

FINANCIAL INSTITUTIONS INC

Form 10-Q

August 05, 2009

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

Form 10-Q

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

For the quarterly period ended June 30, 2009

or

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

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

Smaller reporting
company

(Do not check if a smaller
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 10,821,386 shares of Common Stock, \$0.01 par value, outstanding as of July 31, 2009.

FINANCIAL INSTITUTIONS, INC.
Form 10-Q
For the Quarterly Period Ended June 30, 2009
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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 (Unaudited)**

| <i>(Dollars in thousands, except share and per share data)</i> | June 30, 2009 | December 31, 2008 |
|---|--------------------------|------------------------------|
| ASSETS | | |
| Cash and cash equivalents: | | |
| Cash and due from banks | \$ 41,405 | \$ 34,528 |
| Federal funds sold and interest-bearing deposits in other banks | 39,910 | 20,659 |
| Total cash and cash equivalents | 81,315 | 55,187 |
| Securities available for sale, at fair value | 498,561 | 547,506 |
| Securities held to maturity, at amortized cost (fair value of \$48,211 and \$59,147, respectively) | 47,465 | 58,532 |
| Loans held for sale | 3,005 | 1,013 |
| Loans | 1,218,572 | 1,121,079 |
| Less: Allowance for loan losses | 20,614 | 18,749 |
| Loans, net | 1,197,958 | 1,102,330 |
| Company owned life insurance | 24,260 | 23,692 |
| Premises and equipment, net | 35,976 | 36,712 |
| Goodwill | 37,369 | 37,369 |
| Other assets | 70,815 | 54,578 |
| Total assets | \$ 1,996,724 | \$ 1,916,919 |
| LIABILITIES AND SHAREHOLDERS EQUITY | | |
| Deposits: | | |
| Noninterest-bearing demand | \$ 292,825 | \$ 292,586 |
| Interest-bearing demand | 357,443 | 344,616 |
| Savings and money market | 366,373 | 348,594 |
| Certificates of deposit | 683,619 | 647,467 |
| Total deposits | 1,700,260 | 1,633,263 |
| Short-term borrowings | 33,128 | 23,465 |
| Long-term borrowings | 46,849 | 47,355 |
| Other liabilities | 24,032 | 22,536 |
| Total liabilities | 1,804,269 | 1,726,619 |
| Shareholders equity: | | |
| Series A 3% Preferred Stock, \$100 par value, 1,533 shares authorized and issued | 153 | 153 |
| Series A Preferred Stock, \$100 par value, 7,503 shares authorized and issued, aggregate liquidation preference \$37,515; net of \$1,848 and \$2,016 discount, respectively | 35,667 | 35,499 |

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| | | |
|--|--------------|--------------|
| Series B-1 8.48% Preferred Stock, \$100 par value, 200,000 shares authorized, 174,223 shares issued | 17,422 | 17,422 |
| Total preferred equity | 53,242 | 53,074 |
| Common stock, \$0.01 par value, 50,000,000 shares authorized, 11,348,122 shares issued | 113 | 113 |
| Additional paid-in capital | 26,562 | 26,397 |
| Retained earnings | 126,542 | 124,952 |
| Accumulated other comprehensive loss | (4,184) | (4,013) |
| Treasury stock, at cost 526,736 and 550,103 shares, respectively | (9,820) | (10,223) |
| Total shareholders' equity | 192,455 | 190,300 |
| Total liabilities and shareholders' equity | \$ 1,996,724 | \$ 1,916,919 |

See accompanying notes to the consolidated financial statements.

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

| <i>(Dollars in thousands, except per share amounts)</i> | Three months ended | | Six months ended | |
|---|--------------------|-----------|------------------|-----------|
| | June 30, | | June 30, | |
| | 2009 | 2008 | 2009 | 2008 |
| Interest income: | | | | |
| Interest and fees on loans | \$ 17,847 | \$ 16,400 | \$ 34,906 | \$ 33,128 |
| Interest and dividends on investment securities | 5,429 | 7,942 | 11,436 | 16,176 |
| Other interest income | 26 | 194 | 53 | 504 |
| Total interest income | 23,302 | 24,536 | 46,395 | 49,808 |
| Interest expense: | | | | |
| Deposits | 4,888 | 7,419 | 9,903 | 16,655 |
| Short-term borrowings | 56 | 132 | 94 | 284 |
| Long-term borrowings | 713 | 798 | 1,426 | 1,597 |
| Total interest expense | 5,657 | 8,349 | 11,423 | 18,536 |
| Net interest income | 17,645 | 16,187 | 34,972 | 31,272 |
| Provision for loan losses | 2,088 | 1,358 | 3,994 | 2,074 |
| Net interest income after provision for loan losses | 15,557 | 14,829 | 30,978 | 29,198 |
| Noninterest income: | | | | |
| Service charges on deposits | 2,517 | 2,518 | 4,837 | 5,018 |
| ATM and debit card | 908 | 856 | 1,719 | 1,608 |
| Loan servicing | 470 | 232 | 727 | 418 |
| Company owned life insurance | 275 | 27 | 535 | 46 |
| Broker-dealer fees and commissions | 234 | 401 | 503 | 860 |
| Net gain on sale of loans held for sale | 246 | 92 | 416 | 256 |
| Net gain on investment securities | 1,153 | 47 | 1,207 | 220 |
| Impairment charges on investment securities | (1,733) | (3,791) | (1,783) | (3,791) |
| Net gain on sale of other assets | | 115 | 158 | 152 |
| Other | 445 | 435 | 887 | 889 |
| Total noninterest income | 4,515 | 932 | 9,206 | 5,676 |
| Noninterest expense: | | | | |
| Salaries and employee benefits | 8,437 | 8,169 | 17,168 | 16,605 |
| Occupancy and equipment | 2,683 | 2,567 | 5,559 | 5,147 |
| FDIC assessments | 1,593 | 88 | 2,273 | 133 |
| Professional services | 591 | 480 | 1,440 | 1,037 |
| Computer and data processing | 562 | 580 | 1,179 | 1,161 |
| Supplies and postage | 476 | 437 | 941 | 878 |
| Advertising and promotions | 249 | 283 | 423 | 433 |
| Other | 1,849 | 1,781 | 3,535 | 3,264 |

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| | | | | |
|--|----------|----------|----------|----------|
| Total noninterest expense | 16,440 | 14,385 | 32,518 | 28,658 |
| Income before income taxes | 3,632 | 1,376 | 7,666 | 6,216 |
| Income tax expense (benefit) | 1,004 | (255) | 2,071 | 806 |
| Net income | \$ 2,628 | \$ 1,631 | \$ 5,595 | \$ 5,410 |
| Preferred stock dividends, net of amortization | 925 | 370 | 1,843 | 741 |
| Net income available to common shareholders | \$ 1,703 | \$ 1,261 | \$ 3,752 | \$ 4,669 |
| Earnings per common share (Note 2): | | | | |
| Basic | \$ 0.16 | \$ 0.12 | \$ 0.35 | \$ 0.43 |
| Diluted | \$ 0.16 | \$ 0.12 | \$ 0.35 | \$ 0.43 |
| See accompanying notes to the consolidated financial statements. | | | | |

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
Consolidated Statement of Changes in Shareholders' Equity (Unaudited)

| <i>(Dollars in thousands, except per share data)</i> | Preferred Equity | Common Stock | Additional Paid-in Capital | Retained Earnings | Accumulated Other Comprehensive Loss | Treasury Stock | Total Shareholders' Equity |
|---|-----------------------------|-------------------------|---|------------------------------|---|---------------------------|---|
| Balance at January 1, 2009 | \$ 53,074 | \$ 113 | \$ 26,397 | \$ 124,952 | \$ (4,013) | \$ (10,223) | \$ 190,300 |
| Comprehensive income: | | | | | | | |
| Net income | | | | 5,595 | | | 5,595 |
| Other comprehensive income, net of tax | | | | | (171) | | (171) |
| Total comprehensive income | | | | | | | 5,424 |
| Issuance costs of Series A Preferred Stock | | | (68) | | | | (68) |
| Share-based compensation plans: | | | | | | | |
| Share-based compensation | | | 515 | | | | 515 |
| Restricted stock awards issued, net | | | (252) | | | 252 | |
| Directors' retainer | | | (30) | | | 151 | 121 |
| Accrued undeclared cumulative dividend on Series A Preferred Stock, net of amortization | 168 | | | (362) | | | (194) |
| Cash dividends declared: | | | | | | | |
| Series A 3% Preferred-\$1.50 per share | | | | (2) | | | (2) |
| Series A Preferred-\$98.61 per share | | | | (740) | | | (740) |
| Series B-1 8.48% Preferred-\$4.24 per share | | | | (739) | | | (739) |
| Common-\$0.20 per share | | | | (2,162) | | | (2,162) |
| Balance at June 30, 2009 | \$ 53,242 | \$ 113 | \$ 26,562 | \$ 126,542 | \$ (4,184) | \$ (9,820) | \$ 192,455 |

See accompanying notes to the consolidated financial statements.

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

| <i>(Dollars in thousands)</i> | Six months ended | |
|---|-------------------------|-------------|
| | June 30, | |
| | 2009 | 2008 |
| Cash flows from operating activities: | | |
| Net income | \$ 5,595 | \$ 5,410 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 2,034 | 1,955 |
| Net amortization of premiums and discounts on investment securities | 949 | 293 |
| Provision for loan losses | 3,994 | 2,074 |
| Amortization of unvested stock-based compensation | 515 | 552 |
| Deferred income tax expense (benefit) | 5,211 | (1,078) |
| Proceeds from sale of loans held for sale | 58,416 | 21,194 |
| Originations of loans held for sale | (59,992) | (20,958) |
| Increase in company owned life insurance | (535) | (46) |
| Net gain on investment securities | (1,207) | (220) |
| Impairment charge on investment securities | 1,783 | 3,791 |
| Net gain on sale of loans held for sale | (416) | (256) |
| Net gain on sale and disposal of other assets | (158) | (152) |
| (Increase) decrease in other assets | (4,629) | 458 |
| Increase (decrease) in other liabilities | 3,090 | (1,267) |
| Net cash provided by operating activities | 14,650 | 11,750 |
| Cash flows from investing activities: | | |
| Purchase of investment securities: | | |
| Available for sale | (214,940) | (255,479) |
| Held to maturity | (17,223) | (27,823) |
| Proceeds from principal payments, maturities and calls on investment securities: | | |
| Available for sale | 178,974 | 224,420 |
| Held to maturity | 26,501 | 30,902 |
| Proceeds from sale of securities available for sale | 82,198 | 47,545 |
| Net loan originations | (116,409) | (48,688) |
| Purchase of company owned life insurance | (33) | (66) |
| Proceeds from sales of other assets | 1,042 | 903 |
| Purchase of premises and equipment | (1,198) | (1,650) |
| Net cash used by investing activities | (61,088) | (29,936) |
| Cash flows from financing activities: | | |
| Net increase in deposits | 66,997 | 19,784 |
| Net increase in short-term borrowings | 9,663 | 26,334 |
| Repayment of long-term borrowings | (506) | (5,079) |
| Purchase of common stock | | (2,899) |
| Issuance of preferred and common shares | 53 | 112 |
| Stock options exercised | | 26 |
| Cash dividends paid to preferred shareholders | (1,481) | (741) |

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| | | |
|--|-----------|-----------|
| Cash dividends paid to common shareholders | (2,160) | (2,975) |
| Net cash provided by financing activities | 72,566 | 34,562 |
| Net increase in cash and cash equivalents | 26,128 | 16,376 |
| Cash and cash equivalents, beginning of period | 55,187 | 46,673 |
| Cash and cash equivalents, end of period | \$ 81,315 | \$ 63,049 |

See accompanying notes to the consolidated financial statements.

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

(1.) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**Nature of Operations**

Financial Institutions, Inc., a financial holding company organized under the laws of New York State, and its subsidiaries provide deposit, lending and other financial services to individuals and businesses in Central and Western New York. The Company owns all of the capital stock of Five Star Bank, a New York State-chartered bank, and Five Star Investment Services, Inc., a broker-dealer subsidiary offering noninsured investment products. The Company also owns 100% of FISIT Statutory Trust I (the Trust), which was formed in February 2001 for the purpose of issuing trust preferred securities. 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 in this Quarterly Report on Form 10-Q include the accounts of the Company and its subsidiaries. The Trust is not included in the consolidated financial statements of the Company. All significant intercompany accounts and transactions have been eliminated in consolidation. The accounting and reporting policies conform to general practices within the banking industry and to U.S. generally accepted accounting principles. Prior years consolidated financial statements are re-classified whenever necessary to conform to the current year presentation.

These financial statements have been prepared by the Company, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission. Certain information and footnote disclosures normally included in financial statements prepared in conformity with U.S. generally accepted accounting principles 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 to present fairly the consolidated balance sheet, statements of income, shareholders equity and cash flows for the periods indicated, and contain adequate disclosure to make the information presented not misleading. These consolidated financial statements should be read in conjunction with the Company's 2008 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.

Use of Estimates

The preparation of these financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates. Material estimates relate to the determination of the allowance for loan losses, assumptions used in the defined benefit pension plan accounting, the valuation of goodwill and deferred tax assets, and the valuation and other than temporary impairment considerations related to the securities portfolio.

Cash Flow Information

Supplemental cash flow information addressing certain cash payments and noncash investing and financing activities for each of the six months ended June 30, 2009 and 2008 was as follows (in thousands):

| | Six months ended | |
|--|-------------------------|-------------|
| | June 30, | |
| | 2009 | 2008 |
| Cash payments: | | |
| Interest | \$ 9,735 | \$ 19,422 |
| Income taxes | | 1,755 |
| Noncash investing and financing activities: | | |
| Real estate and other assets acquired in settlement of loans | \$ 804 | \$ 555 |
| Accrued and declared unpaid dividends | 1,692 | 2,013 |
| Increase in net unsettled security transactions | 18,336 | 3,618 |

Loans securitized

15,983

Recently Adopted Accounting Pronouncements

Earnings Per Share. On January 1, 2009, the Company adopted the provisions of Financial Accounting Standards Board (FASB) Staff Position (FSP) on Emerging Issues Task Force (EITF) Issue 03-6, *Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities* (FSP EITF 03-6-1). FSP EITF 03-6-1 states that unvested share-based payment awards that contain nonforfeitable rights to dividends or dividend equivalents (whether paid or unpaid) are participating securities and shall be included in the computation of earnings per common share (EPS) pursuant to the two-class method. FSP EITF 03-6-1 was effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those years. The adoption of FSP EITF 03-6-1 did not have a material impact on the Company's EPS calculations.

