

FINANCIAL INSTITUTIONS INC
Form 10-Q
May 06, 2014
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Form 10-Q

(Mark One)

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

For the quarterly period ended March 31, 2014

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
(State or other jurisdiction of
incorporation or organization)

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

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

14569
(Zip Code)

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports),

and (2) has been subject to such filing requirements for the past 90 days. Yes No

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

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

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

Large accelerated filer Accelerated filer

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

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

The registrant had 13,851,876 shares of Common Stock, \$0.01 par value, outstanding as of April 30, 2014.

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FINANCIAL INSTITUTIONS, INC.

Form 10-Q

For the Quarterly Period Ended March 31, 2014

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Table of Contents**PART I. FINANCIAL INFORMATION****ITEM 1. Financial Statements****FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES****Consolidated Statements of Financial Condition**

| <i>(Dollars in thousands, except share and per share data)</i> | March 31, 2014 (Unaudited) | December 31, 2013 |
|------------------------------------------------------------------------------------------------------|-------------------------------------------|------------------------------|
| ASSETS | | |
| Cash and cash equivalents: | | |
| Cash and due from banks | \$ 72,307 | \$ 59,598 |
| Federal funds sold and interest-bearing deposits in other banks | 94 | 94 |
| Total cash and cash equivalents | 72,401 | 59,692 |
| Securities available for sale, at fair value | 674,650 | 609,400 |
| Securities held to maturity, at amortized cost (fair value of \$256,091 and \$250,657, respectively) | 253,576 | 249,785 |
| Loans held for sale | 900 | 3,381 |
| Loans (net of allowance for loan losses of \$27,152 and \$26,736, respectively) | 1,821,688 | 1,806,883 |
| Company owned life insurance | 49,582 | 49,171 |
| Premises and equipment, net | 36,121 | 36,009 |
| Goodwill and other intangible assets, net | 49,913 | 50,002 |
| Other assets | 56,788 | 64,313 |
| Total assets | \$ 3,015,619 | \$ 2,928,636 |
| LIABILITIES AND SHAREHOLDERS EQUITY | | |
| Deposits: | | |
| Noninterest-bearing demand | \$ 532,914 | \$ 535,472 |
| Interest-bearing demand | 541,660 | 470,733 |
| Savings and money market | 812,734 | 717,928 |
| Certificates of deposit | 646,112 | 595,923 |
| Total deposits | 2,533,420 | 2,320,056 |
| Short-term borrowings | 196,746 | 337,042 |
| Other liabilities | 22,588 | 16,699 |
| Total liabilities | 2,752,754 | 2,673,797 |
| Shareholders equity: | | |
| Series A 3% preferred stock, \$100 par value, 1,533 shares authorized and 1,496 shares issued | 149 | 149 |

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| | | |
|--------------------------------------------------------------------------------------------------------|--------------|--------------|
| Series B-1 8.48% preferred stock, \$100 par value, 200,000 shares authorized and 171,927 shares issued | 17,193 | 17,193 |
| Total preferred equity | 17,342 | 17,342 |
| Common stock, \$0.01 par value, 50,000,000 shares authorized and 14,161,597 shares issued | 142 | 142 |
| Additional paid-in capital | 67,182 | 67,574 |
| Retained earnings | 190,375 | 186,137 |
| Accumulated other comprehensive (loss) income | (6,424) | (10,187) |
| Treasury stock, at cost 308,614 and 332,242 shares, respectively | (5,752) | (6,169) |
| Total shareholders' equity | 262,865 | 254,839 |
| Total liabilities and shareholders' equity | \$ 3,015,619 | \$ 2,928,636 |

See accompanying notes to the consolidated financial statements.

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

| <i>(In thousands, except per share amounts)</i> | Three months ended March 31, | |
|------------------------------------------------------------|---------------------------------------------|---------------|
| | 2014 | 2013 |
| Interest income: | | |
| Interest and fees on loans | \$ 20,267 | \$ 20,379 |
| Interest and dividends on investment securities | 4,792 | 4,369 |
| Total interest income | 25,059 | 24,748 |
| Interest expense: | | |
| Deposits | 1,525 | 1,671 |
| Short-term borrowings | 259 | 190 |
| Total interest expense | 1,784 | 1,861 |
| Net interest income | 23,275 | 22,887 |
| Provision for loan losses | 2,106 | 2,709 |
| Net interest income after provision for loan losses | 21,169 | 20,178 |
| Noninterest income: | | |
| Service charges on deposits | 2,250 | 2,141 |
| ATM and debit card | 1,174 | 1,249 |
| Investments in limited partnerships | 626 | 161 |
| Investment advisory | 563 | 699 |
| Company owned life insurance | 403 | 415 |
| Loan servicing | 154 | 73 |
| Net gain on disposal of investment securities | 313 | 892 |
| Net gain on sale of loans held for sale | 105 | 200 |
| Net (loss) gain on disposal of other assets | (35) | 1 |
| Other | 804 | 722 |
| Total noninterest income | 6,357 | 6,553 |
| Noninterest expense: | | |
| Salaries and employee benefits | 9,256 | 9,709 |
| Occupancy and equipment | 3,235 | 3,169 |
| Professional services | 972 | 937 |
| Computer and data processing | 723 | 704 |
| Supplies and postage | 512 | 680 |
| FDIC assessments | 422 | 361 |

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| | | |
|---------------------------------------------|----------|----------|
| Advertising and promotions | 179 | 214 |
| Other | 1,914 | 1,810 |
| Total noninterest expense | 17,213 | 17,584 |
| Income before income taxes | 10,313 | 9,147 |
| Income tax expense | 3,094 | 2,998 |
| Net income | \$ 7,219 | \$ 6,149 |
| Preferred stock dividends | 366 | 368 |
| Net income available to common shareholders | \$ 6,853 | \$ 5,781 |
| Earnings per common share (Note 2): | | |
| Basic | \$ 0.50 | \$ 0.42 |
| Diluted | \$ 0.50 | \$ 0.42 |
| Cash dividends declared per common share | \$ 0.19 | \$ 0.18 |
| Weighted average common shares outstanding: | | |
| Basic | 13,773 | 13,717 |
| Diluted | 13,824 | 13,767 |

See accompanying notes to the consolidated financial statements.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Consolidated Statements of Comprehensive Income (Loss) (Unaudited)

| <i>(Dollars in thousands)</i> | Three months ended March 31, | |
|----------------------------------------------------------------|------------------------------------|----------|
| | 2014 | 2013 |
| Net income | \$ 7,219 | \$ 6,149 |
| Other comprehensive income (loss), net of tax: | | |
| Net unrealized gains (losses) on securities available for sale | 3,744 | (2,315) |
| Pension and post-retirement obligations | 19 | 199 |
| Total other comprehensive income (loss), net of tax | 3,763 | (2,116) |
| Comprehensive income | \$ 10,982 | \$ 4,033 |

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)

Three months ended March 31, 2014 and 2013

| <i>(Dollars in thousands, except per share data)</i> | Preferred Equity | Common Stock | Additional Paid-in Capital | Retained Earnings | Accumulated Other Comprehensive Income (Loss) | Treasury Stock | Total Shareholders' Equity |
|----------------------------------------------------------|---------------------|-----------------|----------------------------------|----------------------|-----------------------------------------------------------|-------------------|----------------------------------|
| Balance at January 1, 2013 | \$ 17,471 | \$ 142 | \$ 67,710 | \$ 172,244 | \$ 3,253 | \$ (6,923) | \$ 253,897 |
| Comprehensive income: | | | | | | | |
| Net income | | | | 6,149 | | | 6,149 |
| Other comprehensive loss, net of tax | | | | | (2,116) | | (2,116) |
| Purchases of common stock for treasury | | | | | | (229) | (229) |
| Repurchase of Series B-1 8.48% preferred stock | (52) | | (1) | | | | (53) |
| Share-based compensation plans: | | | | | | | |
| Share-based compensation | | | 102 | | | | 102 |
| Stock options exercised | | | (2) | | | 15 | 13 |
| Restricted stock awards issued, net | | | (496) | | | 496 | |
| Excess tax benefit on share-based compensation | | | 6 | | | | 6 |
| Cash dividends declared: | | | | | | | |
| Series A 3% Preferred-\$0.75 per share | | | | (1) | | | (1) |
| Series B-1 8.48% Preferred-\$2.12 per share | | | | (367) | | | (367) |
| Common-\$0.18 per share | | | | (2,471) | | | (2,471) |
| Balance at March 31, 2013 | \$ 17,419 | \$ 142 | \$ 67,319 | \$ 175,554 | \$ 1,137 | \$ (6,641) | \$ 254,930 |
| Balance at January 1, 2014 | \$ 17,342 | \$ 142 | \$ 67,574 | \$ 186,137 | \$ (10,187) | \$ (6,169) | \$ 254,839 |
| Comprehensive income: | | | | | | | |
| Net income | | | | 7,219 | | | 7,219 |
| Other comprehensive income, net of tax | | | | | 3,763 | | 3,763 |
| Purchases of common stock for treasury | | | | | | (194) | (194) |
| Share-based compensation plans: | | | | | | | |

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| | | |
|------------------------------------------------|-------------------------------------------------------------------------------|---------|
| Share-based compensation | 103 | 103 |
| Stock options exercised | | 110 |
| Restricted stock awards issued, net | (501) | 501 |
| Excess tax benefit on share-based compensation | 6 | 6 |
| Cash dividends declared: | | |
| Series A 3% Preferred-\$0.75 per share | (1) | (1) |
| Series B-1 8.48% Preferred-\$2.12 per share | (365) | (365) |
| Common-\$0.19 per share | (2,615) | (2,615) |
| Balance at March 31, 2014 | \$ 17,342 \$ 142 \$ 67,182 \$ 190,375 \$ (6,424) \$ (5,752) \$ 262,865 | |

See accompanying notes to the consolidated financial statements.

Table of Contents**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES****Consolidated Statements of Cash Flows (Unaudited)***(Dollars in thousands)*

| | Three months ended March 31, | |
|------------------------------------------------------------------------------------------|-----------------------------------------|-----------------|
| | 2014 | 2013 |
| Cash flows from operating activities: | | |
| Net income | \$ 7,219 | \$ 6,149 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 1,013 | 1,051 |
| Net amortization of premiums on securities | 885 | 1,328 |
| Provision for loan losses | 2,106 | 2,709 |
| Share-based compensation | 103 | 102 |
| Deferred income tax expense | 275 | 1,702 |
| Proceeds from sale of loans held for sale | 4,804 | 10,288 |
| Originations of loans held for sale | (3,071) | (10,712) |
| Increase in company owned life insurance | (403) | (415) |
| Net gain on sale of loans held for sale | (105) | (200) |
| Net gain on disposal of investment securities | (313) | (892) |
| Net loss (gain) on sale and disposal of other assets | 35 | (1) |
| Decrease in other assets | 4,891 | 2,192 |
| Increase (decrease) in other liabilities | 3,111 | (857) |
| Net cash provided by operating activities | 20,550 | 12,444 |
| Cash flows from investing activities: | | |
| Purchases of available for sale securities | (95,366) | (124,157) |
| Purchases of held to maturity securities | (5,735) | (1,076) |
| Proceeds from principal payments, maturities and calls on available for sale securities | 16,617 | 45,067 |
| Proceeds from principal payments, maturities and calls on held to maturity securities | 4,398 | 1,483 |
| Proceeds from sales of securities available for sale | 19,470 | 952 |
| Net loan originations | (16,155) | (13,570) |
| Purchases of company owned life insurance | (8) | (7) |
| Proceeds from sales of other assets | | 239 |
| Purchases of premises and equipment | (1,071) | (1,712) |
| Net cash used in investing activities | (77,850) | (92,781) |
| Cash flows from financing activities: | | |
| Net increase in deposits | 213,364 | 147,703 |
| Net decrease in short-term borrowings | (140,296) | (40,186) |
| Repurchase of preferred stock | | (53) |
| Purchase of common stock for treasury | (194) | (229) |
| Proceeds from stock options exercised | 110 | 13 |
| Excess tax benefit on share-based compensation, net | 6 | 6 |

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| | | |
|------------------------------------------------------------------|-----------|-----------|
| Cash dividends paid to common and preferred shareholders | (2,981) | (2,562) |
| Net cash provided by financing activities | 70,009 | 104,692 |
| Net increase in cash and cash equivalents | 12,709 | 24,355 |
| Cash and cash equivalents, beginning of period | 59,692 | 60,436 |
| Cash and cash equivalents, end of period | \$ 72,401 | \$ 84,791 |
| Supplemental information: | | |
| Cash paid for interest | \$ 1,659 | \$ 1,812 |
| Cash paid for income taxes | 3,100 | 140 |
| Noncash investing and financing activities: | | |
| Real estate and other assets acquired in settlement of loans | 97 | 410 |
| Accrued and declared unpaid dividends | 2,981 | 2,839 |
| Increase (decrease) in net unsettled security purchases | 2,797 | (43,978) |
| Loans transferred from held for sale to held for investment | 853 | |
| See accompanying notes to the consolidated financial statements. | | |

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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

Nature of Operations

Financial Institutions, Inc., is a financial holding company organized in 1931 under the laws of New York State (New York or NYS). Through its wholly-owned New York chartered banking subsidiary, Five Star Bank, Financial Institutions, Inc. offers a broad array of deposit, lending and other financial services to individuals, municipalities and businesses in Western and Central New York. The Company has also expanded its indirect lending network to include relationships with franchised automobile dealers in the Capital District of New York and Northern Pennsylvania. References to the Company mean the consolidated reporting entities and references to the Bank mean Five Star Bank.

Basis of Presentation

The consolidated financial statements include the accounts of Financial Institutions, Inc. and its subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation. The accounting and reporting policies conform to U.S. generally accepted accounting principles (GAAP). Certain information and footnote disclosures normally included in financial statements prepared in conformity with GAAP have been condensed or omitted pursuant to such rules and regulations. However, in the opinion of management, the accompanying consolidated financial statements reflect all adjustments of a normal and recurring nature necessary for a fair presentation of the consolidated statements of financial condition, income, comprehensive income, changes in shareholders' equity and cash flows for the periods indicated, and contain adequate disclosure to make the information presented not misleading. Prior years' consolidated financial statements are re-classified whenever necessary to conform to the current year's presentation. These consolidated financial statements should be read in conjunction with the Company's 2013 Annual Report on Form 10-K. The results of operations for any interim periods are not necessarily indicative of the results which may be expected for the entire year.

