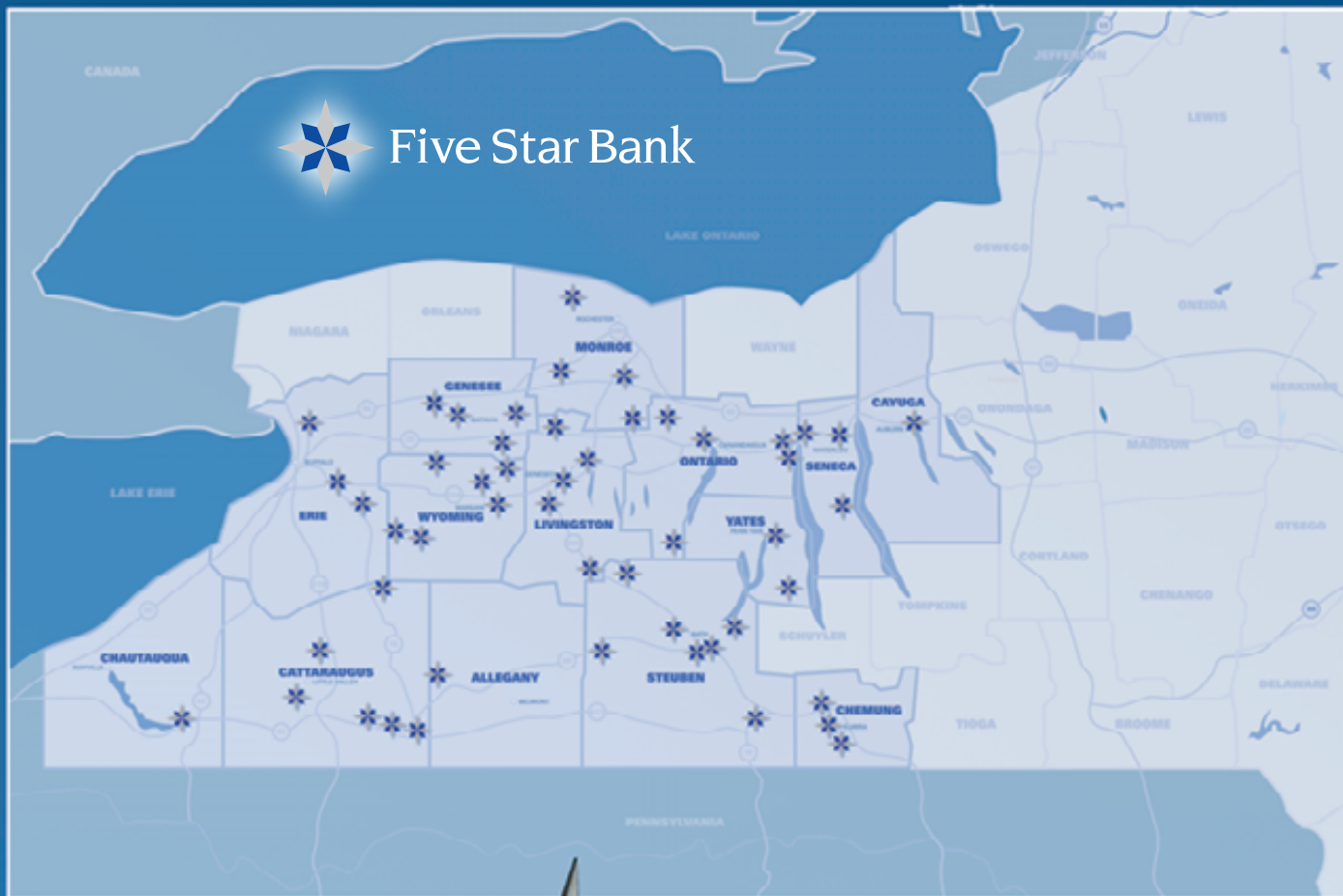






Five Star Bank



Financial Institutions, Inc.®

With total assets of \$2.2 billion, Financial Institutions, Inc. is the parent company of Five Star Bank, which provides a wide range of consumer and commercial banking services to individuals, municipalities and businesses through a network of over 50 offices and over 70 ATMs in Western and Central New York State. Through its investment services affiliate, Five Star Investment Services, Inc., FII also provides diversified financial services to its customers and clients, including brokerage and insurance. More information on FII and its subsidiaries is available through the Company web site at www.fiiwarsaw.com.



Dear Fellow Shareholders,

“All of these efforts resulted in a 63% increase in earnings per share in 2010 over 2009.”

I am pleased to report that 2010 was a very productive year in many respects, fulfilling our pledge made last year to “Unlock the Potential” of our community banking franchise.

We successfully leveraged the expertise and capabilities of our Board of Directors, Executive Management Team, and our staff, to focus on a “back to basics” approach to community banking. This strategy enabled us to properly respond to the credit needs in our marketplace and grow our loan portfolio in a balanced and disciplined fashion while further strengthening our asset quality. We were also successful in managing our expenses this past year, while continuing to invest for the future, whether it be in staff, technology, or facilities.

All of these efforts resulted in a 63% increase in earnings per share in 2010 over 2009. Net income for the full year 2010 was \$21.3 million compared to \$14.4 million in 2009.

Net Interest Income and Net Interest Margin

Net interest income for the year ended December 31, 2010 totaled \$78.8 million, an increase of \$6.5 million, or 9%, compared to \$72.3 million for the same period last year. Average earning assets increased \$124.3 million during 2010 compared with last year, primarily driven by an \$85.4 million, or 7%, increase in loans and a \$71.2 million, or 12%, increase in securities. This asset growth was supported by a \$125.0 million, or 7%, increase in deposits from a year ago. These growth rates reflect not only on the capabilities of our associates to effectively meet and exceed the needs in our marketplace, but illustrate how well our community bank brand is viewed.

The Company’s net interest margin was 4.07% for the year ended December 31, 2010 as compared to 4.04% for 2009. These results demonstrate management’s ability to profitably grow the balance sheet in a challenging economic and interest rate environment by means of aggressive business development efforts, disciplined loan underwriting and effective relationship pricing.

Noninterest Income

We were able to achieve solid noninterest income results in spite of regulatory challenges impacting service charges on deposit accounts. Overall, total noninterest income increased \$659 thousand, or 4%, for 2010 as compared to 2009. ATM and debit card income increased \$385 thousand, or 11%, due to higher utilization rates. We were also successful in growing our broker-dealer fees and commissions by \$261 thousand, or 26%.

Noninterest Expense

As indicated earlier, we spent a great deal of time and effort this past year in reducing our costs while continuing to invest for the future. Overall, noninterest expense declined by \$1.9 million, or 3%. Salaries and benefits declined by \$823 thousand or 2% due to a lower incentive costs and pension expense. Our 2010 FDIC insurance premium costs were \$1.1 million lower than 2009, due in part to a 2009 special assessment of \$923 thousand, and a reduction in our assessment rate, which is tied directly to our improved financial performance. Professional and legal fees declined by \$327 thousand or 13% as a result of lower loan workout costs and an overall more efficient use of our legal resources. We increased our advertising and promotional costs by \$172 thousand or 18% to support our business development and branding initiatives. We also increased our computer and data processing costs by \$147 thousand or 6% to gain efficiencies in workflow, enhance customer service, and to better manage regulatory compliance requirements.

Table of Contents

President & CEO’s Message	1
Financial Highlights	4
Officers & Board of Directors	6
Annual Report on Form 10-K	
Shareholder Information ... Inside Back Cover	

These efforts to consistently grow our revenues and to control expenses in a disciplined manner resulted in an improved efficiency ratio of 60.36% for 2010 as compared to 65.52% for 2009.

Asset Quality

We continued to place a heavy emphasis on asset quality this past year, not only in our loan portfolio, but also in our securities portfolio. Put another way, our success in growing our revenues by \$7.2 million or roughly 8% was not achieved by increasing the credit or interest rate risk in our company.

Non-performing assets at December 31, 2010 were \$8.9 million or 0.40% of total assets, down from \$10.4 million at the end of 2009. This ratio is significantly better than our peer group which stands at 3.30% of total assets as of December 31, 2010.

Total charge-offs for 2010 were \$7.0 million or 0.54% of total loans, primarily due to a \$3.1 million charge-off related to one commercial loan. This represents a modest increase from 2009 when charge-offs were \$5.7 million or 0.47% of total loans.

Our allowance for loan losses was \$20.5 million at December 31, 2010 and resulted in a ratio of allowance for loan losses to total loans of 1.52% compared to an allowance of \$20.7 million or 1.64% at December 31, 2009. Lastly, the ratio of allowance for loan losses as a percentage of non-performing loans at December 31, 2010 was 270% compared to 239% at December 31, 2009.

These asset quality metrics illustrate the high quality of our balance sheet and our continued focus on active risk management.

Capital

The issues surrounding changes to the fundamental definition of capital have the banking industry on high alert. The Dodd-Frank Act, The Consumer Protection Act, the Federal Deposit Insurance Act, Basel III, and related components such as the Collins Amendment, in combination with the uncertainty surrounding measures to be taken by the Regulatory Agencies, require constant vigilance and careful consideration. The phaseout of certain elements of capital, escalating required capital ratios, new capital buffers, liquidity net stable funding and liquidity coverage ratio standards will raise the bar against which safety and soundness are measured. Our Board of Directors and Executive Management Team have made the quantity and quality of capital a top strategic priority. Our continued financial strength has allowed us to increase our capital levels, while taking advantage of inexpensive capital, and never taking our eyes off of the changing landscape. Our intense focus on capital planning supports our mission of charting a clear and certain course that will serve to strengthen our franchise, increase shareholder value, and continue to provide for the financial needs of the communities we serve. Our goal is not to meet the standards, but to exceed the standards, against which the best are measured.

Total shareholders equity at December 31, 2010 was \$212.1 million or 10% of total assets compared to \$198.3 million at this time last year. Our Tier 1 leverage ratio improved to 8.31% at December 31, 2010 from 7.96% at December 31, 2009, while the total risk-based capital ratio improved from 13.21% to 13.60% over the same one-year period.

Our tangible common equity to tangible asset ratio improved 25 basis points to 5.56% at December 31, 2010 from 5.31% at December 31, 2009. Tangible common equity is becoming an increasingly important indicator of a bank's ability to absorb losses during periods of financial and economic stress. At Financial Institutions, Inc. we are committed to continued improvement in our tangible common equity ratio.

In keeping with our commitment to make the quantity and quality of capital a top strategic priority, on February 23, 2011, the Company announced that we redeemed one-third, or \$12.5 million of the outstanding \$37.5 million of our Series A preferred stock issued to the U.S. Department of Treasury, pursuant to the Troubled Asset Relief Program ("TARP"). Subsequent to that payment, on March 7, 2011, we announced the commencement of an underwritten follow-on common stock offering of approximately \$40.0 million. At that time we announced our intent to use the net proceeds to repurchase the

"Our goal is not to meet the standards, but to exceed the standards, against which the best are measured."

remaining Series A preferred stock along with the related warrant, of up to 378,175 shares, issued under TARP. The pricing of the offering occurred on March 9, 2011 and closed on March 15, 2011. The offering was very well received and resulted in net proceeds of approximately \$43.0 million, as we issued 2,813,475 shares at \$16.35 per share before associated offering expenses.

While we are extremely pleased with the opportunity to maximize the use of the TARP funds by continuing to lend through a challenging economic and regulatory environment, we are proud of our steadfast commitment to profitable growth, and to position our company for both organic and acquisition opportunities.

Strategic Direction

The Company ended 2010 in a strong position, whether it be from an earnings perspective, asset quality position, or from a marketplace standpoint. Earnings per share were up 63% from last year, net income increased 47%, asset quality was strong, and deposit market-share increased in 32 of the 44 markets we serve. This standing was confirmed by being named to the Sandler O'Neil Small All Stars list of the top performing publicly traded small corporate banks and thrifts in the nation. FII was one of only 32 selected for the list. Selection is based on growth, profitability, credit quality, and capital strength.

However, our Western New York region, while performing better than other parts of the U.S., is still experiencing historically high unemployment. The passage of the Dodd-Frank Act in 2010 has also created many challenges for banks of all sizes. Specific provisions of this Act have impacted service charge revenue due to restrictions on assessing overdraft fees. The Durbin Amendment has the potential to cut banks' interchange income on merchant transactions by up to 70%. Dozens of new regulations will add to compliance costs. And finally, low interest rates, coupled with a flattening yield curve are squeezing banks' margins.

In order to address the challenges that these issues present and to fully leverage our marketplace opportunities, the Company completed a comprehensive strategic planning process this fall and has charted a strategic course which will enable us to successfully navigate through these rough seas over the next several years. We have the size and expertise needed to compete. We have developed a comprehensive and exciting strategic plan that charts our course of action. Finally, we have a very capable leadership team to steer the ship through these turbulent seas and to capitalize on the opportunities that lie ahead.

On behalf of our Board of Directors, Senior Management, and our hundreds of dedicated employees, thank you for your continued support and confidence in Five Star Bank and Financial Institutions, Inc.

"The Company completed a comprehensive strategic planning process this fall and has charted a strategic course which will enable us to successfully navigate through these rough seas over the next several years."

Sincerely,



Peter G. Humphrey
President & CEO



FIVE-YEAR FINANCIAL HIGHLIGHTS

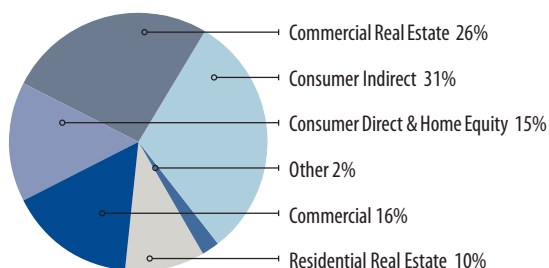
At or for the year ended December 31,

(Dollars in thousands, except per share data)

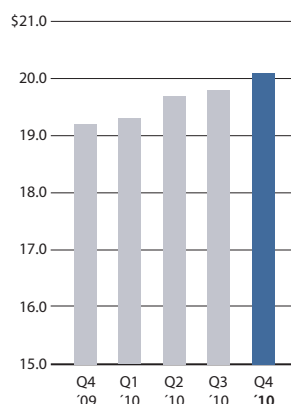
	2010	2009	2008	2007	2006
Selected Financial Condition Data					
Total assets	\$ 2,214,307	\$ 2,062,389	\$ 1,916,919	\$ 1,857,876	\$ 1,907,552
Loans, net	1,325,524	1,243,265	1,102,330	948,652	909,434
Investment securities	694,530	620,074	606,038	754,720	775,536
Deposits	1,882,890	1,742,955	1,633,263	1,575,971	1,617,695
Borrowings	103,877	106,390	70,820	68,210	87,199
Shareholders' equity	212,144	198,294	190,300	195,322	182,388
Common shareholders' equity ⁽¹⁾	158,359	144,876	137,226	177,741	164,765
Tangible common shareholders' equity ⁽²⁾	120,990	107,507	99,577	139,786	126,502
Selected Operations Data					
Interest income	\$ 96,509	\$ 94,482	\$ 98,948	\$ 105,212	\$ 103,070
Interest expense	17,720	22,217	33,617	47,139	43,604
Net interest income	78,789	72,265	65,331	58,073	59,466
Provision (credit) for loan losses	6,687	7,702	6,551	116	(1,842)
Net interest income after provision (credit) for loan losses	72,102	64,563	58,780	57,957	61,308
Noninterest income (loss) ⁽³⁾	19,454	18,795	(48,778)	20,680	21,911
Noninterest expense	60,917	62,777	57,461	57,428	59,612
Income (loss) before income taxes	30,639	20,581	(47,459)	21,209	23,607
Income tax expense (benefit)	9,352	6,140	(21,301)	4,800	6,245
Net income (loss)	\$ 21,287	\$ 14,441	\$ (26,158)	\$ 16,409	\$ 17,362
Preferred stock dividends and accretion	3,725	3,697	1,538	1,483	1,486
Net income (loss) applicable to common shareholders	\$ 17,562	\$ 10,744	\$ (27,696)	\$ 14,926	\$ 15,876
Stock And Related Per Share Data					
Earnings (loss) per common share:					
Basic	\$ 1.62	\$ 0.99	\$ (2.54)	\$ 1.34	\$ 1.40
Diluted	1.61	0.99	(2.54)	1.33	1.40
Cash dividends declared on common stock	0.40	0.40	0.54	0.46	0.34
Common book value per share ⁽¹⁾	14.48	13.39	12.71	16.14	14.53
Tangible common book value per share ⁽²⁾	11.06	9.94	9.22	12.69	11.15
Market price (NASDAQ: FISL):					
High	20.74	15.99	22.50	23.71	25.38
Low	10.91	3.27	10.06	16.18	17.43
Close	18.97	11.78	14.35	17.82	23.05

LOAN PORTFOLIO COMPOSITION

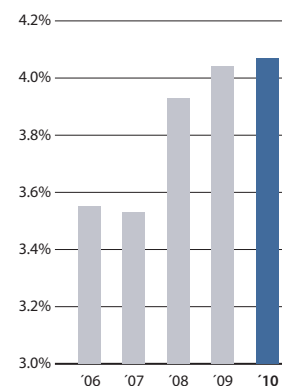
at December 31, 2010



NET INTEREST INCOME (in millions)



NET INTEREST MARGIN



(continued from previous page)

At or for the year ended December 31,

(Dollars in thousands, except per share data)

	2010	2009	2008	2007	2006
Selected Financial Ratios And Other Data					
Performance Ratios:					
Net income (loss) returns on:					
Average assets	0.98 %	0.71 %	(1.37) %	0.86 %	0.90 %
Average equity	10.07	7.43	(14.30)	8.84	9.86
Average common equity ⁽¹⁾	11.14	7.61	(16.84)	8.89	10.02
Average tangible common equity ⁽²⁾	14.59	10.37	(21.87)	11.50	13.23
Common dividend payout ratio ⁽⁴⁾	24.69	40.40	-	34.33	24.29
Net interest margin (fully tax-equivalent)	4.07	4.04	3.93	3.53	3.55
Efficiency ratio ⁽⁵⁾	60.36 %	65.52 %	64.07 %	68.77 %	69.78 %
Capital Ratios:					
Leverage ratio	8.31 %	7.96 %	8.05 %	9.35 %	8.91 %
Tier 1 risk-based capital	12.34	11.95	11.83	15.74	15.85
Total risk-based capital	13.60	13.21	13.08	16.99	17.10
Equity to assets ⁽⁶⁾	9.75	9.55	9.60	9.73	9.08
Common equity to assets ^{(1) (6)}	7.28	6.94	8.63	8.81	8.17
Tangible common equity to tangible assets ^{(2) (6)}	5.65 %	5.19 %	6.78 %	6.95 %	6.32 %
Asset Quality:					
Non-performing loans	\$ 7,582	\$ 8,681	\$ 8,196	\$ 8,077	\$ 15,840
Non-performing assets	8,895	10,442	9,252	9,498	17,043
Allowance for loan losses	20,466	20,741	18,749	15,521	17,048
Net loan charge-offs	\$ 6,962	\$ 5,710	\$ 3,323	\$ 1,643	\$ 1,341
Total non-performing loans to total loans	0.56 %	0.69 %	0.73 %	0.84 %	1.71 %
Total non-performing assets to total assets	0.40	0.51	0.48	0.51	0.89
Net charge-offs to average loans	0.54	0.47	0.32	0.18	0.14
Allowance for loan losses to total loans	1.52	1.64	1.67	1.61	1.84
Allowance for loan losses to non-performing loans	270 %	239 %	229 %	192 %	108 %
Other Data:					
Number of branches	50	50	51	50	50
Full-time equivalent employees	577	572	600	621	640

(1) Excludes preferred shareholders' equity.

(2) Excludes preferred shareholders' equity, goodwill and other intangible assets.

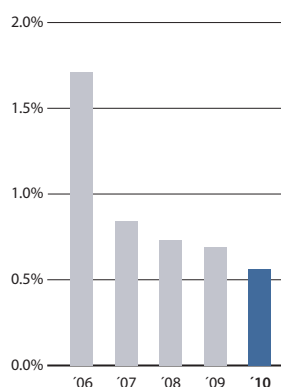
(3) The 2010, 2009 and 2008 figures include OTTI charges of \$594 thousand, \$4.7 million and \$68.2 million, respectively. There were no OTTI charges in the other years presented.

(4) Common dividend payout ratio equals dividends declared during the year divided by earnings per share for the year. There is no ratio shown for years where the Company both declared a dividend and incurred a loss because the ratio would result in a negative payout since the dividend declared (paid out) will always be greater than 100% of earnings.

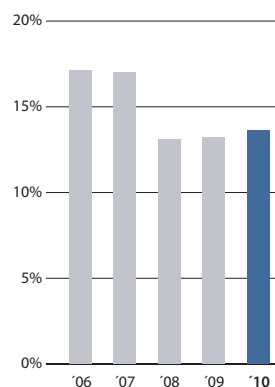
(5) Efficiency ratio equals noninterest expense less other real estate expense and amortization of intangible assets as a percentage of net revenue, defined as the sum of tax-equivalent net interest income and noninterest income before net gains and impairment charges on investment securities, proceeds from company-owned life insurance included in income, and net gains from the sales of commercial-related loans held for sale and trust relationships (all from continuing operations).

(6) Ratios calculated using average balances for the periods shown.

NON-PERFORMING LOANS TO TOTAL LOANS



TOTAL RISK-BASED CAPITAL RATIO



Financial Institutions, Inc.®

Officers

Peter G. Humphrey
President and Chief Executive Officer

Martin K. Birmingham
Executive Vice President
Commercial Banking
Eastern Regional President

George D. Hagi
Executive Vice President and
Chief Risk Officer

Richard J. Harrison
Executive Vice President
Retail Lending

Karl F. Krebs
Executive Vice President,
Chief Financial Officer

Ronald Mitchell McLaughlin
Executive Vice President
Chief Information Officer

John J. Witkowski
Executive Vice President
Retail Banking
Western Regional President

John L. Rizzo
Senior Vice President, In-House Counsel
and Corporate Secretary

Steven R. Ambrose
Senior Vice President
Workout Asset Group
& Loan Review

Scott D. Bader
Senior Vice President
Technology Services

Rita M. Bartol
Senior Vice President
Director of Human Resources

Michael D. Burneal
Senior Vice President
Bank Services

David G. Case
Senior Vice President
Commercial Market Executive

David R. Caster
Senior Vice President
Business Banking

Jonathan W. Chase
Senior Vice President
Consumer Underwriting

Mark J. DeBacco
Senior Vice President
Regional Commercial
Credit Officer

J. Michael DeVoria
Senior Vice President
Business Banking
Market Executive

Sonia M. Dumbleton
Senior Vice President
Controller

Martin T. Griffith
Senior Vice President
Commercial Market Executive

Michael D. Grover
Senior Vice President
Financial Reporting and Tax

Jeffrey P. Kenefick
Senior Vice President
Southern Tier
Regional President

Kevin B. Klotzbach
Senior Vice President
Treasurer

Robert J. McKnight
Senior Vice President
Commercial Market Executive

Matthew T. Murtha
Senior Vice President
Director of Sales and
Marketing

Edward S. Oexle
Senior Vice President
Commercial Market Executive

Brenda B. Schell
Senior Vice President
Audit

John J. Vaughan
Senior Vice President
Retail Credit

David C. Watson
Senior Vice President
Regional Commercial
Credit Officer

Kenneth V. Winn
Senior Vice President
Credit and Compliance

David A. Young
Senior Vice President
Commercial Market Executive

Board of Directors

Karl V. Anderson, Jr. ^{1, 4}
Retired President and CEO
Bank of Avoca

John E. Benjamin ^{2, 3}
Chairman of the Board
Financial Institutions, Inc.
and Five Star Bank

Barton P. Dambra ^{1, 4}
President
Markin Tubing LP

Samuel M. Gullo ^{1, 2, 3}
Owner and Operator,
Family Furniture

Susan R. Holliday ^{2, 3, 4}
President and Publisher
Rochester Business Journal, Inc.

Peter G. Humphrey
President and CEO
Financial Institutions, Inc.
and Five Star Bank

Erland E. Kailbourne ²
Chairman
Albany International, Corp.

Robert N. Latella ^{2, 3, 4}
Attorney
Hiscock & Barclay, LLP

James L. Robinson ^{1, 2}
Retired President, CEO
and Treasurer
Olean Wholesale Grocery
Cooperative

James H. Wyckoff ²
Professor
Curry School of Education at
the University of Virginia

¹ Audit Committee
James L. Robinson, Chair

² Executive/Nominating and
Governance Committee
Erland E. Kailbourne, Chair

³ Management Development and
Compensation Committee
Susan R. Holliday, Chair

⁴ Risk Oversight Committee
Robert N. Latella, Chair



FINANCIAL REVIEW

	PAGE
Business.....	9
Market for Registrant’s Common Equity, Related Shareholder Matters and Issuer Purchases of Equity Securities.....	23
Selected Financial Data.....	25
Management’s Discussion and Analysis of Financial Condition and Results of Operations.....	28
Quantitative and Qualitative Disclosures About Market Risk.....	51
Financial Statements and Supplementary Data.....	53
Controls and Procedures.....	100

GENERAL

Financial Institutions, Inc. is a financial holding company organized in 1931 under the laws of New York State (“New York” or “NYS”). Through its subsidiaries, including its wholly-owned, New York State chartered banking subsidiary, Five Star Bank, Financial Institutions, Inc. provides a broad array of deposit, lending and other financial services to retail, commercial, and municipal customers in Western and Central New York. All references in this Annual Report to the parent company are to Financial Institutions, Inc. (“FII”). Unless otherwise indicated or unless the context requires otherwise, all references in this Annual Report to “the Company,” “we,” “our” or “us” means Financial Institutions, Inc. and its subsidiaries on a consolidated basis. Five Star Bank is referred to as Five Star Bank, “FSB” or “the Bank”. The parent company is a legal entity separate and distinct from its subsidiaries, assisting those subsidiaries by providing financial resources and management. Our executive offices are located at 220 Liberty Street, Warsaw, New York.

We conduct business primarily through our banking subsidiary, Five Star Bank, which adopted its current name in 2005 when we merged three of our bank subsidiaries, Wyoming County Bank, National Bank of Geneva and Bath National Bank into our New York chartered bank subsidiary, First Tier Bank & Trust, which was renamed Five Star Bank. In addition, our business operations include a wholly-owned broker-dealer subsidiary, Five Star Investment Services, Inc. (“FSIS”).

OTHER INFORMATION

The Company’s Annual Report on Form 10-K, including the exhibits and schedules filed as part of the Annual Report on Form 10-K, may be inspected at the public reference facility maintained by the SEC at its public reference room at 100 F. Street, N.E., Room 1580, Washington, DC 20549 and copies of all or any part thereof may be obtained from that office upon payment of the prescribed fees. You may call the SEC at 1-800-SEC-0330 for further information on the operation of the public reference room and you can request copies of the documents upon payment of a duplicating fee, by writing to the SEC. In addition, the SEC maintains a website that contains reports, proxy and information statements and other information regarding registrants, including us, that file electronically with the SEC which can be accessed at www.sec.gov.

We also make available, free of charge through our website at www.fiiwarsaw.com, all reports filed with the SEC, including our Annual Report on Form 10-K, Quarterly Reports on Form 10-Q and Current Reports on Form 8-K, as well as any amendments to those reports, as soon as reasonably practicable after those documents are filed with, or furnished to, the SEC. Information available on our website is not a part of, and is not incorporated into, this Annual Report.

MARKET AREAS AND COMPETITION

We provide a wide range of consumer and commercial banking and financial services to individuals, municipalities and businesses through a network of over 50 offices and more than 70 ATMs in fourteen contiguous counties of Western and Central New York: Allegany, Cattaraugus, Cayuga, Chautauqua, Chemung, Erie, Genesee, Livingston, Monroe, Ontario, Seneca, Steuben, Wyoming and Yates Counties.

Our market area is economically diversified in that we serve both rural markets and the larger more affluent markets of suburban Rochester and suburban Buffalo. Rochester and Buffalo are the two largest metropolitan areas in New York outside of New York City, with combined metropolitan area populations of over two million people. We anticipate increasing our presence in and around these metropolitan statistical areas in the coming years.

We face significant competition in both making loans and attracting deposits, as Western and Central New York have a high density of financial institutions. Our competition for loans comes principally from commercial banks, savings banks, savings and loan associations, mortgage banking companies, credit unions, insurance companies and other financial service companies. Our most direct competition for deposits has historically come from commercial banks, savings banks and credit unions. We face additional competition for deposits from non-depository competitors such as the mutual fund industry, securities and brokerage firms and insurance companies. We generally compete with other financial service providers on factors such as; level of customer service, responsiveness to customer needs, availability and pricing of products, and geographic location.

LENDING ACTIVITIES

General

We offer a broad range of loans including commercial business and revolving lines of credit, commercial mortgages, equipment loans, residential mortgage loans and home equity loans and lines of credit, home improvement loans, automobile loans and personal loans. Newly originated and refinanced fixed rate residential mortgage loans are either retained in our portfolio or sold to the secondary market with servicing rights retained.

We continually evaluate and update our lending policy. The key elements of our lending philosophy include the following:

- To ensure consistent underwriting, employees must share a common view of the risks inherent in lending activities as well as the standards to be applied in underwriting and managing credit risk;
- Pricing of credit products should be risk-based;
- The loan portfolio must be diversified to limit the potential impact of negative events; and
- Careful, timely exposure monitoring through dynamic use of our risk rating system is required to provide early warning and assure proactive management of potential problems.

Commercial Business and Commercial Mortgage Lending

We originate commercial business loans in our primary market areas and underwrite them based on the borrower's ability to service the loan from operating income. We offer a broad range of commercial lending products, including term loans and lines of credit. Short and medium-term commercial loans, primarily collateralized, are made available to businesses for working capital (including inventory and receivables), business expansion (including acquisition of real estate, expansion and improvements) and the purchase of equipment. Commercial business loans are offered to the agricultural industry for short-term crop production, farm equipment and livestock financing. As a general practice, where possible, a collateral lien is placed on any available real estate, equipment or other assets owned by the borrower and a personal guarantee of the owner is obtained. As of December 31, 2010, \$70.0 million, or 33%, of the aggregate commercial business loan portfolio were at fixed rates, while \$141.0 million, or 67%, were at variable rates.

We also offer commercial mortgage loans to finance the purchase of real property, which generally consists of real estate with completed structures and, to a smaller extent, agricultural real estate financing. Commercial mortgage loans are secured by first liens on the real estate and are typically amortized over a 10 to 20 year period. The underwriting analysis includes credit verification, appraisals and a review of the borrower's financial condition and repayment capacity. As of December 31, 2010, \$100.0 million, or 28%, of the aggregate commercial mortgage portfolio were at fixed rates, while \$252.9 million, or 72%, were at variable rates.

We utilize government loan guarantee programs where available and appropriate. See "Government Guarantee Programs" below.

Government Guarantee Programs

We participate in government loan guarantee programs offered by the Small Business Administration ("SBA"), U.S. Department of Agriculture, Rural Economic and Community Development and Farm Service Agency, among others. As of December 31, 2010, we had loans with an aggregate principal balance of \$55.1 million that were covered by guarantees under these programs. The guarantees typically only cover a certain percentage of these loans. By participating in these programs, we are able to broaden our base of borrowers while minimizing credit risk.

Residential Mortgage Lending

We originate fixed and variable rate one-to-four family residential mortgages collateralized by owner-occupied properties located in our market areas. We offer a variety of real estate loan products, which are generally amortized over periods of up to 30 years. Loans collateralized by one-to-four family residential real estate generally have been originated in amounts of no more than 80% of appraised value or have mortgage insurance. Mortgage title insurance and hazard insurance are normally required. We sell certain one-to-four family residential mortgages to the secondary mortgage market and typically retain the right to service the mortgages. To assure maximum salability of the residential loan products for possible resale, we have formally adopted the underwriting, appraisal, and servicing guidelines of the Federal Home Loan Mortgage Corporation ("FHLMC") as part of our standard loan policy. As of December 31, 2010, the residential mortgage servicing portfolio totaled \$328.9 million, the majority of which have been sold to FHLMC. As of December 31, 2010, our residential mortgage loan portfolio totaled \$129.6 million, or 10% of our total loan portfolio. We do not engage in sub-prime or other high-risk residential mortgage lending as a line-of-business.

Consumer Lending

We offer a variety of loan products to our consumer customers, including home equity loans and lines of credit, automobile loans, secured installment loans and various other types of secured and unsecured personal loans. At December 31, 2010, outstanding consumer loan balances were concentrated in indirect automobile loans and home equity products.

We indirectly originate, through franchised new car dealers, indirect consumer loans. The consumer indirect loan portfolio is primarily comprised of new and used automobile loans with terms that typically range from 36 to 84 months. We have expanded our relationships with franchised new car dealers in Western, Central and, most recently, into the Capital District of New York, and have selectively originated a mix of new and used automobile loans from those dealers. In the latter part of 2010, we began efforts to expand our dealer network into Northern Pennsylvania and anticipate indirectly originating loans there in the first half of 2011. As of December 31, 2010, the consumer indirect portfolio totaled \$418.0 million, or 31% of our total loan portfolio.

We also originate, independently of the indirect loans described above, consumer automobile loans, recreational vehicle loans, boat loans, home improvement loans, closed-end home equity loans, home equity lines of credit, personal loans (collateralized and uncollateralized) and deposit account collateralized loans. The terms of these loans typically range from 12 to 180 months and vary based upon the nature of the collateral and the size of loan. The majority of the consumer lending program is underwritten on a secured basis using the customer's home or the financed automobile, mobile home, boat or recreational vehicle as collateral. As of December 31, 2010, \$97.2 million, or 47%, of the home equity portfolio was at fixed rates, while \$111.2 million, or 53%, was at variable rates. The other consumer portfolio totaled \$26.1 million as of December 31, 2010, all of which were fixed loans.

Credit Administration

Our loan policy establishes standardized underwriting guidelines, as well as the loan approval process and the committee structures necessary to facilitate and ensure the highest possible loan quality decision-making in a timely and businesslike manner. The policy establishes requirements for extending credit based on the size, risk rating and type of credit involved. The policy also sets limits on individual loan officer lending authority and various forms of joint lending authority, while designating which loans are required to be approved at the committee level.

Our credit objectives are as follows:

- Compete effectively and service the legitimate credit needs of our target market;
- Enhance our reputation for superior quality and timely delivery of products and services;
- Provide pricing that reflects the entire relationship and is commensurate with the risk profiles of our borrowers;
- Retain, develop and acquire profitable, multi-product, value added relationships with high quality borrowers;
- Focus on government guaranteed lending and establish a specialization in this area to meet the needs of the small businesses in our communities; and
- Comply with the relevant laws and regulations.

Our policy includes loan reviews, under the supervision of the Audit and Risk Oversight committees of the Board of Directors and directed by the Chief Risk Officer, in order to render an independent and objective evaluation of our asset quality and credit administration process.

Risk ratings are assigned to loans in the commercial business and commercial mortgage portfolios. The risk ratings are specifically used as follows:

- Profile the risk and exposure in the loan portfolio and identify developing trends and relative levels of risk;
- Identify deteriorating credits; and
- Reflect the probability that a given customer may default on its obligations.

Through the loan approval process, loan administration and loan review program, management seeks to continuously monitor our credit risk profile and assesses the overall quality of the loan portfolio and adequacy of the allowance for loan losses.

We have several procedures in place to assist in maintaining the overall quality of our loan portfolio. Delinquent loan reports are monitored by credit administration to identify adverse levels and trends. Loans, including impaired loans, are generally classified as non-accruing if they are past due as to maturity or payment of principal or interest for a period of more than 90 days, unless such loans are well-collateralized and in the process of collection. Loans that are on a current payment status or past due less than 90 days may also be classified as non-accruing if repayment in full of principal and/or interest is uncertain.

Allowance for Loan Losses

The allowance for loan losses is established through charges to earnings in the form of a provision for loan losses. The allowance reflects management's estimate of the amount of probable loan losses in the portfolio, based on factors such as:

- Specific allocations for individually analyzed credits;
- Risk assessment process;
- Historical net charge-off experience;
- Evaluation of the loan portfolio with loan reviews;
- Levels and trends in delinquent and non-accruing loans;
- Trends in volume and terms;
- Effects of changes in lending policy;
- Experience, ability and depth of management;
- National and local economic trends and conditions;
- Concentrations of credit;
- Interest rate environment;
- Customer leverage;
- Information (availability of timely financial information); and
- Collateral values.

Our methodology in the estimation of the allowance for loan losses includes the following broad areas:

1. Impaired commercial business and commercial mortgage loans, generally in excess of \$50 thousand are reviewed individually and assigned a specific loss allowance, if considered necessary, in accordance with U.S. generally accepted accounting principles ("GAAP").
2. The remaining portfolios of commercial business and commercial mortgage loans are segmented by risk rating into the following loan classification categories: uncriticized or pass, special mention, substandard and doubtful. Uncriticized loans, special mention loans, substandard loans and all doubtful loans not assigned a specific loss allowance are assigned allowance allocations based on historical net loan charge-off experience for each of the respective loan categories, supplemented with additional reserve amounts, if considered necessary, based upon qualitative factors. These qualitative factors include the levels and trends in delinquencies and non-accruing loans; trends in volume and terms of loans; effects of changes in lending policy; experience, ability, and depth of management; national and local economic conditions; concentrations of credit, interest rate environment; customer leverage; information (availability of timely financial information); and collateral values, among others.
3. The retail loan portfolio is segmented into the following types of loans: residential real estate, home equity (home equity loans and lines of credit), consumer indirect and other consumer. Allowance allocations for the real estate related loan portfolios (residential and home equity) are based on the average loss experience for the previous eight quarters, supplemented with qualitative factors similar to the elements described above. Allowance allocations for the consumer indirect and other consumer portfolios are based on vintage analyses performed with historical loss experience at 36 months and 24 months aging, respectively. The allocations on these portfolios are also supplemented with qualitative factors.