Table of Contents**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Unaudited)****(1.) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

Derivative Financial Instruments. On January 1, 2009, the Company adopted the provisions of SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities – an amendment of FASB Statement No. 133* (SFAS 161). The statement amended the disclosure requirements for derivative financial instruments and hedging activities. Expanded qualitative disclosures required under SFAS 161 include: (1) how and why an entity uses derivative financial instruments; (2) how derivative financial instruments and related hedged items are accounted for under SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, and related interpretations; and (3) how derivative financial instruments and related hedged items affect an entity’s financial position, financial performance, and cash flows. SFAS 161 also requires several added quantitative disclosures in financial statements. As SFAS 161 amended only the disclosure requirements for derivative financial instruments and hedged items, the adoption had no impact on the Company’s financial statements.

Fair Value Measurements and Impairment of Securities. On January 1, 2008, the Company adopted the provisions of Statement of Financial Accounting Standards (SFAS) No. 157, *Fair Value Measurements* (SFAS 157), for the Company’s financial assets and financial liabilities. In accordance with the provisions of FSP 157-2, *Effective Date of FASB Statement No. 157*, the Company deferred the effective date of SFAS 157 for the Company’s nonfinancial assets and nonfinancial liabilities, except for those items recognized or disclosed at fair value on an annual or more frequently recurring basis, until January 1, 2009. The adoption of the fair value measurement provisions of SFAS 157 for the Company’s nonfinancial assets and nonfinancial liabilities had no impact on the Company’s financial statements.

In April 2009, the FASB issued three final Staff Positions intended to provide additional application guidance and enhance disclosures regarding fair value measurements and impairments of securities. The three FSPs are as follows: FSP 157-4, *Determining Fair Value When the Volume and Level of Activity for the Assets or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly* (FSP SFAS 157-4), affirms that the objective of fair value when the market for an asset is not active is the price that would be received to sell the asset in an orderly transaction, and clarifies and includes additional factors for determining whether there has been a significant decrease in market activity for an asset when the market for that asset is not active. FSP SFAS 157-4 requires an entity to base its conclusion about whether a transaction was not orderly on the weight of the evidence. FSP SFAS 157-4 also amended SFAS 157, *Fair Value Measurements*, to expand certain disclosure requirements. The Company adopted the provisions of FSP SFAS 157-4 during the second quarter of 2009. Adoption of FSP SFAS 157-4 did not significantly impact the Company’s financial statements.

FSP 115-2 and FSP 124-2, *Recognition and Presentation of Other-than-temporary impairments* (FSP 115-2 and FSP 124-2), (i) changes existing guidance for determining whether an impairment is other than temporary to debt securities and (ii) replaces the existing requirement that the entity’s management assert it has both the intent and ability to hold an impaired security until recovery with a requirement that management assert: (a) it does not have the intent to sell the security; and (b) it is more likely than not it will not have to sell the security before recovery of its cost basis. Under FSP SFAS 115-2 and SFAS 124-2, 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. The amount of the impairment related to other factors is recognized in other comprehensive income. The Company adopted the provisions of FSP SFAS 115-2 and SFAS 124-2 during the second quarter of 2009 at which time management concluded that previously recorded impairment charges resulted from securities impaired due to reasons of credit quality. Adoption of FSP SFAS 115-2 and SFAS 124-2 did not significantly impact the Company’s financial statements.

FSP 107-1 and APB 28-1, *Interim Disclosures about Fair Value of Financial Instruments* (FSP 107-1 and APB 28-1), amends SFAS 107, *Disclosures about Fair Value of Financial Instruments*, to require an entity to provide disclosures about the fair value of financial instruments in interim financial information and amends Accounting Principles Board (APB) Opinion No. 28, *Interim Financial Reporting*, to require those disclosures in summarized financial information at interim reporting periods. The new interim disclosures required by FSP SFAS 107-1 and APB 28-1 are included in

Note 9, Fair Value Measurements.

Subsequent Events. In May 2009, the FASB issued SFAS No. 165, *Subsequent Events* (SFAS 165). SFAS 165 establishes general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued or available to be issued. SFAS 165 defines (i) the period after the balance sheet date during which a reporting entity's management should evaluate events or transactions that may occur for potential recognition or disclosure in the financial statements (ii) the circumstances under which an entity should recognize events or transactions occurring after the balance sheet date in its financial statements, and (iii) the disclosures an entity should make about events or transactions that occurred after the balance sheet date. SFAS 165 became effective for the Company's financial statements for periods ending after June 15, 2009. The adoption of SFAS 165 did not significantly impact the Company's financial statements. Subsequent events were evaluated through August 5, 2009, the date in which these financial statements were filed.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

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

Recently Issued Accounting Pronouncements not Yet Adopted

In June 2009, the FASB issued SFAS No. 166, *Accounting for Transfers of Financial Assets* (SFAS 166), and SFAS No.167, *Amendments to FASB Interpretation No. 46(R)* (SFAS 167), which change the way entities account for securitizations and special-purpose entities.

SFAS 166 amends SFAS 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, to enhance reporting about transfers of financial assets, including securitizations, and where companies have continuing exposure to the risks related to transferred financial assets. SFAS 166 eliminates the concept of a qualifying special-purpose entity and changes the requirements for derecognizing financial assets. SFAS 166 also requires additional disclosures about all continuing involvements with transferred financial assets including information about gains and losses resulting from transfers during the period. SFAS 166 will be effective January 1, 2010 and is not expected to have a significant impact on the Company's financial statements.

SFAS 167 amends FIN 46 (Revised December 2003), *Consolidation of Variable Interest Entities*, to change how a company determines when an entity that is insufficiently capitalized or is not controlled through voting (or similar rights) should be consolidated. The determination of whether a company is required to consolidate an entity is based on, among other things, an entity's purpose and design and a company's ability to direct the activities of the entity that most significantly impact the entity's economic performance. SFAS 167 requires additional disclosures about the reporting entity's involvement with variable-interest entities and any significant changes in risk exposure due to that involvement as well as its affect on the entity's financial statements. SFAS 167 will be effective January 1, 2010 and is not expected to have a significant impact on the Company's financial statements.

In June 2009, the FASB issued SFAS No. 168, *The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles - a replacement of FASB Statement No. 162* (SFAS 168). SFAS 168 establishes the FASB Accounting Standards Codification (the Codification) as the source of authoritative accounting principles recognized by the FASB to be applied by non-governmental entities in the preparation of financial statements in conformity with generally accepted accounting principles. Rules and interpretive releases of the SEC under authority of federal securities laws are also sources of authoritative guidance for SEC registrants. All guidance contained in the Codification carries an equal level of authority. All non-grandfathered, non-SEC accounting literature not included in the Codification is superseded and deemed non-authoritative. SFAS 168 will be effective for the Company's financial statements for periods ending after September 15, 2009. SFAS 168 is not expected have a significant impact on the Company's financial statements.

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

(2.) EARNINGS PER COMMON SHARE

The Company's restricted stock awards pay nonforfeitable common stock dividends and meet the criteria of a participating security pursuant to FSP EITF 03-6-1. Accordingly, EPS is calculated using the two-class method, under which earnings are allocated to both common shares and participating securities. This FSP requires retrospective application, thus basic and diluted earnings per share presented for the three and six month periods ended June 30, 2008 were calculated in accordance with this FSP. Neither basic nor diluted earnings per share for the three or six month periods ended June 30, 2008 changed from the adoption of this FSP.

The computation of basic and diluted EPS is presented in the following table (in thousands, except per share amounts).

| | Three months ended | | Six months ended | |
|--|---------------------------|-------------|-------------------------|-------------|
| | June 30, | | June 30, | |
| | 2009 | 2008 | 2009 | 2008 |
| Net income | \$ 2,628 | \$ 1,631 | \$ 5,595 | \$ 5,410 |
| Less: Preferred stock dividends and amortization of discount | 925 | 370 | 1,843 | 741 |
| Net income available to common shareholders | 1,703 | 1,261 | 3,752 | 4,669 |
| Less: Earnings (loss) allocated to participating securities | 5 | (3) | 15 | 14 |
| Earnings allocated to common shares outstanding | \$ 1,698 | \$ 1,264 | \$ 3,737 | \$ 4,655 |
| Weighted average common shares used to calculate basic EPS | 10,724 | 10,879 | 10,720 | 10,909 |
| Add: Effect of common stock equivalents | 42 | 49 | 36 | 42 |
| Weighted average common shares used to calculate diluted EPS | 10,766 | 10,928 | 10,756 | 10,951 |
| Earnings per common share: | | | | |
| Basic | \$ 0.16 | \$ 0.12 | \$ 0.35 | \$ 0.43 |
| Diluted | \$ 0.16 | \$ 0.12 | \$ 0.35 | \$ 0.43 |

The following securities were considered antidilutive and, therefore, were excluded from the computation of diluted EPS:

| | | | | |
|-------------------------|-----|-----|-----|-----|
| Stock options | 554 | 392 | 566 | 386 |
| Restricted stock awards | | | 20 | |
| Warrant | 378 | | 378 | |
| | 932 | 392 | 964 | 386 |

All shares of restricted stock are deducted from weighted average shares outstanding for the computation of basic EPS. Shares of restricted stock, stock options, and warrant are included in the calculation of diluted EPS using the

treasury stock method.

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

(3.) INVESTMENT SECURITIES

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

| | June 30, 2009 | | | |
|---|---------------------------|-----------------------------|------------------------------|-----------------------|
| | Amortized Cost | Unrealized Gains | Unrealized Losses | Fair Value |
| Securities available for sale: | | | | |
| U.S. Government agencies and government sponsored enterprises | \$ 93,858 | \$ 256 | \$ 297 | \$ 93,817 |
| State and political subdivisions | 92,627 | 2,573 | 10 | 95,190 |
| Mortgage-backed securities: | | | | |
| Federal National Mortgage Association | 119,439 | 2,281 | 522 | 121,198 |
| Federal Home Loan Mortgage Corporation | 65,944 | 1,107 | 134 | 66,917 |
| Government National Mortgage Association | 48,897 | 31 | 116 | 48,812 |
| Collateralized mortgage obligations: | | | | |
| Federal National Mortgage Association | 20,546 | 119 | 157 | 20,508 |
| Federal Home Loan Mortgage Corporation | 27,985 | 495 | 50 | 28,430 |
| Government National Mortgage Association | 661 | 17 | | 678 |
| Privately issued | 19,864 | 334 | 684 | 19,514 |
| Total collateralized mortgage obligations | 69,056 | 965 | 891 | 69,130 |
| Total mortgage-backed securities | 303,336 | 4,384 | 1,663 | 306,057 |
| Asset-backed securities | 3,716 | 393 | 612 | 3,497 |
| Total available for sale securities | \$ 493,537 | \$ 7,606 | \$ 2,582 | \$ 498,561 |
| Securities held to maturity: | | | | |
| State and political subdivisions | \$ 47,465 | \$ 887 | \$ 141 | \$ 48,211 |

| | December 31, 2008 | | | |
|---|---------------------------|-----------------------------|------------------------------|-----------------------|
| | Amortized Cost | Unrealized Gains | Unrealized Losses | Fair Value |
| Securities available for sale: | | | | |
| U.S. Government agencies and government sponsored enterprises | \$ 67,871 | \$ 609 | \$ 307 | \$ 68,173 |
| State and political subdivisions | 129,572 | 2,181 | 42 | 131,711 |
| Mortgage-backed securities: | | | | |
| Federal National Mortgage Association | 136,348 | 3,725 | 86 | 139,987 |
| Federal Home Loan Mortgage Corporation | 94,960 | 2,649 | 14 | 97,595 |
| Government National Mortgage Association | 1,926 | 17 | 25 | 1,918 |
| Collateralized mortgage obligations: | | | | |
| Federal National Mortgage Association | 17,856 | 74 | 642 | 17,288 |
| Federal Home Loan Mortgage Corporation | 44,838 | 334 | 214 | 44,958 |
| Government National Mortgage Association | 1,350 | 9 | | 1,359 |

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| | | | | |
|---|------------|----------|----------|------------|
| Privately issued | 42,296 | 5 | 2,854 | 39,447 |
| Total collateralized mortgage obligations | 106,340 | 422 | 3,710 | 103,052 |
| Total mortgage-backed securities | 339,574 | 6,813 | 3,835 | 342,552 |
| Asset-backed securities | 3,918 | | | 3,918 |
| Equity securities | 923 | 281 | 52 | 1,152 |
| Total available for sale securities | \$ 541,858 | \$ 9,884 | \$ 4,236 | \$ 547,506 |
| Securities held to maturity: | | | | |
| State and political subdivisions | \$ 58,532 | \$ 619 | \$ 4 | \$ 59,147 |

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

(3.) INVESTMENT SECURITIES (Continued)

Sales of securities available for sale were as follows:

| | Three months ended | | Six months ended | |
|-----------------------|---------------------------|-------------|-------------------------|-------------|
| | June 30, | | June 30, | |
| | 2009 | 2008 | 2009 | 2008 |
| Proceeds from sales | \$ 88,370 | \$ 14,109 | \$ 98,745 | \$ 47,545 |
| Gross realized gains | 2,558 | 50 | 2,973 | 223 |
| Gross realized losses | 1,405 | 3 | 1,766 | 3 |

The scheduled maturities of securities available for sale and securities held to maturity at June 30, 2009 are shown below. 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 | \$ 41,343 | \$ 41,803 |
| Due from one to five years | 145,221 | 148,436 |
| Due after five years through ten years | 82,092 | 83,076 |
| Due after ten years | 224,881 | 225,246 |
| | \$ 493,537 | \$ 498,561 |
| Debt securities held to maturity: | | |
| Due in one year or less | \$ 37,533 | \$ 37,589 |
| Due from one to five years | 7,587 | 8,017 |
| Due after five years through ten years | 1,809 | 1,991 |
| Due after ten years | 536 | 614 |
| | \$ 47,465 | \$ 48,211 |

The following tables show the investments gross unrealized losses and fair value, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position at June 30, 2009 and December 31, 2008 (in thousands).

| | June 30, 2009 | | | | Total | |
|---|----------------------------|------------------------------|----------------------------|------------------------------|-----------------------|------------------------------|
| | Less than 12 months | | 12 months or longer | | | |
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| Securities available for sale: | | | | | | |
| U.S. Government agencies and government sponsored enterprises | \$ 54,329 | \$ 44 | \$ 10,990 | \$ 253 | \$ 65,319 | \$ 297 |
| State and political subdivisions | 790 | 3 | 192 | 7 | 982 | 10 |
| Mortgage-backed securities: | | | | | | |
| Federal National Mortgage Association | 28,849 | 521 | 452 | 1 | 29,301 | 522 |
| Federal Home Loan Mortgage Corporation | 11,117 | 134 | | | 11,117 | 134 |