Subsequent Events

The Company has evaluated events and transactions for potential recognition or disclosure through the day the financial statements were issued and determined that there were no 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, the valuation and other than temporary impairment (OTTI) considerations related to the securities portfolio, and assumptions used in the defined benefit pension plan accounting.

Recent Accounting Pronouncements

In January 2014, the Financial Accounting Standards Board issued Accounting Standards Update (ASU) No. 2014-04, *Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure*. The

objective of this guidance is to clarify when an in substance repossession or foreclosure occurs, that is, when a creditor should be considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan such that the loan receivable should be derecognized and the real estate property recognized. ASU No. 2014-04 states that an in substance repossession or foreclosure occurs, and a creditor is considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan, upon either (1) the creditor obtaining legal title to the residential real estate property upon completion of a foreclosure or (2) the borrower conveying all interest in the residential real estate property to the creditor to satisfy that loan through completion of a deed in lieu of foreclosure or through a similar legal agreement. Additionally, ASU No. 2014-04 requires interim and annual disclosure of both (1) the amount of foreclosed residential real estate property held by the creditor and (2) the recorded investment in consumer mortgage loans collateralized by residential real estate property that are in the process of foreclosure according to local requirements of the applicable jurisdiction. ASU No. 2014-04 is effective for interim and annual reporting periods beginning after December 15, 2014. The adoption of ASU No. 2014-04 is not expected to have a material impact on the Company's consolidated statements of income and condition.

Table of Contents**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Unaudited)****(2.) 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 March 31, | |
|----------------------------------------------------------|-----------------------------------------|-------------|
| | 2014 | 2013 |
| Net income available to common shareholders | \$ 6,853 | \$ 5,781 |
| Weighted average common shares outstanding: | | |
| Total shares issued | 14,162 | 14,162 |
| Unvested restricted stock awards | (64) | (80) |
| Treasury shares | (325) | (365) |
| | | |
| Total basic weighted average common shares outstanding | 13,773 | 13,717 |
| Incremental shares from assumed: | | |
| Exercise of stock options | 22 | 7 |
| Vesting of restricted stock awards | 29 | 43 |
| | | |
| Total diluted weighted average common shares outstanding | 13,824 | 13,767 |
| Basic earnings per common share | \$ 0.50 | \$ 0.42 |
| | | |
| Diluted earnings per common share | \$ 0.50 | \$ 0.42 |

There were approximately 14 thousand and 151 thousand average shares subject to stock options which were excluded from the computation of diluted EPS for the three month periods ended March 31, 2014 and 2013, respectively, because the effect would be antidilutive.

(3.) INVESTMENT SECURITIES

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

| | Amortized Cost | Unrealized Gains | Unrealized Losses | Fair Value |
|---------------------------------------------------------------|---------------------------|-----------------------------|------------------------------|-----------------------|
| March 31, 2014 | | | | |
| Securities available for sale: | | | | |
| U.S. Government agencies and government sponsored enterprises | \$ 190,967 | \$ 1,659 | \$ 2,132 | \$ 190,494 |

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Mortgage-backed securities:

| | | | | |
|------------------------------------------|---------|-------|-------|---------|
| Federal National Mortgage Association | 174,591 | 1,561 | 3,784 | 172,368 |
| Federal Home Loan Mortgage Corporation | 34,713 | 641 | 130 | 35,224 |
| Government National Mortgage Association | 60,857 | 2,164 | 113 | 62,908 |

Collateralized mortgage obligations:

| | | | | |
|------------------------------------------|---------|-------|-------|---------|
| Federal National Mortgage Association | 65,427 | 339 | 1,708 | 64,058 |
| Federal Home Loan Mortgage Corporation | 104,334 | 232 | 3,656 | 100,910 |
| Government National Mortgage Association | 46,172 | 924 | 156 | 46,940 |
| Privately issued | | 1,402 | | 1,402 |

| | | | | |
|-------------------------------------------|---------|-------|-------|---------|
| Total collateralized mortgage obligations | 215,933 | 2,897 | 5,520 | 213,310 |
|-------------------------------------------|---------|-------|-------|---------|

| | | | | |
|----------------------------------|---------|-------|-------|---------|
| Total mortgage-backed securities | 486,094 | 7,263 | 9,547 | 483,810 |
|----------------------------------|---------|-------|-------|---------|

| | | | | |
|-------------------------|----|-----|--|-----|
| Asset-backed securities | 18 | 328 | | 346 |
|-------------------------|----|-----|--|-----|

| | | | | |
|-------------------------------------|------------|----------|-----------|------------|
| Total available for sale securities | \$ 677,079 | \$ 9,250 | \$ 11,679 | \$ 674,650 |
|-------------------------------------|------------|----------|-----------|------------|

Securities held to maturity:

| | | | | |
|----------------------------------|------------|----------|-------|------------|
| State and political subdivisions | \$ 253,576 | \$ 2,578 | \$ 63 | \$ 256,091 |
|----------------------------------|------------|----------|-------|------------|

Table of Contents**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Unaudited)****(3.) INVESTMENT SECURITIES (Continued)**

| | Amortized Cost | Unrealized Gains | Unrealized Losses | Fair Value |
|---------------------------------------------------------------|-------------------|---------------------|----------------------|-------------------|
| December 31, 2013 | | | | |
| Securities available for sale: | | | | |
| U.S. Government agencies and government sponsored enterprises | \$ 135,840 | \$ 1,414 | \$ 2,802 | \$ 134,452 |
| Mortgage-backed securities: | | | | |
| Federal National Mortgage Association | 173,507 | 1,511 | 4,810 | 170,208 |
| Federal Home Loan Mortgage Corporation | 36,737 | 562 | 205 | 37,094 |
| Government National Mortgage Association | 61,832 | 2,152 | 142 | 63,842 |
| Collateralized mortgage obligations: | | | | |
| Federal National Mortgage Association | 63,838 | 261 | 3,195 | 60,904 |
| Federal Home Loan Mortgage Corporation | 102,660 | 169 | 5,856 | 96,973 |
| Government National Mortgage Association | 43,734 | 913 | 586 | 44,061 |
| Privately issued | | 1,467 | | 1,467 |
| Total collateralized mortgage obligations | 210,232 | 2,810 | 9,637 | 203,405 |
| Total mortgage-backed securities | 482,308 | 7,035 | 14,794 | 474,549 |
| Asset-backed securities | 18 | 381 | | 399 |
| Total available for sale securities | \$ 618,166 | \$ 8,830 | \$ 17,596 | \$ 609,400 |
| Securities held to maturity: | | | | |
| State and political subdivisions | \$ 249,785 | \$ 1,340 | \$ 468 | \$ 250,657 |

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

| | Three months ended March 31, | |
|----------------------|-----------------------------------------|-------------|
| | 2014 | 2013 |
| Proceeds from sales | \$ 19,470 | \$ 952 |
| Gross realized gains | 313 | 892 |

The scheduled maturities of securities available for sale and securities held to maturity at March 31, 2014 are shown below (in thousands). Actual expected maturities may differ from contractual maturities because issuers may have the right to call or prepay obligations.

| | Amortized Cost | Fair Value |
|--------------------------------------------|---------------------------|-----------------------|
| Debt securities available for sale: | | |
| Due in one year or less | \$ 49,052 | \$ 49,051 |
| Due from one to five years | 51,365 | 52,669 |
| Due after five years through ten years | 252,569 | 248,478 |
| Due after ten years | 324,093 | 324,452 |
| | \$ 677,079 | \$ 674,650 |
| Debt securities held to maturity: | | |
| Due in one year or less | \$ 24,841 | \$ 24,908 |
| Due from one to five years | 111,876 | 112,972 |
| Due after five years through ten years | 116,817 | 118,157 |
| Due after ten years | 42 | 54 |
| | \$ 253,576 | \$ 256,091 |

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Table of Contents**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Unaudited)****(3.) 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 |
| March 31, 2014 | | | | | | |
| Securities available for sale: | | | | | | |
| U.S. Government agencies and government sponsored enterprises | \$ 82,112 | \$ 1,072 | \$ 22,184 | \$ 1,060 | \$ 104,296 | \$ 2,132 |
| Mortgage-backed securities: | | | | | | |
| Federal National Mortgage Association | 96,533 | 2,416 | 25,166 | 1,368 | 121,699 | 3,784 |
| Federal Home Loan Mortgage Corporation | 8,490 | 130 | | | 8,490 | 130 |
| Government National Mortgage Association | 6,097 | 113 | | | 6,097 | 113 |
| Collateralized mortgage obligations: | | | | | | |
| Federal National Mortgage Association | 35,545 | 656 | 15,645 | 1,052 | 51,190 | 1,708 |
| Federal Home Loan Mortgage Corporation | 71,893 | 2,158 | 20,989 | 1,498 | 92,882 | 3,656 |
| Government National Mortgage Association | 8,417 | 156 | | | 8,417 | 156 |
| Total collateralized mortgage obligations | 115,855 | 2,970 | 36,634 | 2,550 | 152,489 | 5,520 |
| Total mortgage-backed securities | 226,975 | 5,629 | 61,800 | 3,918 | 288,775 | 9,547 |
| Total available for sale securities | 309,087 | 6,701 | 83,984 | 4,978 | 393,071 | 11,679 |
| Securities held to maturity: | | | | | | |
| State and political subdivisions | 10,907 | 63 | | | 10,907 | 63 |
| Total temporarily impaired securities | \$ 319,994 | \$ 6,764 | \$ 83,984 | \$ 4,978 | \$ 403,978 | \$ 11,742 |

December 31, 2013

| Securities available for sale: | | | | | | |
|---------------------------------------------------------------|-------------------|------------------|------------------|-----------------|-------------------|------------------|
| U.S. Government agencies and government sponsored enterprises | \$ 86,177 | \$ 2,788 | \$ 2,717 | \$ 14 | \$ 88,894 | \$ 2,802 |
| Mortgage-backed securities: | | | | | | |
| Federal National Mortgage Association | 103,778 | 3,491 | 20,689 | 1,319 | 124,467 | 4,810 |
| Federal Home Loan Mortgage Corporation | 14,166 | 205 | | | 14,166 | 205 |
| Government National Mortgage Association | 14,226 | 142 | | | 14,226 | 142 |
| Collateralized mortgage obligations: | | | | | | |
| Federal National Mortgage Association | 35,632 | 2,586 | 11,760 | 609 | 47,392 | 3,195 |
| Federal Home Loan Mortgage Corporation | 72,655 | 4,980 | 15,762 | 876 | 88,417 | 5,856 |
| Government National Mortgage Association | 8,396 | 586 | | | 8,396 | 586 |
| Total collateralized mortgage obligations | 116,683 | 8,152 | 27,522 | 1,485 | 144,205 | 9,637 |
| Total mortgage-backed securities | 248,853 | 11,990 | 48,211 | 2,804 | 297,064 | 14,794 |
| Total available for sale securities | 335,030 | 14,778 | 50,928 | 2,818 | 385,958 | 17,596 |
| Securities held to maturity: | | | | | | |
| State and political subdivisions | 72,269 | 468 | | | 72,269 | 468 |
| Total temporarily impaired securities | \$ 407,299 | \$ 15,246 | \$ 50,928 | \$ 2,818 | \$ 458,227 | \$ 18,064 |

The total number of security positions in the investment portfolio in an unrealized loss position at March 31, 2014 was 141 compared to 331 at December 31, 2013. At March 31, 2014, the Company had positions in 21 investment securities with a fair value of \$84.0 million and a total unrealized loss of \$5.0 million that have been in a continuous unrealized loss position for more than 12 months. There were a total of 120 securities positions in the Company's investment portfolio, with a fair value of \$320.0 million and a total unrealized loss of \$6.8 million at March 31, 2014, that have been in a continuous unrealized loss position for less than 12 months. The unrealized loss on these investment securities was predominantly caused by changes in market interest rates subsequent to purchase. The fair value of most of the investment securities in the Company's portfolio fluctuates as market interest rates change.

Table of Contents**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Unaudited)****(3.) INVESTMENT SECURITIES (Continued)**

The Company reviews investment securities on an ongoing basis for the presence of other-than-temporary impairment (OTTI) with formal reviews performed quarterly. When evaluating debt securities for OTTI, management considers many factors, including: (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, (3) whether the market decline was affected by macroeconomic conditions, and (4) whether the Company has the intention to sell the debt security or whether it is more likely than not that it will be required to sell the debt security before its anticipated recovery. The assessment of whether OTTI exists involves a high degree of subjectivity and judgment and is based on the information then available to management. There was no impairment recorded during the three months ended March 31, 2014 and 2013.

Based on management's review and evaluation of the Company's debt securities as of March 31, 2014, the debt securities with unrealized losses were not considered to be OTTI. As of March 31, 2014, 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 March 31, 2014, 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.

(4.) LOANS

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

| | Principal Amount Outstanding | Net Deferred Loan Costs (Fees) | Loans, Net |
|---------------------------|---------------------------------------------|-----------------------------------------------|-------------------|
| March 31, 2014 | | | |
| Commercial business | \$ 268,308 | \$ 44 | \$ 268,352 |
| Commercial mortgage | 469,725 | (962) | 468,763 |
| Residential mortgage | 110,290 | (126) | 110,164 |
| Home equity | 326,744 | 5,604 | 332,348 |
| Consumer indirect | 620,916 | 26,630 | 647,546 |
| Other consumer | 21,488 | 179 | 21,667 |
| Total | \$ 1,817,471 | \$ 31,369 | 1,848,840 |
| Allowance for loan losses | | | (27,152) |

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Total loans, net \$ 1,821,688

December 31, 2013

| | | | |
|----------------------|------------|---------|------------|
| Commercial business | \$ 265,751 | \$ 15 | \$ 265,766 |
| Commercial mortgage | 470,312 | (1,028) | 469,284 |
| Residential mortgage | 113,101 | (56) | 113,045 |
| Home equity | 320,658 | 5,428 | 326,086 |
| Consumer indirect | 609,390 | 26,978 | 636,368 |
| Other consumer | 22,893 | 177 | 23,070 |

Total \$ 1,802,105 \$ 31,514 1,833,619

Allowance for loan losses (26,736)

Total loans, net \$ 1,806,883

Loans held for sale (not included above) were comprised entirely of residential real estate mortgages and totaled \$900 thousand and \$3.4 million as of March 31, 2014 and December 31, 2013, respectively.

