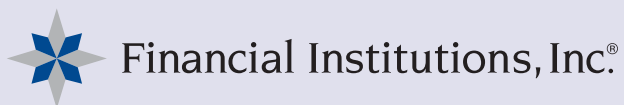
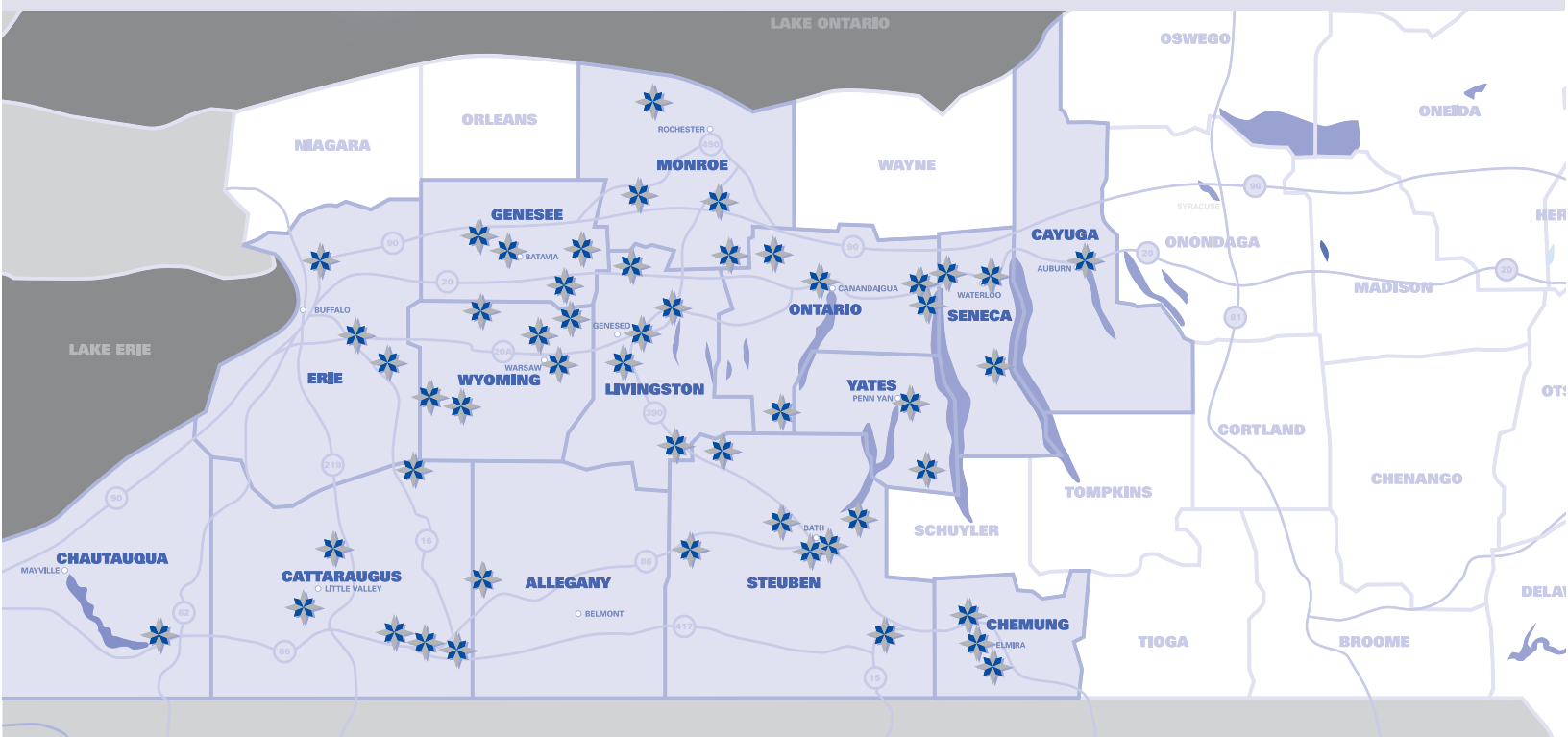




Financial  
Institutions, Inc.



With total assets of \$2.3 billion and employing over 600 individuals, Financial Institutions, Inc. provides diversified financial services through its subsidiaries, Five Star Bank and Five Star Investment Services, Inc. Five Star Bank provides a wide range of consumer and commercial banking services to individuals, municipalities and businesses through an extensive network of branch offices and ATMs in Western and Central New York State. Five Star Investment Services provides investment advice, brokerage and insurance products and services within the same New York State markets. The Company's stock is listed on the NASDAQ Global Select Market under the symbol FISI. Additional information is available at the Company's website: [www.fiiwarsaw.com](http://www.fiiwarsaw.com).



There's a nice side benefit of being prepared for rainy days. It means we're also prepared to take advantage of the sunny days that come our way.



Dear Fellow Shareholders,

Readers of our previous annual letters know that we are strong proponents of being prepared for any eventuality, come rain or shine. Heeding the Boy Scout motto has positioned us to weather the considerable economic challenges of recent years.

There's a side benefit to being prepared for rainy days. It means we're also prepared to take advantage of the sunny days that come our way. As I write this letter, we're anticipating a third quarter 2012 closing on our purchase of four retail banking branches from HSBC and four retail banking branches from First Niagara Bank. Our strong capital position allows us to fund these accretive acquisitions without the need to raise additional capital. I am confident that the strength of our organization and depth of experience on our management team enable us to accomplish these acquisitions without sacrificing our focus on core business activities.

The deposits associated with these branches total approximately \$376 million, while loans total approximately \$94 million, growing our balance sheet by approximately 16%. We anticipate a smooth conversion of the branches and are very excited about this opportunity to add value for our shareholders. I think you'll agree that this acquisition is an ideal fit for our Company. It expands our branch network in Western and Central New York into a fifteenth contiguous county, and significantly increases our presence in several of our current markets. We look forward to extending our proven brand of community banking to new customers at the branches to be acquired in Albion, Batavia, Brockport, Elmira, Elmira Heights, Horseheads, Medina, and Waterloo.

A key focus during the transition will be the smooth and seamless integration of new branch employees into our operations. In a complementary initiative, we have introduced a program in 2012 to enhance what we refer to as our brand integrity. The purpose of the program is to rally all of our employees, current and new, around actions and behaviors that strengthen the Five Star culture and customer experience. Through the years we've cultivated a strong brand image as a true community bank, and our brand integrity initiative will further commit our employees to deliver on that promise every day with every customer.

Another enhancement that our customers will notice involves our market management philosophy. It describes the way our retail, commercial, and investment services teams are coordinating their efforts to create a seamless, customer-centric focus. The ability to leverage our cross-market opportunities, to a greater degree than ever before, is already apparent in our improved market share rankings.

As you read the rest of this report, I'd like to call your attention to a few key indicators of our success. In 2011, our loans increased \$138.8 million to \$1.485 billion; that's a 10% increase over the prior year and represents gains in virtually

every category of loans. Our deposits increased by \$48.7 million to \$1.932 billion, a 3% increase. Our net interest income in 2011 was \$81.9 million, an increase of \$3.1 million or 4% over 2010, and our net income increased by \$1.5 million or 7% to \$22.8 million. At the same time, we increased our quarterly dividend by 30% during 2011, from \$0.10 per share in the first quarter to \$0.13 per share in the fourth quarter.

I'm pleased to report that our overall performance earned us an SNL Financial ranking in the top 100 best performing community banks in the United States in 2011. We've also improved our SBA Lender Ranking to 37th in the nation and 2nd in our market areas.

In 2011, we fully exited the TARP program, redeeming the \$37.5 million of preferred stock and warrant issued to the U.S. Treasury. The result is enhanced autonomy and greater operating flexibility. We were also able to redeem \$16.7 million of the Company's 10.20% junior subordinated debentures in 2011, eliminating \$1.7 million in annual interest expense.

In summary, our continued strong financial performance, in combination with our enhanced capital structure has laid a foundation that we are confident will drive increased performance and growth benefitting our shareholders, employees, customers, and communities for many years into the future.

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

Sincerely,



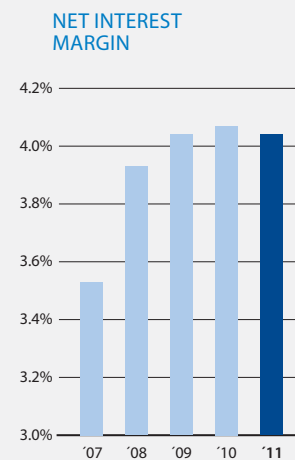
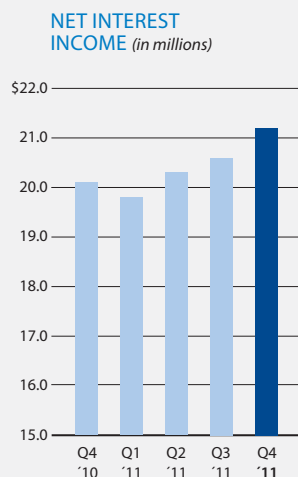
Peter G. Humphrey  
President and CEO  
March 31, 2012



# Five-Year Financial Highlights



Financial Institutions, Inc.®

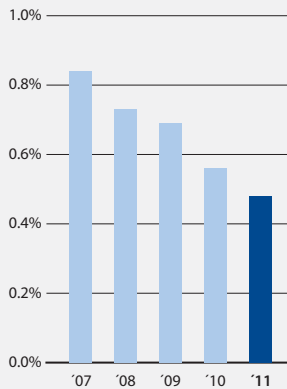


At or for the year ended December 31,

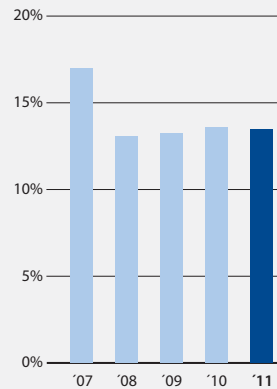
(Dollars in thousands, except per share data)

	2011	2010	2009	2008	2007
<b>Selected Financial Condition Data</b>					
Total assets	\$ 2,336,353	\$ 2,214,307	\$ 2,062,389	\$ 1,916,919	\$ 1,857,876
Total loans, net	1,461,516	1,325,524	1,243,265	1,102,330	948,652
Total investment securities	650,815	694,530	620,074	606,038	754,720
Total deposits	1,931,599	1,882,890	1,742,955	1,633,263	1,575,971
Borrowings	150,698	103,877	106,390	70,820	68,210
Shareholders' equity	237,194	212,144	198,294	190,300	195,322
Common shareholders' equity <sup>(1)</sup>	219,721	158,359	144,876	137,226	177,741
Tangible common shareholders' equity <sup>(2)</sup>	182,352	120,990	107,507	99,577	139,786
<b>Selected Operations Data</b>					
Interest income	\$ 95,118	\$ 96,509	\$ 94,482	\$ 98,948	\$ 105,212
Interest expense	13,255	17,720	22,217	33,617	47,139
Net interest income	81,863	78,789	72,265	65,331	58,073
Provision for loan losses	7,780	6,687	7,702	6,551	116
Net interest income after provision for loan losses	74,083	72,102	64,563	58,780	57,957
Total noninterest income (loss)	23,925	19,454	18,795	(48,778)	20,680
Total noninterest expense	63,794	60,917	62,777	57,461	57,428
Income (loss) before income taxes	34,214	30,639	20,581	(47,459)	21,209
Income tax expense (benefit)	11,415	9,352	6,140	(21,301)	4,800
Net income (loss)	\$ 22,799	\$ 21,287	\$ 14,441	\$ (26,158)	\$ 16,409
Preferred stock dividends and accretion	3,182	3,725	3,697	1,538	1,483
Net income (loss) applicable to common shareholders	\$ 19,617	\$ 17,562	\$ 10,744	\$ (27,696)	\$ 14,926
<b>Stock and Related Per Share Data</b>					
Earnings (loss) per common share:					
Basic	\$ 1.50	\$ 1.62	\$ 0.99	\$ (2.54)	\$ 1.34
Diluted	1.49	1.61	0.99	(2.54)	1.33
Cash dividends declared on common stock	0.47	0.40	0.40	0.54	0.46
Common book value per share <sup>(1)</sup>	15.92	14.48	13.39	12.71	16.14
Tangible common book value per share <sup>(2)</sup>	13.21	11.06	9.94	9.22	12.69
Stock price (NASDAQ: FISI):					
High	20.36	20.74	15.99	22.50	23.71
Low	.18	10.91	3.27	10.06	16.18
Close	.14	18.97	11.78	14.35	17.82