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| | | | | | | |
|--|-------------------|-----------------|------------------|-----------------|-------------------|-----------------|
| Government National Mortgage Association | 8,209 | 115 | 65 | 1 | 8,274 | 116 |
| Collateralized mortgage obligations: | | | | | | |
| Federal National Mortgage Association | 6,053 | 7 | 6,221 | 150 | 12,274 | 157 |
| Federal Home Loan Mortgage Corporation | 774 | 3 | 1,988 | 47 | 2,762 | 50 |
| Privately issued | | | 11,661 | 684 | 11,661 | 684 |
| Total collateralized mortgage obligations | 6,827 | 10 | 19,870 | 881 | 26,697 | 891 |
| Total mortgage-backed securities | 55,002 | 780 | 20,387 | 883 | 75,389 | 1,663 |
| Asset-backed securities | 1,927 | 612 | | | 1,927 | 612 |
| Total available for sale securities | 112,048 | 1,439 | 31,569 | 1,143 | 143,617 | 2,582 |
| Securities held to maturity: | | | | | | |
| State and political subdivisions | 6,481 | 141 | | | 6,481 | 141 |
| Total temporarily impaired securities | \$ 118,529 | \$ 1,580 | \$ 31,569 | \$ 1,143 | \$ 150,098 | \$ 2,723 |

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

(3.) INVESTMENT SECURITIES (Continued)

| | Less than 12 months | | December 31, 2008 12 months or longer | | Total | |
|---|---------------------|-------------------|--|-------------------|------------------|-------------------|
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| Securities available for sale: | | | | | | |
| U.S. Government agencies and government sponsored enterprises | \$ 50 | \$ 1 | \$ 11,704 | \$ 306 | \$ 11,754 | \$ 307 |
| State and political subdivisions | 6,191 | 41 | 84 | 1 | 6,275 | 42 |
| Mortgage-backed securities: | | | | | | |
| Federal National Mortgage Association | 10,432 | 65 | 484 | 21 | 10,916 | 86 |
| Federal Home Loan Mortgage Corporation | 5,533 | 14 | | | 5,533 | 14 |
| Government National Mortgage Association | 227 | 3 | 1,059 | 22 | 1,286 | 25 |
| Collateralized mortgage obligations: | | | | | | |
| Federal National Mortgage Association | 828 | 1 | 7,181 | 641 | 8,009 | 642 |
| Federal Home Loan Mortgage Corporation | | | 7,224 | 214 | 7,224 | 214 |
| Privately issued | 24,425 | 2,045 | 10,975 | 809 | 35,400 | 2,854 |
| Total collateralized mortgage obligations | 25,253 | 2,046 | 25,380 | 1,664 | 50,633 | 3,710 |
| Total mortgage-backed securities | 41,445 | 2,128 | 26,923 | 1,707 | 68,368 | 3,835 |
| Equity securities | 310 | 52 | | | 310 | 52 |
| Total available for sale securities | 47,996 | 2,222 | 38,711 | 2,014 | 86,707 | 4,236 |
| Securities held to maturity: | | | | | | |
| State and political subdivisions | 554 | 4 | | | 554 | 4 |
| Total temporarily impaired securities | \$ 48,550 | \$ 2,226 | \$ 38,711 | \$ 2,014 | \$ 87,261 | \$ 4,240 |

The Company reviews investment securities on an ongoing basis for the presence of other-than-temporary-impairment (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. The amount of the impairment related to other factors is recognized in other comprehensive income. Evaluating whether the impairment of a debt security is other than temporary involves assessing i.) the intent to sell the debt security or ii.) the likelihood of being required to sell the security before the recovery of its amortized cost basis. In determining whether the other-than-temporary impairment includes a credit loss, the Company uses its best estimate of the present value of cash flows expected to be collected from the debt security considering factors such as: a.) the length of time and the extent to which the fair value has been less than the amortized cost basis, b.) adverse conditions specifically related to the security, an industry, or a geographic area, c.) the historical and implied volatility of the fair value of the security, d.) the payment structure of the debt security and the likelihood of the issuer being able to make payments that increase in

the future, e.) failure of the issuer of the security to make scheduled interest or principal payments, f.) any changes to the rating of the security by a rating agency, and g.) recoveries or additional declines in fair value subsequent to the balance sheet date.

During the second quarter of 2009 the Company recorded OTTI charges totaling \$1.7 million on five privately issued whole loan collateralized mortgage obligations (CMOs) designated as impaired due to reasons of credit quality. The Company also determined that it intended to sell the securities prior to recovery of amortized cost basis. During the first quarter of 2009 the Company recorded an impairment charge of \$50 thousand related to a debt security in the available for sale portfolio considered to be other-than-temporarily impaired. Impairment charges totaling \$3.8 million were recorded on privately issued whole loan CMOs and pooled trust preferred securities during the three and six month periods ended June 30, 2008.

As of June 30, 2009, management has the ability and intent to hold the securities classified as held to maturity in the table above until they mature, at which time the Company expects to receive full value for the securities. Furthermore, as of June 30, 2009, management does not have the intent to sell any of the securities classified as available for sale in a loss position at June 30, 2009 and believes that it is more likely than not that the Company will not have to sell any such securities before a recovery of amortized cost. The unrealized losses are largely due to increases in market interest rates over the yields available at the time the underlying securities were purchased. The fair value is expected to recover as the bonds approach their maturity date or repricing date or if market yields for such investments decline. Management does not believe any of the securities are impaired due to reasons of credit quality. Accordingly, as of June 30, 2009, management has concluded that unrealized losses on its investment securities are temporary and no further impairment loss has been realized in the Company's consolidated statements of income.

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

(4.) LOANS

Loans outstanding, including net unearned income and net deferred fees and costs of \$14.9 million and \$12.3 million as of June 30, 2009 and December 31, 2008, respectively, are summarized as follows (in thousands):

| | June 30, 2009 | December 31, 2008 |
|---------------------------------|--------------------------|------------------------------|
| Commercial | \$ 198,608 | \$ 158,543 |
| Commercial real estate | 282,048 | 262,234 |
| Agricultural | 42,997 | 44,706 |
| Residential real estate | 149,926 | 177,683 |
| Consumer indirect | 319,735 | 255,054 |
| Consumer direct and home equity | 225,258 | 222,859 |
| | | |
| Total loans | 1,218,572 | 1,121,079 |
| Less: Allowance for loan losses | 20,614 | 18,749 |
| | | |
| Total loans, net | \$ 1,197,958 | \$ 1,102,330 |

(5.) GOODWILL AND OTHER INTANGIBLE ASSETS

The carrying amount of goodwill totaled \$37.4 million as of June 30, 2009 and December 31, 2008. In accordance with SFAS 142, the Company is required to test goodwill annually for impairment or more frequently if events and circumstances warrant.

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

(6.) COMPREHENSIVE INCOME

Presented below is a reconciliation of net income to comprehensive income including the components of other comprehensive income for the periods indicated (in thousands):

| | Six months ended June 30, | | | | | |
|---|----------------------------------|--------------------------------------|------------------------------|---------------------------|--------------------------------------|------------------------------|
| | 2009 | 2009 | 2008 | 2008 | 2008 | 2008 |
| | Pre-tax Amount | Tax Expense (Benefit) | Net-of-tax Amount | Pre-tax Amount | Tax Expense (Benefit) | Net-of-tax Amount |
| Securities available for sale: | | | | | | |
| Net unrealized losses arising during the period | \$ (1,200) | \$ (465) | \$ (735) | \$ (12,220) | \$ (4,728) | \$ (7,492) |
| Reclassification adjustments: | | | | | | |
| Realized net gains included in income | (1,207) | (467) | (740) | (220) | (85) | (135) |
| Impairment charges included in income | 1,783 | 690 | 1,093 | 3,791 | 1,467 | 2,324 |
| | (624) | (242) | (382) | (8,649) | (3,346) | (5,303) |
| Pension and post-retirement benefit liabilities | 345 | 134 | 211 | (23) | (9) | (14) |

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| | | | | | | | | | | |
|--------------------------|----|-------|----|-------|-------|-------|---------|----|---------|---------|
| Other comprehensive loss | \$ | (279) | \$ | (108) | (171) | \$ | (8,672) | \$ | (3,355) | (5,317) |
| Net income | | | | | 5,595 | | | | | 5,410 |
| Comprehensive income | | | | | \$ | 5,424 | | | \$ | 93 |

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

The components of accumulated other comprehensive loss, net of tax, for the periods indicated were as follows (in thousands):

| | June 30, 2009 | December 31, 2008 |
|--|--------------------------|------------------------------|
| Net unrealized gain on securities available for sale | \$ 3,081 | \$ 3,463 |
| Unfunded pension and post-retirement benefit liabilities | (7,265) | (7,476) |
| | \$ (4,184) | \$ (4,013) |

(7.) SHARE-BASED COMPENSATION PLANS

The Company maintains certain stock-based compensation plans, approved by the Company's shareholders that are administered by the Board, or the Compensation Committee of the Board. In addition, on May 6, 2009 the shareholders of the Company approved two share-based compensation plans, the 2009 Management Stock Incentive Plan (Management Plan) and the 2009 Directors' Stock Incentive Plan (Director's Plan). An aggregate of 690,000 shares has been reserved for issuance by the Company under the terms of the Management Plan pursuant to the grant of incentive stock options (not to exceed 500,000 shares), non-qualified stock options and restricted stock grants all which are defined in the Plan. An aggregate of 250,000 shares has been reserved for issuance by the Company under the terms of the Director's Plan pursuant to the grant of non-qualified stock options and restricted stock grants, all which are defined in the Plan.

The share-based compensation plans were established to allow for the granting of compensation awards to attract, motivate and retain employees, executive officers and non-employee directors who contribute to the success and profitability of the Company and to give such persons a proprietary interest in the Company, thereby enhancing their personal interest in the Company's success.

The share-based compensation expense associated with the amortization of unvested stock compensation included in the consolidated statements of income (unaudited) for the periods indicated (in thousands):

| | Three months ended June 30, | | Six months ended June 30, | |
|---------------------------------|--|-------------|--------------------------------------|-------------|
| | 2009 | 2008 | 2009 | 2008 |
| Stock options: | | | | |
| Management Stock Incentive Plan | \$ 48 | \$ 80 | \$ 122 | \$ 179 |
| Director Stock Incentive Plan | 12 | 9 | 23 | 16 |
| | 60 | 89 | 145 | 195 |
| Restricted stock awards: | | | | |
| Management Stock Incentive Plan | 140 | 138 | 302 | 357 |
| Director Stock Incentive Plan | 68 | | 68 | |
| | 208 | 138 | 370 | 357 |
| Total share-based compensation | \$ 268 | \$ 227 | \$ 515 | \$ 552 |

The Company awarded grants of 48,500 restricted shares to certain key officers during the six months ended June 30, 2009. The market price of the restricted shares on the date of grant was \$13.21. Both a performance requirement and a service requirement must be satisfied before the participant becomes vested in the shares. The performance period for

the awards is the Company's fiscal year ending on December 31, 2009. As a result of not satisfying certain performance requirements for the fiscal year ending December 31, 2008, 41,200 restricted shares granted in the first six months of 2008 were forfeited during the first six months of 2009. There was no reversal of restricted stock award expense required during the six months ended June 30, 2009, as the Company reduced share-based compensation expense related to the forfeited shares during 2008. During the six months ended June 30, 2009 the Company granted 8,000 restricted shares to directors, of which 4,000 shares vested immediately and 4,000 shares will vest after completion of a one-year service requirement. The market price of the restricted shares on the date of grant was \$14.86.

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

(8.) EMPLOYEE BENEFIT PLANS**Defined Benefit Pension Plan**

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

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

| | Three months ended | | Six months ended | |
|---|---------------------------|-------------|-------------------------|-------------|
| | June 30, | | June 30, | |
| | 2009 | 2008 | 2009 | 2008 |
| Service cost | \$ 422 | \$ 364 | \$ 844 | \$ 728 |
| Interest cost on projected benefit obligation | 456 | 390 | 913 | 780 |
| Expected return on plan assets | (462) | (523) | (924) | (1,046) |
| Amortization of unrecognized prior service cost | 3 | 3 | 6 | 6 |
| Amortization of unrecognized loss | 182 | | 364 | |
| Net periodic pension cost | \$ 601 | \$ 234 | \$ 1,203 | \$ 468 |

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 Internal Revenue Code. In April 2009, the Company made the minimum required contribution for fiscal year 2009 of \$1.6 million to the pension plan. The Company may make additional contributions to its pension plan in fiscal year 2009.

Defined Contribution Plan

Employees that meet certain age and service requirements are eligible to participate in the Company sponsored 401(k) plan. Under the plan, participants may make contributions, in the form of salary deferrals, up to the maximum Internal Revenue Code limit. The Company matches a participant's contributions up to 4.5% of compensation, calculated as 100% of the first 3% of compensation and 50% of the next 3% of compensation deferred by the participant. The Company may also make additional discretionary matching contributions, although no such additional discretionary contributions were made in 2009 or 2008. The expense included in salaries and employee benefits in the consolidated statements of income for this plan amounted to \$218 thousand and \$216 thousand for the three months ended June 30, 2009 and June 30, 2008, respectively. For the six months ended June 30, 2009 and June 30, 2008 the expense for the plan amounted to \$452 thousand and \$516 thousand, respectively.

Supplemental Executive Retirement Plans

During the third quarter of 2008 the Company established non-qualified supplemental executive retirement plans (SERPs) for two active executives. The Company has accrued a liability, all of which is unfunded, of \$798 thousand as of June 30, 2009, and recorded expense of \$249 thousand and \$489 thousand for the three and six month periods, respectively, ended June 30, 2009. There were no amounts recorded for these SERPs prior to the third quarter of 2008.

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

(9.) FAIR VALUE MEASUREMENTS**Valuation Hierarchy**

SFAS 157 defines fair value as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. For SFAS 157 disclosures, SFAS 157 establishes a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value into three levels.

Level 1 - Unadjusted quoted prices in active markets for assets or liabilities identical to those to be reported at fair value. An active market is a market in which transactions occur for the item to be fair valued with sufficient frequency and volume to provide pricing information on an ongoing basis. The Company's Level 1 assets primarily include exchange traded equity securities.

Level 2 - Inputs other than quoted prices included within Level 1 inputs that are observable for the asset or liability, either directly or indirectly. These inputs include: (a) quoted prices for similar assets or liabilities in active markets; (b) quoted prices for identical or similar assets or liabilities in markets that are not active, such as when there are few transactions for the asset or liability, the prices are not current, price quotations vary substantially over time or in which little information is released publicly; (c) inputs other than quoted prices that are observable for the asset or liability; and (d) inputs that are derived principally from or corroborated by observable market data by correlation or other means. The Company's Level 2 assets primarily include debt securities classified as available for sale and not included in Level 3.

Level 3 - Significant unobservable inputs for the asset or liability. These inputs should be used to determine fair value only when observable inputs are not available. Unobservable inputs should be developed based on the best information available in the circumstances, which might include internally generated data and assumptions being used to price the asset or liability. The Company's Level 3 assets primarily include pooled trust preferred securities.

Investment Securities. Fair values of equity securities are determined using public quotations, when available. Where quoted market prices are not available, fair values may be estimated based on dealer quotes, pricing models, discounted cash flow methodologies, or similar techniques for which the determination of fair value may require significant judgment or estimation. Fair values of public bonds and those private securities that are actively traded in the secondary market have been determined through the use of third-party pricing services using market observable inputs. Private placement securities and other securities where the Company does not receive a public quotation are valued by discounting the expected cash flows. Market rates used are applicable to the yield, credit quality and average maturity of each security. Private equity securities may also utilize internal valuation methodologies appropriate for the specific asset. Fair values might also be determined using broker quotes or through the use of internal models or analysis.

