FINANCIAL INSTITUTIONS INC
Form 10-Q
November 04, 2016
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2016

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

(Exact name of registrant as specified in its charter)

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

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

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 x No ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every

Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No ¨

Indicate by check mark whether the regsitrant 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 x
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 x

The registrant had 14,527,719 shares of Common Stock, $0.01 par value, outstanding as of October 28, 2016.

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FINANCIAL INSTITUTIONS, INC.

Form 10-Q

For the Quarterly Period Ended September 30, 2016

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PART I. FINANCIAL INFORMATION

ITEM 1. Financial Statements

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Consolidated Statements of Financial Condition (Unaudited)

(Dollars in thousands, except share and per share data)	September 30, 2016	December 31, 2015
ASSETS		
Cash and due from banks	$ 110,721	$ 60,121
Securities available for sale, at fair value	559,495	544,395
Securities held to maturity, at amortized cost (fair value of $538,630 and $490,064, respectively)	528,708	485,717
Loans held for sale	844	1,430
Loans (net of allowance for loan losses of $29,350 and $27,085, respectively)	2,254,644	2,056,677
Company owned life insurance	62,942	63,045
Premises and equipment, net	40,178	39,445
Goodwill and other intangible assets, net	75,943	66,946
Other assets	53,890	63,248
Total assets	$ 3,687,365	$ 3,381,024
LIABILITIES AND SHAREHOLDERS EQUITY		
Deposits:		
Noninterest-bearing demand	$ 657,624	$ 641,972
Interest-bearing demand	629,413	523,366
Savings and money market	1,052,224	928,175
Time deposits	724,096	637,018
Total deposits	3,063,357	2,730,531
Short-term borrowings	230,200	293,100
Long-term borrowings, net of issuance costs of $957 and $1,010, respectively	39,043	38,990
Other liabilities	28,494	24,559
Total liabilities	3,361,094	3,087,180
Shareholders equity:		
Series A 3% preferred stock, $100 par value; 1,533 shares authorized; 1,492 shares issued	149	149
Series B-1 8.48% preferred stock, $100 par value; 200,000 shares authorized; 171,906 shares issued	17,191	17,191
Total preferred equity	17,340	17,340

Common stock, $0.01 par value; 50,000,000 shares authorized; 14,692,214 and 14,397,509 shares issued, respectively	147	144
Additional paid-in capital	81,459	72,690
Retained earnings	232,396	218,920
Accumulated other comprehensive loss	(1,961)	(11,327)
Treasury stock, at cost 164,495 and 207,317 shares, respectively	(3,110)	(3,923)
Total shareholders equity	326,271	293,844
Total liabilities and shareholders equity	$ 3,687,365	$ 3,381,024

See accompanying notes to the consolidated financial statements.

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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,	
	2016	**2015**	**2016**	**2015**
Interest income:				
Interest and fees on loans	$ 23,619	$ 21,210	$ 68,044	$ 61,793
Interest and dividends on investment securities	5,741	5,797	17,196	16,170
Other interest income			1	
Total interest income	29,360	27,007	85,241	77,963
Interest expense:				
Deposits	2,192	1,917	6,237	5,364
Short-term borrowings	500	342	1,183	785
Long-term borrowings	618	617	1,853	1,132
Total interest expense	3,310	2,876	9,273	7,281
Net interest income	26,050	24,131	75,968	70,682
Provision for loan losses	1,961	754	6,281	4,783
Net interest income after provision for loan losses	24,089	23,377	69,687	65,899
Noninterest income:				
Service charges on deposits	1,913	2,037	5,392	5,880
Insurance income	1,407	1,265	4,262	3,930
ATM and debit card	1,441	1,297	4,187	3,773
Investment advisory	1,326	523	3,934	1,551
Company owned life insurance	486	488	2,340	1,448
Investments in limited partnerships	161	336	253	865
Loan servicing	104	153	332	416
Net gain on sale of loans held for sale	46	53	202	161
Net gain on investment securities	426	286	2,426	1,348
Net gain on other assets	199		285	20
Amortization of tax credit investment		(390)		(390)
Other	1,030	957	3,059	2,755
Total noninterest income	8,539	7,005	26,672	21,757
Noninterest expense:				
Salaries and employee benefits	11,325	10,278	33,757	31,107
Occupancy and equipment	3,617	3,417	10,906	10,491

Professional services	956	1,064	5,236	2,898
Computer and data processing	832	779	2,549	2,291
Supplies and postage	490	540	1,548	1,611
FDIC assessments	406	444	1,283	1,277
Advertising and promotions	214	312	938	789
Other	2,778	2,484	7,739	7,101
Total noninterest expense	20,618	19,318	63,956	57,565
Income before income taxes	12,010	11,064	32,403	30,091
Income tax expense	3,541	2,748	9,165	8,389
Net income	$ 8,469	$ 8,316	$ 23,238	$ 21,702
Preferred stock dividends	366	366	1,097	1,097
Net income available to common shareholders	$ 8,103	$ 7,950	$ 22,141	$ 20,605
Earnings per common share (Note 3):				
Basic	$ 0.56	$ 0.56	$ 1.53	$ 1.46
Diluted	$ 0.56	$ 0.56	$ 1.53	$ 1.46
Cash dividends declared per common share	$ 0.20	$ 0.20	$ 0.60	$ 0.60
Weighted average common shares outstanding:				
Basic	14,456	14,087	14,429	14,076
Diluted	14,500	14,139	14,485	14,124

See accompanying notes to the consolidated financial statements.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Consolidated Statements of Comprehensive Income (Unaudited)

(Dollars in thousands)	Three months ended September 30,		Nine months ended September 30,	
	2016	**2015**	**2016**	**2015**
Net income	$ 8,469	$ 8,316	$ 23,238	$ 21,702
Other comprehensive income (loss), net of tax:				
Net unrealized (losses) gains on securities available for sale	(1,446)	5,492	8,948	2,546
Pension and post-retirement obligations	139	138	418	413
Total other comprehensive income (loss), net of tax	(1,307)	5,630	9,366	2,959
Comprehensive income	$ 7,162	$ 13,946	$ 32,604	$ 24,661

See accompanying notes to the consolidated financial statements.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Consolidated Statements of Changes in Shareholders Equity (Unaudited)

Nine months ended September 30, 2016 and 2015

(Dollars in thousands, except per share data)	Preferred Equity	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Loss	Treasury Stock	Total Shareholders Equity
Balance at January 1, 2015	**$ 17,340**	**$ 144**	**$ 72,955**	**$ 203,312**	**$ (9,011)**	**$ (5,208)**	**$ 279,532**
Comprehensive income:							
Net income				21,702			21,702
Other comprehensive income, net of tax					2,959		2,959
Purchases of common stock for treasury						(41)	(41)
Share-based compensation plans:							
Share-based compensation			520				520
Stock options exercised			1			251	252
Restricted stock awards issued, net			(1,060)			1,060	
Stock awards			11			43	54
Cash dividends declared:							
Series A 3% Preferred-$2.25 per share				(3)			(3)
Series B-1 8.48% Preferred-$6.36 per share				(1,094)			(1,094)
Common-$0.60 per share				(8,447)			(8,447)
Balance at September 30, 2015	**$ 17,340**	**$ 144**	**$ 72,427**	**$ 215,470**	**$ (6,052)**	**$ (3,895)**	**$ 295,434**
Balance at January 1, 2016	**$ 17,340**	**$ 144**	**$ 72,690**	**$ 218,920**	**$ (11,327)**	**$ (3,923)**	**$ 293,844**
Comprehensive income:							
Net income				23,238			23,238
Other comprehensive income, net of tax					9,366		9,366
Common stock issued		3	8,097				8,100
Share-based compensation plans:							
Share-based compensation			597				597
Stock options exercised			20			794	814
Restricted stock awards issued, net			24			(24)	
Excess tax benefit on share-based compensation			10				10
Stock awards			21			43	64
Cash dividends declared:							
				(3)			(3)

Series A 3% Preferred-$2.25 per share							
Series B-1 8.48% Preferred-$6.36 per share				(1,094)			(1,094)
Common-$0.60 per share				(8,665)			(8,665)
Balance at September 30, 2016	**$ 17,340**	**$ 147**	**$ 81,459**	**$ 232,396**	**$ (1,961)**	**$ (3,110)**	**$ 326,271**

See accompanying notes to the consolidated financial statements.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Consolidated Statements of Cash Flows (Unaudited)

(Dollars in thousands)	Nine months ended September 30, 2016	Nine months ended September 30, 2015
Cash flows from operating activities:		
Net income	$ 23,238	$ 21,702
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	4,480	4,065
Net amortization of premiums on securities	2,325	2,355
Provision for loan losses	6,281	4,783
Share-based compensation	597	520
Deferred income tax (benefit) expense	(523)	318
Proceeds from sale of loans held for sale	9,246	10,370
Originations of loans held for sale	(8,458)	(11,022)
Income on company owned life insurance	(2,340)	(1,448)
Net gain on sale of loans held for sale	(202)	(161)
Net gain on investment securities	(2,426)	(1,348)
Amortization of tax credit investment		390
Net gain on other assets	(285)	(20)
Decrease in other assets	3,548	2,830
Increase in other liabilities	1,943	1,819
Net cash provided by operating activities	37,424	35,153
Cash flows from investing activities:		
Purchases of available for sale securities	(192,140)	(271,899)
Purchases of held to maturity securities	(90,602)	(53,768)
Proceeds from principal payments, maturities and calls on available for sale securities	107,418	118,378
Proceeds from principal payments, maturities and calls on held to maturity securities	48,424	23,826
Proceeds from sales of securities available for sale	85,772	37,620
Net loan originations	(204,691)	(130,485)
Proceeds from company owned life insurance, net of purchases	2,443	(34)
Proceeds from sales of other assets	602	167
Purchases of premises and equipment	(4,242)	(4,957)
Cash consideration paid for acquisition, net of cash acquired	(868)	
Net cash used in investing activities	(247,884)	(281,152)
Cash flows from financing activities:		
Net increase in deposits	332,826	302,973
Net decrease in short-term borrowings	(62,900)	(93,404)
Issuance of long-term debt		40,000
Debt issuance costs		(1,060)

Purchase of common stock for treasury		(41)
Proceeds from stock options exercised	814	252
Excess tax benefit on share-based compensation, net	10	
Cash dividends paid to common and preferred shareholders	(9,690)	(9,538)
Net cash provided by financing activities	261,060	239,182
Net increase (decrease) in cash and cash equivalents	50,600	(6,817)
Cash and cash equivalents, beginning of period	60,121	58,151
Cash and cash equivalents, end of period	$ 110,721	$ 51,334
Supplemental information:		
Cash paid for interest	$ 8,144	$ 5,566
Cash paid for income taxes, net of refunds received	4,708	4,257
Noncash investing and financing activities:		
Real estate and other assets acquired in settlement of loans	443	286
Accrued and declared unpaid dividends	3,257	3,183
Increase in net unsettled security purchases	2,290	2,232
Securities transferred from available for sale to held to maturity (at fair value)		165,238
Common stock issued for acquisition	8,100	
Assets acquired and liabilities assumed in business combinations:		
Fair value of assets acquired	4,848	
Fair value of liabilities assumed	1,845	

See accompanying notes to the consolidated financial statements.