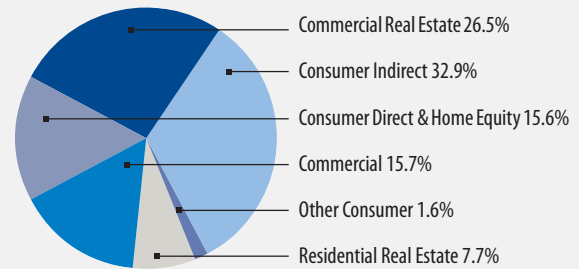
### NON-PERFORMING LOANS TO TOTAL LOANS



### TOTAL RISK-BASED CAPITAL RATIO



### LOAN PORTFOLIO COMPOSITION at December 31, 2011



(continued from previous page)

At or for the year ended December 31,

(Dollars in thousands, except per share data)

	2011	2010	2009	2008	2007
<b>Selected Financial Ratios and Other Data</b>					
<b>Performance Ratios:</b>					
Net income (loss), returns on:					
Average assets	1.00 %	0.98 %	0.71 %	(1.37)%	0.86 %
Average equity	9.82	10.07	7.43	(14.30)	8.84
Average common equity <sup>(1)</sup>	9.47	11.14	7.61	(16.84)	8.89
Average tangible common equity <sup>(2)</sup>	11.55	14.59	10.37	(21.87)	11.50
Common dividend payout ratio <sup>(3)</sup>	31.33	24.69	40.40	-	34.33
Net interest rate margin (fully tax-equivalent)	4.04	4.07	4.04	3.93	3.53
Efficiency ratio <sup>(4)</sup>	60.55 %	60.36 %	65.52 %	64.07 %	68.77 %
<b>Capital Ratios:</b>					
Leverage ratio	8.63 %	8.31 %	7.96 %	8.05 %	9.35 %
Tier 1 risk-based capital	12.20	12.34	11.95	11.83	15.74
Total risk-based capital	13.45	13.60	13.21	13.08	16.99
Equity to assets <sup>(5)</sup>	10.20	9.75	9.55	9.60	9.73
Common equity to assets <sup>(1) (5)</sup>	9.10	7.28	6.94	8.63	8.81
Tangible common equity to tangible assets <sup>(2) (5)</sup>	7.58 %	5.65 %	5.19 %	6.78 %	6.95 %
<b>Asset Quality:</b>					
Non-performing loans	\$ 7,076	\$ 7,582	\$ 8,681	\$ 8,196	\$ 8,077
Non-performing assets	9,187	8,895	10,442	9,252	9,498
Allowance for loan losses	23,260	20,466	20,741	18,749	15,521
Net loan charge-offs	\$ 4,986	\$ 6,962	\$ 5,710	\$ 3,323	\$ 1,643
Non-performing loans to total loans	0.48 %	0.56 %	0.69 %	0.73 %	0.84 %
Non-performing assets to total assets	0.39	0.40	0.51	0.48	0.51
Net charge-offs to average loans	0.36	0.54	0.47	0.32	0.18
Allowance for loan losses to total loans	1.57	1.52	1.64	1.67	1.61
Allowance for loan losses to non-performing loans	329 %	270 %	239 %	229 %	192 %
<b>Other Data:</b>					
Number of branches	50	50	50	51	50
Full-time equivalent employees	575	577	572	600	621

(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 and proceeds from company-owned life insurance included in income (all from continuing operations).

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



## OFFICERS

### PETER G. HUMPHREY

*President and Chief Executive Officer*

### MARTIN K. BIRMINGHAM

*Commercial Banking  
Executive Vice President  
Regional President*

### GEORGE D. HAGI

*Executive Vice President and  
Chief Risk Officer*

### RICHARD J. HARRISON

*Executive Vice President  
Chief of Retail Banking*

### KARL F. KREBS

*Executive Vice President,  
Chief Financial Officer*

### R. MITCHELL MCLAUGHLIN

*Executive Vice President  
Chief Information Officer*

### JOHN L. RIZZO

*Senior Vice President, In-House Counsel  
and Corporate Secretary*

### STEVEN R. AMBROSE

*Senior Vice President  
Workout Asset Group  
& Loan Review*

### RITA M. BARTOL

*Senior Vice President  
Director of Human Resources*

### MICHAEL D. BURNEAL

*Senior Vice President  
Bank Services*

### DAVID G. CASE

*Senior Vice President  
Regional Market Executive*

### DAVID R. CASTER

*Senior Vice President  
Business Banking*

### JONATHAN W. CHASE

*Senior Vice President  
Consumer Underwriting*

### ANTHONY G. CUTRONA

*Senior Vice President  
Retail Banking*

### MARK J. DEBACCO

*Senior Vice President  
Regional Commercial  
Credit Officer*

### SONIA M. DUMBLETON

*Senior Vice President  
Controller*

### MARTIN T. GRIFFITH

*Senior Vice President  
Regional Market Executive*

### MICHAEL D. GROVER

*Senior Vice President  
Financial Reporting and Tax*

### JEFFREY P. KENEFICK

*Senior Vice President  
Regional President*

### KEVIN B. KLOTZBACH

*Senior Vice President  
Treasurer*

### ROBERT J. MCKNIGHT

*Senior Vice President  
Commercial Banking Executive*

### MATTHEW T. MURTHA

*Senior Vice President  
Director of Marketing*

### EDWARD S. OEXLE

*Senior Vice President  
Commercial Banking Executive*

### BRENDA B. SCHELL

*Senior Vice President  
Audit*

### JOHN J. VAUGHAN

*Senior Vice President  
Retail Credit*

### KENNETH V. WINN

*Senior Vice President  
Credit and Compliance*

### DAVID A. YOUNG

*Senior Vice President  
Commercial Banking Executive*

### PETER W. AHERNS

*Firm Principal  
Five Star Investment Services*

## BOARD OF DIRECTORS

### KARL V. ANDERSON, JR.<sup>1,4</sup>

*Retired President and CEO  
Bank of Avoca*

### JOHN E. BENJAMIN

*Chairman of the Board  
Financial Institutions, Inc.  
and Five Star Bank*

### BARTON P. DAMBRA<sup>1,4</sup>

*President  
Markin Tubing LP*

### SAMUEL M. GULLO<sup>1,3</sup>

*Owner and Operator,  
Family Furniture*

### SUSAN R. HOLLIDAY<sup>2,3,4</sup>

*President and Publisher  
Rochester Business Journal, Inc.*

### PETER G. HUMPHREY

*President and CEO  
Financial Institutions, Inc.  
and Five Star Bank*

### ERLAND E. KAILBOURNE<sup>2,3</sup>

*Retired Chairman and CEO  
Fleet National Bank*

### ROBERT N. LATELLA<sup>2,3,4</sup>

*Attorney  
Hiscock & Barclay, LLP*

### JAMES L. ROBINSON<sup>1,2</sup>

*Retired President, CEO  
and Treasurer  
Olean Wholesale Grocery  
Cooperative*

### JAMES H. WYCKOFF<sup>2</sup>

*Professor  
Curry School of Education at  
the University of Virginia*

<sup>1</sup> AUDIT COMMITTEE  
James L. Robinson, Chair

<sup>2</sup> EXECUTIVE/NOMINATING AND  
GOVERNANCE COMMITTEE  
Erland E. Kailbourne, Chair

<sup>3</sup> MANAGEMENT DEVELOPMENT  
AND COMPENSATION  
COMMITTEE  
Susan R. Holliday, Chair

<sup>4</sup> RISK OVERSIGHT COMMITTEE  
Robert N. Latella, Chair



Financial  
Institutions, Inc.

## 2011 ANNUAL REPORT

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## FORWARD LOOKING INFORMATION

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

- statements with respect to the beliefs, plans, objectives, goals, guidelines, expectations, anticipations, and future financial condition, results of operations and performance of Financial Institutions, Inc. (“the parent” or “FII”) and its subsidiaries (collectively “the Company,” “we,” “our,” “us”); and
- statements preceded by, followed by or that include the words “may,” “could,” “should,” “would,” “believe,” “anticipate,” “estimate,” “expect,” “intend,” “plan,” “projects,” or similar expressions.

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

- If we experience greater credit losses than anticipated, earnings may be adversely impacted;
- Geographic concentration may unfavorably impact our operations;
- We depend on the accuracy and completeness of information about or from customers and counterparties;
- We are subject to environmental liability risk associated with our lending activities;
- We are highly regulated and may be adversely affected by changes in banking laws, regulations and regulatory practices;
- Ongoing financial reform legislation may result in new regulations that could require us to maintain higher capital levels and/or increase our costs of operations or limit certain activities or lines of business;
- New or changing tax, accounting, and regulatory rules and interpretations could significantly impact our strategic initiatives, results of operations, cash flows, and financial condition;
- Changes in New York State banking regulations or other laws could adversely affect us;
- If our security systems, or those of merchants, merchant acquirers or other third parties containing information about customers, are compromised, we may be subject to liability and damage to our reputation;
- We could be subject to losses if we fail to properly safeguard sensitive and confidential information;
- Our information systems may experience an interruption or breach in security;
- We rely on other companies to provide key components of our business infrastructure;
- We may not be able to attract and retain skilled people;
- The potential for business interruption exists throughout our organization;
- Our expansion efforts, particularly through new and acquired branches, may not be successful if we fail to manage our growth effectively;
- We may fail to realize any benefits and may incur unanticipated losses related to the assets we acquire and liabilities we assume from current or future acquisitions;
- We are subject to interest rate risk;
- Our business may be adversely affected by conditions in the financial markets and economic conditions generally;
- Our earnings are significantly affected by the fiscal and monetary policies of the federal government and its agencies;
- The soundness of other financial institutions could adversely affect us;
- Our market value could result in an impairment of goodwill;
- We operate in a highly competitive industry and market area;
- Liquidity is essential to our businesses;
- We may need to raise additional capital in the future and such capital may not be available on acceptable terms or at all;
- We rely on dividends from our subsidiaries for most of our revenue;
- The market price for our common stock varies, and you should purchase common stock for long-term investment only;
- We may issue debt and equity securities or securities convertible into equity securities, any of which may be senior to our common stock as to distributions and in liquidation, which could negatively affect the value of our common stock;
- We may not pay dividends on our common stock; and
- Our certificate of incorporation, our bylaws, and certain banking laws contain anti-takeover provisions.

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

**GENERAL**

Financial Institutions, Inc. is a financial holding company organized in 1931 under the laws of New York State (“New York” or “NYS”). Through its subsidiaries, including its wholly-owned, New York 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”. FII is a legal entity separate and distinct from its subsidiaries, assisting those subsidiaries by providing financial resources and oversight. 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 and investment adviser subsidiary, Five Star Investment Services, Inc. (“FSIS”).

**Our Business Strategy**

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

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

**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 banking activities, though concentrated in the communities where we maintain branches, also extend into neighboring counties. In addition, we have expanded our consumer indirect lending presence to the Capital District of New York and Northern Pennsylvania.

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 a combined metropolitan area 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 both 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.

## 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 our 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”), the Federal Home Loan Mortgage Corporation (“FHLMC”), the Small Business Administration (“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;
- 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.

## **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, 2011, \$75.0 million, or 32%, of the aggregate commercial business loan portfolio were at fixed rates, while \$158.8 million, or 68%, 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, 2011, \$122.1 million, or 31%, of the aggregate commercial mortgage portfolio were at fixed rates, while \$271.1 million, or 69%, were at variable rates.

We utilize government loan guarantee programs where available and appropriate.