Financial Assets Measured at Fair Value on a Recurring Basis

The following table summarizes financial assets measured and recorded at fair value on a recurring basis as of June 30, 2009, segregated by the level of the valuation inputs within the fair value hierarchy utilized to measure fair value (in thousands):

| | Level 1 | Level 2 | Level 3 | Total |
|---|----------------|----------------|----------------|--------------|
| Securities available for sale: | | | | |
| U.S. Government agencies and government sponsored enterprises | \$ | \$ 93,817 | \$ | \$ 93,817 |
| State and political subdivisions | | 95,190 | | 95,190 |
| Mortgage-backed securities | | 306,057 | | 306,057 |
| Asset-backed securities: | | | | |
| Trust preferred securities | | | 2,837 | 2,837 |
| Other | | 322 | 338 | 660 |

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| | | | | |
|-------------------------------------|----|------------|----------|------------|
| Total available for sale securities | \$ | \$ 495,386 | \$ 3,175 | \$ 498,561 |
|-------------------------------------|----|------------|----------|------------|

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

(9.) FAIR VALUE MEASUREMENTS (Continued)

The following table presents changes in Level 3 available for sale securities measured at fair value on a recurring basis during the six months ended June 30, 2009 (in thousands):

| | |
|---|----------|
| Balance at December 31, 2008 | \$ 3,772 |
| Capitalized interest | 114 |
| Principal paydowns and amortization of premiums | (9) |
| Coupon payments applied to principal | (114) |
| Total losses (realized/unrealized): | |
| Included in earnings | |
| Included in other comprehensive income | (588) |
| Balance at June 30, 2009 | \$ 3,175 |

Financial Assets and Liabilities Measured at Fair Value on a Nonrecurring Basis

Certain financial assets and financial liabilities are measured at fair value on a nonrecurring basis; that is, the instruments are not measured at fair value on an ongoing basis but are subject to fair value adjustments in certain circumstances (for example, when there is evidence of impairment). Examples of these nonrecurring uses of fair value include: loans held for sale, mortgage servicing assets and collateral dependent impaired loans. As of June 30, 2009, the Company had no liabilities measured at fair value on a nonrecurring basis.

Loans held for sale are carried at the lower of cost or fair value. As of June 30, 2009, loans held for sale were reduced to their fair value of \$3.0 million by a \$46 thousand increase in their valuation allowance. Fair value is based on observable market rates for comparable loan products which is considered a level 2 fair value measurement.

Mortgage servicing rights (MSR) are carried at the lower of cost or fair value. Due primarily to a decline in the estimated prepayment speed of the Company's sold loan portfolio with servicing retained, the fair value of the Company's MSR increased during 2009. As a result of this increase, the Company reduced its corresponding valuation allowance by \$38 thousand during the first quarter of 2009 and an additional \$126 thousand during the second quarter of 2009. A valuation allowance of \$198 thousand existed as of June 30, 2009. The mortgage servicing rights are a Level 3 fair value measurement, as fair value is determined by calculating the present value of the future servicing cash flows from the underlying mortgage loans.

During the second quarter of 2009, certain impaired loans were remeasured and reported at fair value through a specific valuation allowance allocation of the allowance for loan losses based upon the fair value of the underlying collateral. Impaired loans with a carrying value of \$1.1 million were reduced by specific valuation allowance allocations totaling \$438 thousand to a total reported fair value of \$704 thousand. The collateral dependent impaired loans are a Level 2 fair measurement, as fair value is determined based upon estimates of the fair value of the collateral underlying the impaired loans typically using appraisals of comparable property or valuation guides.

Nonfinancial Assets and Nonfinancial Liabilities

Certain nonfinancial assets measured at fair value on a non-recurring basis include nonfinancial assets and nonfinancial liabilities measured at fair value in the second step of a goodwill impairment test, and intangible assets and other nonfinancial long-lived assets measured at fair value for impairment assessment. There were no nonfinancial assets or nonfinancial liabilities measured at fair value during the three or six month periods ended June 30, 2009.

Fair Value of Financial Instruments

SFAS 107, *Disclosures about Fair Value of Financial Instruments*, as amended, requires disclosure of the fair value of financial assets and financial liabilities, including those financial assets and financial liabilities that are not measured and reported at fair value on a recurring basis or non-recurring basis.

The following discussion describes the valuation methodologies used for assets and liabilities measured or disclosed at fair value. The techniques utilized in estimating the fair values of financial instruments are reliant on the assumptions

used, including discount rates and estimates of the amount and timing of future cash flows. 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.

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

(9.) FAIR VALUE MEASUREMENTS (Continued)

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.

The estimated fair value approximates carrying value for cash and cash equivalents, Federal Home Loan Bank (FHLB) and Federal Reserve Bank (FRB) stock, company owned life insurance, accrued interest receivable, short-term borrowings and accrued interest payable. Fair value estimates for other financial instruments are discussed below.

Loans held for sale. The fair value is based on estimates, quoted market prices and investor commitments.

Loans. For variable rate loans that re-price frequently, fair value approximates carrying amount. The fair value for fixed rate loans is estimated through discounted cash flow analysis using interest rates currently being offered on loans with similar terms and credit quality. For criticized and classified loans, fair value is estimated by discounting expected cash flows at a rate commensurate with the risk associated with the estimated cash flows, or estimates of fair value discounts based on observable market information.

Deposits. The fair values for demand accounts, money market and savings deposits are equal to their carrying amounts. The fair values of certificates of deposit are estimated using a discounted cash flow approach that applies prevailing market interest rates for similar maturity instruments.

Long-term borrowings (excluding junior subordinated debentures). The fair value for long-term borrowings is estimated using a discounted cash flow approach that applies prevailing market interest rates for similar maturity instruments.

Junior subordinated debentures. The fair value for the junior subordinated debentures is estimated using a discounted cash flow approach that applies prevailing market interest rates for similar maturity instruments.

The fair value of a financial instrument is the current amount that would be exchanged between willing parties, other than in a forced liquidation. Fair value is best determined based upon quoted market prices. However, in many instances, there are no quoted market prices for the Company's various financial instruments. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. Accordingly, the fair value estimates may not be realized in an immediate settlement of the instrument. The accounting guidelines exclude certain financial instruments and all non-financial instruments from its disclosure requirements. Accordingly, the aggregate fair value amounts presented at June 30, 2009 and December 31, 2008 may not necessarily represent the underlying fair value of the Company.

The estimated fair values of financial instruments were as follows:

| | June 30, 2009 | | December 31, 2008 | |
|-------------------------------|--------------------|----------------------------|--------------------|----------------------------|
| | Carrying Amount | Estimated Fair Value | Carrying Amount | Estimated Fair Value |
| Financial assets: | | | | |
| Cash and cash equivalents | \$ 81,315 | \$ 81,315 | \$ 55,187 | \$ 55,187 |
| Securities available for sale | 498,561 | 498,561 | 547,506 | 547,506 |
| Securities held to maturity | 47,465 | 48,211 | 58,532 | 59,147 |
| Loans held for sale | 3,005 | 3,005 | 1,013 | 1,032 |
| Loans | 1,197,958 | 1,257,984 | 1,102,330 | 1,169,660 |
| Company owned life insurance | 24,260 | 24,260 | 23,692 | 23,692 |
| Accrued interest receivable | 7,336 | 7,336 | 7,556 | 7,556 |

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| | | | | |
|---|-----------|-----------|---------|---------|
| FHLB and FRB stock | 6,735 | 6,735 | 6,035 | 6,035 |
| Financial liabilities: | | | | |
| Demand, savings and money market deposits | 1,016,641 | 1,016,641 | 985,796 | 985,796 |
| Time deposits | 683,619 | 689,880 | 647,467 | 654,334 |
| Short-term borrowings | 33,128 | 33,128 | 23,465 | 23,465 |
| Long-term borrowings (excluding junior subordinated debentures) | 30,147 | 31,188 | 30,653 | 32,005 |
| Junior subordinated debentures | 16,702 | 12,213 | 16,702 | 12,232 |
| Accrued interest payable | 8,730 | 8,730 | 7,041 | 7,041 |

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

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

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

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

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

changes in financial market conditions, either internationally, nationally or locally in areas in which the Company conducts its operations, including without limitation, reduced rates of business formation and growth, commercial and residential real estate development and real estate prices;

fluctuations in markets for equity, fixed-income, commercial paper and other securities, including availability, market liquidity levels, and pricing;

changes in interest rates, the quality and composition of the loan and securities portfolios, demand for loan products, deposit flows and competition;

changes in fiscal, monetary, regulatory, trade and tax policies and laws, including policies of the U.S. Department of Treasury and the Federal Reserve Board;

the Company's participation or lack of participation in governmental programs implemented under the Emergency Economic Stabilization Act (EESA) and the American Recovery and Reinvestment Act (ARRA), including without limitation the Troubled Asset Relief Program (TARP), the Capital Purchase Program (CPP), and the Temporary Liquidity Guarantee Program (TLGP) and the impact of such programs and related regulations on the Company and on international, national, and local economic and financial markets and conditions;

changes in consumer spending and savings habits;

increased competitive challenges and expanding product and pricing pressures among financial institutions;

demand for financial services in the Company's market areas;

legislation or regulatory changes which adversely affect the Company's operations or business, including the Obama Administration's regulatory reform proposals concerning the financial services sector released on June 17, 2009;

the Company's ability to comply with applicable laws and regulations, including restrictions on dividend payments;

changes in accounting policies or procedures as may be required by the Financial Accounting Standards Board or regulatory agencies;

increased costs of deposit insurance and changes with respect to Federal Deposit Insurance Corporation (FDIC) insurance coverage levels; and

declines in the market value of the Company's publicly traded stock price or declines in the Company's ability to generate future cash flows may increase the potential that goodwill recorded on the Company's consolidated statement of financial position be designated as impaired and that the Company may incur a goodwill write-down in the future.

The Company cautions readers not to place undue reliance on any forward-looking statements, which speak only as of the date made, and advises readers that various factors, including those described above, could affect the Company's financial performance and could cause the Company's actual results or circumstances for future periods to differ

materially from those anticipated or projected.

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

Table of Contents**APPLICATION OF CRITICAL ACCOUNTING POLICIES AND ACCOUNTING ESTIMATES**

The Company's consolidated financial statements are prepared in accordance with U.S. generally accepted accounting principles and are consistent with predominant practices in the banking industry. Application of critical accounting policies, which are those policies that management believes are the most important to the Company's financial position and results, requires management to make estimates, assumptions, and judgments that affect the amounts reported in the consolidated financial statements and accompanying notes and are based on information available as of the date of the financial statements. Future changes in information may affect these estimates, assumptions and judgments, which, in turn, may affect amounts reported in the financial statements.

The Company has numerous accounting policies, of which the most significant are presented in Note 1, Summary of Significant Accounting Policies, of the notes to consolidated financial statements included in the Company's 2008 Annual Report on Form 10-K. These policies, along with the disclosures presented in the other financial statement notes and in this discussion, provide information on how significant assets, liabilities, revenues and expenses are reported in the consolidated financial statements and how those reported amounts are determined. Based on the sensitivity of financial statement amounts to the methods, assumptions, and estimates underlying those amounts, management has determined that the accounting policies with respect to the allowance for loan losses, valuation of goodwill and deferred tax assets, the valuation of securities and determination of other-than-temporary impairment (OTTI), and accounting for defined benefit plans require particularly subjective or complex judgments important to the Company's financial position and results of operations, and, as such, are considered to be critical accounting policies. These estimates and assumptions are based on management's best estimates and judgment and are evaluated on an ongoing basis using historical experience and other factors, including the current economic environment. The Company adjusts these estimates and assumptions when facts and circumstances dictate. Illiquid credit markets and volatile equity have combined with declines in consumer spending to increase the uncertainty inherent in these estimates and assumptions. As future events cannot be determined with precision, actual results could differ significantly from the Company's estimates.

For additional information regarding critical accounting policies, refer to Note 1, Summary of Significant Accounting Policies, of the notes to consolidated financial statements and the section captioned "Critical Accounting Estimates" in Management's Discussion and Analysis of Financial Condition and Results of Operations included in the 2008 Annual Report on Form 10-K. There have been no material changes in the Company's application of critical accounting policies related to the allowance for loan losses, valuation of goodwill and deferred tax assets, the valuation of securities and determination of OTTI, and accounting for defined benefit plans since December 31, 2008.

OVERVIEW

The principal objective of this discussion is to provide an overview of the financial condition and results of operations of the Company for the periods covered in this quarterly report. Certain reclassifications have been made to make prior periods comparable. This discussion and tabular presentations should be read in conjunction with the accompanying consolidated financial statements and accompanying notes.

RESULTS OF OPERATIONS**Summary of Performance**

Net income was \$2.6 million for the second quarter of 2009 compared to \$1.6 million for the second quarter of 2008. Net income available to common shareholders for the second quarter of 2009 was \$1.7 million, or \$0.16 per diluted share, compared with \$1.3 million, or \$0.12 per diluted share, for the second quarter of last year. Net income for the six months ended June 30, 2009 totaled \$5.6 million compared to \$5.4 million for the same period in 2008. For the first six months of 2009 net income available to common shareholders was \$3.8 million, or \$0.35 per diluted share, compared with \$4.7 million, or \$0.43 per diluted share, for the first six months of 2008.

Net income increased \$1.0 million, or 61%, for the three months ended June 30, 2009 and increased \$185 thousand, or 3%, for the six months ended June 30, 2009 compared to the same periods in 2008. The increase for the three months ended June 30, 2009 was primarily the result of a \$1.5 million increase in net interest income and a \$3.6 million increase in noninterest income partly offset by a \$730 thousand increase in the provision for loan losses, a \$2.1 million increase in noninterest expense and a \$1.3 million increase in income tax expense. The increase in net income during the six months ended June 30, 2009 was primarily the result of a \$3.7 million increase in net interest income and a

\$3.5 million increase in noninterest income partly offset by a \$1.9 million increase in the provision for loan losses, a \$3.9 million increase in noninterest expense and a \$1.3 million increase in income tax expense.

Details of the changes in the various components of net income are further discussed in the sections that follow.

Table of Contents**Net Interest Income**

Net interest income was \$17.6 million for the second quarter of 2009, compared to \$16.2 million for second quarter of 2008. For the six months ended June 30, 2009, net interest income was \$35.0 million compared to \$31.3 million for the same period in 2008. The increases for both periods resulted primarily from favorable changes in the mix and repricing of our earning assets and decreases in both the prime interest rate and the federal funds rate during the last nine months of 2008.

