;
- Legal and regulatory proceedings and related matters, such as the action brought by a putative class of consumers against us as described in Part II, Item 1, "Legal Proceedings," could adversely affect us and the banking industry in general;
- Any future FDIC insurance premium increases may adversely affect our earnings;
- We are highly regulated, and any adverse regulatory action may result in additional costs, loss of business opportunities, and reputational damage;
- The policies of the Federal Reserve have a significant impact on our earnings;
- Our insurance brokerage subsidiary is subject to risk related to the insurance industry;
- Our investment advisory and wealth management operations are subject to risk related to the regulation of the financial services industry and market volatility;
- We make certain assumptions and estimates in preparing our financial statements that may prove to be incorrect, which could significantly impact our results of operations, cash flows and financial condition, and we are subject to new or changing accounting rules and interpretations, and the failure by us to correctly interpret or apply these evolving rules and interpretations could have a material adverse effect;
- The value of our goodwill and other intangible assets may decline in the future;
- We may be unable to successfully implement our growth strategies, including the integration and successful management of newly-acquired businesses;
- Acquisitions may disrupt our business and dilute shareholder value;
- Our tax strategies and the value of our deferred tax assets and liabilities could adversely affect our operating results and regulatory capital ratios;

MANAGEMENT'S DISCUSSION AND ANALYSIS

- Liquidity is essential to our businesses;
- We rely on dividends from our subsidiaries for most of our revenue;
- If our risk management framework does not effectively identify or mitigate our risks, we could suffer losses;
- We face competition in staying current with technological changes and banking alternatives to compete and meet customer demands;
- We rely on other companies to provide key components of our business infrastructure;
- A breach in security of our or third-party information systems, including the occurrence of a cyber incident or a deficiency in cybersecurity, or a failure by us to comply with New York State cybersecurity regulations, may subject us to liability, result in a loss of customer business or damage our brand image;
- We are subject to interest rate risk, and a rising rate environment may reduce our income and result in higher defaults on our loans, whereas a falling rate environment may result in earlier loan prepayments than we expect, which may reduce our income;
- The soundness of other financial institutions could adversely affect us;
- 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 not pay or may reduce the dividends on our common stock;
- We may issue debt and equity securities or securities convertible into equity securities, any of which may be senior to our common stock as to distributions and in liquidation, which could dilute our current shareholders or negatively affect the value of our common stock;
- Our certificate of incorporation, our bylaws, and certain banking laws may have an anti-takeover effect;
- The market price of our common stock may fluctuate significantly in response to a number of factors;
- We may not be able to attract and retain skilled people;
- We use financial models for business planning purposes that may not adequately predict future results;
- We depend on the accuracy and completeness of information about or from customers and counterparties;
- Our business may be adversely affected by conditions in the financial markets and economic conditions generally; and
- Severe weather, natural disasters, public health emergencies and pandemics, acts of war or terrorism, and other external events could significantly impact our business.

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

GENERAL

The Parent is a financial holding company headquartered in New York State, providing diversified financial services through its subsidiaries, Five Star Bank (the "Bank"), SDN Insurance Agency, LLC ("SDN"), Courier Capital, LLC ("Courier Capital") and HNP Capital, LLC ("HNP Capital"). The Company offers a broad array of deposit, lending and other financial services to individuals, municipalities and businesses in Western and Central New York through its wholly-owned New York-chartered banking subsidiary, the Bank. Our indirect lending network includes relationships with franchised automobile dealers in Western and Central New York, the Capital District of New York and Northern and Central Pennsylvania. SDN provides a broad range of insurance services to personal and business clients. Courier Capital and HNP Capital provide customized investment advice, wealth management, investment consulting and retirement plan services to individuals, businesses, institutions, foundations and retirement plans.

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

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

MANAGEMENT'S DISCUSSION AND ANALYSIS

A key aspect of our current business strategy is to foster a community-oriented culture where our customers and employees establish long-standing and mutually beneficial relationships. We believe that we are well-positioned to be a strong competitor within our market area because of our focus on community banking needs and customer service, our comprehensive suite of deposit, loan, insurance and wealth management products typically found at larger banks, our highly experienced management team and our strategically located banking centers. We have evolved to meet changing customer needs by opening what we refer to as financial solution center branches. These financial solution center branches have a smaller footprint than our traditional branches, focus on technology to provide solutions that fit our customer preferences for transacting business with us, and are staffed by certified personal bankers who are trained to meet a broad array of customer needs. In recent years, we have opened four financial solution centers in the Rochester and Buffalo markets. We believe that the foregoing factors all help to grow our core deposits, which supports a central element of our business strategy - the growth of a diversified and high-quality loan portfolio.

EXECUTIVE OVERVIEW

Summary of 2021 Second Quarter Results

Net income increased \$9.1 million to \$20.2 million for the second quarter of 2021 compared to \$11.1 million for the second quarter of 2020. Net income available to common shareholders for the second quarter of 2021 was \$19.8 million, or \$1.25 per diluted share, compared with \$10.8 million, or \$0.67 per diluted share, for the second quarter of last year. Return on average common equity was 17.34% and return on average assets was 1.52% for the second quarter of 2021 compared to 10.11% and 0.97%, respectively, for the second quarter of 2020.

Net income for both periods was significantly impacted by the benefit (provision) for credit losses. The increase in net income for the second quarter of 2021 was driven by a \$4.6 million benefit for credit losses as compared to a provision of \$3.7 million in the second quarter of 2020. Continued improvement in the national unemployment forecast, positive trends in qualitative factors and lower net charge-offs resulted in a release of credit loss reserves and the corresponding benefit for credit losses in the quarter.

Net interest income totaled \$37.7 million in the second quarter of 2021, up from \$34.2 million in the second quarter of 2020. The increase was primarily the result of an increase in interest-earning assets, the positive impact of PPP loan forgiveness in the second quarter of 2021, and a decrease in interest expense. The decrease in interest expense was primarily due to a favorable shift in deposit categories, with a lower allocation of time deposits, coupled with a lower interest-bearing cost of funds. Average Federal Reserve interest-earning cash, average investment securities and average loans were up \$157.1 million, \$290.3 million and \$251.8 million, respectively, in the second quarter of 2021 compared to the same quarter in 2020.

The provision for credit losses - loans was a \$3.9 million benefit in the second quarter of 2021 compared to a provision of \$3.7 million in the second quarter of 2020. Net recoveries during the recent quarter were \$394 thousand compared to net charge-offs of \$786 thousand in the second quarter of 2020. Net charge-offs (recoveries) expressed as an annualized percentage of average loans outstanding were (0.04)% during the second quarter of 2021 compared with 0.09% in the second quarter of 2020. See the "Allowance for Credit Losses - Loans" and "Non-Performing Assets and Potential Problem Loans" sections of this Management's Discussion and Analysis for further discussion regarding the change in the provision (benefit) for credit losses - loans and the decrease in net charge-offs.

Noninterest income totaled \$10.2 million in the second quarter of 2021, compared to \$9.7 million in the second quarter of 2020. The increase in noninterest income for the second quarter was primarily due to increases in service charges on deposits, investment advisory income, insurance income, income from investments in limited partnerships and card interchange income, partially offset by decreases in income (loss) from derivative instruments, net and net gain (loss) on investment securities. Service charges on deposits was \$807 thousand higher than the second quarter of 2020, primarily due to our COVID-19 relief initiatives of temporarily waiving or eliminating fees during the second quarter of 2020. Investment advisory income was \$635 thousand higher than the second quarter of 2020, due to an increase in assets under management, driven by a combination of market gains, new customer accounts and contributions to existing accounts. Insurance income was \$328 thousand higher than the second quarter of 2020 primarily due to the Landmark Group acquisition in 2021. Income from investments in limited partnerships of \$238 thousand was recognized in the second quarter of 2021 as compared to a loss of \$244 thousand in the second quarter of 2020. Card interchange income of \$1.1 million was recognized in the second quarter of 2021 as compared to \$819 thousand in the second quarter of 2020. Income (loss) from derivative instruments, net was \$2.5 million lower than the second quarter of 2020. Income from derivative instruments, net is based on the number and value of interest rate swap transactions executed during the quarter combined with the impact of changes in the fair market value of borrower-facing trades. A lower level of interest swap transactions was executed during the quarter and fair market values were negatively impacted by the second quarter decrease in longer-term rates. Net gain (loss) on investment securities was a loss of \$3 thousand in the second quarter of 2021 compared to a net gain of \$674 thousand in the second quarter of 2020.

Noninterest expense totaled \$26.9 million in the second quarter of 2021, compared to \$26.6 million in the second quarter of 2020. The increase in noninterest expense was primarily the result of increases in computer and data processing expense, partially offset by a decrease in salaries and employee benefits expense. Computer and data processing expense increased primarily due to increased investments in technology, including costs related to the Bank's online and mobile platform, Five Star Bank Digital Banking, launched in the second quarter of 2020. The decrease in salaries and employee benefits expense reflects the 2020 streamlining of retail branches to better align with shifting customer needs and preferences, including the decision to close a total of seven branches.

The regulatory Common Equity Tier 1 Ratio and Total Risk-Based Capital Ratio were 10.38%, and 13.54%, respectively, at June 30, 2021. See the "Liquidity and Capital Management" section of this Management's Discussion and Analysis for further discussion regarding regulatory capital and the Basel III capital rules.

MANAGEMENT'S DISCUSSION AND ANALYSIS

Buffalo Branch Openings

Two new Five Star Bank branches opened in the City of Buffalo in June of 2021, consistent with the Company's long-term strategy to expand in the urban markets of Buffalo and Rochester. The branches are in vibrant commercial corridors at 451 Elmwood Avenue and 2222 Seneca Street, extending the reach of Five Star Bank's distribution system in both northern and southern directions from the existing downtown branch.

The Company used green and energy efficient materials during the construction of these two new branches. Materials sourced for the Elmwood Avenue and Seneca Street branches received certifications from Cradle to Cradle, Declare, Forest Stewardship Council, Green Square and GreenGuard. Additionally, materials with a high percentage of recycled content were used when possible.

Operational, Accounting and Reporting Impacts Related to the COVID-19 Pandemic

The COVID-19 pandemic has negatively impacted the global economy, including our operating footprint of Western and Central New York. In response to this crisis, the Coronavirus Aid, Relief, and Economic Security ("CARES") Act was passed by Congress and signed into law on March 27, 2020. The CARES Act provided an estimated \$2.2 trillion to fight the COVID-19 pandemic and stimulate the economy by supporting individuals and businesses through loans, grants, tax changes, and other types of relief. Some of the provisions applicable to the Company include, but are not limited to:

- *Accounting for Loan Modifications* - The CARES Act provided that a financial institution may elect to suspend (1) the application of GAAP for certain loan modifications related to COVID-19 that would otherwise be categorized as a troubled debt restructuring ("TDR") and (2) any determination that such loan modifications would be considered a TDR, including the related impairment for accounting purposes.
- *Paycheck Protection Program* - The CARES Act established the Paycheck Protection Program ("PPP"), an expansion of the Small Business Administration's ("SBA") 7(a) loan program and the Economic Injury Disaster Loan Program ("EIDL"), administered directly by the SBA. On December 27, 2020, the Consolidated Appropriations Act, 2021 provided approximately \$284 billion for PPP loans in an additional round of funding under the program and extended the PPP through March 31, 2021. This additional round of PPP loan funding is authorized for first-time borrowers and for second draws by certain borrowers who have previously received PPP loans. On March 30, 2021, the PPP Extension Act of 2021 was signed into law, which extended the program to May 31, 2021.
- *Mortgage Forbearance* - Under the CARES Act, a borrower with a federally backed mortgage loan that is experiencing financial hardship due to COVID-19 may request a forbearance through September 30, 2021.

Also, in response to the COVID-19 pandemic, the Board of Governors of the Federal Reserve System ("FRB"), the Federal Deposit Insurance Corporation ("FDIC"), the National Credit Union Administration ("NCUA"), the Office of the Comptroller of the Currency ("OCC"), and the Consumer Financial Protection Bureau ("CFPB"), in consultation with the state financial regulators (collectively, the "agencies") issued a joint interagency statement (issued March 22, 2020; revised statement issued April 7, 2020). Some of the provisions applicable to the Company include, but are not limited to:

- *Accounting for Loan Modifications* - Loan modifications that do not meet the conditions of the CARES Act may still qualify as a modification that does not need to be accounted for as a TDR. The agencies confirmed with FASB staff that short-term modifications made on a good faith basis in response to COVID-19 to borrowers who were current prior to any relief are not TDRs. This includes short-term (e.g., six months) modifications such as payment deferrals, fee waivers, extensions of repayment terms, or insignificant delays in payment.
- *Past Due Reporting* - With regard to loans not otherwise reportable as past due, financial institutions are not expected to designate loans with deferrals granted due to COVID-19 as past due because of the deferral. A loan's payment date is governed by the due date stipulated in the legal agreement. If a financial institution agrees to a payment deferral, these loans would not be considered past due during the period of the deferral.
- *Nonaccrual Status and Charge-offs* - During short-term COVID-19 modifications, these loans generally should not be reported as nonaccrual or as classified.

Effective March 23, 2020 through July 9, 2020, for consumer customers, the Bank waived early CD penalty fees for withdrawals up to \$20,000 (limited to one penalty-free withdrawal per CD account); eliminated all insufficient funds (overdrafts) and returned item fees; eliminated all Pay by Phone fees; waived all late fees; offered the opportunity for monthly mortgage, home equity loan or home equity line payment relief; offered the opportunity to defer unsecured consumer loans or lines of credit and secured consumer loans and lines of credit payments; and offered unsecured personal loans up to \$5,000, up to 60 months at 2.95% APR subject to credit approval. ATM access fees were reinitiated on September 19, 2020.

MANAGEMENT'S DISCUSSION AND ANALYSIS

As part of the first round of PPP loans we have helped more than 1,700 customers obtain more than \$270 million in loans as of December 31, 2020. Of those loans, we have helped customers complete the forgiveness process for approximately \$183 million of loans in the first six months of 2021. Also, during the first six months of 2021, we have helped customers obtain approximately \$107 million of new PPP loans under the second round of the PPP. Additionally, as of June 30, 2021, approximately 3% of our commercial loan and mortgage customers, 1% of our residential real estate loans and lines customers and less than 1% of our indirect loans customers have active payment deferrals in accordance with the previously noted loan modifications under the CARES Act or agencies guidelines.

RESULTS OF OPERATIONS

Net Interest Income and Net Interest Margin

Net interest income is our primary source of revenue, comprising 77% of revenue during the six months ended June 30, 2021. Net interest income is the difference between interest income on interest-earning assets, such as loans and investment securities, and interest expense on interest-bearing deposits and other borrowings used to fund interest-earning and other assets or activities. Net interest income is affected by changes in interest rates and by the amount and composition of earning assets and interest-bearing liabilities, as well as the sensitivity of the balance sheet to changes in interest rates, including characteristics such as the fixed or variable nature of the financial instruments, contractual maturities and repricing frequencies.

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

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

	Three months ended June 30,		Six months ended June 30,	
	2021	2020	2021	2020
Interest income per consolidated statements of income	\$ 40,952	\$ 39,759	\$ 82,225	\$ 81,412
Adjustment to fully taxable equivalent basis	169	233	353	479
Interest income adjusted to a fully taxable equivalent basis	41,121	39,992	82,578	81,891
Interest expense per consolidated statements of income	3,220	5,578	6,636	14,107
Net interest income on a taxable equivalent basis	\$ 37,901	\$ 34,414	\$ 75,942	\$ 67,784

Analysis of Net Interest Income for the Three Months Ended June 30, 2021 and 2020

Net interest income on a taxable equivalent basis for the three months ended June 30, 2021, was \$37.9 million, an increase of approximately \$3.5 million versus the comparable quarter last year of \$34.4 million. The increase in net interest income was primarily due to increases in average loans and average investment securities of \$251.8 million, or 7%, and \$290.3 million, or 38%, respectively, compared to the second quarter of 2020, deferred fee amortization of \$1.3 million on PPP loans, which included accelerated amortization of fees on PPP loans paid-off through the forgiveness process during the second quarter of 2021, and a decrease in interest expense of \$2.4 million. The decrease in interest expense was primarily due to a favorable shift in deposit categories, with a lower allocation of time deposits, coupled with a lower interest-bearing cost of funds. Average PPP loans, net of deferred fees were \$232.0 million for the three months ended June 30, 2021 compared to \$176.7 million for the three months ended June 30, 2020.