Table of Contents**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Unaudited)****(4.) 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 |
|--------------------------|------------------------------------|------------------------------------|-------------------------------------|---------------------------|-------------------|----------------|------------------------|
| March 31, 2014 | | | | | | | |
| Commercial business | \$ 1,943 | \$ | \$ | \$ 1,943 | \$ 3,706 | \$ 262,659 | \$ 268,308 |
| Commercial mortgage | 1,290 | | | 1,290 | 9,545 | 458,890 | 469,725 |
| Residential mortgage | 468 | | | 468 | 760 | 109,062 | 110,290 |
| Home equity | 378 | | | 378 | 826 | 325,540 | 326,744 |
| Consumer indirect | 1,258 | 354 | | 1,612 | 1,387 | 617,917 | 620,916 |
| Other consumer | 85 | 53 | 6 | 144 | 40 | 21,304 | 21,488 |
| Total loans, gross | \$ 5,422 | \$ 407 | \$ 6 | \$ 5,835 | \$ 16,264 | \$ 1,795,372 | \$ 1,817,471 |
| December 31, 2013 | | | | | | | |
| Commercial business | \$ 558 | \$ 199 | \$ | \$ 757 | \$ 3,474 | \$ 261,520 | \$ 265,751 |
| Commercial mortgage | 800 | | | 800 | 9,663 | 459,849 | 470,312 |
| Residential mortgage | 542 | | | 542 | 1,078 | 111,481 | 113,101 |
| Home equity | 750 | 143 | | 893 | 925 | 318,840 | 320,658 |
| Consumer indirect | 2,129 | 476 | | 2,605 | 1,471 | 605,314 | 609,390 |
| Other consumer | 126 | 72 | 6 | 204 | 5 | 22,684 | 22,893 |
| Total loans, gross | \$ 4,905 | \$ 890 | \$ 6 | \$ 5,801 | \$ 16,616 | \$ 1,779,688 | \$ 1,802,105 |

There were no loans past due greater than 90 days and still accruing interest as of March 31, 2014 and December 31, 2013. There were \$6 thousand in consumer overdrafts which were past due greater than 90 days as of March 31, 2014 and December 31, 2013. Consumer overdrafts are overdrawn deposit accounts which have been reclassified as loans but by their terms do not accrue interest.

Troubled Debt Restructurings

A modification of a loan constitutes a troubled debt restructuring (TDR) when a borrower is experiencing financial difficulty and the modification constitutes a concession. The Company offers various types of concessions when

modifying loans, however, forgiveness of principal is seldom granted. Commercial loans modified in a TDR may involve temporary interest-only payments, term extensions, reducing the interest rate for the remaining term of the loan, extending the maturity date at an interest rate lower than the current market rate for new debt with similar risk, requesting additional collateral, releasing collateral for consideration, or substituting or adding a new borrower or guarantor.

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

| | Number of Contracts | Pre- Modification Outstanding Recorded Investment | Post- Modification Outstanding Recorded Investment |
|-----------------------|--------------------------------|--------------------------------------------------------------------------|---------------------------------------------------------------------------|
| March 31, 2014 | | | |
| Commercial business | | \$ | \$ |
| Commercial mortgage | | | |
| Total | | \$ | \$ |
| March 31, 2013 | | | |
| Commercial business | 2 | \$ 189 | \$ 181 |
| Commercial mortgage | | | |
| Total | 2 | \$ 189 | \$ 181 |

Table of Contents**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Unaudited)****(4.) LOANS (Continued)**

All of the loans identified as TDRs by the Company during the three month period ended March 31, 2013 were previously on nonaccrual status and reported as impaired loans prior to restructuring. The modifications primarily related to extending the amortization periods of the loans. Nonaccrual loans that are restructured remain on nonaccrual status, but may move to accrual status after they have performed according to the restructured terms for a period of time. The TDR classification did not have a material impact on the Company's determination of the allowance for loan losses because the modified loans were impaired and evaluated for a specific reserve both before and after restructuring.

There were no loans modified as a TDR within the previous 12 months that defaulted during the three months ended March 31, 2014 or 2013. 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 three 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 |
|-------------------------------------|----------------------------------------------|-------------------------------------------------------|------------------------------|--------------------------------------------|-------------------------------------------|
| March 31, 2014 | | | | | |
| With no related allowance recorded: | | | | | |
| Commercial business | \$ 1,869 | \$ 2,420 | \$ | \$ 1,831 | \$ |
| Commercial mortgage | 1,095 | 1,126 | | 937 | |
| | 2,964 | 3,546 | | 2,768 | |
| With an allowance recorded: | | | | | |
| Commercial business | 1,837 | 1,857 | 397 | 1,669 | |
| Commercial mortgage | 8,450 | 8,850 | 926 | 8,657 | |
| | 10,287 | 10,707 | 1,323 | 10,326 | |
| | \$ 13,251 | \$ 14,253 | \$ 1,323 | \$ 13,094 | \$ |

December 31, 2013

With no related allowance recorded:

| | | | | | |
|---------------------|----------|----------|----|--------|----|
| Commercial business | \$ 1,777 | \$ 2,273 | \$ | \$ 659 | \$ |
| Commercial mortgage | 875 | 906 | | 760 | |
| | 2,652 | 3,179 | | 1,419 | |

With an allowance recorded:

| | | | | |
|---------------------|--------|--------|-------|-------|
| Commercial business | 1,697 | 1,717 | 201 | 3,196 |
| Commercial mortgage | 8,788 | 9,188 | 1,057 | 3,758 |
| | 10,485 | 10,905 | 1,258 | 6,954 |

| | | | | |
|-----------|-----------|----------|----------|----|
| \$ 13,137 | \$ 14,084 | \$ 1,258 | \$ 8,373 | \$ |
|-----------|-----------|----------|----------|----|

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

Table of Contents**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Unaudited)****(4.) 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 that do not meet the criteria above that are analyzed individually as part of the process described above are considered Uncriticized or pass-rated loans and are included in groups of homogeneous loans with similar risk and loss characteristics.

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 |
|-----------------------|--------------------------------|--------------------------------|
| March 31, 2014 | | |
| Uncriticized | \$ 249,625 | \$ 449,042 |
| Special mention | 8,133 | 3,713 |
| Substandard | 10,550 | 16,970 |
| Doubtful | | |
| Total | \$ 268,308 | \$ 469,725 |

| December 31, 2013 | | |
|--------------------------|-------------------|-------------------|
| Uncriticized | \$ 250,553 | \$ 449,447 |
| Special mention | 6,311 | 6,895 |
| Substandard | 8,887 | 13,970 |
| Doubtful | | |
| Total | \$ 265,751 | \$ 470,312 |

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

| | Residential Mortgage | Home Equity | Consumer Indirect | Other Consumer |
|--------------------------|---------------------------------|------------------------|------------------------------|---------------------------|
| March 31, 2014 | | | | |
| Performing | \$ 109,530 | \$ 325,918 | \$ 619,529 | \$ 21,442 |
| Non-performing | 760 | 826 | 1,387 | 46 |
| Total | \$ 110,290 | \$ 326,744 | \$ 620,916 | \$ 21,488 |
| December 31, 2013 | | | | |
| Performing | \$ 112,023 | \$ 319,733 | \$ 607,919 | \$ 22,882 |
| Non-performing | 1,078 | 925 | 1,471 | 11 |
| Total | \$ 113,101 | \$ 320,658 | \$ 609,390 | \$ 22,893 |

Table of Contents**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Unaudited)****(4.) LOANS (Continued)****Allowance for Loan Losses**

The following tables set forth the changes in the allowance for loan losses for the three month periods ended as of the dates indicated (in thousands):

| | Commercial Business | Commercial Mortgage | Residential Mortgage | Home Equity | Consumer Indirect | Other Consumer | Total |
|-----------------------------------|--------------------------------|--------------------------------|---------------------------------|------------------------|------------------------------|---------------------------|--------------|
| March 31, 2014 | | | | | | | |
| Allowance for loan losses: | | | | | | | |
| Beginning balance | \$ 4,273 | \$ 7,743 | \$ 676 | \$ 1,367 | \$ 12,230 | \$ 447 | \$ 26,736 |
| Charge-offs | 68 | | 78 | 106 | 2,455 | 269 | 2,976 |
| Recoveries | 29 | 7 | 21 | 11 | 1,105 | 113 | 1,286 |
| Provision | 455 | 230 | 53 | 99 | 1,104 | 165 | 2,106 |
| Ending balance | \$ 4,689 | \$ 7,980 | \$ 672 | \$ 1,371 | \$ 11,984 | \$ 456 | \$ 27,152 |
| Evaluated for impairment: | | | | | | | |
| Individually | \$ 397 | \$ 926 | \$ | \$ | \$ | \$ | \$ 1,323 |
| Collectively | \$ 4,292 | \$ 7,054 | \$ 672 | \$ 1,371 | \$ 11,984 | \$ 456 | \$ 25,829 |
| Loans: | | | | | | | |
| Ending balance | \$ 268,308 | \$ 469,725 | \$ 110,290 | \$ 326,744 | \$ 620,916 | \$ 21,488 | \$ 1,817,471 |
| Evaluated for impairment: | | | | | | | |
| Individually | \$ 3,706 | \$ 9,545 | \$ | \$ | \$ | \$ | \$ 13,251 |
| Collectively | \$ 264,602 | \$ 460,180 | \$ 110,290 | \$ 326,744 | \$ 620,916 | \$ 21,488 | \$ 1,804,220 |
| March 31, 2013 | | | | | | | |
| Allowance for loan losses: | | | | | | | |
| Beginning balance | \$ 4,884 | \$ 6,581 | \$ 740 | \$ 1,282 | \$ 10,715 | \$ 512 | \$ 24,714 |
| Charge-offs | 239 | 3 | 162 | 269 | 1,718 | 252 | 2,643 |

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| | | | | | | | |
|------------|-----|-----|----|-----|-------|-----|-------|
| Recoveries | 37 | 14 | 17 | 37 | 805 | 137 | 1,047 |
| Provision | 485 | 379 | 73 | 233 | 1,510 | 29 | 2,709 |

| | | | | | | | |
|----------------|----------|----------|--------|----------|-----------|--------|-----------|
| Ending balance | \$ 5,167 | \$ 6,971 | \$ 668 | \$ 1,283 | \$ 11,312 | \$ 426 | \$ 25,827 |
|----------------|----------|----------|--------|----------|-----------|--------|-----------|

Evaluated for impairment:

| | | | | | | | |
|--------------|----------|--------|----|----|----|----|----------|
| Individually | \$ 1,335 | \$ 657 | \$ | \$ | \$ | \$ | \$ 1,992 |
|--------------|----------|--------|----|----|----|----|----------|

| | | | | | | | |
|--------------|----------|----------|--------|----------|-----------|--------|-----------|
| Collectively | \$ 3,832 | \$ 6,314 | \$ 668 | \$ 1,283 | \$ 11,312 | \$ 426 | \$ 23,835 |
|--------------|----------|----------|--------|----------|-----------|--------|-----------|

Loans:

| | | | | | | | |
|----------------|------------|------------|------------|------------|------------|-----------|--------------|
| Ending balance | \$ 259,054 | \$ 425,586 | \$ 126,058 | \$ 287,844 | \$ 563,428 | \$ 24,581 | \$ 1,686,551 |
|----------------|------------|------------|------------|------------|------------|-----------|--------------|

Evaluated for impairment:

| | | | | | | | |
|--------------|----------|----------|----|----|----|----|----------|
| Individually | \$ 5,616 | \$ 2,767 | \$ | \$ | \$ | \$ | \$ 8,383 |
|--------------|----------|----------|----|----|----|----|----------|

| | | | | | | | |
|--------------|------------|------------|------------|------------|------------|-----------|--------------|
| Collectively | \$ 253,438 | \$ 422,819 | \$ 126,058 | \$ 287,844 | \$ 563,428 | \$ 24,581 | \$ 1,678,168 |
|--------------|------------|------------|------------|------------|------------|-----------|--------------|

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(4.) LOANS (Continued)

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, inferring higher potential losses on an individual customer basis. Loan repayment is often dependent on the successful operation and management of the properties, as well as on the collateral securing the loan. Economic events or conditions in the real estate market could have an adverse impact on the cash flows generated by properties securing the Company's commercial real estate loans and on the value of such properties.

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

Consumer indirect and other consumer loans may entail greater credit risk than residential mortgage loans and home equities, 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 which can be recovered on such loans.

(5.) GOODWILL AND OTHER INTANGIBLE ASSETS

The carrying amount of goodwill totaled \$48.5 million as of March 31, 2014 and December 31, 2013. The goodwill relates to the Company's primary subsidiary and reporting unit, Five Star Bank. The Company performs a goodwill impairment test on an annual basis or more frequently if events and circumstances warrant.