Management presents a quarterly review of the adequacy of the allowance for loan losses to our Board of Directors based on the methodology described above. See also the section titled *Lending Activities* under "Management's Discussion and Analysis of Financial Condition and Results of Operations" of this report.

INVESTMENT ACTIVITIES

Our investment policy is contained within our overall Asset-Liability Management and Investment Policy. This policy dictates that investment decisions will be made based on the safety of the investment, liquidity requirements, potential returns, cash flow targets, need for collateral and desired risk parameters. In pursuing these objectives, we consider the ability of an investment to provide earnings consistent with factors of quality, maturity, marketability, pledgeable nature and risk diversification. Our Treasurer, guided by the Asset-Liability Committee (“ALCO”), is responsible for investment portfolio decisions within the established policies.

Our investment securities strategy centers on providing liquidity to meet loan demand and redeeming liabilities, meeting pledging requirements, managing credit risks, managing overall interest rate risks and maximizing portfolio yield. Our current policy generally limits security purchases to the following:

- U.S. treasury securities;
- U.S. government agency securities, which are securities issued by official Federal government bodies (e.g. the Government National Mortgage Association (“GNMA”)) and U.S. government-sponsored enterprise (“GSE”) securities, which are securities issued by independent organizations that are in part sponsored by the federal government (e.g., the Federal Home Loan Bank (“FHLB”) system, the Federal National Mortgage Association (“FNMA”), FHLMC, SBA and the Federal Farm Credit Bureau);
- Mortgage-backed securities (“MBS”) include mortgage-backed pass-through securities (“pass-throughs”) and collateralized mortgage obligations (“CMO”) issued by GNMA, FNMA and FHLMC. See also the section titled *Investing Activities* under “Management’s Discussion and Analysis of Financial Condition and Results of Operations;”
- Investment grade municipal securities, including revenue, tax and bond anticipation notes, statutory installment notes and general obligation bonds;
- Certain creditworthy un-rated securities issued by municipalities;
- Certificates of deposit;
- Equity securities at the holding company level; and
- Limited partnership investments in Small Business Investment Companies.

SOURCES OF FUNDS

Our primary sources of funds are deposits, borrowed funds and repurchase agreements, scheduled amortization and prepayments of principal from loans and mortgage-backed securities, maturities and calls of investment securities and funds provided by operations.

We offer a variety of deposit account products with a range of interest rates and terms. The deposit accounts consist of noninterest-bearing demand, interest-bearing demand, savings, money market, club accounts and certificates of deposit. We also offer certificates of deposit with balances in excess of \$100,000 to local municipalities, businesses, and individuals as well as Individual Retirement Accounts and other qualified plan accounts. The flow of deposits is influenced significantly by general economic conditions, prevailing interest rates and competition. Our deposits are obtained predominantly from the areas in which our branch offices are located. We rely primarily on competitive pricing of our deposit products, customer service and long-standing relationships with customers to attract and retain these deposits. We have also utilized certificate of deposit sales in the national brokered market (“brokered deposits”) as a wholesale funding source; however, we had no brokered deposits at December 31, 2010. Our borrowings consist mainly of advances entered into with the FHLB, federal funds purchased and securities sold under repurchase agreements.

OPERATING SEGMENTS

Our primary operating segment is our subsidiary bank, FSB. Our brokerage subsidiary, FSIS, is also deemed an operating segment; however, it does not meet the applicable thresholds for separation.

SUPERVISION AND REGULATION

The Company and our subsidiaries are subject to an extensive system of laws and regulations that are intended primarily for the protection of customers and depositors and not for the protection of security holders. These laws and regulations govern such areas as capital, permissible activities, allowance for loan losses, loans and investments, and rates of interest that can be charged on loans. Described below are elements of selected laws and regulations. The descriptions are not intended to be complete and are qualified in their entirety by reference to the full text of the statutes and regulations described.

Holding Company Regulation. As a bank holding company and financial holding company, we are subject to comprehensive regulation by the Board of Governors of the Federal Reserve System, frequently referred to as the Federal Reserve Board ("FRB"), under the Bank Holding Company Act, as amended by, among other laws, the Gramm-Leach-Bliley Act of 1999 (the "Gramm-Leach-Bliley Act"), and by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), enacted on July 21, 2010. We must file reports with the FRB and such additional information as the FRB may require, and our holding company and non-banking affiliates are subject to examination by the FRB. Under FRB policy, a bank holding company must serve as a source of strength for its subsidiary banks. Under this policy, the FRB may require, and has required in the past, a holding company to contribute additional capital to an undercapitalized subsidiary bank. The Bank Holding Company Act provides that a bank holding company must obtain FRB approval before:

- Acquiring directly or indirectly, ownership or control of any voting shares of another bank or bank holding company if, after such acquisition, it would own or control more than 5% of such shares (unless it already owns or controls the majority of such shares);
- Acquiring all or substantially all of the assets of another bank or bank holding company, or
- Merging or consolidating with another bank holding company.

The Bank Holding Company Act generally prohibits a bank holding company from acquiring direct or indirect ownership or control of more than 5% of the voting shares of any company which is not a bank or bank holding company, or from engaging directly or indirectly in activities other than those of banking, managing or controlling banks, or providing services for its subsidiaries. The principal exceptions to these prohibitions involve certain non-bank activities which, by statute or by FRB regulation or order, have been identified as activities closely related to the business of banking or managing or controlling banks. The list of activities permitted by the FRB includes, among other things: lending; operating a savings institution, mortgage company, finance company, credit card company or factoring company; performing certain data processing operations; providing certain investment and financial advice; underwriting and acting as an insurance agent for certain types of credit related insurance; leasing property on a full-payout, non-operating basis; selling money orders, travelers' checks and United States Savings Bonds; real estate and personal property appraising; providing tax planning and preparation services; and, subject to certain limitations, providing securities brokerage services for customers. These activities may also be affected by federal legislation.

The Gramm-Leach-Bliley Act amended portions of the Bank Holding Company Act to authorize bank holding companies, such as us, directly or through non-bank subsidiaries to engage in securities, insurance and other activities that are financial in nature or incidental to a financial activity. In order to undertake these activities, a bank holding company must become a "financial holding company" by submitting to the appropriate Federal Reserve Bank a declaration that the company elects to be a financial holding company and a certification that all of the depository institutions controlled by the company are well capitalized and well managed. During the second quarter of 2008, we received FRB approval for an election to reinstate our status as a financial holding company under the Gramm-Leach-Bliley Act.

Depository Institution Regulation. Our bank subsidiary is subject to regulation by the Federal Deposit Insurance Corporation ("FDIC"). This regulatory structure includes:

- Real estate lending standards, which provide guidelines concerning loan-to-value ratios for various types of real estate loans;
- Risk-based capital rules, including accounting for interest rate risk, concentration of credit risk and the risks posed by non-traditional activities;
- Rules requiring depository institutions to develop and implement internal procedures to evaluate and control credit and settlement exposure to their correspondent banks;
- Rules restricting types and amounts of equity investments; and
- Rules addressing various safety and soundness issues, including operations and managerial standards, standards for asset quality, earnings and compensation standards.

Capital Adequacy Requirements. The FRB and FDIC have issued substantially similar risk-based and leverage capital guidelines applicable to bank holding companies and banks. In addition, these regulatory agencies may from time to time require that a bank holding company or bank maintain capital above the minimum levels, based on its financial condition or actual or anticipated growth.

The FRB's risk-based guidelines establish a two-tier capital framework. Tier 1 capital generally consists of common shareholders' equity, retained earnings, a limited amount of qualifying perpetual preferred stock, qualifying trust preferred securities and non-controlling interests in the equity accounts of consolidated subsidiaries, less goodwill and certain intangibles. Tier 2 capital generally consists of certain hybrid capital instruments and perpetual debt, mandatory convertible debt securities and a limited amount of subordinated debt, qualifying preferred stock, loan loss allowance, and unrealized holding gains on certain equity securities. The sum of Tier 1 and Tier 2 capital represents qualifying total capital, at least 50% of which must consist of Tier 1 capital.

Risk-based capital ratios are calculated by dividing Tier 1 and total capital by risk-weighted assets. Assets and off-balance sheet exposures are assigned to one of four categories of risk-weights, based primarily on relative credit risk. For bank holding companies, generally the minimum Tier 1 risk-based capital ratio is 4% and the minimum total risk-based capital ratio is 8%. Our Tier 1 and total risk-based capital ratios under these guidelines at December 31, 2010 were 12.34% and 13.60%, respectively.

The FRB's leverage capital guidelines establish a minimum leverage ratio determined by dividing Tier 1 capital by adjusted average total assets. The minimum leverage ratio is 3% for bank holding companies that meet certain specified criteria, including having the highest regulatory rating. All other bank holding companies generally are required to maintain a leverage ratio of at least 4%. At December 31, 2010, we had a leverage ratio of 8.31%. See also the section titled *Liquidity and Capital Resources* under "Management's Discussion and Analysis of Financial Condition and Results of Operations" and Note 10, *Regulatory Matters*, of the notes to consolidated financial statements under "Financial Statements and Supplementary Data".

The federal regulatory authorities' risk-based capital guidelines are based upon the 1988 capital accord ("Basel I") of the Basel Committee on Banking Supervision (the "Basel Committee"). The Basel Committee is a committee of central banks and bank supervisors/regulators from the major industrialized countries that develops broad policy guidelines for use by each country's supervisors in determining the supervisory policies and regulations to which they apply. Actions of the Committee have no direct effect on banks in participating countries. In 2004, the Basel Committee published a new capital accord ("Basel II") to replace Basel I. Basel II provides two approaches for setting capital standards for credit risk – an internal ratings-based approach tailored to individual institutions' circumstances and a standardized approach that bases risk weightings on external credit assessments to a much greater extent than permitted in existing risk-based capital guidelines. Basel II also would set capital requirements for operational risk and refine the existing capital requirements for market risk exposures.

A final rule implementing the advanced approaches of Basel II in the United States would apply only to certain large or internationally active banking organizations, or "core banks" – defined as those with consolidated total assets of \$250 billion or more or consolidated on-balance sheet foreign exposures of \$10 billion or more, became effective as of April 1, 2008. Certain other U.S. banking organizations would have the option to adopt the requirements of this rule. We are not required to comply with the advanced approaches of Basel II.

In July 2008, the agencies issued a proposed rule that would give banking organizations that do not use the advanced approaches the option to implement a new risk-based capital framework that generally parallels the relevant approaches under Basel II, but recognizes that U.S. markets have unique characteristics and risk profiles, most notably with respect to risk weighting residential mortgage exposures. To date, no final rule has been adopted.

In 2009, the United States Department of Treasury (the "Treasury") issued a policy statement (the "Treasury Policy Statement") entitled "Principles for Reforming the U.S. and International Regulatory Capital Framework for Banking Firms," which contemplates changes to the existing regulatory capital regime involving substantial revisions to major parts of the Basel I and Basel II capital frameworks and affecting all regulated banking organizations and other systemically important institutions. The Treasury Policy Statement calls for, among other things, higher and stronger capital requirements for all banking firms, with changes to the regulatory capital framework to be phased in over a period of several years.

On December 17, 2009, the Basel Committee issued a set of proposals (the "2009 Capital Proposals") that would significantly revise the definitions of Tier 1 capital and Tier 2 capital. Among other things, the 2009 Capital Proposals would re-emphasize that common equity is the predominant component of Tier 1 capital. Concurrently with the release of the 2009 Capital Proposals, the Basel Committee also released a set of proposals related to liquidity risk exposure (the "2009 Liquidity Proposals"). The 2009 Liquidity Proposals include the implementation of (i) a "liquidity coverage ratio" or LCR, designed to ensure that a bank maintains an adequate level of unencumbered, high-quality assets sufficient to meet the bank's liquidity needs over a 30-day time horizon under an acute liquidity stress scenario and (ii) a "net stable funding ratio" or NSFR, designed to promote more medium and long-term funding of the assets and activities of banks over a one-year time horizon.

The Dodd-Frank Act includes certain provisions concerning the capital regulations of the U.S. banking regulators, which are often referred to as the “Collins Amendment.” These provisions are intended to subject bank holding companies to the same capital requirements as their bank subsidiaries and to eliminate or significantly reduce the use of hybrid capital instruments, especially trust preferred securities, as regulatory capital. Under the Collins Amendment, trust preferred securities issued by a company, such as our company, with total consolidated assets of less than \$15 billion before May 19, 2010 and treated as regulatory capital are grandfathered, but any such securities issued later are not eligible as regulatory capital. The banking regulators must develop regulations setting minimum risk-based and leverage capital requirements for holding companies and banks on a consolidated basis that are no less stringent than the generally applicable requirements in effect for depository institutions under the prompt corrective action regulations discussed below. The banking regulators also must seek to make capital standards countercyclical so that the required levels of capital increase in times of economic expansion and decrease in times of economic contraction. The Dodd-Frank Act requires these new capital regulations to be adopted by the FRB in final form 18 months after its date of enactment (July 21, 2010). To date, no proposed regulations have been issued.

In December 2010 and January 2011, the Basel Committee published the final texts of reforms on capital and liquidity generally referred to as “Basel III.” Although Basel III is intended to be implemented by participating countries for large, internationally active banks, its provisions are likely to be considered by U.S. banking regulators in developing new regulations applicable to other banks in the United States, including Five Star Bank.

For banks in the United States, among the most significant provisions of Basel III concerning capital are the following:

- A minimum ratio of common equity to risk-weighted assets reaching 4.5%, plus an additional 2.5% as a capital conservation buffer, by 2019 after a phase-in period.
- A minimum ratio of Tier 1 capital to risk-weighted assets reaching 6.0% by 2019 after a phase-in period.
- A minimum ratio of total capital to risk-weighted assets, plus the additional 2.5% capital conservation buffer, reaching 10.5% by 2019 after a phase-in period.
- An additional countercyclical capital buffer to be imposed by applicable national banking regulators periodically at their discretion, with advance notice.
- Restrictions on capital distributions and discretionary bonuses applicable when capital ratios fall within the buffer zone.
- Deduction from common equity of deferred tax assets that depend on future profitability to be realized.
- Increased capital requirements for counterparty credit risk relating to OTC derivatives, repos and securities financing activities.
- For capital instruments issued on or after January 13, 2013 (other than common equity), a loss-absorbency requirement such that the instrument must be written off or converted to common equity if a trigger event occurs, either pursuant to applicable law or at the direction of the banking regulator. A trigger event is an event under which the banking entity would become nonviable without the write-off or conversion, or without an injection of capital from the public sector. The issuer must maintain authorization to issue the requisite shares of common equity if conversion were required.

The Basel III provisions on liquidity include complex criteria establishing the LCR and NSFR. The purpose of the LCR is to ensure that a bank maintains adequate unencumbered, high quality liquid assets to meet its liquidity needs for 30 days under a severe liquidity stress scenario. The purpose of the NSFR is to promote more medium and long-term funding of assets and activities, using a one-year horizon. Although Basel III is described as a “final text,” it is subject to the resolution of certain issues and to further guidance and modification, as well as to adoption by U.S. banking regulators, including decisions as to whether and to what extent it will apply to U.S. banks that are not large, internationally active banks.

Prompt Corrective Action. The Federal Deposit Insurance Corporation Improvement Act of 1991, among other things, identifies five capital categories for insured depository institutions (well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized and critically undercapitalized) and requires the respective federal bank regulatory agencies to implement systems for “prompt corrective action” for insured depository institutions that do not meet minimum capital requirements within these categories. This act imposes progressively more restrictive constraints on operations, management and capital distributions, depending on the category in which an institution is classified. Failure to meet the capital guidelines could also subject a banking institution to capital raising requirements. An “undercapitalized” bank must develop a capital restoration plan and its parent holding company must guarantee that bank’s compliance with the plan. The liability of the parent holding company under any such guarantee is limited to the lesser of five percent of the bank’s assets at the time it became “undercapitalized” or the amount needed to comply with the plan. Furthermore, in the event of the bankruptcy of the parent holding company, such guarantee would take priority over the parent’s general unsecured creditors. In addition, the Federal Deposit Insurance Corporation Improvement Act requires the various regulatory agencies to prescribe certain non-capital standards for safety and soundness relating generally to operations and management, asset quality and executive compensation and permits regulatory action against a financial institution that does not meet these standards.

The various federal bank regulatory agencies have adopted substantially similar regulations that define the five capital categories identified by the Federal Deposit Insurance Corporation Improvement Act, using the total risk-based capital, Tier 1 risk-based capital and leverage capital ratios as the relevant capital measures. These regulations establish various degrees of corrective action to be taken when an institution is considered undercapitalized. Under the regulations, a "well capitalized" institution must have a Tier 1 risk-based capital ratio of at least 6%, a total risk-based capital ratio of at least 10% and a leverage ratio of at least 5% and not be subject to a capital directive or order. An institution is "adequately capitalized" if it has a Tier 1 risk-based capital ratio of at least 4%, a total risk-based capital ratio of at least 8% and a leverage ratio of at least 4% (3% in certain circumstances). An institution is "undercapitalized" if it has a Tier 1 risk-based capital ratio of less than 4%, a total risk-based capital ratio of less than 8% or a leverage ratio of less than 4% (3% in certain circumstances). An institution is "significantly undercapitalized" if it has a Tier 1 risk-based capital ratio of less than 3%, a total risk-based capital ratio of less than 6% or a leverage ratio of less than 3%. An institution is "critically undercapitalized" if its tangible equity is equal to or less than 2% of total assets. Generally, an institution may be reclassified in a lower capitalization category if it is determined that the institution is in an unsafe or unsound condition or engaged in an unsafe or unsound practice.

As of December 31, 2010, our subsidiary bank met the requirements to be classified as "well-capitalized."

Dividends. The FRB policy is that a bank holding company should pay cash dividends only to the extent that its net income for the past year is sufficient to cover both the cash dividends and a rate of earnings retention that is consistent with the holding company's capital needs, asset quality and overall financial condition, and that it is inappropriate for a bank holding company experiencing serious financial problems to borrow funds to pay dividends. Furthermore, a bank that is classified under the prompt corrective action regulations as "undercapitalized" will be prohibited from paying any dividends.

On December 23, 2008, as part of the TARP Capital Purchase Program of the Treasury, we sold to the Treasury 7,503 shares of our fixed rate cumulative perpetual preferred stock, Series A preferred stock ("Series A"), having a liquidation preference amount of \$5,000 per share, for a purchase price of \$37.5 million in cash and issued to Treasury a ten-year warrant to purchase 378,175 shares of the Company's common stock at an exercise price of \$14.88 per share (the "Warrant").

We may redeem the Series A preferred stock at any time by repaying the Treasury, without penalty, subject to Treasury's consultation with our appropriate regulatory agency and approval. Additionally, upon redemption of the Series A preferred stock, the Warrant generally may be repurchased from the Treasury at its fair market value as agreed-upon by us and the Treasury. In February 2011, the Company repaid one-third or \$12.5 million of its obligation.

The securities purchase agreement between us and the Treasury provides that prior to the earlier of (i) December 23, 2011 and (ii) the date on which all of the shares of the Series A preferred stock have been redeemed by us or transferred by the Treasury to third parties, we may not, without the consent of the Treasury, (a) pay a quarterly cash dividend on our common stock of more than \$0.10 per share or (b) subject to limited exceptions, redeem, repurchase or otherwise acquire shares of our common stock, preferred stock (other than the Series A preferred stock) or trust preferred securities. In addition, under the terms of the Series A preferred stock, we may not pay dividends on our common stock at any time we are in arrears on the dividends payable on the Series A preferred stock. Dividends on the Series A preferred stock are payable quarterly at a rate of 5% per annum for the first five years and a rate of 9% per annum thereafter if not redeemed prior to that time.

Our primary source for cash dividends is the dividends we receive from our subsidiary bank. Our bank is subject to various regulatory policies and requirements relating to the payment of dividends, including requirements to maintain capital above regulatory minimums. Approval of the New York State Banking Department is required prior to paying a dividend if the dividends declared by the Bank exceed the sum of the Bank's net profits for that year and its retained net profits for the preceding two calendar years.

Federal Deposit Insurance Assessments. The Bank's deposits are insured to the maximum extent permitted by the Deposit Insurance Fund ("DIF"). Upon enactment of the Emergency Economic Stabilization Act of 2008 on October 3, 2008, federal deposit insurance coverage levels under the DIF temporarily increased from \$100,000 to \$250,000 per deposit category, per depositor, per institution, through December 31, 2009. On May 20, 2009, the Helping Families Save Their Homes Act extended the temporary increase through December 31, 2013. The Dodd-Frank Act permanently increases the maximum amount of deposit insurance to \$250,000 per deposit category, per depositor, per institution retroactive to January 1, 2008, and noninterest-bearing transaction accounts have unlimited deposit insurance through December 31, 2013.

As the insurer, the FDIC is authorized to conduct examinations of, and to require reporting by, FDIC-insured institutions. The FDIC also may prohibit any FDIC-insured institution from engaging in any activity the FDIC determines by regulation or order to pose a serious threat to the DIF. The FDIC also has the authority to initiate enforcement actions against banks. Insurance of deposits may be terminated by the FDIC upon a finding that the institution has engaged or is engaging in unsafe and unsound practices, is in an unsafe or unsound condition to continue operations or has violated any applicable law, regulation, rule, order or condition imposed by the FDIC or written agreement entered into with the FDIC. The management of the Bank does not know of any practice, condition or violation that might lead to termination of deposit insurance.

The FDIC maintains the DIF by assessing depository institutions an insurance premium on a quarterly basis under a risk-based assessment system. The amount of the assessment is a function of the institution's risk category, of which there are four, and assessment base. An institution's risk category is determined according to its supervisory ratings and capital levels and is used to determine the institution's assessment rate. The assessment rate for risk categories are calculated according to a formula, which relies on supervisory ratings and either certain financial ratios or long-term debt ratings. An insured bank's assessment base is currently determined by its level of deposits. Because the system is risk-based, it allows banks to pay lower assessments to the FDIC as their capital level and supervisory ratings improve. By the same token, if these indicators deteriorate, the institution will have to pay higher assessments to the FDIC.

Under the Federal Deposit Insurance Act, the FDIC Board has the authority to set the annual assessment rate range for the various risk categories within certain regulatory limits and to impose special assessments upon insured depository institutions when deemed necessary by the FDIC's Board. As part of the Deposit Insurance Fund Restoration Plan adopted by the FDIC in October 2008, on February 27, 2009, the FDIC adopted the final rule modifying the risk-based assessment system, which set initial base assessment rates between 12 and 45 basis points, beginning April 1, 2009. The FDIC imposed an emergency special assessment on June 30, 2009, which totaled \$923 thousand for our Bank. In addition, in September 2009, the FDIC extended the Restoration Plan period to eight years. In November 2009, the FDIC adopted a final rule requiring prepayment of 13 quarters of FDIC premiums. The Bank's required prepayment amounted to \$9.9 million and was collected in December 2009.

In October 2010, the FDIC adopted a new Restoration Plan for the DIF to ensure that the fund reserve ratio reaches 1.35% by September 30, 2020, as required by the Dodd-Frank Act. Under the Restoration Plan, the FDIC did not institute the uniform three-basis point increase in assessment rates scheduled to take place on January 1, 2011 and maintained the current schedule of assessment rates for all depository institutions. At least semi-annually, the FDIC will update its loss and income projections for the DIF and, if needed, will increase or decrease assessment rates, following notice-and-comment rulemaking, if required.

In November 2010, the FDIC issued a notice of proposed rulemaking to change the deposit insurance assessment base from total domestic deposits to average total assets minus average tangible equity, as required by the Dodd-Frank Act, effective April 1, 2011. The FDIC also issued a notice of proposed rulemaking to revise the deposit insurance assessment system for large institutions. The FDIC proposed to create a two tier system - one for most large institutions that have more than \$10 billion in assets, and another for "highly complex" institutions that have over \$50 billion in assets and are fully owned by a parent with over \$500 billion in assets. These proposals did not apply to us or the Bank.

On February 9, 2011, the FDIC adopted a final rule which redefines the deposit insurance assessment base as required by the Dodd-Frank Act. The final rule sets the deposit insurance assessment base as average consolidated total assets minus average tangible equity. It also sets a new assessment rate schedule which reflects assessment rate adjustments including potentially reduced rates tied to unsecured debt and potentially increased rates for brokered deposits. The final rule generally becomes effective on April 1, 2011. Under the new rule, our FDIC insurance premiums are expected to decline in 2011. However, there can be no assurances that such premium reductions will be realized in 2011.

Transactions with Affiliates. FII and FSB are affiliates within the meaning of the Federal Reserve Act. The Federal Reserve Act imposes limitations on a bank with respect to extensions of credit to, investments in, and certain other transactions with, its parent bank holding company and the holding company's other subsidiaries. Furthermore, bank loans and extensions of credit to affiliates also are subject to various collateral requirements.

Community Reinvestment Act. Under the Community Reinvestment Act, every FDIC-insured institution is obligated, consistent with safe and sound banking practices, to help meet the credit needs of its entire community, including low and moderate income neighborhoods. The Community Reinvestment Act requires the appropriate federal banking regulator, in connection with the examination of an insured institution, to assess the institution's record of meeting the credit needs of its community and to consider this record in its evaluation of certain applications, such as a merger or the establishment of a branch. An unsatisfactory rating may be used as the basis for the denial of an application and will prevent a bank holding company of the institution from making an election to become a financial holding company.

As of its last Community Reinvestment Act examination, Five Star Bank received a rating of "outstanding."

Interstate Banking and Branching. The FRB may approve an application of a bank holding company to acquire control of, or acquire all or substantially all of the assets of, a bank located in a state other than the bank holding company's home state, without regard to whether the transaction is prohibited by the laws of any state. The FRB may not approve the acquisition of a bank that has not been in existence for the minimum time period (not exceeding five years) specified by the law of the target bank's home state. The FRB also may not approve an application if the bank holding company (and its bank affiliates) controls or would control more than ten percent of the insured deposits in the U.S. or, generally, 30% or more of the deposits in the target bank's home state or in any state in which the target bank maintains a branch. Individual states may waive the 30% statewide concentration limit. Each state may limit the percentage of total insured deposits in the state that may be held or controlled by a bank or bank holding company to the extent the limitation does not discriminate against out-of-state banks or bank holding companies.

The federal banking agencies are authorized to approve interstate bank merger transactions without regard to whether these transactions are prohibited by the law of any state, unless the home state of one of the banks opted out of interstate mergers prior to June 1, 1997. Interstate acquisitions of branches are permitted only if the law of the state in which the branch is located permits these acquisitions. Interstate mergers and branch acquisitions are subject to the nationwide and statewide-insured deposit concentration limits described above.

Privacy Rules. Federal banking regulators, as required under the Gramm-Leach-Bliley Act, have adopted rules limiting the ability of banks and other financial institutions to disclose nonpublic information about consumers to non-affiliated third parties. The rules require disclosure of privacy policies to consumers and, in some circumstances, allow consumers to prevent disclosure of certain personal information to non-affiliated third parties. The privacy provisions of the Gramm-Leach-Bliley Act affect how consumer information is transmitted through diversified financial services companies and conveyed to outside vendors.

International Money Laundering Abatement and Financial Anti-Terrorism Act of 2001. The President signed the USA Patriot Act of 2001 into law in October 2001. This act contains the International Money Laundering Abatement and Financial Anti-Terrorism Act of 2001 (the “IMLAFA”). The IMLAFA substantially broadens existing anti-money laundering legislation and the extraterritorial jurisdiction of the U.S., imposes new compliance and due diligence obligations, creates new crimes and penalties, compels the production of documents located both inside and outside the U.S., including those of foreign institutions that have a correspondent relationship in the U.S., and clarifies the safe harbor from civil liability to customers. The Treasury Department has issued a number of regulations implementing the USA Patriot Act that apply certain of its requirements to financial institutions such as our banking and broker-dealer subsidiaries. The regulations impose obligations on financial institutions to maintain appropriate policies, procedures and controls to detect, prevent and report money laundering and terrorist financing. The increased obligations of financial institutions, including us, to identify their customers, watch for and report suspicious transactions, respond to requests for information by regulatory authorities and law enforcement agencies, and share information with other financial institutions, requires the implementation and maintenance of internal procedures, practices and controls which have increased, and may continue to increase, our costs and may subject us to liability.

As noted above, enforcement and compliance-related activity by government agencies has increased. Money laundering and anti-terrorism compliance is among the areas receiving a high level of focus in the present environment.

Regulatory Reform. On July 21 2010, the Dodd-Frank Act was signed into law. The Dodd-Frank Act (as amended) implements far-reaching changes across the financial regulatory landscape, including provisions that, among other things, will:

- Centralize responsibility for consumer financial protection by creating a new agency, the Bureau of Consumer Financial Protection, with broad rulemaking, supervision and enforcement authority for a wide range of consumer protection laws that would apply to all banks and certain others, including the examination and enforcement powers with respect to any bank with more than \$10 billion in assets.
- Require new capital rules and apply the same leverage and risk-based capital requirements that apply to insured depository institutions to most bank holding companies.
- Change the assessment base for federal deposit insurance from the amount of insured deposits to consolidated average assets less tangible capital.
- Increase the minimum ratio of net worth to insured deposits of the Deposit Insurance Fund from 1.15% to 1.35% and require the FDIC, in setting assessments, to offset the effect of the increase on institutions with assets of less than \$10 billion. As a result, this increase is generally expected to impose more deposit insurance cost on institutions with assets of \$10 billion or more.
- Provide for new disclosure and other requirements relating to executive compensation and corporate governance, including guidelines or regulations on incentive-based compensation and a prohibition on compensation arrangements that encourage inappropriate risks or that could provide excessive compensation.
- Make permanent the \$250 thousand limit for federal deposit insurance and provide unlimited federal deposit insurance until January 1, 2013 for non-interest bearing demand transaction accounts and IOLTA accounts at all insured depository institutions.
- Repeal the federal prohibitions on the payment of interest on demand deposits, thereby permitting depository institutions to pay interest on business transaction and other accounts.
- Allow de novo interstate branching by banks.
- Increase the authority of the FRB to examine the Company and its non-bank subsidiary.
- Require all bank holding companies to serve as a source of financial strength to their depository institution subsidiaries in the event such subsidiaries suffer from financial distress.

- Restrict proprietary trading by banks, bank holding companies and others, and their acquisition and retention of ownership interests in and sponsorship of hedge funds and private equity funds. This restriction is commonly referred to as the “Volcker Rule.” There is an exception in the Volcker Rule to allow a bank to organize and offer hedge funds and private equity funds to customers if certain conditions are met. These conditions include, among others, requirements that the bank provides *bona fide* investment advisory services; the funds are organized only in connection with such services and to customers of such services; the bank does not have more than a *de minimis* interest in the funds, limited to a 3% ownership interest in any single fund and an aggregated investment in all funds of 3% of Tier 1 capital; the bank does not guarantee the obligations or performance of the funds; and no director or employee of the bank has an ownership interest in the fund unless he or she provides services directly to the funds. Further details on the scope of the Volcker Rule and its exceptions are expected to be defined in regulations due to be issued later in 2011.

Many aspects of the Dodd-Frank Act are subject to rulemaking and will take effect over several years, making it difficult to anticipate the overall financial impact on us and the financial services industry more generally. Provisions in the legislation that affect deposit insurance assessments, and payment of interest on demand deposits could increase the costs associated with deposits. Provisions in the legislation that require revisions to the capital requirements of the Company and Five Star Bank could require the Company and the Bank to seek additional sources of capital in the future.

TARP-Related Compensation and Corporate Governance Requirements. The Emergency Economic Stabilization Act of 2008 (“EESA”) was signed into law on October 3, 2008 and authorized the Treasury to provide funds to be used to restore liquidity and stability to the U.S. financial system pursuant to the TARP. Under the authority of EESA, Treasury instituted the TARP Capital Purchase Program to encourage U.S. financial institutions to build capital to increase the flow of financing to U.S. businesses and consumers and to support the U.S. economy. As noted above, on December 23, 2008, we participated in this program by issuing 7,503 shares of our Series A preferred stock to the Treasury for a purchase price of \$37.5 million in cash and issued the Warrant to the Treasury. In February 2011, the Company repaid one-third or \$12.5 million of its obligation.

In addition to the restrictions on the Company’s ability to pay dividends on and repurchase its stock, as described above under “Dividends,” participation in the TARP Capital Purchase Program also includes certain requirements and restrictions regarding compensation that were expanded significantly by the American Recovery and Reinvestment Act of 2009 (“ARRA”), as implemented by the Treasury’s Interim Final Rule on TARP Standards for Compensation and Corporate Governance. These requirements and restrictions include, among others, the following: (i) a prohibition on paying or accruing bonuses, retention awards and incentive compensation, other than qualifying long-term restricted stock or pursuant to certain preexisting employment contracts, to our five most highly-compensated employees; (ii) a general prohibition on providing severance benefits, or other benefits due to a change in control of the Company, to our senior executive officers (“SEOs”) and next five most highly compensated employees; (iii) a requirement to make subject to clawback any bonus, retention award, or incentive compensation paid to any of the SEOs and any of the next twenty most highly compensated employees if such compensation was based on materially inaccurate financial statements or any other materially inaccurate performance metric criteria; (iv) a requirement to establish a policy on luxury or excessive expenditures; (v) a requirement to annually provide shareholders with a non-binding advisory “say on pay” vote on executive compensation; (vi) a prohibition on deducting more than \$500,000 in annual compensation, including performance-based compensation, to the executives covered under Internal Revenue Code Section 162(m); (vii) a requirement that the compensation committee of the board of directors evaluate and review on a semi-annual basis the risks involved in employee compensation plans; and (viii) a prohibition on providing tax “gross-ups” to our SEOs and the next 20 most highly compensated employees. These requirements and restrictions will remain applicable to us until we have redeemed the Series A preferred stock in full.

Incentive Compensation. On October 22, 2009, the Federal Reserve issued a comprehensive proposal on incentive compensation policies (the “Incentive Compensation Proposal”) intended to ensure that the incentive compensation policies of banking organizations do not undermine the safety and soundness of such organizations by encouraging excessive risk-taking. The Incentive Compensation Proposal, which covers all employees that have the ability to materially affect the risk profile of an organization, either individually or as part of a group, is based upon the key principles that a banking organization’s incentive compensation arrangements should (i) provide incentives that do not encourage risk-taking beyond the organization’s ability to effectively identify and manage risks, (ii) be compatible with effective internal controls and risk management, and (iii) be supported by strong corporate governance, including active and effective oversight by the organization’s board of directors. Banking organizations are instructed to begin an immediate review of their incentive compensation policies to ensure that they do not encourage excessive risk-taking and implement corrective programs as needed. Where there are deficiencies in the incentive compensation arrangements, they must be immediately addressed.

Additionally, the Incentive Compensation Proposal will require the Federal Reserve to review, as part of the regular, risk-focused examination process, the incentive compensation arrangements of banking organizations, such as us, that are not “large, complex banking organizations.” These reviews will be tailored to each organization based on the scope and complexity of the organization’s activities and the prevalence of incentive compensation arrangements. The findings of the supervisory initiatives will be included in reports of examination. Deficiencies will be incorporated into the organization’s supervisory ratings, which can affect the organization’s ability to make acquisitions and take other actions. Enforcement actions may be taken against a banking organization if its incentive compensation arrangements, or related risk-management control or governance processes, pose a risk to the organization’s safety and soundness and the organization is not taking prompt and effective measures to correct the deficiencies.

The scope and content of the U.S. banking regulators' policies on executive compensation are continuing to develop and are likely to continue evolving in the near future. It cannot be determined at this time whether compliance with such policies will adversely affect our ability to hire, retain and motivate its key employees.

Sarbanes-Oxley Act of 2002. The Sarbanes-Oxley Act of 2002 implemented a broad range of corporate governance, accounting and reporting measures for companies that have securities registered under the Exchange Act, including publicly-held bank holding companies such as Financial Institutions. Specifically, the Sarbanes-Oxley Act of 2002 and the various regulations promulgated thereunder, established, among other things: (i) requirements for audit committees, including independence, expertise, and responsibilities; (ii) responsibilities regarding financial statements for the Chief Executive Officer and Chief Financial Officer of the reporting company; (iii) the forfeiture of bonuses or other incentive-based compensation and profits from the sale of the reporting company's securities by the Chief Executive Officer and Chief Financial Officer in the twelve-month period following the initial publication of any financial statements that later require restatement; (iv) the creation of an independent accounting oversight board; (v) standards for auditors and regulation of audits, including independence provisions that restrict non-audit services that accountants may provide to their audit clients; (vi) disclosure and reporting obligations for the reporting company and their directors and executive officers, including accelerated reporting of stock transactions and a prohibition on trading during pension blackout periods; (vii) a prohibition on personal loans to directors and officers, except certain loans made by insured financial institutions on non-preferential terms and in compliance with other bank regulatory requirements; and (viii) a range of civil and criminal penalties for fraud and other violations of the securities laws.

Consumer Laws and Regulations. In addition to the laws and regulations discussed herein, the Bank is also subject to certain consumer laws and regulations that are designed to protect consumers in transactions with banks. While the list set forth herein is not exhaustive, these laws and regulations include, among others, the Truth in Lending Act, the Truth in Savings Act, the Electronic Funds Transfer Act, the Expedited Funds Availability Act, the Equal Credit Opportunity Act, the Fair Housing Act, the Home Mortgage Disclosure Act and the Real Estate Settlement Procedures Act. These laws and regulations mandate certain disclosure requirements and regulate the manner in which financial institutions must deal with customers when taking deposits or making loans to such customers. The Bank must comply with the applicable provisions of these consumer protection laws and regulations as part of its ongoing customer relations. The Check Clearing for the 21st Century Act (the "Check 21 Act"), which became effective on October 28, 2004, creates a new negotiable instrument, called a "substitute check", which banks are required to accept as the legal equivalent of a paper check if it meets the requirements of the Check 21 Act. The Check 21 Act is designed to facilitate check truncation, to foster innovation in the check payment system, and to improve the payment system by shortening processing times and reducing the volume of paper checks.