### **Government Guarantee Programs**

We participate in government loan guarantee programs offered by the SBA, U.S. Department of Agriculture, Rural Economic and Community Development and Farm Service Agency, among others. As of December 31, 2011, we had loans with an aggregate principal balance of \$60.1 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 FHLMC as part of our standard loan policy. As of December 31, 2011, the residential mortgage servicing portfolio totaled \$297.8 million, the majority of which has been sold to FHLMC. As of December 31, 2011, our residential mortgage loan portfolio totaled \$113.9 million, or 8% 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, 2011, outstanding consumer loan balances were concentrated in indirect automobile loans and home equity products.

We selectively originate a mix of new and used indirect consumer loans through franchised new car dealers. The consumer indirect loan portfolio is primarily comprised of 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 the Capital District of New York, and most recently, Northern Pennsylvania. As of December 31, 2011, the consumer indirect portfolio totaled \$487.7 million, or 33% 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, 2011, \$117.6 million, or 51%, of the home equity portfolio was at fixed rates, while \$114.2 million, or 49%, was at variable rates. Approximately 69% of the loans in the home equity portfolio are first lien positions at December 31, 2011. The other consumer portfolio totaled \$24.3 million as of December 31, 2011, all of which were fixed rate 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 our 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;
- Reflect the probability that a given customer may default on its obligations; and
- Assist with risk-based pricing.

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 "Allowance for Loan Losses" under "Management's Discussion and Analysis of Financial Condition and Results of Operations".

## SOURCES OF FUNDS

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

### Deposits

We maintain a full range of deposit products and accounts to meet the needs of the residents and businesses in our primary service area. Products include an array of checking and savings account programs for individuals and small businesses, including money market accounts, certificates of deposit, sweep investment capabilities as well as Individual Retirement Accounts and other qualified plan accounts. We rely primarily on competitive pricing of our deposit products, customer service and long-standing relationships with customers to attract and retain these deposits and seek to make our services convenient to the community by offering 24-hour ATM access at some of our facilities, access to other ATM networks available at other local financial institutions and retail establishments, and telephone banking services including account inquiry and balance transfers. We also take advantage of the use of technology by allowing our customers banking access via the Internet and various advanced systems for cash management for our business customers.

We had no traditional brokered deposits at December 31, 2011; however, we do participate in the Certificate of Deposit Account Registry Service ("CDARS") program, which enables depositors to receive FDIC insurance coverage for deposits otherwise exceeding the maximum insurable amount. Through the CDARS program, deposits in excess of the maximum insurable amount are placed with multiple participating financial institutions. Reciprocal CDARS deposits totaled \$46.5 million at December 31, 2011.

### Borrowings

We have access to a variety of borrowing sources and use both short-term and long-term borrowings to support our asset base. Borrowings from time-to-time include federal funds purchased, securities sold under agreements to repurchase and FHLB advances. We also offer customers a deposit account that sweeps balances in excess of an agreed upon target amount into overnight 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 separate disclosure requirements.

## OTHER INFORMATION

All of the reports we file with the SEC, including the Annual Report on Form 10-K, Quarterly Reports on Form 10-Q and Current Reports on Form 8-K, as well as any amendments thereto may be read 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](http://www.sec.gov).

We also make available, free of charge, through our website, 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. These filings may be viewed by accessing the *Company Filings* subsection of the *SEC Filings* section under the *Investor Relations* tab on our website ([www.fiiwarsaw.com](http://www.fiiwarsaw.com)). Information available on our website is not a part of, and is not incorporated into, this Annual Report.

## 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 our 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.

**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, 2011 were 12.20% and 13.45%, 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, 2011, we had a leverage ratio of 8.63%. See also the section titled "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.

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.

On September 3, 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 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 developed 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 FRB adopted final regulations effective July 28, 2011, which established a capital floor and amended advanced risk-based capital adequacy standards. The rule mandated that the capital requirements for insured depository institutions be the minimum for covered institutions, a provision of the Dodd-Frank Act. The rule also implemented elements of the Collins Amendment.

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 FRB has not yet issued proposed rules for these countercyclical capital standards.

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, 2011, 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.

In December 2008, under the Treasury's Troubled Asset Relief Program ("TARP") Capital Purchase Program, we entered into a Securities Purchase Agreement - Standard Terms with the Treasury pursuant to which, among other things, we 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 our common stock, par value \$0.01 per share, at an exercise price of \$14.88 per share (the "Warrant").

Pursuant to the terms of the Purchase Agreement, our ability to declare or pay dividends on any of our shares was limited. Specifically, we were 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 our common stock, other junior securities or preferred stock ranking *pari passu* with the Series A preferred stock in any quarter unless all accrued and unpaid dividends were paid on the Series A preferred stock for all past dividend periods (including the latest completed dividend period), subject to certain limited exceptions.

We fully redeemed the Series A preferred stock during the first quarter of 2011 and repurchased the Warrant in the following quarter. The complete redemption of the Series A preferred stock removed the TARP restrictions pertaining to our ability to declare and pay dividends and repurchase our common stock, as well as certain restrictions associated with executive compensation.

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 Department of Financial Services is required prior to paying a dividend if the dividend declared by the Bank exceeds 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 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 became effective on April 1, 2011. Under the new rule, our FDIC insurance premiums decreased \$994 thousand to \$1.5 million in 2011 compared to \$2.5 million in 2010.

**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, has or will:

- Centralized 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 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.
- Changed the assessment base for federal deposit insurance from the amount of insured deposits to consolidated average assets less tangible capital. As a result, this change generally imposes more deposit insurance cost on institutions with assets of \$10 billion or more.
- 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.
- 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.
- Made permanent the \$250 thousand limit for federal deposit insurance and provided unlimited federal deposit insurance until December 31, 2012 for non-interest bearing demand transaction accounts and IOLTA accounts at all insured depository institutions.
- Repealed the federal prohibitions on the payment of interest on commercial demand deposits, thereby permitting depository institutions to pay interest on business transaction and other accounts.
- Allow de novo interstate branching by banks.
- Increased the authority of the FRB to examine us and our non-bank subsidiary.
- Required 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. The FRB issued proposed rules in November 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 may require us to maintain higher capital levels and/or increase our cost of operations and limit certain activities or lines of business.

**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.

Participation in the TARP Capital Purchase Program included certain requirements and restrictions regarding payment of dividends and 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. Our redemption of the Series A preferred stock during the first quarter of 2011, as described under “Dividends”, effectively ended these requirements and restrictions.

**Incentive Compensation.** On April 14, 2011, the Federal Reserve issued a proposed regulation 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 were 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 our 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 our operating environment 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 our financial condition or results of operations. A change in statutes, regulations or regulatory policies applicable to us or our 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, 2011, we had 613 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 9, 2012, the date of the 2012 Annual Meeting of Shareholders).

<b>Name</b>	<b>Age</b>	<b>Started In</b>	<b>Positions/Offices</b>
Peter G. Humphrey	57	1977	President and Chief Executive Officer of the Company and the Bank since 1994.
Karl F. Krebs	56	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., a mortgage and construction loan broker, 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	51	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, a financial holding company, 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	45	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	59	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	66	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 2001 to 2003.
Kevin B. Klotzbach	59	2001	Senior Vice President and Treasurer of the Bank since 2001.
R. Mitchell McLaughlin	54	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	62	2010	Senior Vice President and Corporate Secretary of the Company and the Bank since 2010. General counsel for the Company and the Bank since 2007. Genesee County (New York) Attorney from 1976 to 2010.

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

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Our common stock is traded on the NASDAQ Global Select Market under the ticker symbol "FISI." At December 31, 2011, 13,803,116 shares of our common stock were outstanding and held by approximately 1,400 shareholders of record. During 2011, the high sales price of our common stock was \$20.36 and the low sales price was \$12.18. The closing price per share of common stock on December 31, 2011, the last trading day of our fiscal year, was \$16.14. We declared dividends of \$0.47 per common share during the year ended December 31, 2011. 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. See the discussions in the section captioned "Supervision and Regulation" included under "Business", in the section captioned "Liquidity and Capital Resources" included under "Management's Discussion and Analysis of Financial Condition and Results of Operations" and in Note 10, Regulatory Matters, in the accompanying financial statements included under "Financial Statements and Supplementary Data", all of which are included elsewhere in this report.

**Equity Compensation Plan Information**

The following table sets forth, as of December 31, 2011, 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.

<b>Plan Category</b>	<b>Number of securities to be issued upon exercise of outstanding options, warrants and rights (a)</b>	<b>Weighted average exercise price of outstanding options, warrants and rights (b)</b>	<b>Number of securities remaining for future issuance under equity compensation plans (excluding securities reflected in column (a)) (c)</b>
Equity compensation plans approved by shareholders	534,712 <sup>(1)</sup>	\$ 20.70 <sup>(1)</sup>	664,350 <sup>(2)</sup>
Equity compensation plans not approved by shareholders	-	\$ -	-

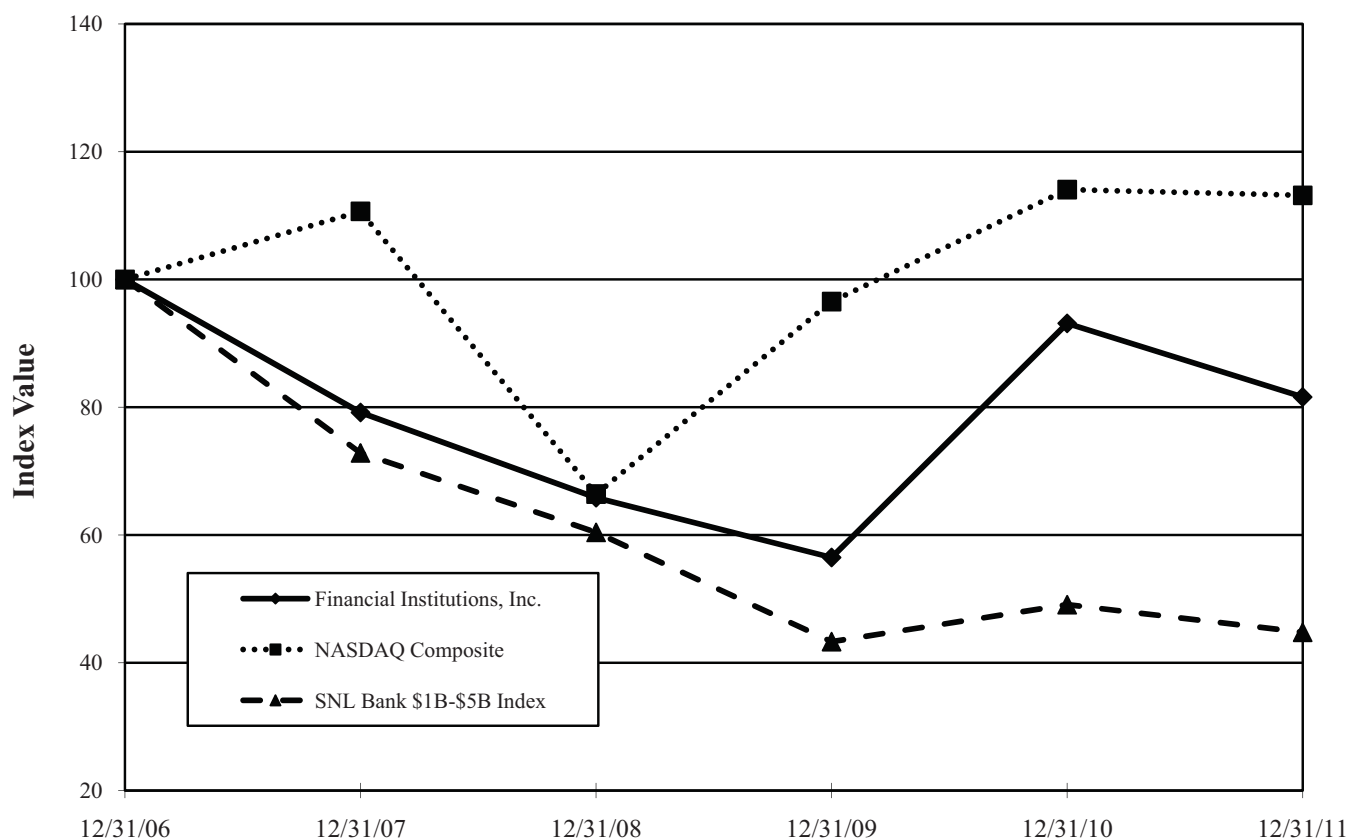
<sup>(1)</sup> Includes 166,654 shares of unvested restricted stock awards outstanding as of December 31, 2011. The weighted average exercise price excludes such awards.

