
**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 September 30, 2012

or

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

For the transition period from _____ to _____

Commission File Number: 000-26481



Financial Institutions, Inc.

(Exact name of registrant as specified in its charter)

NEW YORK
(State or other jurisdiction of
incorporation or organization)

16-0816610
(I.R.S. Employer
Identification No.)

220 LIBERTY STREET, WARSAW, NEW YORK
(Address of principal executive offices)

14569
(Zip Code)

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

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

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

Large accelerated filer ☐

Accelerated filer ☒

Non-accelerated filer ☐ (Do not check if a smaller company)

Smaller reporting company ☐

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

The registrant had 13,787,889 shares of Common Stock, \$0.01 par value, outstanding as of October 31, 2012.

Table of Contents

FINANCIAL INSTITUTIONS, INC.
Form 10-Q
For the Quarterly Period Ended September 30, 2012
TABLE OF CONTENTS

	<u>PAGE</u>
PART I. FINANCIAL INFORMATION	
ITEM 1. Financial Statements	
Consolidated Statements of Financial Condition—at September 30, 2012 (Unaudited) and December 31, 2011	3
Consolidated Statements of Income (Unaudited)—Three and nine months ended September 30, 2012 and 2011	4
Consolidated Statements of Comprehensive Income (Unaudited)—Three and nine months ended September 30, 2012 and 2011	5
Consolidated Statements of Changes in Shareholders' Equity (Unaudited)—Nine months ended September 30, 2012 and 2011	6
Consolidated Statements of Cash Flows (Unaudited)—Nine months ended September 30, 2012 and 2011	7
Notes to Consolidated Financial Statements (Unaudited)	8
ITEM 2. Management's Discussion and Analysis of Financial Condition and Results of Operations	29
ITEM 3. Quantitative and Qualitative Disclosures About Market Risk	47
ITEM 4. Controls and Procedures	47
PART II. OTHER INFORMATION	
ITEM 1. Legal Proceedings	48
ITEM 1A. Risk Factors	48
ITEM 6. Exhibits	49
Signatures	50

PART I. FINANCIAL INFORMATION

ITEM 1. Financial Statements

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

	September 30,	December 31,
	2012	2011
	(Unaudited)	
ASSETS		
Cash and cash equivalents:		
Cash and due from banks	\$ 76,951	\$ 57,489
Federal funds sold and interest-bearing deposits in other banks	94	94
Total cash and cash equivalents	77,045	57,583
Securities available for sale, at fair value	748,618	627,518
Securities held to maturity, at amortized cost (fair value of \$20,118 and \$23,964, respectively)	19,564	23,297
Loans held for sale	1,411	2,410
Loans (net of allowance for loan losses of \$24,301 and \$23,260, respectively)	1,634,684	1,461,516
Company owned life insurance	46,890	45,556
Premises and equipment, net	36,653	33,085
Goodwill and other intangible assets, net	50,924	37,369
Other assets	37,530	48,019
Total assets	<u>\$2,653,319</u>	<u>\$2,336,353</u>
LIABILITIES AND SHAREHOLDERS' EQUITY		
Deposits:		
Noninterest-bearing demand	\$ 490,706	\$ 393,421
Interest-bearing demand	472,023	362,555
Savings and money market	673,883	474,947
Time deposits	695,107	700,676
Total deposits	2,331,719	1,931,599
Short-term borrowings	38,282	150,698
Other liabilities	31,476	16,862
Total liabilities	<u>2,401,477</u>	<u>2,099,159</u>
Shareholders' equity:		
Series A 3% preferred stock, \$100 par value; 1,533 shares authorized, 1,499 and 1,500 shares issued, respectively	150	150
Series B-1 8.48% preferred stock, \$100 par value, 200,000 shares authorized, 173,210 and 173,235 shares issued, respectively	17,321	17,323
Total preferred equity	17,471	17,473
Common stock, \$0.01 par value, 50,000,000 shares authorized and 14,161,597 shares issued	142	142
Additional paid-in capital	67,562	67,247
Retained earnings	168,474	158,079
Accumulated other comprehensive income	5,161	945
Treasury stock, at cost – 376,308 and 358,481 shares, respectively	(6,968)	(6,692)
Total shareholders' equity	<u>251,842</u>	<u>237,194</u>
Total liabilities and shareholders' equity	<u>\$2,653,319</u>	<u>\$2,336,353</u>

See accompanying notes to the consolidated financial statements.

Table of Contents

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

(In thousands, except per share amounts)

	Three months ended September 30,		Nine months ended September 30,	
	2012	2011	2012	2011
Interest income:				
Interest and fees on loans	\$21,048	\$19,180	\$60,096	\$57,286
Interest and dividends on investment securities	4,251	4,594	12,384	13,957
Total interest income	25,299	23,774	72,480	71,243
Interest expense:				
Deposits	2,029	2,728	6,596	8,859
Short-term borrowings	171	172	456	354
Long-term borrowings	—	256	—	1,321
Total interest expense	2,200	3,156	7,052	10,534
Net interest income	23,099	20,618	65,428	60,709
Provision for loan losses	1,764	3,480	4,608	5,618
Net interest income after provision for loan losses	21,335	17,138	60,820	55,091
Noninterest income:				
Service charges on deposits	2,292	2,257	6,101	6,605
ATM and debit card	1,219	1,117	3,368	3,256
Broker-dealer fees and commissions	609	541	1,630	1,329
Company owned life insurance	433	422	1,300	967
Net gain on sale of loans held for sale	323	318	981	659
Net gain on disposal of investment securities	596	2,340	2,164	2,347
Loan servicing	142	64	645	662
Impairment charges on investment securities	—	—	(91)	—
Net (loss) gain on disposal of other assets	(114)	7	(79)	44
Other	853	970	2,475	2,289
Total noninterest income	6,353	8,036	18,494	18,158
Noninterest expense:				
Salaries and employee benefits	12,438	9,113	30,565	26,384
Occupancy and equipment	2,915	2,722	8,400	8,209
Professional services	1,452	570	3,243	1,823
Computer and data processing	976	603	2,462	1,854
Supplies and postage	899	461	1,930	1,337
FDIC assessments	356	437	957	1,212
Advertising and promotions	261	477	499	895
Loss on extinguishment of debt	—	1,083	—	1,083
Other	2,321	1,546	5,800	4,718
Total noninterest expense	21,618	17,012	53,856	47,515
Income before income taxes	6,070	8,162	25,458	25,734
Income tax expense	1,805	2,664	8,341	8,697
Net income	\$ 4,265	\$ 5,498	\$17,117	\$17,037
Preferred stock dividends	368	368	1,105	1,508
Accretion of discount on Series A preferred stock	—	—	—	1,305
Net income available to common shareholders	\$ 3,897	\$ 5,130	\$16,012	\$14,224
Earnings per common share (Note 4):				
Basic	\$ 0.28	\$ 0.38	\$ 1.17	\$ 1.10
Diluted	\$ 0.28	\$ 0.37	\$ 1.16	\$ 1.09
Cash dividends declared per common share	\$ 0.14	\$ 0.12	\$ 0.41	\$ 0.34
Weighted average common shares outstanding:				
Basic	13,703	13,635	13,692	12,876
Diluted	13,759	13,704	13,748	12,968

See accompanying notes to the consolidated financial statements.

Table of Contents

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

(Dollars in thousands)

	Three months ended September 30,		Nine months ended September 30,	
	2012	2011	2012	2011
Net income	\$ 4,265	\$ 5,498	\$17,117	\$17,037
Other comprehensive income:				
Unrealized gains on securities:				
Change in net unrealized securities gains arising during period	5,053	7,733	8,048	23,654
Deferred tax expense	(2,002)	(3,063)	(3,188)	(9,371)
Reclassification adjustment for gains included in income before income taxes	(596)	(2,340)	(2,073)	(2,347)
Related tax expense	236	927	821	930
Change in net unrealized gains on securities, net of tax	2,691	3,257	3,608	12,866
Change in pension and post-retirement obligations:				
Change in net actuarial gain\loss	336	146	1,007	436
Related tax expense	(133)	(58)	(399)	(173)
Change in pension and post-retirement obligations, net of tax	203	88	608	263
Other comprehensive income	2,894	3,345	4,216	13,129
Comprehensive income	<u>\$ 7,159</u>	<u>\$ 8,843</u>	<u>\$21,333</u>	<u>\$30,166</u>

See accompanying notes to the consolidated financial statements.

Table of Contents

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES Consolidated Statements of Changes in Shareholders' Equity (Unaudited) Nine months ended September 30, 2012 and 2011

(Dollars in thousands,
except per share data)

	Preferred Equity	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Treasury Stock	Total Shareholders' Equity
Balance at January 1, 2011	\$ 53,785	\$ 113	\$ 26,029	\$144,599	\$ (4,722)	\$(7,660)	\$ 212,144
Comprehensive income:							
Net income	—	—	—	17,037	—	—	17,037
Other comprehensive income, net of tax	—	—	—	—	13,129	—	13,129
Total comprehensive income							30,166
Purchases of common stock for treasury	—	—	—	—	—	(205)	(205)
Issuance of common stock	—	29	43,098	—	—	—	43,127
Repurchase of warrant issued to U.S. Treasury	—	—	(2,080)	—	—	—	(2,080)
Redemption of Series A preferred stock	(37,515)	—	68	—	—	—	(37,447)
Repurchase of Series B-1 8.48% preferred stock	(96)	—	—	—	—	—	(96)
Share-based compensation plans:							
Share-based compensation	—	—	863	—	—	—	863
Stock options exercised	—	—	(28)	—	—	119	91
Restricted stock awards issued, net	—	—	(991)	—	—	991	—
Excess tax benefit on share-based compensation	—	—	64	—	—	—	64
Directors' retainer	—	—	(12)	—	—	110	98
Accretion of discount on Series A preferred stock	1,305	—	—	(1,305)	—	—	—
Cash dividends declared:							
Series A 3% Preferred-\$2.25 per share	—	—	—	(4)	—	—	(4)
Series A Preferred-\$53.24 per share	—	—	—	(399)	—	—	(399)
Series B-1 8.48% Preferred-\$6.36 per share	—	—	—	(1,105)	—	—	(1,105)
Common-\$0.34 per share	—	—	—	(4,362)	—	—	(4,362)
Balance at September 30, 2011	\$ 17,479	\$ 142	\$ 67,011	\$154,461	\$ 8,407	\$(6,645)	\$ 240,855
Balance at January 1, 2012	\$ 17,473	\$ 142	\$ 67,247	\$158,079	\$ 945	\$(6,692)	\$ 237,194
Comprehensive income:							
Net income	—	—	—	17,117	—	—	17,117
Other comprehensive income, net of tax	—	—	—	—	4,216	—	4,216
Total comprehensive income							21,333
Purchases of common stock for treasury	—	—	—	—	—	(554)	(554)
Repurchase of Series B-1 8.48% preferred stock	(2)	—	—	—	—	—	(2)
Share-based compensation plans:							
Share-based compensation	—	—	373	—	—	—	373
Stock options exercised	—	—	(5)	—	—	31	26
Restricted stock awards issued, net	—	—	(140)	—	—	140	—
Excess tax benefit on share-based compensation	—	—	97	—	—	—	97
Directors' retainer	—	—	(10)	—	—	107	97
Cash dividends declared:							
Series A 3% Preferred-\$2.25 per share	—	—	—	(3)	—	—	(3)
Series B-1 8.48% Preferred-\$6.36 per share	—	—	—	(1,102)	—	—	(1,102)
Common-\$0.41 per share	—	—	—	(5,617)	—	—	(5,617)
Balance at September 30, 2012	\$ 17,471	\$ 142	\$ 67,562	\$168,474	\$ 5,161	\$(6,968)	\$ 251,842

See accompanying notes to the consolidated financial statements.

Table of Contents

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

(Dollars in thousands)

	Nine months ended September 30,	
	2012	2011
Cash flows from operating activities:		
Net income	\$ 17,117	\$ 17,037
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	2,761	2,580
Net amortization of premiums on securities	3,958	4,227
Provision for loan losses	4,608	5,618
Share-based compensation	373	863
Deferred income tax expense	3,684	2,122
Proceeds from sale of loans held for sale	42,847	20,464
Originations of loans held for sale	(40,867)	(19,070)
Increase in company owned life insurance	(1,300)	(967)
Net gain on sale of loans held for sale	(981)	(659)
Net gain on disposal of investment securities	(2,164)	(2,347)
Impairment charges on investment securities	91	—
Net loss (gain) on sale and disposal of other assets	79	(44)
Loss on extinguishment of debt	—	1,083
Decrease in other assets	4,745	353
Increase (decrease) in other liabilities	3,419	(216)
Net cash provided by operating activities	38,370	31,044
Cash flows from investing activities:		
Purchases of investment securities:		
Available for sale	(245,020)	(130,587)
Held to maturity	(10,803)	(12,018)
Proceeds from principal payments, maturities and calls on investment securities:		
Available for sale	136,912	126,908
Held to maturity	14,479	18,304
Proceeds from sales of securities available for sale	2,303	10,077
Net loan originations	(102,391)	(105,514)
Loans sold or participated to others	—	13,033
Purchases of company owned life insurance	(34)	(18,034)
Proceeds from sales of other assets	549	509
Purchases of premises and equipment	(4,554)	(3,056)
Net cash received in branch acquisition	195,778	—
Net cash used in investing activities	(12,781)	(100,378)
Cash flows from financing activities:		
Net increase in deposits	113,301	100,781
Net (decrease) increase in short-term borrowings	(112,416)	25,965
Repayments of long-term borrowings	—	(26,767)
Proceeds from issuance of common stock, net of issuance costs	—	43,127
Repurchase of preferred stock	(2)	(37,543)
Purchase of common stock for treasury	(554)	(205)
Repurchase of warrant issued to U.S. Treasury	—	(2,080)
Proceeds from stock options exercised	26	91
Excess tax benefit on share-based compensation	97	64
Cash dividends paid to preferred shareholders	(1,105)	(1,750)
Cash dividends paid to common shareholders	(5,474)	(3,806)
Net cash (used in) provided by financing activities	(6,127)	97,877
Net increase in cash and cash equivalents	19,462	28,543
Cash and cash equivalents, beginning of period	57,583	39,058
Cash and cash equivalents, end of period	\$ 77,045	\$ 67,601

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

Basis of Presentation

The consolidated financial statements include the accounts of Financial Institutions, Inc. 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, shareholders’ equity and cash flows for the periods indicated, and contain adequate disclosure to make the information presented not misleading. Prior years’ consolidated financial statements are re-classified whenever necessary to conform to the current year’s presentation. These consolidated financial statements should be read in conjunction with the Company’s 2011 Annual Report on Form 10-K. The results of operations for any interim periods are not necessarily indicative of the results which may be expected for the entire year.

Subsequent Events

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

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 loan losses, assumptions used in the defined benefit pension plan accounting, the carrying value of goodwill and deferred tax assets, and the valuation and other than temporary impairment considerations related to the securities portfolio.

Recent Accounting Pronouncements

In May 2011, the Financial Accounting Standards Board (the “FASB”) issued Accounting Standards Update (“ASU”) No. 2011-04, *“Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs.”* The provisions of ASU No. 2011-04 provide a consistent definition of fair value and common requirements for the measurement of and disclosure about fair value between U.S. GAAP and International Financial Reporting Standards (“IFRS”). The changes to U.S. GAAP as a result of ASU No. 2011-04 are as follows: (1) the concepts of highest and best use and valuation premise are only relevant when measuring the fair value of nonfinancial assets (that is, it does not apply to financial assets or any liabilities); (2) extends the prohibition on applying a blockage factor in valuing financial instruments with quoted prices in active markets; (3) creates an exception to the basic fair value measurement principles for an entity that holds a group of financial assets and financial liabilities with offsetting positions in market risks or counterparty credit risk that are managed on the basis of the entity’s net exposure to either of those risks by allowing the entity, if certain criteria are met, to measure the fair value of the net asset or liability position in a manner consistent with how market participants would price the net risk position; (4) aligns the fair value measurement of instruments classified within an entity’s shareholders’ equity with the guidance for liabilities; and (5) enhances disclosure requirements for Level 3 fair value measurements to disclose quantitative information about unobservable inputs and assumptions used, to describe the valuation processes used by the entity, and to qualitatively describe the sensitivity of fair value measurements to changes in unobservable inputs and the interrelationships between those inputs. In addition, entities must report the level in the fair value hierarchy of items that are not measured at fair value in the statement of condition but whose fair value must be disclosed. The Company adopted the provisions of ASU No. 2011-04 effective January 1, 2012. The fair value measurement provisions of ASU No. 2011-04 had no material impact on the Company’s consolidated financial statements. See Note 11 to the consolidated financial statements for the enhanced disclosures required by ASU No. 2011-04.

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

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

In June 2011, the FASB issued ASU No. 2011-05, “*Presentation of Comprehensive Income*.” The provisions of ASU No. 2011-05 allow an entity the option to present the total of comprehensive income, the components of net income, and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. In both options, an entity is required to present each component of net income along with total net income, each component of other comprehensive income along with a total for other comprehensive income, and a total amount for comprehensive income. Under either method, entities are required to present on the face of the financial statements reclassification adjustments for items that are reclassified from other comprehensive income to net income in the statement(s) where the components of net income and the components of other comprehensive income are presented. ASU No. 2011-05 also eliminates the option to present the components of other comprehensive income as part of the statement of changes in shareholders’ equity but does not change the items that must be reported in other comprehensive income or when an item of other comprehensive income must be reclassified to net income. ASU No. 2011-05 was effective for the Company’s interim reporting period beginning on or after January 1, 2012, with retrospective application required. In December 2011, the FASB issued ASU No. 2011-12, “*Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05*.” The provisions of ASU No. 2011-12 defer indefinitely the requirement for entities to present reclassification adjustments out of accumulated other comprehensive income by component in both the statement in which net income is presented and the statement in which other comprehensive income is presented. ASU No. 2011-12, which shares the same effective date as ASU No. 2011-05, does not defer the requirement for entities to present components of comprehensive income in either a single continuous statement of comprehensive income or in two separate but consecutive statements. The Company adopted the provisions of ASU No. 2011-05 and ASU No. 2011-12 which resulted in a new statement of comprehensive income beginning with the interim period ended March 31, 2012. The adoption of ASU No. 2011-05 and ASU No. 2011-12 had no material impact on the Company’s statements of income and financial condition.

In September 2011, the FASB issued ASU No. 2011-08 “*Testing Goodwill for Impairment*.” The provisions of ASU 2011-08 permit an entity the option to first perform a qualitative assessment to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount. If an entity believes, as a result of its qualitative assessment, that it is more likely than not that the fair value of a reporting unit is less than its carrying amount, the quantitative impairment test is required. Otherwise, no further impairment testing is required. ASU No. 2011-08 includes examples of events and circumstances that may indicate that a reporting unit’s fair value is less than its carrying amount. The provisions of ASU No. 2011-08 are effective for annual and interim goodwill impairment tests performed beginning in 2012. The adoption of ASU No. 2011-08 did not have a material impact on the Company’s consolidated financial statements.

In July 2012, the FASB issued ASU No. 2012-02, “*Testing Indefinite-Lived Intangible Assets for Impairment*.” The provisions of ASU No. 2012-02 permit an entity to first assess qualitative factors to determine whether it is more likely than not that an indefinite-lived intangible asset is impaired as a basis for determining whether it is necessary to perform a quantitative impairment test, as is currently required by GAAP. ASU No. 2012-02 is effective for annual and interim impairment tests performed for fiscal years beginning after September 15, 2012. The Company does not have any indefinite-lived intangible assets other than goodwill, therefore the adoption of ASU No. 2012-02 is expected to have no material impact on the Company’s consolidated financial statements.

(2.) SUPPLEMENTAL CASH FLOW INFORMATION

Supplemental cash flow information addressing certain cash payments and noncash investing and financing activities was as follows (in thousands):

	Nine months ended September 30,	
	2012	2011
Cash payments:		
Interest	\$ 8,046	\$12,425
Income taxes	3,787	5,191
Noncash investing and financing activities:		
Real estate and other assets acquired in settlement of loans	\$ 250	\$ 237
Accrued and declared unpaid dividends	2,287	2,008
Increase in net unsettled security transactions	11,148	1,341
Accretion of preferred stock discount	—	1,305
Net transfer of loans to held for sale	—	13,576
Assets acquired and liabilities assumed in branch acquisition:		
Loans and other non-cash assets, excluding goodwill and core deposit intangible asset	77,912	—
Deposits and other liabilities	287,331	—

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

(3.) BRANCH ACQUISITIONS

On January 19, 2012, the Bank entered into agreements with First Niagara Bank, National Association (“First Niagara”) to acquire four retail bank branches in Medina, Brockport, Batavia and Waterloo, New York (the “First Niagara Branches”) and four retail bank branches previously owned by HSBC Bank USA, National Association (“HSBC”) in Elmira, Elmira Heights, Horseheads and Albion, New York (the “HSBC Branches”). First Niagara assigned its rights to the HSBC branches in connection with its acquisition of HSBC’s Upstate New York banking franchise. Under the terms of the agreements, the Bank assumed all related deposits and purchased the related branch premises and certain performing loans. The transaction to acquire the First Niagara Branches was completed on June 22, 2012 and the transaction to acquire the HSBC Branches was completed on August 17, 2012. The combined assets acquired and deposits assumed in the two transactions were recorded at their estimated fair values as follows:

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

The transactions were accounted for using the acquisition method of accounting and accordingly, assets acquired, liabilities assumed and consideration exchanged were recorded at their estimated fair values on the acquisition dates. Fair values are preliminary and in certain cases are subject to refinement for up to one year after the closing date of the acquisition as additional information relative to fair values becomes available.

The operating results of the acquired branches included in the Company’s consolidated statement of income for the nine months ended September 30, 2012 reflect only amounts from the acquisition dates through September 30, 2012, the end of the third quarter. The operating results of the acquired branches prior to the acquisition dates were not material for purposes of supplemental disclosure under the FASB guidance on business combinations.

The Company acquired the loan portfolios at a fair value discount of \$824 thousand. The discount represents expected credit losses, net of market interest rate adjustments. The discount on loans receivable will be amortized to interest income over the estimated remaining life of the acquired loans using the level yield method. The core deposit intangible asset will be amortized on an accelerated basis over a period of approximately nine and a half years. The time deposit premium of \$335 thousand will be accreted over the estimated remaining life of the related deposits as a reduction of interest expense.

Preliminary goodwill of \$11.6 million is calculated as the purchase premium after adjusting for the fair value of net assets acquired and represents the value expected from the synergies created and the economies of scale expected from combining the operations of the acquired branches with those of the Bank. All goodwill and core deposit intangible assets arising from this acquisition are expected to be deductible for tax purposes.