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

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

Nature of Operations

Financial Institutions, Inc., (the Company) is a financial holding company organized in 1931 under the laws of New York State. The Company provides diversified financial services through its subsidiaries, Five Star Bank, Scott Danahy Naylon, LLC (Scott Danahy Naylon) and Courier Capital, LLC (Courier Capital). The Company offers a broad array of deposit, lending and other financial services to individuals, municipalities and businesses in Western and Central New York through its wholly-owned New York chartered banking subsidiary, Five Star Bank (the Bank). The Bank also has indirect lending network relationships with franchised automobile dealers in the Capital District of New York and Northern and Central Pennsylvania. Scott Danahy Naylon provides a broad range of insurance services to personal and business clients across 44 states. Acquired on January 5, 2016, Courier Capital provides customized investment management, investment consulting and retirement plan services to individuals, businesses, institutions, foundations and retirement plans across nine states.

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, changes in shareholders equity and cash flows for the periods indicated, and contain adequate disclosure to make the information presented not misleading. These consolidated financial statements should be read in conjunction with the Company s 2015 Annual Report on Form 10-K for the year ended December 31, 2015. The results of operations for any interim periods are not necessarily indicative of the results which may be expected for the entire year.

Reclassifications

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

Subsequent Events

The Company has evaluated events and transactions for potential recognition or disclosure through the day the financial statements were issued and determined there were no material recognizable subsequent events.

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, the carrying value of goodwill and deferred tax assets, and assumptions used in the defined benefit pension plan accounting.

Recent Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2014-09, *Revenue from Contracts with Customers (Topic 606).* ASU 2014-09 implements a common revenue standard that clarifies the principles for recognizing revenue. The core principle of ASU 2014-09 is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. To achieve that core principle, an entity should apply the following steps: (i) identify the contract(s) with a customer, (ii) identify the performance obligations in the contract, (iii) determine the transaction price, (iv) allocate the transaction price to the performance obligations in the contract and (v) recognize revenue when (or as) the entity satisfies a performance obligation. The effective date was recently deferred for one year to the interim and annual periods beginning on or after December 15, 2017. Early adoption is permitted as of the original effective date interim and annual periods beginning on or after December 15, 2016. The Company continues to assess the potential impact of ASU 2014-09 on its accounting and disclosures.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

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

In January 2016, the FASB issued ASU No. 2016-01, *Financial Instruments Overall (Subtopic 825-10) Recognition and Measurement of Financial Assets and Financial Liabilities*. ASU 2016-01 is intended to improve the recognition and measurement of financial instruments by requiring equity investments to be measured at fair value with changes in fair value recognized in net income; requiring entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes; requiring separate presentation of financial assets and financial liabilities by measurement category and form of financial asset on the balance sheet or the accompanying notes to the financial statements; eliminating the requirement for entities to disclose the method(s) and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured and amortized at cost on the balance sheet; and requiring an entity to present separately in other comprehensive income the portion of the total change in the fair value of a liability resulting from a change in the instrument-specific credit risk when the entity has elected to measure the liability at fair value in accordance with the fair value option for financial instruments. ASU 2016-01 is effective for annual periods and interim periods within those annual periods, beginning after December 15, 2017. The amendments should be applied by means of a cumulative-effect adjustment to the balance sheet as of the beginning of the fiscal year of adoption. The amendments related to equity securities without readily determinable fair values (including disclosure requirements) should be applied prospectively to equity investments that exist as of the date of adoption. The Company is assessing the impact of ASU 2016-01 on its accounting and disclosures.

In February 2016, the FASB issued ASU No. 2016-02, *Leases (Topic 842)*. ASU 2016-02 establishes a right of use model that requires a lessee to record a right of use asset and a lease liability for all leases with terms longer than 12 months. Leases will be classified as either finance or operating, with classification affecting the pattern of expense recognition in the income statement. For lessors, the guidance modifies the classification criteria and the accounting for sales-type and direct financing leases. A lease will be treated as a sale if it transfers all of the risks and rewards, as well as control of the underlying asset, to the lessee. If risks and rewards are conveyed without the transfer of control, the lease is treated as a financing. If the lessor doesn t convey risks and rewards or control, an operating lease results. The amendments are effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Entities are required to use a modified retrospective approach for leases that exist or are entered into after the beginning of the earliest comparative period in the financial statements, with certain practical expedients available. Early adoption is permitted. The Company is assessing the impact of ASU 2016-02 on its accounting and disclosures.

In March 2016, the FASB issued ASU No. 2016-09, *Compensation Stock Compensation (Topic 718) Improvements to Employee Share-Based Payment Accounting*. ASU 2016-09 requires all income tax effects of awards to be recognized in the income statement when the awards vest or are settled. It also allows an employer to repurchase more of an employee s shares than it can today for tax withholding purposes without triggering liability accounting and to make a policy election for forfeitures as they occur. The guidance is effective for fiscal years beginning after December 15, 2016, and interim periods within those years. Early adoption is permitted. The Company is assessing the impact of ASU 2016-09 on its accounting and disclosures.

In June 2016, the FASB issued ASU No. 2016-13, *Financial Instruments Credit Losses (Topic 326) Measurement of Credit Losses on Financial Instruments*. ASU 2016-13 amends guidance on reporting credit losses for financial assets held at amortized cost basis and available for sale debt securities. Topic 326 eliminates the probable initial recognition threshold in current GAAP and instead, requires an entity to reflect its current estimate of all expected credit losses based on historical experience, current conditions and reasonable and supportable forecasts. The allowance for credit losses is a valuation account that is deducted from the amortized cost basis of the financial assets to present the net amount expected to be collected. The guidance is effective for fiscal years beginning after December 15, 2019, and interim periods within those years. Early adoption is permitted beginning after December 15, 2018. The Company is assessing the impact of ASU 2016-13 on its accounting and disclosures.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(2.) BUSINESS COMBINATIONS

Courier Capital Acquisition

On January 5, 2016, the Company completed the acquisition of Courier Capital Corporation, a registered investment advisory and wealth management firm with approximately $1.2 billion in assets under management. Consideration for the acquisition totaled $9.0 million and included stock of $8.1 million and $918 thousand of cash. The acquisition also included up to $2.8 million of potential future payments of stock and up to $2.2 million of potential future cash bonuses contingent upon Courier Capital meeting certain EBITDA performance targets through 2018. In addition, the Company purchased two pieces of real property in Buffalo and Jamestown, New York used by Courier Capital for total cash considerations of $1.3 million. As a result of the acquisition, the Company recorded goodwill of $6.0 million and other intangible assets of $3.9 million. The goodwill is not expected to be deductible for income tax purposes. Pro forma results of operations for this acquisition have not been presented because the effect of this acquisition was not material to the Company s consolidated financial statements.

This acquisition was accounted for under the acquisition method in accordance with FASB ASC Topic 805. Accordingly, the assets and liabilities, both tangible and intangible, were recorded at their estimated fair values as of the acquisition date. Due to the timing of the closing of the acquisition, the fair values of other intangibles recorded are subject to adjustment as additional information becomes available to indicate a more accurate or appropriate fair value for the intangibles during the measurement period, which is not to exceed one year from the acquisition date. The following table presents the allocation of acquisition cost to the assets acquired and liabilities assumed, based on their estimated fair values.

Cash	$ 50
Identified intangible assets	3,928
Premises and equipment, accounts receivable and other assets	870
Deferred tax liability	(1,797)
Other liabilities	(48)
Net assets acquired	$ 3,003

The amounts assigned to goodwill and other intangible assets for the Courier Capital acquisition are as follows:

		Amount allocated	Useful life (in years)
Goodwill		$ 6,015	n/a
Other intangible assets	customer relationships	3,900	20
Other intangible assets	other	28	5

$	9,943

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(3.) 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 Spetmber 30,	
	2016	2015	2016	2015
Net income available to common shareholders	$ 8,103	$ 7,950	$ 22,141	$ 20,605
Weighted average common shares outstanding:				
Total shares issued	14,692	14,398	14,688	14,398
Unvested restricted stock awards	(72)	(100)	(76)	(92)
Treasury shares	(164)	(211)	(183)	(230)
Total basic weighted average common shares outstanding	14,456	14,087	14,429	14,076
Incremental shares from assumed:				
Exercise of stock options	16	23	21	22
Vesting of restricted stock awards	28	29	35	26
Total diluted weighted average common shares outstanding	14,500	14,139	14,485	14,124
Basic earnings per common share	$ 0.56	$ 0.56	$ 1.53	$ 1.46
Diluted earnings per common share	$ 0.56	$ 0.56	$ 1.53	$ 1.46

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				
Restricted stock awards			3	1
Total			3	1

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(4.) 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, 2016				
Securities available for sale:				
U.S. Government agencies and government sponsored enterprises	$ 175,134	$ 5,508	$ 5	$ 180,637
Mortgage-backed securities:				
Federal National Mortgage Association	312,771	7,501		320,272
Federal Home Loan Mortgage Corporation	39,425	773	11	40,187
Government National Mortgage Association	16,332	672	15	16,989
Collateralized mortgage obligations:				
Federal National Mortgage Association	328		1	327
Federal Home Loan Mortgage Corporation	73		1	72
Privately issued		816		816
Total mortgage-backed securities	368,929	9,762	28	378,663
Asset-backed securities		195		195
Total available for sale securities	$ 544,063	$ 15,465	$ 33	$ 559,495
Securities held to maturity:				
State and political subdivisions	300,922	8,136	45	309,013
Mortgage-backed securities:				
Federal National Mortgage Association	10,422	276		10,698
Federal Home Loan Mortgage Corporation	1,351		1	1,350
Government National Mortgage Association	25,402	366	1	25,767
Collateralized mortgage obligations:				
Federal National Mortgage Association	75,287	426	105	75,608
Federal Home Loan Mortgage Corporation	98,439	942	128	99,253
Government National Mortgage Association	16,885	72	16	16,941
Total mortgage-backed securities	227,786	2,082	251	229,617
Total held to maturity securities	$ 528,708	$ 10,218	$ 296	$ 538,630
December 31, 2015				

Securities available for sale:				
U.S. Government agencies and government sponsored enterprises	$ 260,748	$ 1,164	$ 1,049	$ 260,863
Mortgage-backed securities:				
Federal National Mortgage Association	209,671	1,092	2,333	208,430
Federal Home Loan Mortgage Corporation	24,564	282	194	24,652
Government National Mortgage Association	26,465	943	4	27,404
Collateralized mortgage obligations:				
Federal National Mortgage Association	16,998	90	154	16,934
Federal Home Loan Mortgage Corporation	5,175	1	91	5,085
Privately issued		809		809
Total mortgage-backed securities	282,873	3,217	2,776	283,314
Asset-backed securities		218		218
Total available for sale securities	$ 543,621	$ 4,599	$ 3,825	$ 544,395
Securities held to maturity:				
State and political subdivisions	294,423	6,562	4	300,981
Mortgage-backed securities:				
Federal National Mortgage Association	9,242	14	79	9,177
Government National Mortgage Association	25,607	33	159	25,481
Collateralized mortgage obligations:				
Federal National Mortgage Association	56,791		818	55,973
Federal Home Loan Mortgage Corporation	80,570		1,120	79,450
Government National Mortgage Association	19,084	19	101	19,002
Total mortgage-backed securities	191,294	66	2,277	189,083
Total held to maturity securities	$ 485,717	$ 6,628	$ 2,281	$ 490,064

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(4.) INVESTMENT SECURITIES (Continued)

Investment securities with a total fair value of $939.3 million at September 30, 2016 were pledged and encumbered as collateral to secure public deposits and for other purposes required or permitted by law.