Our net interest margin for the second quarter of 2021 was 3.06%, 17-basis points lower than 3.23% for the same period in 2020. This comparable period decrease was a function of an eight-basis point lower contribution from net free funds and a nine-basis point decrease in the interest rate spread. The lower interest rate spread was a result of a 45-basis point decrease in the yield on average interest-earning assets and a 36-basis point decrease in the cost of average interest-bearing liabilities.

For the second quarter of 2021, the yield on average interest earning assets of 3.31% was 45-basis points lower than the second quarter of 2020 of 3.76%. Loan yields decreased 16-basis points during the second quarter of 2021 to 3.98% from 4.14%. The yield on investment securities decreased 72-basis points during the second quarter of 2021 to 1.77% from 2.49%. Overall, a favorable volume variance increased interest income by \$4.0 million during the second quarter of 2021, while the earning asset rate changes decreased interest income by \$2.9 million which collectively drove a \$1.1 million increase in interest income.

MANAGEMENT'S DISCUSSION AND ANALYSIS

Average interest-earning assets were \$4.97 billion for the second quarter of 2021 compared to \$4.27 billion for the second quarter of 2020, an increase of \$699.2 million, or 16%, from the comparable quarter last year, with average loans up \$251.8 million from \$3.41 billion to \$3.67 billion and average securities up \$290.3 million from \$766.6 million to \$1.06 billion. The growth in average loans reflected increases in most loan categories. Commercial loans, in particular, were up \$202.1 million from \$1.89 billion to \$2.09 billion, or 11%, from the second quarter of 2020. The average balances of PPP loans net of deferred fees, which are included in commercial loans, were \$232.0 million and \$176.7 million in the second quarter of 2021 and 2020, respectively. Residential real estate lines were down \$16.6 million, or 17%, primarily due to consumer behavior, partially offset by an increase of \$14.3 million, or 2%, in residential real estate loans. Consumer indirect loans increased by \$51.9 million, or 6%, and other consumer loans increased by \$201 thousand, or 1%. Loans comprised 73.7% of average interest-earning assets during the second quarter of 2021 compared to 79.9% during the second quarter of 2020. Loans generally have significantly higher yields compared to securities and federal funds sold and interest-bearing deposits and, as such, have a more positive effect on the net interest margin. The yield on average loans was 3.98% for the second quarter of 2021, a decrease of 16-basis points compared to 4.14% for the comparable quarter in 2020. An increase in the volume of average loans resulted in a \$2.6 million increase in interest income, partially offset by a \$1.4 million decrease due to the unfavorable rate variance. Securities represented 21.3% of average interest-earning assets during the second quarter of 2021 compared to 17.9% during the second quarter of 2020. The increase in investment securities is due to the redeployment of excess liquidity intended to benefit interest income. The unfavorable rate variance resulted in a \$1.5 million decrease in interest income from investment securities, partially offset by a \$1.4 million increase due to an increase in the average volume.

The cost of average interest-bearing liabilities of 0.35% in the second quarter of 2021 compared to 0.71% in the second quarter of 2020, was 36-basis points lower and the cost of average interest-bearing deposits decreased 38-basis points from 0.62% to 0.24%. Average short-term borrowings decreased \$110.3 million from \$110.3 million to \$0 in the second quarter of 2021 compared to the same quarter of 2020. The decrease in average short-term borrowings was a result of the Company's decision to utilize brokered deposits as a cost-effective alternative to Federal Home Loan Bank borrowings. The cost of long-term borrowings for the second quarter of 2021 decreased 56-basis points from 6.29% to 5.73% compared to the same quarter of 2020. Overall, interest-bearing liability rate and volume changes resulted in \$2.4 million of lower interest expense.

Average interest-bearing liabilities of \$3.71 billion in the second quarter of 2021 were \$532.8 million, or 17%, higher than the second quarter of 2020. On average, interest-bearing deposits grew \$608.6 million from \$3.03 billion to \$3.64 billion, and noninterest-bearing demand deposits (a principal component of net free funds) were up \$179.3 million from \$912.2 million to \$1.09 billion. The increase in average deposits was primarily due an increase in reciprocal deposit programs and to growth in non-public demand. For further discussion of the reciprocal deposit programs, refer to the "Funding Activities - Deposits" section of this Management's Discussion and Analysis. Overall, interest-bearing deposit rate and volume changes resulted in a \$2.5 million decrease in interest expense during the second quarter of 2021, primarily due to the overall lower interest rate market conditions. Average borrowings decreased \$75.9 million from \$149.6 million to \$73.7 million compared to the second quarter of 2020. Overall, short and long-term borrowing rate and volume changes resulted in \$154 thousand of higher interest expense during the second quarter of 2021.

Analysis of Net Interest Income for the Six Months Ended June 30, 2021 and 2020

Net interest income on a taxable equivalent basis for the six months ended June 30, 2021, was \$75.9 million, an increase of \$8.2 million versus the comparable period last year of \$67.8 million. The increase in net interest income was due primarily to deferred fee amortization of \$4.2 million on PPP loans, which included accelerated amortization of fees on PPP loans paid-off through the forgiveness process, increases in average loans and average investment securities of \$334.9 million, or 10%, and \$212.9 million, or 28%, respectively, compared to the first six months of 2020, and a decrease in interest expense of \$7.5 million. The decrease in interest expense was primarily due to a favorable shift in deposit categories, with a lower allocation of time deposits, coupled with a lower interest-bearing cost of funds. Average PPP loans, net of deferred fees were \$240.2 million for the six months ended June 30, 2021 compared to \$88.3 million for the six months ended June 30, 2020.

The net interest margin for the first six months of 2021 was 3.17%, ten-basis points lower than 3.27% for the same period in 2020. This comparable period decrease was a function of a 13-basis point lower contribution from net free funds, partially offset by a three-basis point increase in interest rate spread. The higher interest rate spread was a result of a 50-basis point decrease in the yield on average interest-earning assets and a 53-basis point decrease in the cost of average interest-bearing liabilities.

For the first six months of 2021, the yield on average earning assets of 3.45% was 50-basis points lower than the first six months of 2020 of 3.95%. Loan yields decreased 32-basis points during the first six months of 2021 to 4.05% from 4.37%. The yield on investment securities decreased 65-basis points during the first six months of 2021 to 1.83% from 2.48%. Overall, a favorable volume variance increased interest income by \$9.1 million during the first six months of 2021, while the earning asset rate changes decreased interest income by \$8.4 million, which collectively drove a \$687 thousand increase in interest income.

MANAGEMENT'S DISCUSSION AND ANALYSIS

Average interest-earning assets were \$4.82 billion for the first six months of 2021 compared to \$4.16 billion for the first six months of 2020, an increase of \$658.6 million, or 16%, from the comparable period last year, with average loans up \$334.9 million from \$3.31 billion to \$3.65 billion and average securities up \$212.9 million from \$773.3 million to \$986.1 million. The growth in average loans reflected increases in most loan categories. Commercial loans, in particular, were up \$306.9 million from \$1.78 billion to \$2.09 billion, or 17%, from the first six months of 2020. The average balances of PPP loans net of deferred fees, which are included in commercial loans, were \$240.2 million and \$88.3 million in the first six months of 2021 and 2020, respectively. Residential real estate loans were up \$19.3 million, or 3%, partially offset by a decrease of \$15.8 million, or 16%, in residential real estate lines. Consumer indirect loans increased by \$24.1 million, or 3%, and other consumer loans increased by \$450 thousand, or 3%. Loans represented 75.7% of average interest-earning assets during the first six months of 2021 compared to 79.6% during the first six months of 2020. Loans generally have significantly higher yields compared to securities and federal funds sold and interest-bearing deposits and, as such, have a more positive effect on the net interest margin. The yield on average loans was 4.05% for the first six months of 2021, a decrease of 32-basis points compared to 4.37% for first six months of 2020. An increase in the volume of average loans resulted in a \$6.9 million increase in interest income, partially offset by a \$5.5 million decrease due to the unfavorable rate variance. Securities represented 20.4% of average interest-earning assets during first six months of 2021 compared to 18.6% during the first six months of 2020. The increase in investment securities is due to the redeployment of excess liquidity intended to benefit interest income. The unfavorable rate variance resulted in a \$2.6 million decrease in interest income from investment securities, partially offset by a \$2.1 million increase due to an increase in the average volume.

The cost of average interest-bearing liabilities of 0.37% in the first six months of 2021 compared to 0.90% in the first six months of 2020 was 53-basis points lower and the cost of average interest-bearing deposits decreased 54-basis points from 0.79% to 0.25%. Average short-term borrowings decreased \$139.5 million from \$140.0 million to \$585 thousand in the first six months of 2021 compared to the same period of 2020. The decrease in average short-term borrowings was a result of the Company's decision to utilize brokered deposits as a cost-effective alternative to Federal Home Loan Bank borrowings. The cost of long-term borrowings for the first six months of 2021 decreased 54-basis points from 6.29% to 5.75% in the first six months of 2021 compared to the same period of 2020. Overall, interest-bearing liability rate and volume decreases resulted in \$7.5 million of lower interest expense.

Average interest-bearing liabilities of \$3.58 billion in the first six months of 2021 were \$425.7 million, or 14%, higher than the first six months of 2020. On average, interest-bearing deposits grew \$530.8 million from \$2.98 billion to \$3.51 billion, and noninterest-bearing demand deposits (a principal component of net free funds) were up \$251.1 million from \$817.1 million to \$1.07 billion. The increase in average deposits was primarily due to growth in non-public demand and an increase in reciprocal deposit programs. For further discussion of the reciprocal deposit programs, refer to the "Funding Activities - Deposits" section of this Management's Discussion and Analysis. Overall, interest-bearing deposit rate and volume changes resulted in \$7.3 million of lower interest expense during the first six months of 2021, primarily due to the overall lower interest rate market conditions. Average borrowings decreased \$105.1 million from \$179.3 million to \$74.3 million compared to the first six months of 2020. Overall, short and long-term borrowing rate and volume changes resulted in \$175 thousand of lower interest expense during the first six months of 2021.

MANAGEMENT'S DISCUSSION AND ANALYSIS

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

	Three months ended June 30,					
	2021			2020		
	Average Balance	Interest	Average Rate	Average Balance	Interest	Average Rate
Interest-earning assets:						
Federal funds sold and interest-earning deposits	\$ 249,312	\$ 61	0.10%	\$ 92,214	\$ 24	0.10%
Investment securities (1):						
Taxable	925,649	3,863	1.67	585,970	3,662	2.50
Tax-exempt (2)	131,249	804	2.45	180,666	1,109	2.46
Total investment securities	1,056,898	4,667	1.77	766,636	4,771	2.49
Loans:						
Commercial business	791,412	7,006	3.55	757,588	6,537	3.47
Commercial mortgage	1,302,136	12,914	3.98	1,133,832	12,185	4.32
Residential real estate loans	595,925	5,088	3.42	581,651	5,333	3.67
Residential real estate lines	82,926	711	3.44	99,543	922	3.72
Consumer indirect	878,884	10,282	4.69	827,030	9,799	4.77
Other consumer	15,356	392	10.23	15,155	421	11.19
Total loans	3,666,639	36,393	3.98	3,414,799	35,197	4.14
Total interest-earning assets	4,972,849	41,121	3.31	4,273,649	39,992	3.76
Less: Allowance for credit losses	(52,048)			(44,585)		
Other noninterest-earning assets	419,944			395,296		
Total assets	<u>\$ 5,340,745</u>			<u>\$ 4,624,360</u>		
Interest-bearing liabilities:						
Deposits:						
Interest-bearing demand	\$ 842,832	\$ 301	0.14%	\$ 712,300	242	0.14%
Savings and money market	1,856,659	862	0.19	1,329,632	1,041	0.31
Time deposits	935,885	1,002	0.43	984,832	3,394	1.39
Total interest-bearing deposits	3,635,376	2,165	0.24	3,026,764	4,677	0.62
Short-term borrowings	—	—	—	110,272	284	1.03
Long-term borrowings	73,709	1,055	5.73	39,297	617	6.29
Total borrowings	73,709	1,055	5.73	149,569	901	2.41
Total interest-bearing liabilities	3,709,085	3,220	0.35	3,176,333	5,578	0.71
Noninterest-bearing demand deposits	1,091,490			912,238		
Other noninterest-bearing liabilities	63,984			90,350		
Shareholders' equity	476,186			445,439		
Total liabilities and shareholders' equity	<u>\$ 5,340,745</u>			<u>\$ 4,624,360</u>		
Net interest income (tax-equivalent)		<u>\$ 37,901</u>			<u>\$ 34,414</u>	
Interest rate spread			2.96%			3.05%
Net earning assets	<u>\$ 1,263,764</u>			<u>\$ 1,097,316</u>		
Net interest margin (tax-equivalent)			3.06%			3.23%
Ratio of average interest-earning assets to average interest-bearing liabilities			134.07%			134.55%

(1) Investment securities are shown at amortized cost.

(2) The interest on tax-exempt securities is calculated on a tax-equivalent basis assuming a Federal income tax rate of 21%.

MANAGEMENT'S DISCUSSION AND ANALYSIS

	Six months ended June 30,					
	2021			2020		
	Average Balance	Interest	Average Rate	Average Balance	Interest	Average Rate
Interest-earning assets:						
Federal funds sold and interest-earning deposits	\$ 186,526	\$ 88	0.10%	\$ 75,761	\$ 235	0.62%
Investment securities (1):						
Taxable	849,428	7,359	1.73	587,576	7,319	2.49
Tax-exempt (2)	136,698	1,679	2.46	185,689	2,280	2.46
Total investment securities	986,126	9,038	1.83	773,265	9,599	2.48
Loans:						
Commercial business	795,119	15,419	3.91	664,237	13,051	3.95
Commercial mortgage	1,293,262	25,159	3.92	1,117,247	25,499	4.59
Residential real estate loans	599,376	10,348	3.45	580,029	10,781	3.72
Residential real estate lines	85,290	1,456	3.44	101,111	2,105	4.19
Consumer indirect	860,978	20,270	4.75	836,915	19,718	4.74
Other consumer	15,760	800	10.24	15,310	903	11.87
Total loans	3,649,785	73,452	4.05	3,314,849	72,057	4.37
Total interest-earning assets	4,822,437	82,578	3.45	4,163,875	81,891	3.95
Less: Allowance for loan losses	(53,018)			(42,600)		
Other noninterest-earning assets	424,360			378,968		
Total assets	<u>\$ 5,193,779</u>			<u>\$ 4,500,243</u>		
Interest-bearing liabilities:						
Deposits:						
Interest-bearing demand	\$ 817,058	\$ 557	0.14%	\$ 689,917	\$ 586	0.17%
Savings and money market	1,790,983	1,752	0.20	1,236,630	2,622	0.43
Time deposits	900,103	2,091	0.47	1,050,784	8,488	1.62
Total interest-bearing deposits	3,508,144	4,400	0.25	2,977,331	11,696	0.79
Short-term borrowings	585	119	41.07	140,049	1,176	1.69
Long-term borrowings	73,673	2,117	5.75	39,288	1,235	6.29
Total borrowings	74,258	2,236	6.02	179,337	2,411	2.70
Total interest-bearing liabilities	3,582,402	6,636	0.37	3,156,668	14,107	0.90
Noninterest-bearing demand deposits	1,068,240			817,106		
Other noninterest-bearing liabilities	70,705			83,141		
Shareholders' equity	472,432			443,328		
Total liabilities and shareholders' equity	<u>\$ 5,193,779</u>			<u>\$ 4,500,243</u>		
Net interest income (tax-equivalent)		<u>\$ 75,942</u>			<u>\$ 67,784</u>	
Interest rate spread			3.08%			3.05%
Net earning assets	<u>\$ 1,240,035</u>			<u>\$ 1,007,207</u>		
Net interest margin (tax-equivalent)			3.17%			3.27%
Ratio of average interest-earning assets to average interest-bearing liabilities			134.61%			131.91%

(1) Investment securities are shown at amortized cost.

(2) The interest on tax-exempt securities is calculated on a tax-equivalent basis assuming a Federal income tax rate of 21%.