The following table provides a reconciliation of goodwill and other intangible assets, net:

	Goodwill	Other intangible assets, net	Total
Balance, December 31, 2011	\$37,369	\$ —	\$37,369
Addition: Branch acquisitions	11,599	2,042	13,641
Less: Amortization of core deposit intangible assets	—	(86)	(86)
Balance, September 30, 2012	<u>\$48,968</u>	<u>\$ 1,956</u>	<u>\$50,924</u>

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 September 30,		Nine months ended September 30,	
	2012	2011	2012	2011
Net income available to common shareholders	\$ 3,897	\$ 5,130	\$16,012	\$14,224
Less: Earnings allocated to participating securities	—	9	3	29
Net income available to common shareholders for EPS	<u>\$ 3,897</u>	<u>\$ 5,121</u>	<u>\$16,009</u>	<u>\$14,195</u>
Weighted average common shares outstanding:				
Total shares issued	14,162	14,162	14,162	13,409
Unvested restricted stock awards	(99)	(171)	(116)	(164)
Treasury shares	<u>(360)</u>	<u>(356)</u>	<u>(354)</u>	<u>(369)</u>
Total basic weighted average common shares outstanding	13,703	13,635	13,692	12,876
Incremental shares from assumed:				
Exercise of stock options	4	—	4	3
Vesting of restricted stock awards	52	69	52	59
Exercise of warrant	<u>—</u>	<u>—</u>	<u>—</u>	<u>30</u>
Total diluted weighted average common shares outstanding	13,759	13,704	13,748	12,968
Basic earnings per common share	<u>\$ 0.28</u>	<u>\$ 0.38</u>	<u>\$ 1.17</u>	<u>\$ 1.10</u>
Diluted earnings per common share	<u>\$ 0.28</u>	<u>\$ 0.37</u>	<u>\$ 1.16</u>	<u>\$ 1.09</u>

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:

Stock options	295	394	309	372
Restricted stock awards	<u>—</u>	<u>—</u>	<u>1</u>	<u>5</u>
	<u>295</u>	<u>394</u>	<u>310</u>	<u>377</u>

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
September 30, 2012				
Securities available for sale:				
U.S. Government agencies and government sponsored enterprises	\$ 96,281	\$ 3,943	\$ 3	\$100,221
State and political subdivisions	177,480	7,214	7	184,687
Mortgage-backed securities:				
Federal National Mortgage Association	123,346	4,731	—	128,077
Federal Home Loan Mortgage Corporation	51,586	1,869	—	53,455
Government National Mortgage Association	60,341	4,019	—	64,360
Collateralized mortgage obligations:				
Federal National Mortgage Association	60,336	1,463	2	61,797
Federal Home Loan Mortgage Corporation	70,456	1,814	—	72,270
Government National Mortgage Association	80,085	1,916	1	82,000
Privately issued	103	698	—	801
Total collateralized mortgage obligations	210,980	5,891	3	216,868
Total mortgage-backed securities	446,253	16,510	3	462,760
Asset-backed securities	157	793	—	950
Total available for sale securities	<u>\$720,171</u>	<u>\$ 28,460</u>	<u>\$ 13</u>	<u>\$748,618</u>
Securities held to maturity:				
State and political subdivisions	<u>\$ 19,564</u>	<u>\$ 554</u>	<u>\$ —</u>	<u>\$ 20,118</u>
December 31, 2011				
Securities available for sale:				
U.S. Government agencies and government sponsored enterprises	\$ 94,947	\$ 2,770	\$ 5	\$ 97,712
State and political subdivisions	119,099	5,336	11	124,424
Mortgage-backed securities:				
Federal National Mortgage Association	98,679	2,944	—	101,623
Federal Home Loan Mortgage Corporation	63,838	1,017	—	64,855
Government National Mortgage Association	73,226	3,376	—	76,602
Collateralized mortgage obligations:				
Federal National Mortgage Association	28,339	581	7	28,913
Federal Home Loan Mortgage Corporation	22,318	675	1	22,992
Government National Mortgage Association	103,975	2,654	18	106,611
Privately issued	327	1,762	—	2,089
Total collateralized mortgage obligations	154,959	5,672	26	160,605
Total mortgage-backed securities	390,702	13,009	26	403,685
Asset-backed securities	297	1,400	—	1,697
Total available for sale securities	<u>\$605,045</u>	<u>\$ 22,515</u>	<u>\$ 42</u>	<u>\$627,518</u>
Securities held to maturity:				
State and political subdivisions	<u>\$ 23,297</u>	<u>\$ 667</u>	<u>\$ —</u>	<u>\$ 23,964</u>

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

	Three months ended September 30,		Nine months ended September 30,	
	2012	2011	2012	2011
Proceeds from sales	\$633	\$15,552	\$2,303	\$24,452
Gross realized gains	596	2,340	2,164	2,344
Gross realized losses	—	—	—	—

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

(5.) INVESTMENT SECURITIES (Continued)

The scheduled maturities of securities available for sale and securities held to maturity at September 30, 2012 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	\$ 29,303	\$ 29,629
Due from one to five years	73,220	76,262
Due after five years through ten years	263,593	274,455
Due after ten years	354,055	368,272
	<u>\$720,171</u>	<u>\$748,618</u>
Debt securities held to maturity:		
Due in one year or less	\$ 14,273	\$ 14,346
Due from one to five years	4,372	4,660
Due after five years through ten years	829	990
Due after ten years	90	122
	<u>\$ 19,564</u>	<u>\$ 20,118</u>

There were no unrealized losses in held to maturity securities at September 30, 2012 or December 31, 2011. Unrealized losses on investment securities available for sale 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
September 30, 2012						
U.S. Government agencies and government sponsored enterprises	\$ —	\$ —	\$4,359	\$ 3	\$ 4,359	\$ 3
State and political subdivisions	625	7	—	—	625	7
Mortgage-backed securities:						
Collateralized mortgage obligations:						
Federal National Mortgage Association	—	—	1,277	2	1,277	2
Government National Mortgage Association	3,457	1	—	—	3,457	1
Total collateralized mortgage obligations	3,457	1	1,277	2	4,734	3
Total mortgage-backed securities	3,457	1	1,277	2	4,734	3
Total temporarily impaired securities	<u>\$4,082</u>	<u>\$ 8</u>	<u>\$5,636</u>	<u>\$ 5</u>	<u>\$ 9,718</u>	<u>\$ 13</u>
December 31, 2011						
U.S. Government agencies and government sponsored enterprises	\$2,177	\$ 1	\$5,246	\$ 4	\$ 7,423	\$ 5
State and political subdivisions	452	2	646	9	1,098	11
Mortgage-backed securities:						
Collateralized mortgage obligations:						
Federal National Mortgage Association	—	—	1,817	7	1,817	7
Federal Home Loan Mortgage Corporation	—	—	388	1	388	1
Government National Mortgage Association	6,138	18	—	—	6,138	18
Total collateralized mortgage obligations	6,138	18	2,205	8	8,343	26
Total mortgage-backed securities	6,138	18	2,205	8	8,343	26
Total temporarily impaired securities	<u>\$8,767</u>	<u>\$ 21</u>	<u>\$8,097</u>	<u>\$ 21</u>	<u>\$16,864</u>	<u>\$ 42</u>

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

(5.) INVESTMENT SECURITIES (Continued)

The total number of security positions in the investment portfolio in an unrealized loss position at September 30, 2012 was 11 compared to 14 at December 31, 2011. At September 30, 2012, the Company had positions in 7 investment securities with an amortized cost of \$5.6 million and an unrealized loss of \$5 thousand that have been in a continuous unrealized loss position for more than 12 months. There were a total of 4 securities positions in the Company's investment portfolio, with an amortized cost of \$4.1 million and a total unrealized loss of \$8 thousand at September 30, 2012, that have been in a continuous unrealized loss position for less than 12 months. The unrealized loss on these investment securities was predominantly caused by changes in market interest rates, average life or credit spreads subsequent to purchase. The fair value of most of the investment securities in the Company's portfolio fluctuates as market interest rates change.

The Company reviews investment securities on an ongoing basis for the presence of other-than-temporary impairment ("OTTI") with formal reviews performed quarterly. When evaluating debt securities for OTTI, management considers many factors, including: (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, (3) whether the market decline was affected by macroeconomic conditions, and (4) whether the Company has the intention to sell the debt security or whether it is more likely than not that it will be required to sell the debt security before its anticipated recovery. The assessment of whether OTTI exists involves a high degree of subjectivity and judgment and is based on the information available to management.

During the nine months ended September 30, 2012, the Company recognized an OTTI charge of \$91 thousand related to a privately issued whole loan CMO that was determined to be impaired due to credit quality. No impairment was recorded during the nine months ended September 30, 2011.

Based on management's review and evaluation of the Company's debt securities as of September 30, 2012, the debt securities with unrealized losses were not considered to be OTTI. As of September 30, 2012, the Company does not intend to sell any debt securities which have an unrealized loss, it is unlikely the Company will be required to sell these securities before recovery and the Company expects to recover the entire amortized cost of these impaired securities. Accordingly, as of September 30, 2012, management has concluded that unrealized losses on its investment securities are temporary and no further impairment loss has been realized in the Company's consolidated statements of income.

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
September 30, 2012			
Commercial business	\$ 245,404	\$ (97)	\$ 245,307
Commercial mortgage	403,924	(804)	403,120
Residential mortgage	139,785	199	139,984
Home equity	275,345	3,866	279,211
Consumer indirect	538,058	25,618	563,676
Other consumer	27,599	88	27,687
Total	<u>\$1,630,115</u>	<u>\$ 28,870</u>	1,658,985
Allowance for loan losses			(24,301)
Total loans, net			<u>\$1,634,684</u>
December 31, 2011			
Commercial business	\$ 233,727	\$ 109	\$ 233,836
Commercial mortgage	394,034	(790)	393,244
Residential mortgage	113,865	46	113,911
Home equity	227,853	3,913	231,766
Consumer indirect	465,807	21,906	487,713
Other consumer	24,138	168	24,306
Total	<u>\$1,459,424</u>	<u>\$ 25,352</u>	1,484,776
Allowance for loan losses			(23,260)
Total loans, net			<u>\$1,461,516</u>

Loans held for sale (not included above) were comprised entirely of residential real estate mortgages and totaled \$1.4 million and \$2.4 million as of September 30, 2012 and December 31, 2011, respectively.

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
September 30, 2012							
Commercial business	\$ 48	\$ 17	\$ —	\$ 65	\$ 3,621	\$ 241,718	\$ 245,404
Commercial mortgage	24	—	—	24	3,388	400,512	403,924
Residential mortgage	995	—	—	995	1,597	137,193	139,785
Home equity	319	82	—	401	929	274,015	275,345
Consumer indirect	1,111	121	—	1,232	876	535,950	538,058
Other consumer	158	22	3	183	20	27,396	27,599
Total loans, gross	<u>\$ 2,655</u>	<u>\$ 242</u>	<u>\$ 3</u>	<u>\$ 2,900</u>	<u>\$ 10,431</u>	<u>\$1,616,784</u>	<u>\$1,630,115</u>
December 31, 2011							
Commercial business	\$ 35	\$ —	\$ —	\$ 35	\$ 1,259	\$ 232,433	\$ 233,727
Commercial mortgage	165	—	—	165	2,928	390,941	394,034
Residential mortgage	517	—	—	517	1,644	111,704	113,865
Home equity	749	68	—	817	682	226,354	227,853
Consumer indirect	984	92	—	1,076	558	464,173	465,807
Other consumer	106	10	5	121	—	24,017	24,138
Total loans, gross	<u>\$ 2,556</u>	<u>\$ 170</u>	<u>\$ 5</u>	<u>\$ 2,731</u>	<u>\$ 7,071</u>	<u>\$1,449,622</u>	<u>\$1,459,424</u>

There were no loans past due greater than 90 days and still accruing interest as of September 30, 2012 and December 31, 2011. There were \$3 thousand and \$5 thousand in consumer overdrafts which were past due greater than 90 days as of September 30, 2012 and December 31, 2011, respectively. Consumer overdrafts are overdrawn deposit accounts which have been reclassified as loans but by their terms do not accrue interest.

Troubled Debt Restructurings

A modification of a loan constitutes a troubled debt restructuring ("TDR") when a borrower is experiencing financial difficulty and the modification constitutes a concession. The Company offers various types of concessions when modifying loans, however, forgiveness of principal is rarely granted. 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, requesting additional collateral, releasing collateral for consideration, or substituting or adding a new borrower or guarantor.

The following presents information related to loans modified in a TDR during the periods indicated (dollars in thousands).

	Three months ended			Nine months ended		
	Pre- Modification	Post- Modification		Pre- Modification	Post- Modification	
	Number of Contracts	Outstanding Recorded Investment	Outstanding Recorded Investment	Number of Contracts	Outstanding Recorded Investment	Outstanding Recorded Investment
September 30, 2012						
Commercial business	1	\$ 103	\$ 103	3	\$ 536	\$ 536
Commercial mortgage	—	—	—	4	648	648
Total	<u>1</u>	<u>\$ 103</u>	<u>\$ 103</u>	<u>7</u>	<u>\$ 1,184</u>	<u>\$ 1,184</u>
September 30, 2011						
Commercial business	4	\$ 75	\$ 75	6	\$ 142	\$ 142
Commercial mortgage	—	—	—	1	280	280
Total	<u>4</u>	<u>\$ 75</u>	<u>\$ 75</u>	<u>7</u>	<u>\$ 422</u>	<u>\$ 422</u>

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

(6.) LOANS (Continued)

All of the loans identified as TDRs by the Company were previously on nonaccrual status and reported as impaired loans prior to restructuring. The modifications primarily related to extending the amortization periods of the loans. All loans restructured during the three and nine months ended September 30, 2012 are on nonaccrual status as of September 30, 2012. Nonaccrual loans that are restructured remain on nonaccrual status, but may move to accrual status after they have performed according to the restructured terms for a period of time. The TDR classification did not have a material impact on the Company's determination of the allowance for loan losses because the modified loans were impaired and evaluated for a specific reserve both before and after restructuring.

There were no loans modified as a TDR within the previous 12 months that defaulted during the three or nine months ended September 30, 2012 or 2011. For purposes of this disclosure, a loan modified as a TDR is considered to have defaulted when the borrower becomes 90 days past due.

Impaired Loans

Management has determined that specific commercial loans on nonaccrual status and all loans that have had their terms restructured in a troubled debt restructuring are impaired loans. The following table presents the recorded investment, unpaid principal balance and related allowance of impaired loans as of the dates indicated and average recorded investment and interest income recognized on impaired loans for the year-to-date periods ended as of the dates indicated (in thousands):

	<u>Recorded Investment ⁽¹⁾</u>	<u>Unpaid Principal Balance ⁽¹⁾</u>	<u>Related Allowance</u>	<u>Average Recorded Investment</u>	<u>Interest Income Recognized</u>
<u>September 30, 2012</u>					
With no related allowance recorded:					
Commercial business	\$ 997	\$ 1,412	\$ —	\$ 574	\$ —
Commercial mortgage	1,432	1,750	—	1,077	—
	<u>2,429</u>	<u>3,162</u>	<u>—</u>	<u>1,651</u>	<u>—</u>
With an allowance recorded:					
Commercial business	2,624	2,624	620	1,640	—
Commercial mortgage	1,956	1,956	664	1,590	—
	<u>4,580</u>	<u>4,580</u>	<u>1,284</u>	<u>3,230</u>	<u>—</u>
	<u>\$ 7,009</u>	<u>\$ 7,742</u>	<u>\$ 1,284</u>	<u>\$ 4,881</u>	<u>\$ —</u>
<u>December 31, 2011</u>					
With no related allowance recorded:					
Commercial business	\$ 342	\$ 1,266	\$ —	\$ 361	\$ —
Commercial mortgage	605	696	—	583	—
	<u>947</u>	<u>1,962</u>	<u>—</u>	<u>944</u>	<u>—</u>
With an allowance recorded:					
Commercial business	917	917	436	1,033	—
Commercial mortgage	2,323	2,323	644	2,172	—
	<u>3,240</u>	<u>3,240</u>	<u>1,080</u>	<u>3,205</u>	<u>—</u>
	<u>\$ 4,187</u>	<u>\$ 5,202</u>	<u>\$ 1,080</u>	<u>\$ 4,149</u>	<u>\$ —</u>

⁽¹⁾ Difference between recorded investment and unpaid principal balance represents partial charge-offs.

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

(6.) LOANS (Continued)

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 not meeting 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.

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

	Commercial Business	Commercial Mortgage
<u>September 30, 2012</u>		
Uncriticized	\$ 228,160	\$ 388,011
Special mention	8,153	8,238
Substandard	9,091	7,675
Doubtful	—	—
Total	<u>\$ 245,404</u>	<u>\$ 403,924</u>
<u>December 31, 2011</u>		
Uncriticized	\$ 221,477	\$ 383,700
Special mention	7,445	2,388
Substandard	4,805	7,946
Doubtful	—	—
Total	<u>\$ 233,727</u>	<u>\$ 394,034</u>

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 table sets forth the Company's retail loan portfolio, categorized by payment status, as of the dates indicated (in thousands):

	Residential Mortgage	Home Equity	Consumer Indirect	Other Consumer
<u>September 30, 2012</u>				
Performing	\$138,188	\$274,416	\$537,182	\$27,579
Non-performing	1,597	929	876	20
Total	<u>\$139,785</u>	<u>\$275,345</u>	<u>\$538,058</u>	<u>\$27,599</u>
<u>December 31, 2011</u>				
Performing	\$112,221	\$227,171	\$465,249	\$24,138
Non-performing	1,644	682	558	—
Total	<u>\$113,865</u>	<u>\$227,853</u>	<u>\$465,807</u>	<u>\$24,138</u>

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

(6.) LOANS (Continued)

Allowance for Loan Losses

Loans and the related allowance for loan losses are presented below as of the dates indicated (in thousands):

	Commercial Business	Commercial Mortgage	Residential Mortgage	Home Equity	Consumer Indirect	Other Consumer	Total
September 30, 2012							
Loans:							
Ending balance	\$ 245,404	\$ 403,924	\$ 139,785	\$ 275,345	\$ 538,058	\$ 27,599	\$ 1,630,115
Evaluated for impairment:							
Individually	\$ 3,621	\$ 3,388	\$ —	\$ —	\$ —	\$ —	\$ 7,009
Collectively	\$ 241,783	\$ 400,536	\$ 139,785	\$ 275,345	\$ 538,058	\$ 27,599	\$ 1,623,106
Allowance for loan losses:							
Ending balance	\$ 4,276	\$ 6,648	\$ 796	\$ 1,232	\$ 10,808	\$ 541	\$ 24,301
Evaluated for impairment:							
Individually	\$ 620	\$ 664	\$ —	\$ —	\$ —	\$ —	\$ 1,284
Collectively	\$ 3,656	\$ 5,984	\$ 796	\$ 1,232	\$ 10,808	\$ 541	\$ 23,017
September 30, 2011							
Loans:							
Ending balance	\$ 223,708	\$ 382,267	\$ 116,399	\$ 218,936	\$ 445,296	\$ 24,639	\$ 1,411,245
Evaluated for impairment:							
Individually	\$ 2,380	\$ 2,330	\$ —	\$ —	\$ —	\$ —	\$ 4,710
Collectively	\$ 221,328	\$ 379,937	\$ 116,399	\$ 218,936	\$ 445,296	\$ 24,639	\$ 1,406,535
Allowance for loan losses:							
Ending balance	\$ 4,578	\$ 6,263	\$ 887	\$ 1,150	\$ 9,569	\$ 530	\$ 22,977
Evaluated for impairment:							
Individually	\$ 1,039	\$ 393	\$ —	\$ —	\$ —	\$ —	\$ 1,432
Collectively	\$ 3,539	\$ 5,870	\$ 887	\$ 1,150	\$ 9,569	\$ 530	\$ 21,545

The following table sets forth the changes in the allowance for loan losses for the three and nine month periods ended September 30, 2012 (in thousands):

	Commercial Business	Commercial Mortgage	Residential Mortgage	Home Equity	Consumer Indirect	Other Consumer	Total
Three months ended September 30, 2012							
Beginning balance	\$ 4,364	\$ 6,713	\$ 801	\$ 1,164	\$ 10,618	\$ 460	\$ 24,120
Charge-offs	337	27	47	80	1,846	201	2,538
Recoveries	50	91	8	15	722	69	955
Provision (credit)	199	(129)	34	133	1,314	213	1,764
Ending balance	\$ 4,276	\$ 6,648	\$ 796	\$ 1,232	\$ 10,808	\$ 541	\$ 24,301
Nine months ended September 30, 2012							
Beginning balance	\$ 4,036	\$ 6,418	\$ 858	\$ 1,242	\$ 10,189	\$ 517	\$ 23,260
Charge-offs	536	374	280	177	4,648	605	6,620
Recoveries	282	167	106	35	2,195	268	3,053
Provision (credit)	494	437	112	132	3,072	361	4,608
Ending balance	\$ 4,276	\$ 6,648	\$ 796	\$ 1,232	\$ 10,808	\$ 541	\$ 24,301

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

(6.) LOANS (Continued)

The following table sets forth the changes in the allowance for loan losses for the three and nine month periods ended September 30, 2011 (in thousands):

	Commercial Business	Commercial Mortgage	Residential Mortgage	Home Equity	Consumer Indirect	Other Consumer	Total
Three months ended September 30, 2011							
Beginning balance	\$ 4,011	\$ 5,763	\$ 957	\$1,050	\$ 8,319	\$ 532	\$20,632
Charge-offs	75	194	36	142	1,226	208	1,881
Recoveries	61	158	45	21	371	90	746
Provision (credit)	581	536	(79)	221	2,105	116	3,480
Ending balance	<u>\$ 4,578</u>	<u>\$ 6,263</u>	<u>\$ 887</u>	<u>\$1,150</u>	<u>\$ 9,569</u>	<u>\$ 530</u>	<u>\$22,977</u>
Nine months ended September 30, 2011							
Beginning balance	\$ 3,712	\$ 6,431	\$ 1,013	\$ 972	\$ 7,754	\$ 584	\$20,466
Charge-offs	390	572	48	404	3,571	687	5,672
Recoveries	325	197	75	38	1,576	354	2,565
Provision (credit)	931	207	(153)	544	3,810	279	5,618
Ending balance	<u>\$ 4,578</u>	<u>\$ 6,263</u>	<u>\$ 887</u>	<u>\$1,150</u>	<u>\$ 9,569</u>	<u>\$ 530</u>	<u>\$22,977</u>

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 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, inferring 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 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 mortgage loans and home equities (comprised of home equity loans and home equity lines) are generally made on the basis of 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, 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, as indirect consumer loans are typically secured by depreciable assets, such as automobiles, and other consumer loans are typically unsecured. 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, thus are more likely to be affected by adverse personal circumstances such as job loss, illness or personal bankruptcy. 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.) SHAREHOLDERS' EQUITY

Common Stock

The changes in shares of common stock were as follows for the nine month periods indicated:

	<u>Outstanding</u>	<u>Treasury</u>	<u>Issued</u>
<u>September 30, 2012</u>			
Shares outstanding at December 31, 2011	13,803,116	358,481	14,161,597
Restricted stock awards issued	57,541	(57,541)	—
Restricted stock awards forfeited	(49,684)	49,684	—
Stock options exercised	1,650	(1,650)	—
Treasury stock purchases	(33,150)	33,150	—
Directors' retainer	5,816	(5,816)	—
Shares outstanding at September 30, 2012	<u>13,785,289</u>	<u>376,308</u>	<u>14,161,597</u>
<u>September 30, 2011</u>			
Shares outstanding at December 31, 2010	10,937,506	410,616	11,348,122
Shares issued in common stock offering	2,813,475	—	2,813,475
Restricted stock awards issued	53,070	(53,070)	—
Stock options exercised	6,357	(6,357)	—
Treasury stock purchases	(10,467)	10,467	—
Directors' retainer	5,889	(5,889)	—
Shares outstanding at September 30, 2011	<u>13,805,830</u>	<u>355,767</u>	<u>14,161,597</u>

(8.) SHARE-BASED COMPENSATION PLANS

The Company maintains certain stock-based compensation plans that were approved by the Company's shareholders and are administered by the Board, or the Management Development and Compensation Committee of the Board. The share-based compensation plans were established to allow for the granting of compensation awards to attract, motivate and retain employees, executive officers and non-employee directors who contribute to the success 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 Company awarded grants of 49,441 restricted shares to certain members of management during the nine months ended September 30, 2012. The weighted average market price of the restricted shares on the date of grant was \$17.42. Either a service requirement or both service and performance requirements must be satisfied before the participant becomes vested in the shares. Where applicable, the performance period for the awards is the Company's fiscal year ending December 31, 2012. During the nine months ended September 30, 2012, the Company granted 8,100 restricted shares of common stock to directors, of which 4,050 shares vested immediately and 4,050 shares will vest after completion of a one-year service requirement. The market price of the restricted stock on the date of grant was \$16.74. The restricted stock awards granted to management and directors in 2012 do not have rights to dividends or dividend equivalents.