<sup>(2)</sup> Represents the 940,000 aggregate shares approved for issuance under our two active equity compensation plans, reduced by 278,930 shares, which are the 170,082 restricted stock awards issued under these plans to date plus an adjustment of 108,848 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.

## Stock Performance Graph

The stock performance graph below compares (a) the cumulative total return on our common stock for the period beginning December 31, 2006 as reported by the NASDAQ Global Select Market, through December 31, 2011, (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					
	12/31/06	12/31/07	12/31/08	12/31/09	12/31/10	12/31/11
Financial Institutions, Inc.	100.00	79.17	65.84	56.47	93.13	81.59
NASDAQ Composite	100.00	110.66	66.42	96.54	114.06	113.16
SNL Bank \$1B-\$5B Index	100.00	72.84	60.42	43.31	49.09	44.77

## SELECTED FINANCIAL DATA

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

	At or for the year ended December 31,				
	2011	2010	2009	2008	2007
<b>Selected financial condition data:</b>					
Total assets	\$ 2,336,353	\$ 2,214,307	\$ 2,062,389	\$ 1,916,919	\$ 1,857,876
Loans, net	1,461,516	1,325,524	1,243,265	1,102,330	948,652
Investment securities	650,815	694,530	620,074	606,038	754,720
Deposits	1,931,599	1,882,890	1,742,955	1,633,263	1,575,971
Borrowings	150,698	103,877	106,390	70,820	68,210
Shareholders' equity	237,194	212,144	198,294	190,300	195,322
Common shareholders' equity <sup>(1)</sup>	219,721	158,359	144,876	137,226	177,741
Tangible common shareholders' equity <sup>(2)</sup>	182,352	120,990	107,507	99,577	139,786
<b>Selected operations data:</b>					
Interest income	\$ 95,118	\$ 96,509	\$ 94,482	\$ 98,948	\$ 105,212
Interest expense	13,255	17,720	22,217	33,617	47,139
Net interest income	81,863	78,789	72,265	65,331	58,073
Provision for loan losses	7,780	6,687	7,702	6,551	116
Net interest income after provision for loan losses	74,083	72,102	64,563	58,780	57,957
Noninterest income (loss) <sup>(3)</sup>	23,925	19,454	18,795	(48,778)	20,680
Noninterest expense	63,794	60,917	62,777	57,461	57,428
Income (loss) before income taxes	34,214	30,639	20,581	(47,459)	21,209
Income tax expense (benefit)	11,415	9,352	6,140	(21,301)	4,800
Net income (loss)	<u>\$ 22,799</u>	<u>\$ 21,287</u>	<u>\$ 14,441</u>	<u>\$ (26,158)</u>	<u>\$ 16,409</u>
Preferred stock dividends and accretion	3,182	3,725	3,697	1,538	1,483
Net income (loss) applicable to common shareholders	<u>\$ 19,617</u>	<u>\$ 17,562</u>	<u>\$ 10,744</u>	<u>\$ (27,696)</u>	<u>\$ 14,926</u>
<b>Stock and related per share data:</b>					
Earnings (loss) per common share:					
Basic	\$ 1.50	\$ 1.62	\$ 0.99	\$ (2.54)	\$ 1.34
Diluted	1.49	1.61	0.99	(2.54)	1.33
Cash dividends declared on common stock	0.47	0.40	0.40	0.54	0.46
Common book value per share <sup>(1)</sup>	15.92	14.48	13.39	12.71	16.14
Tangible common book value per share <sup>(2)</sup>	13.21	11.06	9.94	9.22	12.69
Market price (NASDAQ: FISI):					
High	20.36	20.74	15.99	22.50	23.71
Low	12.18	10.91	3.27	10.06	16.18
Close	16.14	18.97	11.78	14.35	17.82

<sup>(1)</sup> Excludes preferred shareholders' equity.

<sup>(2)</sup> Excludes preferred shareholders' equity, goodwill and other intangible assets.

<sup>(3)</sup> The 2011, 2010, 2009 and 2008 figures include other-than-temporary impairment ("OTTI") charges of \$18 thousand, \$594 thousand, \$4.7 million and \$68.2 million, respectively. There were no OTTI charges in 2007.



(Dollars in thousands, except per share data)

	At or for the year ended December 31,				
	2011	2010	2009	2008	2007
<b>Selected financial ratios and other data:</b>					
<b>Performance ratios:</b>					
Net income (loss), returns on:					
Average assets	1.00%	0.98%	0.71%	-1.37%	0.86%
Average equity	9.82	10.07	7.43	-14.30	8.84
Average common equity <sup>(1)</sup>	9.47	11.14	7.61	-16.84	8.89
Average tangible common equity <sup>(2)</sup>	11.55	14.59	10.37	-21.87	11.50
Common dividend payout ratio <sup>(3)</sup>	31.33	24.69	40.40	NA	34.33
Net interest margin (fully tax-equivalent)	4.04	4.07	4.04	3.93	3.53
Efficiency ratio <sup>(4)</sup>	60.55%	60.36%	65.52%	64.07%	68.77%
<b>Capital ratios:</b>					
Leverage ratio	8.63%	8.31%	7.96%	8.05%	9.35%
Tier 1 risk-based capital	12.20	12.34	11.95	11.83	15.74
Total risk-based capital	13.45	13.60	13.21	13.08	16.99
Equity to assets <sup>(5)</sup>	10.20	9.75	9.55	9.60	9.73
Common equity to assets <sup>(1) (5)</sup>	9.10	7.28	6.94	8.63	8.81
Tangible common equity to tangible assets <sup>(2) (5)</sup>	7.58%	5.65%	5.19%	6.78%	6.95%
<b>Asset quality:</b>					
Non-performing loans	\$ 7,076	\$ 7,582	\$ 8,681	\$ 8,196	\$ 8,077
Non-performing assets	9,187	8,895	10,442	9,252	9,498
Allowance for loan losses	23,260	20,466	20,741	18,749	15,521
Net loan charge-offs	\$ 4,986	\$ 6,962	\$ 5,710	\$ 3,323	\$ 1,643
Non-performing loans to total loans	0.48%	0.56%	0.69%	0.73%	0.84%
Non-performing assets to total assets	0.39	0.40	0.51	0.48	0.51
Net charge-offs to average loans	0.36	0.54	0.47	0.32	0.18
Allowance for loan losses to total loans	1.57	1.52	1.64	1.67	1.61
Allowance for loan losses to non-performing loans	329%	270%	239%	229%	192%
<b>Other data:</b>					
Number of branches	50	50	50	51	50
Full time equivalent employees	575	577	572	600	621

<sup>(1)</sup> Excludes preferred shareholders' equity.

<sup>(2)</sup> Excludes preferred shareholders' equity, goodwill and other intangible assets.

<sup>(3)</sup> 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.

<sup>(4)</sup> 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 (all from continuing operations).

<sup>(5)</sup> Ratios calculated using average balances for the periods shown.

## SELECTED QUARTERLY DATA

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

2011				
	Fourth Quarter	Third Quarter	Second Quarter	First Quarter
Interest income	\$ 23,875	\$ 23,774	\$ 23,830	\$ 23,639
Interest expense	2,721	3,156	3,577	3,801
Net interest income	21,154	20,618	20,253	19,838
Provision for loan losses	2,162	3,480	1,328	810
Net interest income, after provision for loan losses	18,992	17,138	18,925	19,028
Noninterest income	5,767	8,036	4,974	5,148
Noninterest expense	16,279	17,012	15,153	15,350
Income before income taxes	8,480	8,162	8,746	8,826
Income tax expense	2,718	2,664	3,027	3,006
Net income	\$ 5,762	\$ 5,498	\$ 5,719	\$ 5,820
Preferred stock dividends	369	368	370	2,075
Net income applicable to common shareholders	\$ 5,393	\$ 5,130	\$ 5,349	\$ 3,745
Earnings per common share <sup>(1)</sup> :				
Basic	\$ 0.39	\$ 0.38	\$ 0.39	\$ 0.33
Diluted	0.39	0.37	0.39	0.33
Market price (NASDAQ: FISI):				
High	\$ 17.26	\$ 17.98	\$ 17.93	\$ 20.36
Low	12.18	13.63	15.20	16.40
Close	16.14	14.26	16.42	17.52
Dividends declared	\$ 0.13	\$ 0.12	\$ 0.12	\$ 0.10

*(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 <sup>(1)</sup> :				
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

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

## 2011 FOURTH QUARTER RESULTS

Net income was \$5.8 million for the fourth quarter of 2011 compared with \$5.1 million for the fourth quarter of 2010. After preferred dividends, fourth quarter diluted earnings per share for 2011 was \$0.39 compared with \$0.38 per share for the fourth quarter of 2010.

Net interest income totaled \$21.2 million for the three months ended December 31, 2011, an increase of \$1.1 million or 5% over the fourth quarter of 2010. Average earning assets increased \$77.0 million during the fourth quarter 2011 compared to the same quarter last year, as a \$127.4 million increase in average loans was partially offset by a \$50.4 million decrease in investment securities and interest earning deposits.

The net interest margin on a tax-equivalent basis was 4.07% in the fourth quarter of 2011, compared with 4.01% in the fourth quarter of 2010. Our yield on earning-assets decreased 25 basis points in the fourth quarter of 2011 compared with the same quarter last year. This was due to the effect of reinvesting cash flows in the low interest rate environment. The cost of interest-bearing liabilities decreased 38 basis points compared with the fourth quarter of 2010, primarily a result of the redemption of our 10.20% junior subordinated debentures and the continued re-pricing of the our certificates of deposit.

The provision for loan losses was \$2.2 million for the fourth quarter of 2011 compared with \$2.0 million for the fourth quarter of 2010. Net charge-offs were \$1.9 million, or 0.51% annualized, of average loans, up from \$1.2 million, or 0.37% annualized, of average loans in the fourth quarter of 2010. Net charge-offs for the fourth quarter of 2011 includes \$905 thousand for the charge-off of a commercial business relationship. See the sections “Allowance for Loan Losses” and “Non-performing Assets and Potential Problem Loans” for additional information on net charge-offs and non-performing loans.

Noninterest income totaled \$5.8 million for the fourth quarter of 2011, a 9% increase over the fourth quarter of 2010. The majority of the increase related to higher pre-tax net gains from the sale of investment securities of \$656 thousand during the fourth of quarter 2011 compared with \$30 thousand during the fourth quarter of 2010.

Noninterest expense was \$16.3 million for the fourth quarter of 2011, a decrease of \$94 thousand million or 1% from the fourth quarter of 2010.

Income tax expense for the fourth quarter of 2011 was \$2.7 million compared to \$1.9 million for the fourth quarter of 2010. The change in income tax expense was primarily due to a \$1.5 million increase in pretax income between the years.

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## MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

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*The following is a discussion and analysis of our financial position and results of operations and should be read in conjunction with the our consolidated financial statements and notes thereto appearing under "Financial Statements and Supplementary Data" of this report.*

### OVERVIEW

#### 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. We have also expanded our indirect lending network to include relationships with franchised automobile dealers in the Capital District of New York and Northern Pennsylvania. Through our wholly-owned banking subsidiary, Five Star Bank, we provide a wide range of services, including business and consumer loan and depository services, as well as other traditional banking services. Through our nonbanking subsidiary, Five Star Investment Services, we provide brokerage and investment advisory 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.

#### Recent Developments

On January 19, 2012, Five Star Bank entered into an agreement to acquire four retail banking branches currently owned by HSBC Bank USA, N.A. located in Elmira, Elmira Heights, Horseheads and Albion, New York and four retail banking branches currently owned by First Niagara Bank, N.A. located in Medina, Waterloo, Batavia and Brockport, New York. The deposits associated with these branches total approximately \$376 million, while loans total approximately \$94 million. The transactions are subject to customary closing conditions, including regulatory approvals, and are expected to close by the end of the third quarter of this year.