The Company's other intangible assets, consisting entirely of a core deposit intangible asset, were as follows (in thousands):

| | March 31, 2014 | December 31, 2013 |
|---------------------------|---------------------------|------------------------------|
| Gross carrying amount | \$ 2,042 | \$ 2,042 |
| Accumulated amortization | (665) | (576) |
| Net carrying value | \$ 1,377 | \$ 1,466 |

Amortization expense for the core deposit intangible was \$89 thousand and \$101 thousand for the three months ended March 31, 2014 and 2013, respectively. As of March 31, 2014, the estimated core deposit intangible amortization expense for the remainder of 2014 and each of the next five years is as follows (in thousands):

| | |
|--------------------------|--------|
| 2014 (remainder of year) | \$ 252 |
| 2015 | 296 |
| 2016 | 251 |
| 2017 | 205 |
| 2018 | 160 |
| 2019 | 115 |

Table of Contents**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Unaudited)****(6.) SHAREHOLDERS EQUITY****Common Stock**

The changes in shares of common stock were as follows for the three month periods ended March 31, 2014 and 2013:

| | Outstanding | Treasury | Issued |
|-----------------------------------------|--------------------|-----------------|---------------|
| March 31, 2014 | | | |
| Shares outstanding at December 31, 2013 | 13,829,355 | 332,242 | 14,161,597 |
| Restricted stock awards issued | 33,842 | (33,842) | |
| Restricted stock awards forfeited | (7,037) | 7,037 | |
| Stock options exercised | 5,925 | (5,925) | |
| Treasury stock purchases | (9,102) | 9,102 | |
| Shares outstanding at March 31, 2014 | 13,852,983 | 308,614 | 14,161,597 |
| March 31, 2013 | | | |
| Shares outstanding at December 31, 2012 | 13,787,709 | 373,888 | 14,161,597 |
| Restricted stock awards issued | 33,035 | (33,035) | |
| Restricted stock awards forfeited | (6,237) | 6,237 | |
| Stock options exercised | 800 | (800) | |
| Treasury stock purchases | (11,349) | 11,349 | |
| Shares outstanding at March 31, 2013 | 13,803,958 | 357,639 | 14,161,597 |

(7.) ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS)

The following table presents the components of other comprehensive income (loss) for the three month periods ended March 31, 2014 and 2013 (in thousands):

| | Pre-tax Amount | Tax Effect | Net-of-tax Amount |
|---------------------------------------------------------------------------------|---------------------------|-------------------|------------------------------|
| March 31, 2014 | | | |
| Securities available for sale and transferred securities: | | | |
| Change in unrealized gain/loss during the period | \$ 6,650 | \$ 2,634 | \$ 4,016 |
| Reclassification adjustment for net gains included in net income ⁽¹⁾ | (450) | (178) | (272) |

| | | | |
|------------------------------------------------------------------|------------|------------|------------|
| Total securities available for sale and transferred securities | 6,200 | 2,456 | 3,744 |
| Amortization of pension and post-retirement items: | | | |
| Prior service credit | (12) | (5) | (7) |
| Net actuarial losses | 44 | 18 | 26 |
| Total pension and post-retirement obligations | 32 | 13 | 19 |
| Other comprehensive income | \$ 6,232 | \$ 2,469 | \$ 3,763 |
| March 31, 2013 | | | |
| Securities available for sale: | | | |
| Change in unrealized gain/loss during the period | \$ (2,942) | \$ (1,166) | \$ (1,776) |
| Reclassification adjustment for net gains included in net income | (892) | (353) | (539) |
| Total securities available for sale | (3,834) | (1,519) | (2,315) |
| Amortization of pension and post-retirement items: | | | |
| Prior service credit | (12) | (5) | (7) |
| Net actuarial losses | 341 | 135 | 206 |
| Total pension and post-retirement obligations | 329 | 130 | 199 |
| Other comprehensive loss | \$ (3,505) | \$ (1,389) | \$ (2,116) |

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

Table of Contents**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Unaudited)****(7.) ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS) (Continued)**

Activity in accumulated other comprehensive income (loss), net of tax, for the three month periods ended March 31, 2014 and 2013 was as follows (in thousands):

| | Securities Available for Sale and Transferred Securities | Pension and Post- retirement Obligations | Accumulated Other Comprehensive Income (Loss) |
|------------------------------------------------------------------|---------------------------------------------------------------------------------|-------------------------------------------------------------|----------------------------------------------------------------------|
| March 31, 2014 | | | |
| Balance at beginning of year | \$ (5,337) | \$ (4,850) | \$ (10,187) |
| Other comprehensive income before reclassifications | 4,016 | | 4,016 |
| Amounts reclassified from accumulated other comprehensive income | (272) | 19 | (253) |
| Net current period other comprehensive income | 3,744 | 19 | 3,763 |
| Balance at end of period | \$ (1,593) | \$ (4,831) | \$ (6,424) |
| March 31, 2013 | | | |
| Balance at beginning of year | \$ 16,060 | \$ (12,807) | \$ 3,253 |
| Other comprehensive (loss) income before reclassifications | (1,776) | | (1,776) |
| Amounts reclassified from accumulated other comprehensive income | (539) | 199 | (340) |
| Net current period other comprehensive (loss) income | (2,315) | 199 | (2,116) |
| Balance at end of period | \$ 13,745 | \$ (12,608) | \$ 1,137 |

The following table presents the amounts reclassified out of each component of accumulated other comprehensive income (loss) for the three month periods ended March 31, 2014 and 2013 (in thousands):

Details About Accumulated Other Comprehensive Income Components
Amount Reclassified from Accumulated Other Comprehensive Income
Affected Line Item in the Consolidated Statement of Income
Three months ended March 31, 2014 2013

| | | | |
|------------------------------------------------------------------------------------------------------------------------------------|--------|--------|-----------------------------------------------|
| Realized gain on sale of investment securities | \$ 313 | \$ 892 | 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 | 137 | | Interest income |
| | 450 | 892 | Total before tax |
| | (178) | (353) | Income tax expense |
| | 272 | 539 | Net of tax |
| Amortization of pension and post-retirement items: | | | |
| Prior service credit ⁽¹⁾ | 12 | 12 | Salaries and employee benefits |
| Net actuarial losses ⁽¹⁾ | (44) | (341) | Salaries and employee benefits |
| | (32) | (329) | Total before tax |
| | 13 | 130 | Income tax benefit |
| | (19) | (199) | Net of tax |
| Total reclassified for the period | \$ 253 | \$ 340 | |

⁽¹⁾ These items are included in the computation of net periodic pension expense. See Note 9 Employee Benefit Plans for additional information.

Table of Contents**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Unaudited)****(8.) SHARE-BASED COMPENSATION PLANS**

The Company maintains certain stock-based compensation plans that were approved by the Company's shareholders and are administered by the Company's Board of Directors, or the Management Development and Compensation 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 Company awarded grants of 22,642 shares of restricted common stock to certain members of management during the three months ended March 31, 2014. Fifty 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, 2014. The remaining fifty percent of the shares will be earned based on the Company's achievement of a relative total shareholder return (TSR) performance requirement, on a percentile basis, compared to a defined group of peer companies over a three-year performance period ended December 31, 2016. The shares earned based on the achievement of the EPS and TSR performance requirements, if any, will vest based on the recipient's continuous service to the Company on December 31, 2016.

The grant-date fair value of the TSR portion of the award granted during the three month period ended March 31, 2014 was determined using the Monte Carlo simulation model on the date of grant, assuming the following (i) expected term of 2.87 years, (ii) risk free interest rate of 0.62%, (iii) expected dividend yield of 3.59% and (iv) expected stock price volatility over the expected term of the TSR award of 39.4%. The grant-date fair value of all other restricted stock awards is equal to the closing market price of our common stock on the date of grant.

In addition, the Company granted 11,200 shares of restricted common stock to management during the three months ended March 31, 2014. The shares will vest after completion of a three-year service requirement. The market price of the restricted stock awards on the date of grant was \$21.19.

The restricted stock awards granted to management in 2014 do not have rights to dividends or dividend equivalents.

The following is a summary of restricted stock award activity for the three month period ended March 31, 2014:

| | Number of Shares | Weighted Average Market Price at Grant Date |
|----------------------------------|-----------------------------|--------------------------------------------------------------------|
| Outstanding at beginning of year | 65,040 | \$ 16.92 |
| Granted | 33,842 | 17.63 |
| Vested | (24,728) | 17.02 |
| Forfeited | (7,037) | 20.07 |

| | | | |
|------------------------------|--------|----|-------|
| Outstanding at end of period | 67,117 | \$ | 16.91 |
|------------------------------|--------|----|-------|

As of March 31, 2014, there was \$737 thousand of unrecognized compensation expense related to unvested restricted stock awards that is expected to be recognized over a weighted average period of 2.4 years.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

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

The Company uses the Black-Scholes valuation method to estimate the fair value of its stock option awards. There were no stock options awarded during 2014 or 2013. The following is a summary of stock option activity for the three months ended March 31, 2014 (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 | 192,934 | \$ 19.83 | | |
| Exercised | (5,925) | 18.62 | | |
| Expired | (15,623) | 23.78 | | |
| Outstanding and exercisable at end of period | 171,386 | \$ 19.52 | 2.5 | \$ 602 |

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 three months ended March 31, 2014 and 2013 was \$25 thousand and \$3 thousand, respectively. The total cash received as a result of option exercises under stock compensation plans for the three months ended March 31, 2014 and 2013 was \$110 thousand and \$13 thousand, respectively.

The Company amortizes the expense related to restricted stock 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 March 31, | |
|----------------------------------------|---------------------------------|--------|
| | 2014 | 2013 |
| Salaries and employee benefits | \$ 81 | \$ 85 |
| Other noninterest expense | 22 | 17 |
| Total share-based compensation expense | \$ 103 | \$ 102 |

(9.) 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 March 31, | |
|-----------------------------------------------|-----------------------------------------|-------------|
| | 2014 | 2013 |
| Service cost | \$ 479 | \$ 516 |
| Interest cost on projected benefit obligation | 574 | 505 |
| Expected return on plan assets | (1,029) | (921) |
| Amortization of prior service credit | (12) | (12) |
| Amortization of net actuarial losses | 44 | 341 |
| Net periodic pension expense | \$ 56 | \$ 429 |

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 2014 fiscal year.

Table of Contents**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Unaudited)****(10.) COMMITMENTS AND CONTINGENCIES**

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

| | March 31, 2014 | December 31, 2013 |
|------------------------------|---------------------------|------------------------------|
| Commitments to extend credit | \$ 434,700 | \$ 431,236 |
| Standby letters of credit | 10,403 | 8,618 |

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

The Company also extends rate lock agreements to borrowers related to the origination of residential mortgage loans. To mitigate the interest rate risk inherent in these rate lock agreements, 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 \$532 thousand at March 31, 2014. There were no forward sales commitments outstanding as of December 31, 2013. 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.

(11.) FAIR VALUE MEASUREMENTS**Determination of Fair Value – Assets Measured at Fair Value on a Recurring and Nonrecurring Basis**

Valuation Hierarchy

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

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

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

Level 3 - Unobservable inputs for determining the fair values of assets or liabilities that reflect an entity's own assumptions about the assumptions that market participants would use in pricing the assets or liabilities. Transfers between levels of the fair value hierarchy are recorded as of the end of the reporting period.

Table of Contents**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Unaudited)****(11.) 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 and collateral value is determined based on appraisals performed by qualified licensed appraisers hired by the Company. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Appraised and reported values may be discounted based on management's historical knowledge, changes in market conditions from the time of valuation, and/or management's expertise and knowledge of the client and the client's business. Such discounts are typically significant and result in a Level 3 classification of the inputs for determining fair value. Impaired loans are reviewed and evaluated on at least a quarterly basis for additional impairment and adjusted accordingly, based on the same factors identified above.

Loan servicing rights: Loan servicing rights do not trade in an active market with readily observable market data. As a result, the Company estimates the fair value of loan servicing rights by using a discounted cash flow model to calculate the present value of estimated future net servicing income. The assumptions used in the discounted cash flow

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

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

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

Table of Contents**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Unaudited)****(11.) 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 |
|---------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------|--------------------------------------------------------------|--------------|
| March 31, 2014 | | | | |
| Measured on a recurring basis: | | | | |
| Securities available for sale: | | | | |
| U.S. Government agencies and government sponsored enterprises | \$ | \$ 190,494 | \$ | \$ 190,494 |
| Mortgage-backed securities | | 483,810 | | 483,810 |
| Asset-backed securities | | 346 | | 346 |
| | \$ | \$ 674,650 | \$ | \$ 674,650 |
| Measured on a nonrecurring basis: | | | | |
| Loans: | | | | |
| Loans held for sale | \$ | \$ 900 | \$ | \$ 900 |
| Collateral dependent impaired loans | | | 8,964 | 8,964 |
| Other assets: | | | | |
| Loan servicing rights | | | 1,517 | 1,517 |
| Other real estate owned | | | 412 | 412 |
| | \$ | \$ 900 | \$ 10,893 | \$ 11,793 |
| December 31, 2013 | | | | |
| Measured on a recurring basis: | | | | |
| Securities available for sale: | | | | |
| | \$ | \$ 134,452 | \$ | \$ 134,452 |

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| | | | | |
|---------------------------------------------------------------|----|------------|----|------------|
| U.S. Government agencies and government sponsored enterprises | | | | |
| Mortgage-backed securities | | 474,549 | | 474,549 |
| Asset-backed securities | | 399 | | 399 |
| | \$ | \$ 609,400 | \$ | \$ 609,400 |

Measured on a nonrecurring basis:

| | | | | |
|-------------------------------------|----|----------|-----------|-----------|
| Loans: | | | | |
| Loans held for sale | \$ | \$ 3,381 | \$ | \$ 3,381 |
| Collateral dependent impaired loans | | | 9,227 | 9,227 |
| Other assets: | | | | |
| Loan servicing rights | | | 1,565 | 1,565 |
| Other real estate owned | | | 333 | 333 |
| | \$ | \$ 3,381 | \$ 11,125 | \$ 14,506 |

There were no transfers between Levels 1 and 2 during the three months ended March 31, 2014 and 2013. There were no liabilities measured at fair value on a recurring or nonrecurring basis during the three month periods ended March 31, 2014 and 2013.

Table of Contents**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Unaudited)****(11.) FAIR VALUE MEASUREMENTS (Continued)**

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

| Asset | Fair Value | Valuation Technique | Unobservable Input | Unobservable Input Value or Range |
|-------------------------------------|-------------------|----------------------------------------------------------------|--------------------------------------|------------------------------------------|
| Collateral dependent impaired loans | \$ 8,964 | Appraisal of collateral ⁽¹⁾ Discounted cash flow | Appraisal adjustments ⁽²⁾ | 18% - 100% discount |
| | | | Discount rate | 4.5% ⁽³⁾ |
| | | | Risk premium rate | 11.0% ⁽³⁾ |
| Loan servicing rights | 1,517 | Discounted cash flow | Discount rate | 5.2% ⁽³⁾ |
| | | | Constant prepayment rate | 11.2% ⁽³⁾ |
| | | | | |
| Other real estate owned | 412 | Appraisal of collateral ⁽¹⁾ | Appraisal adjustments ⁽²⁾ | 39% - 49% discount |

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

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

(3) Weighted averages.