The following is a summary of restricted stock award activity for the nine months ended September 30, 2012:

	<u>Number of Shares</u>	<u>Weighted Average Market Price at Grant Date</u>
Outstanding at beginning of year	166,654	\$ 14.34
Granted	57,541	17.32
Vested	(94,431)	12.75
Forfeited	(49,684)	16.67
Outstanding at end of period	<u>80,080</u>	<u>\$ 16.91</u>

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

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

The Company uses the Black-Scholes valuation method to estimate the fair value of its stock option awards. There were no stock options awarded during 2012 or 2011. The following is a summary of stock option activity for the nine months ended September 30, 2012 (dollars in thousands, except per share amounts):

	Number of Options	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value
Outstanding at beginning of year	368,058	\$ 20.70		
Granted	—	—		
Exercised	(1,650)	15.85		
Forfeited	—	—		
Expired	(44,533)	24.55		
Outstanding at end of period	321,875	\$ 20.19	2.8 years	\$ 79
Exercisable at end of period	321,875	\$ 20.19	2.8 years	\$ 79

As of September 30, 2012, all compensation expense related to stock options had been fully recognized.

The aggregate intrinsic value (the amount by which the market price of the stock on the date of exercise exceeded the market price of the stock on the date of grant) of option exercises for the nine months ended September 30, 2012 and 2011 was \$2 thousand and \$31 thousand, respectively. The total cash received as a result of option exercises under stock compensation plans for the nine months ended September 30, 2012 and 2011 was \$26 thousand and \$91 thousand, respectively. The tax benefits realized in connection with these stock option exercises were not significant.

The Company amortizes the expense related to restricted stock awards over the vesting period. Share-based compensation expense is included in the consolidated statements of income under salaries and employee benefits for awards granted to management and in 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 September 30,		Nine months ended September 30,	
	2012	2011	2012	2011
Stock options:				
Management Stock Incentive Plan	\$ 4	\$ 23	\$ 12	\$ 51
Director Stock Incentive Plan	—	—	—	14
Total stock options	4	23	12	65
Restricted stock awards:				
Management Stock Incentive Plan	34	249	246	694
Director Stock Incentive Plan	17	15	115	104
Total restricted stock awards	51	264	361	798
Total share-based compensation	<u>\$ 55</u>	<u>\$ 287</u>	<u>\$ 373</u>	<u>\$ 863</u>

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

(9.) EMPLOYEE BENEFIT PLANS

Defined Benefit Pension Plan

The Company participates in The New York State Bankers Retirement System (the “System”), a defined benefit pension plan covering many of its employees, subject to the limitations related to the plan closure effective December 31, 2006. The benefits are based on years of service and the employee’s highest average compensation during five consecutive years of employment. The defined benefit plan was closed to new participants effective December 31, 2006. Only employees hired on or before December 31, 2006 and who met participation requirements on or before January 1, 2008 are eligible to receive benefits.

The components of the Company’s net periodic benefit expense for its pension plan were as follows (in thousands):

	Three months ended September 30,		Nine months ended September 30,	
	2012	2011	2012	2011
Service cost	\$ 510	\$ 439	\$ 1,528	\$ 1,317
Interest cost on projected benefit obligation	504	507	1,513	1,520
Expected return on plan assets	(803)	(664)	(2,409)	(1,990)
Amortization of unrecognized prior service cost	5	5	15	14
Amortization of unrecognized loss	343	152	1,028	456
Net periodic pension cost	<u>\$ 559</u>	<u>\$ 439</u>	<u>\$ 1,675</u>	<u>\$ 1,317</u>

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 satisfied the minimum required contribution to its pension plan of \$1.7 million for the 2012 fiscal year by contributing \$10.0 million prior to December 31, 2011.

(10.) COMMITMENTS AND CONTINGENCIES

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):

	September 30,	December 31,
	2012	2011
Commitments to extend credit	\$ 419,384	\$ 374,266
Standby letters of credit	10,588	8,855

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and 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.

The Company also 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. The notional value of forward sales commitments totaled \$2.1 million and \$2.9 million at September 30, 2012 and December 31, 2011, respectively.

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

(11.) 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.

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.

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 impaired loans: Fair value of impaired loans with specific allocations of the allowance for loan losses 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. Impaired loans are reviewed and evaluated on at least a quarterly basis for additional impairment and adjusted accordingly, based on the same factors identified above.

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

(11.) FAIR VALUE MEASUREMENTS (Continued)

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.

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

(11.) FAIR VALUE MEASUREMENTS (Continued)

Assets Measured at Fair Value

The following table presents for each of the fair-value hierarchy levels the Company's assets that are measured at fair value on a recurring and non-recurring 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
September 30, 2012				
Measured on a recurring basis:				
Securities available for sale:				
U.S. Government agencies and government sponsored enterprises	\$ —	\$100,221	\$ —	\$100,221
State and political subdivisions	—	184,687	—	184,687
Mortgage-backed securities	—	462,760	—	462,760
Asset-backed securities:				
Trust preferred securities	—	766	—	766
Other	—	184	—	184
	<u>\$ —</u>	<u>\$748,618</u>	<u>\$ —</u>	<u>\$748,618</u>
Measured on a nonrecurring basis:				
Loans:				
Loans held for sale	\$ —	\$ 1,411	\$ —	\$ 1,411
Collateral dependent impaired loans	—	—	3,296	3,296
Other assets:				
Loan servicing rights	—	—	1,763	1,763
Other real estate owned	—	—	303	303
	<u>\$ —</u>	<u>\$ 1,411</u>	<u>\$ 5,362</u>	<u>\$ 6,773</u>
December 31, 2011				
Measured on a recurring basis:				
Securities available for sale:				
U.S. Government agencies and government sponsored enterprises	\$ —	\$ 97,712	\$ —	\$ 97,712
State and political subdivisions	—	124,424	—	124,424
Mortgage-backed securities	—	403,685	—	403,685
Asset-backed securities:				
Trust preferred securities	—	—	1,636	1,636
Other	—	61	—	61
	<u>\$ —</u>	<u>\$625,882</u>	<u>\$ 1,636</u>	<u>\$627,518</u>
Measured on a nonrecurring basis:				
Loans:				
Loans held for sale	\$ —	\$ 2,410	\$ —	\$ 2,410
Collateral dependent impaired loans	—	—	2,160	2,160
Other assets:				
Loan servicing rights	—	—	1,973	1,973
Other real estate owned	—	—	475	475
	<u>\$ —</u>	<u>\$ 2,410</u>	<u>\$ 4,608</u>	<u>\$ 7,018</u>

There were no transfers between level 1 and 2 for the three and nine months ended September 30, 2012. There were no liabilities measured at fair value on a recurring or nonrecurring basis during the three or nine month periods ended September 30, 2012 and 2011.

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

(11.) FAIR VALUE MEASUREMENTS (Continued)

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 (dollars in thousands).

Asset	Fair Value	Valuation Technique	Unobservable Input	Unobservable Input Value or Range
Collateral dependent impaired loans	\$3,296	Appraisal of collateral ⁽¹⁾ Discounted cash flow	Appraisal adjustments ⁽²⁾ Discount rate Risk premium rate	16% -100% discount 5.0% ⁽³⁾ 10.2% ⁽³⁾
Loan servicing rights	1,763	Discounted cash flow	Discount rate Constant prepayment rate	4.2% ⁽³⁾ 28.4% ⁽³⁾
Other real estate owned	303	Appraisal of collateral ⁽¹⁾	Appraisal adjustments ⁽²⁾	20% - 61% discount

⁽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.

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 three months ended September 30, 2012. The Company transferred all of the assets classified as Level 3 assets at December 31, 2011 to Level 2 during the three months ended March 31, 2012. The transfers of the \$1.5 million of pooled trust preferred securities out of Level 3 was primarily the result of using observable pricing information or a third party pricing quote that appropriately reflects the fair value of those securities, without the need for adjustment based on our own assumptions regarding the characteristics of a specific security or the current liquidity in the market.

The reconciliation for all assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) is as follows for the periods indicated (in thousands):

	Nine months ended September 30,	
	2012	2011
Securities available for sale, beginning of period	\$ 1,636	\$ 572
Sales	(360)	(1,674)
Principal paydowns and other	—	(54)
Total gains (losses) realized/unrealized:		
Included in earnings	331	1,613
Included in other comprehensive income	(102)	4,884
Transfers from Level 3 to Level 2	(1,505)	—
Securities available for sale, end of period	<u>\$ —</u>	<u>\$ 5,341</u>

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

(11.) FAIR VALUE MEASUREMENTS (Continued)

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. Fair value estimates for other financial instruments not included elsewhere in this disclosure are discussed below.

Securities held to maturity: The fair value of the Company’s investment securities held to maturity is primarily measured using information from a third-party 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.

Loans: The fair value of the Company’s loans was estimated by discounting the expected future cash flows using the current interest rates at which similar loans would be made for the same remaining maturities. Loans were first segregated by type such as commercial, residential mortgage, and consumer, and were then further segmented into fixed and variable rate and loan quality categories. Expected future cash flows were projected based on contractual cash flows, adjusted for estimated prepayments.

Time deposits: The fair value of time deposits was estimated using a discounted cash flow approach that applies prevailing market interest rates for similar maturity instruments. The fair values of the Company’s time deposit liabilities do not take into consideration the value of the Company’s long-term relationships with depositors, which may have significant value.

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	September 30, 2012		December 31, 2011	
		Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
Financial assets:					
Cash and cash equivalents	Level 1	\$ 77,045	\$ 77,045	\$ 57,583	\$ 57,583
Securities available for sale	Level 2	748,618	748,618	625,882	625,882
Securities available for sale ⁽¹⁾	Level 3	—	—	1,636	1,636
Securities held to maturity	Level 1	19,564	20,118	23,297	23,964
Loans held for sale	Level 2	1,411	1,476	2,410	2,442
Loans	Level 2	1,631,388	1,664,388	1,459,356	1,490,999
Loans ⁽²⁾	Level 3	3,296	3,296	2,160	2,160
Accrued interest receivable	Level 1	8,952	8,952	7,655	7,655
FHLB and FRB stock	Level 1	6,066	6,066	10,674	10,674
Financial liabilities:					
Non-maturity deposits	Level 1	1,636,612	1,636,612	1,230,923	1,230,923
Time deposits	Level 2	695,107	699,402	700,676	702,720
Short-term borrowings	Level 1	38,282	38,282	150,698	150,698
Accrued interest payable	Level 1	4,213	4,213	5,207	5,207

⁽¹⁾ Comprised of trust preferred asset-backed securities.

⁽²⁾ Comprised of collateral dependent impaired loans.

Table of Contents

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, 2011. 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 document that are not historical facts are forward looking statements made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995 (the "Act"). In addition, certain statements may be contained in our future filings with SEC, in press releases, and in oral and written statements made by or with our approval that are not statements of historical fact and constitute forward looking statement within the meaning of the Act. Forward looking statements describe our future plans, strategies and expectations and are based on certain assumptions. Words such as "may," "could," "should," "would," "believe," "anticipate," "estimate," "expect," "intend," "plan," "target," "projects," and other similar expressions are intended to identify forward looking statements but are not the exclusive means of identifying such statements.

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 identified under the heading "Risk Factors" in Item 1A of Part I of our Annual Report on Form 10-K for the year ended December 31, 2011, could affect our financial performance and could cause our actual results or circumstances for future periods to differ materially from those anticipated or projected.

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

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

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

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

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

MANAGEMENT'S DISCUSSION AND ANALYSIS

Branch Acquisitions

On January 19, 2012, the Bank entered into agreements with First Niagara Bank, National Association ("First Niagara") to acquire four retail bank branches in Medina, Brockport, Batavia and Waterloo, New York (the "First Niagara Branches") and four retail bank branches previously owned by HSBC Bank USA, National Association ("HSBC") in Elmira, Elmira Heights, Horseheads and Albion, New York (the "HSBC Branches"). First Niagara assigned its rights to the HSBC branches in connection with its acquisition of HSBC's Upstate New York banking franchise. Under the terms of the agreements, the Bank assumed all related deposits and purchased the related branch premises and certain performing loans. The transaction to acquire the First Niagara Branches was completed on June 22, 2012 and the transaction to acquire the HSBC Branches was completed on August 17, 2012. The combined assets acquired and deposits assumed in the two transactions were recorded at their estimated fair values as follows:

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

The transactions were accounted for using the acquisition method of accounting and accordingly, assets acquired, liabilities assumed and consideration exchanged were recorded at their estimated fair values on the acquisition dates. Fair values are preliminary and in certain cases are subject to refinement for up to one year after the closing date of the acquisition as additional information relative to fair values becomes available.

The operating results of the acquired branches included in our consolidated statement of income for the nine months ended September 30, 2012 reflect only amounts from the acquisition dates through September 30, 2012, the end of the third quarter.

We acquired the loan portfolios at a fair value discount of \$824 thousand. The discount represents expected credit losses, net of market interest rate adjustments. The discount on loans receivable will be amortized to interest income over the estimated remaining life of the acquired loans using the level yield method. The core deposit intangible asset will be amortized on an accelerated basis over a period of approximately nine and a half years. The time deposit premium of \$335 thousand will be accreted over the estimated remaining life of the related deposits as a reduction of interest expense.

Preliminary goodwill of \$11.6 million is calculated as the purchase premium after adjusting for the fair value of net assets acquired and represents the value expected from the synergies created and the economies of scale expected from combining the operations of the acquired branches with those of the Bank. All goodwill and core deposit intangible assets arising from this acquisition are expected to be deductible for tax purposes.

In anticipation of the branch acquisitions, we leveraged our balance sheet through the execution of short-term FHLB advances in order to "pre-acquire" investment securities. This strategy allowed us to purchase securities over time and carry out a dollar cost averaging strategy. Our purchase of investment securities was comprised of mortgage-backed securities, U.S. Government agencies and sponsored enterprise bonds and tax-exempt municipal bonds. The cash received at the time of closing the transactions was used to pay down the short-term FHLB advances used to fund the purchase of the investment securities.

Management Transition

In August, the Company announced a management transition resulting from the retirement of Peter G. Humphrey as President and Chief Executive Officer. As part of the transition, John Benjamin, the Company's Chairman and Interim Chief Executive Officer announced the promotion of Richard Harrison as Chief Operating Officer and Martin Birmingham as President and Chief of Community Banking, with a combined 45 years of local banking experience. Mr. Harrison and Mr. Birmingham were instrumental in the structuring, negotiating and integrating the branch office acquisitions.

MANAGEMENT'S DISCUSSION AND ANALYSIS

RESULTS OF OPERATIONS

Summary of Performance

Net income totaled \$4.3 million for the third quarter of 2012 compared to \$5.5 million for the third quarter of 2011. Net income available to common shareholders for the third quarter of 2012 was \$3.9 million, or \$0.28 per diluted share, compared with \$5.1 million, or \$0.37 per diluted share, for the third quarter of last year. Return on average equity was 6.77% and return on average assets was 0.65% for the third quarter of 2012 compared to 9.07% and 0.95%, respectively, for the third quarter of 2011.

Net income for the three and nine months ended September 30, 2012 was reduced by expenses related to the branch acquisitions. Pre-tax acquisition expenses were approximately \$1.9 million for the three months ended September 30, 2012 and \$3.0 million for the nine months ended September 30, 2012, consisting mainly of professional fees, computer and data processing and supplies and postage expended to facilitate the purchase of the branches.

Net income for the three and nine months ended September 30, 2012 was further reduced by expenses incurred in connection with the retirement of the Company's former President and Chief Executive Officer. Pre-tax retirement-related expenses were approximately \$2.6 million for the three and nine months ended September 30, 2012, consisting of separation pay and a supplemental executive retirement plan ("SERP").

Net income for the nine months ended September 30, 2012 totaled \$17.1 million compared to \$17.0 million for the same period in 2011. For the first nine months of 2012 net income available to common shareholders was \$16.0 million, or \$1.16 per diluted share, compared with \$14.2 million, or \$1.09 per diluted share, for the first nine months of 2011. Return on average equity was 9.32% and return on average assets was 0.92% for the nine months ended September 30, 2012 compared to 9.95% and 1.01%, respectively, for the same period in 2011.

Net Interest Income and Net Interest Margin

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

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

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

	Three months ended September 30,		Nine months ended September 30,	
	2012	2011	2012	2011
Interest income per consolidated statements of income	\$25,299	\$23,774	\$72,480	\$71,243
Adjustment to fully taxable equivalent basis	603	511	1,678	1,559
Interest income adjusted to a fully taxable equivalent basis	25,902	24,285	74,158	72,802
Interest expense per consolidated statements of income	2,200	3,156	7,052	10,534
Net interest income on a taxable equivalent basis	<u>\$23,702</u>	<u>\$21,129</u>	<u>\$67,106</u>	<u>\$62,268</u>

MANAGEMENT'S DISCUSSION AND ANALYSIS***Analysis of Net Interest Income for the Three Months ended September 30, 2012 and September 30, 2011***

Net interest income on a taxable equivalent basis for the three months ended September 30, 2012, was \$23.7 million, an increase of \$2.6 million or 12% versus the comparable quarter last year. The increase in taxable equivalent net interest income was primarily attributable to favorable volume variances (as changes in the balances and mix of earning assets and interest-bearing liabilities added \$3.7 million to taxable equivalent net interest income), partly offset by unfavorable rate variances (as the impact of changes in the interest rate environment and product pricing reduced taxable equivalent net interest income by \$1.1 million).

The net interest margin for the third quarter of 2012 was 3.96%, 6 basis points lower than 4.02% for the same period in 2011. This comparable period decrease was a function of a 1 basis point decrease in interest rate spread, combined with a 5 basis point lower contribution from net free funds (due principally to lower rates on interest-bearing liabilities reducing the value of noninterest-bearing deposits and other net free funds). The lower interest rate spread was a net result of a 30 basis point decrease in the yield on earning assets and a 29 basis point decrease in the cost of interest-bearing liabilities.

The Federal Reserve left the Federal funds rate unchanged at 0.25% during 2010, 2011 and thus far in 2012. During 2011, the Federal Reserve disclosed that short-term interest rates would be held near zero through at least the middle of 2013, in anticipation of low growth and little risk of inflation. In April 2012, the Federal Reserve further announced that interest rates will likely remain at exceptionally low levels through late 2014.

The yield on earning assets was 4.32% for the third quarter of 2012, 30 basis points lower than the third quarter of 2011. Loan yields decreased 35 basis points to 5.10%, also impacted by the lower interest rate environment. Residential mortgage and consumer indirect loans in particular, down 49 and 68 basis points, respectively, experienced lower yields given the competitive pricing pressures in a low interest rate environment. The yield on investment securities dropped 35 basis points to 2.60%, also impacted by the lower interest rate environment, prepayments of mortgage-related investment securities and the impact of investing the excess cash related to our branch acquisitions into low yielding securities. Overall, earning asset rate changes reduced interest income by \$2.0 million.

The cost of average interest-bearing liabilities of 0.46% in the third quarter of 2012 was 29 basis points lower than the third quarter of 2011. The average cost of interest-bearing deposits was 0.47% in 2012, 25 basis points lower than 2011, reflecting the lower rate environment, mitigated by a focus on product pricing to retain balances. Borrowing costs decreased 67 basis points to 0.43%, primarily a result of the redemption of the Company's 10.20% junior subordinated debentures during the third quarter of 2011. The interest-bearing liability rate changes resulted in approximately \$900 thousand of lower interest expense.

Average interest-earning assets were \$2.388 billion for the third quarter of 2012, an increase of \$297.2 million or 14% from the comparable quarter last year, primarily due to a \$244.3 million increase in average loans. The growth in average loans was comprised of increases in all loan categories, with consumer loans up \$148.5 million, commercial loans up \$72.9 million and residential mortgage loans up \$22.9 million.

Average interest-bearing liabilities of \$1.891 billion in the third quarter of 2012 were \$226.1 million or 14% higher than the third quarter of 2011. On average, interest-bearing deposits grew \$223.6 million, while noninterest-bearing demand deposits (a principal component of net free funds) were up \$71.7 million. The increases in average deposits were primarily attributable to retail deposits assumed in the branch acquisitions. Average borrowings increased \$2.4 million between the third quarter periods, with short-term borrowings higher by \$13.0 million, offset by a decrease in long-term funding. There was no long-term debt outstanding during the first nine months of 2012. During the third quarter of 2011 we repaid all of our outstanding long-term debt, including our 10.20% junior subordinated debentures.