MANAGEMENT'S DISCUSSION AND ANALYSIS

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

Increase (decrease) in:	Three months ended June 30, 2021 vs. 2020			Six months ended June 30, 2021 vs. 2020		
	Volume	Rate	Total	Volume	Rate	Total
Interest income:						
Federal funds sold and interest-earning deposits	\$ 38	\$ (1)	\$ 37	\$ 159	\$ (306)	\$ (147)
Investment securities:						
Taxable	1,675	(1,474)	201	2,672	(2,632)	40
Tax-exempt	(303)	(2)	(305)	(602)	1	(601)
Total investment securities	1,372	(1,476)	(104)	2,070	(2,631)	(561)
Loans:						
Commercial business	296	173	469	2,540	(172)	2,368
Commercial mortgage	1,717	(988)	729	3,711	(4,051)	(340)
Residential real estate loans	129	(374)	(245)	352	(785)	(433)
Residential real estate lines	(146)	(65)	(211)	(302)	(347)	(649)
Consumer indirect	608	(125)	483	567	(15)	552
Other consumer	6	(35)	(29)	26	(129)	(103)
Total loans	2,610	(1,414)	1,196	6,894	(5,499)	1,395
Total interest income	4,020	(2,891)	1,129	9,123	(8,436)	687
Interest expense:						
Deposits:						
Interest-bearing demand	46	13	59	98	(127)	(29)
Savings and money market	330	(509)	(179)	887	(1,757)	(870)
Time deposits	(161)	(2,231)	(2,392)	(1,072)	(5,325)	(6,397)
Total interest-bearing deposits	215	(2,727)	(2,512)	(87)	(7,209)	(7,296)
Short-term borrowings	(142)	(142)	(284)	(2,289)	1,232	(1,057)
Long-term borrowings	497	(59)	438	996	(114)	882
Total borrowings	355	(201)	154	(1,293)	1,118	(175)
Total interest expense	570	(2,928)	(2,358)	(1,380)	(6,091)	(7,471)
Net interest income	\$ 3,450	\$ 37	\$ 3,487	\$ 10,503	\$ (2,345)	\$ 8,158

Provision for Credit Losses

The provision for credit losses for the three and six months ended June 30, 2021 were benefits of \$4.6 million and \$6.6 million, respectively, compared to provisions of \$3.7 million and \$17.7 million for the corresponding periods in 2020. The benefits in the second quarter and first six months of 2021 were due to continued improvement in the national unemployment forecast, the designated loss driver for our current expected credit loss ("CECL") model, and positive trends in qualitative factors, resulting in releases of credit loss reserves. The provisions in the second quarter and first six months of 2020 was driven by the adoption of the CECL standard and the impact of the COVID-19 pandemic on the economic environment. The provision for credit losses - loans varies based primarily on forecasted unemployment rates, loan growth, net charge-offs, collateral values associated with collateral dependent loans and qualitative factors.

See the "Allowance for Credit Losses - Loans" and "Non-Performing Assets and Potential Problem Loans" sections of this Management's Discussion and Analysis for further discussion.

MANAGEMENT'S DISCUSSION AND ANALYSIS

Noninterest Income

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

	Three months ended June 30,		Six months ended June 30,	
	2021	2020	2021	2020
Service charges on deposits	\$ 1,287	\$ 480	\$ 2,579	\$ 2,067
Insurance income	1,147	819	2,543	2,168
Card interchange income	2,194	1,776	4,152	3,378
Investment advisory	2,886	2,251	5,658	4,497
Company owned life insurance	693	462	1,350	927
Investments in limited partnerships	238	(244)	1,093	(31)
Loan servicing	91	50	188	57
Income (loss) from derivative instruments, net	(592)	1,940	1,283	2,686
Net gain on sale of loans held for sale	790	612	1,868	864
Net gain (loss) on investment securities	(3)	674	71	895
Net gain (loss) on other assets	153	(1)	148	63
Net gain (loss) on tax credit investments	276	(40)	191	(80)
Other	1,030	934	2,025	2,132
Total noninterest income	<u>\$ 10,190</u>	<u>\$ 9,713</u>	<u>\$ 23,149</u>	<u>\$ 19,623</u>

Service charges on deposits increased \$807 thousand to \$1.3 million for the second quarter of 2021, compared to \$480 thousand for the second quarter of 2020. For the first six months of 2021, service charges on deposits increased \$512 thousand, or 25%, to \$2.6 million compared to \$2.1 million for the first six months of 2020. The increases were the result of our COVID-19 relief initiatives of temporarily waiving or eliminating fees during the second quarter of 2020.

Insurance income increased \$328 thousand, or 40%, to \$1.1 million for the second quarter of 2021 compared to \$819 thousand for the second quarter of 2020. For the first six months of 2021, insurance income increased \$375 thousand to \$2.5 million compared to \$2.2 million for the first six months of 2020. The increases were primarily due to acquisition of Landmark Group in the first quarter of 2021.

Card interchange income increased \$418 thousand, or 40%, to \$2.2 million for the second quarter of 2021, compared to \$1.8 million for the second quarter of 2020. For the first six months of 2021, card interchange income increased \$774 thousand, or 23%, to \$4.2 million compared to \$3.4 million for the first six months of 2020. The increases were primarily due to an increase in customer transactions.

Investment advisory income increased \$635 thousand, or 28%, to \$2.9 million for the second quarter of 2021, compared to \$2.3 million for the second quarter of 2020. For the first six months of 2021, investment advisory income increased \$1.2 million, or 26%, to \$5.7 million compared to \$4.5 million for the first six months of 2020. The increases were primarily the result of an increase in assets under management driven by a combination of market gains, new customer accounts and contributions to existing accounts in 2021.

Income (loss) from investments in limited partnerships increased \$482 thousand, to income of \$238 thousand for the second quarter of 2021 compared to a loss of \$244 thousand for the second quarter of 2020. For the first six months of 2021, income (loss) from investments in limited partnerships increased \$1.1 million, to income of \$1.1 million compared to a loss of \$31 thousand for the first six months of 2020. We have investments in limited partnerships, primarily small business investment companies, and account for these investments under the equity method. The income from these equity method investments fluctuates based on the maturity and performance of the underlying investments.

Income (loss) from derivative instruments, net decreased \$2.5 million to a loss of \$592 thousand for the second quarter of 2021 compared to income of \$1.9 million for the second quarter of 2020. For the first six months of 2021, income from derivative instruments, net decreased \$1.4 million to \$1.3 million compared to \$2.7 million for the first six months of 2020. Income from derivative instruments, net is based on the number and value of interest rate swap transactions executed during the quarter combined with the impact of changes in the fair market value of borrower-facing trades. A lower level of interest rate swap transactions was executed during the second quarter of 2021 and fair market values were negatively impacted by the decrease in longer-term interest rates in 2021.

Net gain (loss) on investment securities was a loss of \$3 thousand for the second quarter of 2021 compared to a gain of \$674 thousand for the second quarter of 2020. For the first six months of 2021, net gain on investment securities was \$71 thousand compared to \$895 thousand for the first six months of 2020. The net gains in the second quarter and first six months of 2020 were primarily attributable to the management of premium risk, largely achieved through the sale of \$25.9 million of fixed rate mortgage backed securities with higher expected prepayment speeds. Proceeds were reinvested in current coupon bonds, with lower anticipated prepayment behavior.

MANAGEMENT'S DISCUSSION AND ANALYSIS

Noninterest Expense

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

	Three months ended June 30,		Six months ended June 30,	
	2021	2020	2021	2020
Salaries and employee benefits	\$ 14,519	\$ 15,074	\$ 28,984	\$ 30,088
Occupancy and equipment	3,286	3,388	6,668	7,144
Professional services	1,603	1,580	3,498	3,732
Computer and data processing	3,460	2,699	6,581	5,372
Supplies and postage	430	517	914	1,070
FDIC assessments	480	539	1,245	911
Advertising and promotions	436	545	760	1,100
Amortization of intangibles	266	287	537	581
Other	2,464	1,946	4,497	4,247
Total noninterest expense	<u>\$ 26,944</u>	<u>\$ 26,575</u>	<u>\$ 53,684</u>	<u>\$ 54,245</u>

Salaries and employee benefits expense decreased by \$555 thousand, or 4%, to \$14.5 million for the second quarter of 2021 compared to \$15.1 million for the second quarter of 2020. For the first six months of 2021, salaries and employee benefits expense decreased by \$1.1 million, or 4%, to \$29.0 compared to \$30.1 million for the first six months of 2020. The decreases reflect a streamlining of retail branches to better align with shifting customer needs and preferences, including the closure of seven branches since the second quarter of 2020.

Computer and data processing expense increased \$761 thousand, or 28%, to \$3.5 million for the second quarter of 2021 compared to \$2.7 million for the second quarter of 2020. For the first six months of 2021, computer and data processing expense increased \$1.2 million, or 23%, to \$6.6 million compared to \$5.4 million for the first six months of 2020. The increases were primarily due to investments in technology, including costs related to the Bank's ongoing digital banking initiatives.

Other expense increased \$518 thousand, or 27%, to \$2.5 million for the second quarter of 2021 compared to \$1.9 million for the second quarter of 2020. The increase was primarily due to lower education, travel and business development expenses as a result of the stay-at-home orders implemented in the second quarter of 2020 in response to the COVID-19 pandemic, combined with lower expense incurred in connection with indirect consumer lending activity, which was significantly lower in the second quarter of 2020.

Our efficiency ratio for the first six months of 2021 was 54.22% compared with 62.70% for the first six months of 2020. The lower efficiency ratio was primarily the result of an increase in net interest income, associated with an increase in average interest-earning assets, and an increase in noninterest income compared to the prior year quarter. The efficiency ratio is calculated by dividing total noninterest expense by net revenue, defined as the sum of tax-equivalent net interest income and noninterest income before net gains on investment securities. An increase in the efficiency ratio indicates that more resources are being utilized to generate the same volume of income, while a decrease indicates a more efficient allocation of resources. The efficiency ratio, a banking industry financial measure, is not required by GAAP. However, the efficiency ratio is used by management in its assessment of financial performance specifically as it relates to noninterest expense control. Management also believes such information is useful to investors in evaluating Company performance.

Income Taxes

For the six months ended June 30, 2021, we recorded income tax expense of \$10.7 million, versus \$2.8 million for the same period in the prior year. In the first six months of 2021, we recognized tax credit investments resulting in a reduction in income tax expense of \$668 thousand, and a net gain recorded in noninterest income of \$191 thousand. In the first six months of 2020, we recognized tax credit investments resulting in a reduction in income tax expense of \$393 thousand, and a net loss recorded in noninterest income of \$80 thousand. For the three months ended June 30, 2021, we recorded income tax expense of \$5.4 million, versus \$2.4 million for the same period in the prior year.

During the three months ended June 30, 2021, New York State enacted legislation that temporarily increases the corporate tax rate from 6.5% to 7.25% for taxable years beginning in 2021, 2022 and 2023 for taxpayers with New York State income over \$5.0 million. This rate change did not result in a material impact to our tax provision for the three and six months ended June 30, 2021.

Our effective tax rates for the first six months of 2021 and 2020 were 20.8% and 18.4%, respectively. Our effective tax rates for the second quarter of 2021 and 2020 were 21.1% and 18.0%, respectively. The increase in effective tax rates is the result of higher pre-tax earnings in comparison to the prior year. Effective tax rates are typically 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, earnings on Company owned life insurance and the impact of tax credit investments. In addition, our effective tax rate for 2021 and 2020 reflects the New York State tax benefit generated by our real estate investment trust.

MANAGEMENT'S DISCUSSION AND ANALYSIS

ANALYSIS OF FINANCIAL CONDITION

INVESTING ACTIVITIES

Investment Securities

The following table summarizes the composition of our investment securities portfolio as of the dates indicated (in thousands):

	Investment Securities Portfolio Composition			
	June 30, 2021		December 31, 2020	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Securities available for sale:				
U.S. Government agency and government-sponsored enterprise securities	\$ 6,249	\$ 6,563	\$ 6,239	\$ 6,635
Mortgage-backed securities:				
Agency mortgage-backed securities	888,975	895,858	601,426	620,989
Non-Agency mortgage-backed securities	—	424	—	435
Total available for sale securities	895,224	902,845	607,665	628,059
Securities held to maturity:				
State and political subdivisions	113,437	116,820	144,506	148,984
Mortgage-backed securities	105,427	109,224	127,467	133,051
Total held to maturity securities	218,864	226,044	271,973	282,035
Allowance for credit losses - securities	(6)		(7)	
Total held to maturity securities, net	218,858		271,966	
Total investment securities	\$ 1,114,082	\$ 1,128,889	\$ 879,631	\$ 910,094

The available for sale ("AFS") investment securities portfolio increased \$274.8 million from \$628.1 million at December 31, 2020 to \$902.8 million at June 30, 2021. The increase from year-end 2020 was primarily due to the deployment of excess liquidity into cash flowing agency backed securities. The AFS portfolio had net unrealized gains of \$7.6 million and \$20.4 million at June 30, 2021 and December 31, 2020, respectively. The fair value of most of the investment securities in the AFS portfolio fluctuates as market interest rates change.

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 June 30, 2021. Mortgage-backed securities are included in maturity categories based on their stated maturity date. Actual maturities may differ from the contractual maturities presented because borrowers may have the right to call or prepay certain investments. No tax-equivalent adjustments were made to the weighted average yields (dollars in thousands).

	Due in one year or less		Due from one to five years		Due after five years through ten years		Due after ten years		Total	
	Cost	Yield	Cost	Yield	Cost	Yield	Cost	Yield	Cost	Yield
Available for sale debt securities:										
U.S. Government agencies and government-sponsored enterprises	\$ —	—%	\$ 6,249	2.42%	\$ —	—%	\$ —	—%	\$ 6,249	2.42%
Mortgage-backed securities	4,875	2.17	55,024	2.45	162,075	1.98	667,001	1.50	888,975	1.65
	4,875	2.17	61,273	2.45	162,075	1.98	667,001	1.50	895,224	1.66
Held to maturity debt securities:										
State and political subdivisions	39,335	2.08	72,989	1.90	1,113	1.99	—	—	113,437	1.96
Mortgage-backed securities	—	—	2,295	2.28	17,680	2.16	85,452	2.24	105,427	2.22
	39,335	2.08	75,284	1.91	18,793	2.15	85,452	2.24	218,864	2.09
Total investment securities	\$44,210	2.09%	\$136,557	2.15%	\$180,868	2.00%	\$752,453	1.59%	\$1,114,088	1.74%

MANAGEMENT'S DISCUSSION AND ANALYSIS

Impairment Assessment

For AFS securities in an unrealized loss position, we first assess whether (i) we intend to sell, or (ii) it is more likely than not that we will be required to sell the security before recovery of its amortized cost basis. If either case is affirmative, any previously recognized allowances are charged-off and the security's amortized cost is written down to fair value through income. If neither case is affirmative, the security is evaluated to determine whether the decline in fair value has resulted from credit losses or other factors. In making this assessment, management considers the extent to which fair value is less than amortized cost, any changes to the rating of the security by a rating agency and any adverse conditions specifically related to the security, among other factors. If this assessment indicates that a credit loss exists, the present value of cash flows expected to be collected from the security are compared to the amortized cost basis of the security. If the present value of cash flows expected to be collected is less than the amortized cost basis, a credit loss exists and an allowance for credit losses is recorded for the credit loss, limited by the amount that the fair value is less than the amortized cost basis. Any impairment that has not been recorded through an allowance for credit losses is recognized in other comprehensive income. Adjustments to the allowance are reported in our income statement as a component of credit loss expense. AFS securities are charged-off against the allowance or, in the absence of any allowance, written down through income when deemed uncollectible by management or when either of the aforementioned criteria regarding intent or requirement to sell is met. For the six months ended June 30, 2021 and 2020 no allowance for credit losses has been recognized on AFS securities in an unrealized loss position as management does not believe any of the securities are impaired due to reasons of credit quality.

LENDING ACTIVITIES

The following table summarizes the composition of our loan portfolio, excluding loans held for sale and including net unearned income and net deferred fees and costs, as of the dates indicated (in thousands).

	Loan Portfolio Composition			
	June 30, 2021		December 31, 2020	
	Amount	% of Total	Amount	% of Total
Commercial business	\$ 731,208	20.1%	\$ 794,148	22.1%
Commercial mortgage	1,315,404	36.2	1,253,901	34.9
Total commercial	2,046,612	56.3	2,048,049	57.0
Residential real estate loans	590,303	16.3	599,800	16.7
Residential real estate lines	80,781	2.2	89,805	2.5
Consumer indirect	899,018	24.8	840,421	23.4
Other consumer	15,454	0.4	17,063	0.4
Total consumer	1,585,556	43.7	1,547,089	43.0
Total loans	3,632,168	100.0%	3,595,138	100.0%
Less: Allowance for credit losses - loans	46,365		52,420	
Total loans, net	\$ 3,585,803		\$ 3,542,718	

Total loans increased \$37.0 million to \$3.63 billion at June 30, 2021 from \$3.60 billion at December 31, 2020. The increase in loans was primarily attributable to our organic growth initiatives.