Changes in Level 3 Fair Value Measurements

There were no assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) as of or during the three months ended March 31, 2014.

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.

Table of Contents**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Unaudited)****(11.) 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 | March 31, 2014 Carrying Amount | Estimated Fair Value | December 31, 2013 Carrying Amount | Estimated Fair Value |
|-------------------------------|----------------------------------------------------|--------------------------------------|----------------------------|-----------------------------------------|----------------------------|
| Financial assets: | | | | | |
| Cash and cash equivalents | Level 1 | \$ 72,401 | \$ 72,401 | \$ 59,692 | \$ 59,692 |
| Securities available for sale | Level 2 | 674,650 | 674,650 | 609,400 | 609,400 |
| Securities held to maturity | Level 2 | 253,576 | 256,091 | 249,785 | 250,657 |
| Loans held for sale | Level 2 | 900 | 900 | 3,381 | 3,381 |
| Loans | Level 2 | 1,812,724 | 1,816,875 | 1,797,656 | 1,802,407 |
| Loans ⁽¹⁾ | Level 3 | 8,964 | 8,964 | 9,227 | 9,227 |
| Accrued interest receivable | Level 1 | 8,928 | 8,928 | 8,150 | 8,150 |
| FHLB and FRB stock | Level 2 | 13,394 | 13,394 | 19,663 | 19,663 |
| Financial liabilities: | | | | | |
| Non-maturity deposits | Level 1 | 1,887,308 | 1,887,308 | 1,724,133 | 1,724,133 |
| Time deposits | Level 2 | 646,112 | 646,986 | 595,923 | 596,928 |
| Short-term borrowings | Level 1 | 196,746 | 196,746 | 337,042 | 337,042 |
| Accrued interest payable | Level 1 | 3,532 | 3,532 | 3,407 | 3,407 |

⁽¹⁾ Comprised of collateral dependent impaired loans.

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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, 2013. In addition, please read this section in conjunction with our Consolidated Financial Statements and Notes to Consolidated Financial Statements contained herein.

FORWARD LOOKING INFORMATION

Statements and financial analysis contained in this document that are not historical facts are forward looking statements made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995 (the Act). Forward looking statements describe our future plans, strategies and expectations and are based on certain assumptions. Words such as may, could, should, would, believe, anticipate, estimate, expect, intend, projects, and other similar expressions are intended to identify forward looking statements but are not the exclusive means of identifying such statements.

We caution readers not to place undue reliance on any forward looking statements, which speak only as of the date made, and advise readers that various factors, including those identified under the heading Risk Factors in Item 1A of Part I of our Annual Report on Form 10-K for the year ended December 31, 2013, could affect our financial performance and could cause our actual results or circumstances for future periods to differ materially from those anticipated or projected.

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

GENERAL

Financial Institutions, Inc. is a financial holding company headquartered in New York State, providing banking and nonbanking financial services to individuals, municipalities and businesses primarily in our Western and Central New York footprint. We have also expanded our indirect lending network to include relationships with franchised automobile dealers in the Capital District of New York and Northern Pennsylvania. Through our wholly-owned banking subsidiary, Five Star Bank (the Bank), we offer a wide range of services, including business and consumer loan and depository services, brokerage and investment advisory services, as well as other financial services and traditional banking services. During February 2014, the Bank formed a wholly-owned subsidiary, Five Star REIT, Inc. as a special purpose real estate investment trust. For further discussion of Five Star REIT, Inc., refer to the Income Taxes section of this Management's Discussion and Analysis. References in this report to the Company, we, our or mean the consolidated reporting entity and references to the Bank mean Five Star Bank.

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

Our business strategy is to maintain a community bank philosophy, which consists of focusing on and understanding the individualized banking needs of the businesses and residents of the communities we serve. 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 our larger competitors, allowing us to maintain long-standing and broad based banking relationships with our customers. Our core customers are primarily comprised of households, small- to medium-sized businesses and community organizations who prefer to build a banking relationship with a community bank that offers and combines high quality, competitively-priced banking products with personalized service. We believe that our level of personal service provides us with a competitive advantage over larger banks, which tend to consolidate decision-making authority outside local communities.

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

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MANAGEMENT'S DISCUSSION AND ANALYSIS

EXECUTIVE OVERVIEW

Summary of 2014 First Quarter Results

Net income increased \$1.1 million or 17% to \$7.2 million for the first quarter of 2014 compared to \$6.1 million for the first quarter of 2013. Net income available to common shareholders for the first quarter of 2014 was \$6.9 million, or \$0.50 per diluted share, compared with \$5.8 million, or \$0.42 per diluted share, for the first quarter of last year. Return on average equity was 11.19% and return on average assets was 0.99% for the first quarter of 2014 compared to 9.75% and 0.90%, respectively, for the first quarter of 2013.

Net interest income totaled \$23.3 million in the first quarter 2014, up from \$22.9 million in the first quarter 2013. Average earning assets were up \$202.3 million, led by a \$134.2 million increase in loans and a \$68.2 million increase in investment securities in the first quarter of 2014 compared to the same quarter in 2013. The growth in earning assets was offset by a narrowing net interest margin. First quarter 2014 net interest margin was 3.52%, a decrease of 21 basis points from 3.73% reported in the first quarter of 2013.

The provision for loans losses was \$2.1 million in the first quarter of 2014, improved from \$2.7 million in the first quarter of 2013. Net charge-offs during the recent quarter were \$1.7 million, up from \$1.6 million in the first quarter of 2013. Net charge-offs expressed as an annualized percentage of average loans outstanding were 0.37% during the first three months of 2014 compared with 0.38% in the first quarter of 2013.

Noninterest income totaled \$6.4 million in the first quarter of 2014, compared to \$6.6 million in the first quarter of 2013. Included in these totals are gains realized from the sale of investment securities. Exclusive of those gains, noninterest income was \$6.0 million in the recently completed quarter and \$5.7 million in the first quarter of 2013. The main factor contributing to the higher noninterest income was income of \$626 thousand from investments in limited partnerships in the first quarter of 2014, compared to \$161 thousand in the first quarter of 2013. The Company's investments in limited partnerships are primarily small business investment companies.

Noninterest expense in the first quarter of 2014 totaled \$17.2 million compared with \$17.6 million in the first quarter of 2013. The declines in noninterest expense were largely due to decreases in salaries and employee benefits due to lower pension and benefit costs during the first quarter of 2014.

The regulatory Tier 1 risk-based capital ratio at March 31, 2014, was 10.89%, up from 10.84% a year ago. The increase in the regulatory Tier 1 risk-based capital ratio reflected an increase in Tier 1 capital, partially offset by an increase in risk-weighted assets caused by organic balance sheet growth.

2014 Expectations

Net interest income is expected to increase moderately. We anticipate an increase in earning assets as we remained focused on loan growth, which will be partly funded with expected paydowns and liquidity from our securities portfolio. However, those benefits to net interest income are expected to be partially offset by continued 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, while the opportunity for deposit repricing is limited.

The commercial loan portfolio is expected to grow consistent with our strategic initiatives and continued support of middle market lending. Automobile loan originations remain strong, reflecting the positive impact from our

investment in automotive dealer relationships. The home equity portfolio is expected to increase as the lower origination cost to customers and the convenient application process has made these products an increasingly attractive alternative to conventional residential mortgage loans, accordingly we expect run-off to outpace new originations in the residential mortgage portfolio.

We anticipate the increase in total loans will modestly outpace growth in total deposits. This reflects our continued focus on the overall cost of funds, through the use of short-term borrowings as well as the continued shift towards low- and no-cost demand deposits and money market deposit accounts.

Noninterest income, excluding the impact of any securities gains and investments in limited partnerships, is expected to be slightly higher than recent levels, reflecting our continued efforts to increase both account and transaction-based fee income. Management will continue to explore opportunities to increase noninterest income from non-deposit related sources, which may include expanding the products and services we offer through strategic acquisitions of insurance, wealth management and mortgage banking businesses.

Noninterest expense is expected to remain around current levels as we remain committed to diligent expense control.

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

The effective tax rate for 2014 is expected to be approximately 30%, primarily reflecting the impacts of tax-exempt income, tax advantaged investments, and the formation of our real estate investment trust in early 2014.

Table of Contents**MANAGEMENT'S DISCUSSION AND ANALYSIS****RESULTS OF OPERATIONS****Net Interest Income and Net Interest Margin**

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

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

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

| | Three months ended March 31, | |
|--------------------------------------------------------------|---------------------------------------------|-------------|
| | 2014 | 2013 |
| Interest income per consolidated statements of income | \$ 25,059 | \$ 24,748 |
| Adjustment to fully taxable equivalent basis | 695 | 628 |
| Interest income adjusted to a fully taxable equivalent basis | 25,754 | 25,376 |
| Interest expense per consolidated statements of income | 1,784 | 1,861 |
| Net interest income on a taxable equivalent basis | \$ 23,970 | \$ 23,515 |

2014 Leverage Strategy

During the first quarter of 2014, we utilized the proceeds of short-term FHLB advances to purchase high-quality investment securities of approximately \$50 million. Our purchase of investment securities was comprised of mortgage-backed securities, U.S. Government agencies and sponsored enterprise bonds and tax-exempt municipal bonds. All of the securities purchased were of high credit quality with a low to moderate duration. This strategy allowed us to increase net interest income by taking advantage of the positive interest rate spread between the FHLB

advances and the newly acquired investment securities. While the underlying leverage strategy contributed to a lower net interest margin, it successfully increased tax-equivalent net interest income by approximately \$270 thousand in the first quarter of 2014.

Analysis of Net Interest Income for the Three Month Periods ended March 31, 2014 and 2013

Net interest income on a taxable equivalent basis for the three months ended March 31, 2014, was \$24.0 million, an increase of \$455 thousand or 2% versus the comparable quarter last year. The increase in taxable equivalent net interest income was primarily attributable to favorable volume variances (as changes in the balances and mix of earning assets and interest-bearing liabilities added \$1.8 million to taxable equivalent net interest income), partly offset by unfavorable rate variances (as the impact of changes in the interest rate environment and product pricing reduced taxable equivalent net interest income by \$1.4 million).

Actions by the Federal Open Market Committee of the Federal Reserve Board have compressed net interest income and net interest margins for the banking industry by maintaining low rates on interest-earning assets. Throughout 2013 and thus far into 2014, margins in the banking industry were pressured downward as higher-yielding legacy assets rolled off and were reinvested in the current low rate environment. Low interest rates, coupled with a competitive lending environment, have proven challenging for the profitability of the banking industry. It is expected that these challenges will continue until interest rates rise.

The net interest margin for the first quarter of 2014 was 3.52%, 21 basis points lower than 3.73% for the same period in 2013. This comparable period decrease was a function of a 20 basis point decrease in interest rate spread, combined with a lower contribution from net free funds of one basis point (due principally to lower rates on interest-bearing liabilities reducing the value of noninterest-bearing deposits and other net free funds). The lower interest rate spread was a net result of a 24 basis point decrease in the yield on earning assets and a 4 basis point decrease in the cost of interest-bearing liabilities.

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MANAGEMENT'S DISCUSSION AND ANALYSIS

For the first quarter of 2014, the yield on average earning assets of 3.79% was 24 basis points lower than the first quarter of 2013. Loan yields decreased 38 basis points to 4.45%. Commercial mortgage and consumer indirect loans in particular, down 40 and 57 basis points, respectively, experienced lower yields given the competitive pricing pressures in a low interest rate environment. The yield on investment securities increased 4 basis points to 2.43%. Overall, earning asset rate changes reduced interest income by \$1.5 million during the first quarter of 2014, but that was more than offset by a favorable volume variance that drove a \$1.9 million increase in interest income.

The cost of average interest-bearing liabilities of 0.33% in the first quarter of 2014 was 4 basis points lower than the first quarter of 2013. The cost of short-term funding decreased 2 basis points to 0.38% for the first quarter of 2014. The interest-bearing liability rate changes resulted in \$123 thousand of lower interest expense, which was partly offset by a \$46 thousand volume-related increase in interest expense.

Average interest-earning assets were \$2.75 billion for first quarter 2014, an increase of \$202.3 million or 8% from the comparable quarter last year, with average loans up \$134.2 million and average securities up \$68.2 million. The growth in average loans was comprised of increases in most loan categories, with consumer and commercial loans up \$90.5 million and \$60.7 million, respectively, partially offset by a \$17.0 million decrease in residential mortgage loans. The growth in average securities was primarily a result of our previously described leverage strategy.

Average interest-bearing liabilities of \$2.17 billion in first quarter of 2014 were \$138.1 million or 7% higher than the first quarter of 2013. On average, interest-bearing deposits grew \$55.1 million, while noninterest-bearing demand deposits (a principal component of net free funds) were up \$42.4 million. The increase in average deposits was mainly due to 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. Average short-term borrowings increased \$83.0 million between the first quarter periods, largely due to the incremental borrowings associated with the previously mentioned 2014 leverage strategy.