Other Future Legislation and Changes in Regulations. In addition to the specific proposals described above, from time to time, various legislative and regulatory initiatives are introduced in Congress and state legislatures, as well as by regulatory agencies. Such initiatives may include proposals to expand or contract the powers of bank holding companies and depository institutions or proposals to substantially change the financial institution regulatory system. Such legislation could change banking statutes and the operating environment of the Company in substantial and unpredictable ways. If enacted, such legislation could increase or decrease the cost of doing business, limit or expand permissible activities or affect the competitive balance among banks, savings associations, credit unions, and other financial institutions. We cannot predict whether any such legislation will be enacted, and, if enacted, the effect that it, or any implementing regulations, would have on the financial condition or results of operations of the Company. A change in statutes, regulations or regulatory policies applicable to the Company or any its subsidiaries could have a material effect on our business.

Impact of Inflation and Changing Prices

Our financial statements included herein have been prepared in accordance with GAAP, which requires us to measure financial position and operating results principally using historic dollars. Changes in the relative value of money due to inflation or recession are generally not considered. The primary effect of inflation on our operations is reflected in increased operating costs. In our view, changes in interest rates affect the financial condition of a financial institution to a far greater degree than changes in the inflation rate. While interest rates are generally influenced by changes in the inflation rate, they do not necessarily change at the same rate or in the same magnitude. Interest rates are sensitive to many factors that are beyond our control, including changes in the expected rate of inflation, general and local economic conditions and the monetary and fiscal policies of the United States government, its agencies and various other governmental regulatory authorities.

Regulatory and Economic Policies

Our business and earnings are affected by general and local economic conditions and by the monetary and fiscal policies of the U.S. government, its agencies and various other governmental regulatory authorities. The FRB regulates the supply of money in order to influence general economic conditions. Among the instruments of monetary policy available to the FRB are (i) conducting open market operations in U.S. government obligations, (ii) changing the discount rate on financial institution borrowings, (iii) imposing or changing reserve requirements against financial institution deposits, and (iv) restricting certain borrowings and imposing or changing reserve requirements against certain borrowings by financial institutions and their affiliates. These methods are used in varying degrees and combinations to directly affect the availability of bank loans and deposits, as well as the interest rates charged on loans and paid on deposits. For that reason, the policies of the FRB could have a material effect on our earnings.

EMPLOYEES

At December 31, 2010, we had 616 employees. None of the employees are subject to a collective bargaining agreement and management believes its relations with employees are good.

EXECUTIVE OFFICERS OF REGISTRANT

The following table sets forth current information regarding our executive officers and certain other significant employees (ages are as of May 4, 2011, the date of the 2011 Annual Meeting of Shareholders).

Name	Age	Started In	Positions/Offices
Peter G. Humphrey	56	1977	President and Chief Executive Officer of the Company and the Bank since 1994.
Karl F. Krebs	55	2009	Executive Vice President and Chief Financial Officer of the Company and the Bank since 2009. Senior Financial Specialist at West Valley Environmental Services, LLC prior to joining FII in 2009. President of Robar General Funding Corp. from 2006 to 2008. Senior Vice President and Line-of-Business Finance Director at Five Star Bank from 2005 to 2006 and Senior Vice President at Wyoming County Bank from 2004 to 2005.
Rita M. Bartol	50	2010	Senior Vice President and Director of Human Resources of the Company and the Bank since late 2010. Senior Vice President and Director of Human Resources at Cardinal Financial Corporation in 2010 and Vice President and Director of Human Resources at Union Bankshares Corporation from 2006 to 2010. Vice President and Human Resources and Organizational Development Manager at M & T Bank Corporation from 1998 to 2005.
Martin K. Birmingham	44	2005	Executive Vice President and Regional President / Commercial Banking Executive Officer of the Bank since 2009. Senior Vice President and Regional President of the Bank since 2005. Senior Team Leader and Regional President of the Rochester Market at Bank of America (formally Fleet Boston Financial) from 2000 to 2005.
George D. Hagi	58	2006	Executive Vice President and Chief Risk Officer of the Company and the Bank since 2006. Senior Vice President and Director of Risk Management at First National Bankshares of Florida and FNB Corp. from 1997 to 2005.
Richard J. Harrison	65	2003	Executive Vice President and Senior Retail Lending Administrator of the Bank since 2009. Senior Vice President and Senior Retail Lending Administrator of the Bank since 2003. Executive Vice President and Chief Credit Officer at Savings Bank of the Finger Lakes from 2000 to 2003.
Kevin B. Klotzbach	58	2001	Senior Vice President and Treasurer of the Bank since 2001.
R. Mitchell McLaughlin	53	1981	Executive Vice President and Chief Information Officer of the Bank since 2009. Senior Vice President and Chief Information Officer of the Bank since 2006.
John L. Rizzo	61	2010	Senior Vice President and Corporate Secretary of the Company and the Bank since 2010. Counsel (in-house) for the Company and the Bank since 2007. Genesee County (New York) Attorney from 1976 to 2010.
John J. Witkowski	48	2005	Executive Vice President and Regional President / Retail Banking Executive Officer of the Bank since 2009. Senior Vice President and Regional President of the Bank since 2005. Senior Vice President and Director of Sales for Business Banking / Client Development Group at Bank of America from 1993 to 2005.

**MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED SHAREHOLDER MATTERS AND ISSUER
PURCHASES OF EQUITY SECURITIES**

Our common stock is traded on the NASDAQ Global Select Market under the ticker symbol "FISI." At December 31, 2010, 10,937,506 shares of our common stock were outstanding and held by approximately 1,300 shareholders of record. During 2010, the high sales price of our common stock was \$20.74 and the low sales price was \$10.91. The closing price per share of common stock on December 31, 2010, the last trading day of the Company's fiscal year, was \$18.97. We declared dividends of \$0.40 per common share during the year ended December 31, 2010. See additional information regarding the market price and dividends paid under "Selected Financial Data."

We have paid regular quarterly cash dividends on our common stock and our Board of Directors presently intends to continue this practice, subject to our results of operations and the need for those funds for debt service and other purposes. However, the payment of dividends is subject to continued compliance with minimum regulatory capital requirements and TARP restrictions. See the discussions in the section captioned *Supervision and Regulation* included under "Business", the section captioned *Liquidity and Capital Resources* under "Management's Discussion and Analysis of Financial Condition and Results of Operations" and in Note 10, *Regulatory Matters*, of the notes to consolidated financial statements under "Financial Statements and Supplementary Data", all of which are included elsewhere in this report and incorporated herein by reference thereto.

Equity Compensation Plan Information

The following table sets forth, as of December 31, 2010, information about our equity compensation plans that have been approved by our shareholders, including the number of shares of our common stock exercisable under all outstanding options, warrants and rights, the weighted average exercise price of all outstanding options, warrants and rights and the number of shares available for future issuance under our equity compensation plans. We have no equity compensation plans that have not been approved by our shareholders.

Plan Category	Number of securities to be issued upon exercise of outstanding options, warrants and rights (a)	Weighted average exercise price of outstanding options, warrants and rights (b)	Number of securities remaining for future issuance under equity compensation plans (excluding securities reflected in column (a)) (c)
Equity compensation plans approved by shareholders	560,689 ⁽¹⁾	\$ 20.64 ⁽¹⁾	748,101 ⁽²⁾
Equity compensation plans not approved by shareholders	-	\$ -	-

⁽¹⁾ Includes 150,796 shares of unvested restricted stock awards outstanding as of December 31, 2010. The weighted average exercise price excludes such awards.

⁽²⁾ Represents the 940,000 aggregate shares approved for issuance under our two active equity compensation plans, reduced by 191,899 shares, which are the 117,012 restricted stock awards issued under these plans to date plus an adjustment of 74,887 shares. Pursuant to the terms of the plans, for purposes of calculating the number of shares available for issuance, each share of common stock granted pursuant to a restricted stock award shall count as 1.64 shares of common stock.

Sales of Unregistered Securities

2009 Management Incentive Plan

On May 6, 2009, our shareholders approved our 2009 Management Stock Incentive Plan. Pursuant to the terms of the 2009 Management Stock Incentive Plan, we have the ability to grant incentive stock options, non-qualified stock options and restricted stock to members of our management team. Between May 6, 2009 and December 31, 2010, we granted shares of restricted stock to members of our management team under the 2009 Management Stock Incentive Plan as described in the table below.

Date	Number of shares issued	Number of individuals receiving awards
October 1, 2009	1,972	1
January 13, 2010	40,188	5
February 23, 2010	59,152	23
December 15, 2010	500	1

These shares of restricted stock were issued without registration under the Securities Act of 1933, as amended (the “Securities Act”) in reliance on the exemption from registration in Section 4(2) of the Securities Act. These shares of restricted stock are subject to the resale prohibitions under the Securities Act and may not be sold or transferred without registration except in accordance with Rule 144 of the Securities Act.

2009 Directors’ Stock Incentive Plan

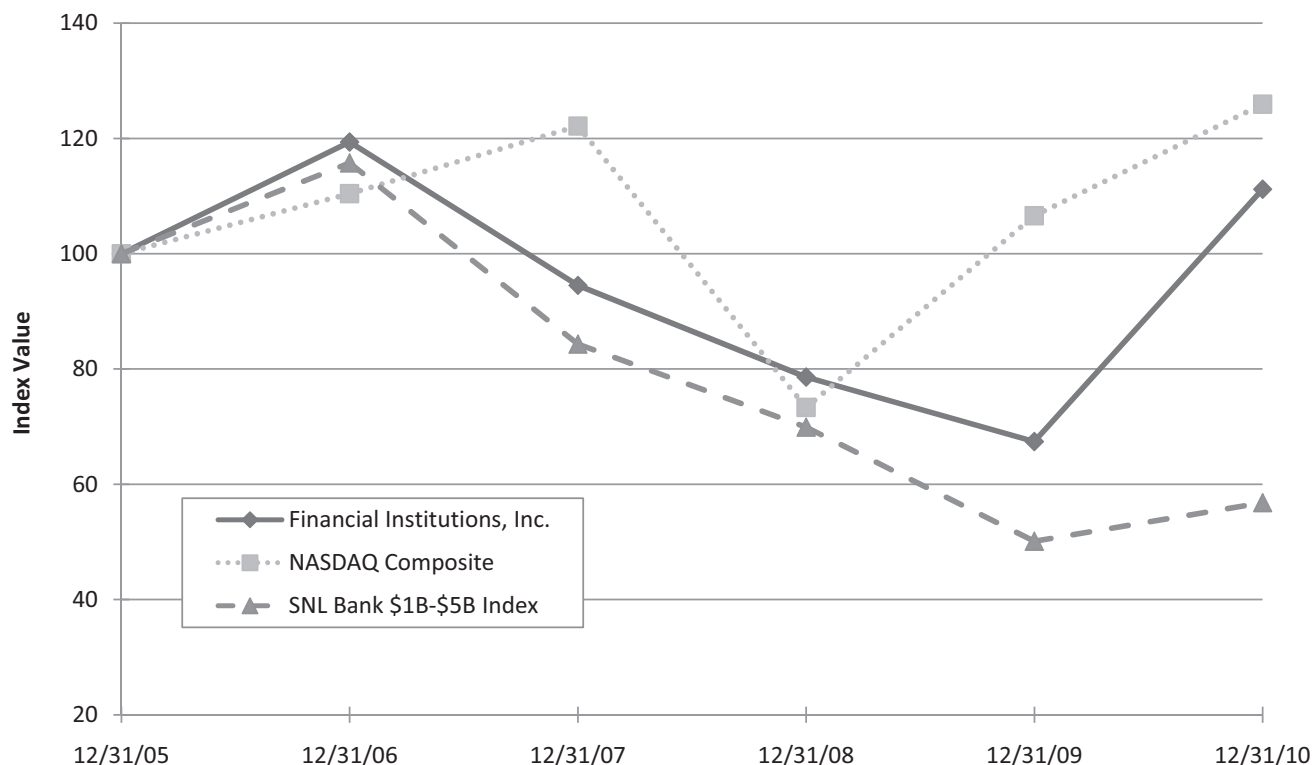
On May 6, 2009, our shareholders approved our 2009 Directors’ Stock Incentive Plan. Pursuant to the terms of the 2009 Directors’ Stock Incentive Plan, we have the ability to grant non-qualified stock options and restricted stock to our non-employee directors. On May 6, 2009, we granted a total of 8,000 shares of restricted stock to ten of our non-employee directors and on May 6, 2010, we granted a total of 7,200 shares of restricted stock to nine of our non-employee directors.

These shares of restricted stock were issued without registration under the Securities Act in reliance on the exemption from registration in Section 4(2) of the Securities Act. These shares of restricted stock are subject to the resale prohibitions under the Securities Act and may not be sold or transferred without registration except in accordance with Rule 144 of the Securities Act.

Stock Performance Graph

The stock performance graph below compares (a) the cumulative total return on our common stock for the period beginning December 31, 2005 as reported by the NASDAQ Global Select Market, through December 31, 2010, (b) the cumulative total return on stocks included in the NASDAQ Composite Index over the same period, and (c) the cumulative total return, as compiled by SNL Financial L.C., of Major Exchange (NYSE, AMEX and NASDAQ) Banks with \$1 billion to \$5 billion in assets over the same period. Cumulative return assumes the reinvestment of dividends. The graph was prepared by SNL Financial, LC and is expressed in dollars based on an assumed investment of \$100.

Total Return Performance



Index	Period Ending					
	12/31/05	12/31/06	12/31/07	12/31/08	12/31/09	12/31/10
Financial Institutions, Inc.	100.00	119.37	94.50	78.59	67.41	111.16
NASDAQ Composite	100.00	110.39	122.15	73.32	106.57	125.91
SNL Bank \$1B-\$5B Index	100.00	115.72	84.29	69.91	50.11	56.81

SELECTED FINANCIAL DATA

(Dollars in thousands, except selected ratios and per share data)

	At or for the year ended December 31,				
	2010	2009	2008	2007	2006
Selected financial condition data:					
Total assets	\$ 2,214,307	\$ 2,062,389	\$ 1,916,919	\$ 1,857,876	\$ 1,907,552
Loans, net	1,325,524	1,243,265	1,102,330	948,652	909,434
Investment securities	694,530	620,074	606,038	754,720	775,536
Deposits	1,882,890	1,742,955	1,633,263	1,575,971	1,617,695
Borrowings	103,877	106,390	70,820	68,210	87,199
Shareholders' equity	212,144	198,294	190,300	195,322	182,388
Common shareholders' equity ⁽¹⁾	158,359	144,876	137,226	177,741	164,765
Tangible common shareholders' equity ⁽²⁾	120,990	107,507	99,577	139,786	126,502
Selected operations data:					
Interest income	\$ 96,509	\$ 94,482	\$ 98,948	\$ 105,212	\$ 103,070
Interest expense	17,720	22,217	33,617	47,139	43,604
Net interest income	78,789	72,265	65,331	58,073	59,466
Provision (credit) for loan losses	6,687	7,702	6,551	116	(1,842)
Net interest income after provision (credit) for loan losses	72,102	64,563	58,780	57,957	61,308
Noninterest income (loss) ⁽³⁾	19,454	18,795	(48,778)	20,680	21,911
Noninterest expense	60,917	62,777	57,461	57,428	59,612
Income (loss) before income taxes	30,639	20,581	(47,459)	21,209	23,607
Income tax expense (benefit)	9,352	6,140	(21,301)	4,800	6,245
Net income (loss)	\$ 21,287	\$ 14,441	\$ (26,158)	\$ 16,409	\$ 17,362
Preferred stock dividends and accretion	3,725	3,697	1,538	1,483	1,486
Net income (loss) applicable to common shareholders	\$ 17,562	\$ 10,744	\$ (27,696)	\$ 14,926	\$ 15,876
Stock and related per share data:					
Earnings (loss) per common share:					
Basic	\$ 1.62	\$ 0.99	\$ (2.54)	\$ 1.34	\$ 1.40
Diluted	1.61	0.99	(2.54)	1.33	1.40
Cash dividends declared on common stock	0.40	0.40	0.54	0.46	0.34
Common book value per share ⁽¹⁾	14.48	13.39	12.71	16.14	14.53
Tangible common book value per share ⁽²⁾	11.06	9.94	9.22	12.69	11.15
Market price (NASDAQ: FISI):					
High	20.74	15.99	22.50	23.71	25.38
Low	10.91	3.27	10.06	16.18	17.43
Close	18.97	11.78	14.35	17.82	23.05

⁽¹⁾ Excludes preferred shareholders' equity.

⁽²⁾ Excludes preferred shareholders' equity, goodwill and other intangible assets.

⁽³⁾ The 2010, 2009 and 2008 figures include other-than-temporary impairment ("OTTI") charges of \$594 thousand, \$4.7 million and \$68.2 million, respectively. There were no OTTI charges in the other years presented.

(Dollars in thousands, except per share data)

	At or for the year ended December 31,				
	2010	2009	2008	2007	2006
Selected financial ratios and other data:					
Performance ratios:					
Net income (loss), returns on:					
Average assets	0.98%	0.71%	-1.37%	0.86%	0.90%
Average equity	10.07	7.43	-14.30	8.84	9.86
Average common equity ⁽¹⁾	11.14	7.61	-16.84	8.89	10.02
Average tangible common equity ⁽²⁾	14.59	10.37	-21.87	11.50	13.23
Common dividend payout ratio ⁽³⁾	24.69	40.40	NA	34.33	24.29
Net interest margin (fully tax-equivalent)	4.07	4.04	3.93	3.53	3.55
Efficiency ratio ⁽⁴⁾	60.36%	65.52%	64.07%	68.77%	69.78%
Capital ratios:					
Leverage ratio	8.31%	7.96%	8.05%	9.35%	8.91%
Tier 1 risk-based capital	12.34	11.95	11.83	15.74	15.85
Total risk-based capital	13.60	13.21	13.08	16.99	17.10
Equity to assets ⁽⁵⁾	9.75	9.55	9.60	9.73	9.08
Common equity to assets ^{(1) (5)}	7.28	6.94	8.63	8.81	8.17
Tangible common equity to tangible assets ^{(2) (5)}	5.65%	5.19%	6.78%	6.95%	6.32%
Asset quality:					
Non-performing loans	\$ 7,582	\$ 8,681	\$ 8,196	\$ 8,077	\$ 15,840
Non-performing assets	8,895	10,442	9,252	9,498	17,043
Allowance for loan losses	20,466	20,741	18,749	15,521	17,048
Net loan charge-offs	\$ 6,962	\$ 5,710	\$ 3,323	\$ 1,643	\$ 1,341
Total non-performing loans to total loans	0.56%	0.69%	0.73%	0.84%	1.71%
Total non-performing assets to total assets	0.40	0.51	0.48	0.51	0.89
Net charge-offs to average loans	0.54	0.47	0.32	0.18	0.14
Allowance for loan losses to total loans	1.52	1.64	1.67	1.61	1.84
Allowance for loan losses to non-performing loans	270%	239%	229%	192%	108%
Other data:					
Number of branches	50	50	51	50	50
Full time equivalent employees	577	572	600	621	640

⁽¹⁾ Excludes preferred shareholders' equity.

⁽²⁾ Excludes preferred shareholders' equity, goodwill and other intangible assets.

⁽³⁾ Common dividend payout ratio equals dividends declared during the year divided by earnings per share for the year. There is no ratio shown for years where we both declared a dividend and incurred a loss because the ratio would result in a negative payout since the dividend declared (paid out) will always be greater than 100% of earnings.

⁽⁴⁾ 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, proceeds from company owned life insurance included in income, and net gains from the sale of trust relationships (all from continuing operations).

⁽⁵⁾ Ratios calculated using average balances for the periods shown.

SELECTED QUARTERLY DATA

(Dollars in thousands, except per share data)

	2010			
	Fourth Quarter	Third Quarter	Second Quarter	First Quarter
Interest income	\$ 24,297	\$ 24,186	\$ 24,202	\$ 23,824
Interest expense	4,229	4,393	4,526	4,572
Net interest income	20,068	19,793	19,676	19,252
Provision for loan losses	1,980	2,184	2,105	418
Net interest income, after provision for loan losses	18,088	17,609	17,571	18,834
Noninterest income	5,274	5,131	4,966	4,083
Noninterest expense	16,373	14,936	14,870	14,738
Income before income taxes	6,989	7,804	7,667	8,179
Income tax expense	1,891	2,141	2,469	2,851
Net income	\$ 5,098	\$ 5,663	\$ 5,198	\$ 5,328
Preferred stock dividends	933	932	931	929
Net income applicable to common shareholders	\$ 4,165	\$ 4,731	\$ 4,267	\$ 4,399
Earnings per common share ⁽¹⁾ :				
Basic	\$ 0.38	\$ 0.44	\$ 0.39	\$ 0.41
Diluted	0.38	0.43	0.39	0.40
Market price (NASDAQ: FISI):				
High	\$ 20.74	\$ 19.94	\$ 19.48	\$ 15.40
Low	16.80	14.14	14.07	10.91
Close	18.97	17.66	17.76	14.62
Dividends declared	\$ 0.10	\$ 0.10	\$ 0.10	\$ 0.10

(Dollars in thousands, except per share data)

	2009			
	Fourth Quarter	Third Quarter	Second Quarter	First Quarter
Interest income	\$ 24,390	\$ 23,697	\$ 23,302	\$ 23,093
Interest expense	5,175	5,619	5,657	5,766
Net interest income	19,215	18,078	17,645	17,327
Provision for loan losses	1,088	2,620	2,088	1,906
Net interest income, after provision for loan losses	18,127	15,458	15,557	15,421
Noninterest income	5,183	4,406	4,515	4,691
Noninterest expense	15,117	15,142	16,440	16,078
Income before income taxes	8,193	4,722	3,632	4,034
Income tax expense	2,756	1,313	1,004	1,067
Net income	\$ 5,437	\$ 3,409	\$ 2,628	\$ 2,967
Preferred stock dividends	927	927	925	918
Net income applicable to common shareholders	\$ 4,510	\$ 2,482	\$ 1,703	\$ 2,049
Earnings per common share ⁽¹⁾ :				
Basic	\$ 0.42	\$ 0.23	\$ 0.16	\$ 0.19
Diluted	0.42	0.23	0.16	0.19
Market price (NASDAQ: FISI):				
High	\$ 12.25	\$ 15.00	\$ 15.99	\$ 14.95
Low	9.71	9.90	6.98	3.27
Close	11.78	9.97	13.66	7.62
Dividends declared	\$ 0.10	\$ 0.10	\$ 0.10	\$ 0.10

⁽¹⁾ Earnings per share data is computed independently for each of the quarters presented. Therefore, the sum of the quarterly earnings or loss per common share amounts may not equal the total for the year.

OVERVIEW AND OUTLOOK

Business Overview

Financial Institutions, Inc. is a financial holding company headquartered in New York State, providing banking and nonbanking financial services to individuals and businesses primarily in our Western and Central New York footprint. Through our wholly-owned banking subsidiary, Five Star Bank, we provide a wide range of services, including business and consumer loan and depository services, as well as other traditional banking services. Through our nonbanking subsidiary, Five Star Investment Services, we provide brokerage services to supplement our banking business.

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

Outlook

The general state of the U.S. economy and, in particular, economic and market conditions in Western and Central New York have a significant impact on loan demand, the ability of borrowers to repay loans and the value of any collateral securing loans and may also affect deposit levels. Accordingly, future general economic conditions and the impact on credit risk are key uncertainties that may materially affect our results of operations.

Approximately 20% of our investment securities portfolio at December 31, 2010 is comprised of municipal securities issued by or on behalf of New York and its political subdivisions, agencies or instrumentalities, the interest on which is exempt from federal income tax. Risks associated with investing in municipal securities include political, economic and regulatory factors which may affect the issuers. The concerns facing the State of New York may lead nationally recognized rating agencies to downgrade its debt obligations. It is uncertain how the financial markets may react to any potential future ratings downgrade in New York's debt obligations. However, the fallout from continued budgetary concerns and a possible ratings downgrade could adversely affect the value of New York's obligations.

Our interest rate spread affects our profitability. Our interest rate spread is the difference between the interest rate we receive on interest-earning assets, such as loans and investment securities, and the interest rate we pay on deposits and other borrowings. If the interest rates we pay on our deposits and other borrowings were to increase at a faster rate than the interest rates we receive on our loans and investments securities, our interest rate spread will decline, which could adversely affect our profitability.

Legislative and regulatory reforms continue to be adopted which impose additional restrictions on current business practices including passage of the Dodd-Frank Act. The Dodd-Frank Act is complex and we continue to assess how this legislation and subsequent rule-making will affect us. As hundreds of regulations are promulgated, we will continue to evaluate impacts such as changes in regulatory costs and fees, modifications to consumer products or disclosures required by the Consumer Financial Protection Bureau and the requirements of the enhanced supervision provisions, among others.

Recent Developments

On February 23, 2011, the Company was granted approval from the Treasury and redeemed \$12.5 million of the \$37.5 million in Series A preferred stock issued by the Company in December 2008. The redemption will result in a reduction of the associated Series A preferred stock dividends and Tier 1 Capital in future periods. Upon issuance in December 2008, the discount associated with the Series A preferred stock was \$2.0 million, which is being accreted to retained earnings as an adjustment to dividends using the effective yield method. At December 31, 2010, the Series A preferred stock discount totaled \$1.3 million. As a result of the redemption, the Company will accelerate the accretion of the remaining discount in proportion to the Series A preferred stock redeemed in the first quarter of 2011. This transaction has no effect on the outstanding warrant to purchase common stock issued to the Treasury as part of the original issuance of the Series A preferred stock. The Company may apply for approval to repay the remaining balance of the Series A preferred stock in future periods.

2010 Performance Summary

Our reported net income was \$21.3 million for the year ended December 31, 2010, compared to a net income of \$14.4 million for the year ended December 31, 2009. For 2010, net income available to common shareholders was \$17.6 million, or \$1.61 per diluted common share. Net income available to common shareholders was \$10.7 million for 2009, or \$0.99 per diluted common share. Cash dividends of \$0.40 per common share were paid in 2010 and 2009.

We had total assets of \$2.214 billion at December 31, 2010 compared to \$2.062 billion at December 31, 2009. At December 31, 2010, shareholders' equity totaled \$212.1 million with book value per common share at \$14.48, compared to \$198.3 million with book value per share at \$13.39 at the end of 2009. Tangible common equity to tangible common assets improved to 5.65% during 2010 from 5.19% in 2009. The Tier 1 capital ratio was 12.34% as of December 31, 2010 compared to 11.95% at December 31, 2009.

Key factors behind these results are discussed below.

- At December 31, 2010, total gross loans (includes loans held for sale) were \$1.349 billion, up 7% from year-end 2009, primarily in commercial mortgage and consumer indirect loans, as we have focused our business development efforts in these areas in accordance with our strategic objectives. Total deposits at December 31, 2010, were \$1.883 billion, up 8% from year-end 2009, primarily attributable to a \$113.6 million increase in retail deposits. Our deposit mix remains favorably weighted in lower cost demand, savings and money market accounts, which comprised 60.7% of total deposits at the end of 2010.
- Nonperforming loans were \$7.6 million at December 31, 2010, compared to \$8.7 million at December 31, 2009, as our loan portfolio continues to benefit from responsible underwriting and lending practices.
- Net charge-offs were \$7.0 million in 2010 (or 0.54% of average loans) compared to \$5.7 million in 2009 (or 0.47% of average loans). We had a \$5.0 million participation interest in one commercial business loan, which was sold during the third quarter of 2010 for \$1.9 million, resulting in a charge-off of \$3.1 million.
- The provision for loan losses was \$6.7 million and \$7.7 million, respectively, for 2010 and 2009. At year-end 2010, the allowance for loan losses of \$20.5 million represented 1.52% of total loans (covering 270% of non-performing loans), compared to \$20.7 million or 1.64% (covering 239% of non-performing loans) at year-end 2009. See also section captioned *Lending Activities* for additional information on net charge-offs and non-performing loans.
- Taxable equivalent net interest income was \$80.7 million for 2010 or 8% higher than \$75.0 million in 2009. Taxable equivalent interest income increased \$1.2 million, while interest expense decreased by \$4.5 million. The increase in taxable equivalent net interest income was a function of a favorable volume variance (increasing taxable equivalent net interest income by \$6.3 million), partially offset by an unfavorable rate variance (decreasing taxable equivalent net interest income by \$573 thousand). See also section captioned *Net Interest Income and Net Interest Margin* for additional information on taxable equivalent net interest income and net interest margin.
- The net interest margin for 2010 was 4.07%, 3 basis points higher than 4.04% in 2009. The increase in net interest margin was attributable to a 10 basis point increase in interest rate spread (the net of a 36 basis point decrease in the cost of interest-bearing liabilities and a 26 basis decrease in the yield on earning assets), partially offset by a 7 basis point lower contribution from net free funds (primarily attributable to lower rates on interest-bearing liabilities reducing the value of noninterest-bearing deposits and other net free funds). See also section captioned *Net Interest Income and Net Interest Margin* for additional information on taxable equivalent net interest income and net interest margin.
- Noninterest income was \$19.5 million for 2010 compared to \$18.8 million for 2009. Core fee-based revenues (defined as service charges on deposit accounts, ATM and debit fees, and broker-dealer fees and commissions) totaled \$14.9 million for 2010, up \$166 thousand from \$14.7 million for 2009. Net mortgage banking income was \$1.8 million for 2010, compared to \$2.0 million in 2009, a decrease of \$233 thousand from 2009, primarily attributable to lower secondary mortgage production experienced during 2010 and a decrease in our loan serviced for others portfolio. For additional discussion concerning noninterest income see section captioned *Noninterest Income*.
- Net investment securities losses (defined as impairment charges on investment securities and net gain on disposal of investment securities) were \$425 thousand for 2010, compared to net investment securities losses of \$1.2 million for 2009, primarily attributable to other-than-temporary write-downs on investment securities.
- Noninterest expense for 2010 was \$60.9 million, a decrease of \$1.9 million or 3% over 2009. FDIC assessments decreased \$1.1 million, salaries and employee benefits decreased \$823 thousand, and collectively all remaining noninterest expense categories were up \$107 thousand or less than half a percent compared to 2009. Other noninterest expense for 2010 includes \$1.0 million of losses relating to irregular instance of fraudulent debit card activity. The efficiency ratio (as defined under "Selected Financial Data") was 60.36% for 2010 and 65.52% for 2009. For additional discussion regarding noninterest expense see section captioned *Noninterest Expense*.
- Income tax expense for 2010 was \$9.4 million compared to \$6.1 million for 2009. The change in income tax expense was primarily due to a \$10.1 million increase in pretax income between the years. For additional discussion concerning income tax see section captioned *Income Taxes*.

**RESULTS OF OPERATIONS FOR THE YEARS ENDED
DECEMBER 31, 2010 AND DECEMBER 31, 2009**

Net Interest Income and Net Interest Margin

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

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

The following table reconciles interest income per the consolidated statements of operations to interest income adjusted to a fully taxable equivalent basis for the years ended December 31 (in thousands):

	2010	2009	2008
Interest income per consolidated statements of operations	\$ 96,509	\$ 94,482	\$ 98,948
Adjustment to fully taxable equivalent basis	1,895	2,692	4,292
Interest income adjusted to a fully taxable equivalent basis	98,404	97,174	103,240
Interest expense per consolidated statement of operations	17,720	22,217	33,617
Net interest income on a taxable equivalent basis	\$ 80,684	\$ 74,957	\$ 69,623

Taxable equivalent net interest income of \$80.7 million for 2010 was \$5.7 million or 8% higher than 2009. While the average yields on our loans and assets declined, the impact was far exceeded by the benefit of substantial loan production and asset growth. The average balance of loans rose \$85.4 million to \$1.295 billion, reflecting growth in the commercial and consumer indirect loan portfolios, as we have focused business development efforts in those areas, and the average balance of interest-earning assets rose \$124.3 million to \$1.981 billion, both increases of 7%. We will continue to pursue loan development efforts in the commercial and consumer indirect lending portfolios in accordance with our prudent underwriting standards.

The increase in taxable equivalent net interest income was a function of a favorable volume variance (as balance sheet changes in both volume and mix increased taxable equivalent net interest income by \$6.3 million), partially offset by an unfavorable rate variance (decreasing taxable equivalent net interest income by \$573 thousand). The change in mix and volume of earning assets increased taxable equivalent interest income by \$6.8 million, while the change in volume and composition of interest-bearing liabilities increased interest expense by \$499 thousand, for a net favorable volume impact of \$6.3 million on taxable equivalent net interest income. Rate changes on earning assets reduced interest income by \$5.6 million, while changes in rates on interest-bearing liabilities lowered interest expense by \$5.0 million, for a net unfavorable rate impact of \$573 thousand.

The net interest margin for 2010 was 4.07% compared to 4.04% in 2009. The 3 basis point improvement in net interest margin was attributable to a 10 basis point increase in interest rate spread (the net of a 36 basis point decrease in the cost of interest-bearing liabilities and a 26 basis decrease in the yield on earning assets), partially offset by a 7 basis point lower contribution from net free funds (primarily attributable to lower rates on interest-bearing liabilities reducing the relative value of noninterest-bearing deposits and other net free funds).

The Federal Reserve left the Federal funds rate unchanged at 0.25% during 2010 and 2009.

For 2010, the yield on average earning assets of 4.97% was 26 basis points lower than 2009. Loan yields decreased 15 basis points to 5.86%. Commercial mortgage and consumer indirect loans in particular, down 26 and 34 basis points, respectively, experienced lower yields given the competitive pricing pressures in a low interest rate environment. The yield on investment securities dropped 69 basis points to 3.31%, also impacted by the lower interest rate environment and prepayments of mortgage-related investment securities. Overall, earning asset rate changes reduced interest income by \$5.6 million.

The cost of average interest-bearing liabilities of 1.10% in 2010 was 36 basis points lower than 2009. The average cost of interest-bearing deposits was 0.97% in 2010, 36 basis points lower than 2009, reflecting the lower rate environment, mitigated by a focus on product pricing to retain balances. The cost of wholesale funding (comprised of short-term borrowings and long-term borrowings) decreased 14 basis points to 3.33% for 2010. The interest-bearing liability rate changes resulted in \$5.0 million lower interest expense.

Average interest-earning assets of \$1.981 billion in 2010 were \$124.3 million or 7% higher than 2009. Average investment securities increased \$71.2 million, mostly in high quality U.S. Government agency securities. Average loans increased \$85.4 million or 7%, with a \$33.3 million increase in commercial loans and a \$74.2 million increase in consumer loans, offset by a \$22.1 million decrease in residential mortgage loans.

Average interest-bearing liabilities of \$1.610 billion in 2010 were up \$85.1 million or 6% versus 2009, mainly attributable to higher average retail deposit balances. The impacts of the recent recession have had a positive impact on our deposit balances, as consumers tend to save more conservatively when consumer confidence is low. On average, interest-bearing deposits grew \$89.0 million, while average noninterest-bearing demand deposits (a principal component of net free funds) increased by \$36.0 million. Average wholesale funding decreased \$3.9 million, net of the \$6.0 million increase and \$9.9 million decrease in short-term and long-term borrowings, respectively.

The recently enacted Dodd-Frank Act repealed the federal prohibitions on the payment of interest on demand deposits for commercial accounts, thereby permitting depository institutions to pay interest on business transaction and other accounts beginning July 21, 2011. Although the ultimate impact of this legislation on us has not yet been determined, we expect interest costs associated with demand deposits to increase as a result of competitor responses to this change. See the section captioned *Supervision and Regulation* included under “Business” for a detailed discussion of this legislation.

The following tables present, for the periods indicated, information regarding: (i) the average balance sheet; (ii) the amount of interest income from interest-earning assets and the resulting annualized yields (tax-exempt yields have been adjusted to a tax-equivalent basis using the applicable Federal tax rate in each year); (iii) the amount of interest expense on interest-bearing liabilities and the resulting annualized rates; (iv) net interest income; (v) net interest rate spread; (vi) net interest income as a percentage of average interest-earning assets ("net interest margin"); and (vii) the ratio of average interest-earning assets to average interest-bearing liabilities. Investment securities are at amortized cost for both held to maturity and available for sale securities. Loans include net unearned income, net deferred loan fees and costs and non-accruing loans. Dollar amounts are shown in thousands.