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

	Three months ended September 30,		Nine months ended September 30,	
	2016	2015	2016	2015
Proceeds from sales	$ 23,497	$ 8,112	$ 85,772	$ 37,620
Gross realized gains	426	286	2,426	1,359
Gross realized losses				11

The scheduled maturities of securities available for sale and securities held to maturity at September 30, 2016 are shown below (in thousands). Actual 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	$ 105	$ 105
Due from one to five years	153,605	156,094
Due after five years through ten years	268,354	277,631
Due after ten years	121,999	125,665
	$ 544,063	$ 559,495
Debt securities held to maturity:		
Due in one year or less	$ 42,584	$ 42,684
Due from one to five years	178,401	183,536
Due after five years through ten years	92,745	95,657
Due after ten years	214,978	216,753
	$ 528,708	$ 538,630

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(4.) INVESTMENT SECURITIES (Continued)

Unrealized losses on investment securities 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, 2016						
Securities available for sale:						
U.S. Government agencies and government sponsored enterprises	$	$	$ 1,515	$ 5	$ 1,515	$ 5
Mortgage-backed securities:						
Federal Home Loan Mortgage Corporation	4,992	11			4,992	11
Government National Mortgage Association	1,171	15			1,171	15
Collateralized mortgage obligations:						
Federal National Mortgage Association	326	1			326	1
Federal Home Loan Mortgage Corporation	73	1			73	1
Total mortgage-backed securities	6,562	28			6,562	28
Total available for sale securities	6,562	28	1,515	5	8,077	33
Securities held to maturity:						
State and political subdivisions	12,710	45			12,710	45
Mortgage-backed securities:						
Federal Home Loan Mortgage Corporation	1,349	1			1,349	1
Government National Mortgage Association	1,630	1			1,630	1
Collateralized mortgage obligations:						
Federal National Mortgage Association	26,315	89	3,600	16	29,915	105
	27,838	127	496	1	28,334	128

Federal Home Loan Mortgage Corporation						
Government National Mortgage Association	6,677	14	1,510	2	8,187	16
Total mortgage-backed securities	63,809	232	5,606	19	69,415	251
Total held to maturity securities	76,519	277	5,606	19	82,125	296
Total temporarily impaired securities	$ 83,081	$ 305	$ 7,121	$ 24	$ 90,202	$ 329
December 31, 2015						
Securities available for sale:						
U.S. Government agencies and government sponsored enterprises	$ 82,298	$ 735	$ 26,302	$ 314	$ 108,600	$ 1,049
Mortgage-backed securities:						
Federal National Mortgage Association	123,774	2,134	9,562	199	133,336	2,333
Federal Home Loan Mortgage Corporation	12,660	194			12,660	194
Government National Mortgage Association	1,405	4			1,405	4
Collateralized mortgage obligations:						
Federal National Mortgage Association	7,778	154			7,778	154
Federal Home Loan Mortgage Corporation	4,998	91			4,998	91
Total mortgage-backed securities	150,615	2,577	9,562	199	160,177	2,776
Total available for sale securities	232,913	3,312	35,864	513	268,777	3,825
Securities held to maturity:						
State and political subdivisions	3,075	4			3,075	4
Mortgage-backed securities:						
Federal National Mortgage Association	5,666	79			5,666	79
Government National Mortgage Association	8,790	159			8,790	159
Collateralized mortgage obligations:						
Federal National Mortgage Association	55,973	818			55,973	818
Federal Home Loan Mortgage Corporation	79,323	1,120			79,323	1,120
Government National Mortgage Association	14,559	101			14,559	101
Total mortgage-backed securities	164,311	2,277			164,311	2,277
Total held to maturity securities	167,386	2,281			167,386	2,281
Total temporarily impaired securities	$ 400,299	$ 5,593	$ 35,864	$ 513	$ 436,163	$ 6,106

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(4.) INVESTMENT SECURITIES (Continued)

The Company had 78 security positions in the investment portfolio in an unrealized loss position at September 30, 2016 compared to 174 at December 31, 2015. At September 30, 2016, the Company had positions in 17 investment securities with a fair value of $7.1 million and a total unrealized loss of $24 thousand that have been in a continuous unrealized loss position for more than 12 months. At September 30, 2016, there were a total of 61 securities positions in the Company s investment portfolio with a fair value of $83.1 million and a total unrealized loss of $305 thousand that had been in a continuous unrealized loss position for less than 12 months. At December 31, 2015, the Company had positions in 14 investment securities with a fair value of $35.9 million and a total unrealized loss of $513 thousand that had been in a continuous unrealized loss position for more than 12 months. At December 31, 2015, there were a total of 160 securities positions in the Company s investment portfolio with a fair value of $400.3 million and a total unrealized loss of $5.6 million that had been in a continuous unrealized loss position for less than 12 months. The unrealized loss on investment securities was predominantly caused by changes in market interest rates subsequent to purchase. The fair value of most of the investment securities in the Company s portfolio fluctuates as market interest rates change.

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: (i) the length of time and the extent to which the fair value has been less than cost, (ii) the financial condition and near-term prospects of the issuer, (iii) whether the market decline was affected by macroeconomic conditions and (iv) 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 then available to management. There was no impairment recorded during the nine months ended September 30, 2016 and 2015.

Based on management s review and evaluation of the Company s debt securities as of September 30, 2016, the debt securities with unrealized losses were not considered to be other-than-temporarily impaired. As of September 30, 2016, the Company did not intend to sell any of the securities in a loss position and believes that it is not likely that it will be required to sell any such securities before the anticipated recovery of amortized cost. Accordingly, as of September 30, 2016, 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.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(5.) 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, 2016			
Commercial business	$ 350,181	$ 407	$ 350,588
Commercial mortgage	637,799	(1,461)	636,338
Residential real estate loans	419,547	6,335	425,882
Residential real estate lines	120,901	2,762	123,663
Consumer indirect	703,499	26,145	729,644
Other consumer	17,700	179	17,879
Total	$ 2,249,627	$ 34,367	2,283,994
Allowance for loan losses			(29,350)
Total loans, net			$ 2,254,644
December 31, 2015			
Commercial business	$ 313,475	$ 283	$ 313,758
Commercial mortgage	567,481	(1,380)	566,101
Residential real estate loans	376,023	5,051	381,074
Residential real estate lines	124,766	2,581	127,347
Consumer indirect	652,494	24,446	676,940
Other consumer	18,361	181	18,542
Total	$ 2,052,600	$ 31,162	2,083,762
Allowance for loan losses			(27,085)
Total loans, net			$ 2,056,677

Loans held for sale (not included above) were comprised entirely of residential real estate mortgages and totaled $844 thousand and $1.4 million as of September 30, 2016 and December 31, 2015, respectively.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(5.) 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, 2016							
Commercial business	$ 659	$	$	$ 659	$ 2,157	$ 347,365	$ 350,181
Commercial mortgage	1,105			1,105	1,345	635,349	637,799
Residential real estate loans	846			846	1,239	417,462	419,547
Residential real estate lines	122	23		145	274	120,482	120,901
Consumer indirect	1,596	311		1,907	1,077	700,515	703,499
Other consumer	106	31	8	145	1	17,554	17,700
Total loans, gross	$ 4,434	$ 365	$ 8	$ 4,807	$ 6,093	$ 2,238,727	$ 2,249,627
December 31, 2015							
Commercial business	$ 321	$ 612	$	$ 933	$ 3,922	$ 308,620	$ 313,475
Commercial mortgage	68	146		214	947	566,320	567,481
Residential real estate loans	723	395		1,118	1,848	373,057	376,023
Residential real estate lines	199	34		233	235	124,298	124,766
Consumer indirect	1,975	286		2,261	1,467	648,766	652,494
Other consumer	98	13	8	119	13	18,229	18,361
Total loans, gross	$ 3,384	$ 1,486	$ 8	$ 4,878	$ 8,432	$ 2,039,290	$ 2,052,600

There were no loans past due greater than 90 days and still accruing interest as of September 30, 2016 and December 31, 2015. There was $8 thousand in consumer overdrafts which were past due greater than 90 days as of September 30, 2016 and December 31, 2015. 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. Commercial loans modified in a TDR may involve temporary interest-only payments, term extensions, reductions in the interest rate for the remaining term of the loan, extensions of the maturity date at an interest rate lower than the current market rate for new debt with similar risk, collateral concessions, forgiveness of principal, forbearance agreements, or substituting or adding a new borrower or guarantor.

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

	Quarter-to-Date			Year-to-Date		
	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
September 30, 2016						
Commercial business		$	$	3	$ 526	$ 526
Commercial mortgage				1	550	550
Total		$	$	4	$ 1,076	$ 1,076
September 30, 2015						
Commercial business		$	$	2	$ 1,342	$ 1,342
Commercial mortgage				1	682	330
Total		$	$	3	$ 2,024	$ 1,672

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(5.) LOANS (Continued)

The loans identified as a TDR by the Company during the nine month periods ended September 30, 2016 and 2015 were previously reported as impaired loans prior to restructuring. Each of the loans restructured during the nine months ended September 30, 2016 and 2015 were on nonaccrual status at the end of the respective period. The modifications related to collateral concessions and forbearance agreements. 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 classifications 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 nine months ended September 30, 2016. There were two commercial business loans with an aggregate pre-default balance of $1.3 million restructured in the 12 months prior to September 30, 2015 that went into default during the nine months ended September 30, 2015. 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 nine month periods ended as of the dates indicated (in thousands):

	Recorded Investment(1)	Unpaid Principal Balance(1)	Related Allowance	Average Recorded Investment	Interest Income Recognized
September 30, 2016					
With no related allowance recorded:					
Commercial business	$ 1,074	$ 1,594	$	$ 1,149	$
Commercial mortgage	729	938		737	
	1,803	2,532		1,886	
With an allowance recorded:					
Commercial business	1,083	1,083	460	1,058	
Commercial mortgage	616	616	124	745	

		1,699		1,699		584		1,803	
	$	3,502	$	4,231	$	584	$	3,689	$
December 31, 2015									
With no related allowance recorded:									
Commercial business	$	1,441	$	1,810	$		$	1,352	$
Commercial mortgage		937		1,285				1,013	
		2,378		3,095				2,365	
With an allowance recorded:									
Commercial business		2,481		2,481		996		1,946	
Commercial mortgage		10		10		10		449	
		2,491		2,491		1,006		2,395	
	$	4,869	$	5,586	$	1,006	$	4,760	$

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

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(5.) 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 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
September 30, 2016		
Uncriticized	$ 330,433	$ 616,955
Special mention	10,676	14,182
Substandard	9,072	6,662
Doubtful		

Total	$ 350,181	$ 637,799
December 31, 2015		
Uncriticized	$ 298,413	$ 551,603
Special mention	4,916	9,015
Substandard	10,146	6,863
Doubtful		
Total	$ 313,475	$ 567,481

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 Real Estate Loans	Residential Real Estate Lines	Consumer Indirect	Other Consumer
September 30, 2016				
Performing	$ 418,308	$ 120,627	$ 702,422	$ 17,691
Non-performing	1,239	274	1,077	9
Total	$ 419,547	$ 120,901	$ 703,499	$ 17,700
December 31, 2015				
Performing	$ 374,175	$ 124,531	$ 651,027	$ 18,340
Non-performing	1,848	235	1,467	21
Total	$ 376,023	$ 124,766	$ 652,494	$ 18,361