Analysis of Net Interest Income for the Nine Months ended September 30, 2012 and September 30, 2011

Net interest income on a taxable equivalent basis for the first nine months of 2012 was \$67.1 million, an increase of \$4.8 million or 8% versus the same period last year. The increase in taxable equivalent net interest income was primarily attributable to a favorable volume variance (as changes in the balances and mix of earning assets and interest-bearing liabilities added \$8.3 million to taxable equivalent net interest income), partially offset by an unfavorable rate variance (as the impact of changes in the interest rate environment and product pricing decreased taxable equivalent net interest income by \$3.4 million).

The net interest margin for the first nine months of 2012 was 3.97%, 5 basis points lower than 4.02% for the same period last year. The interest rate spread was 3.86% during the first nine months of 2012 compared to 3.85% during the first nine months of 2011. This 1 basis point increase in interest rate spread was offset by a 6 basis point decrease in the contribution from net free funds. The higher interest rate spread was a net result of a 32 basis point decrease in the yield on earning assets and a 33 basis point decrease in the cost of interest-bearing liabilities.

The yield on earning assets was 4.38% for the first nine months of 2012. The yield was 32 basis points lower than the same period last year, which is attributable to decreases in the yields on the investment security portfolio (down 27 basis points, to 2.70%) and loan portfolio (down 46 basis points to 5.13%).

MANAGEMENT'S DISCUSSION AND ANALYSIS

The cost of interest-bearing liabilities was 0.52% for the first nine months of 2012, 33 basis points lower than the same period in 2011. Rates on interest-bearing deposits were down 24 basis points to 0.53%. The cost of short-term borrowings decreased 9 basis points to 0.44%.

Average interest-earning assets were \$2.259 billion for the first nine months of 2012, an increase of \$192.0 million or 9% from the comparable period last year, with a \$192.9 million increase in average loans partially offset by a \$834 thousand decrease in average securities. The growth in average loans was comprised of increases in consumer loans (up \$121.2 million, primarily indirect loans), commercial loans (up \$71.4 million) and residential mortgage loans (up \$361 thousand).

Average interest-bearing liabilities of \$1.803 billion in the first nine months of 2012 were \$145.4 million or 9% higher than the first nine months of 2011. On average, interest-bearing deposits grew \$116.8 million (attributable to increases of \$58.3 in retail deposits and \$58.5 million in municipal deposits), while noninterest-bearing demand deposits were up \$49.6 million. Average borrowings increased \$28.6 million between the first nine months of 2012 and the same period in 2011, with short-term borrowings higher by \$49.9 million, offset by a decrease in long-term funding.

Table of Contents

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 September 30,					
	2012			2011		
	Average Balance	Interest	Average Rate	Average Balance	Interest	Average Rate
Interest-earning assets:						
Federal funds sold and interest-earning deposits	\$ 168	\$ —	0.16%	\$ 93	\$ —	0.18%
Investment securities ⁽¹⁾ :						
Taxable	551,770	3,131	2.27	552,129	3,647	2.64
Tax-exempt ⁽²⁾	194,026	1,723	3.55	140,815	1,458	4.14
Total investment securities	745,796	4,854	2.60	692,944	5,105	2.95
Loans:						
Commercial business	248,060	2,884	4.62	216,980	2,591	4.74
Commercial mortgage	409,884	5,672	5.51	368,071	5,254	5.66
Residential mortgage	141,808	1,826	5.15	118,952	1,678	5.64
Home equity	271,131	2,919	4.28	217,808	2,399	4.37
Consumer indirect	544,527	7,034	5.14	450,813	6,608	5.82
Other consumer	26,179	713	10.84	24,644	650	10.47
Total loans	1,641,589	21,048	5.10	1,397,268	19,180	5.45
Total interest-earning assets	2,387,553	25,902	4.32	2,090,305	24,285	4.62
Allowance for loan losses	(24,604)			(21,118)		
Other noninterest-earning assets	244,548			225,669		
Total assets	<u>\$2,607,497</u>			<u>\$2,294,856</u>		
Interest-bearing liabilities:						
Deposits:						
Interest-bearing demand	\$ 425,739	\$ 152	0.14	\$ 366,567	\$ 144	0.16
Savings and money market	611,564	227	0.15	436,336	248	0.23
Time deposits	695,682	1,650	0.94	706,435	2,336	1.31
Total interest-bearing deposits	1,732,985	2,029	0.47	1,509,338	2,728	0.72
Short-term borrowings	157,973	171	0.43	145,007	172	0.47
Long-term borrowings	—	—	—	10,527	256	9.74
Total borrowings	157,973	171	0.43	155,534	428	1.10
Total interest-bearing liabilities	1,890,958	2,200	0.46	1,664,872	3,156	0.75
Noninterest-bearing demand deposits	447,204			375,518		
Other noninterest-bearing liabilities	18,625			14,087		
Shareholders' equity	250,710			240,379		
Total liabilities and shareholders' equity	<u>\$2,607,497</u>			<u>\$2,294,856</u>		
Net interest income (tax-equivalent)		<u>\$23,702</u>			<u>\$21,129</u>	
Interest rate spread			<u>3.86%</u>			<u>3.87%</u>
Net earning assets	<u>\$ 496,595</u>			<u>\$ 425,433</u>		
Net interest margin (tax-equivalent)			<u>3.96%</u>			<u>4.02%</u>
Ratio of average interest-earning assets to average interest-bearing liabilities			<u>126.26%</u>			<u>125.55%</u>

⁽¹⁾ Investment securities are shown at amortized cost and include non-performing securities.

⁽²⁾ The interest on tax-exempt securities is calculated on a tax equivalent basis assuming a Federal tax rate of 35%.

MANAGEMENT'S DISCUSSION AND ANALYSIS

	Nine months ended September 30,					
	2012			2011		
	Average Balance	Interest	Average Rate	Average Balance	Interest	Average Rate
Interest-earning assets:						
Federal funds sold and interest-earning deposits	\$ 119	\$ —	0.21%	\$ 155	\$ —	0.21%
Investment securities ⁽¹⁾ :						
Taxable	524,756	9,268	2.35	556,077	11,063	2.65
Tax-exempt ⁽²⁾	170,798	4,794	3.74	140,311	4,453	4.23
Total investment securities	695,554	14,062	2.70	696,388	15,516	2.97
Loans:						
Commercial business	239,319	8,343	4.66	212,337	7,617	4.80
Commercial mortgage	407,928	16,743	5.48	363,547	15,701	5.77
Residential mortgage	123,930	4,896	5.27	123,569	5,250	5.67
Home equity	249,044	7,961	4.27	213,001	7,098	4.46
Consumer indirect	519,175	20,216	5.20	433,578	19,677	6.07
Other consumer	24,391	1,937	10.61	24,860	1,943	10.45
Total loans	1,563,787	60,096	5.13	1,370,892	57,286	5.59
Total interest-earning assets	2,259,460	74,158	4.38	2,067,435	72,802	4.70
Allowance for loan losses	(24,305)			(20,912)		
Other noninterest-earning assets	240,035			215,409		
Total assets	<u>\$2,475,190</u>			<u>\$2,261,932</u>		
Interest-bearing liabilities:						
Deposits:						
Interest-bearing demand	\$ 409,331	\$ 443	0.14	\$ 384,651	\$ 467	0.16
Savings and money market	557,800	761	0.18	446,355	785	0.24
Time deposits	696,051	5,392	1.03	715,390	7,607	1.42
Total interest-bearing deposits	1,663,182	6,596	0.53	1,546,396	8,859	0.77
Short-term borrowings	139,330	456	0.44	89,419	354	0.53
Long-term borrowings	—	—	—	21,265	1,321	8.29
Total borrowings	139,330	456	0.44	110,684	1,675	2.02
Total interest-bearing liabilities	1,802,512	7,052	0.52	1,657,080	10,534	0.85
Noninterest-bearing demand deposits	411,036			361,393		
Other noninterest-bearing liabilities	16,268			14,537		
Shareholders' equity	245,374			228,922		
Total liabilities and shareholders' equity	<u>\$2,475,190</u>			<u>\$2,261,932</u>		
Net interest income (tax-equivalent)		<u>\$67,106</u>			<u>\$62,268</u>	
Interest rate spread			<u>3.86%</u>			<u>3.85%</u>
Net earning assets	<u>\$ 456,948</u>			<u>\$ 410,355</u>		
Net interest margin (tax-equivalent)			<u>3.97%</u>			<u>4.02%</u>
Ratio of average interest-earning assets to average interest-bearing liabilities			<u>125.35%</u>			<u>124.76%</u>

⁽¹⁾ Investment securities are shown at amortized cost and include non-performing securities.

⁽²⁾ The interest on tax-exempt securities is calculated on a tax equivalent basis assuming a Federal tax rate of 35%.

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 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 September 30, 2012 vs. 2011			Nine months ended September 30, 2012 vs. 2011		
	Volume	Rate	Total	Volume	Rate	Total
Interest income:						
Federal funds sold and interest-earning deposits	\$ —	\$ —	\$ —	\$ —	\$ —	\$ —
Investment securities:						
Taxable	(2)	(514)	(516)	(600)	(1,195)	(1,795)
Tax-exempt	494	(229)	265	895	(554)	341
Total investment securities	492	(743)	(251)	295	(1,749)	(1,454)
Loans:						
Commercial business	363	(70)	293	946	(220)	726
Commercial mortgage	583	(165)	418	1,849	(807)	1,042
Residential mortgage	303	(155)	148	15	(369)	(354)
Home equity	575	(55)	520	1,162	(299)	863
Consumer indirect	1,270	(844)	426	3,564	(3,025)	539
Other consumer	41	22	63	(37)	31	(6)
Total loans	3,135	(1,267)	1,868	7,499	(4,689)	2,810
Total interest income	<u>3,627</u>	<u>(2,010)</u>	<u>1,617</u>	<u>7,794</u>	<u>(6,438)</u>	<u>1,356</u>
Interest expense:						
Deposits:						
Interest-bearing demand	22	(14)	8	29	(53)	(24)
Savings and money market	81	(102)	(21)	173	(197)	(24)
Time deposits	(35)	(651)	(686)	(201)	(2,014)	(2,215)
Total interest-bearing deposits	68	(767)	(699)	1	(2,264)	(2,263)
Short-term borrowings	15	(16)	(1)	171	(69)	102
Long-term borrowings	(128)	(128)	(256)	(660)	(661)	(1,321)
Total borrowings	(113)	(144)	(257)	(489)	(730)	(1,219)
Total interest expense	<u>(45)</u>	<u>(911)</u>	<u>(956)</u>	<u>(488)</u>	<u>(2,994)</u>	<u>(3,482)</u>
Net interest income	<u>\$3,672</u>	<u>\$(1,099)</u>	<u>\$2,573</u>	<u>\$8,282</u>	<u>\$(3,444)</u>	<u>\$ 4,838</u>

Provision for Loan Losses

The provision for loan losses is based upon credit loss experience, growth or contraction of specific segments of the loan portfolio, and the estimate of losses inherent in the current loan portfolio. There were provisions for loan losses of \$1.8 million and \$4.6 million for the three and nine month periods ended September 30, 2012, compared with provisions of \$3.5 million and \$5.6 million for the corresponding periods in 2011, respectively. See "Allowance for Loan Losses" under the section titled "Lending Activities" included herein for additional information.

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 September 30,		Nine months ended September 30,	
	2012	2011	2012	2011
Service charges on deposits	\$2,292	\$2,257	\$6,101	\$6,605
ATM and debit card	1,219	1,117	3,368	3,256
Broker-dealer fees and commissions	609	541	1,630	1,329
Company owned life insurance	433	422	1,300	967
Net gain on sale of loans held for sale	323	318	981	659
Net gain on disposal of investment securities	596	2,340	2,164	2,347
Loan servicing	142	64	645	662
Impairment charges on investment securities	—	—	(91)	—
Net (loss) gain on disposal of other assets	(114)	7	(79)	44
Other	853	970	2,475	2,289
Total noninterest income	<u>\$6,353</u>	<u>\$8,036</u>	<u>\$18,494</u>	<u>\$18,158</u>

The components of noninterest income fluctuated as discussed below.

Service charges on deposit accounts were up \$35 thousand or 2% in the third quarter of 2012 and down \$504 thousand or 8% for the nine months ended September 30, 2012, compared to the same periods a year earlier. The increase in service charges on deposit accounts during the third quarter reflects the accounts added from the branch acquisitions in June 2012 and August 2012. The year-to-date decrease was due to a reduction in consumer non-sufficient funds charges.

ATM and debit card income was up \$102 thousand or 9% and \$112 thousand or 3%, respectively, in the three and nine months ended September 30, 2012, compared to the same periods of 2011. The increased popularity of electronic banking and transaction processing has resulted in higher ATM and debit card point-of-sale usage income.

Broker-dealer fees and commissions were up \$68 thousand or 13% and \$301 thousand or 23%, respectively, in the three and nine months ended September 30, 2012, compared to the same periods of 2011. Broker-dealer fees and commissions fluctuate mainly due to sales volume, which increased during 2012 as a result of improving market and economic conditions and our renewed focus on this line of business.

During the third quarter of 2011 we purchased an additional \$18.0 million of company owned life insurance. The increased amount of insurance was largely responsible for the 2012 increases in company owned life insurance income when compared to the three and nine month periods in 2011.

Gains from the sale of loans held for sale increased \$5 thousand in the third quarter of 2012 and \$322 thousand for the nine months ended September 30, 2012, compared to the same periods a year earlier, due to increased origination volume related primarily to refinancing activity, a result of low interest rates.

Loan servicing income represents fees earned for servicing loans sold to third parties, net of amortization expense and impairment losses, if any, associated with capitalized loan servicing assets. Loan servicing income was up \$78 thousand in the third quarter of 2012 and was down \$17 thousand for the nine months ended September 30, 2012, compared to the same periods a year ago. The increase in loan servicing income for the third quarter of 2012 was primarily due to the aforementioned increase in loan origination volume and loan sale margins.

We recognized pre-tax gains on investment securities of \$596 thousand and \$2.2 million from the sale of pooled trust-preferred securities in the three and nine month periods ended September 30, 2012, respectively. Each of the securities had been written down in prior periods and was included in non-performing assets at the end of the quarter preceding its sale. We continue to monitor the market for the trust-preferred securities and evaluate the potential for future dispositions. The amount and timing of our sale of investments securities is dependent on a number of factors, including our prudent efforts to realize gains while managing duration, premium and credit risk.

Disposals of other assets resulted in a net loss of \$114 thousand in the third quarter of 2012. Due to their proximity to our existing locations we consolidated four branches as part of the branch acquisitions. The majority of the loss on the disposal of other assets was due to write-off of leasehold improvements and other fixed assets for these branches that were closed.

Other noninterest income decreased \$117 thousand or 12% in the third quarter of 2012 and increased \$186 thousand or 8% for the nine months ended September 30, 2012, compared to the same periods a year earlier. Other noninterest income for the third quarter of 2011 includes \$152 thousand of insurance proceeds. Income from our investment in several limited partnerships comprised the majority of the year-to-date increase.

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 September 30,		Nine months ended September 30,	
	2012	2011	2012	2011
Salaries and employee benefits	\$12,438	\$ 9,113	\$30,565	\$26,384
Occupancy and equipment	2,915	2,722	8,400	8,209
Professional services	1,452	570	3,243	1,823
Computer and data processing	976	603	2,462	1,854
Supplies and postage	899	461	1,930	1,337
FDIC assessments	356	437	957	1,212
Advertising and promotions	261	477	499	895
Loss on extinguishment of debt	—	1,083	—	1,083
Other	2,321	1,546	5,800	4,718
Total noninterest expense	<u>\$21,618</u>	<u>\$17,012</u>	<u>\$53,856</u>	<u>\$47,515</u>

The components of noninterest expense fluctuated as discussed below.

During the three and nine month periods ended September 30, 2012, salaries and employee benefits increased by \$3.3 million or 36% and \$4.2 million or 16%, respectively, when compared to the same periods one year earlier. Included in salaries and employee benefits for the three and nine month periods ended September 30, 2012 are pre-tax costs of approximately \$2.6 million that were incurred in association with the retirement of our CEO. After adjusting for these expenses, the increase in salaries and employee benefits for the three and nine months periods ended September 30, 2012 when compared to the same periods in 2011 are attributable to higher pension costs along with increased staffing levels. Full time equivalents increased by 8% from 575 at September 30, 2011 to 623 at September 30, 2012, primarily due to the branch acquisitions.

Professional fees, computer and data processing and supplies and postage, increased collectively by \$1.7 million in the third quarter of 2012 and \$2.6 million for the nine months ended September 30, 2012, when compared to the same periods one year earlier, due to expenses related to the branch acquisition transactions. The management transition described earlier also contributed to the increase in professional fees.

Advertising and promotions costs were down \$216 thousand or 45% in the third quarter of 2012 and \$396 thousand or 44% for the nine months ended September 30, 2012, compared to the same periods a year earlier, due to the timing of marketing campaigns and promotions, coupled with cost management strategies.

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

Other noninterest expense was \$2.3 million in the third quarter of 2012 and \$5.8 million for the nine months ended September 30, 2012, representing increases of \$775 thousand and \$1.1 million, respectively, from the same periods in 2011. The increases in other noninterest expenses were primarily related to the branch acquisition transactions.

The efficiency ratio for the third quarter of 2012 was 73.04% compared with 62.97% for the third quarter of 2011, and 64.29% for the nine months ended September 30, 2012, compared to 60.58% for the same period a year ago. Our higher efficiency ratio was primarily the result of the aforementioned branch acquisition and CEO retirement expenses. The efficiency ratio equals noninterest expense less other real estate expense and amortization of intangible assets as a percentage of net revenue, defined as the sum of tax-equivalent net interest income and noninterest income before net gains and impairment charges on investment securities.

Income Taxes

We recorded income tax expense of \$1.8 million in the third quarter of 2012, compared to of \$2.7 million in the third quarter of 2011. For the nine month period ended September 30, 2012, income tax expense totaled \$8.3 million compared to \$8.7 million in the same period of 2011. These changes were due in part to decreases of \$2.1 million and \$276 thousand in pre-tax income for the three and nine month periods of 2012, respectively, compared to the prior year. The effective tax rates recorded for 2012 on a quarter-to-date and year-to-date basis were 29.7% and 32.8%, respectively, in comparison to the September 30, 2011 quarter-to-date and year-to-date effective tax rates of 32.6% and 33.8%, respectively. The lower effective tax rates in 2012 were a result of the greater impact of tax-exempt income on lower taxable income. Effective tax rates are impacted by items of income and expense that are not subject to federal or state taxation. Our effective tax rates reflect the impact of these items, which include, but are not limited to, interest income from tax-exempt securities and earnings on company owned life insurance.

MANAGEMENT'S DISCUSSION AND ANALYSIS

ANALYSIS OF FINANCIAL CONDITION

INVESTING ACTIVITIES

Investment Securities

The following table sets forth selected information regarding the composition of our investment securities portfolio as of the dates indicated (in thousands):

	Investment Securities Portfolio Composition			
	September 30, 2012		December 31, 2011	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Securities available for sale:				
U.S. Government agencies and government-sponsored enterprise securities	\$ 96,281	\$100,221	\$ 94,947	\$ 97,712
State and political subdivisions	177,480	184,687	119,099	124,424
Mortgage-backed securities:				
Agency mortgage-backed securities	446,150	461,959	390,375	401,596
Non-Agency mortgage-backed securities	103	801	327	2,089
Asset-backed securities ⁽¹⁾	157	950	297	1,697
Total available for sale securities	720,171	748,618	605,045	627,518
Securities held to maturity:				
State and political subdivisions	19,564	20,118	23,297	23,964
Total investment securities	<u>\$739,735</u>	<u>\$768,736</u>	<u>\$628,342</u>	<u>\$651,482</u>

⁽¹⁾ Includes non-performing investment securities. See "Non-Performing Assets and Potential Problem Loans" under the section titled "Lending Activities" included herein for additional information.

Investment securities available for sale increased \$121.1 million or 19%, from \$627.5 million at December 31, 2011 to \$748.6 million at September 30, 2012. When comparing those same periods, the net unrealized gain on investment securities available for sale increased \$6.0 million or 27%. As previously discussed, we leveraged our balance sheet through the execution of short-term FHLB advances in order to "pre-acquire" investment securities in anticipation of the branch acquisitions. Our purchase of investment securities was comprised of mortgage-backed securities, U.S. Government agencies and sponsored enterprise bonds and tax-exempt municipal bonds. This strategy allowed us to purchase securities over time and carry out a dollar cost averaging strategy.

Impairment Assessment

We review investment securities on an ongoing basis for the presence of other-than-temporary impairment ("OTTI") with formal reviews performed quarterly. When evaluating debt securities for OTTI, management considers many factors, including: (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, (3) whether the market decline was affected by macroeconomic conditions, and (4) whether the Company has the intention to sell the debt security or whether it is more likely than not that it will be required to sell the debt security before its anticipated recovery. The assessment of whether OTTI exists involves a high degree of subjectivity and judgment and is based on the information available to management at a point in time.

Securities Deemed to be Other-Than-Temporarily Impaired

There were no securities deemed to be other-than-temporarily impaired during the three months ended September 30, 2012. Through the impairment assessment process, we determined that a privately issued whole loan CMO was other-than-temporarily impaired due to credit quality at March 31, 2012 and recognized an OTTI charge of \$91 thousand related to that security during the first quarter of 2012. No impairment was recorded in the three months or nine months ended September 30, 2011.

MANAGEMENT'S DISCUSSION AND ANALYSIS

LENDING ACTIVITIES

The following table sets forth selected information regarding the composition of the Company's loan portfolio as of the dates indicated (in thousands).

	Loan Portfolio Composition			
	September 30, 2012		December 31, 2011	
	Amount	% of Total	Amount	% of Total
Commercial business	\$ 245,307	14.8%	\$ 233,836	15.7%
Commercial mortgage	403,120	24.3	393,244	26.5
Total commercial	648,427	39.1	627,080	42.2
Residential mortgage	139,984	8.4	113,911	7.7
Home equity	279,211	16.8	231,766	15.6
Consumer indirect	563,676	34.0	487,713	32.9
Other consumer	27,687	1.7	24,306	1.6
Total consumer	870,574	52.5	743,785	50.1
Total loans	1,658,985	100.0%	1,484,776	100.0%
Allowance for loan losses	24,301		23,260	
Total loans, net	<u>\$1,634,684</u>		<u>\$1,461,516</u>	

Total loans increased \$174.2 million to \$1.659 billion as of September 30, 2012 from \$1.485 billion as of December 31, 2011. The majority of the increase related to organic loan growth, however, the increase also reflects loans acquired in the branch acquisition.

Commercial loans increased \$21.3 million and represented 39.1% of total loans as of September 30, 2012, a result of our continued commercial business development efforts.

Residential mortgage loans increased \$26.1 million to \$140.0 million as of September 30, 2012 in comparison to \$113.9 million as of December 31, 2011. This category of loans increased as a result of residential mortgage loans acquired in the branch acquisitions.