	Years ended December 31,								
	2010			2009			2008		
	Average Balance	Interest	Average Rate	Average Balance	Interest	Average Rate	Average Balance	Interest	Average Rate
Interest-earning assets:									
Federal funds sold and other interest-earning deposits	\$ 5,034	\$ 10	0.21%	\$ 37,214	\$ 82	0.22%	\$ 26,568	\$ 619	2.33%
Investment securities:									
Taxable	571,856	17,101	2.99	454,552	16,466	3.62	487,687	21,882	4.49
Tax-exempt	108,900	5,416	4.97	155,054	7,920	5.11	233,864	13,065	5.59
Total investment securities	680,756	22,517	3.31	609,606	24,386	4.00	721,551	34,947	4.84
Loans:									
Commercial business	206,167	9,939	4.82	204,235	9,612	4.71	167,760	10,476	6.24
Commercial mortgage	338,149	20,389	6.03	306,763	19,309	6.29	274,677	18,877	6.87
Residential mortgage	138,954	8,157	5.87	161,055	9,701	6.02	172,083	10,761	6.25
Home equity	202,189	9,224	4.56	193,929	9,121	4.70	189,448	11,041	5.83
Consumer indirect	382,977	25,379	6.63	313,239	21,838	6.97	185,197	13,098	7.07
Other consumer	26,950	2,789	10.35	30,791	3,125	10.15	34,895	3,421	9.80
Total loans	1,295,386	75,877	5.86	1,210,012	72,706	6.01	1,024,060	67,674	6.61
Total interest-earning assets	1,981,176	98,404	4.97	1,856,832	97,174	5.23	1,772,179	103,240	5.83
Less: Allowance for loan losses	20,883			20,355			16,287		
Other noninterest-earning assets	206,303			197,439			149,453		
Total assets	<u>\$ 2,166,596</u>			<u>\$2,033,916</u>			<u>\$1,905,345</u>		
Interest-bearing liabilities:									
Deposits:									
Interest-bearing demand	\$ 382,517	705	0.18	\$ 365,873	772	0.21	\$ 347,702	3,246	0.93
Savings and money market	414,953	1,133	0.27	383,697	1,090	0.28	369,926	3,773	1.02
Certificates of deposit	726,330	13,015	1.79	685,259	17,228	2.51	617,381	22,330	3.62
Total interest-bearing deposits	1,523,800	14,853	0.97	1,434,829	19,090	1.33	1,335,009	29,349	2.20
Short-term borrowings	49,104	365	0.74	43,092	270	0.63	38,028	721	1.90
Long-term borrowings	37,043	2,502	6.75	46,913	2,857	6.09	53,687	3,547	6.61
Total borrowings	86,147	2,867	3.33	90,005	3,127	3.47	91,715	4,268	4.65
Total interest-bearing liabilities	1,609,947	17,720	1.10	1,524,834	22,217	1.46	1,426,724	33,617	2.36
Noninterest-bearing deposits	329,853			293,852			280,467		
Other liabilities	15,485			20,890			15,249		
Shareholders' equity	211,311			194,340			182,905		
Total liabilities and shareholders' equity	<u>\$ 2,166,596</u>			<u>\$2,033,916</u>			<u>\$1,905,345</u>		
Net interest income (tax-equivalent)		<u>\$ 80,684</u>			<u>\$ 74,957</u>			<u>\$ 69,623</u>	
Interest rate spread			<u>3.87%</u>			<u>3.77%</u>			<u>3.47%</u>
Net earning assets	<u>\$ 371,229</u>			<u>\$ 331,998</u>			<u>\$ 345,455</u>		
Net interest margin (tax-equivalent)			<u>4.07%</u>			<u>4.04%</u>			<u>3.93%</u>
Ratio of average interest-earning assets to average interest-bearing liabilities	<u>123.06%</u>			<u>121.77%</u>			<u>124.21%</u>		

Rate /Volume Analysis

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

Increase (decrease) in:	Change from 2010 to 2009			Change from 2009 to 2008		
	Volume	Rate	Total	Volume	Rate	Total
Interest income:						
Federal funds sold and other interest-earning deposits	\$ (65)	\$ (7)	\$ (72)	\$ 179	\$ (716)	\$ (537)
Investment securities:						
Taxable	3,807	(3,172)	635	(1,412)	(4,004)	(5,416)
Tax-exempt	(2,300)	(204)	(2,504)	(4,102)	(1,043)	(5,145)
Total investment securities	1,507	(3,376)	(1,869)	(5,514)	(5,047)	(10,561)
Loans:						
Commercial business	92	235	327	2,015	(2,879)	(864)
Commercial mortgage	1,916	(836)	1,080	2,097	(1,665)	432
Residential mortgage	(1,302)	(242)	(1,544)	(673)	(387)	(1,060)
Home equity	382	(279)	103	256	(2,176)	(1,920)
Consumer indirect	4,665	(1,124)	3,541	8,930	(190)	8,740
Other consumer	(396)	60	(336)	(414)	118	(296)
Total loans	5,357	(2,186)	3,171	12,211	(7,179)	5,032
Total interest income	6,799	(5,569)	1,230	6,876	(12,942)	(6,066)
Interest expense:						
Deposits:						
Interest-bearing demand	34	(101)	(67)	162	(2,636)	(2,474)
Savings and money market	86	(43)	43	135	(2,818)	(2,683)
Certificates of deposit	982	(5,195)	(4,213)	2,257	(7,359)	(5,102)
Total interest-bearing deposits	1,102	(5,339)	(4,237)	2,554	(12,813)	(10,259)
Short-term borrowings	41	54	95	85	(536)	(451)
Long-term borrowings	(644)	289	(355)	(426)	(264)	(690)
Total borrowings	(603)	343	(260)	(341)	(800)	(1,141)
Total interest expense	499	(4,996)	(4,497)	2,213	(13,613)	(11,400)
Net interest income	\$ 6,300	\$ (573)	\$ 5,727	\$ 4,663	\$ 671	\$ 5,334

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 \$6.7 million for the year ended December 31, 2010 compared with \$7.7 million for 2009. See the section captioned *Lending Activities* for further discussion.

Noninterest Income (Loss)

The following table summarizes our noninterest income (loss) for the years ended December 31 (in thousands):

	2010	2009	2008
Service charges on deposits	\$ 9,585	\$ 10,065	\$ 10,497
ATM and debit card	3,995	3,610	3,313
Broker-dealer fees and commissions	1,283	1,022	1,458
Company owned life insurance	1,107	1,096	563
Loan servicing	1,124	1,308	664
Net gain on sale of loans held for sale	650	699	339
Net gain on disposal of investment securities	169	3,429	288
Impairment charges on investment securities	(594)	(4,666)	(68,215)
Net (loss) gain on sale and disposal of other assets	(203)	180	305
Other	2,338	2,052	2,010
Total noninterest income (loss)	\$ 19,454	\$ 18,795	\$ (48,778)

Service charges on deposits were \$9.6 million in 2010, which was \$480 thousand or 5% lower than 2009. The decrease was primarily attributable to lower nonsufficient funds fees in 2010, which were down \$407 thousand to \$7.9 million. In November 2009, the FRB issued a final rule that, effective July 1, 2010, prohibits financial institutions from charging consumers fees for paying overdrafts on automated teller machine and one-time debit card transactions, unless a consumer consents, or opts in, to the overdraft service for those types of transactions, commonly referred to as "Reg.-E". Consumers must be provided a notice that explains the financial institution's overdraft services, including the fees associated with the service, and the consumer's choices. We implemented the provisions of Reg.-E in the third quarter of 2010 and the number of customers that have chosen to opt-in has exceeded our original expectations; however the extent of the adverse impacts of Reg.-E on our future service charge revenue is uncertain.

ATM and debit card income was \$4.0 million for 2010, an increase of \$385 thousand or 11%, compared to 2009, due to higher interchange fees resulting from an increase in the number of cardholders and an increase in customer transactions.

Broker-dealer fees and commissions were up \$261 thousand or 26%, compared to 2009. Broker-dealer fees and commissions fluctuate mainly due to sales volume, which increased during 2010 as a result of improving market and economic conditions.

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 decreased \$184 thousand for the year ended December 31, 2010 compared to 2009, mainly as a result of more rapid amortization of servicing rights due to loans paying off prior to maturity and lower fees collected due to a decrease in the sold and serviced portfolio.

We recognized \$425 thousand in net losses on investment securities during the year ended December 31, 2010 as compared to \$1.2 million of net losses during the same period in 2009. The investment security net losses for 2010 resulted from other-than-temporary impairment charges of \$594 thousand, partly offset by \$169 thousand of gains on the disposal of securities. The 2010 OTTI charges primarily relate to pooled trust preferred securities that were designated as impaired in the first quarter due to credit quality. The \$1.2 million of investment security losses for 2009 are a result of \$4.7 million of other-than-temporary impairment charges, partly offset by \$3.4 million of gains on the sale of securities.

Noninterest Expense

The following table summarizes our noninterest expense for the years ended December 31 (in thousands):

	2010	2009	2008
Salaries and employee benefits	\$ 32,811	\$ 33,634	\$ 31,437
Occupancy and equipment	10,818	11,062	10,502
FDIC assessments	2,507	3,651	674
Computer and data processing	2,487	2,340	2,433
Professional services	2,197	2,524	2,141
Supplies and postage	1,772	1,846	1,800
Advertising and promotions	1,121	949	1,453
Other	7,204	6,771	7,021
Total noninterest expense	<u>\$ 60,917</u>	<u>\$ 62,777</u>	<u>\$ 57,461</u>

Salaries and employee benefits (which includes salary-related expenses and fringe benefit expenses) was \$32.8 million for 2010, down \$823 thousand or 2% from 2009. Average full-time equivalent employees ("FTEs") were 577 for 2010, down 2% from 586 for 2009. Salary-related expenses were relatively unchanged at \$25.3 million for 2010 and \$25.2 million for 2009. Fringe benefit expenses decreased \$876 thousand or 10%, primarily attributable to lower pension costs.

FDIC assessments, comprised mostly of deposit insurance paid to the FDIC, decreased \$1.1 million for the year ended December 31, 2010, due primarily to the one-time special assessment of \$923 thousand incurred in the second quarter of 2009. FDIC assessment rates have also declined as a result of our improved financial ratios, upon which the assessment rate is based.

Professional services expense of \$2.2 million in 2010 decreased \$327 thousand or 13% from 2009, primarily due to lower legal costs associated with loan workouts and other corporate activities.

Advertising and promotions expenses were \$172 thousand or 18% higher in 2010 compared to 2009 due to increases in business development expenses.

Other noninterest expense increased \$433 thousand or 6% during 2010 compared to 2009. This increase was primarily due to a loss of approximately \$1.0 million relating to irregular instances of fraudulent debit card activity that we recorded in the fourth quarter of 2010. We have taken actions to limit our exposure to such fraudulent activity and we are reviewing the remedies that may be available. Any recoveries or other remedies received will be separate from the \$1.0 million loss recorded in 2010 and will be recorded if and when received.

The efficiency ratio for the year ended December 31, 2010 improved to 60.36% compared with 65.52% for 2009. The efficiency ratio is a supplemental financial measure utilized in management's internal evaluations and is not defined under generally accepted accounting principles. The efficiency ratio is calculated by dividing total noninterest expense, excluding other real estate expense and amortization of intangible assets, by net revenue, defined as the sum of tax-equivalent net interest income and noninterest income before net gains and impairment charges on investment securities. Taxes are not part of this calculation. An increase in the efficiency ratio indicates that more resources are being utilized to generate the same volume of income, while a decrease would indicate a more efficient allocation of resources.

Income Taxes

We recognized income tax expense of \$9.4 million for 2010 compared to \$6.1 million for 2009. The change in income tax expense was primarily due to a \$10.1 million increase in pretax income between the years. We also recorded non-recurring tax benefits during 2010 of \$1.2 million related to valuation of our deferred tax assets as a result of the NYS repeal of the experience method for determining bad debts and re-valuing at the highest Federal statutory rate of 35%. Our effective tax rates were 30.5% in 2010 and 29.8% in 2009. Effective tax rates are affected by income and expense items that are not subject to Federal or state taxation. Our income tax provision reflects the impact of such items, including tax-exempt interest income from municipal securities, tax-exempt earnings on bank-owned life insurance and the effect of certain state tax credits.

**RESULTS OF OPERATIONS FOR THE YEARS ENDED
DECEMBER 31, 2009 AND DECEMBER 31, 2008**

Net Interest Income and Net Interest Margin

Net interest income in the consolidated statements of operations (which excludes the taxable equivalent adjustment) was \$72.3 million in 2009 compared to \$65.3 million in 2008. The taxable equivalent adjustments (the adjustments to bring tax-exempt interest to a level that would yield the same after-tax income had that income been subject to a taxation using a 34% tax rate) of \$2.7 million and \$4.3 million for 2009 and 2008, respectively, resulted in fully taxable equivalent net interest income of \$75.0 million in 2009 and \$69.6 million in 2008.

Taxable equivalent net interest income of \$75.0 million for 2009 was \$5.3 million or 8% higher than 2008. The increase in taxable equivalent net interest income was a combination of favorable volume variances (as balance sheet changes in both volume and mix increased taxable equivalent net interest income by \$4.7 million) and favorable interest rate changes (as the impact of changes in the interest rate environment and product pricing increased taxable equivalent net interest income by \$671 thousand). The change in mix and volume of earning assets increased taxable equivalent interest income by \$6.9 million, while the change in volume and composition of interest-bearing liabilities decreased interest expense by \$2.2 million, for a net favorable volume impact of \$4.7 million on taxable equivalent net interest income. Rate changes on earning assets reduced interest income by \$12.9 million, while changes in rates on interest-bearing liabilities lowered interest expense by \$13.6 million, for a net favorable rate impact of \$671 thousand.

The net interest margin for 2009 was 4.04%, compared to 3.93% in 2008. The 11 basis point improvement in net interest margin was attributable to a 30 basis point increase in interest rate spread (the net of a 90 basis point decrease in the cost of interest-bearing liabilities and a 60 basis decrease in the yield on earning assets), partially offset by a 19 basis point lower contribution from net free funds (primarily attributable to lower rates on interest-bearing liabilities reducing the relative value of noninterest-bearing deposits and other net free funds).

For 2009, the yield on average earning assets of 5.23% was 60 basis points lower than 2008. Loan yields also decreased 60 basis points (to 6.01%). Commercial loans in particular, down 97 basis points, experienced lower yields given the repricing of adjustable rate loans and competitive pricing pressures in a low interest rate environment. The yield on securities and short-term investments was down 84 basis points to 4.00%, also impacted by the lower interest rate environment and prepayment speeds of mortgage-related investment securities purchased at a premium. Overall, earning asset rate changes reduced interest income by \$12.9 million.

The cost of average interest-bearing liabilities of 1.46% in 2009 was 90 basis points lower than 2008. The average cost of interest-bearing deposits was 1.33% in 2009, 87 basis points lower than 2008, reflecting the lower rate environment, mitigated by a focus on product pricing to retain balances. The cost of wholesale funding (comprised of short-term borrowings and long-term borrowings) decreased 118 basis points to 3.47% for 2009, with short-term borrowings down 127 basis points and long-term borrowings down 52 basis points. The interest-bearing liability rate changes resulted in \$13.6 million lower interest expense.

Average interest-earning assets of \$1.857 billion in 2009 were \$84.7 million or 5% higher than 2008. Average investment securities decreased \$111.9 million as a result of mortgage-related investment securities sales and maturities. Average loans increased \$186.0 million or 18%, with a \$68.6 million increase in commercial loans and a \$128.4 million increase in consumer loans, offset by a \$11.0 million decrease in residential real-estate loans.

Average interest-bearing liabilities of \$1.525 billion in 2009 were up \$98.1 million or 7% versus 2008, attributable to higher average deposit balances. On average, interest-bearing deposits grew \$99.8 million, while average noninterest-bearing demand deposits (a principal component of net free funds) increased by \$13.4 million. Average wholesale funding decreased \$1.7 million, the net of \$5.1 million increase and \$6.8 million decrease in short-term and long-term borrowings, respectively.

Provision for Loan Losses

The provision for loan losses totaled \$7.7 million for the year ended December 31, 2009, versus \$6.6 million for 2008. The increase in the provision was due to increased net charge-offs and increases in loan portfolio outstandings during 2009. See the section captioned *Lending Activities* for further discussion.

Noninterest Income

Service charges on deposits were \$10.1 million in 2009, which was \$432 thousand or 4% lower than 2008. The decrease was primarily attributable to lower nonsufficient fund fees in 2009, which were down \$505 thousand to \$8.3 million, offset by an increase in other service charges, which increased by \$73 thousand to \$1.8 million in 2009.

ATM and debit card income was \$3.6 million for 2009, an increase of \$297 thousand or 9%, compared to 2008, as the increased popularity of electronic banking and transaction processing has resulted in higher ATM and debit card point-of-sale usage fees.

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 \$644 thousand for the year ended December 31, 2009 compared to 2008, 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.

We invested \$20.0 million in company owned life insurance during the third quarter of 2008, resulting in the \$533 thousand increase when comparing company owned life insurance income for the year ended December 31, 2009 to 2008.

Broker-dealer fees and commissions were down \$436 thousand or 30%, compared to 2008. 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.

Net gain on sale of loans held for sale increased \$360 thousand compared to the prior year, due primarily to higher gains on sales and related income resulting from increased volumes. Secondary mortgage production was \$89.0 million for 2009, compared to \$28.5 million for 2008. In addition, the 2008 income includes \$104 thousand in net gains from the sale of student loans. We exited the student loan business in 2008.

The \$3.4 million net gain on disposal of investment securities for 2009 is comprised of \$6.8 million in gross gains, primarily from securities issued by U.S. government sponsored agencies, and \$3.4 million in gross losses on sales of privately issued whole loan CMOs and auction rate securities. The \$288 thousand net gain on disposal of investment securities for 2008 is comprised of \$291 thousand in gross gains and \$3 thousand in gross losses.

The \$4.7 million of impairment charges on investment securities for 2009 is comprised of valuation write-downs of \$2.4 million on pooled trust preferred securities and \$2.3 million on privately issued whole loan CMOs. The \$68.2 million of impairment charges on investment securities for 2008 is comprised of valuation write-downs of \$30.0 million on pooled TPS, \$5.9 million on privately issued whole loan CMOs and \$32.3 million on auction-rate securities.

Noninterest Expense

Salaries and employee benefits (which includes salary-related expenses and fringe benefit expenses) was \$33.6 million for 2009, up \$2.2 million or 7% from 2008. Average FTEs were 586 for 2009, down 4% from 610 for 2008. Salary-related expenses were relatively unchanged at \$25.2 million for 2009 and \$25.1 million for 2008, a result of fewer FTEs offset by higher incentives and commissions. Fringe benefit expenses increased \$2.1 million or 34%, primarily from higher pension and post-retirement benefit costs.

Compared to 2008, occupancy and equipment expenses of \$11.1 million were up \$560 thousand or 5%, primarily a result of additional expenses related to the opening of two new branches at the end of 2008, combined with increased software maintenance costs.

FDIC assessments, comprised mostly of deposit insurance paid to the FDIC, increased \$3.0 million for the year ended December 31, 2009. The increases resulted from a combination of an increase in deposit levels subject to insurance premiums, higher FDIC insurance premium rates during 2009 and a \$923 thousand special assessment during the second quarter of 2009, coupled with utilization of approximately \$451 thousand in carryforward credits that reduced expense during the first nine months of 2008.

Professional services expense of \$2.5 million in 2009 increased \$383 thousand or 18% from 2008, primarily due to higher legal and other professional consultant costs associated with loan workouts and other corporate activities and projects.

Advertising and promotions expense of \$949 thousand and other noninterest expense of \$6.8 million, collectively, were down \$754 thousand or 9%, reflecting efforts to control selected discretionary expenses.

The efficiency ratio for the year ended December 31, 2009 was 65.52% compared with 64.07% for 2008. The diminished efficiency ratio is reflective of noninterest expense increasing by larger margin than the higher level of 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 and proceeds from company owned life insurance included in income.

Income Taxes

We recognized income tax expense of \$6.1 million for 2009 compared to an income tax benefit of \$21.3 million for 2008. The change in income tax was primarily due to us having pre-tax income for 2009 versus a pre-tax loss for 2008. Our effective tax rates were 29.8% in 2009 and (44.9%) in 2008. Effective tax rates are affected by income and expense items that are not subject to Federal or state taxation. Our income tax provision reflects the impact of such items, including tax-exempt interest income from municipal securities, tax-exempt earnings on bank-owned life insurance and the effect of certain state tax credits. The unusual 2008 effective tax benefit rate results from the relationship between the size of the favorable permanent differences and pre-tax loss.

2010 FOURTH QUARTER RESULTS

Net income was \$5.1 million for the fourth quarter of 2010 compared with \$5.4 million for the fourth quarter of 2009. After preferred dividends, fourth quarter diluted earnings per share for 2010 was \$0.38 compared with \$0.42 per share for the fourth quarter of 2009.

Net interest income totaled \$20.1 million for the three months ended December 31, 2010, an increase of \$853 thousand or 4% over the fourth quarter of 2009. The increase in net interest income compared to the fourth quarter of 2009 resulted primarily from lower funding costs, a result of continued re-pricing of our certificates of deposit in the low rate environment. Average earning assets increased \$102.2 million or 5% in the fourth quarter of 2010 compared with the fourth quarter last year, with most of the growth in the investment securities portfolio, and the indirect consumer and commercial mortgage loan portfolios. The increase in average indirect consumer loans reflected our continued expansion, including expansion of our dealer network into the Capital District of New York State.

The net interest margin on a tax-equivalent basis was 4.01% in the fourth quarter of 2010, compared with 4.06% in the fourth quarter of 2009. Our yield on earning-assets decreased 29 basis points in the fourth quarter of 2010 compared with the same quarter last year. This was due to the effect of reinvesting cash flows in the low interest rate environment and a substantial portion of earning asset growth being concentrated in lower yielding mortgage-backed securities. The cost of interest-bearing liabilities decreased 27 basis points compared with the fourth quarter of 2009 due to continued downward changes in our interest-bearing deposit rates, a result of the continued re-pricing of certificates of deposit.

Noninterest income totaled \$5.3 million for the fourth quarter of 2010, a 2% increase over the fourth quarter of 2009. Noninterest expense was \$16.4 million for the fourth quarter of 2010, an increase of \$1.3 million or 8% from the fourth quarter of 2009. This increase was primarily due to a loss of approximately \$1.0 million relating to irregular instances of fraudulent debit card activity that we recorded in the fourth quarter of 2010.

Total assets at December 31, 2010 were \$2.214 billion, down \$35.2 million from \$2.250 billion at September 30, 2010. Total gross loans (includes loans held for sale) were \$1.349 billion and represented 61% of total assets at December 31, 2010, compared to \$1.326 billion and 59% of total assets at September 30, 2010. Total investment securities were \$694.5 million at December 31, 2010, down \$25.1 million or 3% from September 30, 2010. Total deposits decreased \$63.5 million to \$1.883 billion at December 31, 2010, compared to \$1.946 billion at September 30, 2010, due to seasonal reductions in public deposits. Lower cost demand, savings and money market accounts comprised 60.7% of total deposits at the end of 2010.

Total shareholders' equity was \$212.1 million at December 31, 2010, a \$4.0 million decrease from September 30, 2010, due to a \$7.5 million decrease in accumulated other comprehensive income, partially offset by a net increase of \$3.1 million in our retained earnings. The decrease in accumulated comprehensive income was primarily related to a decrease in unrealized gains on investment securities from \$13.0 million to \$3.1 million driven by an increase in interest rates. Our tangible common equity as a percent of tangible assets was 5.56% as of December 31, 2010, with a tangible common book value per share of \$11.06.

Non-performing assets were \$8.9 million or 0.40% of total assets at December 31, 2010, up from \$8.5 million at September 30, 2010. The ratio of non-performing loans to total loans was 0.56% at the end of the third and fourth quarters of 2010. The provision for loan losses was \$2.0 million for the fourth quarter of 2010, compared to \$2.2 million for the third quarter of 2010. Net charge-offs were \$1.2 million, or 0.37% annualized, of average loans, down from \$4.3 million, or 1.30% annualized, of average loans in the third quarter of 2010. The third quarter of 2010 included a \$3.1 million charge-off related to one commercial business loan.

ANALYSIS OF FINANCIAL CONDITION

OVERVIEW

At December 31, 2010, we had total assets of \$2.214 billion, an increase of 7% from \$2.062 billion as of December 31, 2009, primarily a result of the continued core business growth in both loans and deposits. Total gross loans (includes loans held for sale) were \$1.349 billion as of December 31, 2010, up \$84.7 million, or 7%, when compared to \$1.264 billion as of December 31, 2009. The increase in loans was primarily attributed to the continued expansion of the indirect lending program in existing and new markets and commercial business development efforts. Non-performing assets totaled \$8.9 million as of December 31, 2010, down \$1.5 million from a year ago, due to decreases in both non-performing loans and investment securities for which we have stopped accruing interest. Total deposits amounted to \$1.883 billion and \$1.743 billion as of December 31, 2010 and 2009, respectively. The impacts of the recent recession have had a positive impact on our deposit balances, as consumers tend to save more conservatively when consumer confidence is low. As of December 31, 2010, total borrowed funds were \$103.9 million, compared to \$106.4 million as of December 31, 2009. Book value per common share was \$14.48 and \$13.39 as of December 31, 2010 and 2009, respectively. As of December 31, 2010 our total shareholders' equity was \$212.1 million compared to \$198.3 million a year earlier.

INVESTING ACTIVITIES

The following table summarizes the composition of the available for sale and held to maturity security portfolios (in thousands).

Investment Securities Portfolio Composition						
At December 31,						
	2010		2009		2008	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Securities available for sale:						
U.S. Government agency and government-sponsored enterprise securities	\$ 141,591	\$ 140,784	\$ 134,564	\$ 134,105	\$ 67,871	\$ 68,173
State and political subdivisions	105,622	105,666	80,812	83,659	129,572	131,711
Mortgage-backed securities:						
Agency mortgage-backed securities	414,502	417,709	356,044	356,355	297,278	303,105
Non-Agency mortgage-backed securities	981	1,572	5,087	5,160	42,296	39,447
Asset-backed securities	564	637	1,295	1,222	3,918	3,918
Equity securities	-	-	-	-	923	1,152
Total available for sale securities	663,260	666,368	577,802	580,501	541,858	547,506
Securities held to maturity:						
State and political subdivisions	28,162	28,849	39,573	40,629	58,532	59,147
Total investment securities	<u>\$ 691,422</u>	<u>\$ 695,217</u>	<u>\$ 617,375</u>	<u>\$ 621,130</u>	<u>\$ 600,390</u>	<u>\$ 606,653</u>

Our investment policy is contained within our overall Asset-Liability Management and Investment Policy. This policy dictates that investment decisions will be made based on the safety of the investment, liquidity requirements, potential returns, cash flow targets, need for collateral and desired risk parameters. In pursuing these objectives, we consider the ability of an investment to provide earnings consistent with factors of quality, maturity, marketability, pledgeable nature and risk diversification. Our Treasurer, guided by ALCO, is responsible for investment portfolio decisions within the established policies.

Impairment Assessment

We review investment securities on an ongoing basis for the presence of OTTI with formal reviews performed quarterly. Declines in the fair value of held-to-maturity and available-for-sale securities below their cost that are deemed to be other than temporary are reflected in earnings as realized losses to the extent the impairment is related to credit losses or the security is intended to be sold or will be required to be sold. The amount of the impairment related to non-credit related factors is recognized in other comprehensive income. Evaluating whether the impairment of a debt security is other than temporary involves assessing 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, we use our 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.

As of December 31, 2010, management does not have the intent to sell any of the securities in a loss position and believes that it is likely that it will not be required to sell any such securities before the anticipated 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, repricing date or if market yields for such investments decline. Management does not believe any of the securities in a loss position are impaired due to reasons of credit quality. Accordingly, as of December 31, 2010, management has concluded that unrealized losses on its investment securities are temporary and no further impairment loss has been realized in our consolidated statements of operations. The following discussion provides further details of our assessment of the securities portfolio by investment category.

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

	Unrealized Losses on Investment Securities					
	At December 31,					
	2010		2009		2008	
	Unrealized Losses	% of Total	Unrealized Losses	% of Total	Unrealized Losses	% of Total
Securities available for sale:						
U.S. Government agency and government-sponsored enterprise securities	\$ 1,965	31.6%	\$ 545	19.8%	\$ 307	7.3%
State and political subdivisions	1,472	23.6	3	0.1	42	1.0
Mortgage-backed securities:						
Agency mortgage-backed securities	2,655	42.7	1,638	59.3	981	23.1
Non-Agency mortgage-backed securities	-	-	330	12.0	2,854	67.3
Asset-backed securities	131	2.1	244	8.8	-	-
Equity securities	-	-	-	-	52	1.2
Total available for sale securities	6,223	100.0	2,760	100.0	4,236	99.9
Securities held to maturity:						
State and political subdivisions	-	-	-	-	4	0.1
Total investment securities	\$ 6,223	100.0%	\$ 2,760	100.0%	\$ 4,240	100.0%

U.S. Government Agencies and Government Sponsored Enterprises (“GSE”). As of December 31, 2010, there were 14 securities in the U.S. Government agencies and GSE portfolio that were in an unrealized loss position. Of these, 7 were in an unrealized loss position for 12 months or longer and had an aggregate amortized cost of \$8.9 million and unrealized losses of \$54 thousand. Because the decline in fair value is attributable to changes in interest rates, and not credit quality, and because we do not have the intent to sell these securities and it is likely that we will not be required to sell the securities before their anticipated recovery, we do not consider these securities to be other-than-temporarily impaired at December 31, 2010.

State and Political Subdivisions. As of December 31, 2010, the state and political subdivisions portfolio (“municipals”) totaled \$133.9 million, of which \$105.7 million was classified as available for sale. As of that date, \$28.2 million was classified as held to maturity, with a fair value of \$28.8 million. As of December 31, 2010, there were 95 municipals in an unrealized loss position, all of which were available for sale. These securities had an aggregate amortized cost of \$39.9 million and unrealized losses of \$1.5 million. There were no municipals in an unrealized loss position for 12 months or longer as of December 31, 2010. Because the decline in fair value is attributable to changes in interest rates, and not credit quality, and because we do not have the intent to sell these securities and it is likely that we will not be required to sell the securities before their anticipated recovery, we do not consider these securities to be other-than-temporarily impaired at December 31, 2010.

Agency Mortgage-backed Securities. With the exception of the non-Agency mortgage-backed securities (“non-Agency MBS”) discussed below, all of the mortgage-backed securities held by us as of December 31, 2010, were issued by U.S. Government sponsored entities and agencies (“Agency MBS”), primarily GNMA. The contractual cash flows of our Agency MBS are guaranteed by FNMA, FHLMC or GNMA. The GNMA mortgage-backed securities are backed by the full faith and credit of the U.S. Government.

As of December 31, 2010, there were 36 securities in the U.S. Government agencies and GSE portfolio that were in an unrealized loss position. Of these, only 4 were in an unrealized loss position for 12 months or longer and had an aggregate amortized cost of \$2.3 million and unrealized losses of \$11 thousand. Given the high credit quality inherent in Agency MBS, we do not consider any of the unrealized losses as of December 31, 2010, on such MBS to be credit related or other-than-temporary. As of December 31, 2010, we 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.

Non-Agency Mortgage-backed Securities. Our non-Agency MBS portfolio consists of positions in three privately issued whole loan collateralized mortgage obligations with a fair value of \$1.6 million and net unrealized gains of \$591 thousand as of December 31, 2010. As of that date, each of the 3 non-Agency MBS were rated below investment grade. None of these securities were in an unrealized loss position. To date, we have recognized aggregate OTTI charges of \$6.0 million due to reasons of credit quality against these securities, all of which was recorded prior to 2010.

Asset-backed Securities (“ABS”). As of December 31, 2010, the fair value of the ABS portfolio totaled \$637 thousand and consisted of positions in 15 securities, the majority of which are pooled trust preferred securities (“TPS”) 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, we considered the TPS to be non-performing and stopped accruing interest on the investments during 2009.

During 2010, we recognized OTTI charges totaling \$594 thousand against 5 ABSs. Since the second quarter of 2008, we have written down each of the securities in the ABS portfolio, resulting in aggregate OTTI charges of \$32.9 million through December 31, 2010. We expect to recover the remaining amortized cost of \$564 thousand on the securities. As of December 31, 2010, each of the securities in the ABS portfolio was rated below investment grade. There were 8 ABS in a loss position with an aggregate amortized cost of \$338 thousand and unrealized losses totaling \$131 thousand as of December 31, 2010. Of these, 6 were in an unrealized loss position for 12 months or longer and had an aggregate amortized cost of \$166 thousand and unrealized losses of \$70 thousand. We determined at December 31, 2010 that the unrealized losses in the ABS portfolio are temporary.

Other Investments. As a member of the FHLB 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. We have assessed the ultimate recoverability of our FHLB stock and believe that no impairment currently exists. Our ownership of FHLB stock, which totaled \$2.5 million at December 31, 2010, is included in other assets and recorded at cost.

As a member of the FRB system, we are required to maintain a specified investment in FRB stock based on a ratio relative to our capital. FRB stock totaled \$3.9 million at December 31, 2010, is included in other assets and recorded at cost.

LENDING ACTIVITIES

Total loans were \$1.346 billion at December 31, 2010, an increase \$82.0 million or 6% from December 31, 2009. Commercial loans increased \$26.9 million or 5% and represented 41.9% of total loans at the end of 2010, compared to 42.5% at December 31, 2009. Residential mortgage loans were \$129.6 million, down \$14.6 million or 10% and represented 9.6% of total loans compared to 11.4% at December 31, 2009, while consumer loans increased \$69.8 million to represent 48.5% of total loans at December 31, 2010 and 46.1% at December 31, 2009. The composition of our loan portfolio, excluding loans held for sale and including net unearned income and net deferred fees and costs, is summarized as follows (in thousands):

Loan Portfolio Composition At December 31,										
	2010		2009		2008		2007		2006	
	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent
Commercial business	\$ 211,031	15.7 %	\$ 206,383	16.3 %	\$ 180,100	16.1 %	\$ 157,550	16.3 %	\$ 130,695	14.1 %
Commercial mortgage	352,930	26.2	330,748	26.2	285,383	25.5	272,394	28.3	275,884	29.8
Total commercial	563,961	41.9	537,131	42.5	465,483	41.6	429,944	44.6	406,579	43.9
Residential mortgage	129,580	9.6	144,215	11.4	177,683	15.8	166,863	17.3	163,244	17.6
Home equity	208,327	15.5	200,684	15.9	189,794	16.9	194,144	20.1	203,426	22.0
Consumer indirect	418,016	31.1	352,611	27.9	255,054	22.8	134,977	14.0	106,445	11.5
Other consumer	26,106	1.9	29,365	2.3	33,065	2.9	38,245	4.0	46,788	5.0
Total consumer	652,449	48.5	582,660	46.1	477,913	42.6	367,366	38.1	356,659	38.5
Total loans	1,345,990	100.0 %	1,264,006	100.0 %	1,121,079	100.0 %	964,173	100.0 %	926,482	100.0 %
Allowance for loan losses	20,466		20,741		18,749		15,521		17,048	
Total loans, net	<u>\$ 1,325,524</u>		<u>\$ 1,243,265</u>		<u>\$ 1,102,330</u>		<u>\$ 948,652</u>		<u>\$ 909,434</u>	

The decrease in residential mortgage loans from \$177.7 million to \$144.2 million to \$129.6 million for the periods ending December 31, 2008, 2009 and 2010, respectively, and the increase in consumer indirect loans from \$255.1 million to \$352.6 million to \$418.0 million for the same periods reflects a strategic shift to increase our consumer indirect loan portfolio, while placing less emphasis on expanding our residential mortgage loan portfolio, coupled with our practice of selling the majority of our fixed-rate residential mortgages in the secondary market with servicing rights retained.

Commercial loans are generally viewed as having more inherent risk of default than residential mortgage or consumer loans. Also, the commercial loan balance per borrower is typically larger than that for residential mortgage and consumer loans, inferring higher potential losses on an individual customer basis. Commercial loans increased during 2010 as we continued our commercial business development efforts. The credit risk related to commercial loans is largely influenced by general economic conditions and the resulting impact on a borrower’s operations or on the value of underlying collateral, if any.

Commercial business loans were \$211.0 million at the end of 2010, up \$4.6 million or 2% since year-end 2009, and comprised 15.7% of total loans outstanding at December 31, 2010 compared to 16.3% at December 31, 2009. We typically originate business loans of up to \$15.0 million for small to mid-sized businesses in our market area for working capital, equipment financing, inventory financing, accounts receivable financing, or other general business purposes. Loans of this type are in a diverse range of industries. Within the commercial business classification, loans to finance agricultural production totaled approximately 1% of total loans as of December 31, 2010.

Commercial mortgage loans totaled \$352.9 million at December 31, 2010, up \$22.2 million or 7% from December 31, 2009, and comprised 26.2% of total loans, unchanged from year-end 2009. Commercial mortgage includes both owner occupied and non-owner occupied commercial real estate loans. Approximately 51% of the commercial mortgage portfolio at December 31, 2010 was owner occupied commercial real estate. The majority of our commercial real estate loans are secured by office buildings, manufacturing facilities, distribution/warehouse facilities, and retail centers, which are generally located in our local market area.

Our current lending standards for commercial real estate and real estate construction lending are determined by property type and specifically address many criteria, including: maximum loan amounts, maximum loan-to-value ("LTV"), requirements for pre-leasing and / or pre-sales, minimum debt-service coverage ratios, minimum borrower equity, and maximum loan to cost. Currently, the maximum standard for LTV is 80%, with lower limits established for certain higher risk types, such as raw land which has a 65% LTV maximum. Our LTV guidelines are in compliance with regulatory supervisory limits.

Residential mortgage loans totaled \$129.6 million at the end of 2010, down \$14.6 million or 10% from the prior year and comprised 9.6% of total loans outstanding at December 31, 2010 and 11.4% at December 31, 2009. Residential mortgage loans include conventional first lien home mortgages and we generally limit the maximum loan to 85% of collateral value without credit enhancement (e.g. PMI insurance). As part of management's historical practice of originating and servicing residential mortgage loans, the majority of our fixed-rate residential mortgage loans are sold in the secondary market with servicing rights retained.

Our underwriting and risk-based pricing guidelines for consumer-related real estate loans consist of a combination of borrower FICO (credit score) and the LTV of the property securing the loan. Currently, for home equity products, the maximum acceptable LTV is 90%. The average FICO score for new home equity production in 2010 was 759 compared to 763 in 2009. Residential mortgage products continue to be underwritten using FHLMC and FNMA secondary marketing guidelines.