Table of Contents**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 March 31, | | | | | |
|--------------------------------------------------|------------------------------|----------|-----------------|--------------------|----------|-----------------|
| | 2014 | | | 2013 | | |
| | Average Balance | Interest | Average Rate | Average Balance | Interest | Average Rate |
| Interest-earning assets: | | | | | | |
| Federal funds sold and interest-earning deposits | \$ 316 | \$ | 0.08% | \$ 320 | \$ | 0.21% |
| Investment securities ⁽¹⁾ : | | | | | | |
| Taxable | 654,513 | 3,501 | 2.14 | 622,924 | 3,202 | 2.06 |
| Tax-exempt ⁽²⁾ | 249,924 | 1,986 | 3.18 | 213,346 | 1,795 | 3.37 |
| Total investment securities | 904,437 | 5,487 | 2.43 | 836,270 | 4,997 | 2.39 |
| Loans: | | | | | | |
| Commercial business | 265,137 | 2,911 | 4.45 | 258,958 | 2,871 | 4.50 |
| Commercial mortgage | 472,733 | 5,506 | 4.72 | 418,248 | 5,285 | 5.12 |
| Residential mortgage | 113,390 | 1,373 | 4.85 | 130,425 | 1,650 | 5.06 |
| Home equity | 328,833 | 3,283 | 4.05 | 288,993 | 3,021 | 4.24 |
| Consumer indirect | 642,241 | 6,584 | 4.16 | 588,068 | 6,852 | 4.73 |
| Other consumer | 22,062 | 610 | 11.22 | 25,535 | 700 | 11.12 |
| Total loans | 1,844,396 | 20,267 | 4.45 | 1,710,227 | 20,379 | 4.83 |
| Total interest-earning assets | 2,749,149 | 25,754 | 3.79 | 2,546,817 | 25,376 | 4.03 |
| Allowance for loan losses | (26,750) | | | (24,785) | | |
| Other noninterest-earning assets | 243,001 | | | 258,177 | | |
| Total assets | \$ 2,965,400 | | | \$ 2,780,209 | | |
| Interest-bearing liabilities: | | | | | | |
| Deposits: | | | | | | |
| Interest-bearing demand | \$ 511,073 | \$ 160 | 0.13% | \$ 494,654 | \$ 138 | 0.11% |
| Savings and money market | 761,799 | 235 | 0.13 | 693,684 | 220 | 0.13 |
| Certificates of deposit | 618,126 | 1,130 | 0.74 | 647,551 | 1,313 | 0.82 |
| Total interest-bearing deposits | 1,890,998 | 1,525 | 0.33 | 1,835,889 | 1,671 | 0.37 |
| Short-term borrowings | 274,414 | 259 | 0.38 | 191,412 | 190 | 0.40 |

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| | | | | | | |
|----------------------------------------------------------------------------------|--------------|-----------|---------|--------------|-----------|---------|
| Total interest-bearing liabilities | 2,165,412 | 1,784 | 0.33 | 2,027,301 | 1,861 | 0.37 |
| Noninterest-bearing demand deposits | 524,346 | | | 481,909 | | |
| Other noninterest-bearing liabilities | 14,019 | | | 15,167 | | |
| Shareholders' equity | 261,623 | | | 255,832 | | |
| Total liabilities and shareholders' equity | \$ 2,965,400 | | | \$ 2,780,209 | | |
| Net interest income (tax-equivalent) | | \$ 23,970 | | | \$ 23,515 | |
| Interest rate spread | | | 3.46% | | | 3.66% |
| Net earning assets | \$ 583,737 | | | \$ 519,516 | | |
| Net interest margin (tax-equivalent) | | | 3.52% | | | 3.73% |
| Ratio of average interest-earning assets to average interest-bearing liabilities | | | 126.96% | | | 125.63% |

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

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

Table of Contents**MANAGEMENT'S DISCUSSION AND ANALYSIS**

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

| Increase (decrease) in: | Three months ended March 31, 2014 vs. 2013 | | |
|--------------------------------------------------|-------------------------------------------------------|-------------------|---------------|
| | Volume | Rate | Total |
| Interest income: | | | |
| Federal funds sold and interest-earning deposits | \$ | \$ | \$ |
| Investment securities: | | | |
| Taxable | 166 | 133 | 299 |
| Tax-exempt | 295 | (104) | 191 |
| Total investment securities | 461 | 29 | 490 |
| Loans: | | | |
| Commercial business | 68 | (28) | 40 |
| Commercial mortgage | 655 | (434) | 221 |
| Residential mortgage | (208) | (69) | (277) |
| Home equity | 402 | (140) | 262 |
| Consumer indirect | 598 | (866) | (268) |
| Other consumer | (96) | 6 | (90) |
| Total loans | 1,419 | (1,531) | (112) |
| Total interest income | 1,880 | (1,502) | 378 |
| Interest expense: | | | |
| Deposits: | | | |
| Interest-bearing demand | 5 | 17 | 22 |
| Savings and money market | 21 | (6) | 15 |
| Certificates of deposit | (58) | (125) | (183) |
| Total interest-bearing deposits | (32) | (114) | (146) |
| Short-term borrowings | 78 | (9) | 69 |
| Total interest expense | 46 | (123) | (77) |
| Net interest income | \$ 1,834 | \$ (1,379) | \$ 455 |

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 first quarter of 2014 was \$2.1 million, compared to \$2.7 million for the same period in 2013. 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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Table of Contents**MANAGEMENT'S DISCUSSION AND ANALYSIS****Noninterest Income**

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

| | Three months ended | |
|-----------------------------------------------|---------------------------|-----------------|
| | March 31, | |
| | 2014 | 2013 |
| Service charges on deposits | \$ 2,250 | \$ 2,141 |
| ATM and debit card | 1,174 | 1,249 |
| Investments in limited partnerships | 626 | 161 |
| Investment advisory | 563 | 699 |
| Company owned life insurance | 403 | 415 |
| Loan servicing | 154 | 73 |
| Net gain on disposal of investment securities | 313 | 892 |
| Net gain on sale of loans held for sale | 105 | 200 |
| Net (loss) gain on disposal of other assets | (35) | 1 |
| Other | 804 | 722 |
| Total noninterest income | \$ 6,357 | \$ 6,553 |

Service charges on deposit accounts for the three months ended March 31, 2014 increased \$109 thousand or 5%, compared to the same period in 2013. The increase was primarily due to an increase in service charges on consumer accounts as we repositioned the fee structure for our consumer checking accounts in the second quarter of 2013.

ATM and debit card income decreased \$75 thousand to \$1.2 million in the first in three months of 2014 compared to the same period last year based on lower transaction volumes due to card reissuance associated with third-party security breaches.

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 \$626 thousand in the first quarter of 2014, an increase of \$465 thousand when compared to the first quarter of 2013.

Investment advisory income decreased \$136 thousand or 19% for the first quarter of 2014 compared to 2013. Investment advisory income fluctuates mainly due to sales volume, which decreased during the first quarter of 2014.

Loan servicing income increased \$81 thousand during the first quarter of 2014 compared to the same quarter last year. The increase was a result of slower amortization of servicing rights consistent with reduced refinancing activity in the sold and serviced portfolio, combined with smaller adjustments to the valuation allowance for capitalized mortgage servicing assets compared to the first quarter of 2013, partially offset by lower fees collected due to a decrease in the sold and serviced portfolio.

Noninterest income in the first quarter 2014 included gains totaling \$313 thousand from the sale of five agency securities and one mortgage backed security. All of the gains realized during the first quarter of 2013 resulted from the sale of pooled trust-preferred securities that were written down in prior periods and included in non-performing assets prior to their sale. The amount and timing of our sale of investments securities is dependent on a number of factors, including our prudent efforts to realize gains while managing duration, premium and credit risk.

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Table of Contents**MANAGEMENT'S DISCUSSION AND ANALYSIS****Noninterest Expense**

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

| | Three months ended March 31, | |
|----------------------------------|---------------------------------------------|------------------|
| | 2014 | 2013 |
| Salaries and employee benefits | \$ 9,256 | \$ 9,709 |
| Occupancy and equipment | 3,235 | 3,169 |
| Professional services | 972 | 937 |
| Computer and data processing | 723 | 704 |
| Supplies and postage | 512 | 680 |
| FDIC assessments | 422 | 361 |
| Advertising and promotions | 179 | 214 |
| Other | 1,914 | 1,810 |
| Total noninterest expense | \$ 17,213 | \$ 17,584 |

Salaries and benefits expense decreased by \$453 thousand or 5% in the first quarter of 2014 compared to the same period in 2013. A decrease in salaries was primarily due to lower base salaries as a result of fewer full-time equivalent employees (FTEs). We have managed to lower our FTEs through a combination of attrition and selected branch closures. The decrease in employee benefits was primarily due to lower expense related to our defined benefit retirement plans. We recognized a combined net periodic pension expense of \$56 thousand on our pension and post-retirement obligations during the first quarter of 2014 compared to a combined net periodic pension expense of \$429 thousand during the first quarter of 2013.

Supplies and postage expense decreased by \$168 thousand or 25% in the first quarter of 2014 compared to the same period in 2013. The first quarter of 2013 included expenses for additional print materials related to new product launches.

FDIC assessments increased \$61 thousand during the first quarter of 2014 compared to the same quarter last year, a direct result of the growth in our balance sheet.

Advertising and promotions costs were down \$35 thousand or 16% in the first quarter of 2014 compared to the same period a year earlier due to the timing of marketing campaigns.

Other noninterest expense was \$1.9 million in the first quarter of 2014 compared to \$1.8 million in the first quarter of 2013. The first quarter of 2014 included expenses related to our digital marketing initiatives, including the launch of new retail checking account products in the second quarter of 2013.

Our efficiency ratio for the first quarter of 2014 was 56.96% compared with 59.87% for the first quarter of 2013. The efficiency ratio is calculated by dividing total noninterest expense, excluding other real estate expense and amortization of intangible assets, by net revenue, defined as the sum of tax-equivalent net interest income and noninterest income before net gains and impairment charges on investment securities. 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 three months ended March 31, 2014, we recorded income tax expense of \$3.1 million, versus \$3.0 million a year ago. The effective tax rates for the first quarters of 2014 and 2013 were 30.0% and 32.8%, respectively. Our increased income tax expense due to higher pre-tax income was partially offset by the lower effective tax rate, reflecting tax savings generated by our real estate investment trust, which was funded during February 2014. 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.

During February 2014, the Bank formed a wholly-owned subsidiary, Five Star REIT, Inc. (the REIT), to acquire a portion of the Bank's assets, which will primarily be qualifying mortgage related loans. The Bank made an initial contribution of mortgage related loans to the REIT in return for common stock of the REIT. The REIT expects to purchase mortgage related loans from the Bank on a periodic basis going forward. The REIT entered into service agreements with the Bank for administrative and investment services. We expect the formation of the REIT to result in a lower effective tax rate for 2014.

In March 2014, the New York legislature approved changes in the state tax law which will lower our state income tax rate from 7.1% to 6.5%. The changes will be phased in over two years, beginning in 2015. This lower state tax rate going forward will reduce the benefit provided by the Company's existing deferred tax items. We are currently reviewing the impact of the tax law changes but do not expect they will have a material impact on our consolidated statements of income and condition.

Table of Contents**MANAGEMENT'S DISCUSSION AND ANALYSIS****ANALYSIS OF FINANCIAL CONDITION****INVESTING ACTIVITIES****Investment Securities**

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

| | Investment Securities Portfolio Composition | | | |
|-------------------------------------------------------------------------|----------------------------------------------------|-----------------------|---------------------------|-----------------------|
| | March 31, 2014 | | December 31, 2013 | |
| | Amortized Cost | Fair Value | Amortized Cost | Fair Value |
| Securities available for sale: | | | | |
| U.S. Government agencies and government-sponsored enterprise securities | \$ 190,967 | \$ 190,494 | \$ 135,840 | \$ 134,452 |
| Mortgage-backed securities: | | | | |
| Agency mortgage-backed securities | 486,094 | 482,408 | 482,308 | 473,082 |
| Non-Agency mortgage-backed securities | | 1,402 | | 1,467 |
| Asset-backed securities ⁽¹⁾ | 18 | 346 | 18 | 399 |
| Total available for sale securities | 677,079 | 674,650 | 618,166 | 609,400 |
| Securities held to maturity: | | | | |
| State and political subdivisions | 253,576 | 256,091 | 249,785 | 250,657 |
| Total investment securities | \$ 930,655 | \$ 930,741 | \$ 867,951 | \$ 860,057 |

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

The available for sale (AFS) investment securities portfolio increased \$65.3 million or 11%, from \$609.4 million at December 31, 2013 to \$674.7 million at March 31, 2014. The AFS portfolio had net unrealized losses totaling \$2.4 million and \$8.8 million at March 31, 2014 and December 31, 2013, respectively. The unrealized losses on the AFS portfolio were predominantly caused by changes in market interest rates. The fair value of most of the investment securities in the AFS portfolio fluctuates as market interest rates change.

As previously discussed, we utilized the proceeds from short-term FHLB advances to purchase high-quality investment securities as part of our leverage strategy of approximately \$50 million implemented during the first quarter of 2014. Our purchase of investment securities was comprised of mortgage-backed securities, U.S. Government agencies and sponsored enterprise bonds and tax-exempt municipal bonds. This strategy allowed us to increase net interest income by taking advantage of the positive interest rate spread between the FHLB advances and

the newly acquired investment securities.

Impairment Assessment

We review investment securities on an ongoing basis for the presence of OTTI with formal reviews performed quarterly. Declines in the fair value of held to maturity and available for sale securities below their cost that are deemed to be other than temporary are reflected in earnings as realized losses to the extent the impairment is related to credit losses or the security is intended to be sold or will be required to be sold. The amount of the impairment related to non-credit related factors is recognized in other comprehensive income. Evaluating whether the impairment of a debt security is other than temporary involves assessing the intent to sell the debt security or the likelihood of being required to sell the security before the recovery of its amortized cost basis. In determining whether the other-than-temporary impairment includes a credit loss, we use our best estimate of the present value of cash flows expected to be collected from the debt security considering factors such as: the length of time and the extent to which the fair value has been less than the amortized cost basis, adverse conditions specifically related to the security, an industry, or a geographic area, the historical and implied volatility of the fair value of the security, the payment structure of the debt security and the likelihood of the issuer being able to make payments that increase in the future, failure of the issuer of the security to make scheduled interest or principal payments, any changes to the rating of the security by a rating agency, and recoveries or additional declines in fair value subsequent to the balance sheet date. The assessment of whether OTTI exists involves a high degree of subjectivity and judgment and is based on the information available to management at a point in time.

Securities Deemed to be Other-Than-Temporarily Impaired

There were no securities deemed to be other-than-temporarily impaired during the three month periods ended March 31, 2014 and 2013.