Commercial loans decreased \$1.4 million during the six months ended June 30, 2021 and represented 56.3% of total loans as of June 30, 2021. The decrease was due to a decrease of \$76.0 million in PPP loans, net of deferred fees, from \$248.0 million at December 31, 2020 to \$171.9 million at June 30, 2021. The decrease in commercial loans was partially offset by an increase in commercial mortgage loans and commercial business loans, excluding PPP loans, of \$61.5 million and \$13.1 million, respectively, primarily as a result of our continued commercial business development efforts.

The consumer indirect portfolio totaled \$899.0 million and represented 24.8% of total loans as of June 30, 2021. During the first six months of 2021, we originated \$230.0 million in indirect auto loans with a mix of approximately 28% new auto and 72% used auto. During the first six months of 2020, we originated \$135.6 million in indirect auto loans with a mix of approximately 30% new auto and 70% used auto. Our origination volumes and mix of new and used vehicles financed fluctuate depending on general market conditions.

Loans Held for Sale and Loan Servicing Rights

Loans held for sale (not included in the loan portfolio composition table) were entirely comprised of residential real estate loans and totaled \$3.9 million and \$4.3 million as of June 30, 2021 and December 31, 2020, respectively.

We sell certain qualifying newly originated or refinanced residential real estate loans on the secondary market. Residential real estate loans serviced for others, which are not included in the consolidated statements of financial condition, amounted to \$256.4 million and \$241.7 million as of June 30, 2021 and December 31, 2020, respectively.

MANAGEMENT'S DISCUSSION AND ANALYSIS

Allowance for Credit Losses - Loans

The following table summarizes the activity in the allowance for credit losses - loans for the periods indicated (in thousands).

	Loan Loss Analysis			
	Three months ended June 30,		Six months ended June 30,	
	2021	2020	2021	2020
Allowance for credit losses - loans, beginning of period, prior to adoption of ASC 326				\$ 30,482
Impact of adopting ASC 326				9,594
Allowance for credit losses - loans, beginning of period, after adoption of ASC 326	\$ 49,828	\$ 43,356	\$ 52,420	40,076
Charge-offs:				
Commercial business	92	25	178	8,266
Commercial mortgage	—	1,072	203	1,072
Residential real estate loans	56	2	67	100
Residential real estate lines	—	—	70	—
Consumer indirect	1,157	2,554	3,570	5,978
Other consumer	424	70	505	339
Total charge-offs	1,729	3,723	4,593	15,755
Recoveries:				
Commercial business	379	1,483	617	1,541
Commercial mortgage	7	—	7	—
Residential real estate loans	59	8	64	18
Residential real estate lines	—	—	—	3
Consumer indirect	1,583	1,379	3,253	3,047
Other consumer	95	67	159	217
Total recoveries	2,123	2,937	4,100	4,826
Net (recoveries) charge-offs	(394)	786	493	10,929
Provision (benefit) for credit losses - loans	(3,857)	3,746	(5,562)	17,169
Allowance for credit losses - loans, end of period	\$ 46,365	\$ 46,316	\$ 46,365	\$ 46,316
Net loan (recoveries) charge-offs to average loans (annualized)	-0.04%	0.09%	0.03%	0.66%
Allowance for credit losses - loans to total loans	1.28%	1.33%	1.28%	1.33%
Allowance for credit losses - loans to non-performing loans	699%	351%	699%	351%

The Company adopted CECL effective January 1, 2020, which resulted in an increase to the allowance for credit losses - loans of \$9.6 million and established a reserve for unfunded commitments of \$2.1 million, for a total pre-tax cumulative effect adjustment of \$11.7 million.

The allowance for credit losses for Pooled Loans estimate is based upon periodic review of the collectability of the loans quantitatively correlating historical loan experience with reasonable and supportable forecasts using forward looking information. Adjustments to the quantitative evaluation may be made for differences in current or expected qualitative risk characteristics such as changes in: underwriting standards, delinquency level, regulatory environment, economic condition, Company management and the status of portfolio administration including the Company's Loan Review function. The Company establishes a specific reserve for individually evaluated loans which do not share similar risk characteristics with the loans included in the forecasted allowance for credit losses. These individually evaluated loans are removed from the pooling approach discussed above for the forecasted allowance for credit losses, and include nonaccrual loans, troubled debt restructurings ("TDRs"), and other loans deemed appropriate by management, collectively referred to as collateral dependent loans. See Note 6, Loans, of the notes to consolidated financial statements for further details on collateral dependent loans.

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

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

MANAGEMENT'S DISCUSSION AND ANALYSIS

Net recoveries of \$394 thousand in the second quarter of 2021 represented 0.04% of average loans on an annualized basis compared to net charge-offs of \$786 thousand, or 0.09%, in the second quarter of 2020. For the six months ended June 30, 2021, net charge-offs of \$493 thousand represented 0.03% of average loans, compared to \$10.9 million or 0.66% of average loans for the same period in 2020. The decrease in net charge-offs in the six months ended June 30, 2021 was primarily due to an \$8.2 million partial charge-off of an \$11.9 million commercial loan downgraded in the first quarter of 2020. The borrower's business was related to the hospitality industry and the downgrade and charge-off were precipitated by the impact of the COVID-19 pandemic. The allowance for credit losses - loans was \$46.4 million at June 30, 2021, compared with \$52.4 million at December 31, 2020. The ratio of the allowance for credit losses - loans to total loans was 1.28% and 1.46% at June 30, 2021 and December 31, 2020, respectively. The ratio of allowance for credit losses - loans to non-performing loans was 699% at June 30, 2021, compared with 551% at December 31, 2020.

Non-Performing Assets and Potential Problem Loans

The table below summarizes our non-performing assets at the dates indicated (in thousands).

	Non-Performing Assets	
	June 30, 2021	December 31, 2020
Nonaccrual loans:		
Commercial business	\$ 1,555	\$ 1,975
Commercial mortgage	885	2,906
Residential real estate loans	2,615	2,587
Residential real estate lines	280	323
Consumer indirect	1,250	1,495
Other consumer	8	—
Total nonaccrual loans	6,593	9,286
Accruing loans 90 days or more delinquent	42	231
Total non-performing loans	6,635	9,517
Foreclosed assets	646	2,966
Total non-performing assets	\$ 7,281	\$ 12,483
Non-performing loans to total loans	0.18%	0.26%
Non-performing assets to total assets	0.14%	0.25%

Non-performing assets include non-performing loans and foreclosed assets. Non-performing assets at June 30, 2021 were \$7.3 million, a decrease of \$5.2 million from the \$12.5 million balance at December 31, 2020. The primary component of non-performing assets is non-performing loans, which were \$6.6 million or 0.18% of total loans at June 30, 2021, compared with \$9.5 million or 0.26% of total loans at December 31, 2020.

Approximately \$2.1 million, or 32%, of the \$6.6 million in non-performing loans as of June 30, 2021 were current with respect to payment of principal and interest but were classified as non-accruing because repayment in full of principal and/or interest was uncertain. Included in nonaccrual loans are TDRs of \$0 and \$200 thousand at June 30, 2021 and December 31, 2020, respectively. There were no TDRs accruing interest as of June 30, 2021 and December 31, 2020.

Foreclosed assets consist of real property formerly pledged as collateral for loans, which we have acquired through foreclosure proceedings or acceptance of a deed in lieu of foreclosure. Foreclosed asset holdings represented one property totaling \$646 thousand at June 30, 2021 and two properties totaling \$3.0 million at December 31, 2020. The decrease in foreclosed assets during the first six months of 2021 was the result of the sale of an asset on which foreclosure occurred in the third quarter of 2020. The borrower's business was related to the hospitality industry and the downgrade and partial charge-off in the first quarter of 2020 were precipitated by the impact of the COVID-19 pandemic.

Potential problem loans are loans that are currently performing, but information known about possible credit problems of the borrowers causes us to have concern as to the ability of such borrowers to comply with the present loan payment terms and may result in disclosure of such loans as nonperforming at some time in the future. These loans remain in a performing status due to a variety of factors, including payment history, the value of collateral supporting the credits, and/or personal or government guarantees. We consider loans classified as substandard, which continue to accrue interest, to be potential problem loans. We identified \$28.9 million and \$17.9 million in loans that continued to accrue interest which were classified as substandard as of June 30, 2021 and December 31, 2020, respectively.

MANAGEMENT'S DISCUSSION AND ANALYSIS

FUNDING ACTIVITIES

Deposits

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

	Deposit Composition			
	June 30, 2021		December 31, 2020	
	Amount	% of Total	Amount	% of Total
Noninterest-bearing demand	\$ 1,121,827	24.1%	\$ 1,018,549	23.8%
Interest-bearing demand	799,299	17.2	731,885	17.1
Savings and money market	1,796,813	38.5	1,642,340	38.4
Time deposits < \$250,000	768,161	16.5	684,885	16.0
Time deposits of \$250,000 or more	173,121	3.7	200,708	4.7
Total deposits	\$ 4,659,221	100.0%	\$ 4,278,367	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 June 30, 2021, total deposits were \$4.66 billion, representing an increase of \$380.9 million from December 31, 2020. The increase was due to growth in public, non-public demand, reciprocal and brokered deposits. Time deposits were approximately 20% and 21% of total deposits at June 30, 2021 and December 31, 2020, respectively.

Nonpublic deposits, the largest component of our funding sources, totaled \$2.71 billion and \$2.55 billion at June 30, 2021 and December 31, 2020, respectively, and represented 58% and 60% of total deposits as of the end of each period, respectively. We have managed this segment of funding through a strategy of competitive pricing that minimizes the number of customer relationships that have only a single service high cost deposit account.

As an additional source of funding, we offer a variety of public (municipal) deposit products to the towns, villages, counties and school districts within our market. Public deposits generally range from 20% to 30% of our total deposits. There is a high degree of seasonality in this component of funding, because the level of deposits varies with the seasonal cash flows for these public customers. We maintain the necessary levels of short-term liquid assets to accommodate the seasonality associated with public deposits. Total public deposits were \$977.1 million and \$834.9 million at June 30, 2021 and December 31, 2020, respectively, and represented 21% and 20% of total deposits as of the end of each period, respectively. The increase in public deposits during 2021 was due largely to seasonality.

We also participate in reciprocal deposit 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. Prior to the Economic Growth, Regulatory Relief and Consumer Protection Act ("EGRRCPA") enacted on May 14, 2018, all reciprocal deposits were considered brokered deposits for regulatory reporting purposes. With the enactment of EGRRCPA, reciprocal deposits, subject to certain restrictions, are no longer required to be reported as brokered deposits. Reciprocal deposits totaled \$762.2 million at June 30, 2021, compared to \$612.3 million at December 31, 2020. Reciprocal deposits represented 16% and 14% of total deposits as of the end of each period, respectively.

Brokered deposits totaled \$210.9 million and \$279.6 million at June 30, 2021 and December 31, 2020, respectively, and represented 5% and 7% of total deposits as of the end of each period, respectively.

Borrowings

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

	June 30, 2021	December 31, 2020
Short-term borrowings - FHLB	\$ —	\$ 5,300
Long-term borrowings - Subordinated notes, net	73,756	73,623
Total borrowings	\$ 73,756	\$ 78,923

Short-term Borrowings

Short-term Federal Home Loan Bank ("FHLB") borrowings have original maturities of less than one year and include overnight borrowings which we typically utilize to address short term funding needs as they arise. We had no short-term FHLB borrowings at June 30, 2021 and no amount of short-term FHLB borrowings outstanding at any month-end during the six months ended June 30, 2021. Short-term FHLB borrowings at December 31, 2020 consisted of \$5.3 million in short-term borrowings. The decline in short-term borrowings at June 30, 2021, was the result of the Company's decision to utilize brokered deposits as a cost-effective alternative to FHLB borrowings. Short-term borrowings and brokered deposits have historically been utilized to manage the seasonality of public deposits.

MANAGEMENT'S DISCUSSION AND ANALYSIS

We have credit capacity with the FHLB and can borrow through facilities that include amortizing and term advances or repurchase agreements. We had approximately \$201.8 million of immediate credit capacity with the FHLB as of June 30, 2021. We had approximately \$575.7 million in secured borrowing capacity at the Federal Reserve Bank ("FRB") discount window, none of which was outstanding at June 30, 2021. The FHLB and FRB credit capacity are collateralized by securities from our investment portfolio and certain qualifying loans. We had approximately \$130.0 million and \$145.0 million of credit available under unsecured federal funds purchased lines with various banks as of June 30, 2021 and December 31, 2020, respectively. Additionally, we had approximately \$407.3 million of unencumbered liquid securities available for pledging.

The Parent has a revolving line of credit with a commercial bank allowing borrowings up to \$20.0 million in total as an additional source of working capital. At June 30, 2021, no amounts have been drawn on the line of credit.

Long-term Borrowings

On October 7, 2020, we completed a private placement of \$35.0 million in aggregate principal amount of fixed-to-floating rate subordinated notes to qualified institutional buyers and accredited institutional investors that were subsequently exchanged for subordinated notes with substantially the same terms (the "2020 Notes") registered under the Securities Act of 1933, as amended. The 2020 Notes have a maturity date of October 15, 2030 and bear interest, payable semi-annually, at the rate of 4.375% per annum, until October 15, 2025. Commencing on that date, the interest rate will reset quarterly to an interest rate per annum equal to the then current three-month SOFR plus 4.265%, payable quarterly until maturity. The 2020 Notes are redeemable by us, in whole or in part, on any interest payment date on or after October 15, 2025, and we may redeem the Notes in whole at any time upon certain other specified events. We used the net proceeds for general corporate purposes, organic growth and to support regulatory capital ratios at Five Star Bank.

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

LIQUIDITY AND CAPITAL MANAGEMENT

Liquidity

We continue to actively monitor our liquidity profile and funding concentrations in accordance with our Board approved Liquidity Policy. While funding pressures have not occurred, management is actively monitoring customer activity by way of commercial and consumer line of credit utilization, as well as deposit flows. As of June 30, 2021, all structural liquidity ratios and early warning indicators remain in compliance, with what we believe are ample funding sources available in the event of a stress scenario.

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 both core customer funds and maturing short-term assets; we also rely on our ability to sell or pledge securities and lines-of-credit and our overall ability to access to the financial and capital markets.

Liquidity for the Bank is managed through the monitoring of anticipated changes in loans, the investment portfolio, 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 other banking institutions, the FHLB, the FRB and brokered deposit relationships. The primary source of our non-deposit short-term borrowings is FHLB advances, of which we had \$0 outstanding at June 30, 2021 due to the excess liquidity position partially due to the seasonal inflow of public deposits. In addition to this amount, we have additional collateralized wholesale borrowing capacity of approximately \$907.5 million from various funding sources which include the FHLB, the FRB and commercial banks that we can use to fund lending activities, liquidity needs, and/or to adjust and manage our asset and liability position.

The Parent's funding requirements consist primarily of dividends to shareholders, debt service, income taxes, operating expenses, funding of non-bank subsidiaries, repurchases of our stock, and acquisitions. The Parent obtains funding to meet obligations from dividends received from the Bank, net taxes collected from subsidiaries included in the federal consolidated tax return, and the issuance of debt and equity securities. In addition, the Parent maintains a revolving line of credit with a commercial bank for an aggregate amount of up to \$20.0 million, all of which was available at June 30, 2021. The line of credit has a one-year term and matures in May 2022. Funds drawn would be used for general corporate purposes and backup liquidity.

Cash and cash equivalents were \$206.4 million as of June 30, 2021, up \$112.5 million from \$93.9 million as of December 31, 2020. Net cash provided by operating activities totaled \$30.9 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 \$278.8 million, which included outflows of \$37.5 million for net loan originations, and \$236.7 million from net investment securities transactions. Net cash provided by financing activities of \$360.4 million was attributed to a \$380.9 million increase in deposits, partially offset by a \$5.3 million decrease in short-term borrowings, \$6.0 million in common stock repurchases and \$9.2 million in dividend payments. The increase in the period end cash balance was due to growth in public, non-public demand, reciprocal and brokered deposits.