Consumer loans totaled \$652.4 million at December 31, 2010, up \$69.8 million or 12% compared to 2009, and represented 48.5% of the 2010 year-end loan portfolio versus 46.1% at year-end 2009. Loans in this classification include indirect consumer, home equity and other consumer installment loans. Credit risk for these types of loans is generally influenced by general economic conditions, the characteristics of individual borrowers, and the nature of the loan collateral. Risks of loss are generally on smaller average balances per loan spread over many borrowers. Once charged off, there is usually less opportunity for recovery on these smaller retail loans. Credit risk is primarily controlled by reviewing the creditworthiness of the borrowers, monitoring payment histories, and taking appropriate collateral and guaranty positions.

Consumer indirect loans amounted to \$418.0 million at December 31, 2010 up \$65.4 million or 19% compared to 2009, and represented 31.1% of the 2010 year-end loan portfolio versus 27.9% at year-end 2009. The loans are primarily for the purchase of automobiles (both new and used) and light duty trucks primarily to individuals, but also to corporations and other organizations. The loans are originated through dealerships and assigned to us with terms that typically range from 36 to 84 months. During the year ended December 31, 2010, we originated \$204.4 million in indirect loans with a mix of approximately 33% new auto and 67% used vehicles. This compares with \$199.1 million in indirect loans with a mix of approximately 32% new auto and 68% used vehicles for the same period in 2009. We do business with over 300 franchised auto dealers, primarily in Western and Central New York. During 2010, we continued to grow our indirect lending network by establishing relationships with dealerships in the Capital District of New York. In the latter part of 2010, we began efforts to expand our dealer network into Northern Pennsylvania and anticipate indirectly originating loans there in the first half of 2011.

Home equity consists of home equity lines, as well as home equity loans, some of which are first lien positions. Home equities amounted to \$208.3 million at December 31, 2010 up \$7.6 million or 4% compared to 2009, and represented 15.5% of the 2010 year-end loan portfolio versus 15.9% at year-end 2009. The portfolio had a weighted average LTV at origination of approximately 52% at December 31, 2010. Approximately 37% of the loans in the home equity portfolio are second lien positions at December 31, 2010.

Other consumer loans totaled \$26.1 million at December 31, 2010, down \$3.3 million or 11% compared to 2009, and represented 1.9% of the 2010 year-end loan portfolio versus 2.3% at year-end 2009. Other consumer consists of personal loans (collateralized and uncollateralized) and deposit account collateralized loans.

Factors that are important to managing overall credit quality are sound loan underwriting and administration, systematic monitoring of existing loans and commitments, effective loan review on an ongoing basis, early identification of potential problems, an appropriate allowance for loan losses, and sound nonaccrual and charge off policies.

An active credit risk management process is used for commercial loans to further ensure that sound and consistent credit decisions are made. Credit risk is controlled by detailed underwriting procedures, comprehensive loan administration, and periodic review of borrowers' outstanding loans and commitments. Borrower relationships are formally reviewed and graded on an ongoing basis for early identification of potential problems. Further analyses by customer, industry, and geographic location are performed to monitor trends, financial performance, and concentrations.

The loan portfolio is widely diversified by types of borrowers, industry groups, and market areas within our core footprint. Significant loan concentrations are considered to exist for a financial institution when there are amounts loaned to numerous borrowers engaged in similar activities that would cause them to be similarly impacted by economic or other conditions. At December 31, 2010, no significant concentrations, as defined above, existed in the Company's portfolio in excess of 10% of total loans.

Loans Held for Sale and Mortgage Servicing Rights. Loans held for sale (not included in the loan portfolio composition table) totaled \$3.1 million and \$421 thousand as of December 31, 2010 and 2009, respectively, all of which were residential real estate loans.

We sell certain qualifying newly originated and refinanced residential real estate mortgages on the secondary market. The sold and serviced residential real estate loan portfolio decreased to \$328.9 million as of December 31, 2010 from \$349.8 million as of December 31, 2009. The decrease in the sold and serviced portfolio resulted from a decrease in residential loan origination and refinancing volumes associated with the interest rate environment during 2010 compared to 2009.

Allowance for Loan Losses

The following table summarizes the activity in the allowance for loan losses (in thousands).

Loan Loss Analysis					
Year Ended December 31,					
	2010	2009	2008	2007	2006
Allowance for loan losses, beginning of year	\$ 20,741	\$ 18,749	\$ 15,521	\$ 17,048	\$ 20,231
Charge-offs:					
Commercial business	3,426	2,360	720	618	1,472
Commercial mortgage	263	355	1,192	439	603
Residential mortgage	290	225	320	319	278
Home equity	259	195	110	255	108
Consumer indirect	4,669	3,637	2,011	988	532
Other consumer	909	1,058	1,106	1,276	1,206
Total charge-offs	9,816	7,830	5,459	3,895	4,199
Recoveries:					
Commercial business	326	428	684	1,140	1,777
Commercial mortgage	501	150	315	216	161
Residential mortgage	21	12	26	50	71
Home equity	36	20	19	12	22
Consumer indirect	1,485	1,030	548	235	224
Other consumer	485	480	544	599	603
Total recoveries	2,854	2,120	2,136	2,252	2,858
Net charge-offs	6,962	5,710	3,323	1,643	1,341
Provision (credit) for loan losses	6,687	7,702	6,551	116	(1,842)
Allowance for loan losses, end of year	\$ 20,466	\$ 20,741	\$ 18,749	\$ 15,521	\$ 17,048
Net charge-offs to average loans	0.54%	0.47%	0.32%	0.18%	0.14%
Allowance to end of period loans	1.52%	1.64%	1.67%	1.61%	1.84%
Allowance to end of period non-performing loans	270%	239%	229%	192%	108%

The following table sets forth the allocation of the allowance for loan losses by loan category as of the dates indicated. The allocation is made for analytical purposes and is not necessarily indicative of the categories in which actual losses may occur. The total allowance is available to absorb losses from any segment of the loan portfolio (in thousands).

Allowance for Loan Losses by Loan Category At December 31,										
	2010		2009		2008		2007		2006	
	Loan Loss Allowance	Percentage of loans by category to total loans	Loan Loss Allowance	Percentage of loans by category to total loans	Loan Loss Allowance	Percentage of loans by category to total loans	Loan Loss Allowance	Percentage of loans by category to total loans	Loan Loss Allowance	Percentage of loans by category to total loans
Commercial business	\$ 3,712	15.7%	\$ 4,407	16.3%	\$ 3,300	16.1%	\$ 2,505	16.3%	\$ 3,294	14.1%
Commercial mortgage	6,431	26.2	6,638	26.2	4,635	25.5	4,640	28.3	5,494	29.8
Residential mortgage	1,013	9.6	1,251	11.4	2,516	15.8	1,763	17.3	1,748	17.6
Home equity	972	15.5	1,043	15.9	2,374	16.9	1,869	20.1	2,082	22.0
Consumer indirect	7,754	31.1	6,837	27.9	5,152	22.8	2,284	14.0	1,749	11.5
Other consumer	584	1.9	565	2.3	772	2.9	798	4.0	751	5.0
Unallocated ⁽¹⁾	-	-	-	-	-	-	1,662	-	1,930	-
Total	<u>\$ 20,466</u>	<u>100.0%</u>	<u>\$ 20,741</u>	<u>100.0%</u>	<u>\$ 18,749</u>	<u>100.0%</u>	<u>\$ 15,521</u>	<u>100.0%</u>	<u>\$ 17,048</u>	<u>100.0%</u>

⁽¹⁾ During 2008 management revised estimation techniques related to allocation of the allowance to specific loan segments. The result was the elimination of the unallocated portion of the allowance for loan losses and allocation of the entire balance to specific loan segments.

Management believes that the allowance for loan losses at December 31, 2010 is adequate to cover probable losses in the loan portfolio at that date. Factors beyond our control, however, such as general national and local economic conditions, can adversely impact the adequacy of the allowance for loan losses. As a result, no assurance can be given that adverse economic conditions or other circumstances will not result in increased losses in the portfolio or that the allowance for loan losses will be sufficient to meet actual loan losses. Management presents a quarterly review of the adequacy of the allowance for loan losses to our Board of Directors based on the methodology that is described in further detail under the sections captioned *Lending Activities* under “Business” and “Management’s Discussion and Analysis of Financial Condition and Results of Operations” of this report. See also Critical Accounting Estimates under “Management’s Discussion and Analysis of Financial Condition and Results of Operations” for additional information on the allowance for loan losses.

Non-performing Assets and Potential Problem Loans

The following table sets forth information regarding non-performing assets (in thousands):

Non-performing Assets At December 31,					
	2010	2009	2008	2007	2006
Non-accruing loans:					
Commercial business	\$ 947	\$ 650	\$ 510	\$ 839	\$ 4,031
Commercial mortgage	3,100	2,288	2,670	3,294	7,671
Residential mortgage	2,102	2,376	3,365	2,987	3,127
Home equity	875	880	1,143	661	712
Consumer indirect	514	621	445	278	166
Other consumer	41	7	56	16	130
Total non-accruing loans	<u>7,579</u>	<u>6,822</u>	<u>8,189</u>	<u>8,075</u>	<u>15,837</u>
Restructured accruing loans	-	-	-	-	-
Accruing loans contractually past due over 90 days	<u>3</u>	<u>1,859</u>	<u>7</u>	<u>2</u>	<u>3</u>
Total non-performing loans	<u>7,582</u>	<u>8,681</u>	<u>8,196</u>	<u>8,077</u>	<u>15,840</u>
Foreclosed assets	741	746	1,007	1,421	1,203
Non-performing investment securities	<u>572</u>	<u>1,015</u>	<u>49</u>	<u>-</u>	<u>-</u>
Total non-performing assets	<u>\$ 8,895</u>	<u>\$ 10,442</u>	<u>\$ 9,252</u>	<u>\$ 9,498</u>	<u>\$ 17,043</u>
Non-performing loans to total loans	0.56%	0.69%	0.73%	0.84%	1.71%
Non-performing assets to total assets	0.40%	0.51%	0.48%	0.51%	0.89%

Non-performing assets include non-performing loans, foreclosed assets and non-performing investment securities. Non-performing assets at December 31, 2010 were \$8.9 million, a decrease of \$1.5 million from the \$10.4 million balance at December 31, 2009. The primary component of non-performing assets is non-performing loans, which were \$7.6 million at December 31, 2010, a decrease of \$1.1 million from the \$8.7 million balance at December 31, 2009. The decrease in non-performing loans was attributable to a commercial relationship included in accruing loans past due 90 days or more at December 31, 2009 on which we collected substantially all of the \$1.9 million balance during the first quarter of 2010, partially offset by a \$757 thousand increase in non-accruing loans.

The ratio of non-performing loans to total loans was 0.56% at December 31, 2010, compared to 0.69% at December 31, 2009. This ratio continues to compare favorably to the average of our peer group, which was 3.53% of total loans at December 31, 2010, the most recent period for which information is available (Source: Federal Financial Institutions Examination Council - Bank Holding Company Performance Report as of December 31, 2010 - Top-tier bank holding companies having consolidated assets between \$1 billion and \$3 billion).

Non-accruing loans at December 31, 2010 were \$7.6 million compared to \$6.8 million at December 31, 2009. Approximately \$3.3 million, or 43%, of the \$7.6 million in non-accruing loans as of December 31, 2010 were current with respect to payment of principal and interest, but were classified as non-accruing because repayment in full of principal and/or interest was uncertain. For non-accruing loans outstanding as of December 31, 2010, the amount of interest income forgone totaled \$474 thousand. Included in nonaccrual loans are troubled debt restructurings ("TDRs") of \$534 thousand at December 31, 2010. We had no TDRs which were accruing interest as of December 31, 2010.

Foreclosed assets consist of real property formerly pledged as collateral to loans, which we have acquired through foreclosure proceedings or acceptance of a deed in lieu of foreclosure. Foreclosed asset holdings represented 13 properties totaling \$741 thousand at December 31, 2010 and 14 properties totaling \$746 thousand at December 31, 2009.

Non-performing investment securities for which we have stopped accruing interest were \$572 thousand at December 31, 2010, a decrease of \$443 thousand from the \$1.0 million balance at December 31, 2009. The decrease in non-performing investment securities reflects net losses, both realized and unrealized, in our asset backed securities portfolio.

Potential problem loans are loans that are currently performing, but information known about possible credit problems of the borrowers causes management to have concern as to the ability of such borrowers to comply with the present loan payment terms and may result in disclosure of such loans as nonperforming at some time in the future. These loans remain in a performing status due to a variety of factors, including payment history, the value of collateral supporting the credits, and/or personal or government guarantees. Management considers loans classified as substandard, which continue to accrue interest, to be potential problem loans. We identified \$11.5 million and \$18.4 million in loans that continued to accrue interest which were classified as substandard as of December 31, 2010 and 2009, respectively.

FUNDING ACTIVITIES

Deposits

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

	At December 31,					
	2010		2009		2008	
	Amount	Percent	Amount	Percent	Amount	Percent
Noninterest-bearing demand	\$ 350,877	18.6 %	\$ 324,303	18.6 %	\$ 292,586	17.9 %
Interest-bearing demand	374,900	19.9	363,698	20.9	344,616	21.1
Savings and money market	417,359	22.2	368,603	21.1	348,594	21.3
Certificates of deposit < \$100,000	555,840	29.5	512,969	29.5	482,863	29.6
Certificates of deposit of \$100,000 or more	183,914	9.8	173,382	9.9	164,604	10.1
Total deposits	<u>\$ 1,882,890</u>	<u>100.0 %</u>	<u>\$ 1,742,955</u>	<u>100.0 %</u>	<u>\$ 1,633,263</u>	<u>100.0 %</u>

We offer a variety of deposit products designed to attract and retain customers, with the primary focus on building and expanding long-term relationships. At December 31, 2010, total deposits were \$1.883 billion, representing an increase of \$139.9 million for the year. Certificates of deposit were approximately 39% of total deposits at both December 31, 2010 and 2009.

Nonpublic deposits, the largest component of our funding sources, represented 80% of total deposits and totaled \$1.501 billion and \$1.387 billion as of December 31, 2010 and 2009, respectively. We have managed this segment of funding through a strategy of competitive pricing that minimizes the number of customer relationships that have only a single service high cost deposit account. Nonpublic deposit levels continue to be positively impacted by the 2008 de novo branch expansion as our Henrietta and Greece branches have grown to \$51.0 million and \$34.6 million in deposits, respectively as of December 31, 2010. We had no brokered deposits outstanding at December 31, 2010 or 2009.

As an additional source of funding, we offer a variety of public deposit products to the many towns, villages, counties and school districts within our market. Public deposits generally range from 20% to 25% of our total deposits. 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. We maintain the necessary levels of short-term liquid assets to accommodate the seasonality associated with public deposits. As of December 31, 2010, total public deposits were \$382.2 million or 20% of total deposits, compared to \$355.9 million or 20% of total deposits, as of December 31, 2009. In general, the number of public relationships remained stable in comparison to the prior year.

Short-term Borrowings

Short-term borrowings from the FHLB are used to satisfy funding requirements resulting from daily fluctuations in deposit, loan and investment activities. FHLB borrowings are collateralized by certain investment securities, FHLB stock owned by us and certain qualifying loans. At December 31, 2010, short-term borrowings consisted of Federal funds purchased of \$38.2 million and \$38.9 million of overnight repurchase agreements. At December 31, 2009, short-term borrowings consisted of Federal funds purchased of \$9.4 million, \$35.1 million of overnight repurchase agreements and a \$15.0 million advance from the Federal Reserve's Term Auction Facility.

The following table summarizes information relating to our short-term borrowings (dollars in thousands).

	At or for the Year Ended December 31,		
	2010	2009	2008
Year-end balance	\$ 77,110	\$ 59,543	\$ 23,465
Year-end weighted average interest rate	0.21 %	0.59 %	0.48 %
Maximum outstanding at any month-end	\$ 77,110	\$ 85,912	\$ 56,861
Average balance during the year	\$ 49,104	\$ 43,092	\$ 38,028
Average interest rate for the year	0.74 %	0.63 %	1.90 %

Long-term Borrowings

Long-term borrowings totaled \$26.8 million at December 31, 2010 and consisted of \$10.0 million in FHLB repurchase agreements, \$65 thousand of FHLB amortizing advances and \$16.7 million in junior subordinated debentures. At December 31, 2009, long-term borrowings totaled \$46.8 million and consisted of \$30.0 million in FHLB repurchase agreements, \$145 thousand of FHLB amortizing advances and \$16.7 million in junior subordinated debentures.

In February 2001, we established FISI Statutory Trust I (the "Trust"), which issued 16,200 fixed rate pooled trust preferred securities with a liquidation preference of \$1,000 per security. The trust preferred securities represent an interest in our related junior subordinated debentures, which were purchased by the Trust and have substantially the same payment terms as these trust preferred securities. The subordinated debentures mature in 2031 and are the only assets of the Trust and interest payments from the debentures finance the distributions paid on the trust preferred securities. Distributions on the debentures are payable quarterly at a fixed interest rate equal to 10.20%. We incurred \$487 thousand in costs related to the issuance that are being amortized over 20 years using the straight-line method. The Trust is accounted for as an unconsolidated subsidiary.

Shareholders' Equity

Shareholders' equity increased by \$13.9 million in 2010 to \$212.1 million at December 31, 2010, primarily due to net income of \$21.3 million, partially offset by common and preferred dividends of \$8.1 million. For detailed information on shareholders' equity, see Note 11, Shareholders' Equity, of the notes to consolidated financial statements.

The Company and Bank are subject to various regulatory capital requirements. At December 31, 2010, both the Company and the Bank exceeded all regulatory requirements. For detailed information on regulatory capital, see Note 10, Regulatory Matters, of the notes to consolidated financial statements.

GOODWILL

The carrying amount of goodwill totaled \$37.4 million as of December 31, 2010 and 2009. The goodwill relates to our primary subsidiary and reporting unit, Five Star Bank. We perform a goodwill impairment test on an annual basis or more frequently if events and circumstances warrant. On September 30, 2010, the Company performed the annual goodwill impairment test and determined the estimated fair value of our reporting unit to be in excess of its carrying amount. Accordingly, as of the annual impairment test date, there was no indication of goodwill impairment. We test goodwill for impairment between annual tests if an event occurs or circumstances change that would more likely than not reduce the fair value of our reporting unit below its carrying amount.

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

LIQUIDITY AND CAPITAL RESOURCES

The objective of maintaining adequate liquidity is to assure that we meet our financial obligations. These obligations include the withdrawal of deposits on demand or at their contractual maturity, the repayment of matured borrowings, the ability to fund new and existing loan commitments and the ability to take advantage of new business opportunities. We achieve liquidity by maintaining a strong base of core customer funds, maturing short-term assets, our ability to sell or pledge securities, lines-of-credit, and access to the financial and capital markets. In addition, we currently have an effective shelf registration that allows for the ability to issue up to \$50 million in common stock.

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. FSIS relies on cash flows from operations and funds from FII when necessary.

Our cash and cash equivalents were \$39.1 million as of December 31, 2010, down from \$43.0 million as of December 31, 2009. Our net cash provided by operating activities totaled \$35.4 million and the principal source of operating activity cash flow was net income adjusted for noncash income and expense items. Net cash used in investing activities totaled \$169.2 million, which included net loan origination funding of \$89.5 million and net securities transactions of \$77.8 million. Net cash provided by financing activities of \$129.9 million was attributed to the \$139.9 million and \$17.6 million increase in deposits and borrowings, respectively, partially offset by \$20.1 million repayments of long-term debt and \$7.7 million in cash paid for dividends.

Contractual Obligations and Other Commitments

The following table summarizes the maturities of various contractual obligations and other commitments (in thousands):

	At December 31, 2010				
	Within 1 year	Over 1 to 3 years	Over 3 to 5 Years	Over 5 years	Total
On-Balance sheet:					
Certificates of deposit ⁽¹⁾	\$ 554,104	\$ 141,608	\$ 43,888	\$ 154	\$ 739,754
Long-term borrowings	10,065	-	-	16,702	26,767
Supplemental executive retirement plans	155	318	318	708	1,499
Off-Balance sheet:					
Limited partnership investments ⁽²⁾	\$ 695	\$ 1,391	\$ 695	\$ -	\$ 2,781
Commitments to extend credit ⁽³⁾	357,240	-	-	-	357,240
Standby letters of credit ⁽³⁾	4,075	1,216	1,233	-	6,524
Operating leases	1,218	2,188	1,933	5,868	11,207

⁽¹⁾ Includes the maturity of certificates of deposit amounting to \$100 thousand or more as follows: \$68.1 million in three months or less; \$27.0 million between three months and six months; \$58.5 million between six months and one year; and \$30.3 million over one year.

⁽²⁾ We have committed to capital investments in several limited partnerships of up to \$6.1 million. As of December 31, 2010, we have contributed \$3.3 million to the partnerships, including \$806 thousand during 2010.

⁽³⁾ We do not expect all of the commitments to extend credit and standby letters of credit to be funded. Thus, the total commitment amounts do not necessarily represent our future cash requirements.

Off-Balance Sheet Arrangements

With the exception of obligations in connection with our trust preferred securities and in connection with our irrevocable loan commitments, operating leases and limited partnership investments, we had no other off-balance sheet arrangements that have or are reasonably likely to have a current or future effect on our financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources that is material to investors. For additional information on off-balance sheet arrangements, see Note 1, Summary of Significant Accounting Policies and Note 9, Commitments and Contingencies, in the notes to the accompanying consolidated financial statements.

Security Yields and Maturities Schedule

The following table sets forth certain information regarding the amortized cost ("Cost"), weighted average yields ("Yield") and contractual maturities of our debt securities portfolio as of December 31, 2010. Mortgage-backed securities are included in maturity categories based on their stated maturity date. Actual maturities may differ from the contractual maturities presented because borrowers may have the right to call or prepay certain investments. We have stopped accruing interest on our asset-backed securities. No tax-equivalent adjustments were made to the weighted average yields (in thousands).

	Due in one year or less		Due from one to five years		Due after five years through ten years		Due after ten years		Total	
	Cost	Yield	Cost	Yield	Cost	Yield	Cost	Yield	Cost	Yield
Available for sale debt securities:										
U.S. Government agencies and government-sponsored enterprises \$	-	-%	\$ 59,324	2.25%	\$ 60,113	2.48%	\$ 22,154	1.40%	\$ 141,591	2.21%
State and political subdivisions	17,186	3.53	43,177	3.10	45,259	2.19	-	-	105,622	2.78
Mortgage-backed securities	8,503	4.02	12,423	3.96	118,320	1.96	276,237	3.57	415,483	3.13
Asset-backed securities	-	-	-	-	-	-	564	-	564	-
	<u>25,689</u>	<u>3.69</u>	<u>114,924</u>	<u>2.75</u>	<u>223,692</u>	<u>2.15</u>	<u>298,955</u>	<u>3.41</u>	<u>663,260</u>	<u>2.88</u>
Held to maturity debt securities:										
State and political subdivisions	21,439	2.43	5,490	4.13	1,055	5.08	178	5.53	28,162	2.88
	<u>\$ 47,128</u>	<u>3.12%</u>	<u>\$ 120,414</u>	<u>2.82%</u>	<u>\$ 224,747</u>	<u>2.16%</u>	<u>\$ 299,133</u>	<u>3.41%</u>	<u>\$ 691,422</u>	<u>2.88%</u>

Contractual Loan Maturity Schedule

The following table summarizes the contractual maturities of our loan portfolio at December 31, 2010. Loans, net of deferred loan origination costs, include principal amortization and non-accruing loans. Demand loans having no stated schedule of repayment or maturity and overdrafts are reported as due in one year or less (in thousands).

	Due in less than one year	Due from one to five years	Due after five years	Total
Commercial business	\$ 130,990	\$ 71,730	\$ 8,311	\$ 211,031
Commercial mortgage	80,096	161,978	110,856	352,930
Residential mortgage	25,556	57,534	46,490	129,580
Home equity	35,208	91,464	81,655	208,327
Consumer indirect	136,355	269,061	12,600	418,016
Other consumer	11,772	13,006	1,328	26,106
Total loans	<u>\$ 419,977</u>	<u>\$ 664,773</u>	<u>\$ 261,240</u>	<u>\$ 1,345,990</u>

Loans maturing after one year:

With a predetermined interest rate	\$ 205,867	\$ 166,360	\$ 372,227
With a floating or adjustable rate	458,906	94,880	553,786
Total loans maturing after one year	<u>\$ 664,773</u>	<u>\$ 261,240</u>	<u>\$ 926,013</u>

Capital Resources

The FRB has adopted a system using risk-based capital guidelines to evaluate the capital adequacy of bank holding companies on a consolidated basis. The guidelines require a minimum Tier 1 leverage ratio of 4.00%, a minimum Tier 1 capital ratio of 4.00% and a minimum total risk-based capital ratio of 8.00%. The following table reflects the ratios and their components (in thousands):

	2010	2009
Total shareholders' equity	\$ 212,144	\$ 198,294
Less: Unrealized gain on securities available for sale, net of tax	1,877	1,655
Unrecognized net periodic pension & postretirement benefits (costs), net of tax	(6,599)	(5,357)
Disallowed goodwill and other intangible assets	37,369	37,369
Disallowed deferred tax assets	14,608	17,214
Plus: Qualifying trust preferred securities	16,200	16,200
Tier 1 capital	<u>\$ 181,089</u>	<u>\$ 163,613</u>
Adjusted average total assets (for leverage capital purposes)	<u>\$ 2,177,911</u>	<u>\$ 2,054,699</u>
Tier 1 leverage ratio (Tier 1 capital to adjusted average total assets)	8.31%	7.96%
Total Tier 1 capital	\$ 181,089	\$ 163,613
Plus: Qualifying allowance for loan losses	18,363	17,153
Total risk-based capital	<u>\$ 199,452</u>	<u>\$ 180,766</u>
Net risk-weighted assets	<u>\$ 1,466,957</u>	<u>\$ 1,368,653</u>
Tier 1 capital ratio (Tier 1 capital to net risk-weighted assets)	12.34%	11.95%
Total risk-based capital ratio (Total risk-based capital to net risk-weighted assets)	13.60%	13.21%

CRITICAL ACCOUNTING ESTIMATES

Our consolidated financial statements are prepared in accordance with GAAP and are consistent with predominant practices in the financial services industry. Application of critical accounting policies, which are those policies that management believes are the most important to our 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.

We have 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. 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 OTTI, and accounting for defined benefit plans require particularly subjective or complex judgments important to our financial position and results of operations, and, as such, are considered to be critical accounting policies as discussed below. 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. We adjust 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 our estimates.

Adequacy of the Allowance for Loan Losses

The allowance for loan losses represents management's estimate of probable credit losses inherent in the loan portfolio. Determining the amount of the allowance for loan losses is considered a critical accounting estimate because it requires significant judgment and the use of subjective measurements including management's assessment of the internal risk classifications of loans, changes in the nature of the loan portfolio, industry concentrations, existing economic conditions, the fair value of underlying collateral, and other qualitative and quantitative factors which could affect probable credit losses. Because current economic conditions can change and future events are inherently difficult to predict, the anticipated amount of estimated loan losses, and therefore the appropriateness of the allowance for loan losses, could change significantly. As an integral part of their examination process, various regulatory agencies also review the allowance for loan losses. Such agencies may require additions to the allowance for loan losses or may require that certain loan balances be charged off or downgraded into criticized loan categories when their credit evaluations differ from those of management, based on their judgments about information available to them at the time of their examination. We believe the level of the allowance for loan losses is appropriate as recorded in the consolidated financial statements. For additional discussion related to our accounting policies for the allowance for loan losses, see the sections captioned *Lending Activities* under "Management's Discussion and Analysis of Financial Condition and Results of Operations" and Note 1, *Summary of Significant Accounting Policies*, of the notes to consolidated financial statements under "Financial Statements and Supplementary Data."

Valuation of Goodwill

Goodwill represents the excess of the purchase price over the fair value of net assets acquired in accordance with the purchase method of accounting for business combinations. Goodwill is not amortized but, instead, is subject to impairment tests on at least an annual basis or more frequently if an event occurs or circumstances change that reduce the fair value of a reporting unit below its carrying amount. The Company completes the annual goodwill impairment test as of September 30 of each year. The impairment testing process is conducted by assigning net assets and goodwill to each reporting unit. Currently, the Company's goodwill is evaluated at the entity level as there is only one reporting unit. The fair value of each reporting unit is compared to the recorded book value "step one". If the fair value of the reporting unit exceeds its carrying value, goodwill is not considered impaired and "step two" is not considered necessary. If the carrying value of a reporting unit exceeds its fair value, the impairment test continues ("step two") by comparing the carrying value of the reporting unit's goodwill to the implied fair value of goodwill. The implied fair value is computed by adjusting all assets and liabilities of the reporting unit to current fair value with the offset adjustment to goodwill. The adjusted goodwill balance is the implied fair value of the goodwill. An impairment charge is recognized if the carrying fair value of goodwill exceeds the implied fair value of goodwill.

Valuation of Deferred Tax Assets

The determination of deferred tax expense or benefit is based on changes in the carrying amounts of assets and liabilities that generate temporary differences. The carrying value of our net deferred tax assets assumes that we will be able to generate sufficient future taxable income based on estimates and assumptions (after consideration of historical taxable income as well as tax planning strategies). If these estimates and related assumptions change, we may be required to record valuation allowances against our deferred tax assets resulting in additional income tax expense in the consolidated statements of operations. Management evaluates deferred tax assets on a quarterly basis and assesses the need for a valuation allowance, if any. A valuation allowance is established when management believes that it is more likely than not that some portion of its deferred tax assets will not be realized. Changes in valuation allowance from period to period are included in the Company's tax provision in the period of change. For additional discussion related to our accounting policy for income taxes see Note 14, Income Taxes, of the notes to consolidated financial statements.

Valuation and Other Than Temporary Impairment of Securities

We record all of our securities that are classified as available for sale at fair value. The fair value of equity securities are determined using public quotations, when available. Where quoted market prices are not available, fair values are 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 corporate fixed maturities where we do not receive a public quotation are valued using a variety of acceptable valuation methods. 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.

Securities are evaluated quarterly to determine whether a decline in their fair value is other than temporary. Management utilizes criteria such as, the current intent or requirement to hold or sell the security, the magnitude and duration of the decline and, when appropriate, consideration of negative changes in expected cash flows, creditworthiness, near term prospects of issuers, the level of credit subordination, estimated loss severity, and delinquencies, to determine whether a loss in value is other than temporary. The term "other than temporary" is not intended to indicate that the decline is permanent, but indicates that the prospect for a near-term recovery of value is not necessarily favorable. Declines in the fair value of investment 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 issues or concerns, or the security is intended to be sold. The amount of impairment related to non-credit related factors on securities not intended to be sold is recognized in other comprehensive income.

Defined Benefit Pension Plan

Management is required to make various assumptions in valuing its defined benefit pension plan assets and liabilities. These assumptions include, but are not limited to, the expected long-term rate of return on plan assets, the weighted average discount rate used to value certain liabilities and the rate of compensation increase. We use a third-party specialist to assist in making these estimates and assumptions. Changes in these estimates and assumptions are reasonably possible and may have a material impact on our consolidated financial statements, results of operations or liquidity.

RECENT ACCOUNTING PRONOUNCEMENTS

See Note 1, Summary of Significant Accounting Policies - Recent Accounting Pronouncements, in the notes to consolidated financial statements for a discussion of recent accounting pronouncements.

QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Asset-Liability Management

The principal objective of our interest rate risk management is to evaluate the interest rate risk inherent in assets and liabilities, determine the appropriate level of risk to us given our business strategy, operating environment, capital and liquidity requirements and performance objectives, and manage the risk consistent with the guidelines approved by our Board of Directors. Management is responsible for reviewing with the Board of Directors our 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 has developed an Asset-Liability Policy that meets strategic objectives and regularly reviews the activities of the Bank.

Net Interest Income at Risk Analysis

The primary tool we use to manage interest rate risk is a “rate shock” simulation to measure the rate sensitivity of the statement of financial condition. 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 following table sets forth the results of the modeling analysis as of December 31, 2010 (dollars in thousands):

Changes in interest rate	Net Interest Income			Economic Value of Equity		
	Amount	Change		Amount	Change	
+ 300 basis points	\$ 80,089	\$	(655) (0.81)%	\$ 409,884	\$	(45,722) (10.04)%
+ 200 basis points	80,387		(357) (0.44)	428,304		(27,303) (5.99)
+ 100 basis points	80,342		(402) (0.50)	443,028		(12,578) (2.76)
- 100 basis points	76,204		(4,540) (5.62)	438,274		(17,332) (3.80)

We measure 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 12 months. As of December 31, 2010, a 100 basis point increase in rates would decrease net interest income by \$402 thousand, or 0.5%, over the next twelve-month period. A 100 basis point decrease in rates would decrease net interest income by \$4.5 million, or 5.6%, over a twelve-month period. As of December 31, 2010, a 100 basis point increase in rates would decrease the economic value of equity by \$12.6 million, or 2.8%, over the next twelve-month period. A 100 basis point decrease in rates would decrease the economic value of equity by \$17.3 million, or 3.8%, over a twelve-month period. 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, we typically run other scenarios to measure interest rate risk, which vary depending on the economic and interest rate environments.

The following table presents an analysis of our interest rate sensitivity gap position at December 31, 2010. All interest-earning assets and interest-bearing liabilities are shown based on the earlier of their contractual maturity or re-pricing date. The expected maturities are presented on a contractual basis or, if more relevant, based on projected call dates. Investment securities are at amortized cost for both securities available for sale and securities held to maturity. Loans, net of deferred loan origination costs, include principal amortization adjusted for estimated prepayments (principal payments in excess of contractual amounts) and non-accruing loans. Borrowings include junior subordinated debentures. Because the interest rate sensitivity levels shown in the table could be changed by external factors such as loan prepayments and liability decay rates or by factors controllable by us, such as asset sales, it is not an absolute reflection of our potential interest rate risk profile (in thousands).

	At December 31, 2010				
	Three Months or Less	Over Three Months Through One Year	Over One Year Through Five Years	Over Five Years	Total
INTEREST-EARNING ASSETS:					
Federal funds sold and interest-earning deposits in other banks	\$ -	\$ 94	\$ -	\$ -	\$ 94
Investment securities	99,649	137,148	262,173	192,452	691,422
Loans	420,507	211,128	604,736	112,757	1,349,128
Total interest-earning assets	<u>\$ 520,156</u>	<u>\$ 348,370</u>	<u>\$ 866,909</u>	<u>\$ 305,209</u>	2,040,644
Cash and due from banks					38,964
Other assets ⁽¹⁾					134,699
Total assets					<u>\$ 2,214,307</u>
INTEREST-BEARING LIABILITIES:					
Interest-bearing demand, savings and money market	\$ 792,259	\$ -	\$ -	\$ -	\$ 792,259
Certificates of deposit	180,581	373,523	185,496	154	739,754
Borrowings	77,175	10,000	-	16,702	103,877
Total interest-bearing liabilities	<u>\$ 1,050,015</u>	<u>\$ 383,523</u>	<u>\$ 185,496</u>	<u>\$ 16,856</u>	1,635,890
Noninterest-bearing deposits					350,877
Other liabilities					15,396
Total liabilities					2,002,163
Shareholders' equity					212,144
Total liabilities and shareholders' equity					<u>\$ 2,214,307</u>
Interest sensitivity gap	<u>\$ (529,859)</u>	<u>\$ (35,153)</u>	<u>\$ 681,413</u>	<u>\$ 288,353</u>	<u>\$ 404,754</u>
Cumulative gap	<u>\$ (529,859)</u>	<u>\$ (565,012)</u>	<u>\$ 116,401</u>	<u>\$ 404,754</u>	
Cumulative gap ratio ⁽²⁾	49.5 %	60.6 %	107.2 %	124.7 %	
Cumulative gap as a percentage of total assets	(23.9) %	(25.5) %	5.3 %	18.3 %	

⁽¹⁾ Includes net unrealized gain on securities available for sale and allowance for loan losses.

⁽²⁾ Cumulative total interest-earning assets divided by cumulative total interest-bearing liabilities.

For purposes of interest rate risk management, we direct more attention on simulation modeling, such as "net interest income at risk" as previously discussed, rather than gap analysis. The net interest income at risk simulation modeling is considered by management to be more informative in forecasting future income at risk.

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
Index to Consolidated Financial Statements

	<u>Page</u>
Management's Report on Internal Control over Financial Reporting.....	54
Report of Independent Registered Public Accounting Firm (on Internal Control over Financial Reporting).....	55
Report of Independent Registered Public Accounting Firm (on the Consolidated Financial Statements).....	57
Consolidated Statements of Financial Condition at December 31, 2010 and 2009.....	58
Consolidated Statements of Operations for the years ended December 31, 2010, 2009 and 2008.....	59
Consolidated Statements of Changes in Shareholders' Equity for the years ended December 31, 2010, 2009 and 2008.....	60
Consolidated Statements of Cash Flows for the years ended December 31, 2010, 2009 and 2008.....	62
Notes to Consolidated Financial Statements.....	63

Management's Report on Internal Control over Financial Reporting

Management is responsible for establishing and maintaining adequate internal control over financial reporting for Financial Institutions, Inc. and its subsidiaries (the "Company"), as such term is defined in Exchange Act Rules 13a-15(f). The Company's system of internal control over financial reporting has been designed to provide reasonable assurance to the Company's management and board of directors regarding the reliability of financial reporting and the preparation and fair presentation of financial statements for external purposes in accordance with accounting principles generally accepted in the United States of America.

Any system of internal control over financial reporting, no matter how well designed, has inherent limitations, including the possibility that a control can be circumvented or overridden and misstatements due to error or fraud may occur and not be detected. Also, because of changes in conditions, internal control effectiveness may vary over time. Accordingly, even an effective system of internal control will provide only reasonable assurance with respect to financial statement preparation and presentation.