Our home equity portfolio, which consists of home equity loans and lines, totaled \$279.2 million as of September 30, 2012, up \$47.4 million or 20% compared to December 31, 2011. At the time of closing, we acquired home equity loans and lines totaling \$29.7 million in the branch acquisitions. As of September 30, 2012, approximately 67% of the loans in the home equity portfolio were first lien positions.

The consumer indirect portfolio increased \$76.0 million to \$563.7 million as of September 30, 2012, from \$487.7 million as of December 31, 2011. During the first nine months of 2012, we originated \$242.2 million in indirect auto loans with an equal mix of new auto and used auto. This compares with \$192.7 million in indirect loan auto originations with a mix of approximately 46% new auto and 54% used auto for the same period in 2011.

Loans Held for Sale and Loan Servicing Rights

Loans held for sale (not included in the loan portfolio composition table) totaled \$1.4 million and \$2.4 million as of September 30, 2012 and December 31, 2011, respectively, all of which were residential real estate loans.

We sell certain qualifying newly originated or refinanced residential real estate mortgages on the secondary market. Residential real estate mortgages serviced for others, which are not included in the consolidated statements of financial condition, amounted to \$280.6 million as of September 30, 2012 and \$297.8 million as of December 31, 2011.

MANAGEMENT'S DISCUSSION AND ANALYSIS

Allowance for Loan Losses

The following table sets forth an analysis of the activity in the allowance for loan losses for the periods indicated (in thousands).

	Loan Loss Analysis			
	Three months ended		Nine months ended	
	September 30,		September 30,	
	2012	2011	2012	2011
Balance as of beginning of period	\$24,120	\$20,632	\$23,260	\$20,466
Charge-offs:				
Commercial business	337	75	536	390
Commercial mortgage	27	194	374	572
Residential mortgage	47	36	280	48
Home equity	80	142	177	404
Consumer indirect	1,846	1,226	4,648	3,571
Other consumer	201	208	605	687
Total charge-offs	2,538	1,881	6,620	5,672
Recoveries:				
Commercial business	50	61	282	325
Commercial mortgage	91	158	167	197
Residential mortgage	8	45	106	75
Home equity	15	21	35	38
Consumer indirect	722	371	2,195	1,576
Other consumer	69	90	268	354
Total recoveries	955	746	3,053	2,565
Net charge-offs	1,583	1,135	3,567	3,107
Provision for loan losses	1,764	3,480	4,608	5,618
Balance at end of period	<u>\$24,301</u>	<u>\$22,977</u>	<u>\$24,301</u>	<u>\$22,977</u>
Net loan charge-offs to average loans (annualized)	0.38%	0.32%	0.30%	0.30%
Allowance for loan losses to total loans	1.46%	1.60%	1.46%	1.60%
Allowance for loan losses to non-performing loans	233%	295%	233%	295%

The allowance for loan losses represents the estimated amount of probable credit losses inherent in our loan portfolio. We perform periodic, systematic reviews of the loan portfolio to estimate probable losses in the respective loan portfolios. In addition, we regularly evaluate prevailing economic and business conditions, industry concentrations, changes in the size and characteristics of the portfolio and other pertinent factors. The process we use to determine the overall allowance for loan losses is based on this analysis. Based on this analysis, we believe the allowance for loan losses is adequate as of September 30, 2012.

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

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

Net charge-offs of \$1.6 million in the third quarter of 2012 represented 0.38% of average loans on an annualized basis compared to \$1.1 million or 0.32% in the third quarter of 2011. For the nine months ended September 30, 2012 and 2011, net charge-offs of \$3.6 million and \$3.1 million, respectively, represented 0.30% of average loans for both periods. The provision for loan losses exceeded net charge-offs by \$181 thousand and \$1.0 million for the three and nine months ended September 30, 2012, respectively.

The allowance for loan losses was \$24.3 million at September 30, 2012, compared with \$23.3 million at December 31, 2011 and \$23.0 million at September 30, 2011. The ratio of the allowance for loan losses to total loans was 1.46% at September 30, 2012, compared with 1.57% at December 31, 2011 and 1.60% at September 30, 2011. Contributing to this ratio decline were the loans obtained in the branch acquisitions, which were recorded at fair market value as of the acquisition date with no allowance carried over, as required by U.S. generally accepted accounting principles.

MANAGEMENT'S DISCUSSION AND ANALYSIS

Non-Performing Assets and Potential Problem Loans

The table below sets forth the amounts and categories of the Company's non-performing assets at the dates indicated (in thousands).

	September 30, 2012	Non-Performing Assets December 31, 2011	September 30, 2011
Nonaccrual loans:			
Commercial business	\$ 3,621	\$ 1,259	\$ 2,380
Commercial mortgage	3,388	2,928	2,330
Residential mortgage	1,597	1,644	1,996
Home equity	929	682	501
Consumer indirect	876	558	586
Other consumer	20	—	—
Total nonaccrual loans	10,431	7,071	7,793
Accruing loans 90 days or more delinquent	3	5	4
Total non-performing loans	10,434	7,076	7,797
Foreclosed assets	303	475	582
Non-performing investment securities	766	1,636	5,341
Total non-performing assets	<u>\$ 11,503</u>	<u>\$ 9,187</u>	<u>\$ 13,720</u>
Non-performing loans to total loans	0.63%	0.48%	0.54%
Non-performing assets to total assets	0.43%	0.39%	0.58%

Changes in the level of nonaccrual loans typically represent increases for loans that reach a specified past due status, offset by reductions for loans that are charged-off, paid down, sold, transferred to foreclosed real estate, or are no longer classified as nonaccrual because they have returned to accrual status. Activity in nonaccrual loans for periods indicated was as follows (in thousands).

	Three months ended September 30,	Nine months ended September 30,
	2012	2012
Nonaccrual loans, beginning of period	\$ 11,334	\$ 7,071
Additions	3,617	15,169
Payments	(1,597)	(4,601)
Charge-offs	(2,413)	(6,282)
Returned to accruing status	(443)	(676)
Transferred to other real estate or repossessed assets	(67)	(250)
Nonaccrual loans, end of period	<u>\$ 10,431</u>	<u>\$ 10,431</u>

Non-performing assets include non-performing loans, foreclosed assets and non-performing investment securities. Non-performing assets at September 30, 2012 were \$11.5 million, an increase of \$2.3 million from the \$9.2 million balance at December 31, 2011.

Non-performing loans were \$10.4 million at September 30, 2012, an increase of \$3.4 million from the \$7.1 million balance at December 31, 2011. Commercial non-performing loans increased \$2.8 million from December 31, 2011 primarily due to the addition of two commercial borrowers. As of September 30, 2012, these two commercial borrowers comprised 48% of the total non-performing commercial loan balance and 32% of all non-performing loans. The ratio of non-performing loans to total loans was 0.63% at September 30, 2012, compared to 0.48% at December 31, 2011. The average of our peer group was 2.76% of total loans at June 30, 2012, the most recent period for which information is available (Source: Federal Financial Institutions Examination Council — Bank Holding Company Performance Report as of June 30, 2012 — Top-tier bank holding companies having consolidated assets between \$1 billion and \$3 billion).

Foreclosed assets consist of real property formerly pledged as collateral to loans, which we have acquired through foreclosure proceedings or acceptance of a deed in lieu of foreclosure. Foreclosed asset holdings represented 5 properties totaling \$303 thousand at September 30, 2012 and 8 properties totaling \$475 thousand at December 31, 2011.

MANAGEMENT’S DISCUSSION AND ANALYSIS

As of September 30, 2012, non-performing investment securities for which we have stopped accruing interest consisted of 6 securities with a total fair value of \$766 thousand, compared to 10 securities with a fair value of \$1.6 million at December 31, 2011. The non-performing investment securities are pooled trust preferred securities included in non-performing assets at fair value. During the first nine months of 2012 we recognized pre-tax gains totaling \$2.2 million from the sale of four securities that had been written down in prior periods and classified as non-performing. These securities had a fair value of \$865 thousand at December 31, 2011.

Potential problem loans are loans that are currently performing, but information known about possible credit problems of the borrowers causes management to have concern as to the ability of such borrowers to comply with the present loan payment terms and may result in disclosure of such loans as nonperforming at some time in the future. These loans remain in a performing status due to a variety of factors, including payment history, the value of collateral supporting the credits, and/or personal or government guarantees. Management considers loans classified as substandard, which continue to accrue interest, to be potential problem loans. We identified \$9.8 million and \$8.6 million in loans that continued to accrue interest which were classified as substandard as of September 30, 2012 and December 31, 2011, respectively.

In addition, we currently have a large commercial relationship with an Industrial Development Agency project in our market area. The relationship consists of a \$14.5 million first lien mortgage position and \$3.6 million second lien mortgage on a manufacturing facility. Recent events with the underlying third party tenant of the project has resulted in our monitoring the credit relationship more closely and including the first mortgage loan as “uncriticized—watch” and the second mortgage loan as “special mention” in our loan rating system. The loans are current as of September 30, 2012.

FUNDING ACTIVITIES

Deposits

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

	Deposit Composition			
	September 30, 2012		December 31, 2011	
	Amount	% of Total	Amount	% of Total
Noninterest-bearing demand	\$ 490,706	21.1%	\$ 393,421	20.3%
Interest-bearing demand	472,023	20.2	362,555	18.8
Savings and money market	673,883	28.9	474,947	24.6
Time deposits < \$100,000	450,962	19.3	486,496	25.2
Time deposits of \$100,000 or more	244,145	10.5	214,180	11.1
Total deposits	<u>\$2,331,719</u>	<u>100.0%</u>	<u>\$1,931,599</u>	<u>100.0%</u>

We offer a variety of deposit products designed to attract and retain customers, with the primary focus on building and expanding long-term relationships. As of September 30, 2012, total deposits were \$2.332 billion, an increase of \$400.1 million in comparison to \$1.932 billion as of December 31, 2011. The increase reflects deposits assumed in the branch acquisitions, which at the time of closing totaled \$286.8 million. Time deposits were approximately 30% and 36% of total deposits at September 30, 2012 and December 31, 2011, respectively. Depositors remain hesitant to invest in certificates of deposit for long periods due to the low rate environment and, as a result, reduced both the amount they placed in time deposits and the maturity terms.

Nonpublic deposits represent the largest component of our funding. Total nonpublic deposits were \$1.785 billion and \$1.541 billion as of September 30, 2012 and December 31, 2011, respectively. All of the deposits assumed in the branch acquisitions were nonpublic deposits. We continue to manage this segment of funding through a strategy of competitive pricing and relationship-based sales and marketing that minimizes the number of customer relationships that have only a single high-cost deposit account.

As an additional source of funding, we offer a variety of public deposit products to the many towns, villages, counties and school districts within our market. Public deposits generally range from 20% to 25% of our total deposits. As of September 30, 2012, total public deposits were \$546.7 million in comparison to \$390.2 million as of December 31, 2011. There is a high degree of seasonality in this component of funding, as the level of deposits varies with the seasonal cash flows for these public customers; however, our business development efforts in this line of business have been successful during 2012 and have resulted in an increase in customers and related public deposits. We maintain the necessary levels of short-term liquid assets and credit facilities to accommodate the seasonality associated with public deposits.

MANAGEMENT'S DISCUSSION AND ANALYSIS

Borrowings

The following table summarizes our borrowings as of the dates indicated (in thousands):

	September 30, 2012	December 31, 2011
Short-term borrowings:		
Customer repurchase agreements	\$ 38,282	\$ 36,301
Federal funds purchased	—	11,597
Short-term FHLB borrowings	—	102,800
Total short-term borrowings	<u>\$ 38,282</u>	<u>\$ 150,698</u>

We classify borrowings as short-term or long-term in accordance with the original terms of the agreement. There were no long-term borrowings outstanding as of September 30, 2012 or December 31, 2011.

We have credit capacity with the FHLB and can borrow through facilities that include amortizing and term advances or repurchase agreements. We had approximately \$126.1 million of immediate credit capacity with FHLB as of September 30, 2012. We had approximately \$430.1 million in secured borrowing capacity at the Federal Reserve Bank ("FRB") Discount Window, none of which was outstanding at September 30, 2012. The FHLB and FRB credit capacity are collateralized by securities from our investment portfolio and certain qualifying loans. We had approximately \$114 million of credit available under unsecured federal funds purchased lines with various banks as of September 30, 2012.

Funds are borrowed on an overnight basis through repurchase agreements with bank customers and federal funds purchased from other financial institutions. Customer repurchase agreement borrowings are collateralized by securities of U.S. Government agencies. These short-term repurchase agreements amounted to \$38.3 million and \$36.3 million as of September 30, 2012 and December 31, 2011, respectively. Federal funds purchased are short-term borrowings that typically mature within one to ninety days. There were no Federal funds purchased at September 30, 2012. Federal funds purchased totaled \$11.6 million at December 31, 2011. Short-term FHLB borrowings have original maturities of less than one year and include overnight borrowings which we typically utilizes to address short term funding needs as they arise. There were no FHLB borrowings at September 30, 2012. FHLB borrowings totaled \$102.8 million at December 31, 2011, and consisted of short-term advances.

As previously discussed, we leveraged our balance sheet through the execution of short-term FHLB advances in order to "pre-acquire" investment securities in anticipation of the branch acquisitions. The cash received at the time of closing the transactions was used to pay down the short-term FHLB advances used to fund the purchase of the investment securities.

Shareholders' Equity

Shareholders' equity was \$251.8 million at September 30, 2012, an increase of \$14.6 million from \$237.2 million at December 31, 2011. Net income for the first nine months of 2012 increased shareholders' equity by \$17.1 million, which was partially offset by common and preferred stock dividends of \$6.7 million. Accumulated other comprehensive income included in shareholders' equity increased \$4.2 million during the first nine months of 2012 due primarily to higher net unrealized gains on securities available for sale.

LIQUIDITY AND CAPITAL RESOURCES

Liquidity

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

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

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

MANAGEMENT'S DISCUSSION AND ANALYSIS

Our cash and cash equivalents were \$77.0 million as of September 30, 2012, up \$19.4 million from \$57.6 million as of December 31, 2011. Net cash provided by operating activities totaled \$38.4 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 \$12.8 million, which included cash outflows of \$102.4 million for net loan originations and \$102.1 million from net investment securities transactions, substantially offset by \$195.8 million in cash received through the branch acquisitions. Net cash used by financing activities of \$6.1 million was attributed to a \$113.3 million increase in deposits, partly offset by a \$112.4 million decrease in short-term borrowings and \$6.6 million in dividend payments.

Capital Resources

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.

Quantitative measures established by regulation to ensure capital adequacy require the Company and the Bank to maintain minimum amounts and ratios of Total and Tier 1 capital to risk-weighted assets and of Tier 1 capital to average assets (all as defined in the regulations). These minimum amounts and ratios are included in the table below.

The Company's and the Bank's Tier 1 capital consists of shareholders' equity excluding unrealized gains and losses on securities available for sale (except for unrealized losses which have been determined to be other than temporary and recognized as expense in the consolidated statements of income), goodwill and other intangible assets and disallowed portions of deferred tax assets. Tier 1 capital for the Company includes, subject to limitation, \$17.5 million of preferred stock. The Company and the Bank's total capital are comprised of Tier 1 capital for each entity plus a permissible portion of the allowance for loan losses.

The Tier 1 and total capital ratios are calculated by dividing the respective capital amounts by risk-weighted assets. Risk-weighted assets are calculated based on regulatory requirements and include total assets, excluding goodwill and other intangible assets and disallowed portions of deferred tax assets, allocated by risk weight category and certain off-balance-sheet items (primarily loan commitments and standby letters of credit). The leverage ratio is calculated by dividing Tier 1 capital by adjusted quarterly average total assets, which exclude goodwill and other intangible assets and disallowed portions of deferred tax assets.

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

	September 30, 2012	December 31, 2011
Total shareholders' equity	\$ 251,842	\$ 237,194
Less: Unrealized gain on securities available for sale, net of tax	17,178	13,570
Unrecognized net periodic pension & postretirement benefits (costs), net of tax	(12,017)	(12,625)
Disallowed goodwill and other intangible assets	50,924	37,369
Disallowed deferred tax assets	—	1,794
Tier 1 capital	<u>\$ 195,757</u>	<u>\$ 197,086</u>
Adjusted average total assets (for leverage capital purposes)	<u>\$2,553,405</u>	<u>\$2,282,755</u>
Tier 1 leverage ratio (Tier 1 capital to adjusted average total assets)	7.67%	8.63%
Total Tier 1 capital	\$ 195,757	\$ 197,086
Plus: Qualifying allowance for loan losses	22,459	20,239
Total risk-based capital	<u>\$ 218,216</u>	<u>\$ 217,325</u>
Net risk-weighted assets	<u>\$1,794,844</u>	<u>\$1,616,119</u>
Tier 1 capital ratio (Tier 1 capital to net risk-weighted assets)	10.91%	12.20%
Total risk-based capital ratio (Total risk-based capital to net risk-weighted assets)	12.16%	13.45%

MANAGEMENT'S DISCUSSION AND ANALYSIS

The Company's and the Bank's actual and required regulatory capital ratios were as follows (dollars in thousands):

		Actual		For Capital Adequacy Purposes		Well Capitalized	
		Amount	Ratio	Amount	Ratio	Amount	Ratio
<u>September 30, 2012</u>							
Tier 1 leverage:	Company	\$195,757	7.67%	\$ 102,136	4.00%	\$127,670	5.00%
	Bank	187,029	7.34	101,979	4.00	127,474	5.00
Tier 1 capital:	Company	195,757	10.91	71,794	4.00	107,691	6.00
	Bank	187,029	10.44	71,626	4.00	107,439	6.00
Total risk-based capital:	Company	218,216	12.16	143,588	8.00	179,484	10.00
	Bank	209,436	11.70	143,251	8.00	179,064	10.00
<u>December 31, 2011</u>							
Tier 1 leverage:	Company	\$197,086	8.63%	\$ 91,310	4.00%	\$114,138	5.00%
	Bank	184,639	8.10	91,192	4.00	113,990	5.00
Tier 1 capital:	Company	197,086	12.20	64,645	4.00	96,967	6.00
	Bank	184,639	11.46	64,445	4.00	96,667	6.00
Total risk-based capital:	Company	217,325	13.45	129,290	8.00	161,612	10.00
	Bank	204,817	12.71	128,890	8.00	161,112	10.00

Regulatory capital ratios decreased as of September 30, 2012 when compared to December 31, 2011 primarily as a result of the branch acquisitions. Goodwill of \$11.6 million and core deposit intangibles of \$2.0 million were recorded in conjunction with the branch acquisitions. Such goodwill and intangibles are excluded from regulatory capital as calculated under regulatory accounting practices.

During the second quarter of 2012, U.S. banking regulators issued proposed rules for the U.S. adoption of the Basel III regulatory capital framework. The proposals narrow the definition of capital, increase the minimum levels of required capital, introduce capital buffers and increase the risk weights for various asset classes. Based on our current capital composition and levels, we believe that we would be in compliance with the requirements as set forth in the proposed rules if they were in effect at September 30, 2012.

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.

Table of Contents

ITEM 3. Quantitative and Qualitative Disclosures About Market Risk

Our primary market risk is interest rate risk, which is defined as the potential variability of our earnings that arises from changes in market interest rates and the magnitude of the change at varying points along the yield curve. Changes in market interest rates, whether they are increases or decreases, can trigger repricings and changes in the pace of payments for both assets and liabilities, which individually or in combination may affect our net income, net interest income and net interest margin, either positively or negatively.

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

The primary tool the Company uses to manage interest rate risk is a "rate shock" simulation to measure the rate sensitivity of the balance sheet. Rate shock simulation is a modeling technique used to estimate the impact of changes in rates on net interest income and the economic value of equity. The Company measures net interest income at risk 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 twelve and twenty four months. This simulation is based on management's assumption as to the effect of interest rate changes on assets and liabilities and assumes a parallel shift of the yield curve. It also includes certain assumptions about the future pricing of loans and deposits in response to changes in interest rates. Further, it assumes that delinquency rates would not change as a result of changes in interest rates, although there can be no assurance that this will be the case. While this simulation is a useful measure as to net interest income at risk due to a change in interest rates, it is not a forecast of the future results and is based on many assumptions that, if changed, could cause a different outcome.

In addition to the changes in interest rate scenarios listed above, the Company typically runs other scenarios to measure interest rate risk, which vary depending on the economic and interest rate environments.

The Company has experienced no significant changes in market risk due to changes in interest rates since the Company's Annual Report on Form 10-K for the year ended December 31, 2011, dated March 9, 2012, as filed with the Securities and Exchange Commission.

ITEM 4. Controls and Procedures

Evaluation of disclosure controls and procedures

As of September 30, 2012, the Company carried out an evaluation, under the supervision and with the participation of the Company's management, including the Company's Interim 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 Securities and Exchange Commission ("SEC") under the Securities Exchange Act of 1934 ("Exchange Act"). Based upon that evaluation, the Interim 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 Interim 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 September 30, 2012 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

The Company has experienced no material developments in its legal proceedings from the disclosure included in the Company's Annual Report on Form 10-K for the year ended December 31, 2011, dated March 9, 2012, as filed with the Securities and Exchange Commission.

ITEM 1A. Risk Factors

In addition to the other information set forth in this report, you should carefully consider the factors discussed under Part I, Item 1A, "Risk Factors" in the Company's Annual Report on Form 10-K for the year ended December 31, 2011, dated March 9, 2012, as filed with the Securities and Exchange Commission, as supplemented and updated by the discussion below. These factors could materially adversely affect our business, financial condition, liquidity, results of operations and capital position, and could cause our actual results to differ materially from our historical results or the results contemplated by the forward-looking statements contained in this report.

An interruption or loss in the service of any of our executive officers may negatively impact our ability to achieve key business objectives in support of our plan.

Our future success depends to a significant degree on the skills, experience and efforts of our key executive officers. The loss of the services of any of these individuals could harm our business. If any key executive officers leave us or are seriously injured and unable to work, our business and ability to execute our business plan could be harmed.

On August 27, 2012, Mr. Peter G. Humphrey retired as President and Chief Executive Officer of the Company. We are uncertain as to how long it will take us to find a qualified permanent replacement for the Chief Executive Officer position with the skills and industry experience that we need. An unsuccessful or prolonged search to fill this key leadership position could have an adverse effect on our business.