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(5.) 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 Real Estate Loans	Residential Real Estate Lines	Consumer Indirect	Other Consumer	Total
September 30, 2016							
Loans:							
Ending balance	$ 350,181	$ 637,799	$ 419,547	$ 120,901	$ 703,499	$ 17,700	$ 2,249,627
Evaluated for impairment:							
Individually	$ 2,081	$ 1,334	$	$	$	$	$ 3,415
Collectively	$ 348,100	$ 636,465	$ 419,547	$ 120,901	$ 703,499	$ 17,700	$ 2,246,212
Allowance for loan losses:							
Ending balance	$ 6,524	$ 9,710	$ 1,428	$ 315	$ 11,041	$ 332	$ 29,350
Evaluated for impairment:							
Individually	$ 436	$ 122	$	$	$	$	$ 558
Collectively	$ 6,088	$ 9,588	$ 1,428	$ 315	$ 11,041	$ 332	$ 28,792
September 30, 2015							
Loans:							
Ending balance	$ 297,640	$ 549,911	$ 96,298	$ 401,103	$ 641,453	$ 19,020	$ 2,005,425
Evaluated for impairment:							
Individually	$ 3,064	$ 1,802	$	$	$	$	$ 4,866
Collectively	$ 294,576	$ 548,109	$ 96,298	$ 401,103	$ 641,453	$ 19,020	$ 2,000,559
Allowance for loan losses:							
Ending balance	$ 5,281	$ 8,888	$ 456	$ 1,177	$ 10,264	$ 389	$ 26,455

Evaluated for impairment:														
Individually	$	806	$	278	$		$		$		$		$	1,084
Collectively	$	4,475	$	8,610	$	456	$	1,177	$	10,264	$	389	$	25,371

The following table sets forth the changes in the allowance for loan losses for the three and nine month periods ended September 30, 2016 (in thousands):

		Commercial Business		Commercial Mortgage		Residential Real Estate Loans		Residential Real Estate Lines		Consumer Indirect		Other Consumer		Total
Three months ended September 30, 2016														
Beginning balance	$	6,197	$	9,496	$	1,444	$	318	$	10,696	$	374	$	28,525
Charge-offs		(44)		(156)		(78)		(8)		(2,056)		(158)		(2,500)
Recoveries		75		29		17		4		1,160		79		1,364
Provision		296		341		45		1		1,241		37		1,961
Ending balance	$	6,524	$	9,710	$	1,428	$	315	$	11,041	$	332	$	29,350
Nine months ended September 30, 2016														
Beginning balance	$	5,540	$	9,027	$	1,347	$	345	$	10,458	$	368	$	27,085
Charge-offs		(688)		(168)		(258)		(59)		(6,452)		(434)		(8,059)
Recoveries		244		40		142		11		3,324		282		4,043
Provision		1,428		811		197		18		3,711		116		6,281
Ending balance	$	6,524	$	9,710	$	1,428	$	315	$	11,041	$	332	$	29,350

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(5.) 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, 2015 (in thousands):

	Commercial Business	Commercial Mortgage	Residential Real Estate Loans	Residential Real Estate Lines	Consumer Indirect	Other Consumer	Total
Three months ended September 30, 2015							
Beginning balance	$ 5,334	$ 9,358	$ 465	$ 1,198	$ 10,676	$ 469	$ 27,500
Charge-offs	(106)	(56)	(37)	(98)	(2,380)	(239)	(2,916)
Recoveries	38	44	34	34	905	62	1,117
Provision (credit)	15	(458)	(6)	43	1,063	97	754
Ending balance	$ 5,281	$ 8,888	$ 456	$ 1,177	$ 10,264	$ 389	$ 26,455
Nine months ended September 30, 2015							
Beginning balance	$ 5,621	$ 8,122	$ 570	$ 1,485	$ 11,383	$ 456	$ 27,637
Charge-offs	(1,260)	(866)	(114)	(336)	(6,643)	(652)	(9,871)
Recoveries	172	140	80	53	3,206	255	3,906
Provision (credit)	748	1,492	(80)	(25)	2,318	330	4,783
Ending balance	$ 5,281	$ 8,888	$ 456	$ 1,177	$ 10,264	$ 389	$ 26,455

Risk Characteristics

Commercial business loans primarily consist of loans to small to midsize 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, potentially resulting in higher 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 real estate loans (comprised of conventional mortgages and home equity loans) and residential real estate lines (comprised of 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, particularly in the case of other consumer loans which are unsecured or, in the case of indirect consumer loans, secured by depreciable assets, such as automobiles or boats. In such cases, any repossessed collateral for a defaulted consumer loan may not provide an adequate source of repayment of the outstanding loan balance. In addition, consumer loan collections are dependent on the borrower s continuing financial stability, and thus are more likely to be affected by adverse personal circumstances such as job loss, illness or personal bankruptcy. Furthermore, the application of various federal and state laws, including bankruptcy and insolvency laws, may limit the amount that can be recovered on such loans.

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(6.) GOODWILL AND OTHER INTANGIBLE ASSETS

The carrying amount of goodwill for the Company totaled $66.4 and $60.4 million as of September 30, 2016 and December 31, 2015, respectively. The Company performs a goodwill impairment test on an annual basis as of September 30th or more frequently if events and circumstances warrant.

	Banking	Non-Banking	Total
Balance, December 31, 2015	$ 48,536	$ 11,866	$ 60,402
Acquisition		6,015	6,015
Balance, September 30, 2016	$ 48,536	$ 17,881	$ 66,417

Goodwill and other intangible assets added during the period relates to the Courier Capital acquisition, which was completed on January 5, 2016. See Note 2 Business Combinations for additional information.

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

	September 30, 2016	December 31, 2015
Other intangibles assets:		
Gross carrying amount	$ 12,610	$ 8,682
Accumulated amortization	(3,084)	(2,138)
Net book value	$ 9,526	$ 6,544

Amortization expense for total other intangible assets was $309 thousand and $946 thousand for the three and nine months ended September 30, 2016, $233 thousand and $714 thousand for the three and nine months ended September 30, 2015, respectively. As of September 30, 2016, the estimated amortization expense of other intangible assets for the remainder of 2016 and each of the next five years is as follows (in thousands):

2016 (remainder of year)	$ 303
2017	1,144
2018	1,035
2019	937

2020	840
2021	738

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 ended September 30, 2016 and 2015:

	Outstanding	Treasury	Issued
September 30, 2016			
Shares outstanding at December 31, 2015	14,190,192	207,317	14,397,509
Common stock issued for acquisition	294,705		294,705
Restricted stock awards issued	8,800	(8,800)	
Restricted stock awards forfeited	(10,183)	10,183	
Stock options exercised	41,961	(41,961)	
Stock awards	2,244	(2,244)	
Shares outstanding at September 30, 2016	14,527,719	164,495	14,692,214
September 30, 2015			
Shares outstanding at December 31, 2014	14,118,048	279,461	14,397,509
Restricted stock awards issued	59,834	(59,834)	
Restricted stock awards forfeited	(3,041)	3,041	
Stock options exercised	13,422	(13,422)	
Treasury stock purchases	(1,791)	1,791	
Stock awards	2,363	(2,363)	
Shares outstanding at September 30, 2015	14,188,835	208,674	14,397,509

(8.) ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS)

The following tables present the components of other comprehensive income (loss) for the three and nine month periods ended September 30, 2016 and 2015 (in thousands):

	Pre-tax Amount	Tax Effect	Net-of-tax Amount
Three months ended September 30, 2016			
Securities available for sale and transferred securities:			
Change in unrealized gain/loss during the period	$ (1,922)	$ (742)	$ (1,180)

Reclassification adjustment for net gains included in net income [1]	(433)	(167)	(266)
Total securities available for sale and transferred securities	(2,355)	(909)	(1,446)
Amortization of pension and post-retirement items:			
Prior service credit	(12)	(5)	(7)
Net actuarial losses	238	92	146
Total pension and post-retirement obligations	226	87	139
Other comprehensive loss	$ (2,129)	$ (822)	$ (1,307)
Three months ended September 30, 2015			
Securities available for sale and transferred securities:			
Change in unrealized gain/loss during the period	$ 9,283	$ 3,583	$ 5,700
Reclassification adjustment for net gains included in net income [1]	(338)	(130)	(208)
Total securities available for sale and transferred securities	8,945	3,453	5,492
Amortization of pension and post-retirement items:			
Prior service credit	(12)	(5)	(7)
Net actuarial losses	237	92	145
Total pension and post-retirement obligations	225	87	138
Other comprehensive income	$ 9,170	$ 3,540	$ 5,630

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

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

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

	Pre-tax Amount	Tax Effect	Net-of-tax Amount
Nine months ended September 30, 2016			
Securities available for sale and transferred securities:			
Change in unrealized gain/loss during the period	$ 17,084	$ 6,593	$ 10,491
Reclassification adjustment for net gains included in net income [1]	(2,512)	(969)	(1,543)
Total securities available for sale and transferred securities	14,572	5,624	8,948
Amortization of pension and post-retirement items:			
Prior service credit	(36)	(14)	(22)
Net actuarial losses	716	276	440
Total pension and post-retirement obligations	680	262	418
Other comprehensive income	$ 15,252	$ 5,886	$ 9,366
Nine months ended September 30, 2015			
Securities available for sale and transferred securities:			
Change in unrealized gain/loss during the period	$ 5,693	$ 2,197	$ 3,496
Reclassification adjustment for net gains included in net income [1]	(1,546)	(596)	(950)
Total securities available for sale and transferred securities	4,147	1,601	2,546
Amortization of pension and post-retirement items:			
Prior service credit	(36)	(14)	(22)
Net actuarial losses	708	273	435
Total pension and post-retirement obligations	672	259	413
Other comprehensive income	$ 4,819	$ 1,860	$ 2,959

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

Activity in accumulated other comprehensive income (loss), net of tax, for the three and nine month periods ended September 30, 2016 and 2015 was as follows (in thousands):

	Securities Available for Sale and Transferred Securities	Pension and Post-retirement Obligations	Accumulated Other Comprehensive Income (Loss)
Three months ended September 30, 2016			
Balance at beginning of period	$ 9,698	$ (10,352)	$ (654)
Other comprehensive income before reclassifications	(1,180)		(1,180)
Amounts reclassified from accumulated other comprehensive income (loss)	(266)	139	(127)
Net current period other comprehensive income	(1,446)	139	(1,307)
Balance at end of period	$ 8,252	$ (10,213)	$ (1,961)
Three months ended September 30, 2015			
Balance at beginning of period	$ (1,321)	$ (10,361)	$ (11,682)
Other comprehensive income before reclassifications	5,700		5,700
Amounts reclassified from accumulated other comprehensive income (loss)	(208)	138	(70)
Net current period other comprehensive income	5,492	138	5,630
Balance at end of period	$ 4,171	$ (10,223)	$ (6,052)

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

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

	Securities Available for Sale and Transferred Securities	Pension and Post-retirement Obligations	Accumulated Other Comprehensive Income (Loss)
Nine months ended September 30, 2016			
Balance at beginning of period	$ (696)	$ (10,631)	$ (11,327)
Other comprehensive income before reclassifications	10,491		10,491
Amounts reclassified from accumulated other comprehensive income (loss)	(1,543)	418	(1,125)
Net current period other comprehensive income	8,948	418	9,366
Balance at end of period	$ 8,252	$ (10,213)	$ (1,961)
Nine months ended September 30, 2015			
Balance at beginning of period	$ 1,625	$ (10,636)	$ (9,011)
Other comprehensive income before reclassifications	3,496		3,496
Amounts reclassified from accumulated other comprehensive income (loss)	(950)	413	(537)
Net current period other comprehensive income	2,546	413	2,959
Balance at end of period	$ 4,171	$ (10,223)	$ (6,052)

The following tables present the amounts reclassified out of each component of accumulated other comprehensive income (loss) for the three and nine month periods ended September 30, 2016 and 2015 (in thousands):

Details About Accumulated Other Comprehensive Income (Loss) Components	Amount Reclassified from Accumulated Other Comprehensive	Affected Line Item in the Consolidated Statement of Income