The Company's management has assessed the effectiveness of the Company's internal control over financial reporting as of December 31, 2010. To make this assessment, we used the criteria for effective internal control over financial reporting described in *Internal Control – Integrated Framework*, issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on our assessment and based on such criteria, we believe that, as of December 31, 2010, the Company's internal control over financial reporting was effective.

The Company's independent registered public accounting firm that audited the Company's consolidated financial statements has issued an attestation report on internal control over financial reporting as of December 31, 2010. That report appears herein.



President and Chief Executive Officer
March 7, 2011



Executive Vice President and Chief Financial Officer
March 7, 2011



KPMG LLP
265 Clinton Square
Rochester, NY 14604-1701

Report of Independent Registered Public Accounting Firm

The Board of Directors and Shareholders
Financial Institutions, Inc.:

We have audited Financial Institutions, Inc. and subsidiaries' (the Company) internal control over financial reporting as of December 31, 2010, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management's Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also includes performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.



The Board of Directors and Shareholders
Financial Institutions, Inc.
Page 2 of 2

In our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2010, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated statements of financial condition of the Company as of December 31, 2010 and 2009, and the related consolidated statements of operations, changes in shareholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2010, and our report dated March 7, 2011 expressed an unqualified opinion on those consolidated financial statements.

KPMG LLP

Rochester, New York
March 7, 2011



KPMG LLP
265 Clinton Square
Rochester, NY 14604-1701

Report of Independent Registered Public Accounting Firm

The Board of Directors and Shareholders
Financial Institutions, Inc.:

We have audited the accompanying consolidated statements of financial condition of Financial Institutions, Inc. and subsidiaries (the Company) as of December 31, 2010 and 2009, and the related consolidated statements of operations, changes in shareholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2010. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of the Company as of December 31, 2010 and 2009, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2010, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the Company's internal control over financial reporting as of December 31, 2010, based on criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated March 7, 2011 expressed an unqualified opinion on the effectiveness of the Company's internal control over financial reporting.

KPMG LLP

Rochester, New York
March 7, 2011

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

(Dollars in thousands, except share and per share data)

	December 31,	
	2010	2009
ASSETS		
Cash and cash equivalents:		
Cash and due from banks	\$ 38,964	\$ 42,874
Federal funds sold and interest-bearing deposits in other banks	94	85
Total cash and cash equivalents	39,058	42,959
Securities available for sale, at fair value	666,368	580,501
Securities held to maturity, at amortized cost (fair value of \$28,849 and \$40,629, respectively)	28,162	39,573
Loans held for sale	3,138	421
Loans (net of allowance for loan losses of \$20,466 and \$20,741, respectively)	1,325,524	1,243,265
Company owned life insurance	26,053	24,867
Premises and equipment, net	33,263	34,783
Goodwill	37,369	37,369
Other assets	55,372	58,651
Total assets	<u>\$ 2,214,307</u>	<u>\$ 2,062,389</u>
LIABILITIES AND SHAREHOLDERS' EQUITY		
Deposits:		
Noninterest-bearing demand	\$ 350,877	\$ 324,303
Interest-bearing demand	374,900	363,698
Savings and money market	417,359	368,603
Certificates of deposit	739,754	686,351
Total deposits	1,882,890	1,742,955
Short-term borrowings	77,110	59,543
Long-term borrowings	26,767	46,847
Other liabilities	15,396	14,750
Total liabilities	<u>2,002,163</u>	<u>1,864,095</u>
Commitments and contingencies (Note 9)		
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 of \$37,515; net of \$1,305 and \$1,672 discount, respectively	36,210	35,843
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	53,785	53,418
Common stock, \$0.01 par value, 50,000,000 shares authorized, 11,348,122 shares issued	113	113
Additional paid-in capital	26,029	26,940
Retained earnings	144,599	131,371
Accumulated other comprehensive loss	(4,722)	(3,702)
Treasury stock, at cost – 410,616 and 527,854 shares, respectively	(7,660)	(9,846)
Total shareholders' equity	<u>212,144</u>	<u>198,294</u>
Total liabilities and shareholders' equity	<u>\$ 2,214,307</u>	<u>\$ 2,062,389</u>

See accompanying notes to the consolidated financial statements.

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
Consolidated Statements of Operations

(Dollars in thousands, except per share amounts)

	Years ended December 31,		
	2010	2009	2008
Interest income:			
Interest and fees on loans	\$ 75,877	\$ 72,706	\$ 67,674
Interest and dividends on investment securities	20,622	21,694	30,655
Other interest income	10	82	619
Total interest income	<u>96,509</u>	<u>94,482</u>	<u>98,948</u>
Interest expense:			
Deposits	14,853	19,090	29,349
Short-term borrowings	365	270	721
Long-term borrowings	2,502	2,857	3,547
Total interest expense	<u>17,720</u>	<u>22,217</u>	<u>33,617</u>
Net interest income	78,789	72,265	65,331
Provision for loan losses	6,687	7,702	6,551
Net interest income after provision for loan losses	<u>72,102</u>	<u>64,563</u>	<u>58,780</u>
Noninterest income (loss):			
Service charges on deposits	9,585	10,065	10,497
ATM and debit card	3,995	3,610	3,313
Broker-dealer fees and commissions	1,283	1,022	1,458
Company owned life insurance	1,107	1,096	563
Loan servicing	1,124	1,308	664
Net gain on sale of loans held for sale	650	699	339
Net gain on disposal of investment securities	169	3,429	288
Impairment charges on investment securities	(594)	(4,666)	(68,215)
Net (loss) gain on sale and disposal of other assets	(203)	180	305
Other	2,338	2,052	2,010
Total noninterest income (loss)	<u>19,454</u>	<u>18,795</u>	<u>(48,778)</u>
Noninterest expense:			
Salaries and employee benefits	32,811	33,634	31,437
Occupancy and equipment	10,818	11,062	10,502
FDIC assessments	2,507	3,651	674
Computer and data processing	2,487	2,340	2,433
Professional services	2,197	2,524	2,141
Supplies and postage	1,772	1,846	1,800
Advertising and promotions	1,121	949	1,453
Other	7,204	6,771	7,021
Total noninterest expense	<u>60,917</u>	<u>62,777</u>	<u>57,461</u>
Income (loss) before income taxes	30,639	20,581	(47,459)
Income tax expense (benefit)	9,352	6,140	(21,301)
Net income (loss)	<u>\$ 21,287</u>	<u>\$ 14,441</u>	<u>\$ (26,158)</u>
Preferred stock dividends, net of accretion	3,725	3,697	1,538
Net income (loss) available to common shareholders	<u>\$ 17,562</u>	<u>\$ 10,744</u>	<u>\$ (27,696)</u>
Earnings (loss) per common share (Note 15):			
Basic	\$ 1.62	\$ 0.99	\$ (2.54)
Diluted	\$ 1.61	\$ 0.99	\$ (2.54)

See accompanying notes to the consolidated financial statements.

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
Consolidated Statements of Changes in Shareholders' Equity
Years ended December 31, 2010, 2009 and 2008

*(Dollars in thousands,
except per share data)*

	Preferred Equity	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Treasury Stock	Total Shareholders' Equity
Balance at January 1, 2008	\$ 17,581	\$ 113	\$ 24,778	\$ 158,744	\$ 667	\$ (6,561)	\$ 195,322
Comprehensive income:							
Net loss	-	-	-	(26,158)	-	-	(26,158)
Other comprehensive loss, net of tax	-	-	-	-	(4,680)	-	(4,680)
Total comprehensive loss							(30,838)
Cumulative effect of adoption of new accounting pronouncements	-	-	-	(241)	-	-	(241)
Repurchase of common shares	-	-	-	-	-	(4,818)	(4,818)
Repurchase of Series A 3% preferred stock	(6)	-	3	-	-	-	(3)
Warrant issued in connection with Series A preferred stock	-	-	2,025	-	-	-	2,025
Issue shares of Series A preferred stock	37,515	-	-	-	-	-	37,515
Discount on Series A preferred stock	(2,025)	-	-	-	-	-	(2,025)
Share-based compensation plans:							
Share-based compensation	-	-	603	30	-	-	633
Stock options exercised	-	-	(12)	-	-	44	32
Restricted stock awards issued	-	-	(998)	-	-	998	-
Directors' retainer	-	-	(2)	-	-	114	112
Accrued undeclared cumulative dividend on Series A preferred stock, net of accretion	9	-	-	(56)	-	-	(47)
Cash dividends declared:							
Series A 3% preferred-\$3.00 per share	-	-	-	(5)	-	-	(5)
Series B-1 8.48% preferred-\$8.48 per share	-	-	-	(1,477)	-	-	(1,477)
Common-\$0.54 per share	-	-	-	(5,885)	-	-	(5,885)
Balance at December 31, 2008	\$ 53,074	\$ 113	\$ 26,397	\$ 124,952	\$ (4,013)	\$ (10,223)	\$ 190,300
Comprehensive income:							
Net income	-	-	-	14,441	-	-	14,441
Other comprehensive income, net of tax	-	-	-	-	311	-	311
Total comprehensive income							14,752
Issuance costs of Series A preferred stock	-	-	(68)	-	-	-	(68)
Share-based compensation plans:							
Share-based compensation	-	-	852	2	-	-	854
Stock options exercised	-	-	(4)	-	-	19	15
Restricted stock awards issued, net	-	-	(207)	-	-	207	-
Directors' retainer	-	-	(30)	-	-	151	121
Accrued undeclared cumulative dividend on Series A preferred stock, net of accretion	344	-	-	(537)	-	-	(193)
Cash dividends declared:							
Series A 3% preferred-\$3.00 per share	-	-	-	(5)	-	-	(5)
Series A preferred-\$223.61 per share	-	-	-	(1,678)	-	-	(1,678)
Series B-1 8.48% preferred-\$8.48 per share	-	-	-	(1,477)	-	-	(1,477)
Common-\$0.40 per share	-	-	-	(4,327)	-	-	(4,327)
Balance at December 31, 2009	\$ 53,418	\$ 113	\$ 26,940	\$ 131,371	\$ (3,702)	\$ (9,846)	\$ 198,294

Continued on next page

See accompanying notes to the consolidated financial statements.

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
Consolidated Statements of Changes in Shareholders' Equity (Continued)
Years ended December 31, 2010, 2009 and 2008

*(Dollars in thousands,
except per share data)*

	Preferred Equity	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Treasury Stock	Total Shareholders' Equity
Balance at December 31, 2009	\$ 53,418	\$ 113	\$ 26,940	\$ 131,371	\$ (3,702)	\$ (9,846)	\$ 198,294
<i>Balance carried forward</i>							
Comprehensive income:							
Net income	-	-	-	21,287	-	-	21,287
Other comprehensive loss, net of tax	-	-	-	-	(1,020)	-	(1,020)
Total comprehensive income							20,267
Purchases of treasury stock	-	-	-	-	-	(69)	(69)
Share-based compensation plans:							
Share-based compensation	-	-	1,031	-	-	-	1,031
Stock options exercised	-	-	(74)	-	-	290	216
Restricted stock awards issued, net	-	-	(1,853)	-	-	1,853	-
Directors' retainer			(15)			112	97
Accrued undeclared cumulative dividend on							
Series A preferred stock, net of accretion	367	-	-	(367)	-	-	-
Cash dividends declared:							
Series A 3% preferred-\$3.00 per share	-	-	-	(5)	-	-	(5)
Series A preferred-\$250.00 per share	-	-	-	(1,876)	-	-	(1,876)
Series B-1 8.48% preferred-\$8.48 per share	-	-	-	(1,477)	-	-	(1,477)
Common-\$0.40 per share	-	-	-	(4,334)	-	-	(4,334)
Balance at December 31, 2010	\$ 53,785	\$ 113	\$ 26,029	\$ 144,599	\$ (4,722)	\$ (7,660)	\$ 212,144

See accompanying notes to the consolidated financial statements.

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

(Dollars in thousands)

	Years ended December 31,		
	2010	2009	2008
Cash flows from operating activities:			
Net income (loss)	\$ 21,287	\$ 14,441	\$ (26,158)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:			
Depreciation and amortization	3,537	4,067	3,959
Net amortization of premiums on securities	3,005	2,587	390
Provision for loan losses	6,687	7,702	6,551
Share-based compensation	1,031	854	633
Deferred income tax expense (benefit)	2,468	7,470	(23,848)
Proceeds from sale of loans held for sale	42,195	90,290	28,685
Originations of loans held for sale	(44,262)	(88,999)	(28,453)
Increase in company owned life insurance	(1,107)	(1,096)	(563)
Net gain on sale of loans held for sale	(650)	(699)	(339)
Net gain on disposal of investment securities	(169)	(3,429)	(288)
Impairment charges on investment securities	594	4,666	68,215
Net loss (gain) on sale and disposal of other assets	203	(180)	(305)
Increase in other assets	(353)	(8,773)	(1,322)
Increase (decrease) in other liabilities	961	(6,633)	(5,866)
Net cash provided by operating activities	35,427	22,268	21,291
Cash flows from investing activities:			
Purchases of investment securities:			
Available for sale	(430,952)	(602,259)	(310,191)
Held to maturity	(19,791)	(29,280)	(54,925)
Proceeds from principal payments, maturities and calls on investment securities:			
Available for sale	219,974	353,545	337,704
Held to maturity	30,885	46,891	57,325
Proceeds from sales and calls of securities available for sale	122,090	224,928	58,368
Net loan originations	(89,507)	(165,716)	(161,414)
Purchases of company owned life insurance	(79)	(79)	(20,112)
Proceeds from sales of other assets	611	1,709	1,783
Purchases of premises and equipment	(2,438)	(1,959)	(6,333)
Net cash used in investing activities	(169,207)	(172,220)	(97,795)
Cash flows from financing activities:			
Net increase in deposits	139,935	109,692	57,292
Net increase (decrease) in short-term borrowings	17,567	36,078	(2,178)
Proceeds from long-term borrowings	-	-	30,000
Repayments of long-term borrowings	(20,080)	(508)	(25,212)
Purchases of preferred and common shares	(69)	-	(4,821)
Proceeds from issuance of preferred and common shares, net of issuance costs	-	(68)	35,602
Proceeds from issuance of common stock warrant	-	-	2,025
Proceeds from stock options exercised	216	15	32
Cash dividends paid to preferred shareholders	(3,358)	(3,160)	(1,482)
Cash dividends paid to common shareholders	(4,332)	(4,325)	(6,240)
Net cash provided by financing activities	129,879	137,724	85,018
Net (decrease) increase in cash and cash equivalents	(3,901)	(12,228)	8,514
Cash and cash equivalents, beginning of period	42,959	55,187	46,673
Cash and cash equivalents, end of period	\$ 39,058	\$ 42,959	\$ 55,187

See accompanying notes to the consolidated financial statements.

(1.) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

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 Western and Central New York. The Company owns 100% 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.

The accounting and reporting policies conform to general practices within the banking industry and to U.S. generally accepted accounting principles (“GAAP”). Prior years’ consolidated financial statements are re-classified whenever necessary to conform to the current year’s presentation.

The following is a description of the Company’s significant accounting policies.

(a.) Principles of Consolidation

The consolidated financial statements 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.

(b.) Use of Estimates

In preparing the consolidated financial statements in conformity with GAAP, management is required to make estimates and assumptions that affect the reported amount of assets and liabilities as of the date of the statement of financial condition and reported amounts of revenue and expenses during the reporting period. Material estimates relate to the determination of the allowance for loan losses, assumptions used in the defined benefit pension plan accounting, the carrying value of goodwill and deferred tax assets, and the valuation and other than temporary impairment (“OTTI”) considerations related to the securities portfolio. 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. As future events cannot be determined with precision, actual results could differ significantly from the Company’s estimates.

(c.) Cash Flow Reporting

Cash and cash equivalents include cash and due from banks, federal funds sold and interest-bearing deposits in other banks. Net cash flows are reported for loans, deposit transactions and short-term borrowings.

Supplemental cash flow information is summarized as follows for the years ended December 31 (in thousands):

	2010	2009	2008
Cash paid during the year for:			
Interest expense	\$ 17,676	\$ 21,682	\$ 37,160
Income taxes, net of income tax refunds	6,923	(1,312)	3,797
Non-cash activity:			
Real estate and other assets acquired in settlement of loans	\$ 561	\$ 1,096	\$ 1,185
Dividends declared and unpaid	1,694	1,692	1,497
(Decrease) increase in net unsettled security purchases	(317)	(1,348)	1,453
Loans securitized and sold	-	15,983	-

(d.) Investment Securities

Investment securities are classified as either available for sale or held to maturity. Debt securities that management has the positive intent and ability to hold to maturity are classified as held to maturity and are recorded at amortized cost. Other investment securities are classified as available for sale and recorded at fair value, with unrealized gains and losses excluded from earnings and reported as a component of shareholders’ equity.

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

Purchase premiums and discounts are recognized in interest income using the interest method over the terms of the securities. Securities are evaluated periodically to determine whether a decline in their fair value is other than temporary. Management utilizes criteria such as, the current intent to hold or sell the security, the magnitude and duration of the decline and, when appropriate, consideration of negative changes in expected cash flows, creditworthiness, near term prospects of issuers, the level of credit subordination, estimated loss severity, and delinquencies, to determine whether a loss in value is other than temporary. The term “other than temporary” is not intended to indicate that the decline is permanent, but indicates that the prospect for a near-term recovery of value is not necessarily favorable. Declines in the fair value of investment 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 issues or concerns, or the security is intended to be sold. The amount of impairment related to non-credit related factors is recognized in other comprehensive income. Gains and losses on the sale of securities are recorded on the trade date and are determined using the specific identification method.

(e.) Loans Held for Sale and Mortgage Servicing Rights

The Company generally makes the determination of whether or not to identify a mortgage loan as held for sale at the time the loan is closed based on the Company’s intent and ability to hold the loan. Loans held for sale are recorded at the lower of cost or market computed on the aggregate portfolio basis. The amount, by which cost exceeds market value, if any, is accounted for as a valuation allowance with changes included in the determination of results of operations for the period in which the change occurs. The amount of loan origination cost and fees are deferred at origination of the loans and recognized as part of the gain and loss on sale of the loans, determined using the specific identification method, in the consolidated statement of operations.

The Company originates and sells certain residential real estate loans in the secondary market. The Company typically retains the right to service the mortgages upon sale. Mortgage-servicing rights (“MSRs”) represent the cost of acquiring the contractual rights to service loans for others. MSRs are recorded at their fair value at the time a loan is sold and servicing rights are retained. MSRs are reported in other assets in the consolidated statements of financial position and are amortized to noninterest income in the consolidated statements of operations in proportion to and over the period of estimated net servicing income. The Company uses a valuation model that calculates the present value of future cash flows to determine the fair value of servicing rights. In using this valuation method, the Company incorporates assumptions to estimate future net servicing income, which include estimates of the cost to service the loan, the discount rate, an inflation rate and prepayment speeds. On a quarterly basis the Company evaluates its MSRs for impairment and charges any such impairment to current period earnings. In order to evaluate its MSRs the Company stratifies the related mortgage loans on the basis of their predominant risk characteristics, such as interest rates, year of origination and term, using discounted cash flows and market-based assumptions. Impairment of MSRs is recognized through a valuation allowance, determined by estimating the fair value of each stratum and comparing it to its carrying value. Subsequent increases in fair value are adjusted through the valuation allowance, but only to the extent of the valuation allowance. No impairment loss was recognized during the years ended December 31, 2010 or 2009. The Company recognized an impairment loss of \$343 thousand during the year ended December 31, 2008.

Mortgage loan servicing includes collecting monthly mortgagor payments, forwarding payments and related accounting reports to investors, collecting escrow deposits for the payment of mortgagor property taxes and insurance, and paying taxes and insurance from escrow funds when due. Loan servicing income (a component of noninterest income in the consolidated statements of operations) consists of fees earned for servicing mortgage loans sold to third parties, net of amortization expense and impairment losses associated with capitalized mortgage servicing assets.

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

(f.) Loans

Loans are classified as held for investment when management has both the intent and ability to hold the loan for the foreseeable future, or until maturity or payoff. Loans are carried at the principal amount outstanding, net of any unearned income and unamortized deferred fees and costs on originated loans. Loan origination fees and certain direct loan origination costs are deferred, and the net amount is amortized into net interest income over the contractual life of the related loans or over the commitment period as an adjustment of yield. Interest income on loans is based on the principal balance outstanding computed using the effective interest method.

A loan is considered delinquent when a payment has not been received in accordance with the contractual terms. The accrual of interest income for commercial loans is discontinued when there is a clear indication that the borrower's cash flow may not be sufficient to meet payments as they become due, while the accrual of interest income for retail loans is discontinued when loans reach specific delinquency levels. Loans are generally placed on nonaccrual status when contractually past due 90 days or more as to interest or principal payments, unless the loan is well secured and in the process of collection. Additionally, whenever management becomes aware of facts or circumstances that may adversely impact the collectability of principal or interest on loans, it is management's practice to place such loans on a nonaccrual status immediately, rather than delaying such action until the loans become 90 days past due. When a loan is placed on nonaccrual status, previously accrued and uncollected interest is reversed, amortization of related deferred loan fees or costs is suspended, and income is recorded only to the extent that interest payments are subsequently received in cash and a determination has been made that the principal balance of the loan is collectible. If collectability of the principal is in doubt, payments received are applied to loan principal. A nonaccrual loan is returned to accrual status when all delinquent principal and interest payments become current in accordance with the terms of the loan agreement, the borrower has demonstrated a period of sustained performance (generally a minimum of six months) and the ultimate collectability of the total contractual principal and interest is no longer in doubt.

The Company's loan policy dictates the guidelines to be followed in determining when a loan is charged-off. All charge offs are approved by the Bank's senior loan officers or loan committees, depending on the amount of the charge off, and are reported in aggregate to the Bank's Board of Directors. Commercial business and commercial mortgage loans are charged-off when a determination is made that the financial condition of the borrower indicates that the loan will not be collectible in the ordinary course of business. Residential mortgage loans and home equities are generally charged-off or written down when the credit becomes severely delinquent and the balance exceeds the fair value of the property less costs to sell. Indirect and other consumer loans, both secured and unsecured, are generally charged-off in full during the month in which the loan becomes 120 days past due, unless the collateral is in the process of repossession in accordance with the Company's policy.

A loan is accounted for as a troubled debt restructuring if the Company, for economic or legal reasons related to the borrower's financial condition, grants a significant concession to the borrower that it would not otherwise consider. A troubled debt restructuring may involve the receipt of assets from the debtor in partial or full satisfaction of the loan, or a modification of terms such as a reduction of the stated interest rate or face amount of the loan, a reduction of accrued interest, an extension of the maturity date at a stated interest rate lower than the current market rate for a new loan with similar risk, or some combination of these concessions. Troubled debt restructurings generally remain on nonaccrual status until there is a sustained period of payment performance (usually six months or longer) and there is a reasonable assurance that the payments will continue. See Allowance for Loan Losses below for further policy discussion and see Note 4 for additional information on loans.

(g.) Off-Balance Sheet Financial Instruments

In the ordinary course of business, the Company enters into off-balance sheet financial instruments consisting of commitments to extend credit, stand by letters of credit and financial guarantees. Such financial instruments are recorded in the consolidated financial statements when they are funded or when related fees are incurred or received. The Company periodically evaluates the credit risks inherent in these commitments and establishes loss allowances for such risks if and when these are deemed necessary.

The Company recognizes as liabilities the fair value of the obligations undertaken in issuing the guarantees under the standby letters of credit, net of the related amortization at inception. The fair value approximates the unamortized fees received from the customers for issuing the standby letters of credit. The fees are deferred and recognized on a straight-line basis over the commitment period. Standby letters of credit outstanding at December 31, 2010 had terms ranging from one to five years.

Fees received for providing loan commitments and letters of credit that result in loans are typically deferred and amortized to interest income over the life of the related loan, beginning with the initial borrowing. Fees on commitments and letters of credit are amortized to other income as banking fees and commissions over the commitment period when funding is not expected.

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

(h.) Allowance for Loan Losses

The allowance for loan losses is established through charges to earnings in the form of a provision for loan losses. When a loan or portion of a loan is determined to be uncollectible, the portion deemed uncollectible is charged against the allowance and subsequent recoveries, if any, are credited to the allowance.

The allowance for loan losses is evaluated on a regular basis and is based upon periodic review of the collectability of the loans in light of historical experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral, and prevailing economic conditions. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available.

The allowance consists of specific and general components. Specific allowances are established for impaired loans. Commercial business and commercial mortgage loans are individually evaluated and measured for impairment based on the present value of expected future cash flows discounted at the loan's effective interest rate, a loan's observable market price, or the fair value of the collateral if the loan is collateral dependent. Regardless of the measurement method, impairment is based on the fair value of the collateral when foreclosure is probable. If the recorded investment in impaired loans exceeds the measure of estimated fair value, a specific allowance is established as a component of the allowance for loan losses. Interest payments on impaired loans are typically applied to principal unless collectability of the principal amount is reasonably assured, in which case interest is recognized on a cash basis. Impaired loans, or portions thereof, are charged off when deemed uncollectible.

A loan is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered in determining impairment include payment status and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. The Company determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed. Impairment is measured on a loan by loan basis by either the present value of expected future cash flows discounted at the loan's effective interest rate, the loans obtainable market price, or the fair value of the collateral if the loan is collateral dependent. Large groups of homogeneous loans are collectively evaluated for impairment. Accordingly, the Company does not separately identify individual consumer and residential loans for impairment disclosures unless the loan has been subject to a troubled debt restructure.

General allowances are established for loan losses on a portfolio basis for loans that do not meet the definition of impaired. The portfolio is grouped into similar risk characteristics, primarily loan type. The Company applies an estimated loss rate to each loan group. The loss rate is based on historical experience and as a result can differ from actual losses incurred in the future. The historical loss rate is adjusted for qualitative factors such as levels and trends of delinquent and non-accruing loans, trends in volume and terms, effects of changes in lending policy, the experience, ability and depth of management, national and local economic trends and conditions, and concentrations of credit risk, interest rates, highly leveraged borrowers, information risk and collateral risk. The qualitative factors are reviewed at least quarterly and adjustments are made as needed.

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

(i.) Other Real Estate Owned

Other real estate owned consists of properties acquired through foreclosure or by acceptance of a deed in lieu of foreclosure. These assets are recorded at the lower of fair value of the asset acquired less estimated costs to sell or "cost" (defined as the fair value at initial foreclosure). At the time of foreclosure, or when foreclosure occurs in-substance, the excess, if any, of the loan over the fair market value of the assets received, less estimated selling costs, is charged to the allowance for loan losses and any subsequent valuation write-downs are charged to other expense. In connection with the determination of the allowance for loan losses and the valuation of other real estate owned, management obtains appraisals for properties. Operating costs associated with the properties are charged to expense as incurred. Gains on the sale of other real estate owned are included in income when title has passed and the sale has met the minimum down payment requirements prescribed by GAAP. The balance of other real estate owned at December 31, 2010 was \$741 thousand.

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

(j.) Company Owned Life Insurance

The Company holds life insurance policies on certain current and former employees. The Company is the owner and beneficiary of the policies. The cash surrender value of these policies is included as an asset on the consolidated statements of financial condition, and any increase in cash surrender value is recorded as noninterest income on the consolidated statements of operations. In the event of the death of an insured individual under these policies, the Company would receive a death benefit which would be recorded as noninterest income.

(k.) Premises and Equipment

Premises and equipment are stated at cost, less accumulated depreciation and amortization. Depreciation is computed on the straight-line method over the estimated useful lives of the assets. The Company generally amortizes buildings and building improvements over a period of 15 to 39 years and furniture and equipment over a period of 3 to 10 years. Leasehold improvements are amortized over the shorter of the lease term or the useful life of the improvements. Premises and equipment are periodically reviewed for impairment or when circumstances present indicators of impairment.

(l.) Goodwill and Other Intangible Assets

Goodwill represents the excess of the purchase price over the fair value of net assets acquired in accordance with the purchase method of accounting for business combinations. Goodwill is not amortized but, instead, is subject to impairment tests on at least an annual basis or more frequently if an event occurs or circumstances change that reduce the fair value of a reporting unit below its carrying amount. The Company completes the annual goodwill impairment test as of September 30 of each year. The impairment testing process is conducted by assigning net assets and goodwill to each reporting unit. Currently, the Company's goodwill is evaluated at the entity level as there is only one reporting unit. The fair value of each reporting unit is compared to the recorded book value "step one". If the fair value of the reporting unit exceeds its carrying value, goodwill is not considered impaired and "step two" is not considered necessary. If the carrying value of a reporting unit exceeds its fair value, the impairment test continues ("step two") by comparing the carrying value of the reporting unit's goodwill to the implied fair value of goodwill. The implied fair value is computed by adjusting all assets and liabilities of the reporting unit to current fair value with the offset adjustment to goodwill. The adjusted goodwill balance is the implied fair value of the goodwill. An impairment charge is recognized if the carrying fair value of goodwill exceeds the implied fair value of goodwill.

The company had other intangible assets, consisting entirely of core deposit intangibles, which were fully amortized as of December 31, 2009. Amortization expense for these other intangible assets for the years ended December 31, 2009 and 2008 was \$280 thousand and \$307 thousand, respectively. Amortization of other intangible assets was computed using the straight-line method over the estimated lives of the respective assets (primarily 5 and 7 years).

(m.) Federal Home Loan Bank ("FHLB") and Federal Reserve Bank ("FRB") Stock

The non-marketable investments in FHLB and FRB stock are included in other assets in the consolidated statements of financial condition at par value or cost and are periodically reviewed for impairment. The dividends received relative to these investments are included in other noninterest income in the consolidated statements of operations.

As a member of the FHLB system, the Company is required to maintain a specified investment in FHLB of New York ("FHLBNY") stock in proportion to its volume of certain transactions with the FHLB. FHLBNY stock totaled \$2.5 million and \$3.3 million as of December 31, 2010 and 2009, respectively.

As a member of the FRB system, the Company is required to maintain a specified investment in FRB stock based on a ratio relative to the Company's capital. FRB stock totaled \$3.9 million as of December 31, 2010 and 2009.

(n.) Equity Method Investments

The Company has investments in limited partnerships and accounts for these investments under the equity method. These investments are included in other assets in the consolidated statements of financial condition and totaled \$3.6 million and \$2.7 million as of December 31, 2010 and 2009, respectively.

(o.) Treasury Stock

Acquisitions of treasury stock are recorded at cost. The reissuance of shares in treasury is recorded at weighted-average cost.

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

(p.) Employee Benefits

The Company participates in a non-contributory defined benefit pension plan for certain employees who previously met participation requirements. The Company also provides post-retirement benefits, principally health and dental care, to employees of a previously acquired entity. The Company has closed the pension and post-retirement plans to new participants. The actuarially determined pension benefit is based on years of service and the employee's highest average compensation during five consecutive years of employment. The Company's policy is to at least fund the minimum amount required by the Employment Retirement Income Security Act of 1974. The cost of the pension and post-retirement plans are based on actuarial computations of current and future benefits for employees, and is charged to noninterest expense in the consolidated statements of operations.

The Company recognizes an asset or a liability for a plans' overfunded status or underfunded status, respectively, in the consolidated financial statements and reports changes in the funded status as a component of other comprehensive income, net of applicable taxes, in the year in which changes occur. Prior to 2008, the assets and obligations that determine future funded status were measured as of September 30 of each year. Beginning in 2008, the measurement date was changed to December 31 to coincide with the end of the Company's fiscal year. The effect of changing the measurement date resulted in a \$43 thousand increase to retained earnings.

(q.) Share-Based Compensation Plans

Compensation expense for stock options and restricted stock awards is based on the fair value of the award on the measurement date, which, for the Company, is the date of grant and is recognized ratably over the service period of the award. The fair value of stock options is estimated using the Black-Scholes option-pricing model. The fair value of restricted stock awards is generally the market price of the Company's stock on the date of grant.

Share-based compensation expense is included in the consolidated statements of operations under salaries and employee benefits for awards granted to management and in other noninterest expense for awards granted to directors.

(r.) Income Taxes

Income taxes are accounted for using the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates in effect for the year in which those temporary differences are expected to be recovered or settled. The effect of a change in tax rates on deferred tax assets and liabilities is recognized in income in the period that includes the enactment date. A valuation allowance is recognized on deferred tax assets if, based upon the weight of available evidence, it is more likely than not that some or all of the assets may not be realized. The Company recognizes interest and/or penalties related to income tax matters in income tax expense.

(s.) Earnings (Loss) Per Share

Effective January 1, 2009, the Company adopted new authoritative accounting guidance under Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") Topic 260, "Earnings Per Share," which provides 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 share pursuant to the two-class method. The Company has determined that its outstanding non-vested stock awards are participating securities. Accordingly, effective January 1, 2009, earnings per common share is computed using the two-class method prescribed under FASB ASC Topic 260. All previously reported earnings per common share data has been retrospectively adjusted to conform to the new computation method. The adoption and resulting adjustments to conform to the new guidance did not have a material impact on the Company's consolidated financial statements.

Under the two-class method, basic earnings per common share is computed by dividing net earnings allocated to common stock by the weighted-average number of common shares outstanding during the applicable period, excluding outstanding participating securities. Diluted earnings per common share is computed using the weighted-average number of shares determined for the basic earnings per common share computation plus the dilutive effect of stock compensation using the treasury stock method. A reconciliation of the weighted-average shares used in calculating basic earnings per common share and the weighted average common shares used in calculating diluted earnings per common share for the reported periods is provided in Note 15 - Earnings (Loss) Per Share.

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

(i.) Recent Accounting Pronouncements

FASB ASC 810 Consolidation (“ASC 810”) was amended 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. The new authoritative accounting guidance 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. The new authoritative accounting guidance under ASC 810 was adopted effective January 1, 2010 and did not have a significant impact on the Company’s consolidated financial statements.

FASB ASC 860 Transfers and Servicing (“ASC 860”) was amended to enhance reporting about transfers of financial assets, including securitizations, and where companies have continuing exposure to the risks related to transferred financial assets. The new authoritative accounting guidance eliminates the concept of a “qualifying special-purpose entity” and changes the requirements for derecognizing financial assets. The new authoritative accounting guidance also requires additional disclosures about all continuing involvements with transferred financial assets including information about gains and losses resulting from transfers during the period. The new authoritative accounting guidance under ASC 860 was adopted effective January 1, 2010 and did not have a significant impact on the Company’s consolidated financial statements.

FASB ASC 820 Fair Value Measurements and Disclosures (“ASC 820”) was amended to require some new disclosures and clarify some existing disclosure requirements about fair value measurement. It requires separate presentation of significant transfers into and out of Levels 1 and 2 of the fair value hierarchy and disclosure of the reasons for such transfers. It will also require the presentation of purchases, sales, issuances and settlements within Level 3 on a gross basis rather than a net basis. The amendments also clarify that disclosures should be disaggregated by class of asset or liability and that disclosures about inputs and valuation techniques should be provided for both recurring and non-recurring fair value measurements. These new disclosure requirements were adopted by the Company during the current year, with the exception of the requirement concerning gross presentation of Level 3 activity, which is effective for fiscal years beginning after December 15, 2010. With respect to the portions of this amendment that were adopted during the current period, the adoption of this standard did not have a significant impact on the Company’s consolidated financial statements. The Company believes that the adoption of the remaining portion of this amendment will not have a significant impact on the Company’s consolidated financial statements.

FASB ASC 310 Receivables (“ASC 310”) was amended to require an entity to provide a greater level of disaggregated information about the credit quality of its financing receivables and its allowance for credit losses. The requirements are intended to enhance transparency regarding credit losses and the credit quality of loan and lease receivables. Under this statement, allowance for credit losses and fair value are to be disclosed by portfolio segment, while credit quality information, impaired financing receivables and nonaccrual status are to be presented by class of financing receivable. Disclosure of the nature and extent, the financial impact and segment information of troubled debt restructurings will also be required. These new disclosure requirements were adopted by the Company during the current year and are presented in Note 4 - Loans.

(2.) INVESTMENT SECURITIES

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

December 31, 2010				
	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
Securities available for sale:				
U.S. Government agencies and government sponsored enterprises	\$ 141,591	\$ 1,158	\$ 1,965	\$ 140,784
State and political subdivisions	105,622	1,516	1,472	105,666
Mortgage-backed securities:				
Federal National Mortgage Association	96,300	798	1,030	96,068
Federal Home Loan Mortgage Corporation	83,745	321	1,317	82,749
Government National Mortgage Association	102,633	2,422	7	105,048
Collateralized mortgage obligations:				
Federal National Mortgage Association	8,938	231	11	9,158
Federal Home Loan Mortgage Corporation	15,917	329	1	16,245
Government National Mortgage Association	106,969	1,761	289	108,441
Privately issued	981	591	-	1,572
Total collateralized mortgage obligations	132,805	2,912	301	135,416
Total mortgage-backed securities	415,483	6,453	2,655	419,281
Asset-backed securities	564	204	131	637
Total available for sale securities	\$ 663,260	\$ 9,331	\$ 6,223	\$ 666,368
Securities held to maturity:				
State and political subdivisions	\$ 28,162	\$ 687	\$ -	\$ 28,849

December 31, 2009				
	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
Securities available for sale:				
U.S. Government agencies and government sponsored enterprises	\$ 134,564	\$ 86	\$ 545	\$ 134,105
State and political subdivisions	80,812	2,850	3	83,659
Mortgage-backed securities:				
Federal National Mortgage Association	75,108	629	259	75,478
Federal Home Loan Mortgage Corporation	37,321	413	56	37,678
Government National Mortgage Association	110,576	97	342	110,331
Collateralized mortgage obligations:				
Federal National Mortgage Association	16,274	250	94	16,430
Federal Home Loan Mortgage Corporation	20,879	504	14	21,369
Government National Mortgage Association	95,886	56	873	95,069
Privately issued	5,087	403	330	5,160
Total collateralized mortgage obligations	138,126	1,213	1,311	138,028
Total mortgage-backed securities	361,131	2,352	1,968	361,515
Asset-backed securities	1,295	171	244	1,222
Total available for sale securities	\$ 577,802	\$ 5,459	\$ 2,760	\$ 580,501
Securities held to maturity:				
State and political subdivisions	\$ 39,573	\$ 1,056	\$ -	\$ 40,629

(2.) INVESTMENT SECURITIES (Continued)

Interest and dividends on securities for the years ended December 31 are summarized as follows (in thousands):

	2010	2009	2008
Taxable interest and dividends	\$ 17,101	\$ 16,466	\$ 21,882
Tax-exempt interest and dividends	3,521	5,228	8,773
Total interest and dividends on securities	\$ 20,622	\$ 21,694	\$ 30,655

Sales of securities available for sale for the years ended December 31 were as follows (in thousands):

	2010	2009	2008
Proceeds from sales and calls	\$ 122,090	\$ 224,928	\$ 58,368
Gross realized gains	173	6,826	291
Gross realized losses	4	3,397	3

The scheduled maturities of securities available for sale and securities held to maturity at December 31, 2010 are shown below. Actual expected maturities may differ from contractual maturities because issuers may have the right to call or prepay obligations (in thousands).