Table of Contents

ITEM 6. Exhibits

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

<u>Exhibit Number</u>	<u>Description</u>	<u>Location</u>
10.1	Amendment No. 1 to Assignment, Purchase and Assumption Agreement, effective as of August 16, 2012, by and between Five Star Bank and First Niagara Bank, National Association	Filed Herewith
10.2	Separation and release agreement between Financial Institutions, Inc. and Peter G. Humphrey	Filed Herewith
10.3	Supplemental Executive Retirement Agreement between Financial Institutions, Inc. and Peter G. Humphrey	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	XBRL Instance Document	
*101.SCH	XBRL Taxonomy Extension Schema Document	
*101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document	
*101.LAB	XBRL Taxonomy Extension Label Linkbase Document	
*101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document	
*101.DFE	XBRL Taxonomy Extension Definition Linkbase Document	

* Pursuant to Rule 406T of Regulation S-T, the information in this exhibit shall not be deemed to be “filed” for purposes of Section 18 of the Securities Exchange Act of 1934, or otherwise subject to the liability of that section, and shall not be incorporated by reference into any registration statement, prospectus or other document filed under the Securities Act of 1933, or the Securities Exchange Act of 1934, except as shall be expressly set forth by specific reference in such filings.

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/ **John E. Benjamin** , November 6, 2012
John E. Benjamin
Interim Chief Executive Officer
(Principal Executive Officer)

/s/ **Karl F. Krebs** , November 6, 2012
Karl F. Krebs
Executive Vice President and Chief Financial Officer
(Principal Financial and Principal Accounting Officer)

**AMENDMENT NO. 1 TO ASSIGNMENT,
PURCHASE AND ASSUMPTION AGREEMENT**

THIS AMENDMENT NO. 1 TO ASSIGNMENT, PURCHASE AND ASSUMPTION AGREEMENT, dated as of August 16, 2012 (this “Amendment”), is by and between First Niagara Bank, National Association, a national banking association with its principal office in Buffalo, New York (“Assignor”), and Five Star Bank, a New York State chartered bank with its principal office in Warsaw, New York (“Purchaser”).

RECITALS

WHEREAS, Assignor entered into the Purchase and Assumption Agreement dated as of July 30, 2011 (the “Primary Purchase Agreement”) by and among HSBC Bank USA, National Association, a national banking association (“HSBC”), HSBC Securities (USA) Inc., a Delaware corporation (“HSI”), and HSBC Technology & Services (USA) Inc., a Delaware corporation (“HTSI” and collectively with HSBC and HSI, the “HSBC Sellers”) and Assignor;

WHEREAS, pursuant to, and on the terms and conditions set forth in, the Primary Purchase Agreement, (i) Assignor agreed to purchase from the HSBC Sellers, and the HSBC Sellers agreed to sell to Assignor, those assets identified and defined in the Primary Purchase Agreement as the “Purchased Assets” and referred to and defined in the Primary Purchase Agreement and in this Amendment as the “Primary Purchased Assets” and (ii) the HSBC Sellers agreed to transfer to Assignor, and Assignor agreed to assume, those liabilities and obligations identified and defined in the Primary Purchase Agreement as the “Assumed Liabilities” and referred to and defined in the Primary Purchase Agreement and in this Amendment as the “Primary Assumed Liabilities”;

WHEREAS, the Primary Purchase Agreement permits Assignor, on the terms and conditions set forth therein, to assign its right to purchase a portion of the Primary Purchased Assets and its obligations to assume the related portion of the Primary Assumed Liabilities to a third party purchaser;

WHEREAS, Assignor and Purchaser entered into an Assignment, Purchase and Assumption Agreement dated as of January 19, 2012 (the “APA Agreement”);

WHEREAS, pursuant to, and on the terms and conditions set forth in, the APA Agreement, Assignor assigned its right to purchase a portion of the Primary Purchased Assets and its obligations to assume the related portion of the Primary Assumed Liabilities to Purchaser, and Purchaser agreed to acquire such portion of the Primary Purchased Assets and to assume the related portion of the Primary Assumed Liabilities, on the terms and conditions set forth in the APA Agreement; and in a letter dated January 19, 2012 addressed to Assignor, the HSBC Sellers consented to such assignment, subject to the terms of such consent and to the rights of the HSBC Sellers to consent to any future amendment of the APA Agreement, as provided in Section 14.1 thereof;

WHEREAS, Assignor and the HSBC Sellers amended the Primary Purchase Agreement pursuant an Amendment dated April 30, 2012 (the “First Amendment”) among Assignor and the HSBC Sellers;

WHEREAS, Assignor and the HSBC Sellers amended and restated the Primary Purchase Agreement, as amended by the First Amendment, pursuant to the Purchase and Assumption Agreement among Assignor and the HSBC Sellers, as amended and restated as of May 17, 2012 (the “Restated Primary Purchase Agreement”), a copy of which is attached hereto as Exhibit A;

WHEREAS, Assignor and Purchaser desire to amend the APA Agreement on the terms set forth in this Amendment, subject to the consent of the HSBC Sellers in accordance with Section 14.1 of the APA Agreement.

NOW, THEREFORE, in consideration of the premises and the mutual promises and obligations set forth herein, the parties, intending to be legally bound, agree as follows:

1. Defined Terms.

(a) Except as otherwise expressly provided in this Amendment, terms used in this Amendment as defined terms have the respective meanings assigned to them in the APA Agreement.

(b) The term “Assumed Deposits” in Section 1.1 of the APA Agreement is hereby amended and restated to read as follows: “Assumed Deposits” shall mean deposits (as defined in 12 U.S.C. § 1813(l)) that are held by HSBC or any of its Subsidiaries in connection with the Transferred Business, including demand deposits, savings accounts, money market deposit accounts, mutual fund and reserve fund sweep accounts, negotiable order of withdrawal accounts, certificates of deposit, deposits acquired through the telephone or the internet or other electronic media and, subject to Section 7.11, IRA, Employee Pension Plan and Keogh accounts, including any debit accounts related thereto, in each case, that are listed on Schedule 1.1(a) (as updated pursuant to Section 7.12), excluding: (i) structured deposits; (ii) brokered deposits; (iii) unclaimed deposits subject to unclaimed property statute/escheatment; (iv) deposits constituting money orders, certified and official checks and other items in the process of clearing; (v) deposits by state, county and municipal government agencies and authorities; and (vi) deposits that constitute Excluded Deposits.

(c) The term “Categorized Customer” is added to Section 1.1 of the APA Agreement and shall have the meaning specified in Exhibit 8.10 attached to this Amendment and added as Exhibit 8.10 to the APA Agreement.

(d) The term “Credit Documents” in Section 1.1 of the APA Agreement is hereby amended and restated to read as follows: “Credit Documents” shall mean all credit support, reimbursement agreements and related documents (including, but not limited to, any collateral documents) related to the Letters of Credit and all documents evidencing or securing a Purchased Loan or In-Process Loan in the possession of HSBC or its Subsidiaries (regardless of where located, including in file or imaging systems of HSBC or its Subsidiaries), including, without limitation, all original notes, reimbursement agreements, security agreements, deeds of trust, mortgages, loan agreements, and corresponding reports, certifications and disclosures required by Applicable Law, guarantees, sureties and insurance policies (including title insurance policies), applications and credit information, financial information, insurance information, signature cards, all information on obligors and borrowers and guarantors, taxpayer identification number certifications and records relating thereto, and all modifications, waivers and consents relating to any of the foregoing.

(e) The term “ Designated Loan Losses ” is added to Section 1.1 of the APA Agreement and shall mean any Losses, including but not limited to, enforcement and collection costs and expenses and any amounts not recovered by the holder of a Designated Purchased Loan under a Designated Purchased Loan after the due date thereof, in each case arising out of, related to or resulting from, the failure of Assignor to deliver (or to cause the HSBC Sellers to deliver) an accurate original or copy of the relevant promissory note, together with any and all amendments thereto.

(f) The term “ Designated Purchased Loan ” is added to Section 1.1 of the APA Agreement and shall mean each Purchased Loan for which the applicable Seller Entity does not timely deliver to Purchaser, in accordance with Section 8.3(c) of the Restated Primary Purchase Agreement, an accurate original or copy of the relevant promissory note, together with any and all amendments thereto.

(g) The term “ Eligible Customer ” is added to Section 1.1 of the APA Agreement and shall mean (i) a Banking Center Customer whose primary mailing address is located in Westchester County or (ii) a Banking Center Customer who is designated by the HSBC Sellers’ internal classification system as a “Premier International” customer and who is registered for the HSBC Sellers’ “Global View/Global Transfer” functionality or who is registered on the HSBC Sellers’ “Global Customer Directory.”

(h) The term “ Excluded Deposits ” in Section 1.1 of the APA Agreement is hereby amended and restated to read as follows: “ Excluded Deposits ” shall mean any and all deposits of HSBC and its Affiliates that are not Assumed Deposits, including, but not limited to: (i) any proprietary deposits of HSBC or any of its Affiliates booked at the Banking Centers, (ii) any deposits associated with the Retained Businesses (including deposits booked at the Banking Centers), (iii) deposits acquired through the telephone or the internet or other electronic media from Persons with primary addresses located in the Designated Footprint that are not Banking Center Customers, (iv) any deposits that become Excluded Deposits pursuant to Section 7.11, (v) any deposits of Retained Employees, (vi) deposits that, as of the date that is three (3) Business Days prior to the Closing Date, are subject to a legal hold or levy, including those holds or levies placed on such deposits as a result of an attachment, garnishment, in-arrears child support order and other legal actions, (vii) deposits held in an account designated by HSBC’s internal classification system as a “Premier” deposit account if the relationship manager assigned to such deposit account is located in a branch of Seller other than a Banking Center and (viii) deposits of Banking Center Customers who (a) have a primary mailing address (based on the HSBC Sellers’ records) within a country listed on Schedule 1.1(p) or (b) have a primary mailing address (based on the HSBC Sellers’ records) outside the United States and not having a United States tax identification number recorded on the HSBC Sellers’ account records for such Banking Center Customer.

(i) The term “ In-Process Loans ” is added to Section 1.1 of the APA Agreement and shall mean all applications (and related documentation) for Loans from the HSBC Sellers that would otherwise constitute Purchased Loans if, pursuant to such applications, credit were extended, or the commitment to extend credit became legally binding, prior to the Closing Date, other than the Retained In-Process Loans. To avoid doubt, In-Process Loans shall not include applications for Student Loans, Loans to Retained Employees or Mortgage Loans guaranteed by the Veterans’ Administration or the Federal Housing Administration or for loans to HSBC or its Subsidiaries or any of their Affiliates.

(j) The term “ Letter of Credit ” in Section 1.1(a) of the APA Agreement is hereby amended and restated to read as follows: “ Letter of Credit ” shall mean letters of credit, including any standby letters of credit, issued by HSBC in connection with the Transferred Business, in each case that are listed on Schedule 2.1(b)(10); provided the Letters of Credit shall not include any letter of credit under which a draw has been made and which has not, within 60 days of such draw, been reimbursed by the customer.

(k) The term “ Mortgage Loan ” is added to Section 1.1 of the APA Agreement and shall mean a Loan secured by a first or second mortgage, any home equity loan or any home equity line of credit. References in the APA Agreement to “mortgage loan” or “mortgage loans” shall be construed to be references to a “Mortgage Loan” as defined in the preceding sentence.

(l) The term “ Net Book Value ” in Section 1.1 of the APA Agreement is hereby amended and restated to read as follows: “ Net Book Value ” shall mean the book value net of any associated allowance, reserve or other contra-asset account, as reflected in the applicable HSBC Seller’s books and records, determined in accordance with GAAP consistently applied; provided, however, that no Federal, state, local, or foreign income tax assets or tax liabilities shall be reflected; provided, further, that for purposes of the Closing Payment the Net Book Value of fixed assets shall reflect the depreciation of such fixed assets in accordance with GAAP, consistently applied, until the Closing Date, as if held-for-sale accounting treatment with respect to such fixed assets did not apply, regardless of the treatment of such fixed assets on the applicable HSBC Seller’s books and records.

(m) The term “ Outside Date ” in Section 1.1 of the APA Agreement is hereby amended and restated to read as follows: “ Outside Date ” shall mean August 31, 2012.

(n) The term “ Repurchase Price ” is added to Section 1.1 of the APA Agreement and shall mean, with respect to any Designated Purchased Loan, the unpaid principal balance of the Designated Purchased Loan plus accrued interest and penalties, if any, as reflected in Purchaser’s books and records; provided, however, that no Federal, state, local, or foreign income tax assets or tax liabilities shall be reflected; provided, further, that the treatment of the Designated Purchased Loans on the books and records of Purchaser shall be in a manner consistent with the treatment of other similar loans on the books and records of Purchaser.

(o) The term “Restricted Items” is added to Section 1.1 of the APA Agreement and shall have the meaning specified in Section 7.7 which shall be amended and restated to read as follows: “Notwithstanding anything in this Agreement to the contrary, this Agreement shall not constitute an agreement to assign any Purchased Asset, Assumed Agreement, Assumed Deposits or other Assumed Liability, or any claim or right or any benefit arising thereunder or resulting therefrom if an attempted assignment thereof, without the consent of a third party thereto, would constitute a breach thereof or in any way affect the rights of an HSBC Seller or its Subsidiaries thereunder or be contrary to Applicable Law (any item so restricted from transfer or assignment, a “Restricted Item”). If any such consent or approval is not obtained, Assignor will use commercially reasonable efforts to cause the HSBC Seller to use its reasonable best efforts (which shall not require Assignor or such HSBC Seller to pay any money or other consideration to any Person or to initiate any claim or proceeding against any Person) to secure an arrangement reasonably satisfactory to Purchaser ensuring that Purchaser will receive the benefits under the agreement for which such consent is being sought following the Closing; provided, however, that Assignor shall have no obligation to obtain or to cause the HSBC Seller to obtain such consent or approval or to provide or cause an HSBC Seller to provide such an alternative arrangement other than the undertaking to use reasonable best efforts to obtain or provide the same as set forth in this Section 7.7 and Purchaser shall remain obligated to close the transactions contemplated herein, subject to the other provisions hereof, and, shall have no remedy for failure of Assignor or the HSBC Seller to obtain any such consent or approval or to provide any such alternative arrangement.”

(p) The term “Retained Businesses” in Section 1.1(a) of the APA Agreement is hereby amended and restated to read as follows: “Retained Businesses” shall mean the following businesses (wherever conducted by HSBC and its Affiliates, including within the Designated Footprint) and the current and future Relationships associated therewith: (i) the Middle-Market and Large Corporate Banking Business, (ii) the Private Banking Business, (iii) the Student Loan Business, (iv) the Direct Banking Business, and (v) the business of providing Banking Related Services to Categorized Customers and Eligible Customers whose Relationships are excluded from the Transferred Business pursuant to the processes referred to in Section 8.10. “Retained Businesses” shall also include the business of providing other financial services (including Banking Related Services) to customers of such Retained Businesses and their Related Persons.

(q) The term “Retained In-Process Loans” is added to Section 1.1 of the APA Agreement and shall mean all applications (and related documentation) for Mortgage Loans, including the potential Mortgage Loan associated therewith, that have been submitted to the HSBC Sellers after July 31, 2012.

2. Change to Purchased Assets and Excluded Assets. As used in the APA Agreement, Purchased Assets shall: (i) include In-Process Loans; (ii) shall not include Mortgage Loans originated with or guaranteed by the Veterans Administration or the Federal Housing Administration; and (iii) shall exclude books, records and other data primarily relating to the Excluded Assets or Excluded Liabilities. As used in the APA Agreement, Excluded Assets shall include the Retained In-Process Loans, the Letters of Credit and the Restricted Items.

3. Change to Section 2.1(a)(11): Section 2.1(a)(11) shall be amended and restated to read as follows: “all books, records and other data relating primarily to the Transferred Business, including all files (including suspicious activity reports to the extent permitted by Applicable Law), customer and supplier lists, mailing lists, accounting records, documentation or records primarily relating to the Transferred Business (other than those primarily relating to the Excluded Assets or Excluded Liabilities) or the administration of the Assumed Agreements and the Assumed Deposits, real property files with respect to Purchased Real Property and Real Property Leases (including lease documentation, maintenance records, plans and permits, to the extent in the possession of the HSBC Sellers or any of their respective Subsidiaries), catalogs, printed materials and all technical and other data relating to the Transferred Business other than (a) corporate minute books and, except for Forms W-8 and W-9 and similar tax forms provided to the HSBC Sellers or any of their respective Subsidiaries by customers of the Transferred Business, income tax records of the HSBC Sellers or any of their respective Subsidiaries, (b) personnel files and records and (c) books and records to the extent relating to accounts that have terminated prior to Closing; provided, however, that the HSBC Sellers and their respective Subsidiaries shall have the right to retain copies of all such books, records and other data that are part of the Purchased Assets to the extent reasonably necessary for, and solely for use in connection with, tax, regulatory, litigation or other legitimate, non-competitive purposes.”

4. Change to Closing Documents and Deliveries. If and solely to the extent that Section 8.3(c) of the Restated Primary Purchase Agreement results in a change to the timing of deliveries that would otherwise be made by the HSBC Sellers pursuant to Section 4.2(a)(7) of the APA Agreement, Purchaser consents to such change. Assignor shall upon Purchaser's request use its commercially reasonable efforts to cause the HSBC Sellers to comply with Section 8.3(c) of the Restated Primary Purchase Agreement.

5. Change Regarding Letters of Credit.

(a) In recognition that Purchased Assets shall not include Letters of Credit: (i) Section 2.1(a)(9) of the APA Agreement is hereby amended and restated to read “Intentionally Omitted”; (ii) a new Section 2.1(b)(10) is hereby added to the APA Agreement, to read in its entirety as follows: “the Letters of Credit as set forth on Schedule 2.1(b)(10).”; (iii) the term “Assumed Agreements” in Section 1.1 of the APA shall not include Letters of Credit; (iv) the term “Assumed Letters of Credit” in Section 1.1 of the APA is hereby deleted; (v) a new Exhibit 8.4, in the form of Exhibit 8.4 attached to this Amendment, is hereby added to the APA Agreement; and (vi) Section 8.4 of the APA Agreement is hereby amended and restated to read as follows: “Assignor and Purchaser agree to enter into an agreement (the “Interim Processing Agreement”), in substantially the form attached hereto as Exhibit 8.4, on the Closing Date providing procedures with respect to the handling of the Letters of Credit and draws thereunder following the Closing Date. Purchaser agrees, and the Interim Processing Agreement shall provide, that following the Closing Date, Purchaser shall reimburse Assignor for any draws under the Letters of Credit that are honored by Assignor pursuant to Section 8.4 of the Primary Purchase Agreement. To provide for payment of Purchaser's obligation under this Section 8.4 and the Interim Processing Agreement, if a reimbursement is not otherwise made pursuant to the terms of the Interim Processing Agreement, Purchaser shall issue in favor of Assignor an irrevocable standby letter of credit, in form and substance reasonably acceptable to Assignor (the “Stand-by Facility”), in an aggregate face amount equal to the maximum amount that may be drawn under the Letters of Credit associated with the Banking Centers (subject to any adjustments that may be provided in the Interim Processing Agreement). If reimbursement by Purchaser to Assignor pursuant to the Interim Processing Agreement is not received by the [second (2nd) Business Day] following Assignor's request for reimbursement, Assignor shall be entitled to draw on the Stand-by Facility for any such unreimbursed amounts. On the Closing Date, Assignor shall cause HSBC to transfer and assign its rights under any Credit Documents related to the Letters of Credit associated with the Banking Centers transferred on the Closing Date. In the event that Assignor or the HSBC Sellers receive any reimbursements from customers under the Letters of Credit, Assignor shall, or shall cause the HSBC Sellers to, reasonably promptly transmit such amounts to Purchaser. Following the Closing Date, Assignor shall use commercially reasonable efforts to cause the HSBC Sellers not to renew any Letter of Credit that is scheduled to expire and to send a notification of non-renewal (notice period permitting) with respect to any Letter of Credit that is subject to “automatic” renewals. For clarity, Purchaser shall have no recourse against Assignor or the HSBC Sellers for repayment of amounts properly drawn under the Stand-by Facility except to the extent of any obligation to transmit reimbursements as provided above in this Section 8.4 or in the Interim Processing Agreement. Purchaser acknowledges that the HSBC Sellers shall retain all customer fees associated with the Letters of Credit that have been or that hereafter are paid to the HSBC Sellers. Assignor agrees to reasonably cooperate, and to use commercially reasonable efforts to cause the HSBC Sellers to reasonably cooperate, with Purchaser's efforts, if any, to transfer any Letters of Credit after the Closing Date to Purchaser.”

(b) At the Closing Purchaser shall cause to be executed and delivered the Stand-By Facility and Interim Processing Agreement (as each of such terms is defined in Section 8.4 of the APA Agreement as amended and restated pursuant to this Amendment).

(c) At the Closing Assignor shall cause to be executed and delivered the Interim Processing Agreement (as such terms is defined in Section 8.4 of the APA Agreement as amended and restated pursuant to this Amendment).

6. Change to Section 7.1 of APA Agreement. The following sentence is hereby added at the end of Section 7.1(b) of the APA Agreement: “To the extent that such books, records and other data that are related to the Transferred Business relate to Banking Center Customers, Purchaser shall maintain such books, records and other data in accordance with its record retention policies, but in no event for a period less than seven (7) years from the Closing Date.”

7. Change to Section 7.9(a) of the Restated Primary Purchase Agreement. Purchaser consents to the amendment of Sections 7.9(a)(2), 7.9(d) and 7.9(e) and the addition of Section 7.9(a)(9) to the Restated Primary Purchase Agreement.

8. Verix Cash Advance Terminals. Purchaser agrees that the HSBC Sellers may remove Verix cash advance terminals from the Banking Centers at the HSBC Sellers’ sole expense; provided that if the removal occurs after the Closing Date, such removal will occur after normal business hours and in a manner so as not to unreasonably interfere with the operations of the applicable Banking Center.

9. Special Procedures for Categorized Customers. A new Section 8.10, captioned “ Special Procedures for Categorized Customers ” is hereby added to the APA Agreement and shall read as follows:

(a) The parties acknowledge that Assignor and the HSBC Sellers agreed to the process summarized in Exhibit 8.10 whereby the HSBC Sellers used their reasonable best efforts to identify Categorized Customers and afford such customer options as to where such customer’s eligible deposit and loan accounts will be maintained.

(b) Assignor agrees to use its reasonable best efforts, and to cause the HSBC Sellers to use their reasonable best efforts, to effect the valid election of any Categorized Customer who properly completed and returned a required "Transfer Exception Form" (or who confirmed their election orally with a customer service representative of the HSBC Sellers) by April 27, 2012, including, as applicable, on the Update Date and in connection with the delivery of any Final Closing Statement, adjusting Schedule 1.1(a) (Assumed Deposits), Schedule 1.1(h) (Purchased Overdrafts), Schedule 2.1(a)(6) (Purchased Loans), Schedule 2.1(a)(8) (CRA Assets) and Schedule 2.1(b)(10) (Letters of Credit) to reflect any applicable additions or removals of accounts of Categorized Customers.