	Income (Loss) Three months ended September 30, 2016	2015	
Realized gain on sale of investment securities	$ 426	$ 286	Net gain on disposal of investment securities
Amortization of unrealized holding gains (losses) on investment securities transferred from available for sale to held to maturity	7	52	Interest income
	433	338	Total before tax
	(167)	(130)	Income tax expense
	266	208	Net of tax
Amortization of pension and post-retirement items:			
Prior service credit [1]	12	12	Salaries and employee benefits
Net actuarial losses [1]	(238)	(237)	Salaries and employee benefits
	(226)	(225)	Total before tax
	87	87	Income tax benefit
	(139)	(138)	Net of tax
Total reclassified for the period	$ 127	$ 70	

(1) These items are included in the computation of net periodic pension expense. See Note 10 Employee Benefit Plans for additional information.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

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

Details About Accumulated Other Comprehensive Income (Loss) Components	Amount Reclassified from Accumulated Other Comprehensive Income (Loss) Nine months ended September 30, 2016	2015	Affected Line Item in the Consolidated Statement of Income
Realized gain on sale of investment securities	$ 2,426	$ 1,348	Net gain on disposal of investment securities
Amortization of unrealized holding gains (losses) on investment securities transferred from available for sale to held to maturity	86	198	Interest income
	2,512	1,546	Total before tax
	(969)	(596)	Income tax expense
	1,543	950	Net of tax
Amortization of pension and post-retirement items:			
Prior service credit [1]	36	36	Salaries and employee benefits
Net actuarial losses [1]	(716)	(708)	Salaries and employee benefits
	(680)	(672)	Total before tax
	262	259	Income tax benefit
	(418)	(413)	Net of tax
Total reclassified for the period	$ 1,125	$ 537	

(1) These items are included in the computation of net periodic pension expense. See Note 10 Employee Benefit Plans for additional information.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(9.) 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 Company s Board of Directors or the Management Development and Compensation Committee (the MD&C Committee) of the Board. The share-based compensation plans were established to allow for the grant of compensation awards to attract, motivate and retain employees, executive officers and non-employee directors who contribute to the 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 MD&C Committee approved the grant of restricted stock units (RSUs) and performance share units (PSUs) shown in the table below to certain members of management during the first nine months of 2016.

	Number of Underlying Shares	Weighted Average Per Share Grant Date Fair Value
RSUs	18,500	$ 24.17
PSUs	24,084	24.37

The grant-date fair value for the RSUs granted during the nine month period ended September 30, 2016 is equal to the closing market price of our common stock on the date of grant reduced by the present value of the dividends expected to be paid on the underlying shares.

The number of PSUs that ultimately vest is contingent on achieving specified EPS targets and specified total shareholder return (TSR) targets relative to the SNL Small Cap Bank & Thrifts Index. Thirty percent of the shares subject to each grant will be earned based upon achievement of an EPS performance requirement for the Company s fiscal year ended December 31, 2016. The remaining seventy percent of the shares will be earned based on the Company s achievement of a relative TSR performance requirement, on a percentile basis, compared to the SNL Small Cap Bank & Thrifts Index over a three-year performance period ended December 31, 2018. The shares earned based on the achievement of the EPS and TSR performance requirements, if any, will vest on February 24, 2019, assuming the recipient s continuous service to the Company.

The grant-date fair value for the EPS portion of the PSUs granted during the nine month period ended September 30, 2016 is equal to the closing market price of our common stock on the date of grant reduced by the present value of the dividends expected to be paid on the underlying shares. The grant-date fair value of the TSR portion of the PSUs granted during the nine month period ended September 30, 2016 was determined using the Monte Carlo simulation model on the date of grant, assuming the following (i) expected term of 2.85 years, (ii) risk free interest rate of 0.88%, (iii) expected dividend yield of 2.99% and (iv) expected stock price volatility over the expected term of the TSR award of 24.3%.

During the nine months ended September 30, 2016, the Company issued a total of 2,244 shares of common stock in-lieu of cash for the annual retainer of four non-employee directors and granted a total of 8,800 restricted shares of common stock to non-employee directors, of which 4,400 shares vested immediately and 4,400 shares will vest after completion of a one-year service requirement. The market price of the stock and restricted stock on the date of grant was $28.38.

The following is a summary of restricted stock awards, RSUs and PSUs activity for the nine month period ended September 30, 2016:

	Number of Shares	Weighted Average Market Price at Grant Date
Outstanding at beginning of year	82,908	$ 17.23
Granted	51,384	24.98
Vested	(10,770)	25.11
Forfeited	(14,457)	21.32
Outstanding at end of period	109,065	$ 19.57

At September 30, 2016, the total unrecognized compensation cost related to the nonvested restricted stock awards, RSUs and PSUs granted and expected to vest was $1.2 million. This cost is expected to be recognized over a weighted-average period of 2.0 years.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(9.) 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 2016 or 2015. The following is a summary of stock option activity for the nine months ended September 30, 2016 (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	102,249	$ 19.21		
Exercised	(41,961)	19.41		
Expired	(3,389)	19.72		
Outstanding and exercisable at end of period	56,899	$ 19.04	1.1	$ 459

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, 2016 and 2015 was $342 thousand and $70 thousand, respectively. The total cash received as a result of option exercises under stock compensation plans for the nine months ended September 30, 2016 and 2015 was $814 thousand and $252 thousand, respectively.

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

	Three months ended September 30,		Nine months ended September 30,	
	2016	2015	2016	2015
Salaries and employee benefits	$ 131	$ 118	$ 386	$ 309
Other noninterest expense	34	32	211	211
Total share-based compensation expense	$ 165	$ 150	$ 597	$ 520

(10.) EMPLOYEE BENEFIT PLANS

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

	Three months ended September 30,		Nine months ended September 30,	
	2016	2015	2016	2015
Service cost	$ 722	$ 581	$ 2,164	$ 1,743
Interest cost on projected benefit obligation	601	583	1,804	1,749
Expected return on plan assets	(1,150)	(1,205)	(3,450)	(3,615)
Amortization of prior service credit	(12)	(12)	(36)	(36)
Amortization of net actuarial losses	238	237	716	708
Net periodic pension expense	$ 399	$ 184	$ 1,198	$ 549

The net periodic benefit expense is recorded as a component of salaries and employee benefits in the consolidated statements of income. The Company s funding policy is to contribute, at a minimum, an actuarially determined amount that will satisfy the minimum funding requirements determined under the appropriate sections of the Internal Revenue Code. The Company has no minimum required contribution for the 2016 fiscal year.

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(11.) 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 Company s 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, 2016	December 31, 2015
Commitments to extend credit	$ 529,694	$ 514,818
Standby letters of credit	12,474	11,746

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 which may require payment by the customer of a termination 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, the Company may enter into forward commitments to sell individual residential mortgages. Rate lock agreements and forward commitments are considered derivatives and are recorded at fair value. Forward sales commitments totaled $806 thousand and $1.3 million at September 30, 2016 and December 31, 2015, respectively. In addition, the net change in the fair values of these derivatives was recognized as other noninterest income or other noninterest expense in the consolidated statements of income.

(12.) FAIR VALUE MEASUREMENTS

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

Valuation Hierarchy

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

Level 1 - Unadjusted quoted prices in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date.

Level 2 - Inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly. These might include quoted prices for similar assets or liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets that are not active, inputs other than quoted prices that are observable for the asset or liability (such as interest rates, volatilities, prepayment speeds, credit risks, etc.) or inputs that are derived principally from or corroborated by market data by correlation or other means.

Level 3 - Unobservable inputs for determining the fair values of assets or liabilities that reflect an entity s own assumptions about the assumptions that market participants would use in pricing the assets or liabilities.

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

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(12.) FAIR VALUE MEASUREMENTS (Continued)

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

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

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. 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.

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 the Company believes market participants would use in estimating future net servicing income, including estimates of loan prepayment rates, servicing costs, ancillary income, impound account balances, and discount rates. The significant unobservable inputs used in the fair value measurement of the Company s loan servicing rights are the constant prepayment rates and weighted average discount rate. Significant increases (decreases) in any of those inputs in isolation could result in a significantly lower (higher) fair value measurement. Although the constant prepayment rate and the discount rate are not directly interrelated, they will generally move in opposite directions. Loan servicing rights are classified as Level 3 measurements due to the use of significant unobservable inputs, as well as significant management judgment and estimation.

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

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

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(12.) FAIR VALUE MEASUREMENTS (Continued)

Assets Measured at Fair Value

The following tables present for each of the fair-value hierarchy levels the Company s assets that are measured at fair value on a recurring and 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, 2016				
Measured on a recurring basis:				
Securities available for sale:				
U.S. Government agencies and government sponsored enterprises	$	$ 180,637	$	$ 180,637
Mortgage-backed securities		378,663		378,663
Asset-backed securities		195		195
	$	$ 559,495	$	$ 559,495
Measured on a nonrecurring basis:				
Loans:				
Loans held for sale	$	$ 844	$	$ 844
Collateral dependent impaired loans			1,055	1,055
Other assets:				
Loan servicing rights			1,128	1,128
Other real estate owned			294	294
	$	$ 844	$ 2,477	$ 3,321
December 31, 2015				
Measured on a recurring basis:				
Securities available for sale:				

U.S. Government agencies and government sponsored enterprises	$	$	260,863	$		$	260,863
Mortgage-backed securities			283,314				283,314
Asset-backed securities			218				218
	$	$	544,395	$		$	544,395
Measured on a nonrecurring basis:							
Loans:							
Loans held for sale	$	$	1,430	$		$	1,430
Collateral dependent impaired loans					1,485		1,485
Other assets:							
Loan servicing rights					1,241		1,241
Other real estate owned					163		163
	$	$	1,430	$	2,889	$	4,319

There were no transfers between Levels 1 and 2 during the nine months ended September 30, 2016 and 2015. There were no liabilities measured at fair value on a recurring or nonrecurring basis during the nine month periods ended September 30, 2016 and 2015.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(12.) 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	$ 1,055	Appraisal of collateral (1)	Appraisal adjustments (2)	45% - 50% discount
Loan servicing rights	1,128	Discounted cash flow	Discount rate	4.5% (3)
			Constant prepayment rate	16.8% (3)
Other real estate owned	294	Appraisal of collateral (1)	Appraisal adjustments (2)	19% - 72% 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 nine months ended September 30, 2016.

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.

Long-term borrowings: Long-term borrowings consist of $40 million of subordinated notes issued during the second quarter of 2015. The subordinated notes are publicly traded and are valued based on market prices, which are characterized as Level 2 liabilities in the fair value hierarchy.

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(12.) FAIR VALUE MEASUREMENTS (Continued)

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, 2016 Carrying Amount	September 30, 2016 Estimated Fair Value	December 31, 2015 Carrying Amount	December 31, 2015 Estimated Fair Value
Financial assets:					
Cash and cash equivalents	Level 1	$ 110,721	$ 110,721	$ 60,121	$ 60,121
Securities available for sale	Level 2	559,495	559,495	544,395	544,395
Securities held to maturity	Level 2	528,708	538,630	485,717	490,064
Loans held for sale	Level 2	844	865	1,430	1,430
Loans	Level 2	2,253,589	2,261,010	2,055,192	2,046,235
Loans (1)	Level 3	1,055	1,055	1,485	1,485
Accrued interest receivable	Level 1	9,792	9,792	8,609	8,609
FHLB and FRB stock	Level 2	17,222	17,222	19,991	19,991
Financial liabilities:					
Non-maturity deposits	Level 1	2,339,261	2,339,261	2,093,513	2,093,513
Time deposits	Level 2	724,096	725,418	637,018	636,159
Short-term borrowings	Level 1	230,200	230,200	293,100	293,100
Long-term borrowings	Level 2	39,043	41,114	38,990	40,313
Accrued interest payable	Level 1	5,805	5,805	4,676	4,676

(1) Comprised of collateral dependent impaired loans.