	Amortized Cost	Fair Value
Debt securities available for sale:		
Due in one year or less	\$ 25,689	\$ 25,952
Due from one to five years	114,924	117,338
Due after five years through ten years	223,692	218,640
Due after ten years	298,955	304,438
	<u>\$ 663,260</u>	<u>\$ 666,368</u>
Debt securities held to maturity:		
Due in one year or less	\$ 21,439	\$ 21,583
Due from one to five years	5,490	5,856
Due after five years through ten years	1,055	1,205
Due after ten years	178	205
	<u>\$ 28,162</u>	<u>\$ 28,849</u>

The following tables show the investments' gross unrealized losses (excluding unrealized losses that have been written down through the consolidated statements of operations) and fair value, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position as of December 31 (in thousands).

	December 31, 2010					
	Less than 12 months		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	\$ 47,752	\$ 1,911	\$ 8,821	\$ 54	\$ 56,573	\$ 1,965
State and political subdivisions	38,398	1,472	-	-	38,398	1,472
Mortgage-backed securities:						
Federal National Mortgage Association	46,777	1,030	-	-	46,777	1,030
Federal Home Loan Mortgage Corporation	60,707	1,317	-	-	60,707	1,317
Government National Mortgage Association	5,135	7	-	-	5,135	7
Collateralized mortgage obligations:						
Federal National Mortgage Association	-	-	2,332	11	2,332	11
Federal Home Loan Mortgage Corporation	612	1	-	-	612	1
Government National Mortgage Association	17,798	289	-	-	17,798	289
Total collateralized mortgage obligations	<u>18,410</u>	<u>290</u>	<u>2,332</u>	<u>11</u>	<u>20,742</u>	<u>301</u>
Total mortgage-backed securities	131,029	2,644	2,332	11	133,361	2,655
Asset-backed securities	111	61	96	70	207	131
Total temporarily impaired securities	<u>\$ 217,290</u>	<u>\$ 6,088</u>	<u>\$ 11,249</u>	<u>\$ 135</u>	<u>\$ 228,539</u>	<u>\$ 6,223</u>

(2.) INVESTMENT SECURITIES (Continued)

	December 31, 2009					
	Less than 12 months		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	\$ 83,480	\$ 360	\$ 10,003	\$ 185	\$ 93,483	\$ 545
State and political subdivisions	-	-	150	3	150	3
Mortgage-backed securities:						
Federal National Mortgage Association	24,964	258	643	1	25,607	259
Federal Home Loan Mortgage Corporation	5,627	56	-	-	5,627	56
Government National Mortgage Association	55,304	342	-	-	55,304	342
Collateralized mortgage obligations:						
Federal National Mortgage Association	353	2	5,384	92	5,737	94
Federal Home Loan Mortgage Corporation	490	1	814	13	1,304	14
Government National Mortgage Association	79,645	873	-	-	79,645	873
Privately issued	-	-	2,985	330	2,985	330
Total collateralized mortgage obligations	80,488	876	9,183	435	89,671	1,311
Total mortgage-backed securities	166,383	1,532	9,826	436	176,209	1,968
Asset-backed securities	278	244	-	-	278	244
Total temporarily impaired securities	\$ 250,141	\$ 2,136	\$ 19,979	\$ 624	\$ 270,120	\$ 2,760

There were no unrealized losses in held to maturity securities at December 31, 2010 or December 31, 2009.

The Company reviews investment securities on an ongoing basis for the presence of OTTI with formal reviews performed quarterly. Declines in the fair value of held-to-maturity and available-for-sale securities below their cost that are deemed to be other than temporary are reflected in earnings as realized losses to the extent the impairment is related to credit issues or concerns, or the security is intended to be sold. The amount of the impairment related to non-credit related factors is recognized in other comprehensive income. Evaluating whether the impairment of a debt security is other than temporary involves assessing 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 OTTI 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 following summarizes the amounts of OTTI recognized during the years ended December 31 by investment category (in thousands).

	2010	2009	2008
Mortgage-backed securities – Privately issued whole loan CMOs	\$ -	\$ 2,353	\$ 5,918
Asset-backed securities - Trust preferred securities	526	1,787	23,443
Asset-backed securities - Other	68	526	6,531
Equity securities – Auction rate securities	-	-	32,323
	<u>\$ 594</u>	<u>\$ 4,666</u>	<u>\$ 68,215</u>

At December 31, 2010, the number of investment securities in an unrealized loss position totaled 156. As of December 31, 2010, management does not have the intent to sell any of the securities in a loss position and believes that it is likely that it will not be required to sell any such securities before the anticipated recovery of amortized cost. The unrealized losses are largely due to increases in market interest rates and terms over the yields and terms available at the time the underlying securities were purchased or, for securities determined to have been other-than-temporarily impaired, from the time impairment charges were last recognized and the securities were written down. 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 in a loss position are impaired due to reasons of credit quality. Accordingly, as of December 31, 2010, 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.

(3.) LOANS HELD FOR SALE AND MORTGAGE SERVICING RIGHTS

Loans held for sale were entirely comprised of residential real estate mortgages and totaled \$3.1 million and \$421 thousand as of December 31, 2010 and 2009, respectively.

The Company sells certain qualifying newly originated or refinanced residential real estate mortgages on the secondary market. Residential real estate mortgages serviced for others, which are not included in the consolidated statements of financial condition, amounted to \$328.9 million and \$349.8 million as of December 31, 2010 and 2009, respectively. In connection with these mortgage-servicing activities, the Company administered escrow and other custodial funds which amounted to approximately \$6.2 million at December 31, 2010. The activity in capitalized mortgage servicing assets, included in other assets in the consolidated statements of financial condition, is summarized as follows for the years ended December 31 (in thousands):

	2010	2009	2008
Mortgage servicing assets, beginning of year	\$ 1,534	\$ 925	\$ 1,000
Originations	408	952	230
Amortization	(300)	(343)	(305)
Mortgage servicing assets, end of year	1,642	1,534	925
Valuation allowance	(175)	(185)	(362)
Mortgage servicing assets, net, end of year	\$ 1,467	\$ 1,349	\$ 563

The Company did not securitize any loans in 2010 or 2008. During 2009, the Company pooled \$16.0 million of one-to-four family residential mortgage loans and converted the loans to FHLMC securities. The Company retained servicing responsibilities for this securitization. The mortgage-backed securities received in exchange for the loans were classified as available-for-sale and subsequently sold. The \$564 thousand gain recognized on the sale of the securities is included in the consolidated statements of operations under net gain on disposal of investment securities.

(4.) LOANS

The Company's loan portfolio consisted of the following at December 31 (in thousands):

	Loans, Gross	Net Deferred Loan (Fees) Costs	Loans, Net
2010			
Commercial business	\$ 210,948	\$ 83	\$ 211,031
Commercial mortgage	353,537	(607)	352,930
Residential mortgage	129,553	27	129,580
Home equity	205,070	3,257	208,327
Consumer indirect	400,221	17,795	418,016
Other consumer	25,937	169	26,106
Total	<u>\$ 1,325,266</u>	<u>\$ 20,724</u>	1,345,990
Allowance for loan losses			(20,466)
Total loans, net			<u>\$ 1,325,524</u>
2009			
Commercial business	\$ 206,512	\$ (129)	\$ 206,383
Commercial mortgage	331,268	(520)	330,748
Residential mortgage	144,286	(71)	144,215
Home equity	197,795	2,889	200,684
Consumer indirect	338,495	14,116	352,611
Other consumer	29,192	173	29,365
Total	<u>\$ 1,247,548</u>	<u>\$ 16,458</u>	1,264,006
Allowance for loan losses			(20,741)
Total loans, net			<u>\$ 1,243,265</u>

(4.) LOANS (Continued)

The Company's significant concentrations of credit risk in the loan portfolio relate to a geographic concentration in the communities that the Company serves.

Certain executive officers, directors and their business interests are customers of the Company. Transactions with these parties are based on substantially the same terms as similar transactions with unrelated third parties and do not carry more than normal credit risk. Borrowings by these related parties amounted to \$609 thousand and \$555 thousand at December 31, 2010 and 2009, respectively. During 2010, new borrowings amounted to \$144 thousand (including borrowings of executive officers and directors that were outstanding at the time of their election), and repayments and other reductions were \$90 thousand.

Past Due Loans Aging

The following table provides an analysis, by loan class, of the Company's delinquent and nonaccrual loans as of December 31 (in thousands):

	30-59 Days Past Due	60-89 Days Past Due	Greater Than 90 Days	Total Past Due	Nonaccrual	Current	Total Loans
2010							
Commercial business	\$ 172	\$ 92	\$ -	\$ 264	\$ 947	\$ 209,737	\$ 210,948
Commercial mortgage	163	-	-	163	3,100	350,274	353,537
Residential mortgage	492	6	-	498	2,102	126,953	129,553
Home equity	428	47	-	475	875	203,720	205,070
Consumer indirect	656	107	-	763	514	398,944	400,221
Other consumer	82	1	3	86	41	25,810	25,937
Total loans, gross	<u>\$ 1,993</u>	<u>\$ 253</u>	<u>\$ 3</u>	<u>\$ 2,249</u>	<u>\$ 7,579</u>	<u>\$ 1,315,438</u>	<u>\$ 1,325,266</u>
2009							
Commercial business	\$ 141	\$ 3	\$ 76	\$ 220	\$ 650	\$ 205,642	\$ 206,512
Commercial mortgage	212	319	1,783	2,314	2,288	326,666	331,268
Residential mortgage	1,039	-	-	1,039	2,376	140,871	144,286
Home equity	388	54	-	442	880	196,473	197,795
Consumer indirect	1,304	110	-	1,414	621	336,460	338,495
Other consumer	105	8	-	113	7	29,072	29,192
Total loans, gross	<u>\$ 3,189</u>	<u>\$ 494</u>	<u>\$ 1,859</u>	<u>\$ 5,542</u>	<u>\$ 6,822</u>	<u>\$ 1,235,184</u>	<u>\$ 1,247,548</u>

The table above includes certain loans which were past due greater than 90 days and still accruing interest. As of December 31, 2010, there were \$3 thousand in consumer overdrafts which were past due greater than 90 days. As of December 31, 2009, there were \$76 thousand in commercial business loans and \$1.8 million in commercial mortgage loans which were past due greater than 90 days and still accruing interest.

Interest income on nonaccrual loans, if recognized, is recorded using the cash basis method of accounting. There was no interest income recognized on nonaccrual loans during the years ended December 31, 2010, 2009 and 2008. For the years ended December 31, 2010, 2009 and 2008, estimated interest income of \$474 thousand, \$388 thousand, and \$546 thousand, respectively, would have been recorded if all such loans had been accruing interest according to their original contractual terms.

Troubled Debt Restructured Loans

Troubled debt restructured loans ("TDRs") are loans that the Company, for economic or legal reasons related to the borrower's financial condition, has granted a significant concession to the borrower that it would not otherwise consider. TDRs can be classified as either accrual or nonaccrual loans. Included in nonaccrual loans are commercial TDRs of \$534 thousand at December 31, 2010. The Company had no TDRs on which it continued to accrue interest at December 31, 2010. There were no TDRs outstanding at December 31, 2009.

(4.) LOANS (Continued)

Impaired Loans

Management has determined that specific commercial loans on nonaccrual status and all loans that have had their terms restructured in a troubled debt restructuring are impaired loans. The following table presents data on impaired loans at December 31 (in thousands):

	<u>Recorded Investment</u>	<u>Unpaid Principal Balance</u>	<u>Related Allowance</u>	<u>Average Recorded Investment</u>	<u>Interest Income Recognized</u>
2010					
With no related allowance recorded:					
Commercial business	\$ 372	\$ 524	\$ -	\$ 275	\$ -
Commercial mortgage	187	187	-	481	-
	<u>559</u>	<u>711</u>	<u>-</u>	<u>756</u>	<u>-</u>
With an allowance recorded:					
Commercial business	576	576	149	1,828	-
Commercial mortgage	2,913	2,921	883	1,897	-
	<u>3,489</u>	<u>3,497</u>	<u>1,032</u>	<u>3,725</u>	<u>-</u>
	<u>\$ 4,048</u>	<u>\$ 4,208</u>	<u>\$ 1,032</u>	<u>\$ 4,481</u>	<u>\$ -</u>
2009					
With no related allowance recorded:					
Commercial business	\$ 292	\$ 414	\$ -	\$ 1,200	\$ -
Commercial mortgage	714	716	-	1,222	-
	<u>1,006</u>	<u>1,130</u>	<u>-</u>	<u>2,422</u>	<u>-</u>
With an allowance recorded:					
Commercial business	358	386	155	605	-
Commercial mortgage	1,574	1,574	699	758	69
	<u>1,932</u>	<u>1,960</u>	<u>854</u>	<u>1,363</u>	<u>69</u>
	<u>\$ 2,938</u>	<u>\$ 3,090</u>	<u>\$ 854</u>	<u>\$ 3,785</u>	<u>\$ 69</u>

During the year ended December 31, 2008, the Company's average investment in impaired loans was \$3.1 million. There was no interest income recognized on impaired loans during the year ended December 31, 2008. At December 31, 2010, there were no commitments to lend additional funds to those borrowers whose loans were classified as impaired.

Credit Quality Indicators

The Company utilizes an internal asset classification system as a means of identifying and reporting problem and potential problem commercial loans. Under the Company's risk rating system, the Company classifies problem and potential problem loans as "Special Mention," "Substandard," and "Doubtful". Substandard loans include those characterized by the distinct possibility that some loss will be sustained if the deficiencies are not corrected. Loans classified as Doubtful have all the weaknesses inherent in those classified as Substandard with the added characteristic that the weaknesses present make collection or liquidation in full, on the basis of currently existing facts, conditions and values, highly questionable and improbable. Loans that do not currently expose the Company to sufficient risk to warrant classification in one of the aforementioned categories, but possess weaknesses that deserve management's close attention are deemed to be Special Mention. Risk ratings are updated any time the situation warrants. Loans that do not currently possess a sufficient degree of risk to warrant classification in one of the aforementioned categories are considered "Uncriticized" or pass-rated loans and are included in groups of homogeneous loans with similar risk and loss characteristics.

The following table sets forth the Company's commercial loan portfolio, categorized by internally assigned asset classification, as of December 31 (in thousands):

	<u>Commercial Business</u>	<u>Commercial Mortgage</u>
2010		
Uncriticized	\$ 194,510	\$ 338,061
Special mention	11,479	4,931
Substandard	4,959	10,545
Total	<u>\$ 210,948</u>	<u>\$ 353,537</u>
2009		
Uncriticized	\$ 185,256	\$ 305,129
Special mention	12,737	13,339
Substandard	8,519	12,800
Total	<u>\$ 206,512</u>	<u>\$ 331,268</u>

(4.) LOANS (Continued)

The Company utilizes payment status as a means of identifying and reporting problem and potential problem retail loans. The Company considers nonaccrual loans and loans past due greater than 90 days and still accruing interest to be non-performing. The following table sets forth the Company's retail loan portfolio, categorized by payment status, as of December 31 (in thousands):

	Residential Mortgage	Home Equity	Consumer Indirect	Other Consumer
2010				
Performing	\$ 127,451	\$ 204,195	\$ 399,707	\$ 25,896
Non-performing	2,102	875	514	41
Total	<u>\$ 129,553</u>	<u>\$ 205,070</u>	<u>\$ 400,221</u>	<u>\$ 25,937</u>
2009				
Performing	\$ 141,910	\$ 196,915	\$ 337,874	\$ 29,185
Non-performing	2,376	880	621	7
Total	<u>\$ 144,286</u>	<u>\$ 197,795</u>	<u>\$ 338,495</u>	<u>\$ 29,192</u>

Allowance for Loan Losses

The following table sets forth the changes in the allowance for loan losses for the years ended December 31 (in thousands):

	Commercial	Commercial Mortgage	Residential Mortgage	Home Equity	Consumer Indirect	Other Consumer	Total
2010							
Allowance for loan losses:							
Beginning balance	\$ 4,407	\$ 6,638	\$ 1,251	\$ 1,043	\$ 6,837	\$ 565	\$ 20,741
Charge-offs	3,426	263	290	259	4,669	909	9,816
Recoveries	326	501	21	36	1,485	485	2,854
Provision (credit)	2,405	(445)	31	152	4,101	443	6,687
Ending balance	<u>\$ 3,712</u>	<u>\$ 6,431</u>	<u>\$ 1,013</u>	<u>\$ 972</u>	<u>\$ 7,754</u>	<u>\$ 584</u>	<u>\$ 20,466</u>
Evaluated for impairment:							
Individually	\$ 149	\$ 883	\$ -	\$ -	\$ -	\$ -	\$ 1,032
Collectively	<u>\$ 3,563</u>	<u>\$ 5,548</u>	<u>\$ 1,013</u>	<u>\$ 972</u>	<u>\$ 7,754</u>	<u>\$ 584</u>	<u>\$ 19,434</u>
Loans:							
Ending balance	<u>\$ 210,948</u>	<u>\$ 353,537</u>	<u>\$ 129,553</u>	<u>\$ 205,070</u>	<u>\$ 400,221</u>	<u>\$ 25,937</u>	<u>\$ 1,325,266</u>
Evaluated for impairment:							
Individually	\$ 948	\$ 3,100	\$ -	\$ -	\$ -	\$ -	\$ 4,048
Collectively	<u>\$ 210,000</u>	<u>\$ 350,437</u>	<u>\$ 129,553</u>	<u>\$ 205,070</u>	<u>\$ 400,221</u>	<u>\$ 25,937</u>	<u>\$ 1,321,218</u>

	2009	2008
Beginning balance	\$ 18,749	\$ 15,521
Charge-offs	7,830	5,459
Recoveries	2,120	2,136
Provision (credit)	7,702	6,551
Ending balance	<u>\$ 20,741</u>	<u>\$ 18,749</u>

(4.) LOANS (Continued)

Risk Characteristics

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

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

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

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

(5.) PREMISES AND EQUIPMENT, NET

Major classes of premises and equipment at December 31 are summarized as follows (in thousands):

	2010	2009
Land and land improvements	\$ 4,335	\$ 4,334
Buildings and leasehold improvements	39,215	39,553
Furniture, fixtures, equipment and vehicles	23,645	23,771
Premises and equipment	67,195	67,658
Accumulated depreciation and amortization	(33,932)	(32,875)
Premises and equipment, net	\$ 33,263	\$ 34,783

Depreciation and amortization expense, included in occupancy and equipment expense in the consolidated statements of operations, amounted to \$3.5 million for the year ended December 31, 2010, \$3.8 million for the year ended December 31, 2009 and \$3.7 million for the year ended December 31, 2008.

(6.) GOODWILL AND OTHER INTANGIBLE ASSETS

The carrying amount of goodwill totaled \$37.4 million as of December 31, 2010 and 2009. The goodwill relates to the Company's primary subsidiary and reporting unit, Five Star Bank. The Company performs a goodwill impairment test on an annual basis or more frequently if events and circumstances warrant. On September 30, 2010, the Company performed the annual goodwill impairment test and determined the estimated fair value of our reporting unit to be in excess of its carrying amount. Accordingly, as of the Company's annual impairment test date, there was no indication of goodwill impairment. The Company tests its goodwill for impairment between annual tests if an event occurs or circumstances change that would more likely than not reduce the fair value of our reporting unit below its carrying amount.

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 condition be designated as impaired and that the Company may incur a goodwill write-down in the future.

(7.) DEPOSITS

A summary of deposits as of December 31 are as follows (dollars in thousands):

	2010	2009
Noninterest-bearing demand	\$ 350,877	\$ 324,303
Interest-bearing demand	374,900	363,698
Savings and money market	417,359	368,603
Certificates of deposit, due:		
Within one year	554,104	526,549
One to two years	126,955	132,289
Two to three years	14,653	8,200
Three to five years	43,888	18,968
Thereafter	154	345
Total certificates of deposits	739,754	686,351
Total deposits	<u>\$ 1,882,890</u>	<u>\$ 1,742,955</u>

Certificates of deposit in denominations of \$100,000 or more at December 31, 2010, 2009 and 2008 amounted to \$183.9 million, \$173.4 million and \$164.6 million, respectively. Interest expense on those certificates totaled \$2.4 million, \$3.2 million and \$5.7 million in 2010, 2009 and 2008, respectively.

Interest expense by deposit type for the years ended December 31 is summarized as follows (in thousands):

	2010	2009	2008
Interest-bearing demand	\$ 705	\$ 772	\$ 3,246
Savings and money market	1,133	1,090	3,773
Certificates of deposit	13,015	17,228	22,330
Total interest expense on deposits	<u>\$ 14,853</u>	<u>\$ 19,090</u>	<u>\$ 29,349</u>

(8.) BORROWINGS

Outstanding borrowings are summarized as follows as of December 31 (in thousands):

	2010	2009
Short-term borrowings:		
Federal funds purchased	\$ 38,200	\$ 9,419
Repurchase agreements	38,910	35,124
Other short-term borrowings	-	15,000
Total short-term borrowings	77,110	59,543
Long-term borrowings:		
FHLB advances and repurchase agreements	10,065	30,145
Junior subordinated debentures	16,702	16,702
Total long-term borrowings	26,767	46,847
Total borrowings	<u>\$ 103,877</u>	<u>\$ 106,390</u>

The Company classifies borrowings as short-term or long-term in accordance with the original terms of the agreement. At December 31, 2010, the Company's short-term and long-term borrowings had weighted average rates of 0.21% and 7.87%, respectively.

Short-term Borrowings

Federal funds purchased are short-term borrowings that typically mature within one to ninety days. Federal funds purchased totaled \$38.2 million and \$9.4 million at December 31, 2010 and 2009, respectively. Repurchase agreements are secured overnight borrowings with customers. These short-term repurchase agreements amounted to \$38.9 million and \$35.1 million as of December 31, 2010 and 2009, respectively.

(8.) BORROWINGS (Continued)

Long-term Borrowings

The Company has credit capacity with the FHLB and can borrow through facilities that include an overnight line of credit, amortizing and term advances, and repurchase agreements. The FHLB credit capacity is collateralized by securities from the Company's investment portfolio and certain qualifying loans. FHLB advances totaled \$65 thousand and \$145 thousand as of December 31, 2010 and 2009, respectively. The advances mature on various dates in 2011 and had a weighted average rate of 5.89% at December 31, 2010. FHLB repurchase agreements are stated at the amount of cash received in connection with the transaction. The Company may be required to provide additional collateral based on the fair value of the underlying securities. FHLB repurchase agreements totaled \$10.0 million and \$30.0 million as of December 31, 2010 and 2009, respectively. The FHLB repurchase agreements mature during 2011 and bear a fixed interest rate of 3.98% at December 31, 2010. The \$10.1 million of outstanding FHLB advances and repurchase agreements at December 31, 2010 is scheduled to be paid during 2011.

In February 2001, the Company formed Financial Institutions Statutory Trust I (the "Trust") for the sole purpose of issuing trust preferred securities. The Company's \$502 thousand investment in the common equity of the Trust is classified in the consolidated statements of financial condition as other assets and \$16.7 million of related debentures are classified as long-term borrowings. In 2001, the Company incurred costs relating to the issuance of the debentures totaling \$487 thousand. These costs, which are included in other assets on the consolidated statements of financial condition, were deferred and are being amortized to interest expense using the straight-line method over a twenty year period.

The Company, through the Trust, issued 16,200 fixed rate pooled trust preferred securities with a liquidation preference of \$1,000 per security. The trust preferred securities represent an interest in the related subordinated debentures of the Company, which were purchased by the Trust and have substantially the same payment terms as these trust preferred securities. The subordinated debentures are the only assets of the Trust and interest payments from the debentures finance the distributions paid on the trust preferred securities. Distributions on the debentures are payable semi-annually at a fixed interest rate of 10.20%. The trust preferred securities are subject to mandatory redemption at the liquidation preference, in whole or in part, upon repayment of the subordinated debentures at maturity or their earlier redemption. The subordinated debentures are redeemable prior to the maturity date of February 22, 2031, at the option of the Company on or after February 22, 2011, in whole or in part on semi-annual payment dates (February 22 or August 22) in periods thereafter. The subordinated debentures are also redeemable at any time, in whole, but not in part, upon the occurrence of specific events defined within the trust indenture. The Company has the option to defer distributions on the subordinated debentures from time to time for a period not to exceed 20 consecutive quarters; however the Company has not opted to defer any payments to date.

Interest expense on borrowings for the years ended December 31 is summarized as follows (in thousands):

	2010	2009	2008
Short-term borrowings	\$ 365	\$ 270	\$ 721
Long-term borrowings	2,502	2,857	3,547
Total interest expense on borrowings	<u>\$ 2,867</u>	<u>\$ 3,127</u>	<u>\$ 4,268</u>

(9.) COMMITMENTS AND CONTINGENCIES

Financial Instruments with Off-Balance Sheet Risk

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

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

Off-balance sheet commitments as of December 31 consist of the following (in thousands):

	<u>2010</u>	<u>2009</u>
Commitments to extend credit	\$ 357,240	\$ 316,688
Standby letters of credit	6,524	6,887

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

The Company also extends rate lock agreements to borrowers related to the origination of residential mortgage loans. To mitigate the interest rate risk inherent in these rate lock agreements when the Company intends to sell the related loan, once originated, as well as closed residential mortgage loans held for sale, the Company enters into forward commitments to sell individual residential mortgages. Rate lock agreements and forward commitments are considered derivatives and are recorded at fair value. Forward sales commitments totaled \$8.0 million at December 31, 2010. At December 31, 2010, forward sales commitments had positive fair values, included with other assets in the consolidated statements of financial condition, totaling \$187 thousand and negative fair values, included within other liabilities in the consolidated statements of financial condition, totaling \$13 thousand. At December 31, 2009, forward sales commitments totaled \$4.5 million. At December 31, 2009, these forward sales commitments had positive fair values, included with other assets in the consolidated statements of financial condition, totaling \$63 thousand. In addition, the net change in the fair values of these derivatives was recognized as other noninterest income or other noninterest expense in the consolidated statements of operations.

Lease Obligations

The Company is obligated under a number of noncancellable operating lease agreements for land, buildings and equipment. Certain of these leases provide for escalation clauses and contain renewal options calling for increased rentals if the lease is renewed. Future minimum payments by year and in the aggregate, under the noncancellable leases with initial or remaining terms of one year or more, are as follows at December 31, 2010 (in thousands):

2011	\$ 1,218
2012	1,164
2013	1,024
2014	993
2015	940
Thereafter	<u>5,868</u>
	<u>\$ 11,207</u>

Rent expense relating to these operating leases, included in occupancy and equipment expense in the statements of operations, was \$1.4 million, \$1.5 million and \$1.1 million in 2010, 2009 and 2008, respectively.

Contingent Liabilities

In the ordinary course of business there are various threatened and pending legal proceedings against the Company. Based on consultation with outside legal counsel, management believes that the aggregate liability, if any, arising from such litigation would not have a material adverse effect on the Company's consolidated financial statements.

(10.) REGULATORY MATTERS

General

The supervision and regulation of financial and bank holding companies and their subsidiaries is intended primarily for the protection of depositors, the deposit insurance funds regulated by the FDIC and the banking system as a whole, and not for the protection of shareholders or creditors of bank holding companies. The various bank regulatory agencies have broad enforcement power over financial holding companies and banks, including the power to impose substantial fines, operational restrictions and other penalties for violations of laws and regulations and for safety and soundness considerations.

Capital

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 operations), goodwill and other intangible assets and disallowed portions of deferred tax assets. Tier 1 capital for the Company also includes, subject to limitation, \$16.7 million of trust preferred securities issued by FISFI Statutory Trust I and \$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") (see Note 11, Shareholders' Equity). The Company and the Bank's total capital are comprised of Tier 1 capital for each entity plus a permissible portion of the allowance for loan losses.

The Tier 1 and total capital ratios are calculated by dividing the respective capital amounts by risk-weighted assets. Risk-weighted assets are calculated based on regulatory requirements and include total assets, excluding goodwill and other intangible assets and disallowed portions of deferred tax assets, allocated by risk weight category and certain off-balance sheet items (primarily loan commitments and securities more than one level below investment grade that are subject to the low level exposure rule). The leverage ratio is calculated by dividing Tier 1 capital by adjusted quarterly average total assets, which exclude goodwill and other intangible assets and disallowed portions of deferred tax assets.

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

		Actual		For Capital Adequacy Purposes		Well Capitalized	
		Amount	Ratio	Amount	Ratio	Amount	Ratio
December 31, 2010:							
Tier 1 leverage:	Company	\$ 181,089	8.31 %	\$ 87,116	4.00 %	\$ 108,896	5.00 %
	Bank	156,957	7.22	86,958	4.00	108,697	5.00
Tier 1 capital:	Company	181,089	12.34	58,678	4.00	88,017	6.00
	Bank	156,957	10.74	58,450	4.00	87,674	6.00
Total risk-based capital:	Company	199,452	13.60	117,357	8.00	146,696	10.00
	Bank	175,250	11.99	116,899	8.00	146,124	10.00
December 31, 2009:							
Tier 1 leverage:	Company	\$ 163,613	7.96 %	\$ 82,188	4.00 %	\$ 102,735	5.00 %
	Bank	154,316	7.53	82,018	4.00	102,522	5.00
Tier 1 capital:	Company	163,613	11.95	54,746	4.00	82,119	6.00
	Bank	154,316	11.33	54,475	4.00	81,712	6.00
Total risk-based capital:	Company	180,766	13.21	109,492	8.00	136,865	10.00
	Bank	171,385	12.58	108,949	8.00	136,186	10.00

(10.) REGULATORY MATTERS (Continued)

Five Star Bank has been notified by its regulator that, as of its most recent regulatory examination, it is regarded as well capitalized under the regulatory framework for prompt corrective action. Such determination has been made based on the Bank's Tier 1 capital, total capital, and leverage ratios. There have been no conditions or events since this notification that management believes would change the Bank's categorization as well capitalized under the aforementioned ratios.

Federal Reserve Requirements

The Bank is required to maintain a reserve balance at the FRB of New York. The reserve requirement for the Bank totaled \$1.0 million as of December 31, 2010 and 2009.

Dividend Restrictions

In the ordinary course of business, the Company is dependent upon dividends from Five Star 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.

In addition, pursuant to the terms of the Treasury's TARP Capital Purchase Program (see Note 11, Shareholders' Equity), 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 Treasury.

(11.) SHAREHOLDERS' EQUITY

The Company's authorized capital stock consists of 50,210,000 shares of capital stock, 50,000,000 of which are common stock, par value \$0.01 per share, and 210,000 of which are preferred stock, par value \$100 per share, which is designated into two classes, Class A of which 10,000 shares are authorized, and Class B of which 200,000 shares are authorized. There are two series of Class A preferred stock: Series A 3% preferred stock and the Series A preferred stock. There is one series of Class B preferred stock: Series B-1 8.48% preferred stock. As of December 31, 2010, there were 183,259 shares of preferred stock issued and outstanding.

In addition, the Company currently has an effective shelf registration which allows for the ability to issue up to \$50 million in common stock.

Common Stock

The changes in shares of common stock outstanding were as follows for the years ended December 31:

	2010	2009
Shares outstanding at beginning of period	10,820,268	10,798,019
Restricted stock awards issued, net	99,324	13,172
Stock options exercised	15,563	1,010
Directors' retainer	6,009	8,067
Treasury stock purchases	(3,658)	-
Shares outstanding at end of period	<u>10,937,506</u>	<u>10,820,268</u>

Treasury Stock

The Company had 410,616 shares and 527,854 shares of treasury stock at December 31, 2010 and 2009, respectively. The Company repurchased 3,658 shares of its common stock from employees in order to facilitate the payment of withholding taxes on restricted shares granted. There were no open market transactions during the year ended December 31, 2010. There were no repurchases of the Company's stock during 2009.

(11.) SHAREHOLDERS' EQUITY (Continued)

Preferred Stock and Warrant

Series A 3% Preferred Stock. As of December 31, 2010, there were 1,533 shares of Series A 3% preferred stock issued and outstanding. Holders of Series A 3% preferred stock are entitled to receive an annual dividend of \$3.00 per share, which is cumulative and payable quarterly. Holders of Series A 3% preferred stock have no pre-emptive right in, or right to purchase or subscribe for, any additional shares of the Company's capital stock and have no voting rights. Dividend or dissolution payments to the Class A shareholders must be declared and paid, or set apart for payment, before any dividends or dissolution payments can be declared and paid, or set apart for payment, to the holders of Class B preferred stock or common stock. The Series A 3% preferred stock is not convertible into any other of the Company's securities.

Series A Preferred Stock and Warrant. In December 2008, under the Treasury's TARP Capital Purchase Program, the Company entered into a Securities Purchase Agreement - Standard Terms with the U.S. Treasury pursuant to which, among other things, the Company sold to the Treasury for an aggregate purchase price of \$37.5 million, 7,503 shares of fixed rate cumulative perpetual preferred stock, Series A ("Series A" preferred stock) and a warrant to purchase up to 378,175 shares of common stock, par value \$0.01 per share at an exercise price of \$14.88 per share (subject to certain anti-dilution adjustments) (the "Warrant"), of the Company. The Company's Series A preferred stock qualifies as Tier 1 capital in accordance with regulatory capital requirements (see Note 10, Regulatory Matters).

The Series A preferred stock ranks senior to the Company's common shares and *pari passu*, which is at an equal level in the capital structure, with existing preferred shares ("Series A 3%" preferred stock), other than preferred shares which by their terms rank junior to any other existing preferred shares ("Series B-1 8.48%" preferred stock). The Series A preferred stock pays a compounding cumulative dividend, in cash, at a rate of 5% per annum through February 15, 2014, and 9% per annum thereafter on the liquidation preference of \$5,000 per share. The Company is prohibited from paying any dividend with respect to shares of common stock, other junior securities or preferred stock ranking *pari passu* with the Series A preferred stock or repurchasing or redeeming any shares of the Company's common shares, other junior securities or preferred stock ranking *pari passu* with the Series A preferred stock in any quarter unless all accrued and unpaid dividends are paid on the Series A preferred stock for all past dividend periods (including the latest completed dividend period), subject to certain limited exceptions. The Series A preferred stock is non-voting, other than class voting rights on matters that could adversely affect the Series A preferred stock. The Treasury may also transfer the Series A preferred stock to a third party at any time.

Under the terms of TARP, as amended by the American Recovery and Reinvestment Act of 2009 ("ARRA"), the Company is permitted, subject to consultation with its appropriate Federal banking agency, to repay such assistance without regard to whether the recipient has replaced such funds from any other source or to any waiting period. ARRA further provides that when the recipient repays such assistance in full, the Secretary of Treasury shall liquidate the warrants associated with the assistance at the current market price. The Company is subject to existing supervisory procedures for approving redemption requests for capital instruments if it elects to repay the TARP funds. The FRB will weigh the Company's desire to redeem the Series A preferred stock against the contribution of Treasury capital to the Company's overall soundness, capital adequacy and ability to lend.

The Warrant has a term of 10 years and is exercisable at any time, in whole or in part, at an exercise price of \$14.88 per share (subject to certain anti-dilution adjustments). The \$37.5 million in proceeds was allocated to the Series A preferred stock and the Warrant based on their relative fair values at issuance (\$35.5 million was allocated to the Series A preferred stock and \$2.0 million to the Warrant). The \$2.0 million allocated to the Warrant is being charged to retained earnings as an adjustment to the dividend yield using the effective yield method. The amount charged to retained earnings is deducted from the numerator in calculating basic and diluted earnings per share during the related reporting period (see Note 15, Earnings (Loss) per Share).

Series B-1 8.48% Preferred Stock. As of December 31, 2010, there were 174,223 shares of Series B-1 8.48% preferred stock issued and outstanding. Holders of Series B-1 8.48% preferred stock are entitled to receive an annual dividend of \$8.48 per share, which is cumulative and payable quarterly. Holders of Series B-1 8.48% preferred stock have no pre-emptive right in, or right to purchase or subscribe for, any additional shares of the Company's common stock and have no voting rights. Accumulated dividends on the Series B-1 8.48% preferred stock do not bear interest, and the Series B-1 8.48% preferred stock is not subject to redemption. Dividend or dissolution payments to the Class B shareholders must be declared and paid, or set apart for payment, before any dividends or dissolution payments are declared and paid, or set apart for payment, to the holders of common stock. The Series B-1 8.48% preferred stock is not convertible into any other of the Company's securities.