#### 2011 Significant Events

**Common Stock Offering.** In March 2011, we completed the sale of 2,813,475 shares of our common stock through an underwritten public offering at a price of \$16.35 per share in an effort to restructure our capital position and improve the quality of our capital. The net proceeds of the offering, after deducting underwriting discounts and commissions and offering expenses, amounted to \$43.1 million. A portion of the proceeds from this offering was used to redeem our Series A preferred stock and the junior subordinated debentures.

**Redemption of Series A Preferred Stock.** In March 2011, we completed the full redemption of our \$37.5 million Series A preferred stock issued in connection with the TARP Capital Purchase Program. The redemption resulted in a one-time, non-cash redemption charge of \$1.2 million, reflecting the accelerated accretion of the remaining discount on the preferred stock, which reduced 2011 diluted earnings per common share by \$0.09.

The complete redemption of the Series A preferred stock removed the TARP restrictions pertaining to our ability to declare and pay dividends and repurchase our common stock, as well as certain restrictions associated with executive compensation.

In May 2011, we repurchased the warrant to purchase up to 378,175 shares of our common stock at an exercise price of \$14.88 per share issued to the Treasury. The repurchase price of \$2.1 million was recorded as a reduction of additional paid-in capital.

**Redemption of Junior Subordinated Debentures.** In August 2011, we redeemed all of the 10.20% junior subordinated debentures at a redemption price equaling 105.1% of the principal amount redeemed, plus all accrued and unpaid interest. As a result of the redemption, we recognized a loss on extinguishment of debt of \$1.1 million, consisting of the redemption premium of \$852 thousand and a write-off of the remaining unamortized issuance costs of \$231 thousand, which reduced 2011 diluted earnings per common share by \$0.05.

## MANAGEMENT'S DISCUSSION AND ANALYSIS

### 2011 Performance Summary

Our net income was \$22.8 million for the year ended December 31, 2011, compared to a net income of \$21.3 million for the year ended December 31, 2010. For 2011, net income available to common shareholders was \$19.6 million, or \$1.49 per diluted common share. Net income available to common shareholders was \$17.6 million for 2010, or \$1.61 per diluted common share. Cash dividends of \$0.47 and \$0.40 per common share were declared in 2011 and 2010, respectively.

We had total assets of \$2.336 billion at December 31, 2011 compared to \$2.214 billion at December 31, 2010. At December 31, 2011, shareholders' equity totaled \$237.2 million with book value per common share at \$15.92, compared to \$212.1 million with book value per common share at \$14.48 at the end of 2010. Tangible common equity to tangible common assets improved to 7.58% during 2011 from 5.65% in 2010. The Tier 1 capital ratio was 12.20% as of December 31, 2011 compared to 12.34% at December 31, 2010.

Key factors behind these results are discussed below.

- At December 31, 2011, loans were \$1.485 billion, up 10% from year-end 2010, primarily in commercial 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, 2011, were \$1.932 billion, up 3% from year-end 2010, primarily attributable to a \$40.7 million increase in retail deposits. Our deposit mix remains favorably weighted in lower cost demand, savings and money market accounts, which comprised 64% of total deposits at the end of 2011.
- Nonperforming loans were \$7.1 million at December 31, 2011, compared to \$7.6 million at December 31, 2010, as our loan portfolio continues to benefit from responsible underwriting and lending practices.
- The provision for loan losses was \$7.8 million and \$6.7 million, respectively, for 2011 and 2010. Net charge-offs were \$5.0 million in 2011 (or 0.36% of average loans) compared to \$7.0 million in 2010 (or 0.54% of average loans).
- At year-end 2011, the allowance for loan losses of \$23.3 million represented 1.57% of total loans (covering 329% of nonperforming loans), compared to \$20.5 million or 1.52% (covering 270% of nonperforming loans) at year-end 2010.
- Taxable equivalent net interest income was \$83.9 million for 2011 or 4% higher than \$80.7 million in 2010. Taxable equivalent interest income decreased \$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 \$7.8 million), partially offset by an unfavorable rate variance (decreasing taxable equivalent net interest income by \$4.5 million).
- The net interest margin for 2011 was 4.04%, 3 basis points lower than 4.07% in 2010.
- Noninterest income was \$23.9 million for 2011 compared to \$19.5 million for 2010. 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, unchanged from 2010. Net mortgage banking income was \$1.7 million for 2011, a slight decrease from \$1.8 million in 2010.
- Net investment securities gains (defined as net gain on sales and calls of investment securities and impairment charges on investment securities) were \$3.0 million for 2011, compared to net investment securities losses of \$425 thousand for 2010. During 2011 we recognized an additional \$2.8 million in gains from the sale of investment securities and \$576 thousand less in impairment charges than in 2010. The increase was primarily attributable to the net gain we experienced in 2011 in sales and calls of investment securities that included a gain of \$2.3 million achieved on the sale of four pooled trust preferred securities that had previously been written down.
- Noninterest expense for 2011 was \$63.8 million, an increase of \$2.9 million or 5% over 2010. Salaries and employee benefits increased \$2.6 million, professional services increased by \$420 thousand and we recognized a loss on extinguishment of debt of \$1.1 million as a result of redeeming our 10.20% junior subordinated debentures. FDIC assessments decreased by \$1.0 million and other noninterest expense decreased by \$404 thousand. As previously disclosed, other noninterest expense for 2010 includes \$1.0 million of losses relating to irregular instances of fraudulent debit card activity.
- The efficiency ratio was 60.55% for 2011 and 60.36% for 2010.
- Income tax expense for 2011 was \$11.4 million compared to \$9.4 million for 2010. The change in income tax expense was primarily due to a \$3.6 million increase in pretax income between the years.



## MANAGEMENT'S DISCUSSION AND ANALYSIS

### **RESULTS OF OPERATIONS FOR THE YEARS ENDED DECEMBER 31, 2011 AND DECEMBER 31, 2010**

#### **Net Interest Income and Net Interest Margin**

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

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

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

	<b>2011</b>	<b>2010</b>	<b>2009</b>
Interest income per consolidated statements of income	\$ 95,118	\$ 96,509	\$ 94,482
Adjustment to fully taxable equivalent basis	2,062	1,895	2,692
Interest income adjusted to a fully taxable equivalent basis	97,180	98,404	97,174
Interest expense per consolidated statement of income	13,255	17,720	22,217
Net interest income on a taxable equivalent basis	<u>\$ 83,925</u>	<u>\$ 80,684</u>	<u>\$ 74,957</u>

Taxable equivalent net interest income of \$83.9 million for 2011 was \$3.2 million or 4% higher than 2010. The impact of a decline in average yields on our assets was diminished by a 5% increase in interest-earning assets. The average balance of loans rose \$98.4 million or 8% to \$1.394 billion, reflecting growth in the commercial and consumer indirect loan portfolios, and the average balance of interest-earning assets rose \$98.6 million to \$2.080 billion. Consistent with our strategic plan, we continue to pursue loan development efforts in the commercial and consumer indirect lending portfolios in accordance with 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 \$7.8 million), partially offset by an unfavorable rate variance (decreasing taxable equivalent net interest income by \$4.5 million). The change in mix and volume of earning assets increased taxable equivalent interest income by \$6.3 million, while the change in volume and composition of interest-bearing liabilities decreased interest expense by \$1.5 million, for a net favorable volume impact of \$7.8 million on taxable equivalent net interest income. Rate changes on earning assets reduced interest income by \$7.4 million, while changes in rates on interest-bearing liabilities lowered interest expense by \$2.9 million, for a net unfavorable rate impact of \$4.5 million.

The net interest margin for 2011 was 4.04% compared to 4.07% in 2010.

The slight decrease in net interest margin was attributable to a 3 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). The interest rate spread remained unchanged from the year ended December 31, 2010 at 3.87%, as a 30 basis point decrease in the yield on earning assets offset the 30 basis point decrease in the cost of interest-bearing liabilities.

The Federal Reserve left the Federal funds rate unchanged at 0.25% during 2011 and 2010. During 2011, the Federal Reserve disclosed that short-term interest rates would be held near zero through at least the middle of 2013, in anticipation of low growth and little risk of inflation. In January 2012, the Federal Reserve further announced that it is unlikely that the short-term interest rates will increase until at least 2014.

## MANAGEMENT'S DISCUSSION AND ANALYSIS

For 2011, the yield on average earning assets of 4.67% was 30 basis points lower than 2010. Loan yields decreased 33 basis points to 5.53%. Commercial mortgage and consumer indirect loans in particular, down 31 and 66 basis points, respectively, continued to experience lower yields given the competitive pricing pressures and re-pricing of loans in a low interest rate environment. The yield on investment securities dropped 38 basis points to 2.93%, also impacted by the lower interest rate environment and prepayments of mortgage-related investment securities. Overall, earning asset rate changes reduced interest income by \$7.5 million.

The cost of average interest-bearing liabilities of 0.80% in 2011 was 30 basis points lower than 2010. The average cost of interest-bearing deposits was 0.74% in 2011, 23 basis points lower than 2010, reflecting the low-rate environment, mitigated by a focus on product pricing to retain balances. The cost of borrowings decreased 175 basis points to 1.58% for 2011, primarily a result of the redemption of the 10.20% junior subordinated debentures. The interest-bearing liability rate changes reduced interest expense by \$2.9 million.

Average interest-earning assets of \$2.080 billion in 2011 were \$98.6 million or 5% higher than 2010. Average investment securities increased \$5.0 million while average loans increased \$98.4 million or 8%. Commercial loans increased \$42.1 million and consumer loans increased \$73.5 million, offset by a \$17.2 million decrease in residential mortgage loans.

Average interest-bearing liabilities of \$1.662 billion in 2011 were up \$51.6 million or 3% versus 2010. The impacts of the recent recession have positively impacted our deposit balances, as consumers tend to save more when consumer confidence is low. On average, interest-bearing deposits grew \$22.8 million, while average noninterest-bearing demand deposits (a principal component of net free funds) increased by \$38.4 million. Average borrowings increased \$28.9 million, representing a \$50.0 million increase and \$21.1 million decrease in short-term and long-term borrowings, respectively.

## MANAGEMENT'S DISCUSSION AND ANALYSIS

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,								
	2011			2010			2009		
	Average Balance	Interest	Average Rate	Average Balance	Interest	Average Rate	Average Balance	Interest	Average Rate
<b>Interest-earning assets:</b>									
Federal funds sold and other interest-earning deposits	\$ 140	\$ -	0.20%	\$ 5,034	\$ 10	0.21%	\$ 37,214	\$ 82	0.22%
Investment securities:									
Taxable	545,112	14,185	2.60	571,856	17,101	2.99	454,552	16,466	3.62
Tax-exempt	140,657	5,890	4.19	108,900	5,416	4.97	155,054	7,920	5.11
Total investment securities	685,769	20,075	2.93	680,756	22,517	3.31	609,606	24,386	4.00
Loans:									
Commercial business	215,598	10,311	4.78	206,167	9,939	4.82	204,235	9,612	4.71
Commercial mortgage	370,843	21,216	5.72	338,149	20,389	6.03	306,763	19,309	6.29
Residential mortgage	121,742	6,868	5.64	138,954	8,157	5.87	161,055	9,701	6.02
Home equity	216,428	9,572	4.42	202,189	9,224	4.56	193,929	9,121	4.70
Consumer indirect	444,527	26,549	5.97	382,977	25,379	6.63	313,239	21,838	6.97
Other consumer	24,686	2,589	10.49	26,950	2,789	10.35	30,791	3,125	10.15
Total loans	1,393,824	77,105	5.53	1,295,386	75,877	5.86	1,210,012	72,706	6.01
Total interest-earning assets	2,079,733	97,180	4.67	1,981,176	98,404	4.97	1,856,832	97,174	5.23
Less: Allowance for loan losses	21,567			20,883			20,355		
Other noninterest-earning assets	218,983			206,303			197,439		
Total assets	<u>\$ 2,277,149</u>			<u>\$2,166,596</u>			<u>\$2,033,916</u>		
<b>Interest-bearing liabilities:</b>									
Deposits:									
Interest-bearing demand	\$ 383,122	614	0.16	\$ 382,517	705	0.18	\$ 365,873	772	0.21
Savings and money market	451,030	1,056	0.23	414,953	1,133	0.27	383,697	1,090	0.28
Certificates of deposit	712,411	9,764	1.37	726,330	13,015	1.79	685,259	17,228	2.51
Total interest-bearing deposits	1,546,563	11,434	0.74	1,523,800	14,853	0.97	1,434,829	19,090	1.33
Short-term borrowings	99,122	500	0.50	49,104	365	0.74	43,092	270	0.63
Long-term borrowings	15,905	1,321	8.31	37,043	2,502	6.75	46,913	2,857	6.09
Total borrowings	115,027	1,821	1.58	86,147	2,867	3.33	90,005	3,127	3.47
Total interest-bearing liabilities	1,661,590	13,255	0.80	1,609,947	17,720	1.10	1,524,834	22,217	1.46
Noninterest-bearing deposits	368,268			329,853			293,852		
Other liabilities	15,041			15,485			20,890		
Shareholders' equity	232,250			211,311			194,340		
Total liabilities and shareholders' equity	<u>\$ 2,277,149</u>			<u>\$2,166,596</u>			<u>\$2,033,916</u>		
Net interest income (tax-equivalent)		<u>\$ 83,925</u>			<u>\$ 80,684</u>			<u>\$ 74,957</u>	
Interest rate spread			<u>3.87%</u>			<u>3.87%</u>			<u>3.77%</u>
Net earning assets	<u>\$ 418,143</u>			<u>\$ 371,229</u>			<u>\$ 331,998</u>		
Net interest margin (tax-equivalent)			<u>4.04%</u>			<u>4.07%</u>			<u>4.04%</u>
Ratio of average interest-earning assets to average interest-bearing liabilities	<u>125.17%</u>			<u>123.06%</u>			<u>121.77%</u>		