MANAGEMENT'S DISCUSSION AND ANALYSIS

Capital Management

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

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

Shareholders' equity was \$487.1 million at June 30, 2021, an increase of \$18.8 million from \$468.4 million at December 31, 2020. Net income for the six months ended June 30, 2021 increased shareholders' equity by \$40.9 million, offset by common and preferred stock dividends declared of \$9.3 million. Accumulated other comprehensive loss included in shareholders' equity increased \$8.1 million during the first six months of 2021 due primarily to lower net unrealized gains on securities available for sale.

The FRB and FDIC have adopted a system using risk-based capital guidelines to evaluate the capital adequacy of banks and bank holding companies. As of June 30, 2021, the Company's capital levels remained characterized as “well-capitalized” under the Basel Committee on Banking Supervision's (“BCBS”) capital guidelines for U.S. banks.

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

	June 30, 2021	December 31, 2020
Common shareholders' equity	\$ 469,834	\$ 451,035
Add: CECL transitional amount	10,287	12,061
Less: Goodwill and other intangible assets	71,672	71,235
Net unrealized gain on investment securities (1)	5,343	14,743
Hedging derivative instruments	747	(316)
Net periodic pension and postretirement benefits plan adjustments	(12,024)	(12,299)
Other	—	—
Common Equity Tier 1 (“CET1”) Capital	414,383	389,733
Plus: Preferred stock	17,292	17,328
Less: Other	—	—
Tier 1 Capital	431,675	407,061
Plus: Qualifying allowance for credit losses	35,188	40,509
Subordinated Notes	73,756	73,623
Total regulatory capital	\$ 540,619	\$ 521,193
Adjusted average total assets (for leverage capital purposes)	\$ 5,287,222	\$ 4,933,597
Total risk-weighted assets	\$ 3,992,859	\$ 3,844,380
Regulatory Capital Ratios		
Tier 1 Leverage (Tier 1 capital to adjusted average assets)	8.16%	8.25%
CET1 Capital (CET1 capital to total risk-weighted assets)	10.38	10.14
Tier 1 Capital (Tier 1 capital to total risk-weighted assets)	10.81	10.59
Total Risk-Based Capital (Total regulatory capital to total risk-weighted assets)	13.54	13.56

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

We have elected to apply the 2020 CECL transition provision related to the impact of the CECL accounting standard on regulatory capital, as provided by the US banking agencies' March 2020 interim final rule. Under the 2020 CECL transition provision, the regulatory capital impact of the Day 1 adjustment to the allowance for credit losses (after-tax) upon the January 1, 2020 CECL adoption date has been deferred, and will phase in to regulatory capital at 25% per year commencing January 1, 2022. For the ongoing impact of CECL, we are allowed to defer the regulatory capital impact of the allowance for credit losses in an amount equal to 25% of the change in the allowance for credit losses (pre-tax) recognized through earnings for each period between January 1, 2020, and December 31, 2021. The cumulative adjustment to the allowance for credit losses between January 1, 2020, and December 31, 2021, will also phase in to regulatory capital at 25% per year commencing January 1, 2022.

MANAGEMENT'S DISCUSSION AND ANALYSIS

Basel III Capital Rules

Under the Basel III Capital Rules, the current minimum capital ratios, including an additional capital conservation buffer applicable to the Company and the Bank, are:

- 7.0% CET1 to risk-weighted assets;
- 8.5% Tier 1 capital (that is, CET1 plus Additional Tier 1 capital) to risk-weighted assets; and
- 10.5% Total capital (that is, Tier 1 capital plus Tier 2 capital) to risk-weighted assets.

Banking institutions with a capital conservation buffer below the minimum level will face constraints on dividends, equity repurchases and compensation based on the amount of the shortfall. The Basel III Capital Rules also provide for a “countercyclical capital buffer” that is applicable to only certain covered institutions and does not have any current applicability to the Company or the Bank. Strict eligibility criteria for regulatory capital instruments were also implemented under the Basel III Capital Rules.

The following table presents actual and required capital ratios as of June 30, 2021 and December 31, 2020 for the Company and the Bank under the Basel III Capital Rules. Capital levels required to be considered well capitalized are based upon prompt corrective action regulations, under the Basel III Capital Rules (in thousands):

	Actual		Minimum Capital Required – Basel III		Required to be Considered Well Capitalized	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
June 30, 2021						
Tier 1 leverage:						
Company	\$ 431,675	8.16%	\$ 211,489	4.00%	\$ 264,361	5.00%
Bank	470,805	8.92	211,194	4.00	263,993	5.00
CET1 capital:						
Company	414,383	10.38	279,500	7.00	259,536	6.50
Bank	470,805	11.82	278,881	7.00	258,961	6.50
Tier 1 capital:						
Company	431,675	10.81	339,393	8.50	319,429	8.00
Bank	470,805	11.82	338,642	8.50	318,722	8.00
Total capital:						
Company	540,619	13.54	419,250	10.50	399,286	10.00
Bank	505,992	12.70	418,322	10.50	398,402	10.00
December 31, 2020						
Tier 1 leverage:						
Company	\$ 407,061	8.25%	\$ 197,344	4.00%	\$ 246,680	5.00%
Bank	441,929	8.97	197,064	4.00	246,330	5.00
CET1 capital:						
Company	389,733	10.14	269,107	7.00	249,885	6.50
Bank	441,929	11.52	268,483	7.00	249,306	6.50
Tier 1 capital:						
Company	407,061	10.59	326,772	8.50	307,550	8.00
Bank	441,929	11.52	326,015	8.50	306,838	8.00
Total capital:						
Company	521,193	13.56	403,660	10.50	384,438	10.00
Bank	482,439	12.58	402,725	10.50	383,547	10.00

Dividend Restrictions

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

ITEM 3. Quantitative and Qualitative Disclosures About Market Risk

Market risk refers to the potential impact on earnings or capital arising from movements in interest rates. The Bank's market risk management framework has been developed to control both short-term and long-term exposure within Board approved policy limits and is monitored by the Asset-Liability Management Committee and Board of Directors. Quantitative and qualitative disclosures about market risk were presented at December 31, 2020 in Item 7A of the Company's Annual Report on Form 10-K for the year ended December 31, 2020, as filed with the Securities and Exchange Commission on March 15, 2021. The following is an update of the discussion provided therein.

Portfolio Composition

There was no material change in the composition of assets, deposit liabilities or borrowings from December 31, 2020 to June 30, 2021, aside from asset growth due to an increased liquidity position. The increased liquidity position resulted from continued deposit growth and drove investment security purchases and an excess Federal Reserve interest earning cash balance at quarter end. See the section titled "Analysis of Financial Condition" in Part I, Item 2, "Management's Discussion and Analysis of Financial Condition and Results of Operations" for a discussion of asset, deposit and borrowing activity during the period.

Net Interest Income at Risk

A primary tool used to manage interest rate risk is "rate shock" simulation to measure the rate sensitivity. Rate shock simulation is a modeling technique used to estimate the impact of changes in rates on net interest income as well as economic value of equity.

Net interest income at risk is measured by estimating the changes in net interest income resulting from instantaneous and sustained parallel shifts in interest rates of different magnitudes over a period of 12 months. The following table sets forth the estimated changes to net interest income over the 12-month period ending June 30, 2022 assuming instantaneous changes in interest rates for the given rate shock scenarios (dollars in thousands):

	Changes in Interest Rate			
	-100 bp	+100 bp	+200 bp	+300 bp
Estimated change in net interest income	\$ (2,756)	\$ 2,388	\$ 5,150	\$ 7,749
% Change	-1.90%	1.65%	3.56%	5.35%

In the rising rate scenarios, the model results indicate that net interest income is modeled to increase compared to the flat rate scenario over a one-year timeframe. This is a result of assumed commercial loan products and investment security cash flow repricing at a higher frequency than underlying borrowing and deposit costs. As intermediate and longer-term assets continue to mature and are replaced at higher yields, net interest income improves over longer term timeframes. Model results in the declining rate scenario indicate decreases in net interest income due to assets having the ability to reprice downward, while deposit and borrowing liabilities reach modeled floors.

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

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

Economic Value of Equity At Risk

The economic (or "fair") value of financial instruments on our balance sheet will also vary under the interest rate scenarios previously discussed. This variance is measured by simulating changes in our economic value of equity ("EVE"), which is calculated by subtracting the estimated fair value of liabilities from the estimated fair value of assets. Fair values for financial instruments are estimated by discounting projected cash flows (principal and interest) at current replacement rates for each account type, while fair values of non-financial assets and liabilities are assumed to equal book value and do not vary with interest rate fluctuations. An economic value simulation is a static measure for balance sheet accounts at a given point in time, but this measurement can change substantially over time as the characteristics of our balance sheet evolve and as interest rate and yield curve assumptions are updated.

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

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The analysis that follows presents the estimated EVE resulting from market interest rates prevailing at a given quarter-end (“Pre-Shock Scenario”), and under other interest rate scenarios (each a “Rate Shock Scenario”) represented by immediate, permanent, parallel shifts in interest rates from those observed at June 30, 2021 and December 31, 2020 (dollars in thousands). The analysis additionally presents a measurement of the interest rate sensitivity at June 30, 2021 and December 31, 2020. EVE amounts are computed under each respective Pre-Shock Scenario and Rate Shock Scenario. An increase in the EVE amount is considered favorable, while a decline is considered unfavorable. The following table sets forth the estimated changes to EVE assuming instantaneous changes in interest rates for the given rate shock scenarios (dollars in thousands):

Rate Shock Scenario:	June 30, 2021			December 31, 2020		
	EVE	Change	Percentage Change	EVE	Change	Percentage Change
Pre-Shock Scenario	\$ 687,342			\$ 583,156		
- 100 Basis Points	651,753	\$ (35,589)	-5.18%	574,345	\$ (8,811)	-1.51%
+100 Basis Points	722,418	35,076	5.10	617,768	34,612	5.94
+ 200 Basis Points	752,720	65,378	9.51	638,224	55,068	9.44
+ 300 Basis Points	772,760	85,418	12.43	651,518	68,362	11.72

The increase in the Pre-Shock Scenario EVE at June 30, 2021 compared to December 31, 2020 is the result of growth in investments. The increase in the -100 basis point Rate Shock Scenario to EVE is a result of the growth in deposits over the last two quarters, compounded with the growth of fixed rate long-term assets not receiving the full benefit in value appreciation typically observed in down rate scenarios.

ITEM 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

As of June 30, 2021, the Company carried out an evaluation, under the supervision and with the participation of the Company’s management, including the Company’s Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company’s disclosure controls and procedures pursuant to Rule 13a-15(b), as adopted by the SEC under the Securities Exchange Act of 1934, as amended (“Exchange Act”). Based upon that evaluation, the Company’s Chief Executive Officer and Chief Financial Officer concluded that the Company’s disclosure controls and procedures were effective as of the end of the period covered by this report.

Disclosure controls and procedures are the controls and other procedures that are designed to ensure that information required to be disclosed in the reports that the Company files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC’s rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed in the reports that the Company files or submits under the Exchange Act is accumulated and communicated to management, including the Company’s Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

Changes in Internal Control over Financial Reporting

There were no changes in the Company’s internal control over financial reporting that occurred during the quarter ended June 30, 2021 that have materially affected, or are reasonably likely to materially affect, the Company’s internal control over financial reporting.

PART II. OTHER INFORMATION

ITEM 1. Legal Proceedings

From time to time we are a party to or otherwise involved in legal proceedings arising out of the normal course of business. Regardless of the outcome, litigation can have an adverse impact on us because of prosecution, defense and settlement costs, unfavorable awards, diversion of management resources and other factors.

We are party to an action filed against us on May 16, 2017 by Matthew L. Chipeco, Charlene Mowry, Constance C. Churchill and Joseph W. Ewing in the Court of Common Pleas in Philadelphia, Pennsylvania. Plaintiffs seek class certification to represent classes of consumers in New York and Pennsylvania along with statutory damages, interest and declaratory relief. The plaintiffs seek to represent a putative class of consumers who are alleged to have obtained direct or indirect financing from us for the purchase of vehicles that we later repossessed. The plaintiffs specifically claim that the notices the Bank sent to defaulting consumers after their vehicles were repossessed did not comply with the relevant portions of the Uniform Commercial Code in New York and Pennsylvania. We dispute and believe we have meritorious defenses against these claims and plan to vigorously defend ourselves.

In February 2020, we agreed to engage in mediation with the plaintiffs and the mediation commenced in May 2021. On October 19, 2020, the Court granted plaintiffs' motion for judgment on the pleadings dismissing our affirmative defense against one named New York plaintiff that his claim was time-barred under New York law, applying a six-year statute of limitations rather than the three years limitation period we had argued. The plaintiff's motion for class certification was argued on June 16, 2021 and the motion remains pending.

If we settle these claims or the action is not resolved in our favor, we may suffer reputational damage and incur legal costs, settlements or judgments that exceed the amounts covered by our existing insurance policies. We can provide no assurances that our insurer will insure the legal costs, settlements or judgments we incur in excess of our deductible. If we are unsuccessful in defending ourselves from these claims or if our insurer does not insure us against legal costs we incur in excess of our deductible, the result may materially adversely affect our business, results of operations and financial condition.

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ITEM 6. Exhibits

(a) The following is a list of all exhibits filed or incorporated by reference as part of this Report:

Exhibit Number	Description	Location
10.1+	Financial Institutions, Inc. Amended and Restated 2015 Long-Term Incentive Plan	Filed Herewith
31.1	Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 - Principal Executive Officer	Filed Herewith
31.2	Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 - Principal Financial Officer	Filed Herewith
32	Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002	Filed Herewith
101.INS	Inline XBRL Instance Document – the instance document does not appear in the Interactive Data File because its XBRL tags are embedded within the Inline XBRL document.	
101.SCH	Inline XBRL Taxonomy Extension Schema Document	
101.CAL	Inline XBRL Taxonomy Extension Calculation Linkbase Document	
101.LAB	Inline XBRL Taxonomy Extension Label Linkbase Document	
101.PRE	Inline XBRL Taxonomy Extension Presentation Linkbase Document	
101.DEF	Inline XBRL Taxonomy Extension Definition Linkbase Document	
104	Cover Page Interactive Data File (embedded within the Inline XBRL document)	

+ Management contract, compensatory plan or arrangement.

SIGNATURES

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

FINANCIAL INSTITUTIONS, INC.

/s/ **Martin K. Birmingham** , August 9, 2021

Martin K. Birmingham
President and Chief Executive Officer
(Principal Executive Officer)

/s/ **W. Jack Plants II** , August 9, 2021

W. Jack Plants II
Senior Vice President and Chief Financial Officer and Treasurer
(Principal Financial Officer)

/s/ **Sonia M. Dumbleton** , August 9, 2021

Sonia M. Dumbleton
Senior Vice President and Controller
(Principal Accounting Officer)

**FINANCIAL INSTITUTIONS, INC.
AMENDED AND RESTATED
2015 LONG-TERM INCENTIVE PLAN**

Financial Institutions, Inc. (the “Company”) hereby amends and restates the Financial Institutions, Inc. 2015 Long-Term Incentive Plan (the “Original Plan”) with this Financial Institutions, Inc. Amended and Restated 2015 Long-Term Incentive Plan (the “Plan”) for the benefit of eligible Employees and Directors.

**ARTICLE I
PURPOSE AND EFFECTIVE DATE**

1.1 Purpose. The purpose of the Plan is to advance the interests of the Company, its Subsidiaries, and its stockholders and to promote the growth and profitability of the Company and its Subsidiaries by (a) providing incentives to certain Employees and Directors of the Company and its Subsidiaries to stimulate their efforts toward the continued success of the Company and to operate and manage the business affairs of the Company in a manner that will provide for the long-term growth and profitability of the Company; (b) providing certain Employees and Directors with a means to acquire a proprietary interest in the Company, acquire shares of Common Stock, or to receive compensation which is based upon appreciation in the value of Common Stock; and (c) providing a means of obtaining, rewarding, and retaining Employees and Directors.

1.2 Effective & Expiration Date. The Original Plan became effective as of May 6, 2015 (the “Original Effective Date”), upon the approval of the Plan by the Company’s stockholders on that date. The Plan (as amended and restated) shall become effective as of June 16, 2021 (the “Effective Date”), upon the approval of the Plan by the Company’s stockholders on that date. No Award will be granted under the Plan more than ten (10) years after the Effective Date, but all Awards granted on or prior to such date will continue in effect thereafter subject to the terms thereof and of the Plan.