Table of Contents**MANAGEMENT'S DISCUSSION AND ANALYSIS****LENDING ACTIVITIES**

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

| | Loan Portfolio Composition | | | |
|---------------------------|-----------------------------------|-------------------|--------------------------|-------------------|
| | March 31, 2014 | | December 31, 2013 | |
| | Amount | % of Total | Amount | % of Total |
| Commercial business | \$ 268,352 | 14.5% | \$ 265,766 | 14.5% |
| Commercial mortgage | 468,763 | 25.4 | 469,284 | 25.6 |
| Total commercial | 737,115 | 39.9 | 735,050 | 40.1 |
| Residential mortgage | 110,164 | 6.0 | 113,045 | 6.2 |
| Home equity | 332,348 | 18.0 | 326,086 | 17.8 |
| Consumer indirect | 647,546 | 35.0 | 636,368 | 34.7 |
| Other consumer | 21,667 | 1.1 | 23,070 | 1.2 |
| Total consumer | 1,001,561 | 54.1 | 985,524 | 53.7 |
| Total loans | 1,848,840 | 100.0% | 1,833,619 | 100.0% |
| Allowance for loan losses | 27,152 | | 26,736 | |
| Total loans, net | \$ 1,821,688 | | \$ 1,806,883 | |

Total loans increased \$15.2 million to \$1.85 billion at March 31, 2014 from \$1.83 billion at December 31, 2013. The increase in loans was attributable to organic growth, primarily in the home equity and consumer indirect loan portfolios, partially offset by a decline in residential mortgages.

Commercial loans increased \$2.1 million and represented 39.9% of total loans as of March 31, 2014, a result of our continued commercial business development efforts; although we believe production in the first quarter was lower due to the harsh Northeast winter, which negatively impacted commercial business activities.

Residential mortgage loans decreased \$2.8 million to \$110.2 million as of March 31, 2014 in comparison to \$113.0 million as of December 31, 2013. This category of loans decreased as we continue to sell the majority of newly originated and refinanced residential mortgages to the secondary market rather than being added to our portfolio, coupled with our focus on home equity lending.

Our home equity portfolio, which consists of home equity loans and lines, totaled \$332.3 million as of March 31, 2014, up \$6.3 million or 2% compared to December 31, 2013. We continue to grow our home equity portfolio as the lower origination cost and convenience to customers has made these products an increasingly attractive alternative to

conventional residential mortgage loans. As of March 31, 2014, approximately 77% of the loans in the home equity portfolio were first lien positions.

The consumer indirect portfolio increased \$11.3 million to \$647.5 million as of March 31, 2014, from \$636.4 million as of December 31, 2013, reflecting our continued focus on consumer indirect lending. During the first quarter of 2014, we originated \$77.1 million in indirect auto loans with a mix of approximately 42% new auto and 58% used auto. During the first quarter of 2013, we originated \$64.4 million in indirect auto loans with an equal mix of new and used auto.

Loans Held for Sale and Loan Servicing Rights

Loans held for sale (not included in the loan portfolio composition table) were entirely comprised of residential real estate mortgages and totaled \$900 thousand and \$3.4 million as of March 31, 2014 and December 31, 2013, respectively.

We sell certain qualifying newly originated or refinanced residential real estate mortgages on the secondary market. Residential real estate mortgages serviced for others, which are not included in our consolidated statements of financial condition, amounted to \$233.6 million as of March 31, 2014 and \$237.9 million as of December 31, 2013, as runoff has outpaced production in the first quarter of 2014.

Table of Contents**MANAGEMENT'S DISCUSSION AND ANALYSIS****Allowance for Loan Losses**

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

| | Loan Loss Analysis | |
|----------------------------------------------------|-------------------------------------|--------------|
| | Three months ended March 31, | |
| | 2014 | 2013 |
| Balance as of beginning of period | \$ 26,736 | \$ 24,714 |
| Charge-offs: | | |
| Commercial business | 68 | 239 |
| Commercial mortgage | | 3 |
| Residential mortgage | 78 | 162 |
| Home equity | 106 | 269 |
| Consumer indirect | 2,455 | 1,718 |
| Other consumer | 269 | 252 |
| Total charge-offs | 2,976 | 2,643 |
| Recoveries: | | |
| Commercial business | 29 | 37 |
| Commercial mortgage | 7 | 14 |
| Residential mortgage | 21 | 17 |
| Home equity | 11 | 37 |
| Consumer indirect | 1,105 | 805 |
| Other consumer | 113 | 137 |
| Total recoveries | 1,286 | 1,047 |
| Net charge-offs | 1,690 | 1,596 |
| Provision for loan losses | 2,106 | 2,709 |
| Balance at end of period | \$ 27,152 | \$ 25,827 |
| Net loan charge-offs to average loans (annualized) | 0.37% | 0.38% |
| Allowance for loan losses to total loans | 1.47% | 1.50% |
| Allowance for loan losses to non-performing loans | 167% | 220% |

The allowance for loan losses represents the estimated amount of probable credit losses inherent in our loan portfolio. We perform periodic, systematic reviews of the loan portfolio to estimate probable losses in the respective loan portfolios. In addition, we regularly evaluate prevailing economic and business conditions, industry concentrations, changes in the size and characteristics of the portfolio and other pertinent factors. The process we use to determine the overall allowance for loan losses is based on this analysis. Based on this analysis, we believe the allowance for loan losses is adequate as of March 31, 2014.

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

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

Net charge-offs of \$1.7 million in the first quarter of 2014 represented 0.37% of average loans on an annualized basis compared to \$1.6 million or 0.38% in the first quarter of 2013. The allowance for loan losses was \$27.2 million at March 31, 2014, compared with \$25.8 million at December 31, 2013. The ratio of the allowance for loan losses to total loans was 1.47% at March 31, 2014, compared with 1.50% at December 31, 2013. The ratio of allowance for loan losses to non-performing loans was 167% at March 31, 2014, compared with 220% at December 31, 2013. The decrease in the allowance for loan losses to non-performing loans was a result of a single commercial credit that was classified as non-performing during the fourth quarter of 2013.

Table of Contents**MANAGEMENT'S DISCUSSION AND ANALYSIS****Non-Performing Assets and Potential Problem Loans**

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

| | Non-Performing Assets | |
|-------------------------------------------|------------------------------|------------------------------|
| | March 31, 2014 | December 31, 2013 |
| Nonaccrual loans: | | |
| Commercial business | \$ 3,706 | \$ 3,474 |
| Commercial mortgage | 9,545 | 9,663 |
| Residential mortgage | 760 | 1,078 |
| Home equity | 826 | 925 |
| Consumer indirect | 1,387 | 1,471 |
| Other consumer | 40 | 5 |
| Total nonaccrual loans | 16,264 | 16,616 |
| Accruing loans 90 days or more delinquent | 6 | 6 |
| Total non-performing loans | 16,270 | 16,622 |
| Foreclosed assets | 412 | 333 |
| Non-performing investment securities | 113 | 128 |
| Total non-performing assets | \$ 16,795 | \$ 17,083 |
| Non-performing loans to total loans | 0.88% | 0.91% |
| Non-performing assets to total assets | 0.56% | 0.58% |

Changes in the level of nonaccrual loans typically represent increases for loans that reach a specified past due status, offset by reductions for loans that are charged-off, paid down, sold, transferred to foreclosed real estate, or are no longer classified as nonaccrual because they have returned to accrual status. Activity in nonaccrual loans for the three months ended March 31, 2014 was as follows (in thousands):

| | |
|--------------------------------------------------------|------------------|
| Nonaccrual loans at January 1, 2014 | \$ 16,616 |
| Additions | 6,110 |
| Payments | (3,064) |
| Charge-offs | (2,847) |
| Returned to accruing status | (454) |
| Transferred to other real estate or repossessed assets | (97) |
| Nonaccrual loans at March 31, 2014 | \$ 16,264 |

Non-performing assets include non-performing loans, foreclosed assets and non-performing investment securities. Non-performing assets at March 31, 2014 were \$16.8 million, a decrease of \$288 thousand from \$17.1 million at December 31, 2013. The primary component of non-performing assets is non-performing loans, which were \$16.3 million or 0.88% of total loans at March 31, 2014, a decrease of \$352 thousand from \$16.6 million or 0.91% of total loans at December 31, 2013. Approximately \$12.6 million, or 77%, of the \$16.3 million in non-performing loans as of March 31, 2014 were current with respect to payment of principal and interest, but were classified as non-accruing because repayment in full of principal and/or interest was uncertain. Included in nonaccrual loans are troubled debt restructurings (TDRs) of \$8.7 million at March 31, 2014. We had no TDRs that were accruing interest as of March 31, 2014.

Foreclosed assets consist of real property formerly pledged as collateral to loans, which we have acquired through foreclosure proceedings or acceptance of a deed in lieu of foreclosure. Foreclosed asset holdings represented six properties totaling \$412 thousand at March 31, 2014 and four properties totaling \$333 thousand at December 31, 2013.

Non-performing investment securities for which we have stopped accruing interest were \$113 thousand at March 31, 2014, compared to \$128 thousand at December 31, 2013. Non-performing investment securities are included in non-performing assets at fair value and are comprised of pooled trust preferred securities. There have been no securities transferred to non-performing status since the first quarter of 2009. We continue to monitor the market for these securities and evaluate the potential for future dispositions.

Table of Contents**MANAGEMENT'S DISCUSSION AND ANALYSIS**

Potential problem loans are loans that are currently performing, but information known about possible credit problems of the borrowers causes management to have concern as to the ability of such borrowers to comply with the present loan payment terms and may result in disclosure of such loans as nonperforming at some time in the future. These loans remain in a performing status due to a variety of factors, including payment history, the value of collateral supporting the credits, and/or personal or government guarantees. Management considers loans classified as substandard, which continue to accrue interest, to be potential problem loans. We identified \$14.3 million and \$9.7 million in loans that continued to accrue interest which were classified as substandard as of March 31, 2014 and December 31, 2013, respectively. Included in potential problem loans at March 31, 2014 are three credit relationships with principal balance totaling \$5.1 million, consisting of \$2.4 million in commercial mortgage loans and \$2.7 million in commercial business loans, which were downgraded to substandard status from special mention during the first quarter of 2014.

FUNDING ACTIVITIES**Deposits**

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

| | Deposit Composition | | | |
|----------------------------------------------|----------------------------|-------------------|--------------------------|-------------------|
| | March 31, 2014 | | December 31, 2013 | |
| | Amount | % of Total | Amount | % of Total |
| Noninterest-bearing demand | \$ 532,914 | 21.0% | \$ 535,472 | 23.1% |
| Interest-bearing demand | 541,660 | 21.4 | 470,733 | 20.3 |
| Savings and money market | 812,734 | 32.1 | 717,928 | 30.9 |
| Certificates of deposit < \$100,000 | 364,509 | 14.4 | 369,915 | 16.0 |
| Certificates of deposit of \$100,000 or more | 281,603 | 11.1 | 226,008 | 9.7 |
| Total deposits | \$ 2,533,420 | 100.0% | \$ 2,320,056 | 100.0% |

We offer a variety of deposit products designed to attract and retain customers, with the primary focus on building and expanding long-term relationships. At March 31, 2014, total deposits were \$2.53 billion, representing an increase of \$213.4 million in comparison to \$2.32 billion as of December 31, 2013. Public deposit balances increased \$165.3 million during the first quarter of 2014 due largely to the seasonality of municipal cash flows. Certificates of deposit were approximately 26% of total deposits at March 31, 2014 and December 31, 2013. Depositors remain hesitant to invest in time deposits, such as certificates of deposit, for long periods due to the low interest rate environment. This has resulted in lower amounts being placed in time deposits for generally shorter terms.

Nonpublic deposits, the largest component of our funding sources, totaled \$1.83 billion and \$1.79 billion at March 31, 2014 and December 31, 2013, respectively, and represented 72% and 77% of total deposits as of the end of each period, respectively. We have managed this segment of funding through a strategy of competitive pricing that minimizes the number of customer relationships that have only a single service high cost deposit account.

As an additional source of funding, we offer a variety of public (municipal) deposit products to the many towns, villages, counties and school districts within our market. Public deposits generally range from 20% to 30% of our total deposits. There is a high degree of seasonality in this component of funding, because the level of deposits varies with the seasonal cash flows for these public customers. We maintain the necessary levels of short-term liquid assets to accommodate the seasonality associated with public deposits. Total public deposits were \$698.8 million and \$533.5 million at March 31, 2014 and December 31, 2013, respectively, and represented 28% and 23% of total deposits as of the end of each period, respectively.

We had no traditional brokered deposits at March 31, 2014 or December 31, 2013; however, we do participate in the Certificate of Deposit Account Registry Service (CDARS) and Insured Cash Sweep (ICS) programs, which enable depositors to receive FDIC insurance coverage for deposits otherwise exceeding the maximum insurable amount. CDARS and ICS deposits are considered brokered deposits for regulatory reporting purposes. Through these programs, deposits in excess of the maximum insurable amount are placed with multiple participating financial institutions. Reciprocal CDARS deposits and ICS deposits totaled \$96.1 million and \$76.1 million, respectively, at March 31, 2014, compared to \$61.3 million and \$56.4 million, respectively, at December 31, 2013.

Table of Contents**MANAGEMENT'S DISCUSSION AND ANALYSIS****Borrowings**

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

| | March 31, 2014 | December 31, 2013 |
|-----------------------------|---------------------------|------------------------------|
| Short-term borrowings: | | |
| Repurchase agreements | \$ 38,046 | \$ 39,042 |
| Short-term FHLB borrowings | 158,700 | 298,000 |
| Total short-term borrowings | \$ 196,746 | \$ 337,042 |

We classify borrowings as short-term or long-term in accordance with the original terms of the agreement. There were no long-term borrowings outstanding as of March 31, 2014 or December 31, 2013.

We have credit capacity with the FHLB and can borrow through facilities that include amortizing and term advances or repurchase agreements. We had approximately \$80 million of immediate credit capacity with FHLB as of March 31, 2014. We had approximately \$491 million in secured borrowing capacity at the Federal Reserve Bank (FRB) Discount Window, none of which was outstanding at March 31, 2014. The FHLB and FRB credit capacity are collateralized by securities from our investment portfolio and certain qualifying loans. We had approximately \$120 million of credit available under unsecured federal funds purchased lines with various banks at March 31, 2014. Additionally, we had approximately \$51 million of unencumbered liquid securities available for pledging.