(13.) SEGMENT REPORTING

The Company has two reportable segments: Banking and Non-Banking. These reportable segments have been identified and organized based on the nature of the underlying products and services applicable to each segment, the type of customers to whom those products and services are offered and the distribution channel through which those products and services are made available.

The banking segment includes all of the Company s retail and commercial banking operations. The non-banking segment includes the activities of Scott Danahy Naylon, a full service insurance agency that provides a broad range of insurance services to both personal and business clients, and Courier Capital, an investment advisor and wealth management firm that provides customized investment management, investment consulting and retirement plan services to individuals, businesses, institutions, foundations and retirement plans. The Company operated as two business segments (banking and insurance) until the acquisition of Courier Capital on January 5, 2016, at which time the insurance segment was re-named as the non-banking segment to reflect the inclusion of Courier Capital which has similar products, services and reporting, as noted above. Holding company amounts primarily reflect the differences between segment amounts and consolidated totals and are reflected in the Holding Company and Other column below, along with amounts to eliminate balances and transactions between segments.

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

	Banking	Non-Banking	Holding Company and Other	Consolidated Totals
September 30, 2016				
Goodwill	$ 48,536	$ 17,881	$	$ 66,417
Other intangible assets, net	637	8,889		9,526
Total assets	3,652,723	30,558	4,084	3,687,365
December 31, 2015				
Goodwill	$ 48,536	$ 11,866	$	$ 60,402
Other intangible assets, net	829	5,715		6,544
Total assets	3,356,987	20,315	3,722	3,381,024

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(13.) SEGMENT REPORTING (Continued)

	Banking	Non-Banking [1]	Holding Company and Other	Consolidated Totals
Three months ended September 30, 2016				
Net interest income (expense)	$ 26,667	$	$ (617)	$ 26,050
Provision for loan losses	(1,961)			(1,961)
Noninterest income	6,579	2,086	(126)	8,539
Noninterest expense	(18,148)	(1,759)	(711)	(20,618)
Income (loss) before income taxes	13,137	327	(1,454)	12,010
Income tax (expense) benefit	(3,987)	(129)	575	(3,541)
Net income (loss)	$ 9,150	$ 198	$ (879)	$ 8,469
Nine months ended September 30, 2016				
Net interest income (expense)	$ 77,820	$	$ (1,852)	$ 75,968
Provision for loan losses	(6,281)			(6,281)
Noninterest income	20,386	6,620	(334)	26,672
Noninterest expense	(54,547)	(5,329)	(4,080)	(63,956)
Income (loss) before income taxes	37,378	1,291	(6,266)	32,403
Income tax (expense) benefit	(10,977)	(505)	2,317	(9,165)
Net income (loss)	$ 26,401	$ 786	$ (3,949)	$ 23,238

	Banking	Non-Banking	Holding Company and Other	Consolidated Totals
Three months ended September 30, 2015				
Net interest income (expense)	$ 24,748	$	$ (617)	$ 24,131
Provision for loan losses	(754)			(754)
Noninterest income	6,010	1,124	(129)	7,005
Noninterest expense	(17,679)	(1,152)	(487)	(19,318)

Income (loss) before income taxes		12,325		(28)		(1,233)		11,064
Income tax (expense) benefit		(3,361)		10		603		(2,748)
Net income (loss)	$	8,964	$	(18)	$	(630)	$	8,316
Nine months ended September 30, 2015								
Net interest income (expense)	$	71,814	$		$	(1,132)	$	70,682
Provision for loan losses		(4,783)						(4,783)
Noninterest income		18,363		3,750		(356)		21,757
Noninterest expense		(52,626)		(3,389)		(1,550)		(57,565)
Income (loss) before income taxes		32,768		361		(3,038)		30,091
Income tax (expense) benefit		(9,417)		(144)		1,172		(8,389)
Net income (loss)	$	23,351	$	217	$	(1,866)	$	21,702

(1) Includes activity from Courier Capital since January 5, 2016 (the date of acquisition).

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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, 2015. 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 based on other than historical data are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Forward-looking statements provide current expectations or forecasts of future events and include, among others:

statements with respect to the beliefs, plans, objectives, goals, guidelines, expectations, anticipations, and future financial condition, results of operations and performance of Financial Institutions, Inc. (the Parent) and our subsidiaries (together, the Company, we, our or us); and

statements preceded by, followed by or that include the words may, could, should, would, believe, an estimate, expect, intend, plan, projects, or similar expressions.

These forward-looking statements are not guarantees of future performance, nor should they be relied upon as representing management s views as of any subsequent date. Forward-looking statements involve significant risks and uncertainties and actual results may differ materially from those presented, either expressed or implied, in this document and our Annual Report on Form 10-K for the fiscal year ended December 31, 2015, which we refer to as the Form 10-K, including, but not limited to, those presented in the Management s Discussion and Analysis of Financial Condition and Results of Operations. Factors that might cause such differences include, but are not limited to:

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

Our tax strategies and the value of our deferred tax assets could adversely affect our operating results and regulatory capital ratios;

Geographic concentration may unfavorably impact our operations;

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

Our insurance brokerage subsidiary is subject to risk related to the insurance industry;

Our investment advisory and wealth management operations are subject to risk related to the financial services industry;

Our inability to successfully implement our growth strategies;

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

Commercial real estate and business loans increase our exposure to credit risks;

Our indirect lending involves risk elements in addition to normal credit risk;

We accept deposits that do not have a fixed term and which may be withdrawn by the customer at any time for any reason;

Any future FDIC insurance premium increases may adversely affect our earnings;

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

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

Legal and regulatory proceedings and related matters could adversely affect us and the banking industry in general;

A breach in security of our or third party information systems, including the occurrence of a cyber incident or a deficiency in cyber security, may subject us to liability, result in a loss of customer business or damage our brand image;

We face competition in staying current with technological changes to compete and meet customer demands;

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

We use financial models for business planning purposes that may not adequately predict future results;

We may not be able to attract and retain skilled people;

Acquisitions may disrupt our business and dilute shareholder value;

We are subject to interest rate risk;

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

The fiscal and monetary policies of the federal government and its agencies have a significant impact on our earnings;

The soundness of other financial institutions could adversely affect us;

The value of our goodwill and other intangible assets may decline in the future;

A future proxy contest for the election of directors at our annual meeting or proposals arising out of shareholder initiatives could cause us to incur additional substantial costs and could negatively affect our business;

We operate in a highly competitive industry and market area;

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

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MANAGEMENT S DISCUSSION AND ANALYSIS

Liquidity is essential to our businesses;

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

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

We may not pay or may reduce the dividends on our common stock;

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

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

The market price of our common stock may fluctuate significantly in response to a number of factors.

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

GENERAL

The Parent is a financial holding company headquartered in New York State, providing banking and nonbanking financial services to individuals, municipalities and businesses primarily in our Western and Central New York footprint. The Company provides diversified financial services through its subsidiaries, Five Star Bank, Scott Danahy Naylon, LLC (Scott Danahy Naylon) and Courier Capital, LLC (Courier Capital). The Company offers a broad array of deposit, lending and other financial services to individuals, municipalities and businesses in Western and Central New York through its wholly-owned New York chartered banking subsidiary, Five Star Bank (the Bank). The Bank also has indirect lending network relationships with franchised automobile dealers in the Capital District of New York and Northern and Central Pennsylvania. Scott Danahy Naylon provides a broad range of insurance services to personal and business clients across 44 states. Courier Capital, which we acquired on January 5, 2016, provides customized investment management, investment consulting and retirement plan services to individuals, businesses, institutions, foundations and retirement plans across nine states.

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

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

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

MANAGEMENT S DISCUSSION AND ANALYSIS

EXECUTIVE OVERVIEW

Summary of 2016 Third Quarter Results

Net income increased $153 thousand or 2% to $8.5 million for the third quarter of 2016 compared to $8.3 million for the third quarter of 2015. Net income available to common shareholders for the third quarter of 2016 was $8.1 million, or $0.56 per diluted share, compared with $8.0 million, or $0.56 per diluted share, for the third quarter of last year. Return on average common equity was 10.45% and return on average assets was 0.94% for the third quarter of 2016 compared to 11.60% and 0.99%, respectively, for the third quarter of 2015.

Net interest income totaled $26.1 million in the third quarter of 2016, up from $24.1 million in the third quarter of 2015. Average interest-earning assets were up $224.6 million, led by a $223.6 million increase in average loans in the third quarter of 2016 compared to the same quarter in 2015. The increase in average loans was attributable to organic commercial, residential real estate and consumer indirect loan growth. Third quarter 2016 net interest margin was 3.23%, a slight increase from 3.20% reported in the third quarter of 2015.

The provision for loans losses was $2.0 million in the third quarter of 2016 compared to $754 thousand in the third quarter of 2015. Net charge-offs during the recent quarter were $1.1 million, a $663 thousand decrease from the third quarter of 2015. Net charge-offs expressed as an annualized percentage of average loans outstanding were 0.20% during the third quarter of 2016 compared with 0.35% in the third quarter of 2015. See the Allowance for Loan Losses and Non-Performing Assets and Potential Problem Loans sections of this Management s Discussion and Analysis for further discussion regarding the increase in the provision for loan losses and the decrease in net charge-offs.

Noninterest income totaled $8.5 million in the third quarter of 2016, compared to $7.0 million in the third quarter of 2015. The higher noninterest income in the third quarter of 2016 compared to the same quarter last year is primarily a result of the investment advisory income from Courier Capital, which we acquired during January 2016. Included in the third quarter of 2016 and 2015 are net gains realized on investment securities totaling $426 thousand and $286 thousand, respectively. In addition, the third quarter of 2015 included $390 thousand of amortization of a tax credit investment. The increases in insurance income and ATM and debit card income were offset by decreases in service charges on deposits and investments in limited partnerships when comparing the third quarter periods of 2016 and 2015.

Noninterest expense in the third quarter of 2016 totaled $20.6 million compared with $19.3 million in the third quarter of 2015. The increase in noninterest expense reflects the addition of Courier Capital and our expansion initiatives, including the opening of financial solution centers in the Rochester market.

The regulatory Common equity Tier 1 ratio and Total risk-based capital ratio were 9.58%, and 12.98%, respectively, for the third quarter of 2016. See the Liquidity and Capital Management section of this Management s Discussion and Analysis for further discussion regarding regulatory capital and the Basel III capital rules.

Courier Capital Acquisition

On January 5, 2016, we completed the acquisition of Courier Capital Corporation, a registered investment advisory and wealth management firm with approximately $1.2 billion in assets under management. Consideration for the acquisition totaled $9.0 million and included stock of $8.1 million and $918 thousand of cash. The acquisition also included $2.8 million of potential future payments of stock and $2.2 million of potential future cash bonuses contingent upon Courier Capital meeting certain EBITDA performance targets through 2018. In addition, the Company purchased two pieces of real property in Buffalo and Jamestown, New York used by Courier Capital for total cash considerations of $1.3 million. As a result of the acquisition, we recorded goodwill of $6.0 million and other intangible assets of $3.9 million. The goodwill is not expected to be deductible for income tax purposes. Courier Capital now operates as a subsidiary of the Parent and an affiliate of Five Star Bank and Scott Danahy Naylon.

MANAGEMENT S DISCUSSION AND ANALYSIS

2016 Outlook

We began 2016 in a strong financial condition and with positive momentum. We expect net interest income to increase in 2016. We anticipate an increase in interest-earning assets as we remain focused on loan growth, which will be primarily funded through deposit gathering. However, the benefit to net interest income from increased interest-earning assets is expected to be partially offset by slight downward pressure on net interest margin. We plan to maintain a disciplined approach to loan pricing, but asset yields remain under pressure due to the low interest rate environment and flattening of the yield curve, while the opportunity for deposit repricing remains limited.