10. Reactive Exclusion of Eligible Customers. If, prior to May 11, 2012, an Eligible Customer contacted an HSBC Seller and indicated that he or she would like to maintain his or her Relationship with the HSBC Sellers, Assignor shall cause the HSBC Sellers to take any actions it deems necessary to cause such Eligible Customer's entire Relationship with the HSBC Sellers to be excluded from, as applicable, the Purchased Assets and Assumed Liabilities.

11. Designated Purchased Loans.

(a) Following the Closing Date, if at any time the principal of or interest on a Designated Purchased Loan shall have been due and unpaid by the obligor thereunder for sixty (60) days, Purchaser may, in its sole discretion, and no later than thirty (30) days after such Designated Purchased Loan becomes sixty (60) days past due (or, with respect to any Designated Purchased Loans that are sixty (60) days or more past due as of the date on which the Designated Purchased Loan Schedule is delivered, within thirty (30) days of such delivery date), notify the HSBC Sellers and Assignor that such Designated Purchased Loan has become sixty (60) days past due and present such Designated Purchased Loan to the HSBC Sellers for possible repurchase. Purchaser shall, upon the written request of the HSBC Sellers delivered to Purchaser not later than fifteen (15) days after being notified of such Designated Purchased Loan, sell such Designated Purchased Loan to the HSBC Sellers at the Repurchase Price of such Designated Purchaser Loan as of the date of such sale. If the HSBC Sellers elect to repurchase a Designated Purchased Loan, the parties agree to effect the repurchase as promptly as reasonably practical after such election. The parties agree to work in good faith to effect the intention of this Section 13 with a view towards minimizing Designated Loan Losses and other Losses. Within two (2) Business Days of the Closing Date, Assignor shall cause the HSBC Sellers to use reasonable best efforts deliver to Purchaser, for informational purposes only, a schedule (the "Designated Purchased Loan Schedule") listing each of the Designated Purchased Loans transferred on the Closing Date.

(b) Clause (3) of Section 13.2(a) of the APA Agreement is hereby amended and restated to read as follows: "any of (i) the Excluded Liabilities, (ii) Liens that are not Permitted Liens, (iii) the conduct of the Retained Business after the Closing Date, (iv) the conduct of the Non-Assigned Transferred Business after the Closing or (v) any Designated Loan Losses."

12. Notices. All notices, request, demands and other communications required hereunder shall be in writing and shall be deemed to have been duly given or made if delivered personally, sent by facsimile transmission or telex confirmed in writing within two (2) Business Days, or sent by registered or certified mail, postage prepaid, as follows:

If to Purchaser to: Peter G. Humphrey
President and Chief Executive Officer
Five Star Bank
220 Liberty Street
Warsaw, NY 14569
Facsimile: (585) 786-1108

With a copy to: John L. Rizzo General Counsel Five Star Bank
220 Liberty Street Warsaw, NY 14569 Facsimile: (585) 786-1108

With an additional copy to: James M. Jenkins, Esq. Harter Secrest & Emery LLP 1600 Bausch & Lomb Place
Rochester, NY 14604 Facsimile: (585) 232-6500

If to Assignor: First Niagara Bank 726 Exchange Street Suite 618
Buffalo, New York 14210 Fax: (716) 819-5158 Attention: Kristy Berner
First Vice President & Assistant General Counsel

With a copy to: Pepper Hamilton LLP 3000 Two Logan Square Eighteenth and Arch Streets
Philadelphia, PA 19103-2799 Fax: (215) 981-4750
Attention: Michael Friedman, Esq.

Any party may change the address or fax number to which such communications are to be sent to it by giving written notice of change of address to the other parties in the manner provided above for giving notice.

13. Governing Law. The execution, interpretation, and performance of this Amendment shall be governed by the laws of the State of New York without giving effect to any conflict of laws provision or rule (whether of the State of New York or any other jurisdiction) that would cause the application of the law of any other jurisdiction other than the State of New York.

14. Third Party Beneficiaries. This Amendment shall not benefit or create any right or cause of action in or on behalf of any person other than Assignor and Purchaser, provided that the HSBC Sellers are express third party beneficiaries of this Amendment and shall have the right to enforce the provisions of this Agreement against any party hereto to the same extent as if they were a party to this Agreement but only to the extent the provisions sought to be enforced by the HSBC Sellers do not enlarge their rights or expand the obligations or liabilities of Assignor under the Restated Primary Purchase Agreement.

15. Counterparts. This Amendment may be executed in any number of counterparts, each of which shall be deemed to be an original as against any party whose signature appears thereon, and all of which shall together constitute one and the same instrument. This Amendment shall become binding when two or more counterparts hereof, individually or taken together, shall bear the signatures of all of the parties reflected hereon as the signatories. The execution and delivery of this Amendment may be effected by facsimile or any other electronic means such as “.pdf” or “.tiff” files.

16. Headings. The headings used in this Amendment are inserted for purposes of convenience of reference only and shall not limit or define the meaning of any provisions of this Amendment.

17. Ratification of APA Agreement. Except as expressly amended hereby, the APA Agreement continues in full force and effect.

[Remainder of page left intentionally blank]

IN WITNESS WHEREOF , the parties hereto have caused this Amendment to be executed by their duly authorized officers as of the date and year first above written.

ASSIGNOR:

FIRST NIAGARA BANK, NATIONAL ASSOCIATION

By: /s/ **John R. Koelmel**

Name: John R. Koelmel

Title: President and Chief Executive Officer

PURCHASER:

FIVE STAR BANK

By: /s/ **Peter G. Humphrey**

Name: Peter G. Humphrey

Title: President and Chief Executive Officer

SEPARATION AGREEMENT AND RELEASE OF ALL CLAIMS

This Separation Agreement and Release of all Claims (this “Agreement”) is entered into by and between Financial Institutions, Inc., a bank holding company chartered under the laws of the State of New York, having its principal office at 220 Liberty St., Warsaw, New York 14569, and its subsidiaries and affiliates (collectively referred to as the “Company”); and Peter G. Humphrey (the “Executive” or “you”), an individual residing at 1446 South Rd., Scottsville, New York, 14546.

1. Resignation/Retirement. You agree that your retirement from the Company was effective at the close of business on August 27, 2012 (the “Separation Date”), and that by virtue of your retirement, you resigned your employment in all capacities with the Company.

2. Final Compensation and Benefits. You will receive your regular wages and employment-related benefits through August 31, 2012, all of which will be paid in accordance with the Company’s regular payroll schedule and benefit policies and practices. Your payment for employment-related benefits through August 31, 2012 will include payment for fourteen (14) accrued but unused vacation days, in the amount of Twenty-Two Thousand Eight Hundred Sixty Dollars and Forty-Five Cents (\$22,860.45). You will receive such wages and benefits even if you decide not to sign this Agreement.

3. Termination of Compensation and Benefits. Except as specifically described in Paragraph 5 below, all of your compensation and employment-related benefits will end on August 31, 2012. Notwithstanding, pursuant to Section 10(a) of the Financial Institutions, Inc. 1999 Management Stock Incentive Plan, all of your outstanding, unexercised stock options are immediately vested as of the “Effective Date” of this Agreement as defined in Paragraph 26, below and may be exercised at any time prior to the earlier of: (a) the expiration date of each such stock option; or (b) 13 months from the “Effective Date” of this Agreement as defined in Paragraph 26, below. You will receive additional information regarding your rights to insurance continuation (at your expense) and your retirement benefits. To the extent that you have such rights, nothing in this Agreement will impair them. By signing this Agreement, you agree that upon receipt of the amounts described in Paragraph 2, you have received all wages, benefits and other compensation due to you.

4. Company Property.

a) By no later than August 31, 2012, you shall return to the Company all documents (and all copies thereof) and other property belonging to the Company that you have in your possession or control, with the exception of any property that the Company authorizes you in writing to retain. The documents and property to be returned by you include, but are not limited to, all files, correspondence, e-mail, memoranda, notes, notebooks, drawings, records, plans, forecasts, reports, studies, analyses, compilations of data, proposals, agreements, financial information, research and development information, customer information, marketing information, operational and personnel information, specifications, code, software, databases, computer-recorded information, tangible property and equipment (including, but not limited to, facsimile machines, mobile telephones and servers), credit cards, entry cards, identification badges and keys; and any materials of any kind which contain or embody any proprietary or confidential information of the Company (and all reproductions thereof in whole or in part). You agree to make a diligent search to locate any such documents, property and information.

b) If you have used any computer, server, or e-mail system owned by you or a member of your immediately family to receive, store, review, prepare or transmit any Company confidential or proprietary data, materials or information, then on or before August 31, 2012, you shall provide the Company with a computer-useable copy of all such information and then permanently delete and expunge such confidential or proprietary information from those systems. You agree to provide a signed and notarized certification that you have complied with this provision on or before September 4, 2012, or in the alternative, provide a signed and notarized certification on or before September 4, 2012 that there was no Company confidential or proprietary data, material or information on any computer, server or e-mail system owned by you or a member of your immediately family, and therefore that no copying or deletion was necessary.

c) You and the Company will arrange, at a time mutually convenient, for you to remove personal items from your office and to have a Company representative download personal documents/files from the computer in your office and provide those documents/files to you on a CD, thumb drive or other mutually acceptable storage media. At this time, you will also identify items of Humphrey family memorabilia that you claim were loaned to the Company so a determination can be made which items to return to you.

d) Although you will return the Company cell phone no later than September 28, 2012, the Company will allow you to retain the cell phone number for your personal use, at your expense, and both parties agree to execute any documents necessary to accomplish the transfer of that cell phone number. You will bear the expense and pay any fees associated with that transfer.

5. Separation Benefits. In consideration of your acceptance of the terms of this Agreement, including but not limited to the obligations imposed by Paragraphs 9 through 14 of this Agreement and the Release of All Claims contained in Paragraph 6 of this Agreement, the Company will provide you with the separation benefits described in this Paragraph 5.

a) You will receive a separation pay benefit in the total amount of \$1,000,000.00 less required payroll deductions and withholdings. Subject to the requirements of Paragraph 27, this separation pay benefit will be paid in equal monthly installments for a period of twenty four (24) months in accordance with the Company's regular payroll schedule and practice. These installments will begin on the Company's first regular pay period after October 1, 2012 provided you have executed this Agreement and the revocation period set forth in Paragraph 26 has expired with no revocation.

b) Within 30 days after the "Effective Date" of this Agreement as defined in Paragraph 26 below, you will receive a lump-sum cash payment equal to \$349,950, less required payroll deductions and withholdings.

c) The Board of Directors of the Company has determined that pursuant to the discretion provided under Section 9(b)(1) of the Financial Institutions, Inc. 2009 Management Stock Incentive Plan (the "2009 Plan"), the 4,525 shares of restricted stock granted to you on February 15, 2012 will become 100% vested as of the "Effective Date" of this Agreement as defined in Paragraph 26, below.

d) The Board of Directors of the Company has determined that pursuant to the discretion provided under Section 9(b)(2) of the 2009 Plan, as soon as performance can be determined for the 2012 performance year (which shall be determined as soon as practicable following December 31, 2012, but in no event later than December 31, 2013), a pro-rated portion of the 7,721 shares of restricted stock granted to you on February 17, 2012 will become vested.

e) You will be entitled to the compensation and benefits set forth in the Supplemental Executive Retirement Agreement attached to this Agreement as Exhibit A.

f) The Company will transfer title of the 2011 BMW 550xi (valued at \$42,800) to you, without further consideration, and you will be responsible for all taxes and registration fees due upon such transfer.

The Company makes no representations to you regarding the taxability and/or tax implications of this Agreement. You are solely responsible for any tax consequences associated with the payments made pursuant to this Agreement, regardless of whether the Company should have contributed and withheld taxes from the amounts paid (including Social Security and Medicare). You agree to defend, indemnify, reimburse and hold the Company harmless for any and all taxes, contributions, withholdings, fees, assessments, interest, costs, penalties and other charges that may be imposed on the Company by the Internal Revenue Service, the New York State Tax Department or any other federal, state or local taxing authority by reason of the payments above, the absence of withholdings and deductions made from certain payments above and/or your non-payment or late payment of taxes due, and you alone assume all liability for all such amounts.

You agree that you are not entitled to any other compensation or benefits of any kind or description from the Company, its successors, assigns, affiliates or related companies, or from or under any employee benefit plan or fringe benefit plan sponsored by the Company, its successors, assigns, affiliates or related companies, other than as described in this Agreement, including, but not limited to as described in Paragraph 3, and except for vested benefits under the any qualified retirement plans in which you participate.

You acknowledge and agree that, in the absence of this Agreement, you are not entitled to any of the separation benefits set forth in this Paragraph 5.

6. RELEASE OF ALL CLAIMS

a) By signing this Agreement you agree that you are releasing and waiving your right to bring any legal claim of any nature against the Company. The claims you are giving up include, but are not limited to, claims related, directly or indirectly, to ownership interests in the Company and your employment relationship with the Company, including your separation from employment. This Agreement is intended to be interpreted in the broadest possible manner to include all actual or potential legal claims you may have against the Company, except as expressly provided otherwise in Paragraph 6(d).

b) Specifically, you agree that you are fully and forever giving up all of your legal rights and claims against the Company, whether or not presently known to you, that are based on events occurring before you sign this Agreement. You agree that the legal rights and claims you are waiving include all rights and claims under, as amended, Title VII of the Civil Rights Act of 1964, the Age Discrimination in Employment Act of 1967 (the "ADEA"), the Older Workers Benefit Protection Act of 1990 (the "OWBPA"), the Rehabilitation Act of 1973, the Civil Rights Acts of 1866 and 1991, the Americans With Disabilities Act of 1990 (the "ADA"), the Genetic Information Nondiscrimination Act of 2008 ("GINA"), the Equal Pay Act of 1963, the New York Human Rights Law and any similar federal, state or local statute, regulation, order or common law. You specifically agree that you are releasing claims of discrimination based upon age, race, color, sex, sexual orientation or preference, marital status, religion, national origin, citizenship, veteran status, disability, genetic predisposition or carrier status and other legally protected categories.

c) You also agree that the legal rights and claims you are giving up include your rights under, as amended, the Family and Medical Leave Act of 1993 ("FMLA"), the Employee Retirement Income Security Act of 1974 ("ERISA"), the federal Worker Adjustment and Retraining Notification Act of 1989 ("WARN"), the New York Worker Adjustment and Retraining Notification Act ("NY WARN"), the New York Labor Law (except unemployment insurance and minimum wage claims), the New York Business Corporation Law and any similar federal, state or local statute, regulation, order or common law. You agree that the legal rights and claims you are giving up include all common law rights and claims, such as a breach of express or implied contract, tort (whether negligent or intentional), wrongful discharge, constructive discharge, infliction of emotional distress, defamation, promissory estoppel, and any claim for fraud, omission or misrepresentation, breach of express or implied duties, or violation of public policy or policies, practices, or procedures of the Company. You also agree that you are giving up and forever releasing any right you may have to attorneys' fees for any of the rights and claims described in this Paragraph 6.

d) The claims you are giving up and releasing do not include your vested rights, if any, under any qualified retirement plan in which you participate, and your COBRA, unemployment insurance and workers' compensation rights, if any. Nothing in this Agreement shall be construed to constitute a waiver of: (i) any claims you may have against the Company that arise from events that occur after the date that you sign this Agreement; (ii) your right to file an administrative charge with any governmental agency alleging employment discrimination or challenging the validity of this release of all claims; (iii) your right to participate in any administrative or court investigation, hearing or proceeding; or (iv) any other right that you cannot waive as a matter of law. You agree, however, to waive and release any right to receive any individual remedy or to recover any individual monetary or non-monetary damages as a result of any administrative charge, complaint or lawsuit filed by you or anyone on your behalf. In addition, the release of all claims set forth in this Agreement does not affect your rights as expressly created by this Agreement, and does not limit your ability to enforce this Agreement or to challenge the enforceability of this Agreement.

e) You agree that the release of all claims described in this Paragraph 6 applies not only to the Company, but also to the Company's predecessors, successors and their past, current and future parents, subsidiaries, related entities, and all of their members, shareholders, officers, directors, agents, attorneys, employees, and assigns.

7. No Pending Action. You represent that, as of the date that you sign this Agreement, you have not filed any charge, complaint or action in any forum against the Company. This Agreement may be used as a complete defense in the future if you bring a lawsuit based on any claim that you have released, and if the Company prevails in such lawsuit, you will pay for all costs incurred by the Company, including reasonable attorney's fees.

8. Future Cooperation. You agree that upon reasonable request of the Company, you will do whatever is necessary to assure an orderly transition of your work and responsibilities and to reasonably cooperate with any requests by the Company for information about the business of the Company or your involvement and participation therein. You further agree that you will fully cooperate with any investigation, audit or review by the Company or any federal, state or local regulatory, quasi-regulatory or self-governing authority (including, without limitation, the Securities and Exchange Commission) as any such investigation, audit or review relates to events or incidents that occurred during your employment with the Company, as well as with litigation or other proceedings involving matters that occurred during your employment by the Company. Such cooperation shall include, but not be limited to (taking into account your personal and professional obligations, including those to any new employer or entity to which you provide services), being available to meet and speak with officers or employees of the Company and/or the Company's counsel at reasonable times and locations, executing accurate and truthful documents, giving accurate and truthful testimony, and taking such other actions as may reasonably be requested by the Company and/or the Company's counsel to effectuate the foregoing. You shall be entitled to reimbursement, upon receipt by the Company of suitable documentation, for reasonable and necessary travel and other expenses that you may incur at the specific request of the Company and as approved by the Company in advance and in accordance with its policies and procedures established from time to time. You may also receive reasonable compensation from the Company for time expended while assisting the Company with respect to investigations, audits, reviews, litigations or other proceedings. However, you and the Company agree that no compensation shall be paid for the content or substance of any testimony.

9. Confidential Information. You shall keep secret and retain the confidential nature of all Confidential Information (as defined in Paragraph 9(b) below) of or belonging to the Company and take such other precautions with respect thereto as the Company, in its sole discretion, may reasonably request.

a) You shall not at any time, whether before or after the termination of your employment, use, copy, disclose or make available any Confidential Information to any individual, corporation, partnership, trust, governmental body or other entity; except that you may use, copy or disclose any Confidential Information (i) to the extent it becomes publicly available through no fault on your part, and (ii) to the extent you are required to do so pursuant to applicable law or pursuant to a final order of a court or arbitrator having jurisdiction thereof; provided, however, that prior to such disclosure you shall promptly notify the Company in writing of any such order or request to disclose and shall cooperate fully with the Company in protecting against any such disclosure by narrowing the scope of such disclosure and/or obtaining a protective order with respect to the permitted use of the Confidential Information.

b) For purposes of this Agreement, "Confidential Information" shall mean all information pertaining to the business and operations of the Company that is not generally available to the public and the Company desires to keep confidential, including, but not limited to, information relating to the Company's products, services, suppliers, business partners, operations, research, trade secrets, intellectual property, finances and all documents and other tangible items relating to or containing any such information. You acknowledge that the Confidential Information is vital, sensitive, confidential and proprietary to the Company.

10. Non-Competition. You agree and acknowledge as follows:

a) You agree that the Company is engaged in a highly competitive business, and the success of the Company in the marketplace depends upon its good will and reputation. You agree that reasonable limits on your ability to engage in activities competitive with the Company are warranted to protect the Company's substantial investment in developing and maintaining its status in the marketplace, reputation and good will.

b) For a period of two (2) years following the Separation Date, you shall not engage, anywhere within New York State or in any area outside of New York State in which the Company conducts business, whether directly or indirectly, or through any employee, agent, attorney or any other person or party acting on your behalf, as principal, owner, officer, director, agent, employee, consultant or partner, in the management of a bank holding company, commercial bank, savings bank, credit union or any other financial services provider that competes with the Company or their products or programs ("Restricted Activities"), provided that the foregoing shall neither restrict you from engaging in any Restricted Activities which the Company directs you to undertake or which the Company otherwise expressly authorizes in writing, nor shall the foregoing restrict you from owning less than 5% of the outstanding capital stock of any company that engages in Restricted Activities, provided that you are not otherwise involved with such company as an officer, director, agent, employee or consultant. You agree that this Paragraph, the scope of the territory covered, the actions restricted thereby, and the duration of such covenant are reasonable and necessary to protect the legitimate business interests of the Company. For purposes of this Agreement, "Restricted Activities" in any area outside of New York State in which the Company conducts business shall be limited to lines of business, products, services or programs that the Company offers, sells or provides outside of New York State.

11. Non-Solicitation. You agree that for a period of two (2) years following the Separation Date:

a) You will not, directly or indirectly, canvass, solicit or accept, in any manner, the business of any person (i) who or which is or was a client, customer, supplier or other business contact of the Company and/or (ii) with whom or which you acquired a relationship during your employment with the Company. In making the foregoing covenant, you acknowledge that the Company has a legitimate interest in preventing you from exploiting or appropriating the Company's goodwill as it relates to the Company's clients, customers, suppliers, and other business contacts, which goodwill has been created and maintained at the Company's expense.

b) You will not, directly or indirectly (i) induce any party who or which is a customer, supplier, vendor or other business contact of the Company to patronize any business directly or indirectly in competition with the Company; or (ii) request or advise any party who or which is a customer, supplier, vendor or other business contact of the Company, or its or their successors, to withdraw, curtail, cancel or modify any such customer's or vendor's business with such entity.

c) You will not (i) employ, or knowingly permit any company or business directly or indirectly controlled by you, to employ, any person who was employed by the Company or its affiliates at or within one year prior to termination of your employment or (ii) in any manner to seek to induce any such person to leave his or her employment with the Company.

You acknowledge that the limitations set forth in this Paragraph are reasonable.

12. Intellectual Property. You agree that all copyrights, trademarks, trade names, servicemarks, and other intangible or intellectual property rights that you invented, conceived, developed or enhanced during your employment that relate to the business or operations of the Company or that result from any work you performed for the Company are the sole property of the Company, as the case may be, and you hereby waive any right or interest that you may otherwise have in respect thereof. Upon the reasonable request of the Company, you shall execute, acknowledge and deliver any instrument or document reasonably necessary or appropriate to give effect to this Paragraph and, at the Company's cost, do all other acts and things reasonably necessary to enable the Company, as the case may be, to exploit the same or to obtain patents or similar protection with respect thereto.

13. No Derogatory Statements. You agree that you will not directly or indirectly make, or cause to be made, any written or oral statement or other communication that is derogatory or disparaging to the Company or the Company's predecessors, successors or their past, current or future parents, subsidiaries, related entities, or any of their members, shareholders, officers, directors, agents, attorneys, employees, or assigns. The inclusion of specific individuals in this provision (including, but not limited to, shareholders, officers, directors, agents, attorneys and employees) to protect them from derogatory or disparaging remarks is a material term of this Agreement and intended to make such individuals third-party beneficiaries of this particular provision of the Agreement, with all applicable rights to enforce its terms in the event of a violation.