Federal funds purchased are short-term borrowings that typically mature within one to ninety days. Short-term repurchase agreements are secured overnight borrowings with customers. Short-term FHLB borrowings have original maturities of less than one year and include overnight borrowings which we typically utilize to address short term funding needs as they arise. Short-term FHLB borrowings at March 31, 2014 consisted of \$14.0 million in overnight borrowings and \$144.7 million in short-term advances. Short-term FHLB borrowings at December 31, 2013 consisted of \$198.0 million in overnight borrowings and \$100.0 million in short-term advances. Overnight FHLB borrowings outstanding at the end of 2013 were paid down during the first quarter of 2014 as a result of the aforementioned seasonal inflow of municipal deposits.

As previously discussed, during the first quarter of 2014 we leveraged our balance sheet through the execution of short-term FHLB advances in order to acquire investment securities to take advantage of the positive interest rate spread and increase net interest income.

Shareholders' Equity

Shareholders' equity was \$262.9 million at March 31, 2014, an increase of \$8.1 million from \$254.8 million at December 31, 2013. Net income for the year increased shareholders' equity by \$7.2 million, which was partially offset by common and preferred stock dividends declared of \$3.0 million. Accumulated other comprehensive income included in shareholders' equity increased \$3.8 million during the first three months of 2014 due primarily to lower net

unrealized losses on securities available for sale.

LIQUIDITY AND CAPITAL RESOURCES

Liquidity

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

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

The primary sources of liquidity for the parent company are dividends from the Bank and access to financial and capital markets. Dividends from the Bank are limited by various regulatory requirements related to capital adequacy and earnings trends. The Bank relies on cash flows from operations, core deposits, borrowings and short-term liquid assets. As a secondary source of liquidity, the Company also has the ability to draw up to \$20.0 million on a revolving credit line with a correspondent bank.

Our cash and cash equivalents were \$72.4 million as of March 31, 2014, up \$12.7 million from \$59.7 million as of December 31, 2013. Our net cash provided by operating activities totaled \$20.6 million and the principal source of operating activity cash flow was net income adjusted for noncash income and expense items. Net cash used in investing activities totaled \$77.9 million, which included outflows of \$16.2 million for net loan originations and \$60.6 million from net investment securities transactions. Net cash provided by financing activities of \$70.0 million was attributed to a \$213.4 million increase in deposits, partially offset by a \$140.3 million decrease in short-term borrowings and \$3.0 million in dividend payments.

Table of Contents**MANAGEMENT'S DISCUSSION AND ANALYSIS****Capital Resources**

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

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

The Company's and the Bank's Tier 1 capital consists of shareholders' equity excluding unrealized gains and losses on securities available for sale (except for unrealized losses which have been determined to be other than temporary and recognized as expense in the consolidated statements of income), goodwill and other intangible assets and disallowed portions of deferred tax assets. Tier 1 capital for the Company includes, subject to limitation, \$17.3 million of preferred stock at March 31, 2014 and December 31, 2013. The Company and the Bank's total capital are comprised of Tier 1 capital for each entity plus a permissible portion of the allowance for loan losses.

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

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

| | March 31, 2014 | December 31, 2013 |
|----------------------------------------------------------------------------------------------------|---------------------------|------------------------------|
| Total shareholders' equity | \$ 262,865 | \$ 254,839 |
| Less: Unrealized (loss) gain on securities available for sale, net of tax | (1,467) | (5,293) |
| Net unrecognized gain on available for sale securities transferred to held to maturity, net of tax | (126) | (44) |
| Unrecognized net periodic pension & postretirement benefits (costs), net of tax | (4,831) | (4,850) |
| Disallowed goodwill and other intangible assets | 49,913 | 50,002 |

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| | | |
|---------------------------------------------------------------------------------------|--------------|--------------|
| Tier 1 capital | \$ 219,376 | \$ 215,024 |
| Adjusted average total assets (for leverage capital purposes) | \$ 2,922,244 | \$ 2,816,491 |
| Tier 1 leverage ratio (Tier 1 capital to adjusted average total assets) | 7.51% | 7.63% |
| Total Tier 1 capital | \$ 219,376 | \$ 215,024 |
| Plus: Qualifying allowance for loan losses | 25,208 | 24,854 |
| Total risk-based capital | \$ 244,584 | \$ 239,878 |
| Net risk-weighted assets | \$ 2,014,730 | \$ 1,986,473 |
| Tier 1 capital ratio (Tier 1 capital to net risk-weighted assets) | 10.89% | 10.82% |
| Total risk-based capital ratio (Total risk-based capital to net risk-weighted assets) | 12.14% | 12.08% |

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Table of Contents**MANAGEMENT'S DISCUSSION AND ANALYSIS**

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

| | | Actual | | For Capital Adequacy Purposes | | Well Capitalized | |
|---------------------------|---------|------------|-------|-------------------------------|-------|------------------|-------|
| | | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| March 31, 2014 | | | | | | | |
| Tier 1 leverage: | Company | \$ 219,376 | 7.51% | \$ 116,890 | 4.00% | \$ 146,112 | 5.00% |
| | Bank | 207,938 | 7.12 | 116,871 | 4.00 | 146,088 | 5.00 |
| Tier 1 capital: | Company | 219,376 | 10.89 | 80,589 | 4.00 | 120,884 | 6.00 |
| | Bank | 207,938 | 10.33 | 80,530 | 4.00 | 120,795 | 6.00 |
| Total risk-based capital: | Company | 244,584 | 12.14 | 161,178 | 8.00 | 201,473 | 10.00 |
| | Bank | 233,128 | 11.58 | 161,059 | 8.00 | 201,324 | 10.00 |
| December 31, 2013 | | | | | | | |
| Tier 1 leverage: | Company | \$ 215,024 | 7.63% | \$ 112,660 | 4.00% | \$ 140,825 | 5.00% |
| | Bank | 204,336 | 7.27 | 112,498 | 4.00 | 140,622 | 5.00 |
| Tier 1 capital: | Company | 215,024 | 10.82 | 79,459 | 4.00 | 119,188 | 6.00 |
| | Bank | 204,336 | 10.31 | 79,291 | 4.00 | 118,937 | 6.00 |
| Total risk-based capital: | Company | 239,878 | 12.08 | 158,918 | 8.00 | 198,647 | 10.00 |
| | Bank | 229,139 | 11.56 | 158,583 | 8.00 | 198,228 | 10.00 |

The leverage ratio decreased as of March 31, 2014 when compared to December 31, 2013 as a result of an increase in average assets that more than offset the increase in Tier 1 capital.

Basel III Capital Rules

On July 2, 2013, the FRB approved the final rules implementing the Basel Committee on Banking Supervision's capital guidelines for U.S. banks. Under the final rules, minimum requirements will increase for both the quantity and quality of capital held by the Company. The rules include a new common equity Tier 1 capital to risk-weighted assets ratio of 4.5% and a common equity Tier 1 capital conservation buffer of 2.5% of risk-weighted assets. The final rules also raise the minimum ratio of Tier 1 capital to risk-weighted assets from 4.0% to 6.0% and require a minimum leverage ratio of 4.0%. Strict eligibility criteria for regulatory capital instruments were also implemented under the final rules. On July 9, 2013, the FDIC also approved, as an interim final rule, the regulatory capital requirements for U.S. banks, following the actions of the FRB. On April 8, 2014, the FDIC adopted as final its interim final rule, which is identical in substance to the final rules issued by the FRB in July 2013.

The phase-in period for the final rules will begin for the Company on January 1, 2015, with full compliance with all of the final rules' requirements phased in over a multi-year schedule. Management believes that the Company's capital levels will remain characterized as well-capitalized under the new rules. The final rules approved by the FRB and the FDIC in July 2013 and April 2014, respectively, did not address the proposed liquidity coverage ratio test and the net stable funding ratio test called for by the Basel III liquidity framework. Management will continue to monitor the developments related to these proposals and their potential impact to our capital requirements.

Dividend Restrictions

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

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Table of Contents**ITEM 3. Quantitative and Qualitative Disclosures About Market Risk**

Quantitative and qualitative disclosures about market risk were presented at December 31, 2013 in Item 7A of the Company's Annual Report on Form 10-K for the year ended December 31, 2013, as filed with the Securities and Exchange Commission on March 12, 2014. The following is an update of the discussion provided therein.

Portfolio Composition

There was no material change in the composition of assets, deposit liabilities or borrowings from December 31, 2013 to March 31, 2014. See the section titled "Analysis of Financial Condition" in Part I, Item 2, "Management's Discussion and Analysis of Financial Condition and Results of Operations" for a discussion of asset, deposit and borrowing activity during the period.

Net Interest Income at Risk

A primary tool used to manage interest rate risk is "rate shock" simulation to measure the rate sensitivity. Rate shock simulation is a modeling technique used to estimate the impact of changes in rates on net interest income as well as economic value of equity. At March 31, 2014, the Company was generally asset sensitive, meaning that, in most cases, net interest income tends to rise as interest rates rise and decline as interest rates fall.

Net interest income at risk is measured by estimating the changes in net interest income resulting from instantaneous and sustained parallel shifts in interest rates of different magnitudes over a period of 12 months. The following table sets forth the estimated changes to net interest income over the 12-month period ending March 31, 2015 assuming instantaneous changes in interest rates for the given rate shock scenarios (dollars in thousands):

| | Changes in Interest Rate | | | |
|-------------------------------|---------------------------------|--------------------|--------------------|--------------------|
| | -100 bp | +100 bp | +200 bp | +300 bp |
| Change in net interest income | \$ (997) | \$ 1,706 | \$ 3,953 | \$ 3,918 |
| % Change | (1.04)% | 1.79% | 4.14% | 4.10% |

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

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

Economic Value of Equity At Risk

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

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

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

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The analysis that follows presents the estimated EVE resulting from market interest rates prevailing at a given quarter-end (Pre-Shock Scenario), and under other interest rate scenarios (each a Rate Shock Scenario) represented by immediate, permanent, parallel shifts in interest rates from those observed at March 31, 2014 and December 31, 2013. The analysis additionally presents a measurement of the interest rate sensitivity at March 31, 2014 and December 31, 2013. EVE amounts are computed under each respective Pre- Shock Scenario and Rate Shock Scenario. An increase in the EVE amount is considered favorable, while a decline is considered unfavorable.

| | March 31, 2014 | | | December 31, 2013 | | |
|-----------------------------|----------------|----------|-------------------|-------------------|-----------|-------------------|
| | EVE | Change | Percentage Change | EVE | Change | Percentage Change |
| Rate Shock Scenario: | | | | | | |
| Pre-Shock Scenario | 474,170 | | | 466,008 | | |
| - 100 Basis Points | \$ 476,752 | \$ 2,582 | 0.54% | \$ 476,323 | \$ 10,315 | 2.21% |
| + 100 Basis Points | 463,790 | (10,380) | (2.19) | 452,155 | (13,853) | (2.97) |
| + 200 Basis Points | 449,743 | (24,427) | (5.15) | 435,424 | (30,584) | (6.56) |

The Pre-Shock Scenario EVE was \$474.2 million at March 31, 2014, compared to \$466.0 million at December 31, 2013. The increase in the Pre-Shock Scenario EVE at March 31, 2014, compared to December 31, 2013 resulted primarily from a more favorable valuation of non-maturity deposits, fixed-rate residential loans and mortgage backed securities that reflected alternative funding and investment rate changes used for discounting future cash flows.

The +200 basis point Rate Shock Scenario EVE increased from \$435.4 million at December 31, 2013 to \$449.7 million at March 31, 2014, reflecting the more favorable valuation of non-maturity deposits. The percentage change in the EVE amount from the Pre-Shock Scenario to the +200 basis point Rate Shock Scenario increased from (6.56)% at December 31, 2013 to (5.15)% at March 31, 2014. The decrease in sensitivity resulted from an increased benefit in the valuation of non-maturity deposits in the +200 basis point Rate Shock Scenario EVE as of March 31, 2014, compared to December 31, 2013.

ITEM 4. Controls and Procedures*Evaluation of disclosure controls and procedures*

As of March 31, 2014, the Company carried out an evaluation, under the supervision and with the participation of the Company's management, including the Company's Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures pursuant to Rule 13a-15(b), as adopted by the Securities and Exchange Commission (SEC) under the Securities Exchange Act of 1934 (Exchange Act). Based upon that evaluation, the Company's Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures were effective as of the end of the period covered by this report.

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

Changes in internal control over financial reporting

There were no changes in the Company's internal control over financial reporting that occurred during the quarter ended March 31, 2014 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

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Table of Contents**PART II. OTHER INFORMATION****ITEM 1. Legal Proceedings**

The Company has experienced no material developments in its legal proceedings from the disclosure included in the Company's Annual Report on Form 10-K for the year ended December 31, 2013, dated March 12, 2014, as filed with the Securities and Exchange Commission.

ITEM 1A. Risk Factors

The Company has experienced no material changes in its risk factors from the disclosure included in the Company's Annual Report on Form 10-K for the year ended December 31, 2013, dated March 12, 2014, as filed with the Securities and Exchange Commission.

ITEM 6. Exhibits

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

| Exhibit Number | Description | Location |
|-----------------------|------------------------------------------------------------------------------------------------------------------------|-----------------|
| 31.1 | Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 - Principal Executive Officer | Filed Herewith |
| 31.2 | Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 - Principal Financial Officer | Filed Herewith |
| 32 | Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 | Filed Herewith |
| 101.INS | XBRL Instance Document | |
| 101.SCH | XBRL Taxonomy Extension Schema Document | |
| 101.CAL | XBRL Taxonomy Extension Calculation Linkbase Document | |
| 101.LAB | XBRL Taxonomy Extension Label Linkbase Document | |
| 101.PRE | XBRL Taxonomy Extension Presentation Linkbase Document | |
| 101.DEF | XBRL Taxonomy Extension Definition Linkbase Document | |

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SIGNATURES

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

FINANCIAL INSTITUTIONS, INC.

/s/ Martin K. Birmingham , May 6, 2014
Martin K. Birmingham
President and Chief Executive Officer
(Principal Executive Officer)

/s/ Kevin B. Klotzbach , May 6, 2014
Kevin B. Klotzbach
Executive Vice President, Chief Financial Officer and
Treasurer
(Principal Financial Officer)

/s/ Michael D. Grover , May 6, 2014
Michael D. Grover
Senior Vice President and Chief Accounting Officer
(Principal Accounting Officer)