1.3 Successor Plan. The Original Plan was established as a successor to the 2009 Management Incentive Plan and 2009 Directors’ Stock Incentive Plan (the “Prior Plans”). No additional awards shall be made under the Prior Plans after the Original Effective Date. As provided by Section 4.2, shares of Common Stock authorized under the Prior Plans as of the Original Effective Date became available for issuance or transfer under the Original Plan. Outstanding awards under the Prior Plans continued in effect according to their terms as in effect before the Original Effective Date (subject to such amendments as the Committee determines, consistent with the Prior Plans, as applicable).

**ARTICLE II
DEFINITIONS**

2.1 Award. Award shall mean, collectively, the Options, Restricted Stock Awards, Restricted Stock Unit Awards, Stock Appreciation Rights, Director Awards, and other equity awards that may be granted under the Plan.

2.2 Award Agreement. Award Agreement shall mean a written or electronic agreement entered into between the Company and a Participant setting forth the terms and conditions of an Award made to such Participant under the Plan, such Award Agreement to be in such form as shall be prescribed by the Committee from time to time.

2.3 Board. Board shall mean the board of directors of the Company.

2.4 Cause. Cause as a reason for the termination of a Participant's employment shall have the meaning assigned such term in the executive, employment, severance or similar agreement, if any, between the Participant and the Company or a Subsidiary. If the Participant is not a party to an executive, employment, severance, or similar agreement with the Company or a Subsidiary in which such term is defined, then unless otherwise defined in the applicable Award Agreement, Cause shall mean the commission by the Participant of, or the determination by the Board, based on reasonable evidence of misconduct as presented by a law enforcement agency, or as a result of an internal or external audit or investigation, that the Participant has committed: (a) a criminal offense involving the violation of state or federal law; (b) a breach of fiduciary duty; (c) an act of dishonesty, fraud, or material misrepresentation; or (d) any act of moral turpitude which the Board determines has or may be reasonably expected to have a detrimental impact on the Company's business or operations, or which may prevent, because of its demonstrated or demonstrable effect on employees, regulatory agencies, or customers, the Participant from effectively performing his duties. Any reference to the Company in this definition includes each of its Subsidiaries.

2.5 Change in Control. Change in Control shall have the meaning specified in Section 7.2.

2.6 Code. Code shall mean the Internal Revenue Code of 1986, as amended from time to time, and the regulations and other guidance issued thereunder, as such law, regulations, and guidance may be amended from time to time.

2.7 Committee. Committee shall mean the Management Development & Compensation Committee of the Board, each member of which is a "non-employee director" within the meaning of Rule 16b-3 under the Exchange Act and meets the independence requirements of the Nasdaq Stock Market listing standards.

2.8 Common Stock. Common Stock shall mean the common stock of the Company, \$0.01 par value per share.

2.9 Company. Company shall mean Financial Institutions, Inc., a New York corporation, and its successors and assigns.

2.10 Director. Director shall mean any non-employee member of the board of directors of the Company or a Subsidiary.

2.11 Director Awards. Director Awards shall mean the director awards that may be made to an eligible Director pursuant to Section 6.6.

2.13 Disability. Except as otherwise provided by this Section 2.13, Disability shall have the meaning assigned such term in the executive, employment, severance, or similar agreement, if any, between the Participant and the Company or a Subsidiary, and if the Participant is not a party to an executive, employment, severance, or similar agreement with the Company or a Subsidiary in which such term is defined, then unless otherwise defined in the applicable Award Agreement and except as otherwise provided by this Section 2.13, Disability shall have the meaning assigned such term in the long-term disability plan or policy maintained, or if applicable, most recently maintained, by the Company or any Subsidiary for the Participant. If no long-term disability plan or policy was ever maintained on behalf of the Participant, or if the determination of Disability relates to an Incentive Stock Option, Disability shall mean the condition described in Code Section 22(e)(3).

2.14 Effective Date. Effective Date shall have the meaning specified in Section 1.2.

2.15 Employee. Employee shall mean an employee of the Company or a Subsidiary.

2.16 Exchange Act. Exchange Act shall mean the Securities Exchange Act of 1934, as amended from time to time, and the rules and regulations thereunder, as such law, rules and regulations may be amended from time to time.

2.17 Exercise Price. Exercise Price shall mean the price at which a share of Common Stock may be purchased by a Participant pursuant to the exercise of an Option.

2.18 Fair Market Value. Fair Market Value of Common Stock shall mean the closing price of the Common Stock as reported on the Nasdaq Stock Market on the relevant valuation date or, if there were no Common Stock transactions on such day, on the next preceding date on which there were Common Stock transactions.

2.19 Good Reason. Good Reason as a reason for a Participant's termination of employment shall have the meaning assigned such term in the executive, employment, severance, or similar agreement, if any, between the Participant and the Company or a Subsidiary. If the Participant is not a party to an executive, employment, severance, or similar agreement with the Company or a Subsidiary in which such term is defined, then unless otherwise defined in the applicable Award Agreement, "Good Reason" shall mean (a) a material diminution in the Participant's base salary from the level immediately prior to the Change in Control; or (b) a material change in the geographic location at which the Participant must primarily perform the Participant's services (which shall in no event include a relocation of the Participant's current principal place of business to a location less than fifty (50) miles away) from the geographic location immediately prior to the Change in Control; provided, however, no termination shall be deemed to be for Good Reason unless (i) the Participant provides the Company with written notice setting forth the specific facts or circumstances constituting Good Reason within ninety (90) days after the initial existence of the occurrence of such facts or circumstances, (ii) to the extent curable, the Company has failed to cure such facts or circumstances within thirty (30) days of its receipt of such written notice, and (iii) the effective date of the termination for Good Reason occurs no later than one hundred eighty (180) days after the initial existence of the facts or circumstances constituting Good Reason.

2.20 Incentive Stock Option. Incentive Stock Option shall mean an Option to purchase Common Stock which is granted under the Plan with the intention that it qualify as an "incentive stock option" as that term is defined under Code Section 422.

2.21 Incumbent Board. Incumbent Board shall have the meaning specified in Section 7.2(d).

2.22 Indemnified Person. Indemnified Person shall have the meaning specified in Section 5.4(a).

2.23 Involuntary Termination. Involuntary Termination shall mean termination of a Participant's employment or service by the Company or a Subsidiary without Cause or by the Participant for Good Reason. For avoidance of doubt, an Involuntary Termination shall not include a termination of the Participant's employment or service by the Company or a Subsidiary for Cause or due to the Participant's death, Disability, or voluntary resignation other than for Good Reason.

2.24 Non-Qualified Stock Option. Non-Qualified Stock Option shall mean an Option to purchase Common Stock which is granted under the Plan and that is not an Incentive Stock Option.

2.25 Option. Option shall mean a Non-Qualified Stock Option or an Incentive Stock Option granted pursuant to Section 6.2.

- 2.26 Original Effective Date.** Original Effective Date shall have the meaning specified in Section 1.2.
- 2.27 Original Plan.** Original Plan shall have the meaning assigned to such term in the Preamble hereof.
- 2.28 Over 10% Owner.** Over 10% Owner shall mean an individual who, at the time an Incentive Stock Option is granted to such individual, owns Common Stock possessing more than ten percent (10%) of the total combined voting power of the Company or one of its Subsidiaries, determined by applying the attribution rules of Code Section 424(d).
- 2.29 Participant.** Participant shall mean an Employee or Director who has been granted an Award.
- 2.30 Performance Stock Award.** Performance Stock Award shall mean an Award as described in Section 6.4(c).
- 2.31 Performance Stock Unit Award.** Performance Stock Unit Award shall mean an Award as described in Section 6.5(b).
- 2.32 Plan.** Plan shall have the meaning assigned to such term in the Preamble hereof.
- 2.33 Plan Year.** Plan Year shall mean the calendar year.
- 2.34 Prior Plans.** Prior Plans shall have the meaning specified in Section 1.3.
- 2.35 Replaced Award.** Replaced Award shall have the meaning specified in Section 7.1(a).
- 2.36 Replacement Award.** Replacement Award shall have the meaning specified in Section 7.1(a).
- 2.37 Reporting Person.** Reporting Person shall mean an officer or director of the Company or a Subsidiary subject to the reporting requirements of Section 16 of the Exchange Act.
- 2.38 Restricted Period.** Restricted Period shall mean the period of time during which Restricted Stock Awards granted pursuant to Section 6.4 or Restricted Stock Unit Awards granted pursuant to Section 6.5 are subject to restrictions.
- 2.39 Restricted Stock Award.** Restricted Stock Award shall mean an Award of Common Stock subject to restrictions determined by the Committee as described in Section 6.4.
- 2.40 Restricted Stock Unit Award.** Restricted Stock Unit Award shall mean an Award as described in Section 6.5.
- 2.41 Stock Appreciation Right.** Stock Appreciation Right shall mean an Award of a stock appreciation right as described in Section 6.3.
- 2.42 Strike Price.** Strike Price shall mean the measuring price per share of Common Stock for a Stock Appreciation Right used to determine the payment of such Stock Appreciation Right.
- 2.43 Subsidiary.** Subsidiary shall mean any corporation or other entity, whether domestic or foreign, in which the Company has or obtains, directly or indirectly, a proprietary interest of more than fifty percent (50%) by reason of stock ownership or otherwise.

2.44 Termination of Employment. Termination of Employment shall mean the termination of the employment or other service relationship between a Participant and the Company and its Subsidiaries, regardless of whether severance or similar payments are made to the Participant, for any reason, including, but not by way of limitation, a termination by resignation, discharge, death, Disability, or retirement, as determined by the Committee pursuant to Section 6.1(i)(3).

ARTICLE III **ELIGIBILITY AND PARTICIPATION**

3.1 Eligibility. Subject to the limitation on eligibility for Awards of Incentive Stock Options set forth in Section 6.2(g), any Employee or Director of the Company or a Subsidiary, who is selected by the Committee is eligible to receive an Award under the Plan.

3.2 Participation. Unless otherwise determined by the Committee, as a condition precedent to participation in the Plan, each Employee or Director selected to receive an Award shall enter into an Award Agreement with the Company, agreeing to the terms and conditions of the Plan and the Award granted.

ARTICLE IV **STOCK SUBJECT TO PLAN**

4.1 Types of Shares. The shares of Common Stock subject to the provisions of the Plan shall either be shares of authorized but unissued Common Stock, shares of Common Stock held as treasury stock or previously issued shares of Common Stock reacquired by the Company, including shares purchased on the open market.

4.2 Aggregate Limit. Subject to adjustment in accordance with Section 9.1, the maximum number of shares of Common Stock reserved exclusively for issuance upon an award of or exercise or payment pursuant to Awards under the Plan shall be the sum of the following: (a) 734,000 shares of Common Stock; (b) the number of shares remaining available for issuance under the Prior Plans on the Original Effective Date; and (c) any shares of Common Stock that are subject to outstanding awards under the Prior Plans on the Original Effective Date that are subsequently canceled, expired, forfeited, or otherwise not issued or are settled in cash. All or any of this maximum number of shares of Common Stock reserved under the Plan may be issued pursuant to Awards of Incentive Stock Options or pursuant to any one or more other Awards.

4.3 Calculation of Shares.

(a) **Share Counting.** For purposes of calculating the total number of shares of Common Stock available for grants of Awards hereunder, the following shall apply:

(1) The number of shares of Common Stock available for grants of Awards hereunder shall be reduced by the number of shares for which Awards are actually granted under the Plan or the Original Plan; and

(2) The grant of a Performance Stock Award or Performance Stock Unit Award shall be deemed to be equal to the maximum number of shares of Common Stock which may be issued under such Award.

(b) Shares Added Back. If less than the maximum number of shares of Common Stock which may be issued under a Performance Stock Award or Performance Stock Unit Award are earned and issued, only the number of shares of Common Stock actually issued shall count against the above limit, and the excess of the maximum over the actual number of shares of Common Stock issued shall again become available for grants under the Plan. Further, if any Award under the Plan or the Original Plan shall expire, terminate, be canceled (including cancellation upon the Participant's exercise of a related Award), or is unsettled for any reason without having been exercised in full, or if any Award shall be forfeited to the Company, the unexercised, unsettled, or forfeited Award, shall not count against the aggregate limitations under Section 4.2 and shall again become available for grants under the Plan.

(c) Shares NOT Added Back. Shares of Common Stock equal in number to the shares tendered or withheld in payment of an Option Exercise Price or in settlement of any other Award, and shares of Common Stock that are tendered or withheld in order to satisfy any federal, state, or local tax liability, shall count against the aggregate limitations in Section 4.2 and shall not become available again for grants under the Plan. Provided further, the full number of shares of Common Stock subject to a Stock Appreciation Right shall count against the above limit, and any shares that were estimated to be used for such purposes and were not in fact so used shall not become available again for grants under the Plan.

(d) Cash Settlement. Cash settlements of Awards will not count against the above limits.

4.4 Participant Limits.

(a) Employee Limits. Subject to adjustment in accordance with Section 9.1, the total number of shares of Common Stock for which Awards may be granted in any Plan Year to any Employee shall not exceed fifty thousand (50,000) shares of Common Stock.

(b) Director Limits. The aggregate grant date fair value of Awards granted in any Plan Year to any Director shall not exceed one hundred thousand dollars (\$100,000); provided, however, such limit shall not apply to Awards granted to Directors pursuant to Section 6.6 in lieu of cash-based director fees that the Director elects to receive in the form of shares of Common Stock equal in value to the cash-based director fees that the Director would otherwise have received. The maximum amount that may be paid in any calendar year to any Director in property other than shares of Common Stock (including cash and Awards granted to Directors pursuant to Section 6.6 in lieu of cash-based director fees that the Director elects to receive in the form of shares of Common Stock equal in value to the cash-based director fees that the Director would otherwise have received) in respect of services as a Director shall not exceed \$200,000.

ARTICLE V **ADMINISTRATION**

5.1 Action of the Committee. The Plan shall be administered by the Committee. In administering the Plan, the Committee's actions, determinations, and interpretations made in good faith shall not be subject to review and shall be final, binding, and conclusive on all interested parties.

5.2 Duties and Powers of the Committee. The Committee shall have the power to grant Awards in accordance with the provisions of the Plan and may grant Awards singly, in combination, or in tandem. Subject to the provisions of the Plan, including the prohibition against repricing set forth in Section 8.3, the Committee shall have the discretion and authority to determine: (a) the Employees and Directors to whom Awards will be granted; (b) the number of shares of Common Stock subject to each Award; (c) the terms and conditions of each Award, including, without limitation, the applicable vesting schedule and forfeiture provisions of the Award, Exercise Price, Strike Price, performance goals, performance periods; Restriction Periods and exercise periods; and (d) such other matters applicable to an Award as are permissible under the Plan. Except as otherwise required by the Plan, the Committee shall have the authority to interpret and construe the provisions of the Plan and the Award Agreements, and to make determinations pursuant to any Plan provision or Award Agreement which shall be final and binding on all persons.

5.3 Delegation. The Committee may designate and authorize individual officers or employees of the Company or a Subsidiary who are not members of the Committee to carry out its responsibilities hereunder under such conditions or limitations as the Committee may set, other than its authority and responsibility with regard to Awards granted to a Reporting Person. References in the Plan to Committee shall include the individuals to whom the Committee has delegated to the extent of the authority so delegated.

5.4 No Liability; Indemnification.

(a) No Director, member of the Committee, or officer or employee to whom any duty or power relating to the administration or interpretation of the Plan has been delegated (each, an “Indemnified Person”), shall be liable to any person for any act or determination made in good faith with respect to the Plan or any Award.

(b) Each Indemnified Person shall be indemnified and held harmless by the Company against and from any loss, cost, liability, or expense that may be imposed upon or reasonably incurred by such Indemnified Person in connection with or resulting from any claim, action, suit or proceeding to which the Indemnified Person may be a party or in which the Indemnified Person may be involved by reason of any action taken or failure to act under the Plan and against and from any and all amounts paid by the Indemnified Person in settlement thereof, with the Company’s approval, or paid by the Indemnified Person in satisfaction of any judgment in any such action, suit, or proceeding against him or her, provided the Indemnified Person shall give the Company an opportunity, at its own expense, to handle, and defend the same before the Indemnified Person undertakes to handle and defend it on his or her own behalf. The foregoing right of indemnification shall not be exclusive of any other rights of indemnification to which such Indemnified Persons may be entitled under the Company’s Certificate of Incorporation or policies, as a matter of law, or otherwise, or any power that the Company may have to indemnify them or hold them harmless.