We expect our commercial loan portfolio to grow in a manner that is consistent with our strategic initiatives and continued support of middle market small business lending. Automobile loan originations remained strong through the first nine months of 2016, reflecting the positive impact from our investment in building automotive dealer relationships. The residential real estate portfolio, which includes both first and junior lien residential real estate related products, is expected to increase as we remain focused on the customer experience and our convenient application process.

We anticipate the increase in total loans during 2016 will modestly outpace growth in total deposits. This anticipated outcome reflects our continued focus on targeting loyal relationship-based deposit customers rather than those that are more price sensitive. We expect to continue managing our overall cost of funds during 2016 using short-term borrowings, as well as our continued shift in mix of deposits towards low- and no-cost demand deposits and money market deposit accounts.

Noninterest income during 2016 is expected to be higher than 2015, reflecting our continued efforts to increase both account and transaction-based fee income, coupled with the benefit of revenue from our fee-based subsidiaries, Scott Danahy Naylon and Courier Capital. We anticipate that the results of these efforts will further reduce our reliance on traditional spread-based net interest income, as fee-based activities are a relatively stable revenue source during periods of changing interest rates.

Noninterest expense is expected to increase in 2016 with the addition of Courier Capital, coupled with higher operating costs associated with our revenue enhancing initiatives to further accelerate our growth in the communities we serve, including the opening of additional financial solution centers.

We do not expect significant changes in overall asset quality and allowance measurements.

The effective tax rate for 2016 is expected to be slightly higher than it was in 2015, as the lower effective tax rate in 2015 was partly driven by historic tax credits claimed in 2015. However, our 2016 effective tax rate will continue to reflect the positive impacts of tax-exempt income (including the $911 thousand of non-taxable company owned life death benefit proceeds received in the first quarter of 2016), tax advantaged investments, the formation of our real estate investment trust in early 2014 and benefits from New York State tax law changes that began going into effect during 2015.

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MANAGEMENT S DISCUSSION AND ANALYSIS

RESULTS OF OPERATIONS

Net Interest Income and Net Interest Margin

Net interest income is our primary source of 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,	
	2016	**2015**	**2016**	**2015**
Interest income per consolidated statements of income	$ 29,360	$ 27,007	$ 85,241	$ 77,963
Adjustment to fully taxable equivalent basis	789	781	2,367	2,310
Interest income adjusted to a fully taxable equivalent basis	30,149	27,788	87,608	80,273
Interest expense per consolidated statements of income	3,310	2,876	9,273	7,281
Net interest income on a taxable equivalent basis	$ 26,839	$ 24,912	$ 78,335	$ 72,992

Analysis of Net Interest Income for the Three Month Periods ended September 30, 2016 and 2015

Net interest income on a taxable equivalent basis for the three months ended September 30, 2016, was $26.8 million, an increase of $1.9 million versus the comparable quarter last year. The increase in net interest income was due to an increase in average interest-earning assets of $224.6 million or 7% compared to the third quarter of 2015.

The net interest margin for the third quarter of 2016 was 3.23%, three basis points higher than 3.20% for the same period in 2015. This comparable period increase was a function of a one basis point increase in interest rate spread and a higher contribution from net free funds of two basis points (due principally to increases in average noninterest-bearing deposits and other net free funds). The higher interest rate spread was a result of a five basis point increase in the yield on interest-earning assets, partially offset by a four basis point increase in the cost of average interest-bearing liabilities.

For the third quarter of 2016, the yield on average interest-earning assets of 3.62% was five basis points higher than the third quarter of 2015. Loan yields increased two basis points to 4.18% when comparing the third quarter of 2016 to the same period in 2015. The yield on investment securities decreased two basis points during the third quarter of 2016 to 2.44%. Overall, the interest-earning asset rate changes decreased interest income by $3 thousand during the third quarter of 2016.

Average interest-earning assets were $3.3 billion for the third quarter of 2016, an increase of $224.6 million or 7% from the comparable quarter last year, with average loans up $223.6 million and average securities up $1.0 million. The growth in average loans reflected increases in most loan categories. Commercial loans, in particular, were up $134.6 million or 16% from the third quarter of 2015. Residential real estate loans increased $46.5 million or 13% and consumer indirect loans increased $48.1 million or 7% when comparing the third quarter of 2016 with the same period in 2015. Loans represented 67.8% of average interest-earning assets during the third quarter of 2016 compared to 65.5% during the third quarter of 2015. The increase in the volume of average loans resulted in a $2.3 million increase in interest income, coupled with a $64 thousand increase due to the favorable rate variance. Securities represented 32.2% of average interest-earning assets during the third quarter of 2016 compared to 34.5% during the third quarter of 2015. The increase in the volume of average securities resulted in a $19 thousand increase in interest income, which was more than offset by a $67 thousand decrease due to the unfavorable rate variance.

The cost of average interest-bearing liabilities of 0.51% in the third quarter of 2016 was four basis points higher than the third quarter of 2015. The cost of average interest-bearing deposits increased two basis points to 0.39% and the cost of short-term borrowings increased 22 basis points to 0.63% in the third quarter of 2016 compared to the same quarter of 2015. The cost of long-term borrowings for the third quarter of 2016 was 6.33% compared to 6.34% for the same quarter of 2015. Overall, interest-bearing liability rate and volume increases resulted in $434 thousand of higher interest expense.

MANAGEMENT S DISCUSSION AND ANALYSIS

Average interest-bearing liabilities of $2.6 billion in the third quarter of 2016 were $197.6 million or 8% higher than the third quarter of 2015. On average, interest-bearing deposits grew $211.5 million, while noninterest-bearing demand deposits (a principal component of net free funds) were up $13.3 million. The increase in average deposits was due in part to seasonal inflows of municipal deposits, successful business development efforts in retail banking, and an increase in deposits from our Certificate of Deposit Account Registry Service (CDARS) and Insured Cash Sweep (ICS) programs. For further discussion of the CDARS and ICS programs, refer to the Funding Activities - Deposits section of this Management s Discussion and Analysis. Overall, interest-bearing deposit rate and volume changes resulted in $275 thousand of higher interest expense during the third quarter of 2016. Average borrowings decreased $13.9 million compared to the third quarter of 2015. Overall, short and long-term borrowing rates and volume changes resulted in $159 thousand of higher interest expense during the third quarter of 2016.

Analysis of Net Interest Income for the Nine Months ended September 30, 2016 and 2015

Net interest income on a taxable equivalent basis for the first nine months of 2016 was $78.3 million compared to $73.0 million for the same period last year. The increase in net interest income was due to an increase in average interest-earning assets of $257.5 million or 9% compared to the first nine months of 2015.

The net interest margin for the first nine months of 2016 was 3.24%, four basis points lower than 3.28% for the same period last year. This comparable period decrease was a function of a six basis point decrease in interest rate spread to 3.13% during the first nine months of 2016, partially offset by a two basis point higher contribution from net free funds. The lower interest rate spread was a net result of a seven basis point increase in the cost of interest-bearing liabilities, partially offset by a one basis point increase in the yield on interest-earning assets.

The yield on interest-earning assets was 3.62% for the first nine months of 2016, one basis point higher than the same period last year. A decrease in the yield on the loan portfolio during the period (down one basis point to 4.19%), was offset by an increase in the yield on the investment securities portfolio (up one basis point, to 2.47%). Overall, interest-earning asset rate changes reduced interest income by $84 thousand during the first nine months of 2016, but that was more than offset by a favorable volume variance that increased interest income by $7.4 million, which collectively drove a $7.3 million increase in interest income.

The cost of interest-bearing liabilities of 0.49% for the first nine months of 2016 was seven basis points higher than the same period in 2015. Rates on interest-bearing deposits were up two basis points to 0.37% for the first nine months of 2016 versus the same period in 2015. The cost of short-term borrowings for the first nine months of 2016 was 0.63% or 24 basis points higher than 0.39% for the same period last year. The cost of long-term borrowings for the first nine months of 2016 was 6.33% compared to 6.25% for the first nine months of 2015 due to the issuance of subordinated notes in April 2015. Overall, interest-bearing liability rate and volume increases resulted in $692 thousand and $1.3 million of higher interest expense, respectively.

Average interest-earning assets were $3.2 billion for the first nine months of 2016, an increase of $257.5 million or 9% from the comparable period last year, with average loans up $202.6 million and average securities up $54.9 million. The growth in average loans was comprised of increases in most loan categories. Commercial loans, in particular, were up $143.7 million or 18% from the first nine months of 2015. Residential real estate loans increased $35.7 million or 10% and consumer indirect loans increased $28.0 million or 4% when comparing the first nine months of 2016 with the same period in 2015. Loans represented 67.2% of average interest-earning assets during the first nine months of 2016 compared to 66.2% during the comparable period last year. The increase in the volume of average loans resulted in a $6.4 million increase in interest income, which was partially offset by a $195 thousand decrease due to the unfavorable rate variance. Securities represented 32.8% of average interest-earning assets during the first nine months of 2016 compared to 33.8% during the comparable period last year. The increase in the volume of average securities resulted in a $972 thousand increase in interest income, coupled with a $111 thousand increase due to the favorable rate variance.

Average interest-bearing liabilities of $2.5 billion in the first nine months of 2016 were $196.9 million or 8% higher than the first nine months of 2015. On average, interest-bearing deposits grew $201.1 million, while noninterest-bearing demand deposits were up $33.5 million and average short-term borrowings decreased $19.1 million. Average long-term borrowings increased $14.9 million during the first nine months of 2016 due to the issuance of subordinated notes in April 2015.

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MANAGEMENT S DISCUSSION AND ANALYSIS

The following table 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,					
	2016			2015		
	Average Balance	Interest	Average Rate	Average Balance	Interest	Average Rate
Interest-earning assets:						
Federal funds sold and interest-earning deposits	$ 1	$	%	$	$	%
Investment securities (1):						
Taxable	773,037	4,276	2.21	778,380	4,347	2.23
Tax-exempt (2)	295,829	2,254	3.05	289,435	2,231	3.09
Total investment securities	1,068,866	6,530	2.44	1,067,815	6,578	2.46
Loans:						
Commercial business	352,696	3,691	4.16	297,216	3,085	4.12
Commercial mortgage	625,003	7,261	4.62	545,875	6,210	4.51
Residential real estate loans	417,854	3,987	3.82	371,318	3,756	4.05
Residential real estate lines	123,312	1,165	3.76	127,826	1,172	3.64
Consumer indirect	711,948	6,987	3.90	663,884	6,436	3.85
Other consumer	17,548	528	11.97	18,680	551	11.71
Total loans	2,248,361	23,619	4.18	2,024,799	21,210	4.16
Total interest-earning assets	3,317,228	30,149	3.62	3,092,614	27,788	3.57
Allowance for loan losses	(29,314)			(27,836)		
Other noninterest-earning assets	305,758			279,024		
Total assets	$ 3,593,672			$ 3,343,802		
Interest-bearing liabilities:						
Deposits:						
Interest-bearing demand	$ 547,545	$ 206	0.15%	$ 516,448	$ 199	0.15%
Savings and money market	981,207	335	0.14	903,491	321	0.14
Time deposits	722,098	1,651	0.91	619,459	1,397	0.89
Total interest-bearing deposits	2,250,850	2,192	0.39	2,039,398	1,917	0.37
Short-term borrowings	315,122	500	0.63	329,050	342	0.41
Long-term borrowings	39,032	618	6.33	38,962	617	6.34

Total borrowings	354,154	1,118	1.26	368,012	959	1.04
Total interest-bearing liabilities	2,605,004	3,310	0.51	2,407,410	2,876	0.47
Noninterest-bearing demand deposits	638,417			625,131		
Other noninterest-bearing liabilities	24,387			22,032		
Shareholders equity	325,864			289,229		
Total liabilities and shareholders equity	$ 3,593,672			$ 3,343,802		
Net interest income (tax-equivalent)		$ 26,839			$ 24,912	
Interest rate spread			3.11%			3.10%
Net earning assets	$ 712,224			$ 685,204		
Net interest margin (tax-equivalent)			3.23%			3.20%
Ratio of average interest-earning assets to average interest-bearing liabilities			127.34%			128.46%

(1) Investment securities are shown at amortized cost.