Net interest income increased \$1.5 million, or 9%, when comparing the second quarter of 2009 to that of 2008. For the second quarter of 2009, average loans and securities represented 65% and 32%, respectively, of average earning assets compared to 56% and 42% in the second quarter of 2008. The tax equivalent net interest margin increased by 7 basis points to 4.01% for the second quarter of 2009 compared to 3.94% for the second quarter of 2008. A decrease of \$1.2 million, or 5%, in total interest income was surpassed by a decrease of \$2.7 million, or 32%, in total interest expense.

Interest on investment securities and interest-earning deposits was \$5.5 million for the second quarter of 2009, compared to \$8.1 million for the second quarter of 2008. The average balance of investment securities was \$593.7 million with an average tax equivalent yield of 4.16% for the second quarter of 2009, compared to an average balance of \$744.6 million with an average yield of 4.92% for the second quarter of 2008. The decrease in yield is primarily due to lower market interest rates, coupled with less risk and shorter average maturities in the investment securities.

Interest on loans was \$17.8 million for second quarter of 2009, compared to \$16.4 million for the second quarter of 2008. The average balance of loans was \$1.193 billion with an average yield of 5.99% for the second quarter of 2009 compared to an average balance of \$990.1 million with an average yield of 6.65% for the second quarter of 2008. Average commercial loans in 2009 increased \$61.8 million, as compared to 2008 primarily due to continued strong growth in our commercial loan portfolio. The average balance of consumer indirect loans, comprised almost entirely of automobile loans, increased \$144.4 million for the second quarter of 2009 over the corresponding quarter last year. This 92% increase in volume was primarily responsible for the \$2.4 million increase in interest income on consumer indirect loans when comparing the second quarter of 2009 to that of 2008.

Interest on deposits was \$4.9 million for the second quarter of 2009, compared to \$7.4 million for the second quarter of 2008. The average balance of interest-bearing deposits was \$1.436 billion with an average cost of 1.37% for the second quarter of 2009 compared to an average balance of \$1.337 billion with an average cost of 2.23% for the second quarter of 2008. The average balance of noninterest-bearing deposits increased to \$286.2 million or 4% during the second quarter of this year compared to the same quarter last year. The increase in the balance of total deposits is due to a 12% increase in public and 5% increase in nonpublic deposits, while the decrease in average cost is due primarily to the beneficial repricing of certificates of deposits, and to a lesser extent savings and money market accounts, at lower interest rates. The declines in interest and average cost on borrowed funds from last year's second quarter to this year's second quarter are due to reductions in market interest rates.

Net interest income increased \$3.7 million, or 12%, during the six months ended June 30, 2009 compared to the same period in 2008. For the six months ended June 30, 2009, average loans and securities represented 64% and 33%, respectively, of average earning assets compared to 55% and 42% for the same period in 2008. The tax equivalent net interest margin increased by 22 basis points to 4.05% for the first six months of 2009 compared to 3.83% for the same period in 2008. A decrease of \$3.4 million, or 7%, in total interest income was surpassed by a decrease of \$7.1 million, or 38%, in total interest expense.

Interest on investment securities and interest-earning deposits was \$11.5 million for the six months ended June 30, 2009, compared to \$16.7 million for the same period in 2008. The average balance of investment securities was \$597.4 million with an average tax equivalent yield of 4.35% for the six months ended June 30, 2009 compared to an average balance of \$749.2 million with an average yield of 4.98% for the same period in 2008. The decrease in yield is primarily due to lower market interest rates and less tax-exempt interest income.

Interest on loans was \$34.9 million for first six months of 2009, compared to \$33.1 million for the first six months of 2008. The average balance of loans was \$1.167 billion with an average yield of 6.02% for the six month period ended June 30, 2009 compared to an average balance of \$977.3 million with an average yield of 6.80% for the same period

in 2008. Average commercial loans in 2009 increased \$54.1 million, as compared to 2008 primarily due to strong growth in our commercial loan portfolio. The average balance of consumer indirect loans, comprised almost entirely of automobile loans, increased \$137.1 million for the first six months of 2009 over the corresponding period last year. This 93% increase in volume was primarily responsible for the \$4.6 million increase in interest income on consumer indirect loans when comparing the six months ended June 30, 2009 to the same period in 2008.

Interest on deposits was \$9.9 million for the six month period ended June 30, 2009, compared to \$16.7 million for the same period in 2008. The average balance of interest-bearing deposits was \$1.418 billion with an average cost of 1.41% for the six month period ended June 30, 2009 compared to an average balance of \$1.339 billion with an average cost of 2.50% for the same period in 2008. The average balance of noninterest-bearing deposits increased to \$283.9 million or 5% during the first six months of this year compared to the same period last year. The increase in the balance of total deposits is due to a 4% increase in public and a 7% increase in nonpublic deposits, while the decrease in average cost is due primarily to the beneficial repricing of certificates of deposits, and to a lesser extent savings and money market accounts, at lower interest rates.

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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 June 30, | | | | | |
|--|-----------------------------|----------|-----------------|--------------------|----------|-----------------|
| | 2009 | | | 2008 | | |
| | Average Balance | Interest | Average Rate | Average Balance | Interest | Average Rate |
| Interest-earning assets: | | | | | | |
| Federal funds sold and interest-earning deposits | \$ 49,105 | \$ 26 | 0.21% | \$ 35,733 | \$ 194 | 2.18% |
| Investment securities ⁽¹⁾ : | | | | | | |
| Taxable | 420,952 | 3,970 | 3.77 | 491,541 | 5,411 | 4.40 |
| Tax-exempt ⁽²⁾ | 172,788 | 2,210 | 5.11 | 253,107 | 3,745 | 5.92 |
| Total investment securities | 593,740 | 6,180 | 4.16 | 744,648 | 9,156 | 4.92 |
| Loans held for sale | 2,565 | 31 | 4.71 | 1,289 | 20 | 6.12 |
| Loans: | | | | | | |
| Commercial | 183,733 | 2,108 | 4.60 | 146,778 | 2,285 | 6.26 |
| Commercial real estate | 275,275 | 4,395 | 6.40 | 248,290 | 4,270 | 6.92 |
| Agricultural | 42,368 | 586 | 5.54 | 44,504 | 754 | 6.82 |
| Residential real estate | 168,300 | 2,518 | 5.98 | 169,925 | 2,683 | 6.31 |
| Consumer indirect | 301,112 | 5,240 | 6.98 | 156,728 | 2,800 | 7.19 |
| Consumer direct and home equity | 222,122 | 2,969 | 5.36 | 223,906 | 3,588 | 6.44 |
| Total loans | 1,192,910 | 17,816 | 5.99 | 990,131 | 16,380 | 6.65 |
| Total interest-earning assets | 1,838,320 | 24,053 | 5.24 | 1,771,801 | 25,750 | 5.83 |
| Allowance for loan losses | (20,272) | | | (15,649) | | |
| Other noninterest-earning assets | 194,289 | | | 141,362 | | |
| Total assets | \$ 2,012,337 | | | \$ 1,897,514 | | |
| Interest-bearing liabilities: | | | | | | |
| Deposits: | | | | | | |
| Interest-bearing demand | \$ 366,985 | \$ 186 | 0.20% | \$ 342,463 | \$ 761 | 0.89% |
| Savings and money market | 392,355 | 263 | 0.27 | 378,799 | 957 | 1.02 |
| Certificates of deposit | 676,221 | 4,439 | 2.63 | 615,950 | 5,701 | 3.72 |
| Total interest-bearing deposits | 1,435,561 | 4,888 | 1.37 | 1,337,212 | 7,419 | 2.23 |
| Short-term borrowings | 31,903 | 56 | 0.71 | 31,739 | 132 | 1.67 |
| Long-term borrowings | 46,860 | 713 | 6.08 | 42,163 | 798 | 7.56 |
| Total interest-bearing liabilities | 1,514,324 | 5,657 | 1.50 | 1,411,114 | 8,349 | 2.38 |
| Noninterest-bearing demand deposits | 286,155 | | | 275,570 | | |
| Other noninterest-bearing liabilities | 19,412 | | | 15,527 | | |

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| | | |
|--|--------------|--------------|
| Shareholders' equity | 192,446 | 195,303 |
| Total liabilities and shareholders' equity | \$ 2,012,337 | \$ 1,897,514 |
| Net interest income (tax-equivalent) | \$ 18,396 | \$ 17,401 |
| Interest rate spread | 3.74% | 3.45% |
| Net earning assets | \$ 323,996 | \$ 360,687 |
| Net interest margin (tax-equivalent) | 4.01% | 3.94% |
| Ratio of average interest-earning assets to average interest-bearing liabilities | 121.40% | 125.56% |

(1) Investment securities are shown at amortized cost.

(2) The interest on tax-exempt securities is calculated on a tax equivalent basis assuming a Federal tax rate of 34%.

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| | Six months ended June 30, | | | | | |
|--|---------------------------|----------|-----------------|--------------------|----------|-----------------|
| | 2009 | | | 2008 | | |
| | Average Balance | Interest | Average Rate | Average Balance | Interest | Average Rate |
| Interest-earning assets: | | | | | | |
| Federal funds sold and interest-earning deposits | \$ 46,376 | \$ 53 | 0.23% | \$ 38,270 | \$ 504 | 2.65% |
| Investment securities ⁽¹⁾ : | | | | | | |
| Taxable | 417,267 | 8,403 | 4.03 | 491,927 | 10,993 | 4.47 |
| Tax-exempt ⁽²⁾ | 180,182 | 4,594 | 5.10 | 257,309 | 7,673 | 5.97 |
| Total investment securities | 597,449 | 12,997 | 4.35 | 749,236 | 18,666 | 4.98 |
| Loans held for sale | 2,524 | 61 | 4.80 | 938 | 29 | 6.21 |
| Loans: | | | | | | |
| Commercial | 174,761 | 4,027 | 4.65 | 142,397 | 4,737 | 6.69 |
| Commercial real estate | 272,030 | 8,599 | 6.37 | 247,923 | 8,597 | 6.97 |
| Agricultural | 42,528 | 1,183 | 5.61 | 44,938 | 1,659 | 7.42 |
| Residential real estate | 171,462 | 5,177 | 6.04 | 168,304 | 5,350 | 6.36 |
| Consumer indirect | 284,329 | 9,799 | 6.95 | 147,242 | 5,189 | 7.09 |
| Consumer direct and home equity | 221,576 | 6,060 | 5.52 | 226,470 | 7,567 | 6.72 |
| Total loans | 1,166,686 | 34,845 | 6.02 | 977,274 | 33,099 | 6.80 |
| Total interest-earning assets | 1,813,035 | 47,956 | 5.32 | 1,765,718 | 52,298 | 5.94 |
| Allowance for loan losses | (19,738) | | | (15,590) | | |
| Other noninterest-earning assets | 194,888 | | | 144,066 | | |
| Total assets | \$ 1,988,185 | | | \$ 1,894,194 | | |
| Interest-bearing liabilities: | | | | | | |
| Deposits: | | | | | | |
| Interest-bearing demand | \$ 363,745 | \$ 410 | 0.23% | \$ 343,783 | \$ 1,878 | 1.10% |
| Savings and money market | 382,104 | 514 | 0.27 | 370,112 | 2,281 | 1.24 |
| Certificates of deposit | 672,153 | 8,979 | 2.69 | 624,774 | 12,496 | 4.02 |
| Total interest-bearing deposits | 1,418,002 | 9,903 | 1.41 | 1,338,669 | 16,655 | 2.50 |
| Short-term borrowings | 28,105 | 94 | 0.68 | 29,277 | 284 | 1.95 |
| Long-term borrowings | 46,979 | 1,426 | 6.07 | 42,342 | 1,597 | 7.54 |
| Total interest-bearing liabilities | 1,493,086 | 11,423 | 1.54 | 1,410,288 | 18,536 | 2.64 |
| Noninterest-bearing demand deposits | 283,935 | | | 271,446 | | |
| Other noninterest-bearing liabilities | 19,245 | | | 16,022 | | |
| Shareholders equity | 191,919 | | | 196,438 | | |
| Total liabilities and shareholders equity | \$ 1,988,185 | | | \$ 1,894,194 | | |

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| | | |
|---|------------|------------|
| Net interest income (tax-equivalent) | \$ 36,533 | \$ 33,762 |
| Interest rate spread | 3.78% | 3.30% |
| Net earning assets | \$ 319,949 | \$ 355,430 |
| Net interest margin (tax-equivalent) | 4.05% | 3.83% |
| Ratio of average interest-earning assets to average interest-bearing liabilities | 121.43% | 125.20% |

(1) Investment securities are shown at amortized cost.

(2) The interest on tax-exempt securities is calculated on a tax equivalent basis assuming a Federal tax rate of 34%.

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The following table provides a reconciliation between tax equivalent net interest income as presented in the average balance sheets above and net interest income in the consolidated financial statements filed herewith in Part I, Item 1, Financial Statements (in thousands).

| | Three months ended | | Six months ended | |
|--|---------------------------|-------------|-------------------------|-------------|
| | June 30, | | June 30, | |
| | 2009 | 2008 | 2009 | 2008 |
| Net interest income (tax equivalent) | \$ 18,396 | \$ 17,401 | \$ 36,533 | \$ 33,762 |
| Less: tax-exempt tax equivalent adjustment | 751 | 1,214 | 1,561 | 2,490 |
| Net interest income | \$ 17,645 | \$ 16,187 | \$ 34,972 | \$ 31,272 |

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):

| | Three months ended | | | Six months ended | | |
|--|--|---------------------|--------------------------------------|--|---------------------|--------------------------------------|
| | June 30, 2009 vs. 2008 | | | June 30, 2009 vs. 2008 | | |
| | Increase/(Decrease) | | Total Net Increase (Decrease) | Increase/(Decrease) | | Total Net Increase (Decrease) |
| | Due to Change in Average Volume | Average Rate | | Due to Change in Average Volume | Average Rate | |
| Interest-earning assets: | | | | | | |
| Federal funds sold and interest-earning deposits | \$ 54 | \$ (222) | \$ (168) | \$ 89 | \$ (540) | \$ (451) |
| Investment securities: | | | | | | |
| Taxable | (721) | (720) | (1,441) | (1,569) | (1,021) | (2,590) |
| Tax-exempt | (1,075) | (460) | (1,535) | (2,075) | (1,004) | (3,079) |
| Total investment securities | (1,694) | (1,282) | (2,976) | (3,487) | (2,182) | (5,669) |
| Loans held for sale | 16 | (5) | 11 | 39 | (7) | 32 |
| Loans: | | | | | | |
| Commercial | 501 | (678) | (177) | 936 | (1,646) | (710) |
| Commercial real estate | 444 | (319) | 125 | 797 | (795) | 2 |
| Agricultural | (35) | (133) | (168) | (85) | (391) | (476) |
| Residential real estate | (26) | (139) | (165) | 99 | (272) | (173) |
| Consumer indirect | 2,515 | (75) | 2,440 | 4,727 | (117) | 4,610 |
| Consumer direct and home equity | (29) | (590) | (619) | (161) | (1,346) | (1,507) |
| Total loans | 3,133 | (1,697) | 1,436 | 5,944 | (4,198) | 1,746 |
| | 940 | (2,637) | (1,697) | 1,371 | (5,713) | (4,342) |