## MANAGEMENT'S DISCUSSION AND ANALYSIS

### 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 2011 to 2010			Change from 2010 to 2009		
	Volume	Rate	Total	Volume	Rate	Total
<b>Interest income:</b>						
Federal funds sold and other interest-earning deposits	\$ (5)	\$ (5)	\$ (10)	\$ (65)	\$ (7)	\$ (72)
Investment securities:						
Taxable	(772)	(2,144)	(2,916)	3,807	(3,172)	635
Tax-exempt	1,418	(944)	474	(2,300)	(204)	(2,504)
Total investment securities	646	(3,088)	(2,442)	1,507	(3,376)	(1,869)
Loans:						
Commercial business	452	(80)	372	92	235	327
Commercial mortgage	1,905	(1,078)	827	1,916	(836)	1,080
Residential mortgage	(980)	(309)	(1,289)	(1,302)	(242)	(1,544)
Home equity	636	(288)	348	382	(279)	103
Consumer indirect	3,829	(2,659)	1,170	4,665	(1,124)	3,541
Other consumer	(237)	37	(200)	(396)	60	(336)
Total loans	5,605	(4,377)	1,228	5,357	(2,186)	3,171
<b>Total interest income</b>	<b>6,246</b>	<b>(7,470)</b>	<b>(1,224)</b>	<b>6,799</b>	<b>(5,569)</b>	<b>1,230</b>
<b>Interest expense:</b>						
Deposits:						
Interest-bearing demand	1	(92)	(91)	34	(101)	(67)
Savings and money market	93	(170)	(77)	86	(43)	43
Certificates of deposit	(245)	(3,006)	(3,251)	982	(5,195)	(4,213)
Total interest-bearing deposits	(151)	(3,268)	(3,419)	1,102	(5,339)	(4,237)
Short-term borrowings	281	(146)	135	41	54	95
Long-term borrowings	(1,662)	481	(1,181)	(644)	289	(355)
Total borrowings	(1,381)	335	(1,046)	(603)	343	(260)
<b>Total interest expense</b>	<b>(1,532)</b>	<b>(2,933)</b>	<b>(4,465)</b>	<b>499</b>	<b>(4,996)</b>	<b>(4,497)</b>
<b>Net interest income</b>	<b>\$ 7,778</b>	<b>\$ (4,537)</b>	<b>\$ 3,241</b>	<b>\$ 6,300</b>	<b>\$ (573)</b>	<b>\$ 5,727</b>

### 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 \$7.8 million for the year ended December 31, 2011 compared with \$6.7 million for 2010. See the "Allowance for Loan Losses" section of this Management's Discussion and Analysis for further discussion.

## MANAGEMENT'S DISCUSSION AND ANALYSIS

### Noninterest Income

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

	2011	2010	2009
Service charges on deposits	\$ 8,679	\$ 9,585	\$ 10,065
ATM and debit card	4,359	3,995	3,610
Broker-dealer fees and commissions	1,829	1,283	1,022
Company owned life insurance	1,424	1,107	1,096
Loan servicing	835	1,124	1,308
Net gain on sale of loans held for sale	880	650	699
Net gain on sales and calls of investment securities	3,003	169	3,429
Impairment charges on investment securities	(18)	(594)	(4,666)
Net gain (loss) on sale and disposal of other assets	67	(203)	180
Other	2,867	2,338	2,052
Total noninterest income	<u>\$ 23,925</u>	<u>\$ 19,454</u>	<u>\$ 18,795</u>

The components of noninterest income fluctuated as discussed below.

Service charges on deposits were \$8.7 million in 2011, which was \$906 thousand or 9% lower than 2010. The decrease was primarily due to changes in customer behavior and recent regulatory changes that include requirements for customers to opt in for overdraft coverage for certain types of electronic banking activities.

ATM and debit card income was \$4.4 million for 2011, an increase of \$364 thousand or 9%, compared to 2010. The increased popularity of electronic banking and transaction processing has resulted in higher ATM and debit card point-of-sale usage income.

Broker-dealer fees and commissions were up \$546 thousand or 43%, compared to 2010. Broker-dealer fees and commissions fluctuate mainly due to sales volume, which increased during 2011 as a result of improving market and economic conditions and our renewed focus on this line of business.

Company owned life insurance income was up \$317 thousand or 29% for the year ended December 31, 2011 compared to the same period in 2010. The increase was the result of an additional \$18.0 million investment in company owned life insurance during the third quarter of 2011.

Loan servicing income represents fees earned for servicing mortgage and indirect auto loans sold to third parties, net of amortization expense and impairment losses, if any, associated with capitalized loan servicing assets. Loan servicing income was down \$289 thousand or 26% the year ended December 31, 2011 compared to 2010. Loan servicing income decreased as a result of more rapid amortization of servicing rights due to loans paying off, lower fees collected due to a decrease in the sold and serviced portfolio and write-downs on capitalized mortgage servicing assets.

Net gain on loans held for sale was \$880 thousand in 2011, an increase of \$230 thousand or 35%, compared to 2010, mainly due to the \$153 thousand gain relating to the servicing retained sale of \$13.0 million of indirect auto loans during the third quarter of 2011.

Net gains from the sales of investment securities were \$3.0 million for the year ended December 31, 2011, compared to \$169 thousand in 2010. The current year includes net gains of \$2.3 million from the sale of four pooled trust-preferred securities that had been written down in prior periods and included in non-performing assets. We continue to monitor the market for the trust-preferred securities and evaluate the potential for future dispositions. Net gains of \$730 thousand from the sale of eight mortgage-backed securities were also recognized during 2011. The amount and timing of our sale of investments securities is dependent on a number of factors, including our prudent efforts to realize gains while managing duration, premium and credit risk.

Other noninterest income increased \$529 thousand or 23% for the year ended December 31, 2011, compared to 2010. Other noninterest income for 2011 includes \$152 thousand related to insurance proceeds received for losses relating to an irregular instance of fraudulent debit card activity recorded in the fourth quarter of 2010. Merchant services fees paid by customers for account management and electronic processing of transactions and income from our capital investment in several limited partnerships also contributed to the 2011 increases.



## MANAGEMENT'S DISCUSSION AND ANALYSIS

### Noninterest Expense

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

	2011	2010	2009
Salaries and employee benefits	\$ 35,439	\$ 32,811	\$ 33,634
Occupancy and equipment	10,868	10,818	11,062
Computer and data processing	2,437	2,487	2,340
Professional services	2,617	2,197	2,524
Supplies and postage	1,778	1,772	1,846
FDIC assessments	1,513	2,507	3,651
Advertising and promotions	1,259	1,121	949
Loss on extinguishment of debt	1,083	-	-
Other	6,800	7,204	6,771
Total noninterest expense	<u>\$ 63,794</u>	<u>\$ 60,917</u>	<u>\$ 62,777</u>

The components of noninterest expense fluctuated as discussed below.

Salaries and employee benefits (which includes salary-related expenses and fringe benefit expenses) was \$35.4 million for 2011, up \$2.6 million or 8% from 2010. Average full-time equivalent employees ("FTEs") were 576 for 2011, about the same as 577 for last year. Salary-related expenses increased \$2.0 million for the year ended December 31, 2011, compared to 2010, reflecting an increase in estimated incentive compensation, which was previously limited under the TARP Capital Purchase Program. Fringe benefit expenses increased \$672 thousand or 9%, primarily attributable to higher medical expenses.

Professional services expense of \$2.6 million in 2011 increased \$420 thousand or 19% from 2010. Professional fees increased primarily due to legal and shareholder expenses related to our common stock offering and redemption of both our Series A preferred stock and junior subordinated debentures.

FDIC assessments decreased \$1.0 million for the year ended December 31, 2011, compared to 2010, primarily a result of changes implemented by the FDIC in the method of calculating assessment rates which became effective in the second quarter of 2011.

Advertising and promotions expenses were \$138 thousand or 12% higher in 2011 compared to 2010 due to increases in business development expenses and the opening of a new branch in suburban Rochester in the third quarter of 2011.

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

Other noninterest expense decreased \$404 thousand or 6% during 2011 compared to 2010. The 2010 expense includes a loss of approximately \$1.0 million relating to irregular instances of fraudulent debit card activity.

The efficiency ratio for the year ended December 31, 2011 was 60.55% compared with 60.36% for 2010. 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, 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 \$11.4 million for 2011 compared to \$9.4 million for 2010. The change was due in part to a \$3.6 million increase in pretax income between the years. In addition, during 2010, we recorded non-recurring tax benefits 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 33.4% in 2011 and 30.5% in 2010. 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.

## MANAGEMENT'S DISCUSSION AND ANALYSIS

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

#### **Net Interest Income and Net Interest Margin**

Net interest income in the consolidated statements of income (which excludes the taxable equivalent adjustment) was \$78.8 million in 2010, compared to \$72.3 million in 2009. 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 tax rate of 35% for 2010 and 34% for 2009) of \$1.9 million and \$2.7 million for 2010 and 2009, respectively, resulted in fully taxable equivalent net interest income of \$80.7 million in 2010 and \$75.0 million in 2009.

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%.

The increase in taxable equivalent net interest income was a function of a favorable volume variance (because 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 borrowings decreased \$3.9 million, net of the \$6.0 million increase and \$9.9 million decrease in short-term and long-term borrowings, respectively.

#### **Provision for Loan Losses**

The provision for loan losses was \$6.7 million for the year ended December 31, 2010 compared with \$7.7 million for 2009.

## MANAGEMENT'S DISCUSSION AND ANALYSIS

### Noninterest Income

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, prohibited 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.

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 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 from sales and calls of investment securities. The 2010 OTTI charges primarily related to pooled trust preferred securities that were designated as impaired in the first quarter of that year 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

Salaries and employee benefits 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.

The efficiency ratio for the year ended December 31, 2010 improved to 60.36% compared with 65.52% for 2009.

### 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.

## MANAGEMENT'S DISCUSSION AND ANALYSIS

### ANALYSIS OF FINANCIAL CONDITION

#### OVERVIEW

At December 31, 2011, we had total assets of \$2.336 billion, an increase of 6% from \$2.214 billion as of December 31, 2010, primarily a result of the continued core business growth in both loans and deposits. Net loans were \$1.462 billion as of December 31, 2011, up \$136.0 million, or 10%, when compared to \$1.326 billion as of December 31, 2010. The increase in net 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 \$9.2 million as of December 31, 2011, up \$292 thousand from a year ago. An increase in non-performing investment securities for which we have stopped accruing interest was partly offset by a decrease in non-performing loans and a decrease in foreclosed assets. Total deposits amounted to \$1.932 billion and \$1.883 billion as of December 31, 2011 and 2010, respectively. As of December 31, 2011, borrowed funds totaled \$150.7 million, compared to \$103.9 million as of December 31, 2010. Book value per common share was \$15.92 and \$14.48 as of December 31, 2011 and 2010, respectively. As of December 31, 2011 our total shareholders' equity was \$237.2 million compared to \$212.1 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).