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

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	Nine months ended September 30, 2016			2015		
	Average Balance	Interest	Average Rate	Average Balance	Interest	Average Rate
Interest-earning assets:						
Federal funds sold and interest-earning deposits	$ 129	$ 1	0.61%	$ 50	$	0.30%
Investment securities [1]:						
Taxable	763,796	12,800	2.23	717,330	11,879	2.21
Tax-exempt [2]	293,476	6,763	3.07	285,031	6,601	3.09
Total investment securities	1,057,272	19,563	2.47	1,002,361	18,480	2.46
Loans:						
Commercial business	332,985	10,396	4.17	282,307	8,731	4.13
Commercial mortgage	604,577	20,846	4.61	511,545	17,584	4.60
Residential real estate loans	397,327	11,669	3.92	361,598	11,175	4.12
Residential real estate lines	125,273	3,555	3.79	128,807	3,506	3.64
Consumer indirect	691,343	20,009	3.87	663,286	19,143	3.86
Other consumer	17,678	1,569	11.85	19,084	1,654	11.59
Total loans	2,169,183	68,044	4.19	1,966,627	61,793	4.20
Total interest-earning assets	3,226,584	87,608	3.62	2,969,038	80,273	3.61
Allowance for loan losses	(28,423)			(27,881)		
Other noninterest-earning assets	304,467			300,489		
Total assets	$ 3,502,628			$ 3,241,646		
Interest-bearing liabilities:						
Deposits:						
Interest-bearing demand	$ 566,419	$ 617	0.15%	$ 543,045	$ 552	0.14%
Savings and money market	988,224	989	0.13	891,039	827	0.12
Time deposits	693,153	4,631	0.89	612,637	3,985	0.87
Total interest-bearing deposits	2,247,796	6,237	0.37	2,046,721	5,364	0.35
Short-term borrowings	250,329	1,183	0.63	269,415	785	0.39
Long-term borrowings	39,015	1,853	6.33	24,148	1,132	6.25
Total borrowings	289,344	3,036	1.40	293,563	1,917	0.87
Total interest-bearing liabilities	2,537,140	9,273	0.49	2,340,284	7,281	0.42
Noninterest-bearing demand deposits	626,018			592,564		

Other noninterest-bearing liabilities	22,032			21,603		
Shareholders equity	317,438			287,195		
Total liabilities and shareholders equity	$ 3,502,628			$ 3,241,646		
Net interest income (tax-equivalent)		$ 78,335			$ 72,992	
Interest rate spread			3.13%			3.19%
Net earning assets	$ 689,444			$ 628,754		
Net interest margin (tax-equivalent)			3.24%			3.28%
Ratio of average interest-earning assets to average interest-bearing liabilities			127.17%			126.87%

(1) Investment securities are shown at amortized cost.

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

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

	Three months ended September 30, 2016 vs. 2015			Nine months ended September 30, 2016 vs. 2015		
	Volume	Rate	Total	Volume	Rate	Total
Increase (decrease) in:						
Interest income:						
Federal funds sold and interest-earning deposits	$	$	$	$ 1	$	$ 1
Investment securities:						
Taxable	(30)	(41)	(71)	777	144	921
Tax-exempt	49	(26)	23	195	(33)	162
Total investment securities	19	(67)	(48)	972	111	1,083
Loans:						
Commercial business	581	25	606	1,581	84	1,665
Commercial mortgage	917	134	1,051	3,208	54	3,262
Residential real estate loans	452	(221)	231	1,067	(573)	494
Residential real estate lines	(42)	35	(7)	(98)	147	49
Consumer indirect	471	80	551	812	54	866
Other consumer	(34)	11	(23)	(124)	39	(85)
Total loans	2,345	64	2,409	6,446	(195)	6,251
Total interest income	2,364	(3)	2,361	7,419	(84)	7,335
Interest expense:						
Deposits:						
Interest-bearing demand	12	(5)	7	24	41	65
Savings and money market	27	(13)	14	94	68	162
Time deposits	235	19	254	536	110	646
Total interest-bearing deposits	274	1	275	654	219	873
Short-term borrowings	(15)	173	158	(60)	458	398
Long-term borrowings	1		1	706	15	721
Total borrowings	(14)	173	159	646	473	1,119
Total interest expense	260	174	434	1,300	692	1,992

Net interest income	$ 2,104	$ (177)	$ 1,927	$ 6,119	$ (776)	$ 5,343

Provision for Loan Losses

The provision for loan losses is based upon credit loss experience, growth or contraction of specific segments of the loan portfolio, and the estimate of losses inherent in the current loan portfolio. The provision for loan losses for the three and nine month periods ended September 30, 2016 were $2.0 million and $6.3 million, respectively, compared to $754 thousand and $4.8 million for the corresponding periods in 2015.

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

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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,	
	2016	**2015**	**2016**	**2015**
Service charges on deposits	$ 1,913	$ 2,037	$ 5,392	$ 5,880
Insurance income	1,407	1,265	4,262	3,930
ATM and debit card	1,441	1,297	4,187	3,773
Investment advisory	1,326	523	3,934	1,551
Company owned life insurance	486	488	2,340	1,448
Investments in limited partnerships	161	336	253	865
Loan servicing	104	153	332	416
Net gain on sale of loans held for sale	46	53	202	161
Net gain on investment securities	426	286	2,426	1,348
Net gain on other assets	199		285	20
Amortization of tax credit investment		(390)		(390)
Other	1,030	957	3,059	2,755
Total noninterest income	$ 8,539	$ 7,005	$ 26,672	$ 21,757

Service charges on deposit accounts for the nine months ended September 30, 2016 decreased $488 thousand, or 8%, compared to the same period in 2015. The decrease was primarily due to a decrease in the amount of checking account overdraft activity.

Insurance income increased $332 thousand, or 8%, to $4.3 million for the first nine months of 2016 compared to $3.9 million for the first nine months of 2015, reflecting successful business development efforts.

Investment advisory income increased to $3.9 million in the first nine months of 2016 compared to $1.6 million in the first nine months of 2015, reflecting the contribution from Courier Capital which was acquired early in January of 2016 as part of our strategy to diversify our business lines and increase noninterest income through additional fee-based services.

Income from company owned life insurance increased to $2.3 million in the first nine months of 2016 compared to $1.4 million in the same period in 2015, as the first quarter of 2016 included $911 thousand of death benefit proceeds.

We have investments in limited partnerships, primarily small business investment companies, and account for these investments under the equity method. Income from investments in limited partnerships was $253 thousand and $865 thousand for the nine months ended September 30, 2016 and 2015, respectively. The income from these equity method investments fluctuates based on the performance of the underlying investments.

During the first nine months of 2016, we recognized net gains on investment securities totaling $2.4 million from the sale of 24 agency securities and nine mortgage backed securities. The amount and timing of net gains on investment securities is dependent on a number of factors, including our prudent efforts to realize gains while managing duration, premium and credit risk.

During the third quarter of 2015, the Company recognized $390 thousand of amortization of a historic tax investment in a community-based project. The amortization was included in noninterest income, recorded as contra-income, with an offsetting tax benefit that reduced income tax expense.

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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,	
	2016	2015	2016	2015
Salaries and employee benefits	$ 11,325	$ 10,278	$ 33,757	$ 31,107
Occupancy and equipment	3,617	3,417	10,906	10,491
Professional services	956	1,064	5,236	2,898
Computer and data processing	832	779	2,549	2,291
Supplies and postage	490	540	1,548	1,611
FDIC assessments	406	444	1,283	1,277
Advertising and promotions	214	312	938	789
Other	2,778	2,484	7,739	7,101
Total noninterest expense	$ 20,618	$ 19,318	$ 63,956	$ 57,565

Salaries and employee benefits expense increased by $2.7 million or 9% in the first nine months of 2016 compared to the same period in 2015, reflecting the addition of Courier Capital as well as additional personnel to support organic growth as part of our expansion initiatives.

Occupancy and equipment expense increased by $415 thousand to $10.9 million when comparing the first nine months of 2016 to the same period in 2015. The incremental expenses reflect the addition of Courier Capital and our expansion initiatives, including the opening of financial solution centers in the Rochester market.

Professional services increased $2.3 million when comparing the first nine months of 2016 to the same period in 2015. The current year includes approximately $2.1 million of professional services associated with the proxy contest.

Computer and data processing expense increased $258 thousand, or 11%, when comparing the first nine months of 2016 to the first nine months of 2015. Primarily due to information technology projects to maintain and improve our infrastructure.

Advertising and promotions expense was $938 thousand for the nine month period ended September 30, 2016 compared to $789 thousand for the same time period in 2015. The increase was due to advertising campaigns implemented during the current year to build recognition of our brand in the Rochester and Buffalo markets.

Other noninterest expense was $7.7 million in the first nine months of 2016 compared to $7.1 million in the first nine months of 2015. Other noninterest expense for the first nine months ended September 30, 2016 included an increase of $291 thousand in intangible asset amortization associated with the Courier Capital acquisition.

Our efficiency ratio for the nine months ended September 30, 2016 was 61.94% compared with 60.56% for the first nine months of 2015. The increase in the efficiency ratio is primarily a result of the higher level of noninterest expense associated with the aforementioned proxy contest. The efficiency ratio is calculated by dividing total noninterest expense, excluding other real estate expense and amortization of intangible assets, by net revenue, defined as the sum of tax-equivalent net interest income and noninterest income before net gains on investment securities and proceeds from company owned life insurance. An increase in the efficiency ratio indicates that more resources are being utilized to generate the same volume of income, while a decrease indicates a more efficient allocation of resources.

Income Taxes

For the nine months ended September 30, 2016 and 2015, we recorded income tax expense of $9.2 million and $8.4 million, respectively. The effective tax rates for the year-to-date periods in 2016 and 2015 were 28.3% and 27.9%, respectively. 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. In addition, our effective tax rate reflects the New York State tax savings generated by our real estate investment trust.

In March 2014, the New York legislature approved changes in the state tax law that will be phased-in over two years, beginning in 2015. The primary changes that impact us include the repeal of the Article 32 franchise tax on banking corporations (Article 32) for 2015, expanded nexus standards for 2015 and a reduction in the corporate tax rate for 2016. The repeal of Article 32 and the expanded nexus standards lowered our taxable income apportioned to New York to approximately 85% in both 2016 and 2015. In addition, our New York state income tax rate was reduced from 7.1% to 6.5% during the first nine months of 2016.

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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, 2016		December 31, 2015	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Securities available for sale (AFS):				
U.S. Government agencies and government-sponsored enterprise securities	$ 175,134	$ 180,637	$ 260,748	$ 260,863
Mortgage-backed securities:				
Agency mortgage-backed securities	368,929	377,847	282,873	282,505
Non-Agency mortgage-backed securities		816		809
Asset-backed securities		195		218
Total AFS securities	544,063	559,495	543,621	544,395
Securities held to maturity (HTM):				
State and political subdivisions	300,922	309,013	294,423	300,981
Mortgage-backed securities	227,786	229,617	191,294	189,083
Total HTM securities	528,708	538,630	485,717	490,064