Total
interest-earning
assets

**Interest-bearing
liabilities:**

Deposits:

| | | | | | | |
|--------------------------|-----|---------|---------|-----|---------|---------|
| Interest-bearing demand | 50 | (625) | (575) | 103 | (1,571) | (1,468) |
| Savings and money market | 33 | (727) | (694) | 72 | (1,839) | (1,767) |
| Certificates of deposit | 517 | (1,779) | (1,262) | 889 | (4,406) | (3,517) |

| | | | | | | |
|---------------------------------|-----|---------|---------|-----|---------|---------|
| Total interest-bearing deposits | 512 | (3,043) | (2,531) | 935 | (7,687) | (6,752) |
|---------------------------------|-----|---------|---------|-----|---------|---------|

| | | | | | | |
|-----------------------|---|------|------|------|-------|-------|
| Short-term borrowings | 1 | (77) | (76) | (11) | (179) | (190) |
|-----------------------|---|------|------|------|-------|-------|

| | | | | | | |
|----------------------|----|-------|------|-----|-------|-------|
| Long-term borrowings | 82 | (167) | (85) | 163 | (334) | (171) |
|----------------------|----|-------|------|-----|-------|-------|

| | | | | | | |
|------------------------------------|-----|---------|---------|-------|---------|---------|
| Total interest-bearing liabilities | 574 | (3,266) | (2,692) | 1,032 | (8,145) | (7,113) |
|------------------------------------|-----|---------|---------|-------|---------|---------|

| | | | | | | |
|-------------------------------|--------|--------|--------|--------|----------|----------|
| Change in net interest income | \$ 366 | \$ 629 | \$ 995 | \$ 339 | \$ 2,432 | \$ 2,771 |
|-------------------------------|--------|--------|--------|--------|----------|----------|

Provision for Loan Losses

The provision for loan losses is based upon credit loss experience, growth or contraction of specific segments of the loan portfolio, and the estimate of losses inherent in the current loan portfolio. The provision for loan losses was \$2.1 million and \$4.0 million for the three and six months ended June 30, 2009, respectively, compared with \$1.4 million and \$2.1 million for the same periods in 2008, respectively. The increases were primarily due to the increased size of our lending portfolio and increased nonaccrual loans. See Non-Performing Assets and Allowance for Loan Losses included herein for additional information.

Table of Contents**Noninterest Income**

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

| | Three months ended | | Six months ended | |
|---|--------------------|----------|------------------|----------|
| | June 30, | | June 30, | |
| | 2009 | 2008 | 2009 | 2008 |
| Noninterest income: | | | | |
| Service charges on deposits | \$ 2,517 | \$ 2,518 | \$ 4,837 | \$ 5,018 |
| ATM and debit card | 908 | 856 | 1,719 | 1,608 |
| Loan servicing | 470 | 232 | 727 | 418 |
| Company owned life insurance | 275 | 27 | 535 | 46 |
| Broker-dealer fees and commissions | 234 | 401 | 503 | 860 |
| Net gain on sale of loans held for sale | 246 | 92 | 416 | 256 |
| Net gain on investment securities | 1,153 | 47 | 1,207 | 220 |
| Impairment charges on investment securities | (1,733) | (3,791) | (1,783) | (3,791) |
| Net gain on sale of other assets | | 115 | 158 | 152 |
| Other | 445 | 435 | 887 | 889 |
| Total noninterest income | \$ 4,515 | \$ 932 | \$ 9,206 | \$ 5,676 |

The components of noninterest income fluctuated as discussed below.

Loan servicing income represents fees earned for servicing mortgage loans sold to third parties, net of amortization expense and impairment losses, if any, associated with capitalized mortgage servicing assets. Loan servicing income increased in the three and six month periods ended June 30, 2009 compared to the same periods a year ago, mainly from an increase in the sold and serviced residential real estate portfolio and a recovery in the fair value of capitalized mortgage servicing assets.

The Company invested \$20.0 million in company owned life insurance during the third quarter of 2008, resulting in the \$248 thousand and \$489 thousand increase in income during the three and six month periods ended June 30, 2009, respectively, compared to the same periods in 2008.

Broker-dealer fees and commissions were down \$167 thousand, or 42%, and \$357 thousand, or 42%, in the three and six month months ended June 30, 2009 compared to the same periods a year ago. Broker-dealer fees and commissions fluctuate mainly due to sales volume, which has declined during 2009 as a result of current market and economic conditions.

The \$1.2 million net gain on sale of investment securities for the second quarter of 2009 is comprised of \$2.6 million in gross gains on sales of securities issued by U.S. government sponsored agencies and \$1.4 million in gross losses on sales of privately issued whole loan CMOs.

Impairment charges on investment securities included a \$1.7 million valuation write-down on privately issued whole loan collateralized mortgage obligations (CMOs) in the second quarter of 2009 and \$3.8 million on privately issued whole loan CMOs and pooled trust preferred securities in the second quarter of 2008. See Investing Activities herein for additional information.

Table of Contents**Noninterest Expense**

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

| | Three months ended June 30, | | Six months ended June 30, | |
|--------------------------------|--------------------------------|-----------|------------------------------|-----------|
| | 2009 | 2008 | 2009 | 2008 |
| Noninterest expense: | | | | |
| Salaries and employee benefits | \$ 8,437 | \$ 8,169 | \$ 17,168 | \$ 16,605 |
| Occupancy and equipment | 2,683 | 2,567 | 5,559 | 5,147 |
| FDIC assessments | 1,593 | 88 | 2,273 | 133 |
| Professional services | 591 | 480 | 1,440 | 1,037 |
| Computer and data processing | 562 | 580 | 1,179 | 1,161 |
| Supplies and postage | 476 | 437 | 941 | 878 |
| Advertising and promotions | 249 | 283 | 423 | 433 |
| Other | 1,849 | 1,781 | 3,535 | 3,264 |
| Total noninterest expense | \$ 16,440 | \$ 14,385 | \$ 32,518 | \$ 28,658 |

The components of noninterest expense fluctuated as discussed below.

Salaries and benefits for both the three and six periods of 2009 increased over the comparable 2008 periods despite reductions in the number of full-time equivalent employees (FTEs). For both comparative periods, reduced salaries and wages expense was offset by increases in employee benefit costs, due largely to higher retirement plan expense.

The Company experienced increases of 5% and 8% in occupancy and equipment expense in the three and six month periods ended June 30, 2009, compared to the same periods a year ago. Additional expenses related to the opening of two new branches at the end of 2008, combined with increased software maintenance costs were responsible for the increases.

FDIC assessments, comprised mostly of deposit insurance paid to the FDIC, increased by \$1.5 million from \$88 thousand for the three months ended June 30, 2008 to \$1.6 million for the three months ended June 30, 2009. Similarly, FDIC assessments increased by \$2.1 million from \$133 thousand for the six months ended June 30, 2008 to \$2.3 million for the six months ended June 30, 2009. The increase resulted from a combination of an increase in deposit levels subject to insurance premiums and higher FDIC insurance premium rates during the 2009 periods, coupled with utilization of approximately \$367 thousand in carryforward credits that reduced expense during the six month 2008 period. In addition, the 2009 amounts include a \$923 thousand special assessment.

Professional services increased \$111 thousand and \$403 thousand in the three and six month periods ended June 30, 2009, compared to the same periods a year ago. The Company has incurred higher expenses associated with loan workouts and consulting services during 2009.

The efficiency ratio for the second quarter of 2009 was 69.49% compared with 64.21% for the second quarter of 2008, and 69.60% for the six months ended June 30, 2009, compared to 65.88% for the same period a year ago. The 2009 efficiency ratios, compared to 2008, reflect higher levels of noninterest expense, primarily FDIC assessments, partially offset by increases in net interest income. The efficiency ratio equals noninterest expense less other real estate expense and amortization of intangible assets as a percentage of net revenue, defined as the sum of tax-equivalent net interest income and noninterest income before net gains and impairment charges on investment securities.

Income Taxes

The Company recorded income tax expense of \$1.0 million in the second quarter of 2009, compared to an income tax benefit of \$255 thousand in the second quarter of 2008. For the six month period ended June 30, 2009, income tax expense totaled \$2.1 million compared to \$806 thousand in the same period of 2008. These changes were due in part to increases of \$2.3 million and \$1.4 million in pre-tax income for the three and six month periods of 2009, respectively, compared to the prior year. The effective tax rates recorded for 2009 on a quarter-to-date and

year-to-date basis were 27.6% and 27.0%, respectively, in comparison to the June 30, 2008 quarter-to-date and year-to-date effective tax rates of (18.6)% and 13.0%, respectively. Effective tax rates are impacted by items of income and expense that are not subject to federal or state taxation. The Company's 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.

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Table of Contents**ANALYSIS OF FINANCIAL CONDITION****Investing Activities****Investment Securities Portfolio Composition**

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

| | June 30, 2009 | | December 31, 2008 | |
|---|---------------------------|-----------------------------|---------------------------|-----------------------------|
| | Amortized Cost | Percent of Total | Amortized Cost | Percent of Total |
| Securities available for sale: | | | | |
| U.S. Government agencies and government sponsored enterprises | \$ 93,858 | 17.3% | \$ 67,871 | 11.3% |
| State and political subdivisions | 92,627 | 17.1 | 129,572 | 21.6 |
| Mortgage-backed securities: | | | | |
| Agency mortgage-backed securities | 283,472 | 52.4 | 297,278 | 49.5 |
| Non-Agency mortgage-backed securities | 19,864 | 3.7 | 42,296 | 7.0 |
| Asset-backed securities | 3,716 | 0.7 | 3,918 | 0.7 |
| Equity securities | | | 923 | 0.2 |
| Total available for sale securities | 493,537 | 91.2 | 541,858 | 90.3 |
| State and political subdivisions (held to maturity) | 47,465 | 8.8 | 58,532 | 9.7 |
| Total investment securities | \$ 541,002 | 100.0% | \$ 600,390 | 100.0% |

Impairment Assessment

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

The table below summarizes unrealized losses in each category of the securities portfolio at the end of the periods indicated (in thousands).

| | June 30, 2009 | | December 31, 2008 | |
|---|----------------------------|-----------------------------|----------------------------|-----------------------------|
| | Unrealized Loss | Percent of Total | Unrealized Loss | Percent of Total |
| Securities available for sale: | | | | |
| U.S. Government agencies and government sponsored enterprises | \$ 297 | 10.9% | \$ 307 | 7.3% |

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| | | | | |
|---|----------|--------|----------|--------|
| State and political subdivisions | 10 | 0.3 | 42 | 1.0 |
| Mortgage-backed securities: | | | | |
| Agency mortgage-backed securities | 979 | 36.0 | 981 | 23.1 |
| Non-Agency mortgage-backed securities | 684 | 25.1 | 2,854 | 67.3 |
| Asset-backed securities | 612 | 22.5 | | |
| Equity securities | | | 52 | 1.2 |
| Total available for sale securities | 2,582 | 94.8 | 4,236 | 99.9 |
| State and political subdivisions (held to maturity) | 141 | 5.2 | 4 | 0.1 |
| Total investment securities | \$ 2,723 | 100.0% | \$ 4,240 | 100.0% |

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Table of Contents**Mortgage-backed Securities**

At June 30, 2009, with the exception of \$19.5 million privately issued whole loan collateralized mortgage obligations (CMO), all of the mortgage-backed securities (MBS) held by the Company were issued by U.S. government sponsored entities and agencies (Agency MBS), primarily the Federal National Mortgage Association (FNMA) and the Federal Home Loan Mortgage Corporation (FHLMC). The contractual cash flows of the Company's Agency MBS are guaranteed by FNMA, FHLMC or Government National Mortgage Association (GNMA). FNMA and FHLMC are government sponsored enterprises that were placed under the conservatorship of the U.S. government during the third quarter of 2008. The GNMA mortgage-backed securities are backed by the full faith and credit of the U.S. government. The Company sold Agency MBS securities with an amortized cost totaling \$60.0 million during the six months ended June 30, 2009, and realized a gain of \$2.4 million on those sales.

Given the high credit quality inherent in Agency MBS, the Company does not consider any of the impairments on such MBS to be credit related. As a result of its analyses, the Company determined at June 30, 2009 that the unrealized losses on its Agency MBS are temporary. At June 30, 2009, the Company did not intend to sell any of Agency MBS that were in an unrealized loss position, all of which were performing in accordance with their terms.

The Company's mortgage-backed securities portfolio includes privately issued whole loan CMOs (non-Agency MBS) with a fair value of \$19.5 million which had net unrealized losses of approximately \$350 thousand at June 30, 2009. The Company sold four non-Agency MBS with an amortized cost totaling \$12.4 million during the six months ended June 30, 2009, and realized a loss of \$1.4 million on those sales.

During the three and six months ended June 30, 2009, the Company recognized aggregate OTTI charges of \$1.7 million against certain of these non-Agency MBS that were acquired prior to July 2007. These OTTI charges were comprised of \$1.7 million of impairments against 5 securities recognized at June 30, 2009 due to reasons of credit quality and an impairment of \$50 thousand recognized against a single non-Agency MBS at March 31, 2009. The Company projects adverse changes in cash flows for each of these non-Agency MBS. The Company also determined during the second quarter of 2009 that for those non-Agency MBS where OTTI charges were recorded, that it intended to sell those securities prior to recovery of amortized cost basis.

As a result of its analyses, the Company determined at June 30, 2009 that the unrealized losses on its non-Agency MBS on which impairments have not been recognized are temporary. These temporary unrealized losses are believed to be primarily related to an overall widening in liquidity spreads related to the reduced liquidity and uncertainty in the markets and not the credit quality of the individual issuer or underlying assets. At June 30, 2009, the Company did not intend to sell any of its non-Agency MBS on which impairments have not been recognized.

Asset-backed Securities

As of June 30, 2009, the asset-backed securities (ABS) portfolio consisted of positions in 15 securities, of which 14 are pooled trust preferred securities (TPS) collateralized by preferred debt issued primarily by financial institutions and, to a lesser extent, insurance companies located throughout the United States. As a result of some issuers defaulting and others electing to defer interest payments on the preferred debt which collateralize the securities, the Company considered the TPS to be non-performing as of June 30, 2009, and has stopped accruing interest on the investments.

As a result of its analyses, the Company determined at June 30, 2009 that the unrealized losses on its ABS portfolio are temporary.

At June 30, 2009, the Company did not intend to sell any of its ABS that were in an unrealized loss position.