The Company agrees that the members of its Board of Directors and its Senior Management (specifically, Chief Executive Officer, Chief Operating Officer, Chief Financial Officer, Director of Human Resources, Chief Information Officer and/or President and Chief of Community Banking) will not directly or indirectly make, or cause to be made, any written or oral statement or other communication that is derogatory or disparaging to you. Communications between the individuals listed above in their official capacities shall not violate this provision.

Nothing in this Agreement is intended to or shall prevent or limit you or members of the Company's Board of Directors and Senior Management (as defined above) from providing testimony in response to a valid subpoena, court order, regulatory request or other judicial, administrative or legal process or otherwise as required by law. Both parties will notify the other in writing as promptly as practicable after receiving any request for testimony or information in response to a subpoena, court order, regulatory request or other judicial, administrative or legal process or otherwise as required by law, regarding the anticipated testimony or information to be provided and at least fourteen (14) days prior to providing such testimony or information (or, if such notice is not possible under the circumstances, with as much prior notice as is possible).

14. Confidentiality of Agreement. You agree that you will keep the terms of this Agreement, the benefit being paid under it and the fact of its payment, confidential and that you shall not disclose such information, except that you may disclose this information to your spouse, attorney, accountant or other professional advisor to whom you must make the disclosure in order for them to render professional services to you. You will instruct them, however, to maintain the confidentiality of this information just as you must maintain such confidentiality.

15. Interim Obligations. You understand and agree that the obligations contained in Paragraphs 9 to 14 above are material provisions of this Agreement, for which good and sufficient consideration is provided. However, you also acknowledge and agree that those provisions could be undermined and/or rendered ineffective if you take actions that would be violations of Paragraphs 9 to 14 of this Agreement after the Effective Date of this Agreement, between the date you were presented with a draft of this Agreement (August 24, 2012) and the Effective Date of this Agreement (the "Interim Period"). Accordingly, as a material inducement for the Company to enter this Agreement, you represent and warrant that, during the Interim Period, you did not and will not take any actions, directly or indirectly, that would be violations of this Agreement if they occurred after the Effective Date of this Agreement. This includes, but is not limited to, disclosing confidential information, engaging in Restricted Activities, soliciting customers or employees of the Company, making derogatory statements concerning the Company or any of the entities/individuals listed in Paragraph 13, and/or disclosing the terms of this Agreement or the amounts or benefits to be paid under this Agreement (other than as allowed in Paragraph 14).

16. Remedies. You acknowledge that the Company will suffer material, irreparable harm as a result of any breach the covenants contained in Paragraphs 9 through 14 of this Agreement for which an adequate monetary remedy does not exist and a remedy at law may prove to be inadequate. Accordingly, in the event of an actual or threatened breach by you of any provision of this Agreement, the Company shall, in addition to any other remedies permitted by law, be entitled to obtain remedies in equity, including, without limitation, specific performance, injunctive relief, a temporary restraining order, and/or permanent injunction in any court of competent jurisdiction, to prevent or otherwise restrain a breach of Paragraphs 9 through 14 of this Agreement, without the necessity of proving damages, posting bond or other security, and to recover any and all costs and expenses, including reasonable attorneys' fees, incurred in enforcing this Agreement against you, and you hereby consent to the entry of such relief and agree not to contest such entry. You hereby agree and consent that such injunctive relief may be sought in any state or federal court located in Monroe County, New York. Such relief shall be in addition to and not in substitution of any other remedies available to the Company. The existence of any claim or cause of action by you against the Company, whether predicated on this Agreement, or otherwise, shall not constitute a defense to the enforcement by the Company of said covenants. You agree that you shall not defend on the basis that there is an adequate remedy at law. You further understand and agree that for the purpose of fashioning an appropriate injunctive remedy, the time periods of the restrictions set forth in Paragraphs 10 and 11 above shall be extended by any time period that you are found to be in breach of said covenants. In the event that a court of competent jurisdiction determines that the restrictions contained in this Agreement are unenforceable in whole or in part for any reason, including, without limitation, the duration, scope and remedies set forth above, then same shall not be void, but rather shall be enforced to the extent that same is deemed to be enforceable by said court, as if originally executed in that form by the parties hereto. In the event that a court of competent jurisdiction determines that you have breached any of the covenants contained this Agreement, you agree that (i) the Company shall have no further obligation to make any further payments to you under Paragraph 5 of this Agreement and you will be liable to the Company for any payments already made under Paragraph 5(a) or 5(b) above. In the event a court of competent jurisdiction determines that the Company has breached this Agreement, in addition to any other remedies available to you in law or in equity, you shall be entitled to recover any and all costs and expenses, including reasonable attorneys' fees, incurred in enforcing this Agreement against the Company.

17. Future Employment. You agree that neither you, nor anyone acting on your behalf, will apply for or seek employment with the Company in the future. You agree that in the event you apply for or seek employment with the Company in the future, the Company is under no obligation to consider that application and may deny said application based on this Agreement.

18. No Admission of Liability. You agree that neither any payment under this Agreement, nor any term or condition of it, shall be construed by either you or the Company, at any time, as an admission of liability or wrongdoing by the Company.

19. Binding Nature. The rights and benefits of the Company under this Agreement shall be transferable to, or enforceable by or against, the Company's successors and assigns. You agree that this Agreement also binds all persons who might assert a legal right or claim on your behalf, such as your heirs, personal representatives and assigns, now and in the future.

20. Governing Law/Interpretation. This Agreement shall be governed, construed, and interpreted, and the rights of you and the Company shall be determined in accordance with New York law, without regard to its conflicts of laws principles, except to the extent that the law of the United States governs any matter set forth herein, in which case such Federal law shall govern. The parties further agree that, whenever possible, each provision of this Agreement shall be interpreted in such a manner as to be effective and valid under applicable law, but if any provision of this Agreement is held to be prohibited by or invalid under applicable law, such provision shall be ineffective only to the extent of such prohibition or invalidity, without invalidating the remainder of such provision or the remaining provisions, which shall be fully severable and given full force and effect. However, in the event the Release of All Claims in Paragraph 6 of this Agreement or any portion thereof is determined by any court, arbitrator or agency of competent jurisdiction to be unenforceable for any reason, then the Company shall have the option to rescind this entire Agreement, and immediately recover from you any payments made pursuant to Paragraph 5 above, or to require that you execute another release that is legal and enforceable, without further consideration, payments or compensation.

21. Scope of Agreement. You agree that no promise, inducement or other agreement not expressly contained or referred to in this Agreement has been made conferring any benefit upon you. You also agree that this Agreement contains the entire agreement between the Company and you regarding your termination and supersedes and renders null and void any and all prior or contemporaneous oral or written understandings, statements, representations or promises, including the Executive Agreement between you and Financial Institutions, Inc. dated July 2, 2012 and attached to this Agreement as Exhibit B.

22. Legal Proceedings. Disputes arising under this Agreement shall be heard exclusively by the state or federal courts located in Monroe County, New York. Neither party waives any right it may have to remove such an action to the United States District Court located in Monroe County, New York.

23. Voluntary Agreement. You agree that you are voluntarily signing this Agreement, that you have not been pressured into agreeing to its terms and that you have enough information to decide whether to sign it. **If, for any reason, you believe that this Agreement is not entirely voluntary, or if you believe that you do not have enough information, then you should not sign this Agreement.**

24. Attorney Consultation. You are advised to consult with an attorney of your choice before signing this Agreement. By signing this Agreement, you acknowledge that you have had an opportunity to do so.

25. Period to Consider Agreement. You represent and warrant that the Company has given you a reasonable period of time, of at least twenty-one (21) days, to consider all the terms of this Agreement and for the purpose of consulting with an attorney. A draft of this Agreement was first given to you on August 24, 2012. If you execute this Agreement prior to the expiration of the 21-day period, you represent and warrant that you have freely and willingly elected to do so. The parties further agree that changes to this agreement after August 24, 2012, whether material or immaterial, do not restart the 21-day period. The Company reserves the right to withdraw its offer of this Agreement at any time after the expiration of the 21-day review period or if you take actions during the Interim Period that would be in violation of Paragraphs 9 to 14 of this Agreement if they were taken after the Effective Date of this Agreement.

26. Revocation Period; Effective Date. After you have accepted this Agreement, you will have an additional 7 calendar days in which to revoke your acceptance. If you do not revoke your acceptance, then the 8th day after the date of your signature will be the “Effective Date” of the Agreement, and you may not thereafter revoke it. To revoke this Agreement, you agree to send written notice to: Jack Benjamin, Chair of the Board of Directors, Five Star Bank, 220 Liberty Street, Warsaw, NY 14569. You acknowledge and agree that if you exercise your right to revoke this Agreement, your resignation of employment will remain valid and effective on the Separation Date and you will not be entitled to the separation benefits in Paragraph 5.

27. Section 409A.

a) The compensation and benefits under this Agreement are intended to comply with or be exempt from the requirements of Section 409A of the Internal Revenue Code of 1986, as amended, and the Treasury Regulations and other official guidance promulgated and issued thereunder (collectively, “Section 409A”), and this Agreement will be interpreted in a manner consistent with that intent.

b) The preceding provisions, however, shall not be construed as a guarantee by the Company of any particular tax effect to you under this Agreement. The Company shall not be liable to you for any payment made under this Agreement that is determined to result in an additional tax, penalty or interest under Section 409A, nor for reporting in good faith any payment made under this Agreement as an amount includible in gross income under Section 409A.

c) References to “termination of employment” and similar terms used in this Agreement mean, to the extent necessary to comply with Section 409A, the date that you first incur a “separation from service” within the meaning of Section 409A.

d) To the extent any reimbursement provided under this Agreement is includable in your income, such reimbursements shall be paid to you not later than December 31st of the year following the year in which you incur the expense and the amount of reimbursable expenses provided in one year shall not increase or decrease the amount of reimbursable expenses to be provided in a subsequent year.

e) Notwithstanding anything in this Agreement to the contrary, if at the time of your separation from service with the Company you are a “specified employee” as defined in Section 409A, and any payment payable under this Agreement as a result of such separation from service is required to be delayed by six months pursuant to Section 409A, then the Company will make such payment on the date that is six months following your separation from service with the Company. The amount of such payment will equal the sum of the payments that would have been paid to you during the six-month period immediately following your separation from service had the payment commenced as of such date. Each payment under this Agreement shall be designated as a “separate payment” within the meaning of Section 409A.

28. Regulatory Prohibition. Notwithstanding any other provision of this Agreement to the contrary, any payments made to you pursuant to this 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. 1828(k)) and 12 C.F.R. Part 359.

29. Dodd-Frank Clawback. Notwithstanding any other provision of this Agreement to the contrary, in order to comply with Section 10D of the Securities Exchange Act of 1934, as amended, and any regulations promulgated, or national securities exchange listing conditions adopted, with respect thereto (collectively, the “Clawback Requirements”), if the Company is required to prepare an accounting restatement due to the material noncompliance of the Company with any financial reporting requirements under the securities laws, then you any shall return to the Company, or forfeit if not yet paid, the amount of any “incentive-based compensation” (as defined under the Clawback Requirements) received during the three-year period preceding the date on which the Company is required to prepare the accounting restatement, based on the erroneous data, in excess of what would have been paid to you under the accounting restatement as determined by the Company in accordance with the Clawback Requirements and any policy adopted by the Company pursuant to the Clawback Requirements.

30. Waiver of Jury Trial. **EACH PARTY KNOWINGLY, VOLUNTARILY, AND INTENTIONALLY WAIVES ITS RIGHT TO A TRIAL BY JURY TO THE EXTENT PERMITTED BY LAW IN ANY ACTION OR OTHER LEGAL PROCEEDING ARISING OUT OF OR RELATING TO THIS AGREEMENT. THIS WAIVER APPLIES TO ANY ACTION OR OTHER LEGAL PROCEEDING, WHETHER SOUNDING IN CONTRACT, TORT OR OTHERWISE. EACH PARTY ACKNOWLEDGES THAT IT HAS RECEIVED THE ADVICE OF COMPETENT COUNSEL.**

31. **BY SIGNING THIS AGREEMENT, YOU ACKNOWLEDGE THAT YOU HAVE HAD THE OPPORTUNITY TO REVIEW THIS AGREEMENT CAREFULLY WITH AN ATTORNEY OF YOUR CHOICE, THAT YOU HAVE READ THIS AGREEMENT, THAT YOU UNDERSTAND ITS TERMS, AND THAT YOU VOLUNTARILY AGREE TO THEM.**

EXHIBIT A

SUPPLEMENTAL EXECUTIVE RETIREMENT AGREEMENT

This Supplemental Executive Retirement Agreement (this “Agreement”) is made and entered into as of August __, 2012, by and between Financial Institutions, Inc. (“the Company”), a bank holding company chartered under the laws of the State of New York, and Peter G. Humphrey (the “Executive”).

RECITALS

WHEREAS, the Board of Directors of the Company (the “Board”) recognizes the decades of leadership and service that the Executive has provided to the Company; and

WHEREAS, the Board has previously contemplated providing a supplemental retirement arrangement for the Executive, but the Executive and the Company never entered into any such arrangement; and

WHEREAS, the Board believes that it is in the best interests of the Company and its shareholders to provide the Executive with a supplemental retirement agreement;

NOW, THEREFORE, in consideration of the mutual covenants herein contained, the parties hereby agree as follows:

Supplemental Retirement Payment.

Benefit Amount. Provided that the Executive signs and does not revoke the separation agreement and release of all claims between the Executive and the Company (the “Separation Agreement”), then the Company hereby agrees to pay to the Executive an aggregate payment of \$1,500,000 over a ten-year period, which shall be payable as set forth below (the “Supplemental Retirement Payments”).

Time and Form of Payment. Payment of the the Supplemental Retirement Payments will begin on the Company’s first regular payday following October 1, 2014 and will be made in substantially equivalent payments over the ten-year period following such date in accordance with the Company’s regular payroll procedures in effect from time to time, but in no event less frequently than monthly. If the Executive does not sign the Separation Agreement, or signs and revokes the Separation Agreement, then the Executive shall automatically forfeit the Supplemental Retirement Payments.

Effect of Certain Events.

Death of the Executive. In the event of the death of the Executive at any time following the date of this Agreement, the Executive’s surviving spouse shall be entitled to receive an amount equal to the full amount of the Supplemental Retirement Payments minus the amount, if any, of Supplemental Retirement Payments that have already been paid to the Executive. Payment will be made in the form a lump-sum cash payment no later than the end of the year in which the Executive’s death occurred or the 15th day of the third month following the date of the Executive’s death, if later. If the Executive does not have a surviving spouse at the time of his death, payment shall instead be made to the Executive’s estate.

Disability of the Executive . In the event of the Disability of the Executive at any time following the date of this Agreement, the Executive shall be entitled to receive an amount equal to the full amount of the Supplemental Retirement Payments minus the amount, if any, of Supplemental Retirement Payments that have already been paid to the Executive. Payment will be made in the form a lump-sum cash payment no later than the end of the year of the Executive's Disability or the 15th day of the third month following the date of the Executive's Disability, if later. "Disability" shall mean that the Executive (i) is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment that can be expected to result in death or can be expected to last for a continuous period of not less than 12 months, or (ii) is, by reason of any medically determinable physical or mental impairment that can be expected to result in death or can be expected to last for a continuous period of not less than 12 months, receiving income replacement benefits for a period of not less than three months under an accident and health plan covering employees of the Company.

Change of Control of the Company . In the event of a Change of Control of the Company, the Executive shall be entitled to receive an amount equal to the full amount of the Supplemental Retirement Payments minus the amount, if any, of Supplemental Retirement Payments that have already been paid to the Executive. Payment will be made in the form a lump-sum cash payment as soon as administratively practicable following the date of the Change of Control, but in no event later than 90 days thereafter. "Change of Control" shall mean the first occurrence of one or more of the following events:

Any one person, or more than one person acting as a group, acquires ownership of stock of the Company that, together with stock held by such person or group, constitutes more than 50 percent of the total fair market value or total voting power of the stock of the Company. If any one person, or more than one person acting as a group, is considered to own more than 50 percent of the total fair market value or total voting power of the stock of the Company, the acquisition of additional stock by the same person or persons shall not be considered to cause a change in the ownership of the corporation. An increase in the percentage of stock owned by any one person, or persons acting as a group, as a result of a transaction in which the Company acquires its stock in exchange for property will be treated as an acquisition of stock for purposes of this Section.

Any one person, or more than one person acting as a group, acquires (or has acquired during the 12-month period ending on the date of the most recent acquisition by such person or persons) ownership of stock of the Company possessing 30 percent or more of the total voting power of the stock of the Company. If any one person, or more than one person acting as a group, is considered to effectively control a corporation within the meaning of Treasury Regulation Section 1.409A-3(i)(5)(vi), the acquisition of additional control of the corporation by the same person or persons is not considered to cause a change in the effective control of the corporation.

A majority of members of the Board is replaced during any 12-month period by directors whose appointment or election is not endorsed by a majority of the members of the Board before the date of such appointment or election.

Any one person, or more than one person acting as a group, acquires (or has acquired during the 12-month period ending on the date of the most recent acquisition by such person or persons) assets from the Company that have a total gross fair market value equal to or more than 50 percent of the total gross fair market value of all of the assets of the Company immediately before such acquisition or acquisitions. For this purpose, gross fair market value means the value of the assets of the Company, or the value of the assets being disposed of, determined without regard to any liabilities associated with such assets. Notwithstanding the foregoing, there is no Change of Control event under this Section when there is a transfer to an entity that is controlled by the shareholders of the Company immediately after the transfer. A transfer of assets by the Company is not treated as a change in the ownership of such assets if the assets are transferred to: (A) a shareholder of the Company (immediately before the asset transfer) in exchange for or with respect to its stock; (B) an entity, 50 percent or more of the total value or voting power of which is owned, directly or indirectly, by the Company; (C) a person, or more than one person acting as a group, that owns, directly or indirectly, 50 percent or more of the total value or voting power of all the outstanding stock of the Company; or (D) an entity, at least 50 percent of the total value or voting power of which is owned, directly or indirectly, by a person described in (C) above.

A Change of Control is intended to qualify as a “change in the ownership of a corporation” or a “change in the ownership of a substantial portion of a corporation’s assets” as defined in Section 409A of the Internal Revenue Code of 1986, as amended, and the treasury regulations and other official guidance issued thereunder (collectively, “Section 409A”), and this Agreement shall be administered and interpreted to the extent possible in a manner consistent with that intent. For purposes of the foregoing, persons will be considered acting as a group in accordance with Sections 13(d)(3) and 14(d)(2) of the Securities Exchange Act of 1934, as amended, and Section 409A.

Miscellaneous.

Withholding . The Company shall withhold from any and all payments made under this Agreement all applicable federal, state, local or other taxes.

Notices . Any notice, consent, request or other communication made or given in connection with this Agreement shall be in writing and shall be deemed to have been duly given when delivered or mailed by registered or certified mail, return receipt requested, or by facsimile or by hand delivery, to those listed below at their following respective addresses or at such other address as each may specify by notice to the others:

If to the Company, to:

Financial Institutions, Inc.
Attention: Chairman of the Board
220 Liberty St.
Warsaw, NY 14569

If to the Executive, to:

Peter G. Humphrey
1446 South Rd.
Scottsville, NY 14546

No Mitigation; No Set-Off Against Benefits . The Executive shall not be required to mitigate damages or the amount of any payment provided for under this Agreement by seeking other employment or otherwise, nor shall the amount of any payment provided for in this Agreement be reduced by any compensation earned by the Executive as a result of employment by another employer after the date of termination of the Executive's employment with the Company. In addition, the Company's obligations under this Agreement shall not be affected by any set-off, counterclaim, recoupment, defense or other claim, right or action which the Company may have against the Executive.

Executive Acknowledgement . The Executive acknowledges that he has had the opportunity to discuss this Agreement with and obtain advice from his private attorney, has had sufficient time to and has carefully read and fully understands all of the provisions of this Agreement, and is knowingly and voluntarily entering into this Agreement.

Entire Agreement; Amendment . This Agreement shall supersede any and all existing oral or written agreements, representations, or warranties between the Executive and the Company relating to the subject matter hereof. No provision of this Agreement may be amended or modified unless such amendment or modification is agreed to in writing and signed by the Executive and by the Chairman of the Board.

Governing Law . The validity, construction, interpretation, administration and effect of this Agreement shall be governed by the substantive laws, but not the choice of law rules, of the State of New York.

Construction . The failure of a party to insist upon strict adherence to any term of this Agreement on any occasion shall not be considered a waiver thereof or deprive that party of the right thereafter to insist upon strict adherence to that term or any other term of this Agreement. If any term or provision of this Agreement is declared illegal or unenforceable by any court of competent jurisdiction and cannot be modified to be enforceable, such term or provision shall immediately become null and void, leaving the remainder of this Agreement in full force and effect. Section headings are used herein for convenience of reference only and shall not affect the meaning of any provision of this Agreement. Whenever the context so requires, the use of the singular shall be deemed to include the plural and vice versa. This Agreement may be executed in any number of counterparts, each of which so executed shall be deemed to be an original, and such counterparts will together constitute but one agreement.

Section 409A . This Agreement and the payments hereunder are intended to comply with Section 409A, and this Agreement shall be administered and interpreted consistent with such intent. The Company makes no representation to the Executive regarding the taxation of the compensation under this Agreement, including, but not limited to, the tax effects of Section 409A, and the Executive shall be solely responsible for the taxes imposed upon him with respect to his compensation under this Agreement.

Unfunded Arrangement . This Agreement shall be unfunded. The Company shall not be required to establish any special or separate fund or to segregate any assets to assure the performance of its obligations under this Agreement.

Regulatory Prohibition . Notwithstanding any other provision of this Agreement to the contrary, any payments made to the Executive pursuant to this 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. 1828(k)) and 12 C.F.R. Part 359.

(signature page immediately follows)

IN WITNESS WHEREOF, the parties have executed this Agreement on the date first above written.

FINANCIAL INSTITUTIONS, INC.

By: /s/ **John E. Benjamin**

Name (print): John E. Benjamin

Its: Chairman of the Board

/s/ **Peter G. Humphrey**

Peter G. Humphrey

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

I, John E. Benjamin, 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: November 6, 2012

/s/ John E. Benjamin

John E. Benjamin
Interim Chief Executive Officer
(Principal Executive Officer)

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

I, Karl F. Krebs, 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: November 6, 2012

/s/ Karl F. Krebs

Karl F. Krebs

Executive Vice President and 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**

John E. Benjamin, Interim Chief Executive Officer, and Karl F. Krebs, Executive Vice President and 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 September 30, 2012 and that to the best of his knowledge:

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: November 6, 2012

/s/ **John E. Benjamin**

John E. Benjamin
Interim Chief Executive Officer
(Principal Executive Officer)

Date: November 6, 2012

/s/ **Karl F. Krebs**

Karl F. Krebs
Executive Vice President and 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.