<b>Investment Securities Portfolio Composition</b>						
<b>At December 31,</b>						
	<b>2011</b>		<b>2010</b>		<b>2009</b>	
	<b>Amortized Cost</b>	<b>Fair Value</b>	<b>Amortized Cost</b>	<b>Fair Value</b>	<b>Amortized Cost</b>	<b>Fair Value</b>
<b>Securities available for sale:</b>						
U.S. Government agency and government-sponsored enterprise securities	\$ 94,947	\$ 97,712	\$ 141,591	\$ 140,784	\$ 134,564	\$ 134,105
State and political subdivisions	119,099	124,424	105,622	105,666	80,812	83,659
Mortgage-backed securities:						
Agency mortgage-backed securities	390,375	401,596	414,502	417,709	356,044	356,355
Non-Agency mortgage-backed securities	327	2,089	981	1,572	5,087	5,160
Asset-backed securities	297	1,697	564	637	1,295	1,222
Total available for sale securities	605,045	627,518	663,260	666,368	577,802	580,501
<b>Securities held to maturity:</b>						
State and political subdivisions	23,297	23,964	28,162	28,849	39,573	40,629
Total investment securities	<u>\$ 628,342</u>	<u>\$ 651,482</u>	<u>\$ 691,422</u>	<u>\$ 695,217</u>	<u>\$ 617,375</u>	<u>\$ 621,130</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.

## MANAGEMENT'S DISCUSSION AND ANALYSIS

As of December 31, 2011, management does not have the intent to sell any of the securities in a loss position and believes that it is not likely that it will be required to sell any such securities before the anticipated recovery of amortized cost. 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, 2011, 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 income. 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,					
	2011		2010		2009	
	Unrealized Losses	% of Total	Unrealized Losses	% of Total	Unrealized Losses	% of Total
<b>Securities available for sale:</b>						
U.S. Government agency and government-sponsored enterprise securities	\$ 5	11.9%	\$ 1,965	31.6%	\$ 545	19.8%
State and political subdivisions	11	26.2	1,472	23.6	3	0.1
Mortgage-backed securities:						
Agency mortgage-backed securities	26	61.9	2,655	42.7	1,638	59.3
Non-Agency mortgage-backed securities	-	-	-	-	330	12.0
Asset-backed securities	-	-	131	2.1	244	8.8
Total investment securities	<u>\$ 42</u>	<u>100.0%</u>	<u>\$ 6,223</u>	<u>100.0%</u>	<u>\$ 2,760</u>	<u>100.0%</u>

There were no unrealized losses on investment securities classified as held to maturity as of December 31, 2011, 2010 and 2009.

**U.S. Government Agencies and Government Sponsored Enterprises ("GSE").** As of December 31, 2011, there were five securities in the U.S. Government agencies and GSE portfolio with unrealized losses totaling \$5 thousand. Of these, four were in an unrealized loss position for 12 months or longer and had an aggregate amortized cost of \$5.3 million and unrealized losses of \$4 thousand. 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, 2011.

**State and Political Subdivisions.** As of December 31, 2011, the state and political subdivisions ("municipals") portfolio totaled \$147.7 million, of which \$124.4 million was classified as available for sale. As of that date, \$23.3 million was classified as held to maturity with a fair value of \$24.0 million. As of December 31, 2011, there were three municipals in an unrealized loss position, all of which were available for sale. Of these, one was in an unrealized loss position for 12 months or longer, and had an aggregate amortized cost of \$655 thousand and an unrealized loss of \$9 thousand.

Although there has been a considerable amount of negative information regarding municipal entities in certain states in the U.S., our portfolio is concentrated in municipalities within our geographic footprint and there is currently no indication that the underlying credit issuers (counties, towns, villages, cities, schools, etc.) are likely to default on their debt. Additionally, most of the available for sale bonds are General Obligation issues that require the taxing authority to increase taxes as needed to repay the bond holders.

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 not likely that we will 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, 2011.



## MANAGEMENT'S DISCUSSION AND ANALYSIS

**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, 2011, 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, 2011, there were six securities in the U.S. Government agencies and GSE portfolio that were in an unrealized loss position. Of these, only four were in an unrealized loss position for 12 months or longer and had an aggregate amortized cost of \$2.2 million and unrealized losses of \$8 thousand. Given the high credit quality inherent in Agency MBS, we do not consider any of the unrealized losses as of December 31, 2011, on such MBS to be credit related or other-than-temporary. As of December 31, 2011, 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 \$2.1 million and net unrealized gains of \$1.8 million as of December 31, 2011. As of that date, each of the three non-Agency MBS were rated below investment grade. None of these securities were in an unrealized loss position. During the fourth quarter of 2011 we recognized an OTTI charge of \$18 thousand against one of the non-Agency MBS.

**Asset-backed Securities ("ABS").** As of December 31, 2011, the fair value of the ABS portfolio totaled \$1.7 million and consisted of positions in eleven 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.

Since the second quarter of 2008, we have written down each of the securities in the ABS portfolio, resulting in aggregate OTTI charges of \$22.5 million through December 31, 2011. We expect to recover the remaining amortized cost of \$297 thousand on the securities. As of December 31, 2011, each of the securities in the ABS portfolio was rated below investment grade. None of these securities were in an unrealized loss position.

The market for these securities began to improve during the second quarter of 2011, resulting in substantial increases to their fair value since the beginning of the year. During that time, there were no additions to the portfolio as the increase relates solely to an increase in the fair value of the securities in the portfolio. During 2011, we recognized gains totaling \$2.3 million from the sale of four ABS securities. The four securities had a fair value of \$251 thousand at December 31, 2010. We continue to monitor the market for these securities and evaluate the potential for future dispositions.

**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. 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. At December 31, 2011, our ownership of FHLB and FRB stock totaled \$6.8 million and \$3.9 million, respectively and is included in other assets and recorded at cost.

## MANAGEMENT'S DISCUSSION AND ANALYSIS

### LENDING ACTIVITIES

Total loans were \$1.485 billion at December 31, 2011, an increase of \$138.8 million or 10% from December 31, 2010. Commercial loans increased \$63.1 million or 11% and represented 42.2% of total loans at the end of 2011. Residential mortgage loans were \$113.9 million, down \$15.7 million or 12% and represented 7.7% of total loans compared to 9.6% at December 31, 2010 while consumer loans increased \$91.3 million to represent 50.1% of total loans at December 31, 2011 and 48.5% at December 31, 2010. 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):

<b>Loan Portfolio Composition</b>										
<b>At December 31,</b>										
	<b>2011</b>		<b>2010</b>		<b>2009</b>		<b>2008</b>		<b>2007</b>	
	<b>Amount</b>	<b>Percent</b>	<b>Amount</b>	<b>Percent</b>	<b>Amount</b>	<b>Percent</b>	<b>Amount</b>	<b>Percent</b>	<b>Amount</b>	<b>Percent</b>
Commercial business	\$ 233,836	15.7 %	\$ 211,031	15.7 %	\$ 206,383	16.3 %	\$ 180,100	16.1 %	\$ 157,550	16.3 %
Commercial mortgage	393,244	26.5	352,930	26.2	330,748	26.2	285,383	25.5	272,394	28.3
Total commercial	627,080	42.2	563,961	41.9	537,131	42.5	465,483	41.6	429,944	44.6
Residential mortgage	113,911	7.7	129,580	9.6	144,215	11.4	177,683	15.8	166,863	17.3
Home equity	231,766	15.6	208,327	15.5	200,684	15.9	189,794	16.9	194,144	20.1
Consumer indirect	487,713	32.9	418,016	31.1	352,611	27.9	255,054	22.8	134,977	14.0
Other consumer	24,306	1.6	26,106	1.9	29,365	2.3	33,065	2.9	38,245	4.0
Total consumer	743,785	50.1	652,449	48.5	582,660	46.1	477,913	42.6	367,366	38.1
Total loans	1,484,776	100.0 %	1,345,990	100.0 %	1,264,006	100.0 %	1,121,079	100.0 %	964,173	100.0 %
Allowance for loan losses	23,260		20,466		20,741		18,749		15,521	
Total loans, net	<u>\$ 1,461,516</u>		<u>\$ 1,325,524</u>		<u>\$ 1,243,265</u>		<u>\$ 1,102,330</u>		<u>\$ 948,652</u>	

The decrease in residential mortgage loans from \$144.2 million to \$129.6 million to \$113.9 million for the periods ending December 31, 2009, 2010 and 2011, respectively, and the increase in consumer indirect loans from \$352.6 million to \$418.0 million to \$487.7 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 2011 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.

The Company participates in various lending programs in which guarantees are supplied by U.S. government agencies, such as the SBA, U.S. Department of Agriculture, Rural Economic and Community Development and Farm Service Agency, among others. As of December 31, 2011, the principal balance of such loans (included in commercial loans) was \$60.1 million and the guaranteed portion amounted to \$42.5 million. Most of these loans were guaranteed by the SBA.

Commercial business loans were \$233.8 million at the end of 2011, up \$22.8 million or 11% since year-end 2010, and comprised 15.7% of total loans outstanding at December 31, 2011 and 2010. 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 commercial business loans as of December 31, 2011. As of December 31, 2011, commercial business SBA loans accounted for a total of \$32.9 million or 14% of our commercial business loan portfolio.

Commercial mortgage loans totaled \$393.2 million at December 31, 2011, up \$40.3 million or 11% from December 31, 2010, and comprised 26.5% of total loans, compared to 26.2% at December 31, 2010. Commercial mortgage includes both owner occupied and non-owner occupied commercial real estate loans. Approximately 45% and 51% of the commercial mortgage portfolio at December 31, 2011 and 2010, respectively, 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. As of December 31, 2011, commercial mortgage SBA loans accounted for a total of \$20.5 million or 5% of our commercial mortgage loan portfolio.

## MANAGEMENT'S DISCUSSION AND ANALYSIS

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 85%, 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 \$113.9 million at the end of 2011, down \$15.7 million or 12% from the prior year and comprised 7.7% of total loans outstanding at December 31, 2011 and 9.6% at December 31, 2010. 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 guidelines for consumer-related real estate loans include a combination of borrower FICO (credit score), the LTV of the property securing the loan and evidence of the borrower having sufficient income to repay the loan. Currently, for home equity products, the maximum acceptable LTV is 90%. The average FICO score for new home equity production in 2011 was 755 comparable to 759 in 2010. Residential mortgage products continue to be underwritten using FHLMC and FNMA secondary marketing guidelines.

Consumer loans totaled \$743.8 million at December 31, 2011, up \$91.3 million or 14% compared to 2010, and represented 50.1% of the 2011 year-end loan portfolio versus 48.5% at year-end 2010. 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 \$487.7 million at December 31, 2011 up \$69.7 million or 17% compared to 2010, and represented 32.9% of the 2011 year-end loan portfolio versus 31.1% at year-end 2010. 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, 2011, we originated \$266.7 million in indirect loans with a mix of approximately 46% new auto and 54% used vehicles. This compares with \$204.4 million in indirect loans with a mix of approximately 33% new auto and 67% used vehicles for the same period in 2010. The increase in loans for new autos reflects changes in market conditions in 2011. We do business with nearly 400 franchised auto dealers located in Western and Central New York, the Capital District of New York and Northern Pennsylvania.

Home equity consists of home equity lines, as well as home equity loans, some of which are first lien positions. Home equities amounted to \$231.8 million at December 31, 2011 up \$23.4 million or 11% compared to 2010, and represented 15.6% of the 2011 year-end loan portfolio versus 15.5% at year-end 2010. The portfolio had a weighted average LTV at origination of approximately 53% and 52% at December 31, 2011 and 2010, respectively. Approximately 69% of the loans in the home equity portfolio are first lien positions at December 31, 2011, compared to 63% at December 31, 2010.