Other Debt Securities

The Company assessed the remaining securities in the portfolio that were in an unrealized loss position at June 30, 2009 and determined that the decline in fair value was temporary. Management believes the decline in fair value was caused by an overall widening in spreads related to the reduced liquidity and uncertainty in the markets and not the credit quality of the individual issuer or underlying assets. As of June 30, 2009, there were 64 other debt securities (including issues of U.S. Government Agencies and U.S. Government-Sponsored Enterprises and obligations of State and Political Subdivisions) that were in an unrealized loss position. These securities had an aggregate amortized cost of \$73.2 million and unrealized losses of \$448 thousand. Of the 64 securities in an unrealized loss position, 11 securities with a total amortized cost of \$11.4 million and unrealized losses of \$260 thousand were in an unrealized

loss position for 12 months or longer.

Other Investments

Recently, credit concern surrounding the Federal Home Loan Bank system has been widespread. As a member of the Federal Home Loan Bank of New York (FHLB), Five Star Bank (the Bank) is required to hold FHLB stock. The amount of required FHLB stock is based on the Bank s asset size and the amount of borrowings from the FHLB. The Company has assessed the ultimate recoverability of its FHLB stock and believes no impairment has occurred. The Company s ownership of FHLB stock, which totaled \$3.3 million at June 30, 2009, is included in other assets and recorded at cost.

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The Company's non-Agency MBS and ABS are rated by a nationally recognized rating agency, such as Moody's Investors Services, Inc. (Moody's), Standard & Poor's Corporation (S&P) or Fitch, Inc. (collectively, Rating Agencies). At June 30, 2009, the Company's non-Agency MBS were rated from AAA to Ca by one or more of the Rating Agencies or were unrated (i.e., not assigned a rating by any Rating Agency). The rating indicates the opinion of the Rating Agency as to the credit worthiness of the investment, indicating the obligor's ability to meet its financial commitment on the obligation. Investment grade includes all securities with Fitch/S&P ratings above BB+ and Moody's ratings above Ba1. Securities with a Fitch/S&P rating below BBB- and Moody's ratings below Baa3 are considered to be below investment grade. The Company uses the lowest rating provided by either of the Rating Agencies when classifying each security as investment grade or below investment grade.

The following table provides detail of securities rated below investment grade (dollars in thousands).

| Current Rating ⁽¹⁾ | Number of Cusips | As of June 30, 2009 | | | Unrealized Gains (Losses) | Other-than-temporary impairment losses recognized in earnings 2009 | | | |
|--|------------------|---------------------|----------------|------------|---------------------------|--|-------------------------|-------------------------|---------------|
| | | Par Value | Amortized Cost | Fair Value | | Prior to 2009 ⁽⁴⁾ | 1 st Quarter | 2 nd Quarter | Total to Date |
| Securities with unrealized gains: | | | | | | | | | |
| Non-Agency MBS: | | | | | | | | | |
| Ba1/AAA | 1 | \$ 1,650 | \$ 981 | \$ 981 | \$ | \$ 626 | \$ | \$ 40 | \$ 666 |
| Ca/BB | 1 | 3,591 | 2,770 | 2,770 | | | | 794 | 794 |
| Ca/B ⁽²⁾ | 1 | 928 | 173 | 173 | | 539 | | 214 | 753 |
| Caa1/AAA ⁽²⁾ | 1 | 2,114 | 1,466 | 1,466 | | | | 643 | 643 |
| BB/BB ⁽³⁾ | 1 | 2,634 | 1,389 | 1,513 | 124 | 1,240 | | | 1,240 |
| | 5 | 10,917 | 6,779 | 6,903 | 124 | 2,405 | | 1,691 | 4,096 |
| Asset-backed securities: | | | | | | | | | |
| Ca/CC | 3 | 9,000 | 869 | 952 | 83 | 8,058 | | | 8,058 |
| Ca/C | 1 | 2,042 | 143 | 150 | 7 | 1,862 | | | 1,862 |
| Caa3/CC | 1 | 3,000 | 98 | 146 | 48 | 2,860 | | | 2,860 |
| Baa3/B ⁽²⁾ | 1 | 661 | 67 | 322 | 255 | 545 | 50 | | 595 |
| | 6 | 14,703 | 1,177 | 1,570 | 393 | 13,325 | 50 | | 13,375 |
| Total securities with unrealized gains | 11 | 25,620 | 7,956 | 8,473 | 517 | 15,730 | 50 | 1,691 | 17,471 |

Securities with unrealized losses:

Asset-backed securities:

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| | | | | | | | | | |
|---|----|-----------|-----------|-----------|---------|-----------|-------|----------|--------|
| Ca/CC | 6 | 13,361 | 1,628 | 1,081 | (547) | 11,635 | | | 11,635 |
| Caa2/CCC | 1 | 1,986 | 349 | 334 | (15) | 1,615 | | | 1,615 |
| B2/CCC | 1 | 2,962 | 513 | 496 | (17) | 2,435 | | | 2,435 |
| Ca/C | 1 | 1,054 | 49 | 16 | (33) | 963 | | | 963 |
| Total securities with unrealized losses | 9 | 19,363 | 2,539 | 1,927 | (612) | 16,648 | | | 16,648 |
| | 20 | \$ 44,983 | \$ 10,495 | \$ 10,400 | \$ (95) | \$ 32,378 | \$ 50 | \$ 1,691 | 34,119 |

(1) Ratings presented are Moody's/Fitch except as noted.

(2) Ratings presented are Moody's/S&P.

(3) Ratings presented are Fitch/S&P.

(4) Various securities were written down (deemed OTTI) in each of the last three quarters of 2008.

Equity Securities

During the first quarter of 2009 the Company liquidated its equity securities portfolio, which consisted of auction rate preferred equity securities collateralized by FNMA and FHLMC preferred stock and common equity securities. A \$152 thousand loss was realized on the sale of the equity securities portfolio, comprised of aggregate losses totaling \$242 thousand related to the preferred equity securities and an aggregate gain of \$90 thousand from sale of the common equity securities.

Table of Contents**Lending Activities****Loan Portfolio Composition**

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

| | June 30, 2009 | | December 31, 2008 | |
|---------------------------------|----------------------|----------------|--------------------------|----------------|
| | Amount | Percent | Amount | Percent |
| Commercial | \$ 198,608 | 16.3% | \$ 158,543 | 14.1% |
| Commercial real estate | 282,048 | 23.2 | 262,234 | 23.4 |
| Agriculture | 42,997 | 3.5 | 44,706 | 4.0 |
| Residential real estate | 149,926 | 12.3 | 177,683 | 15.8 |
| Consumer indirect | 319,735 | 26.2 | 255,054 | 22.8 |
| Consumer direct and home equity | 225,258 | 18.5 | 222,859 | 19.9 |
| Total loans | 1,218,572 | 100.0% | 1,121,079 | 100.0% |
| Allowance for loan losses | (20,614) | | (18,749) | |
| Total loans, net | \$ 1,197,958 | | \$ 1,102,330 | |

Total loans increased \$97.5 million to \$1.219 billion as of June 30, 2009 from \$1.121 billion as of December 31, 2008.

Commercial loans increased \$58.2 million to \$523.7 million as of June 30, 2009 from \$465.5 million as of December 31, 2008, a result of the Company's continued focus on commercial business development programs.

Residential real estate loans decreased \$27.8 million to \$149.9 million as of June 30, 2009 in comparison to \$177.7 million as of December 31, 2008. This category of loans decreased as the majority of newly originated and refinanced residential mortgages were sold to the secondary market rather than being added to the portfolio. In addition, the Company securitized \$16.0 million in residential real estate loans during the second quarter of 2009. The Company does not engage in sub-prime or other high-risk residential mortgage lending as a line-of-business.

The consumer indirect portfolio increased by 25%, to \$319.7 million as of June 30, 2009, from \$255.1 million as of December 31, 2008. The Company increased its indirect portfolio by managing existing and developing new relationships with over 250 franchised auto dealers in Western and Central New York State. During the first six months of 2009 the Company originated \$109.2 million in indirect auto loans with a mix of approximately 32% new auto and 68% used auto. This compares with \$66.5 million in indirect loan auto originations with a mix of approximately 34% new auto and 66% used auto for the same period in 2008.

Loans Held for Sale

Loans held for sale (not included in the table above) totaled \$3.0 million and \$1.0 million as of June 30, 2009 and December 31, 2008, respectively, all of which were residential real estate loans.

The Company sells certain qualifying newly originated residential real estate mortgages to the secondary market. Residential real estate mortgages serviced for others totaled \$345.9 million and \$315.7 million as of June 30, 2009 and December 31, 2008, respectively, and are not included in the consolidated statements of financial condition.

Table of Contents**Non-Performing Assets and Allowance for Loan Losses**

The table below sets forth the amounts and categories of the Company's non-performing assets at the dates indicated. At each date presented there were no troubled debt restructurings (which involve forgiving a portion of interest or principal or making loans at rates significantly less than current market rates) (in thousands).

| | June 30, 2009 | December 31, 2008 |
|---|--------------------------|----------------------------------|
| Nonaccrual loans: | | |
| Commercial | \$ 4,162 | \$ 510 |
| Commercial real estate | 1,307 | 2,360 |
| Agriculture | 342 | 310 |
| Residential real estate | 2,658 | 3,365 |
| Consumer indirect | 373 | 445 |
| Consumer direct and home equity | 654 | 1,199 |
| Total nonaccrual loans | 9,496 | 8,189 |
| Restructured loans | | |
| Accruing loans 90 days or more delinquent | 2 | 7 |
| Total non-performing loans | 9,498 | 8,196 |
| Foreclosed assets | 1,046 | 1,007 |
| Nonaccrual investment securities | 3,175 | 49 |
| Total non-performing assets | \$ 13,719 | \$ 9,252 |

| | | |
|-------------------------------------|-------|-------|
| Non-performing loans to total loans | 0.78% | 0.73% |
|-------------------------------------|-------|-------|

| | | |
|---------------------------------------|-------|-------|
| Non-performing assets to total assets | 0.69% | 0.48% |
|---------------------------------------|-------|-------|

Information regarding the activity in nonaccrual loans for the three and six months ended June 30, 2009 is as follows (in thousands):

| | Three months ended June 30, 2009 | Six months ended June 30, 2009 |
|--|---|---|
| Nonaccrual loans, beginning of period | \$ 8,826 | \$ 8,189 |
| Additions | 5,286 | 9,495 |
| Payments | (1,006) | (2,323) |
| Charge-offs | (1,574) | (2,937) |
| Returned to accruing status | (1,611) | (2,124) |
| Transferred to other real estate or repossessed assets | (425) | (804) |
| Nonaccrual loans, end of period | \$ 9,496 | \$ 9,496 |

Non-performing assets include nonaccrual loans, foreclosed assets and nonaccrual investment securities. Non-performing assets at June 30, 2009 increased \$4.5 million from December 31, 2008. In general, the increasing trend in non-performing assets is reflective of the current economic conditions. The increase in nonaccrual commercial loans was primarily related to 2 credit relationships totaling \$3.0 million. The \$3.1 million increase in

nonaccrual investment securities relates to 14 pooled trust preferred securities, comprising the majority of the ABS securities portfolio. Generally, loans and investment securities are placed on nonaccrual status if principal or interest payments become 90 days past due and/or management deem the collectibility of the principal and/or interest to be in question, as well as when required by regulatory requirements. Once interest accruals are discontinued, accrued but uncollected interest is charged to current year operations. Subsequent receipts on nonaccrual assets are recorded as a reduction of principal, and interest income is recorded only after principal recovery is reasonably assured.

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 non-performing 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. The Company identified \$15.1 million and \$20.5 million in loans that continued to accrue interest which were classified as substandard as of June 30, 2009 and December 31, 2008, respectively.

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The allowance for loan losses represents the estimated amount of probable credit losses inherent in the Company's loan portfolio. The Company performs periodic, systematic reviews of the loan portfolio to estimate probable losses in the respective loan portfolios. In addition, the Company regularly evaluates prevailing economic and business conditions, industry concentrations, changes in the size and characteristics of the portfolio and other pertinent factors. The process used by the Company to determine the overall allowance for loan losses is based on this analysis. Based on this analysis the Company believes the allowance for loan losses is adequate as of June 30, 2009.

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 various factors. 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 and carrying amounts of other real estate owned. 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.

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

| | Three months ended | | Six months ended | |
|---|---------------------------|-------------|-------------------------|-------------|
| | June 30, | | June 30, | |
| | 2009 | 2008 | 2009 | 2008 |
| Balance as of beginning of period | \$ 19,657 | \$ 15,549 | \$ 18,749 | \$ 15,521 |
| Charge-offs: | | | | |
| Commercial | 570 | 263 | 672 | 353 |
| Commercial real estate | 63 | 353 | 155 | 783 |
| Agriculture | 3 | 4 | 3 | 4 |
| Residential real estate | 117 | 247 | 171 | 278 |
| Consumer indirect | 714 | 354 | 1,582 | 923 |
| Consumer direct and home equity | 227 | 197 | 611 | 535 |
| Total charge-offs | 1,694 | 1,418 | 3,194 | 2,876 |
| Recoveries: | | | | |
| Commercial | 111 | 131 | 224 | 454 |
| Commercial real estate | 36 | 115 | 79 | 199 |
| Agriculture | 3 | 3 | 9 | 10 |
| Residential real estate | 5 | 3 | 8 | 14 |
| Consumer indirect | 289 | 162 | 465 | 333 |
| Consumer direct and home equity | 119 | 135 | 280 | 309 |
| Total recoveries | 563 | 549 | 1,065 | 1,319 |
| Net charge-offs | 1,131 | 869 | 2,129 | 1,557 |
| Provision for loan losses | 2,088 | 1,358 | 3,994 | 2,074 |
| Balance at end of period | \$ 20,614 | \$ 16,038 | \$ 20,614 | \$ 16,038 |
| Net loan charge-offs to average loans (annualized) | 0.38% | 0.35% | 0.37% | 0.32% |

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| | | | | |
|---|-------|-------|-------|-------|
| Allowance for loan losses to total loans | 1.69% | 1.59% | 1.69% | 1.59% |
| Allowance for loan losses to non-performing loans | 217% | 256% | 217% | 256% |

The provision for loan losses represents management's estimate of the adjustment necessary to maintain the allowance for loan losses at a level representative of probable credit losses inherent in the portfolio. There were provisions for loan losses of \$2.1 million and \$4.0 million for the three and six month periods ended June 30, 2009, compared with provisions of \$1.4 million and \$2.1 million for the corresponding periods in 2008, respectively. The increase in the provision for loan losses is primarily due to growth and the changing mix of the loan portfolio and an increase in nonaccrual loans. Net charge-offs increased by \$262 thousand and \$572 thousand when comparing the three and six month periods of 2009 to the prior year, respectively. The increase in net charge-offs in 2009 related principally to commercial and consumer indirect loans. Also impacting the provision for loan losses in 2009 were considerations of general economic conditions in the Company's market area, as well as growth in the commercial and indirect loan portfolios.

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Funding Activities

Deposits

The Company offers a broad array of deposit products including noninterest-bearing demand, interest-bearing demand, savings and money market accounts and certificates of deposit. As of June 30, 2009, total deposits were \$1.700 billion, an increase of \$67.0 million in comparison to \$1.633 billion as of December 31, 2008.