ARTICLE VI
AWARDS UNDER THE PLAN

6.1 Terms and Conditions of All Awards.

(a) Shares Subject to Grant. The number of shares of Common Stock as to which an Award may be granted will be determined by the Committee in its sole discretion, subject to the Participant limits in Section 4.4.

(b) Award Agreement. Each Award Agreement is subject to the terms of the Plan and any provisions contained in the Award Agreement that are inconsistent with the Plan shall be superseded by the terms of the Plan.

(c) Date of Grant. The date as of which an Award is granted will be the date on which the Committee has approved the terms and conditions of the Award and has determined the recipient of the Award and the number of shares of Common Stock or amount of cash covered by the Award, and has taken all such other actions necessary to complete the grant of the Award.

(d) Transfer and Exercise. Awards are not transferable or assignable except by will or by the laws of descent and distribution and are exercisable, during a Participant's lifetime, only by the Participant, or in the event of the Disability of the Participant, by the Participant or the legal representative of the Participant, or in the event of the death of the Participant, by the legal representative of the Participant's estate, or if no legal representative has been appointed, by the successor in interest determined under the Participant's will. Any transfer or attempted transfer of an Award by a Participant not made in accordance with the Plan and the applicable Award Agreement will be void and of no effect, and the Company will not recognize, or have the duty to recognize, any transfer not made in accordance with the Plan and the applicable Award Agreement, and an Award attempted to be transferred will continue to be bound by the Plan and the applicable Award Agreement.

(e) Payment. Awards for which any payment is due from a Participant including, without limitation, the Exercise Price of an Option or the tax withholding required with respect to an Award pursuant to Section 6.1(g), may be made in any form or manner authorized by the Committee in the Award Agreement or by amendment thereto, including, but not limited to:

(i) U.S. dollars by personal check, bank draft, or money order payable to the Company, by money transfer or direct account debits;

(ii) Delivery to the Company of a number of shares of Common Stock having an aggregate fair market value of not less than the aggregate Exercise Price or minimum tax withholding required for the Award;

(iii) Involvement of a stockbroker in accordance with the federal margin rules set forth in Regulation T;

(iv) A cashless exercise if and to the extent permissible by applicable law; or

(v) Any combination of the above forms and methods.

(f) Dividend Equivalents. If the Committee so determines and provides in an Award Agreement, Participants may be credited with any dividends paid with respect to the shares of Common Stock underlying an Award (other than an Option or Stock Appreciation Right) in a manner determined by the Committee in its sole discretion; provided, however, any dividend equivalents on an Award shall accrue and be paid only if and to the extent the shares of Common Stock underlying the Award become vested or payable. The Committee may apply any other restrictions to such dividend equivalents that the Committee deems appropriate. The Committee, in its sole discretion, may determine the form of payment of dividend equivalents, including cash or shares of Common Stock..

(g) Withholding. The Company shall deduct from all cash payments under the Plan the amount of any federal, state, or local taxes required to be withheld. Whenever the Company proposes or is required to issue or transfer shares of Common Stock under the Plan, or upon the vesting of any Restricted Stock Award, the Company has the right to require the recipient to remit to the Company an amount sufficient to satisfy the amount of any federal, state, or local taxes required to be withheld as a condition of and prior to the delivery or release of such shares.

(h) Deferred Compensation. Notwithstanding the Committee's discretion to determine the terms and conditions of Awards under the Plan, the Committee may require or permit the deferral of the receipt of Awards (other than an Option or Stock Appreciation Right) upon such terms as the Committee deems appropriate and in accordance with the requirements of Code Section 409A.

(i) Treatment of Awards upon Termination of Employment.

(1) All Awards granted under the Plan, including all unexercised Options whether vested or non-vested, shall immediately be forfeited and may not thereafter vest or be exercised in the event a Participant incurs a Termination of Employment for Cause.

(2) Except as otherwise provided by Section 6.1(i)(1), any Award under the Plan to a Participant who has experienced a Termination of Employment or termination of some other service relationship with the Company and its Subsidiaries may be cancelled, accelerated, paid or continued, as provided in the applicable Award Agreement or as the Committee may otherwise determine to the extent not prohibited by or inconsistent with the provisions of the Plan (including Section 6.1(j)), taking into consideration such other factors as the Committee determines are relevant to its decision whether to continue an Award.

(3) Subject to Section 6.1(i)(1), the Committee will, in its absolute discretion, determine the effect of all matters and questions relating to a Termination of Employment as it affects an Award, including, but not by way of limitation, the question of whether a leave of absence constitutes a Termination of Employment.

(j) Exclusion from Minimum Vesting Requirements. Awards granted under Section 6.2, Section 6.3, Section 6.4, Section 6.5 and Section 6.7 shall be subject to the minimum vesting period and continued employment or provision of service requirement specified for the Award by such Section, as applicable, except that:

(1) Up to a maximum of five percent (5%) of the maximum number of shares of Common Stock that may be issued under the Plan pursuant to Section 4.2 may be issued pursuant to Awards granted under Section 6.2, Section 6.3, Section 6.4, Section 6.5 and Section 6.7 without regard for any minimum vesting period or continued employment or provision of service requirements set forth in such Sections;

(2) Continued employment or provision of service for exercisability or vesting shall not be required (i) as the Committee may determine or permit otherwise in connection with the occurrence of a retirement, death, or Disability of a Participant, or in the event of a Change in Control subject to the limitations set forth in Section 7.1; and

(3) Awards granted to Directors pursuant to Section 6.6 in lieu of cash-based director fees that the Director elects to receive in the form of shares of Common Stock equal in value to the cash-based director fees that the Director would otherwise have received shall not be subject to any minimum vesting period or continued provision of service requirement.

6.2 Options. At the time any Option is granted, the Committee will determine whether the Option is to be an Incentive Stock Option or a Non-Qualified Stock Option. Each Incentive Stock Option granted under the Plan shall be clearly identified as to its status as an Incentive Stock Option and the applicable Award Agreement shall reflect such status. Subject to the special conditions applicable to Incentive Stock Options set forth in Section 6.2(g) and the special conditions applicable to substitute Options set forth in Section 6.2(f), Options awarded under the Plan shall be subject to the following terms and conditions:

(a) Exercise Price. Subject to adjustment in accordance with Section 9.1, the Exercise Price per share of Common Stock purchasable under any Option shall be determined by the Committee in its sole discretion and set forth in the applicable Award Agreement; provided, however, the Exercise Price may not be less than the Fair Market Value of the Common Stock subject to the Option on the date the Option is granted.

(b) Option Term. The exercise period for each Option granted under the Plan shall be determined by the Committee in its sole discretion and set forth in the applicable Award Agreement.

(c) Conditions to Exercise. Each Option granted under the Plan shall vest over a period based upon the passage of time or upon the achievement of performance goals (or a combination of both), as determined by the Committee; provided, however, except as otherwise permitted by Section 6.1(j), Options shall not vest for at least one year after the date of grant. The Committee may impose such conditions and restrictions on the exercise of an Option as it may deem appropriate. Each Option granted under the Plan shall be exercisable at such time or times, or upon the occurrence of such event or events, and for such number of shares of Common Stock as determined by the Committee in its sole discretion and set forth in the applicable Award Agreement.

(d) Exercise of Option. An Option shall be exercised by (i) delivery to the Company of a written notice of exercise (on the form or in the manner specified by the Company for such notice) with respect to all or a specified number of shares of Common Stock subject to the Option, and (ii) payment to the Company of the full amount of the Exercise Price in a manner permissible under Section 6.1(e) and the applicable Award Agreement.

(e) No Rights as a Stockholder. The holder of an Option, as such, shall have none of the rights of a stockholder of the Company with respect to the shares of Common Stock underlying such Option until such time as the Option vests, is exercised and the shares of Common Stock are issued to the holder of the Option.

(f) Special Provisions for Substitute Options. Notwithstanding anything to the contrary in this Section 6.2, any Option issued in substitution for an option previously issued by another entity, which substitution occurs in connection with a corporate transaction, may provide for an Exercise Price and may contain such other terms and conditions as the Committee may prescribe to cause such substitute Option to contain as nearly as possible the same terms and conditions (including the applicable vesting and termination provisions) as those contained in the previously issued option being replaced thereby; provided, however, the number of shares of Common Stock and the Exercise Price of any Option issued in substitution for an option previously issued by another entity shall be determined in accordance with the requirements of Code Section 409A.

(g) Special Conditions for Incentive Stock Options. Notwithstanding anything to the contrary in Section 6.1 or this Section 6.2, Incentive Stock Options shall be subject to the following terms and conditions:

(i) Incentive Stock Options may only be granted to Employees of the Company or of a Subsidiary that qualifies as a “subsidiary corporation” within the meaning given such term by Code Section 424.

(ii) The aggregate Fair Market Value (determined as of the date an Incentive Stock Option is granted) of the shares of Common Stock with respect to which Options intended to meet the requirements of Code Section 422 become exercisable for the first time by an Employee during any calendar year (under all plans of the Company and its Subsidiaries) may not exceed one hundred thousand dollars (\$100,000); provided, however, if such limitation is exceeded, the portion of such Incentive Stock Option(s) which cause the limitation to be exceeded will be treated as Non-Qualified Stock Option(s).

(iii) No Incentive Stock Option may be granted after ten (10) years from the date that the Plan is approved by the Company’s stockholders.

(iv) With respect to each grant of an Incentive Stock Option to a Participant who is an Over 10% Owner, the Exercise Price may not be less than one hundred ten percent (110%) of the Fair Market Value of the Common Stock subject to the Incentive Stock Option on the date the Incentive Stock Option is granted.

(v) The exercise period for an Incentive Stock Option must be no longer than ten (10) years from the date that the Incentive Stock Option is granted, or in the case of an Incentive Stock Option granted to an Over 10% Owner, the exercise period may be no longer than five (5) years after the date that the Incentive Stock Option is granted.

(vi) For an Incentive Stock Option issued in substitution for an incentive stock option previously issued by another entity, which substitution occurs in connection with a transaction to which Code Section 424(a) is applicable, both the number of shares of Common Stock and the Exercise Price of the substitute Incentive Stock Option shall be computed in accordance with Code Section 424.

(vii) Incentive Stock Options granted under the Plan are intended to comply with Code Section 422, and the provisions of the Plan and the Award Agreements for any Incentive Stock Options granted under the Plan shall be construed in such manner as to effectuate that intent.

6.3 Stock Appreciation Rights. A Stock Appreciation Right shall entitle the Participant to receive at the time of payment or exercise, for a specified or determinable number of shares of the Common Stock, an amount equal to a percentage (not to exceed 100%) of the excess of Fair Market Value of a share of Common Stock over the applicable Strike Price per share of Common Stock. Each Stock Appreciation Right shall be subject to the following terms and conditions:

(a) Strike Price. Subject to adjustment in accordance with Section 9.1, the Strike Price per share of Common Stock under any Stock Appreciation Right shall be determined by the Committee in its sole discretion and set forth in the applicable Award Agreement; provided, however, the Strike Price may not be less than the Fair Market Value of the Common Stock subject to the Stock Appreciation Right on the date the Stock Appreciation Right is granted.

(b) Conditions to Exercise. Each Stock Appreciation Right granted under the Plan shall vest over a period based upon the passage of time or upon the achievement of performance goals (or a combination of both), as determined by the Committee; provided, however, except as otherwise permitted by Section 6.1(j), Stock Appreciation Rights shall not vest for at least one year after the date of grant. The Committee may impose such conditions and restrictions on the exercise of a Stock Appreciation Right as it may deem appropriate. Each Stock Appreciation Right granted under the Plan shall be exercisable or payable at such time or times, or upon the occurrence of such event or events, and in such amounts as determined by the Committee in its sole discretion, and set forth in the applicable Award Agreement.

(c) No Rights as a Stockholder. The holder of a Stock Appreciation Right, as such, shall have none of the rights of a stockholder of the Company with respect to the shares of Common Stock underlying such Stock Appreciation Right until such time as the Stock Appreciation Right vests, is exercised, or paid and the shares of Common Stock are issued to the holder of the Stock Appreciation Right.

(d) Settlement. Upon settlement of a Stock Appreciation Right, the Company shall pay to the Participant the appreciation in cash, shares of Common Stock (valued at the aggregate fair market value), or a combination thereof, as provided in the Award Agreement or, in the absence of such provision, as the Committee may determine.

6.4 Restricted Stock Awards. Each Restricted Stock Award shall be made in such number of shares of Common Stock, upon such terms and conditions on such shares, for such Restricted Period and with such dividend or voting rights during the Restricted Period as determined by the Committee in its sole discretion and set forth in the applicable Award Agreement. Restricted Stock Awards shall be subject to the following terms and conditions:

(a) Consideration. The Committee may require a payment from the Participant in exchange for the grant of a Restricted Stock Award or may grant a Restricted Stock Award without any consideration from the Participant other than his service to or on behalf of the Company or its Subsidiaries.

(b) Shares. A Restricted Stock Award granted pursuant to the Plan may be evidenced by book entry or in such manner as the Committee shall determine, and the Committee may take any action it deems necessary or advisable to reflect that the shares of Common Stock that are part of the Restricted Stock Award are subject to its applicable terms, conditions, and restrictions applicable, until the restrictions thereon shall have lapsed.

(c) Vesting. Each Restricted Stock Award shall vest over a Restricted Period based upon the passage of time or upon the achievement of performance goals (or a combination of both), as determined by the Committee; provided, however, except as otherwise permitted by Section 6.1(j), Restricted Stock Awards shall not vest for at least one year after the date of grant. Restricted Stock Awards subject to performance goals may be designated as Performance Stock Awards. A Restricted Stock Award may also, in the Committee's discretion, provide for earlier termination of the Restricted Period in the event of the retirement, death, or Disability of the Participant, or in the event of a Change in Control.

(d) Rights as Stockholder. Unless otherwise determined by the Committee and set forth in the applicable Award Agreement, a grant of a Restricted Stock Award shall immediately entitle the Participant to voting and dividend rights with respect to the shares of Common Stock subject to the Award; provided, however, the dividends and other distributions on the shares of Common Stock subject to the Award shall in all cases either (i) be deferred and payment thereof contingent on the vesting of the shares of Common Stock with respect to which such dividends and other distributions are paid, or (ii) be credited with additional number of shares of Restricted Stock determined using the amount of dividends that would have been paid on the number of shares of Common Stock underlying the Award and the fair market value of a share of Common Stock on the applicable dividend payment date, in each case subject to the same vesting and forfeiture restrictions that apply to the shares of Common Stock subject to the Award with respect to which such dividends and other distributions are paid.

6.5 Restricted Stock Unit Awards. Restricted Stock Unit Awards shall entitle the Participant to receive, at a specified future date or event, payment of a specified number of shares of Common Stock or an amount equal to all or a portion of the fair market value of a specified number of shares of Common Stock at the end of the applicable Restricted Period. Each Restricted Stock Unit Award shall be made in such number of shares of Common Stock, upon such terms and conditions, for such Restricted Period and with such dividend equivalent rights during the Restricted Period as determined by the Committee in its sole discretion and set forth in the applicable Award Agreement. Restricted Stock Unit Awards shall be subject to the following terms and conditions:

(a) Consideration. The Committee may require a payment from the Participant in consideration of a payment of a Restricted Stock Unit Award or may grant a Restricted Stock Unit Award without any consideration from the Participant other than his service to or on behalf of the Company or its Subsidiaries.

(b) Vesting. Each Restricted Stock Unit Award shall vest over a Restricted Period based upon the passage of time or upon the achievement of performance goals (or a combination of both), as determined by the Committee provided, however, except as otherwise permitted by Section 6.1(j), Restricted Stock Units shall not vest for at least one year after the date of grant. Restricted Stock Unit Awards subject to performance goals may be designated as Performance Stock Unit Awards. A Restricted Stock Unit Award may also, in the Committee's discretion, provide for earlier termination of the Restricted Period in the event of the retirement, death, or Disability of the Participant, or in the event of a Change in Control.

(c) No Rights as a Stockholder. The holder of a Restricted Stock Unit Award, as such, shall have none of the rights of a stockholder of the Company with respect to the shares of Common Stock underlying such Restricted Stock Unit Award until such time as the Restricted Stock Unit Award vests, is paid and the shares of Common Stock are issued to the holder of the Restricted Stock Unit Award.

(d) Settlement. A Restricted Stock Unit Award may be settled by the delivery of shares of Common Stock, their cash equivalent fair market value, any combination thereof or in any other form of consideration, as determined by the Committee and set forth in the applicable Award Agreement.