(12.) COMPREHENSIVE INCOME (LOSS)

Total comprehensive income (loss) is reported in the accompanying consolidated statements of changes in shareholders' equity. Information related to comprehensive income (loss) for the years ended December 31 was as follows (in thousands):

	Pre-tax Amount	Tax Expense (Benefit)	Net-of-tax Amount
2010			
Securities available for sale:			
Change in net unrealized gain/loss during the period	\$ (16)	\$ 19	\$ (35)
Reclassification adjustment for gains included in income	(169)	(67)	(102)
Reclassification adjustment for impairment charges included in income	594	235	359
	<u>409</u>	<u>187</u>	<u>222</u>
Change in net actuarial gain/loss and prior service benefit (cost) on defined benefit pension and post-retirement plans	(2,192)	(950)	(1,242)
Other comprehensive loss	<u>\$ (1,783)</u>	<u>\$ (763)</u>	<u>(1,020)</u>
Net income			21,287
Comprehensive income			<u>\$ 20,267</u>
2009			
Securities available for sale:			
Change in net unrealized gain/loss during the period	\$ (4,186)	\$ (1,619)	\$ (2,567)
Reclassification adjustment for gains included in income	(3,429)	(1,327)	(2,102)
Reclassification adjustment for impairment charges included in income	4,666	1,805	2,861
	<u>(2,949)</u>	<u>(1,141)</u>	<u>(1,808)</u>
Change in net actuarial gain/loss and prior service benefit (cost) on defined benefit pension and post-retirement plans	3,457	1,338	2,119
Other comprehensive income	<u>\$ 508</u>	<u>\$ 197</u>	<u>311</u>
Net income			14,441
Comprehensive income			<u>\$ 14,752</u>
2008			
Securities available for sale:			
Change in net unrealized gain/loss during the period	\$ (61,464)	\$ (23,778)	\$ (37,686)
Reclassification adjustment for gains included in income	(288)	(111)	(177)
Reclassification adjustment for impairment charges included in income	68,215	26,389	41,826
	<u>6,463</u>	<u>2,500</u>	<u>3,963</u>
Change in net actuarial gain/loss and prior service benefit (cost) on defined benefit pension and post-retirement plans	(14,098)	(5,455)	(8,643)
Other comprehensive loss	<u>\$ (7,635)</u>	<u>\$ (2,955)</u>	<u>(4,680)</u>
Net loss			(26,158)
Comprehensive loss			<u>\$ (30,838)</u>

The components of accumulated other comprehensive income (loss), net of tax, as of December 31 were as follows (in thousands):

	2010	2009
Net actuarial loss and prior service cost on defined benefit pension and post-retirement plans	\$ (6,599)	\$ (5,357)
Net unrealized gain on securities available for sale	1,877	1,655
	<u>\$ (4,722)</u>	<u>\$ (3,702)</u>

(13.) SHARE-BASED COMPENSATION

The Company maintains certain stock-based compensation plans, approved by the Company's shareholders that are administered by the Board, or the Management Development and Compensation Committee of the Board. 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. Under both plans, for purposes of calculating the number of shares of common stock available for issuance, each share of common stock granted pursuant to a restricted stock grant shall count as 1.64 shares of common stock. As of December 31, 2010, there were approximately 225,000 and 523,000 shares available for grant under the Director's Plan and Management Plan, respectively, of which 61% were available for issuance as restricted stock grants.

Under the Management Plan and the Director's Plan (the "Plans"), the Board (or the Compensation Committee) may establish and prescribe grant guidelines including various terms and conditions for the granting of stock-based compensation. For stock options, the exercise price of each option equals the market price of the Company's stock on the date of the grant. All options expire after a period of ten years from the date of grant and generally become fully exercisable over a period of 3 to 5 years from the grant date. When option recipients exercise their options, the Company issues shares from treasury stock and records the proceeds as additions to capital. For restricted stock, shares generally vests over 2 to 3 years from the grant date. Vesting of the shares may be based on years of service, established performance measures or both. If restricted stock grants are forfeited before they vest, the shares are reacquired into treasury stock.

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 for the years ended December 31 was as follows (in thousands):

	2010	2009	2008
Stock options:			
Management Stock Incentive Plan	\$ 110	\$ 222	\$ 378
Director Stock Incentive Plan	43	46	40
Total stock option expense	153	268	418
Restricted stock awards:			
Management Stock Incentive Plan	761	488	215
Director Stock Incentive Plan	117	98	-
Total restricted stock award expense	878	586	215
Total share-based compensation	\$ 1,031	\$ 854	\$ 633

The following is a summary of stock option activity for the year ended December 31, 2010 (dollars in thousands, except per share amounts):

	Number of Options	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value
Outstanding at beginning of year	458,734	\$ 20.30		
Granted	-	-		
Exercised	(15,563)	13.88		
Forfeited	(2,317)	17.94		
Expired	(30,961)	19.25		
Outstanding at end of year	409,893	20.64	4.49 years	\$ 155
Exercisable at end of year	374,290	20.92	4.23 years	\$ 104

(13.) SHARE-BASED COMPENSATION (Continued)

As of December 31, 2010, there was \$62 thousand of unrecognized compensation expense related to unvested stock options, all of which is expected to be recognized during 2011.

The aggregate intrinsic value (the amount by which the market price of the stock on the date of exercise exceeded the market price of the stock on the date of grant) of option exercises for the years ended December 31, 2010, 2009 and 2008 was \$59 thousand, \$1 thousand, and \$10 thousand, respectively. The total cash received as a result of option exercises under stock compensation plans for the years ended December 31, 2010, 2009 and 2008 was \$216 thousand, \$14 thousand, and \$32 thousand, respectively. The tax benefits realized in connection with these stock option exercises were not significant.

The Company uses the Black-Scholes valuation method to estimate the fair value of its stock option awards. This method is dependent on certain assumptions. There were no stock options awarded during 2010 or 2009. The following is a summary of the stock options granted during the year ended December 31, 2008 as well as the weighted average assumptions used to compute their fair value.

Options granted	61,100
Grant date weighted average fair value per share	\$ 5.09
Grant date weighted average share price	\$ 16.98
Risk-free interest rate	3.40%
Expected dividend yield	3.48%
Expected stock price volatility	38.60%
Expected life (in years)	6.19

In the table above the risk-free interest rate is the U.S. Treasury rate commensurate with the expected life of option on the date of their grant. The expected stock price volatility is based upon historical activity of the Company's stock over a span of time equal to the expected life of the options. The expected life for options granted is based upon based on historical experience for the Plans.

The following is a summary of restricted stock award activity for the year ended December 31, 2010:

	Number of Shares	Weighted Average Market Price at Grant Date
Outstanding at beginning of year	77,772	\$ 15.05
Granted	107,040	12.51
Vested	(26,300)	18.24
Forfeited	(7,716)	13.64
Outstanding at end of year	<u>150,796</u>	\$ 12.76

As of December 31, 2010, there was \$869 thousand of unrecognized compensation expense related to unvested restricted stock awards that is expected to be recognized over a weighted average period of 1.66 years.

(14.) INCOME TAXES

Total income tax expense (benefit) was allocated as follows for the years ended December 31 (in thousands):

	<u>2010</u>	<u>2009</u>	<u>2008</u>
Income tax expense (benefit)	\$ 9,352	\$ 6,140	\$ (21,301)
Shareholder's equity	(763)	197	(2,955)

The income tax expense (benefit) for the years ended December 31 consisted of the following (in thousands):

	<u>2010</u>	<u>2009</u>	<u>2008</u>
Current tax expense (benefit):			
Federal	\$ 5,781	\$ (1,355)	\$ 2,043
State	1,103	25	504
Total current tax expense (benefit)	<u>6,884</u>	<u>(1,330)</u>	<u>2,547</u>
Deferred tax expense (benefit):			
Federal	2,852	6,189	(19,640)
State	(384)	1,281	(4,208)
Total deferred tax expense (benefit)	<u>2,468</u>	<u>7,470</u>	<u>(23,848)</u>
Total income tax expense (benefit)	<u>\$ 9,352</u>	<u>\$ 6,140</u>	<u>\$ (21,301)</u>

Income tax expense (benefit) differed from the statutory federal income tax rate for the years ended December 31 as follows:

	<u>2010</u>	<u>2009</u>	<u>2008</u>
Statutory federal tax rate	35.0 %	34.0 %	(34.0) %
Increase (decrease) resulting from:			
Tax exempt interest income	(4.2)	(8.6)	(5.2)
Non-taxable earnings on company owned life insurance	(1.3)	(1.8)	(0.4)
Dividend received deduction	(0.1)	(0.1)	(0.8)
State taxes, net of federal tax benefit	1.5	4.2	(5.2)
Nondeductible expenses	0.6	1.0	0.2
Disallowed interest expense	0.2	0.5	0.5
Other, net	(1.2)	0.6	-
Effective tax rate	<u>30.5 %</u>	<u>29.8 %</u>	<u>(44.9) %</u>

(14.) INCOME TAXES (Continued)

The Company's net deferred tax asset is included in other assets in the Consolidated Statements of Condition. The tax effects of temporary differences that give rise to the deferred tax assets and deferred tax liabilities are as follows at December 31 (in thousands):

	2010	2009
Deferred tax assets:		
Other than temporary impairment of investment securities	\$ 15,418	\$ 14,827
Allowance for loan losses	8,108	7,418
Tax attribute carryforward benefits	2,033	5,559
Share-based compensation	1,250	1,033
Interest on non-accruing loans	781	788
Core deposit intangible	158	258
Accrued pension costs	-	92
Other	665	580
Gross deferred tax assets	28,413	30,555
Deferred tax liabilities:		
Deferred loan origination costs	2,263	3,290
Depreciation and amortization	1,489	1,283
Net unrealized gain on securities available for sale	1,231	1,044
Loan servicing assets	581	522
Prepaid pension costs	139	-
Other	-	1
Gross deferred tax liabilities	5,703	6,140
Net deferred tax asset	\$ 22,710	\$ 24,415

The Company recognizes deferred income taxes for the estimated future tax effects of differences between the tax and financial statement bases of assets and liabilities considering enacted tax laws. These differences result in deferred tax assets and liabilities, which are included in other assets in the Company's consolidated statements of condition. The Company also assesses the likelihood that deferred tax assets will be realizable based on, among other considerations, future taxable income and establishes, if necessary, a valuation allowance for those deferred tax assets determined to not likely be realizable. A deferred tax asset valuation allowance is recognized if, based on the weight of available evidence (both positive and negative), it is more likely than not that some portion or all of the deferred tax assets will not be realized. The future realization of deferred tax benefits depends upon the existence of sufficient taxable income within the carry-back and carry-forward periods. Management judgment is required in determining the appropriate recognition of deferred tax assets and liabilities, including projections of future taxable income.

Based upon the Company's historical and projected future levels of pre-tax and taxable income, the scheduled reversals of taxable temporary differences to offset future deductible amounts, and prudent and feasible tax planning strategies, management believes it is more likely than not that the deferred tax assets will be realized. As such, no valuation allowance has been recorded as of December 31, 2010 or 2009.

The Company and its subsidiaries are subject to federal and New York State ("NYS") income taxes. The federal income tax years currently open for audits are 2007 through 2010. The NYS income tax years currently open for audits are 2009 and 2010.

At December 31, 2010, the Company had no federal or NYS net operating loss carryforwards. The Company has federal tax credits of approximately \$2.0 million which have an unlimited carryforward period.

The Company's unrecognized tax benefits and changes in unrecognized tax benefits were not significant as of or for the years ended December 31, 2010 and 2009. There were no interest or penalties recorded in the income statement in income tax expense for the year ended December 31, 2010. As of December 31, 2010, there were no amounts accrued for interest or penalties related to uncertain tax positions.

(15.) EARNINGS (LOSS) PER SHARE

The following table presents a reconciliation of the earnings and shares used in calculating basic and diluted EPS for each of the years ended December 31 (in thousands, except per share amounts).

	2010	2009	2008
Net income (loss) available to common shareholders	\$ 17,562	\$ 10,744	\$ (27,696)
Less: Earnings (loss) allocated to participating securities	105	87	(230)
Earnings (loss) allocated to common shares outstanding	<u>\$ 17,457</u>	<u>\$ 10,657</u>	<u>\$ (27,466)</u>
Weighted average common shares used to calculate basic EPS	10,767	10,730	10,818
Add: Effect of common stock equivalents	78	39	-
Weighted average common shares used to calculate diluted EPS	<u>10,845</u>	<u>10,769</u>	<u>10,818</u>
Earnings (loss) per common share:			
Basic	\$ 1.62	\$ 0.99	\$ (2.54)
Diluted	\$ 1.61	\$ 0.99	\$ (2.54)

Shares subject to the following securities, outstanding as of December 31 of the respective year, were excluded from the computation of diluted EPS because the effect would be antidilutive:

Stock options	353	459	583
Restricted stock awards	-	-	82
Warrant	-	378	378
	<u>353</u>	<u>837</u>	<u>1,043</u>

(16.) EMPLOYEE BENEFIT PLANS

Defined Benefit Pension Plan

The Company participates in The New York State Bankers Retirement System (the "Plan"), 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 following table provides a reconciliation of the changes in the plan's benefit obligations, fair value of assets and a statement of the funded status as of and for the year ended December 31 (in thousands):

	2010	2009
Change in projected benefit obligation:		
Projected benefit obligation at beginning of period	\$ (33,441)	\$ (30,878)
Service cost	(1,633)	(1,689)
Interest cost	(1,933)	(1,826)
Actuarial loss	(2,969)	(489)
Benefits paid and plan expenses	1,595	1,441
Projected benefit obligation at end of period	<u>(38,381)</u>	<u>(33,441)</u>
Change in plan assets:		
Fair value of plan assets at beginning of period	33,203	24,431
Actual return on plan assets	2,823	5,132
Employer contributions	4,300	5,081
Benefits paid and plan expenses	(1,595)	(1,441)
Fair value of plan assets at end of period	<u>38,731</u>	<u>33,203</u>
Funded (unfunded) status at end of period	<u>\$ 350</u>	<u>\$ (238)</u>

The accumulated benefit obligation was \$34.3 million and \$29.5 million at December 31, 2010 and 2009, respectively.

(16.) EMPLOYEE BENEFIT PLANS (Continued)

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. The Company satisfied the minimum required contribution to its pension plan of \$4.3 million for the 2011 fiscal year prior to December 31, 2010.

Estimated benefit payments under the pension plan over the next ten years at December 31, 2010 are as follows (in thousands):

2011	\$ 1,415
2012	1,504
2013	1,561
2014	1,682
2015	1,795
2016 - 2020	11,669

Net periodic pension cost consists of the following components for the years ended December 31 (in thousands):

	2010	2009	2008
Service cost	\$ 1,633	\$ 1,689	\$ 1,456
Interest cost on projected benefit obligation	1,933	1,826	1,562
Expected return on plan assets	(2,444)	(1,848)	(2,094)
Amortization of unrecognized loss	458	728	-
Amortization of unrecognized prior service cost	11	11	11
Net periodic pension cost	<u>\$ 1,591</u>	<u>\$ 2,406</u>	<u>\$ 935</u>

The actuarial assumptions used to determine the net periodic pension cost were as follows:

	2010	2009	2008
Weighted average discount rate	5.89%	6.03%	6.35%
Rate of compensation increase	3.50%	3.50%	3.50%
Expected long-term rate of return	7.50%	7.50%	7.50%

The actuarial assumptions used to determine the projected benefit obligation were as follows:

	2010	2009	2008
Weighted average discount rate	5.38%	5.89%	6.03%
Rate of compensation increase	3.00%	3.50%	3.50%

The weighted average discount rate was based upon the projected benefit cash flows and the market yields of high grade corporate bonds that are available to pay such cash flows.

(16.) EMPLOYEE BENEFIT PLANS (Continued)

The weighted average expected long-term rate of return is estimated based on current trends in Plan's assets as well as projected future rates of return on those assets and reasonable actuarial assumptions based on the guidance provided by Actuarial Standard of Practice No. 27, "Selection of Economic Assumptions for Measuring Pension Obligations", for long term inflation, and the real and nominal rate of investment return for a specific mix of asset classes. The following assumptions were used in determining the long-term rate of return:

Equity securities	Dividend discount model, the smoothed earnings yield model and the equity risk premium model
Fixed income securities	Current yield-to-maturity and forecasts of future yields
Other financial instruments	Comparison of the specific investment's risk to that of fixed income and equity instruments and using judgment

The long term rate of return considers historical returns. Adjustments were made to historical returns in order to reflect expectations of future returns. These adjustments were due to factor forecasts by economists and long-term U.S. Treasury yields to forecast long-term inflation. In addition forecasts by economists and others for long-term GDP growth were factored into the development of assumptions for earnings growth and per capital income. The Plan's overall investment strategy is to achieve a mix of approximately 97% of investments for long-term growth and 3% for near-term benefit payments with a wide diversification of asset types, fund strategies, and fund managers. The target allocations for Plan assets are shown in the table below. Cash equivalents consist primarily of short term investment funds. Equity securities primarily include investments in common stock and depository receipts. Fixed income securities include corporate bonds, government issues and mortgage backed securities. Other financial instruments primarily include rights and warrants.

Effective March 2009, the Plan revised its investment guidelines. The Plan currently prohibits its investment managers from purchasing the following investments;

Equity securities	Securities in emerging market countries as defined by the Morgan Stanley Emerging Markets Index, Short sales, Unregistered securities and Margin purchases
Fixed income securities	Securities of BBB quality or less, CMOs that have an inverse floating rate and whose payments don't include principal, Commercial MBSs or commercial property mortgages which aren't certified and guaranteed by the U.S. Government, ABSs that aren't issued or guaranteed by the U.S., or its agencies or its instrumentalities, Non-agency residential subprime or ALT-A MBSs and Structured Notes
Other financial instruments	Unhedged currency exposure in countries not defined as "high income economies" by the World Bank

All other investments not prohibited by the Plan are permitted. At December 31, 2010 the Plan holds certain investments which are no longer deemed acceptable to acquire. These positions will be liquidated when the investment managers deem that such liquidation is in the best interest of the Plan.

Asset category:	2011	Percentage of Plan Assets		Weighted Average Expected Long-term Rate of Return
	Target Allocation	2010	2009	
Cash equivalents	0 – 20%	11.2%	13.8%	-
Equity securities	40 – 60	48.2	45.7	4.60%
Fixed income securities	40 – 60	40.6	40.5	1.90%
Other financial instruments	0 – 5	-	-	-

(16.) EMPLOYEE BENEFIT PLANS (Continued)

The major categories of assets in the Plan as of year-end are presented in the following table. Assets are segregated by the level of the valuation inputs within the fair value hierarchy established by ASC Topic 820 utilized to measure fair value (see Note 17 - Fair Value Measurements).

	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs	Total Fair Value
December 31, 2010:				
Cash equivalents:				
Foreign currencies	\$ 84	\$ -	\$ -	\$ 84
Short term investment funds	-	4,266	-	4,266
Total cash equivalents	84	4,266	-	4,350
Equity securities:				
U.S. Large Cap	10,800	-	-	10,800
U.S. Mid Cap	1,103	-	-	1,103
U.S. Small Cap	82	-	-	82
International	6,698	-	-	6,698
Total equities	18,683	-	-	18,683
Fixed income securities:				
Corporate bonds				
Rated single A or higher by S&P	-	2,113	-	2,113
Rate below single A by S&P	-	1,483	-	1,483
Government issues	-	11,259	-	11,259
Collateralized mortgage obligations:				
Rated single A or higher by S&P	-	582	-	582
Rate below single A by S&P	-	261	-	261
Total fixed income securities	-	15,698	-	15,698
Total Plan investments	\$ 18,767	\$ 19,964	\$ -	\$ 38,731

	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs	Total Fair Value
December 31, 2009:				
Cash equivalents:				
Foreign currencies	\$ 114	\$ -	\$ -	\$ 114
Short term investment funds	-	4,486	-	4,486
Total cash equivalents	114	4,486	-	4,600
Equity securities:				
U.S. Large Cap	8,094	-	-	8,094
U.S. Mid Cap	289	-	-	289
U.S. Small Cap	83	-	-	83
International	6,712	-	-	6,712
Total equities	15,178	-	-	15,178
Fixed income securities:				
Corporate bonds				
Rated single A or higher by S&P	-	1,722	-	1,722
Rate below single A by S&P	-	1,433	-	1,433
Government issues	-	9,281	-	9,281
Collateralized mortgage obligations:				
Rated single A or higher by S&P	-	617	-	617
Rate below single A by S&P	-	185	-	185
Other fixed income securities	-	187	-	187
Total fixed income securities	-	13,425	-	13,425
Total Plan investments	\$ 15,292	\$ 17,911	\$ -	\$ 33,203

(16.) EMPLOYEE BENEFIT PLANS (Continued)

There were no assets classified as Level 3 assets during the year ended December 31, 2010. The following is a reconciliation of Level 3 assets for which significant unobservable inputs were used to determine fair value for the year ended December 31, 2009 (in thousands):

Balance at beginning of year	\$ 130
Change in unrealized appreciation	53
Realized loss	(57)
Sale proceeds	(126)
Balance at end of year	<u>\$ -</u>

Postretirement Benefit Plan

Prior to December 31, 2001, an entity acquired by the Company provided health and dental care benefits to retired employees who met specified age and service requirements through a postretirement health and dental care plan in which both the acquired entity and the retirees shared the cost. The plan provided for substantially the same medical insurance coverage as for active employees until their death and was integrated with Medicare for those retirees aged 65 or older. In 2001, the plan's eligibility requirements were amended to curtail eligible benefit payments to only retired employees and active participants who were fully vested under the Plan. In 2003, retirees under age 65 began contributing to health coverage at the same cost-sharing level as that of active employees. The retirees aged 65 or older were offered new Medicare supplemental plans as alternatives to the plan historically offered. The cost sharing of medical coverage was standardized throughout the group of retirees aged 65 or older. In addition, to be consistent with the administration of the Company's dental plan for active employees, all retirees who continued dental coverage began paying the full monthly premium. The accrued liability included in other liabilities in the consolidated statements of financial condition related to this plan amounted to \$162 thousand and \$155 thousand as of December 31, 2010 and 2009, respectively. The postretirement expense for the plan that was included in salaries and employee benefits in the consolidated statements of operations was not significant for the years ended December 31, 2010, 2009 and 2008. The plan is not funded.

The components of accumulated other comprehensive loss related to the defined benefit plan and postretirement benefit plan, on a pre-tax basis as of December 31 are summarized below (in thousands):

	2010	2009
Defined benefit plan:		
Net actuarial loss	\$ (11,188)	\$ (9,056)
Prior service cost	(132)	(143)
	<u>(11,320)</u>	<u>(9,199)</u>
Postretirement benefit plan:		
Net actuarial loss	(252)	(248)
Prior service credit	643	710
	<u>391</u>	<u>462</u>
Total recognized in accumulated other comprehensive loss	<u>\$ (10,929)</u>	<u>\$ (8,737)</u>

Changes in plan assets and benefit obligations recognized in other comprehensive income (loss) on a pre-tax basis during the years ended December 31 are as follows (in thousands):

	2010	2009
Defined benefit plan:		
Net actuarial (loss) gain	\$ (2,590)	\$ 2,795
Amortization of net loss	458	728
Amortization of prior service cost	11	12
	<u>(2,121)</u>	<u>3,535</u>
Postretirement benefit plan:		
Net actuarial loss	(4)	(10)
Amortization of prior service credit	(67)	(68)
	<u>(71)</u>	<u>(78)</u>
Total recognized in other comprehensive income (loss)	<u>\$ (2,192)</u>	<u>\$ 3,457</u>

For the year ending December 31, 2011, the estimated net loss and prior service cost for the plan that will be amortized from accumulated other comprehensive income into net periodic benefit cost is \$608 thousand and \$19 thousand, respectively.

(16.) EMPLOYEE BENEFIT PLANS (Continued)

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 2010, 2009 or 2008. The expense included in salaries and employee benefits in the consolidated statements of operations for this plan amounted to \$936 thousand, \$914 thousand and \$993 thousand in 2010, 2009 and 2008, respectively.

Supplemental Executive Retirement Plans

The Company has a non-qualified Supplemental Executive Retirement Plan ("SERP") covering three former executives. At December 31, 2010, there was a \$1.1 million unfunded pension liability related to the SERP. Pension expense was \$262 thousand, \$648 thousand, and \$309 thousand for 2010, 2009 and 2008, respectively.

(17.) FAIR VALUE MEASUREMENTS

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

Valuation Hierarchy

The fair value of an asset or liability is the price that would be received to sell that asset or paid to transfer that liability in an orderly transaction occurring in the principal market (or most advantageous market in the absence of a principal market) for such asset or liability. ASC Topic 820, "Fair Value Measurements and Disclosures," establishes a fair value hierarchy for valuation inputs that gives the highest priority to quoted prices in active markets for identical assets or liabilities and the lowest priority to unobservable inputs. The fair value hierarchy is as follows:

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

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

Investment securities available for sale: Publicly traded equity securities (stocks) are reported at fair value utilizing Level 1 inputs. Pooled trust preferred securities are reported at fair value utilizing Level 3 inputs. Fair values for these securities are determined through the use of internal valuation methodologies appropriate for the specific asset, which may include the use of a discounted expected cash flow analysis or the use of broker quotes. Other securities classified as available for sale are reported at fair value utilizing Level 2 inputs. For these securities, the Company obtains fair value measurements from an independent pricing service. The fair value measurements consider observable data that may include dealer quotes, market spreads, cash flows, the U.S. Treasury yield curve, live trading levels, trade execution data, market consensus prepayment speeds, credit information and the bond's terms and conditions, among other things.

(17.) FAIR VALUE MEASUREMENTS (Continued)

Collateral dependent impaired loans: The fair value of impaired loans with specific allocations of the allowance for loan losses is generally based on recent real estate appraisals. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by the appraisers to adjust for differences between the comparable sales and income data available. Such adjustments are typically significant and result in a Level 3 classification of the inputs for determining fair value.

Other real estate owned (Foreclosed assets): Nonrecurring adjustments to certain commercial and residential real estate properties classified as other real estate owned are measured at the lower of carrying amount or fair value, less costs to sell. Fair values are generally based on third party appraisals of the property, resulting in a Level 3 classification. In cases where the carrying amount exceeds the fair value, less costs to sell, an impairment loss is recognized.

Mortgage servicing rights: Mortgage servicing rights do not trade in an active market with readily observable market data. As a result, the Company estimates the fair value of mortgage servicing rights by using a discounted cash flow model to calculate the present value of estimated future net servicing income. The assumptions used in the discounted cash flow model are those that we believe market participants would use in estimating future net servicing income, including estimates of loan prepayment rates, servicing costs, ancillary income, impound account balances, and discount rates. Significant assumptions in the valuation of mortgage servicing rights include changes in interest rates, estimated loan repayment rates, and the timing of cash flows, among other factors. Mortgage servicing rights are classified as Level 3 measurements due to the use of significant unobservable inputs, as well as significant management judgment and estimation.

Assets Measured at Fair Value

The following table presents for each of the fair-value hierarchy levels the Company's assets that are measured at fair value on a recurring and non-recurring basis as of December 31, 2010 (in thousands).

	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs	Total Fair Value
Measured on a recurring basis:				
Securities available for sale:				
U.S. Government agencies and government sponsored enterprises	\$ -	\$ 140,784	\$ -	\$ 140,784
State and political subdivisions	-	105,666	-	105,666
Mortgage-backed securities	-	419,281	-	419,281
Asset-backed securities:				
Trust preferred securities	-	-	572	572
Other	-	65	-	65
	<u>\$ -</u>	<u>\$ 665,796</u>	<u>\$ 572</u>	<u>\$ 666,368</u>
Measured on a nonrecurring basis:				
Loans:				
Loans held for sale	\$ -	\$ 3,138	\$ -	\$ 3,138
Collateral dependent impaired loans	-	-	2,457	2,457
Other assets:				
Mortgage servicing rights	-	-	1,467	1,467
Other real estate owned	-	-	741	741
	<u>\$ -</u>	<u>\$ 3,138</u>	<u>\$ 4,665</u>	<u>\$ 7,803</u>

(17.) FAIR VALUE MEASUREMENTS (Continued)

The following table presents for each of the fair-value hierarchy levels the Company's assets that are measured at fair value on a recurring and non-recurring basis as of December 31, 2009 (in thousands).

	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs	Total Fair Value
Measured on a recurring basis:				
Securities available for sale:				
U.S. Government agencies and government sponsored enterprises	\$ -	\$ 134,105	\$ -	\$ 134,105
State and political subdivisions	-	83,659	-	83,659
Mortgage-backed securities	-	361,515	-	361,515
Asset-backed securities:				
Trust preferred securities	-	-	1,015	1,015
Other	-	207	-	207
	<u>\$ -</u>	<u>\$ 579,486</u>	<u>\$ 1,015</u>	<u>\$ 580,501</u>
Measured on a nonrecurring basis:				
Loans:				
Loans held for sale	\$ -	\$ 421	\$ -	\$ 421
Collateral dependent impaired loans	-	-	1,078	1,078
Other assets:				
Mortgage servicing rights	-	-	1,349	1,349
Other real estate owned	-	-	746	746
	<u>\$ -</u>	<u>\$ 421</u>	<u>\$ 3,173</u>	<u>\$ 3,594</u>

There were no liabilities measured at fair value on a recurring or nonrecurring basis during the years ended December 31, 2010 and 2009.

Changes in Level 3 Fair Value Measurements

The reconciliation for all assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the years ended December 31 is as follows (in thousands):

	2010	2009
Securities available for sale (Level 3), beginning of year	\$ 1,015	\$ 3,772
Transfers into Level 3	-	-
Capitalized interest	399	296
Principal paydowns and amortization of premiums	-	(9)
Coupon payments applied to principal	(136)	(273)
Total losses (realized/unrealized):		
Included in earnings	(526)	(2,263)
Included in other comprehensive income	(180)	(508)
Securities available for sale (Level 3), end of year	<u>\$ 572</u>	<u>\$ 1,015</u>

Fair Value of Financial Instruments

The Fair Value of Financial Instruments Subsection of the ASC 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.

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.

(17.) FAIR VALUE MEASUREMENTS (Continued)

The estimated fair value approximates carrying value for cash and cash equivalents, FHLB and 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 December 31, 2010 and December 31, 2009 may not necessarily represent the underlying fair value of the Company.

The carrying values and fair values of financial instruments as of December 31 are as follows (in thousands):

	December 31, 2010		December 31, 2009	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
Financial assets:				
Cash and cash equivalents	\$ 39,058	\$ 39,058	\$ 42,959	\$ 42,959
Securities available for sale	666,368	666,368	580,501	580,501
Securities held to maturity	28,162	28,849	39,573	40,629
Loans held for sale	3,138	3,138	421	421
Loans	1,325,524	1,388,787	1,243,265	1,290,136
Accrued interest receivable	7,613	7,613	7,386	7,386
FHLB and FRB stock	6,353	6,353	7,185	7,185
Financial liabilities:				
Demand, savings and money market deposits	1,143,136	1,143,136	1,056,604	1,056,604
Certificate of deposit	739,754	740,440	686,351	692,429
Short-term borrowings	77,110	77,110	59,543	59,543
Long-term borrowings (excluding junior subordinated debentures)	10,065	10,244	30,145	30,886
Junior subordinated debentures	16,702	10,564	16,702	10,741
Accrued interest payable	7,620	7,620	7,576	7,576

(18.) PARENT COMPANY FINANCIAL INFORMATION

Condensed financial statements pertaining only to the Parent are presented below (in thousands).

Condensed Statements of Condition

	December 31,	
	2010	2009
Assets:		
Cash and due from subsidiary	\$ 23,894	\$ 7,727
Investment in and receivables due from subsidiary	202,754	203,986
Other assets	4,623	5,698
Total assets	<u>\$ 231,271</u>	<u>\$ 217,411</u>
Liabilities and shareholders' equity:		
Junior subordinated debentures	\$ 16,702	\$ 16,702
Other liabilities	2,425	2,415
Shareholders' equity	212,144	198,294
Total liabilities and shareholders' equity	<u>\$ 231,271</u>	<u>\$ 217,411</u>

Condensed Statements of Operations

	Years ended December 31,		
	2010	2009	2008
Dividends from subsidiary and associated companies	\$ 23,151	\$ 5,051	\$ 11,251
Management and service fees from subsidiary	1,163	603	418
Other (loss) income	(134)	182	74
Total income	24,180	5,836	11,743
Operating expenses	4,005	4,436	4,363
Income before income tax benefit and equity in (excess distributions) undistributed earnings of subsidiary	20,175	1,400	7,380
Income tax benefit	1,323	1,286	1,499
Income before equity in (excess distributions) undistributed earnings of subsidiary	21,498	2,686	8,879
Equity in (excess distributions) undistributed earnings of subsidiary	(211)	11,755	(35,037)
Net income (loss)	<u>\$ 21,287</u>	<u>\$ 14,441</u>	<u>\$ (26,158)</u>

(18.) PARENT COMPANY FINANCIAL INFORMATION (Continued)**Condensed Statements of Cash Flows**

	Years ended December 31,		
	2010	2009	2008
Cash flows from operating activities:			
Net income (loss)	\$ 21,287	\$ 14,441	\$ (26,158)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:			
Equity in excess distributions (undistributed earnings) of subsidiary	211	(11,755)	35,037
Depreciation and amortization	193	318	427
Share-based compensation	1,031	854	633
Decrease (increase) in other assets	980	797	(763)
Increase (decrease) in other liabilities	8	(230)	(258)
Net cash provided by operating activities	23,710	4,425	8,918
Cash flows from investing activities:			
Purchase of investment assets, net of disposals	-	(1,323)	(99)
Capital investment in subsidiary	-	(15,000)	(20,000)
Net cash used in investing activities	-	(16,323)	(20,099)
Cash flows from financing activities:			
Purchase of preferred and common shares	(69)	-	(4,821)
Proceeds from issuance of preferred and common shares, net of issuance costs	-	(68)	35,602
Proceeds from issuance of common stock warrant	-	-	2,025
Proceeds from stock options exercised	216	15	32
Dividends paid	(7,690)	(7,485)	(7,722)
Net cash (used in) provided by financing activities	(7,543)	(7,538)	25,116
Net increase (decrease) in cash and cash equivalents	16,167	(19,436)	13,935
Cash and cash equivalents as of beginning of year	7,727	27,163	13,228
Cash and cash equivalents as of end of the year	\$ 23,894	\$ 7,727	\$ 27,163

(19.) SUBSEQUENT EVENT

On February 23, 2011, the Company was granted approval by the Treasury and redeemed \$12.5 million of the \$37.5 million in Series A preferred stock issued by the Company in December 2008. The redemption will result in a reduction of the associated Series A preferred stock dividends and Tier 1 capital in future periods. Upon issuance in December 2008, the discount associated with the Series A preferred stock was \$2.0 million, which is being accreted to retained earnings as an adjustment to dividends using the effective yield method. At December 31, 2010, the Series A preferred stock discount totaled \$1.3 million. As a result of the redemption, the Company will accelerate the accretion of the remaining discount in proportion to the Series A preferred stock redeemed in the first quarter of 2011. This transaction has no effect on the outstanding warrant to purchase common stock issued to the Treasury as part of the original issuance of the Series A preferred stock. The Company may apply for approval to repay the remaining balance of the Series A preferred stock in future periods.

CONTROLS AND PROCEDURES

Effectiveness of Controls and Procedures

As of the end of the period covered by this report, 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 (Principal Executive Officer) and Chief Financial Officer (Principal Accounting 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 the Company's Annual Report on Form 10-K.

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.

All internal control systems, no matter how well designed, have inherent limitations. Therefore, even those systems determined effective can provide only reasonable assurance with respect to financial statement preparation and presentation.

Management Report on Internal Control over Financial Reporting and Attestation Report of Independent Registered Public Accounting Firm

Management of Financial Institutions, Inc. (the Company) is responsible for establishing and maintaining adequate internal control over financial reporting. Management assessed the Company's internal control over financial reporting based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Based on this assessment, management has concluded that, as of December 31, 2010, the Company maintained effective internal control over financial reporting. Management's Report on Internal Control over Financial Reporting is included under "Financial Statements and Supplementary Data" in this report.

KPMG LLP, a registered public accounting firm, has audited the consolidated financial statements included in the Company's Annual Report on Form 10-K, and has issued an attestation report on the effectiveness of the Company's internal control over financial reporting. The Report of Independent Registered Public Accounting Firm that attests the effectiveness of internal control over financial reporting is included under Financial Statements and Supplementary Data this report.

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 December 31, 2010 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

Investor Information

Stock Exchange Listing
NASDAQ GSM: FISI

Annual Meeting
The Annual Meeting of Shareholders will be held at Financial Institutions, Inc.'s offices, 220 Liberty Street, Warsaw, New York, 14569, on Wednesday, May 4, 2011, at 10:00 a.m.

Transfer Agent
For services such as change of address, replacement of lost certificates and changes in registered ownership, or for inquiries regarding your account, contact:

American Stock Transfer & Trust Co.
6201 15th Avenue
Brooklyn, NY 11219
Tel: (800) 937-5449
Fax: (718) 236-2641
Website: www.amstock.com

Investor Relations
Investors, Stock Brokers, Security Analysts and others seeking information about Financial Institutions, Inc. should contact:

Karl F. Krebs, Executive Vice President, Chief Financial Officer, at (585) 786-1100 or e-mail info@fiwarsaw.com

Attorneys
Harter Secrest & Emery LLP
Rochester, New York

Independent Auditors
KPMG LLP
Rochester, New York

Affiliates
Five Star Bank
Five Star Investment Services, Inc.

Financial Information
For a free copy of the company's annual report or Form 10-K for the fiscal year 2010, contact the Corporate Secretary at 220 Liberty Street, Warsaw, New York 14569. This and other financial information is also available at:

Website Address
www.fiwarsaw.com





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