Nonpublic deposits represent the largest component of the Company's funding. Total nonpublic deposits were \$1.336 billion and \$1.280 billion as of June 30, 2009 and December 31, 2008, respectively. The Company continues to manage this segment of funding through a strategy of competitive pricing and relationship-based sales and marketing that minimizes the number of customer relationships that have only a single high-cost deposit account.

The Company offers a variety of public deposit products to the many towns, villages, counties and school districts within our market. Public deposits generally range from 20 to 25% of the Company's total deposits. As of June 30, 2009, total public deposits were \$364.8 million in comparison to \$352.8 million as of December 31, 2008. There is a high degree of seasonality in this component of funding, as the level of deposits varies with the seasonal cash flows for these public customers. The Company maintains the necessary levels of short-term liquid assets to accommodate the seasonality associated with public deposits.

Borrowings

The Company has credit capacity with the FHLB and can borrow through facilities that include an overnight line-of-credit, as well as, amortizing and term advances. The Company's primary borrowing source was FHLB advances and repurchase agreements, which amounted to \$30.1 million and \$30.7 million as of June 30, 2009 and December 31, 2008, respectively. The FHLB borrowings mature on various dates through 2011 and are classified as short-term or long-term in accordance with the original terms of the agreement. The Company had approximately \$37.0 million of immediate credit capacity with FHLB as of June 30, 2009. The FHLB credit capacity is collateralized by securities from the Company's investment portfolio and certain qualifying loans.

The Company has \$8.1 million in secured borrowing capacity at the Federal Reserve Bank (FRB) Discount Window, of which none was outstanding at June 30, 2009. The FRB credit capacity is collateralized by securities from the Company's investment portfolio.

The Company also had \$70.0 million of credit available under unsecured lines of credit with various banks as of June 30, 2009. There were no advances outstanding on these lines of credit as of June 30, 2009. The Company also utilizes short-term retail repurchase agreements with customers as a source of funds. These short-term repurchase agreements amounted to \$33.1 million and \$23.5 million as of June 30, 2009 and December 31, 2008, respectively.

Equity Activities

Total shareholders' equity amounted to \$192.5 million as of June 30, 2009, an increase of \$2.2 million from \$190.3 million as of December 31, 2008. The increase in shareholders' equity resulted primarily from the \$1.6 million in undistributed profits from operations through the first six months ended June 30, 2009.

The Bank is subject to various regulatory capital requirements administered by the Federal Deposit Insurance Corporation and the New York State Banking Department (NYSBD). At June 30, 2009, the Bank's regulatory capital ratios exceeded all regulatory requirements.

Table of Contents**LIQUIDITY AND CAPITAL RESOURCES****Liquidity**

The objective of maintaining adequate liquidity is to assure the ability of the Company to meet its 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. The Company achieves liquidity by maintaining a strong base of core customer funds, maturing short-term assets, its ability to sell securities, lines-of-credit, and access to the financial and capital markets.

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

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

The Company's cash and cash equivalents were \$81.3 million as of June 30, 2009, an increase of \$26.1 million from \$55.2 million as of December 31, 2008. The Company's net cash provided by operating activities totaled \$14.7 million. Net cash used in investing activities totaled \$61.1 million, which included cash outflows of \$116.4 million for net loan originations and cash inflows of \$55.5 million from investment securities transactions. Net cash provided by financing activities of \$72.6 million was primarily attributed to a combined \$76.7 million increase in deposits and net borrowings, offset against \$3.6 million in dividend payments.

Capital Resources

Banks and financial holding companies are subject to various regulatory capital requirements administered by state and federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary, actions by regulators that, if undertaken, could have a direct material impact on the Company's 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, without limitation, \$37.5 million of preferred stock issued to the U.S. Department of Treasury (the Treasury) through the Treasury's Troubled Asset Relief Program (TARP) and, subject to limitation, \$16.7 million of trust preferred securities issued by FISI Statutory Trust I and \$17.5 million of preferred stock. The Company and the Bank's total capital are comprised of Tier 1 capital for each entity plus a permissible portion of the allowance for loan losses.

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

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The Company's and the Bank's actual and required regulatory capital ratios as of June 30, 2009 and December 31, 2008 were as follows (in thousands):

| | Actual | | For Capital Adequacy Purposes | | Well Capitalized | |
|---|------------|-------|-------------------------------|-------|------------------|-------|
| | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| June 30, 2009: | | | | | | |
| Tier 1 leverage: | | | | | | |
| Company | \$ 152,362 | 7.84% | \$ 77,783 | 4.00% | \$ 97,229 | 5.00% |
| Bank (FSB) | 144,361 | 7.44 | 77,640 | 4.00 | 97,051 | 5.00 |
| Tier 1 capital (to risk-weighted assets): | | | | | | |
| Company | 152,362 | 10.69 | 57,027 | 4.00 | 85,540 | 6.00 |
| Bank (FSB) | 144,361 | 10.17 | 56,767 | 4.00 | 85,150 | 6.00 |
| Total risk-based capital (to risk-weighted assets): | | | | | | |
| Company | 170,217 | 11.94 | 114,053 | 8.00 | 142,567 | 10.00 |
| Bank (FSB) | 162,136 | 11.42 | 113,534 | 8.00 | 141,917 | 10.00 |
| December 31, 2008: | | | | | | |
| Tier 1 leverage: | | | | | | |
| Company | \$ 150,426 | 8.05% | \$ 74,764 | 4.00% | \$ 93,456 | 5.00% |
| Bank (FSB) | 120,484 | 6.46 | 74,586 | 4.00 | 93,232 | 5.00 |
| Tier 1 capital (to risk-weighted assets): | | | | | | |
| Company | 150,426 | 11.83 | 50,881 | 4.00 | 76,322 | 6.00 |
| Bank (FSB) | 120,484 | 9.52 | 50,624 | 4.00 | 75,936 | 6.00 |
| Total risk-based capital (to risk-weighted assets): | | | | | | |
| Company | 166,362 | 13.08 | 101,762 | 8.00 | 127,203 | 10.00 |
| Bank (FSB) | 136,340 | 10.77 | 101,248 | 8.00 | 126,560 | 10.00 |

Dividend Restrictions

In the ordinary course of business, the Company is dependent upon dividends from the Bank to provide funds for the payment of interest expense on the junior subordinated debentures, 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. Due to these requirements, as of June 30, 2009, the Bank is required to obtain approval from the New York State Banking Department for future dividend payments.

In addition, pursuant to the terms of the Treasury's TARP Capital Purchase Program, the Company may not declare or pay any cash dividends on its common stock other than regular quarterly cash dividends of not more than \$0.10 without the consent of the U.S. Treasury.

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

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

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

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

The Company has experienced no significant changes in market risk due to changes in interest rates since the Company's Annual Report on Form 10-K for the year ended December 31, 2008, dated March 12, 2009, as filed with the Securities and Exchange Commission.

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

As of June 30, 2009, 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 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 Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

Changes in internal control over financial reporting

There were no changes in the Company's internal control over financial reporting that occurred during the quarter ended June 30, 2009 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

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

The Company has experienced no significant changes in its legal proceedings from the disclosure included in the Company's Annual Report on Form 10-K for the year ended December 31, 2008, dated March 12, 2009, as filed with the Securities and Exchange Commission.

ITEM 1A. Risk Factors

The Company has experienced no significant 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, 2008, dated March 12, 2009, as filed with the Securities and Exchange Commission.

ITEM 4. Submission of Matters to a Vote of Security Holders

The Annual Meeting of Shareholders was held on May 6, 2009. Of 10,805,319 shares entitled to vote at the meeting, 9,330,270 shares were voted. The following matters were voted on at the meeting:

Proposal 1: To elect three Directors for a term of three years. Votes for each nominee were as follows:

| Nominee | Votes For | Votes Withheld |
|-----------------------|-----------|----------------|
| Karl V. Anderson, Jr. | 9,236,145 | 94,125 |
| Erland E. Kailbourne | 8,800,673 | 529,597 |
| Robert N. Latella | 9,192,711 | 137,559 |

On February 20, 2009, John R. Tyler, Jr. informed the Company that he would not be standing for re-election when his term expired at the Annual Meeting of Shareholders on May 6, 2009. Terms of our other directors, John E. Benjamin, Barton P. Dambra, Susan R. Holliday, Peter G. Humphrey, Thomas P. Connolly, Samuel M. Gullo, James L. Robinson and James H. Wyckoff had not expired at the time of the Annual Meeting and they continued in office.

Proposal 2: To adopt the Company's 2009 Management Stock Incentive Plan.

| Votes For | Votes Against | Votes Abstained | Broker Non-votes |
|-----------|---------------|-----------------|------------------|
| 6,828,198 | 956,730 | 57,099 | 1,488,243 |

Proposal 3: To adopt the Company's 2009 Directors' Stock Incentive Plan.

| Votes For | Votes Against | Votes Abstained | Broker Non-votes |
|-----------|---------------|-----------------|------------------|
| 7,157,685 | 621,971 | 62,371 | 1,488,243 |

Proposal 4: Non-binding approval of the Named Executive Officers' Compensation.

| Votes For | Votes Against | Votes Abstained |
|-----------|---------------|-----------------|
| 7,925,830 | 1,336,306 | 68,130 |

Table of Contents**ITEM 6. Exhibits**

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

| Exhibit Number | Description | Location |
|-----------------------|--|---|
| 3.1 | Amended and Restated Certificate of Incorporation of the Company | Incorporated by reference to Exhibit 3.1 of the Form 10-K for the year ended December 31, 2008, dated March 12, 2009 |
| 3.2 | Amended and Restated Bylaws of the Company | Incorporated by reference to Exhibit 3.4 of the Form 10-K for the year ended December 31, 2008, dated March 12, 2009 |
| 4.1 | Warrant to Purchase Common Stock, dated December 23, 2008 issued by the Registrant to the United States Department of the Treasury | Incorporated by reference to Exhibit 4.2 of the Form 8-K, dated December 19, 2008 |
| 10.1 | 1999 Management Stock Incentive Plan | Incorporated by reference to Exhibit 10.1 of the S-1 Registration Statement |
| 10.2 | Amendment Number One to the FII 1999 Management Stock Incentive Plan | Incorporated by reference to Exhibit 10.1 of the Form 8-K, dated July 28, 2006 |
| 10.3 | Form of Non-Qualified Stock Option Agreement Pursuant to the FII 1999 Management Stock Incentive Plan | Incorporated by reference to Exhibit 10.2 of the Form 8-K, dated July 28, 2006 |
| 10.4 | Form of Restricted Stock Award Agreement Pursuant to the FII 1999 Management Stock Incentive Plan | Incorporated by reference to Exhibit 10.3 of the Form 8-K, dated July 28, 2006 |
| 10.5 | Form of Restricted Stock Award Agreement Pursuant to the FII 1999 Management Stock Incentive Plan | Incorporated by reference to Exhibit 10.1 of the Form 8-K, dated January 23, 2008 |
| 10.6 | 1999 Directors Stock Incentive Plan | Incorporated by reference to Exhibit 10.2 of the S-1 Registration Statement |
| 10.7 | Amendment to the 1999 Director Stock Incentive Plan | Incorporated by reference to Exhibit 10.7 of the Form 10-K for the year ended December 31, 2008, dated March 12, 2009 |
| 10.8 | 2009 Management Stock Incentive Plan | Filed Herewith |
| 10.9 | 2009 Directors Stock Incentive Plan | Filed Herewith |
| 10.10 | Amended Stock Ownership Requirements, dated December 14, 2005 | Incorporated by reference to Exhibit 10.19 of the Form 10-K for the year ended December 31, 2005, |

dated March 15, 2006

| | | |
|-------|---|---|
| 10.11 | Executive Agreement with Peter G. Humphrey | Incorporated by reference to Exhibit 10.1 of the Form 8-K, dated March 30, 2005 |
| 10.12 | Executive Agreement with James T. Rudgers | Incorporated by reference to Exhibit 10.2 of the Form 8-K, dated March 30, 2005 |
| 10.13 | Executive Agreement with Ronald A. Miller | Incorporated by reference to Exhibit 10.3 of the Form 8-K, dated March 30, 2005 |
| 10.14 | Executive Agreement with Martin K. Birmingham | Incorporated by reference to Exhibit 10.4 of the Form 8-K, dated March 30, 2005 |
| 10.15 | Agreement with Peter G. Humphrey | Incorporated by reference to Exhibit 10.6 of the Form 8-K, dated March 30, 2005 |
| 10.16 | Executive Agreement with John J. Witkowski | Incorporated by reference to Exhibit 10.7 of the Form 8-K, dated March 14, 2005 |

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| Exhibit Number | Description | Location |
|-----------------------|---|--|
| 10.17 | Executive Agreement with George D. Hagi | Incorporated by reference to Exhibit 10.7 of the Form 8-K, dated February 2, 2006 |
| 10.18 | Voluntary Retirement Agreement with James T. Rudgers | Incorporated by reference to Exhibit 10.1 of the Form 8-K, dated March 24, 2008 |
| 10.19 | Amendment to Voluntary Retirement Agreement with James T. Rudgers | Incorporated by reference to Exhibit 10.1 of the Form 8-K, dated July 1, 2009 |
| 10.20 | Voluntary Retirement Agreement with Ronald A. Miller | Incorporated by reference to Exhibit 10.2 of the Form 8-K, dated March 24, 2008 |
| 10.21 | Letter Agreement, dated December 23, 2008, including the Securities Purchase Agreement-Standard Terms attached thereto, by and between the Company and the United States Department of the Treasury | Incorporated by reference to Exhibit 10.1 of the Form 8-K, dated December 19, 2008 |
| 11.1 | Statement of Computation of Per Share Earnings | Incorporated by reference to Note 2 of the Registrant's unaudited consolidated financial statements under Item 1 filed herewith. |
| 12 | Ratio of Earnings to Fixed Charges and Preferred Dividends | Filed Herewith |
| 31.1 | Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 Principal Executive Officer | Filed Herewith |
| 31.2 | Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 Principal Financial Officer | Filed Herewith |
| 32 | Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 | Filed Herewith |

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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/ Peter G. Humphrey , August 5, 2009

Peter G. Humphrey
President and Chief Executive Officer
(Principal Executive Officer)

/s/ Ronald A. Miller , August 5, 2009

Ronald A. Miller
Executive Vice President and Chief Financial Officer
(Principal Financial and Principal Accounting Officer)

Table of Contents**Exhibit Index**

| Exhibit Number | Description | Location |
|-----------------------|--|-----------------|
| 10.8 | 2009 Management Stock Incentive Plan | Filed Herewith |
| 10.9 | 2009 Directors Stock Incentive Plan | Filed Herewith |
| 12 | Ratio of Earnings to Fixed Charges and Preferred Dividends | Filed Herewith |
| 31.1 | Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 Principal Executive Officer | Filed Herewith |
| 31.2 | Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 Principal Financial Officer | Filed Herewith |
| 32 | Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 | Filed Herewith |