6.6 Director Awards. Subject to the limitations in Section 4.4(b), in addition to the ability of Directors to receive Options, Stock Appreciation Rights, Restricted Stock Awards, Restricted Stock Unit Awards, or other Awards under this Article VI, Directors may also (a) receive Awards of outright shares of Common Stock, subject to the limitations set forth in Section 6.1(j), and (b) be permitted to elect to receive, pursuant to procedures established by the Committee, Awards of outright shares of Common Stock in lieu of cash-based director fees that the Director elects to receive in the form of shares of Common Stock with a fair market value equal to the cash-based director fees that the Director would otherwise have received.

6.7 Other Awards. Subject to applicable law and the limits set forth in Article IV, the Committee may grant to any Participant such other Awards that may be denominated or payable in, valued in whole or in part by reference to, or otherwise based on, or related to, shares of Common Stock or factors that may influence the value of such shares, including, without limitation, convertible or exchangeable debt securities, other rights convertible or exchangeable into shares of Common Stock, purchase rights for shares of Common Stock, Awards with value and payment contingent upon performance of the Company or specified Subsidiaries, affiliates or other business units thereof or any other factors designated by the Committee, and Awards valued by reference to the book value of shares of Common Stock or the value of securities of, or the performance of specified Subsidiaries or affiliates or other business units of the Company. The Committee will determine the terms and conditions of such Awards. Except as otherwise permitted by Section 6.1(j), such Awards shall not vest for at least one year after the date of grant. Shares of Common Stock delivered pursuant to an Award in the nature of a purchase right granted under this Section will be purchased for such consideration, paid for at such time, by such methods, and in such forms, including, without limitation shares of Common Stock, notes or other property, as the Committee determines.

ARTICLE VII

CHANGE IN CONTROL

7.1 Effect of a Change in Control. In the event of a Change in Control, the following acceleration, exercisability, and valuation provisions will apply:

(a) Upon a Change in Control, each then-outstanding Option and Stock Appreciation Right will become fully vested and exercisable, and the restrictions applicable to each outstanding Restricted Stock Award, Restricted Stock Unit or Other Award will lapse, and each Award will be fully vested (with any applicable performance goals deemed to have been achieved at a target level as of the date of such vesting), except to the extent that an Award meeting the requirements of Section 7.1(b) (a “Replacement Award”) is provided to the Participant holding such Award in accordance with Section 7.1(b) to replace or adjust such outstanding Award (a “Replaced Award”);

(b) An Award meets the conditions of this Section 7.1(b) (and hence qualifies as a Replacement Award) if (i) it is of the same type (e.g., stock option for Option, restricted stock award for Restricted Stock Award, restricted stock unit award for Restricted Stock Unit Award, etc.) as the Replaced Award, (ii) it has a value at least equal to the value of the Replaced Award, (iii) it relates to publicly traded equity securities of the Company or its successor in the Change in Control or another entity that is affiliated with the Company or its successor following the Change in Control, (iv) the federal tax consequences to the Participant holding the Replaced Award of the Replacement Award are not less favorable to such Participant than the federal tax consequences of the Replaced Award, and (v) its other terms and conditions are not less favorable to the Participant holding the Replaced Award than the terms and conditions of the Replaced Award (including, but not limited to, the provisions that would apply in the event of a subsequent Change in Control). Without limiting the generality of the foregoing, the Replacement Award may take the form of a continuation of the Replaced Award if the requirements of the preceding sentence are satisfied; and

(c) Except as otherwise provided in an executive, employment, severance, or similar agreement, if any, between the Participant and the Company or a Subsidiary, upon the Involuntary Termination, during the period of two (2) years immediately following a Change in Control, of a Participant holding Replacement Awards, (i) all Replacement Awards held by the Participant will become fully vested and, if applicable, exercisable and free of restrictions (with any applicable performance goals deemed to have been achieved at a target level as of the date of such vesting), and (ii) all Options and Stock Appreciation Rights held by the Participant immediately before such Involuntary Termination that the Participant also held as of the date of the Change in Control and all stock options and stock appreciation rights that constitute Replacement Awards will remain exercisable for a period of ninety (90) days following such Involuntary Termination or until the expiration of the stated term of such stock option or stock appreciation right, whichever period is shorter (provided, however, if the applicable Award Agreement provides for a longer period of exercisability, that provision will control).

7.2 Definition. For purposes of the Plan, a “Change in Control” of the Company shall be deemed to have occurred upon the happening of any of the following events:

(a) There shall be consummated (i) any consolidation or merger of the Company in which the Company is not the continuing or surviving corporation or pursuant to which any shares of the Company’s common stock are to be converted into cash, securities or other property, provided that the consolidation or merger is not with a corporation which was a wholly owned subsidiary of the Company immediately before the consolidation or merger, or (ii) any sale, lease, exchange, or other transfer (in one transaction or a series of related transactions) of all, or substantially all, of the assets of the Company;

(b) For Awards granted prior to June 16, 2021, the stockholders of the Company approve any plan or proposal for the liquidation or dissolution of the Company, and for Awards granted on or after June 16, 2021, the liquidation or dissolution of the Company;

(c) Any person (as such term is used in Sections 13(d) and 14(d) of the Exchange Act) shall become the beneficial owner (within the meaning of Rule 13d-3 under the Exchange Act), directly or indirectly, of twenty percent (20%) or more of the Company’s then-outstanding common stock, provided that such person shall not be a wholly-owned subsidiary of the Company immediately before it becomes such twenty percent (20%) beneficial owner; or

(d) Individuals who constitute the Board on the date hereof (the “Incumbent Board”) cease for any reason to constitute at least a majority thereof within any twelve (12) month period, provided that any person becoming a director subsequent to the date hereof whose election, or nomination for election by the Company’s stockholders, was approved by a vote of at least three quarters of the Directors comprising the Incumbent Board (either by a specific vote or by approval of the proxy statement of the Company in which such person is named as a nominee for director, without objection to such nomination) shall be, for purposes of this clause (d), considered as though such person were a member of the Incumbent Board.

ARTICLE VIII
TERMINATION AND AMENDMENT

8.1 Termination and Amendment of Plan.

(a) Subject to the limitations of Section 8.3, the Board may amend or terminate the Plan at any time; provided, however, the Board shall obtain stockholder approval for any amendment to the Plan that increases the number of shares of Common Stock available under the Plan, materially expands the classes of individuals eligible to receive Awards, materially expands the type of awards available for issuance under the Plan, or would otherwise require stockholder approval under the Code or other applicable laws, or the Nasdaq Stock Market listing standards.

(b) Notwithstanding Section 8.1(a), without the consent of the holder of an Award, no such termination or amendment of the Plan may adversely affect the then value of the Award or the rights of the holder of such Award, and with respect to any Award which provides for the deferral of compensation subject to the provisions of Code Section 409A, no termination or amendment of the Plan shall have the effect of accelerating the payment of such Award if and to the extent that such accelerated payment would violate Code Section 409A.

8.2 Amendment of Award Agreements. Subject to the limitations of Section 8.3, the Board or the Committee may amend an Award Agreement at any time, in their sole discretion; provided, however, without the consent of the holder of an Award, no such amendment of an Award Agreement may adversely affect the then value of the Award or the rights of the holder of such Award, and with respect to any Award which provides for the deferral of compensation subject to the provisions of Code Section 409A, no amendment of the Award Agreement shall have the effect of accelerating the payment of such Award if and to the extent that such accelerated payment would violate Code Section 409A.

8.3 No Repricing. Except as provided by Section 9.1, without the approval of the Company's stockholders, the Exercise Price of an Option or the Strike Price of a Stock Appreciation Right may not be amended or modified after the grant of the Option or Stock Appreciation Right, and an Option or Stock Appreciation Right may not be surrendered or cancelled in consideration of, or in exchange for, cash, other Awards, or the grant of a new Option or Stock Appreciation Right having an Exercise Price or Strike Price below that of the Option or Stock Appreciation Right that was surrendered or cancelled, and without the approval of the Company's stockholders, neither the Board nor the Committee may take any other action with respect to an Option or Stock Appreciation Right that would be treated as a repricing under the rules and regulations of the principal securities exchange on which the shares of Common Stock are traded.

ARTICLE IX
GENERAL PROVISIONS

9.1 Changes in Capitalization; Merger; Liquidation.

(a) The aggregate number of shares of Common Stock reserved for the grant of Awards, for issuance upon the exercise or payment, as applicable, of each outstanding Award and upon vesting of an Award; the annual limit per Participant; the Exercise Price of each outstanding Option; the Strike Price of each outstanding Stock Appreciation Right and the specified number of shares of Common Stock to which each outstanding Award pertains shall be proportionately adjusted for any increase or decrease in the number of issued shares of Common Stock resulting from a stock split, stock dividend, combination or exchange of shares, exchange for other securities, reclassification, reorganization, recapitalization, or any other increase or decrease in the number of outstanding shares of Common Stock effected without consideration to the Company.

(b) In the event of a merger, consolidation, reorganization, extraordinary dividend, spin-off, sale of substantially all of the Company's assets, other change in capital structure of the Company, or tender offer for shares of Common Stock, the Committee may make such adjustments with respect to awards and take such other action as it deems necessary or appropriate, including, without limitation, the substitution of new Awards, or the adjustment of outstanding Awards, the acceleration of Awards, the removal of restrictions on outstanding Awards, or the termination of outstanding Awards in exchange for the cash value determined in good faith by the Committee of the vested or unvested portion of the Award, all as may be provided in the applicable Award Agreement or, if not expressly addressed therein, as the Committee subsequently may determine in its sole discretion. Any adjustment pursuant to this Section may provide, in the Committee's discretion, for the elimination without payment therefor of any fractional shares that might otherwise become subject to any Award, but, except as set forth in this Section, may not otherwise diminish the then value of the Award.

(c) The existence of the Plan and the Awards granted pursuant to the Plan shall not affect in any way the right or power of the Company or a Subsidiary to make or authorize any adjustment, reclassification, reorganization or other change in its capital or business structure, any merger or consolidation of the Company or a Subsidiary, any issue of debt or equity securities having preferences or priorities as to the Common Stock or the rights thereof, the dissolution or liquidation of the Company or a Subsidiary, any sale or transfer of all or any part of its business or assets, or any other corporate act or proceeding.

9.2 Code Section 409A. Options, Stock Appreciation Rights, Restricted Stock Awards, and Director Awards granted under the Plan are intended to be exempt from Code Section 409A, and Restricted Stock Unit Awards, dividend equivalents, and all other Awards awarded under the Plan are intended to be exempt from or comply with Code Section 409A, and the Plan, Award Agreements and the terms of Awards shall be administered and interpreted consistent with such intention. In the event any provisions of the Plan or any Award Agreement are determined by the Committee potentially to violate Code Section 409A, such provisions shall be amended, as necessary, to be exempt from or comply with Section 409A; and until adoption of any such amendment, the provisions shall be construed and interpreted, to the extent possible, to be exempt from or comply with Section 409A. Notwithstanding the foregoing, the Company makes no representations that the payments and benefits provided under the Plan are exempt from or comply with Section 409A, and in no event will the Company be liable for all or any portion of any taxes, penalties, interest, or other expenses that may be incurred by a Participant on account of non-compliance with Section 409A.

9.3 Right to Terminate Employment or Service. Nothing in the Plan or in any Award Agreement confers upon any Participant the right to continue as an officer, employee, director, consultant or other service provider of the Company or any of its Subsidiaries or affects the right of the Company or any of its Subsidiaries to terminate a Participant's employment or services at any time.

9.4 Non-Alienation of Benefits. Except as otherwise expressly provided by the Plan, no Award or benefit under the Plan may be subject in any manner to anticipation, alienation, sale, transfer, assignment, pledge, attachment, encumbrance, or charge; and any attempt to do so shall be void. No such Award or benefit may, prior to receipt by the Participant, be in any manner liable for or subject to the debts, contracts, liabilities, engagements, or torts of the Participant.

9.5 Restrictions on Delivery and Sale of Shares; Legends. Each Award is subject to the condition that if at any time the Committee, in its discretion, shall determine that the listing, registration, or qualification of the shares of Common Stock covered by such Award upon any securities exchange or under any federal or state law is necessary or desirable as a condition of or in connection with the granting of such Award or the purchase or delivery of shares thereunder, the delivery of any or all shares of Common Stock pursuant to such Award may be withheld unless and until such listing, registration, or qualification shall have been effected. If a registration statement is not in effect under the Securities Act of 1933 or any applicable state securities laws with respect to the shares of Common Stock purchasable or otherwise deliverable under Awards then outstanding, the Committee may require, as a condition of exercise of any Option or as a condition to any other delivery of Common Stock pursuant to an Award, that the Participant or other recipient of an Award represent, in writing, that the shares received pursuant to the Award are being acquired for investment and not with a view to distribution and agree that the shares will not be disposed of except pursuant to an effective registration statement, unless the Company shall have received an opinion of counsel that such disposition is exempt from such requirement under the Securities Act of 1933 and any applicable state securities laws. The Company may include on certificates representing shares delivered pursuant to an Award such legends referring to the foregoing representations or restrictions or any other applicable restrictions on resale as the Company, in its discretion, shall deem appropriate.

9.6 FDIA Limitations. Any actions by the Company under the Plan or any Award Agreement must comply with the law, including regulations and other interpretive action, of the Federal Deposit Insurance Act, Federal Deposit Insurance Corporation, or other entities that supervise any of the activities of the Company. Specifically, any payments to the Participant by the Company, whether pursuant to the Plan, an Award Agreement, or otherwise, are subject to and conditioned upon their compliance with Section 18(k) of the Federal Deposit Insurance Act, 12. U.S.C. Section 1828(k), and the regulations promulgated thereunder in 12 C.F.R. Part 359.

9.7 Compensation Recovery Policy. Notwithstanding any provision of the Plan or an Award Agreement, the amount of any cash paid under an Award, any shares of Common Stock granted or issued under an Award, and any amount received with respect to any sale of any such shares of Common Stock, shall be subject to potential cancellation, recoupment, rescission, payback, or other action in accordance with the terms of the Company's compensation recovery policy, if any, or any similar policy that the Company may adopt from time to time, and the Committee shall include a provision in Award Agreements to give effect to such policy.

9.8 Listing and Legal Compliance. The Committee may suspend the exercise or payment of any Award so long as it determines that securities exchange listing or registration or qualification under any securities laws is required in connection therewith and has not been completed on terms acceptable to the Committee.

9.9 Choice of Law. The laws of the State of New York shall govern the Plan, to the extent not preempted by federal law, without reference to the principles of conflict of laws.

9.10 Plan Binding on Successors. The Plan shall be binding upon the successors and assigns of the Company.

9.11 Interpretation. Whenever used in the Plan, nouns in the singular shall include the plural and the plural shall include the singular, and the masculine pronoun shall include the feminine gender. Headings of Articles and Sections in the Plan are inserted for convenience and reference only, and they do not constitute part of the Plan.

* * * * *

**Certification of Principal Executive Officer
Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002**

I, Martin K. Birmingham, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Financial Institutions, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, 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;
 - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: August 9, 2021

/s/ Martin K. Birmingham

Martin K. Birmingham

President and Chief Executive Officer

**Certification of Principal Financial Officer
Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002**

I, W. Jack Plants II, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Financial Institutions, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, 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;
 - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: August 9, 2021

/s/ W. Jack Plants II

W. Jack Plants II
Chief Financial Officer

**Certification pursuant to
18 U.S.C. Section 1350,
as adopted pursuant to
Section 906 of the Sarbanes-Oxley Act of 2002**

Martin K. Birmingham, President and Chief Executive Officer, and W. Jack Plants II, Chief Financial Officer of Financial Institutions, Inc. (the “Company”), each certify in his capacity as an officer of the Company that he has reviewed the Quarterly Report of the Company on Form 10-Q for the period ended June 30, 2021 and that:

1. The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
2. The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: August 9, 2021

/s/ **Martin K. Birmingham**

Martin K. Birmingham
President and Chief Executive Officer
(Principal Executive Officer)

Date: August 9, 2021

/s/ **W. Jack Plants II**

W. Jack Plants
Chief Financial Officer
(Principal Financial Officer)

The purpose of this statement is solely to comply with Title 18, Chapter 63, Section 1350 of the United States Code, as amended by Section 906 of the Sarbanes-Oxley Act of 2002. A signed original of this written statement required by Section 906 has been provided to Financial Institutions, Inc. and will be retained by Financial Institutions, Inc. and furnished to the Securities and Exchange Commission or its staff upon request.