Other consumer loans totaled \$24.3 million at December 31, 2011, down \$1.8 million or 7% compared to 2010, and represented 1.6% of the 2011 year-end loan portfolio versus 1.9% at year-end 2010. 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, 2011, no significant concentrations, as defined above, existed in our portfolio in excess of 10% of total loans.

## MANAGEMENT'S DISCUSSION AND ANALYSIS

**Loans Held for Sale and Loan Servicing Rights.** Loans held for sale (not included in the loan portfolio composition table) were entirely comprised of residential real estate mortgages and totaled \$2.4 million and \$3.1 million as of December 31, 2011 and 2010, respectively.

We sell certain qualifying newly originated or refinanced residential real estate mortgages on the secondary market. Residential real estate mortgages serviced for others, which are not included in the consolidated statements of financial condition, amounted to \$297.8 million and \$328.9 million as of December 31, 2011 and 2010, respectively.

During 2011, we sold \$13.0 million of indirect auto loans, recognizing a gain of \$153 thousand. The loans were reclassified from portfolio to loans held for sale during the second quarter of 2011. As of December 31, 2011, a loan servicing asset for the sold and serviced indirect auto loans of \$574 thousand is included in other assets in the consolidated statements of financial condition.

### Allowance for Loan Losses

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

<b>Loan Loss Analysis</b>					
<b>Year Ended December 31,</b>					
	<b>2011</b>	<b>2010</b>	<b>2009</b>	<b>2008</b>	<b>2007</b>
Allowance for loan losses, beginning of year	\$ 20,466	\$ 20,741	\$ 18,749	\$ 15,521	\$ 17,048
Charge-offs:					
Commercial business	1,346	3,426	2,360	720	618
Commercial mortgage	751	263	355	1,192	439
Residential mortgage	152	290	225	320	319
Home equity	449	259	195	110	255
Consumer indirect	4,713	4,669	3,637	2,011	988
Other consumer	877	909	1,058	1,106	1,276
Total charge-offs	8,288	9,816	7,830	5,459	3,895
Recoveries:					
Commercial business	401	326	428	684	1,140
Commercial mortgage	245	501	150	315	216
Residential mortgage	90	21	12	26	50
Home equity	44	36	20	19	12
Consumer indirect	2,066	1,485	1,030	548	235
Other consumer	456	485	480	544	599
Total recoveries	3,302	2,854	2,120	2,136	2,252
Net charge-offs	4,986	6,962	5,710	3,323	1,643
Provision for loan losses	7,780	6,687	7,702	6,551	116
Allowance for loan losses, end of year	\$ 23,260	\$ 20,466	\$ 20,741	\$ 18,749	\$ 15,521
Net charge-offs to average loans	0.36%	0.54%	0.47%	0.32%	0.18%
Allowance to end of period loans	1.57%	1.52%	1.64%	1.67%	1.61%
Allowance to end of period non-performing loans	329%	270%	239%	229%	192%

## MANAGEMENT'S DISCUSSION AND ANALYSIS

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).

<b>Allowance for Loan Losses by Loan Category</b>										
<b>At December 31,</b>										
	<b>2011</b>		<b>2010</b>		<b>2009</b>		<b>2008</b>		<b>2007</b>	
	<b>Loan Loss Allowance</b>	<b>Percentage of loans by category to total loans</b>	<b>Loan Loss Allowance</b>	<b>Percentage of loans by category to total loans</b>	<b>Loan Loss Allowance</b>	<b>Percentage of loans by category to total loans</b>	<b>Loan Loss Allowance</b>	<b>Percentage of loans by category to total loans</b>	<b>Loan Loss Allowance</b>	<b>Percentage of loans by category to total loans</b>
Commercial business	\$ 4,036	15.7%	\$ 3,712	15.7%	\$ 4,407	16.3%	\$ 3,300	16.1%	\$ 2,505	16.3%
Commercial mortgage	6,418	26.5	6,431	26.2	6,638	26.2	4,635	25.5	4,640	28.3
Residential mortgage	858	7.7	1,013	9.6	1,251	11.4	2,516	15.8	1,763	17.3
Home equity	1,242	15.6	972	15.5	1,043	15.9	2,374	16.9	1,869	20.1
Consumer indirect	10,189	32.9	7,754	31.1	6,837	27.9	5,152	22.8	2,284	14.0
Other consumer	517	1.6	584	1.9	565	2.3	772	2.9	798	4.0
Unallocated <sup>(1)</sup>	-	-	-	-	-	-	-	-	1,662	-
<b>Total</b>	<b>\$ 23,260</b>	<b>100.0%</b>	<b>\$ 20,466</b>	<b>100.0%</b>	<b>\$ 20,741</b>	<b>100.0%</b>	<b>\$ 18,749</b>	<b>100.0%</b>	<b>\$ 15,521</b>	<b>100.0%</b>

<sup>(1)</sup> 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, 2011 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 "Business" in the section titled "Lending Activities". See also "Critical Accounting Estimates" 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):

<b>Non-performing Assets</b>					
<b>At December 31,</b>					
	<b>2011</b>	<b>2010</b>	<b>2009</b>	<b>2008</b>	<b>2007</b>
Non-accruing loans:					
Commercial business	\$ 1,259	\$ 947	\$ 650	\$ 510	\$ 839
Commercial mortgage	2,928	3,100	2,288	2,670	3,294
Residential mortgage	1,644	2,102	2,376	3,365	2,987
Home equity	682	875	880	1,143	661
Consumer indirect	558	514	621	445	278
Other consumer	-	41	7	56	16
Total non-accruing loans	7,071	7,579	6,822	8,189	8,075
Restructured accruing loans	-	-	-	-	-
Accruing loans contractually past due over 90 days	5	3	1,859	7	2
Total non-performing loans	7,076	7,582	8,681	8,196	8,077
Foreclosed assets	475	741	746	1,007	1,421
Non-performing investment securities	1,636	572	1,015	49	-
Total non-performing assets	\$ 9,187	\$ 8,895	\$ 10,442	\$ 9,252	\$ 9,498
Non-performing loans to total loans	0.48%	0.56%	0.69%	0.73%	0.84%
Non-performing assets to total assets	0.39%	0.40%	0.51%	0.48%	0.51%

## MANAGEMENT'S DISCUSSION AND ANALYSIS

Non-performing assets include non-performing loans, foreclosed assets and non-performing investment securities. Non-performing assets at December 31, 2011 were \$9.2 million, an increase of \$292 thousand from the \$8.9 million balance at December 31, 2010. The primary component of non-performing assets is non-performing loans, which were \$7.1 million at December 31, 2011, a decrease of \$508 thousand from the \$7.6 million balance at December 31, 2010.

Approximately \$3.1 million, or 44%, of the \$7.1 million in non-performing loans as of December 31, 2011 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, 2011, the amount of interest income forgone totaled \$438 thousand. Included in nonaccrual loans are troubled debt restructurings ("TDRs") of \$90 thousand at December 31, 2011. We had no TDRs that were accruing interest as of December 31, 2011.

The ratio of non-performing loans to total loans was 0.48% at December 31, 2011, compared to 0.56% at December 31, 2010. This ratio continues to compare favorably to the average of our peer group, which was 3.26% of total loans at September 30, 2011, the most recent period for which information is available (Source: Federal Financial Institutions Examination Council - Bank Holding Company Performance Report as of September 30, 2011 - Top-tier bank holding companies having consolidated assets between \$1 billion and \$3 billion).

Foreclosed assets consist of real property formerly pledged as collateral to loans, which we have acquired through foreclosure proceedings or acceptance of a deed in lieu of foreclosure. Foreclosed asset holdings represented 8 properties totaling \$475 thousand at December 31, 2011 and 13 properties totaling \$741 thousand at December 31, 2010.

Non-performing investment securities for which we have stopped accruing interest were \$1.6 million at December 31, 2011, compared to \$572 thousand at December 31, 2010. Non-performing investment securities are included in non-performing assets at fair value and represent pooled trust preferred securities. The market for these securities began to improve during the second quarter of 2011, resulting in substantial increases to their fair value since the beginning of the year. There have been no securities transferred to non-performing status since the first quarter of 2009. During 2011, we recognized gains of \$2.3 million from the sale of four of the 14 securities classified as non-performing at December 31, 2010. The securities had a fair value of \$251 thousand at December 31, 2010.

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 \$8.6 million and \$11.5 million in loans that continued to accrue interest which were classified as substandard as of December 31, 2011 and 2010, respectively.



## MANAGEMENT'S DISCUSSION AND ANALYSIS

### FUNDING ACTIVITIES

#### Deposits

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

	At December 31,					
	2011		2010		2009	
	Amount	Percent	Amount	Percent	Amount	Percent
Noninterest-bearing demand	\$ 393,421	20.3 %	\$ 350,877	18.6 %	\$ 324,303	18.6 %
Interest-bearing demand	362,555	18.8	374,900	19.9	363,698	20.9
Savings and money market	474,947	24.6	417,359	22.2	368,603	21.1
Certificates of deposit < \$100,000	486,496	25.2	555,840	29.5	512,969	29.5
Certificates of deposit of \$100,000 or more	214,180	11.1	183,914	9.8	173,382	9.9
Total deposits	<u>\$ 1,931,599</u>	<u>100.0 %</u>	<u>\$ 1,882,890</u>	<u>100.0 %</u>	<u>\$ 1,742,955</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, 2011, total deposits were \$1.932 billion, representing an increase of \$48.7 million for the year. Certificates of deposit were approximately 36% and 39% of total deposits at December 31, 2011 and 2010, respectively. Depositors were hesitant to invest in certificates of deposit for long periods due to the low rate environment and, as a result, reduced both the amount they placed in time deposits and the maturity terms.

Nonpublic deposits, the largest component of our funding sources, represented 80% of total deposits and totaled \$1.541 billion and \$1.501 billion as of December 31, 2011 and 2010, 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.

We had no traditional brokered deposits at December 31, 2011 or 2010, however, we do participate in the Certificate of Deposit Account Registry Service ("CDARS") program, which enables depositors to receive FDIC insurance coverage for deposits otherwise exceeding the maximum insurable amount. Through the CDARS program, deposits in excess of the maximum insurable amount are placed with multiple participating financial institutions. Reciprocal CDARS deposits totaled \$46.5 million at December 31, 2011.

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, because the level of deposits varies with the seasonal cash flows for these public customers. We maintain the necessary levels of short-term liquid assets to accommodate the seasonality associated with public deposits. As of December 31, 2011, total public deposits were \$390.2 million or 20% of total deposits, compared to \$382.2 million or 20% of total deposits, as of December 31, 2010. In general, the number of public relationships remained stable in comparison to the prior year.

#### Borrowings

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

	2011	2010
Short-term borrowings:		
Federal funds purchased	\$ 11,597	\$ 38,200
Repurchase agreements	36,301	38,910
Short-term FHLB borrowings	102,800	-
Total short-term borrowings	<u>150,698</u>	<u>77,110</u>
Long-term borrowings:		
FHLB advances and repurchase agreements	-	10,065
Junior subordinated debentures	-	16,702
Total long-term borrowings	<u>-</u>	<u>26,767</u>
Total borrowings	<u>\$ 150,698</u>	<u>\$ 103,877</u>

We classify borrowings as short-term or long-term in accordance with the original terms of the agreement.

## MANAGEMENT'S DISCUSSION AND ANALYSIS

We have credit capacity with the FHLB and can borrow through facilities that include amortizing and term advances or repurchase agreements. We had approximately \$36 million of immediate credit capacity with FHLB as of December 31, 2011. We had approximately \$387 million in secured borrowing capacity at the Federal Reserve Bank ("FRB") Discount Window, none of which was outstanding at December 31, 2011. The FHLB and FRB credit capacity are collateralized by securities from our investment portfolio and certain qualifying loans. We had approximately \$107 million of credit available under unsecured federal funds purchased lines with various banks as of December 31, 2011.

Funds are borrowed on an overnight basis through retail repurchase agreements with bank customers and federal funds purchased from other financial institutions. Retail repurchase agreement borrowings are collateralized by securities of U.S. Government agencies. Federal funds purchased are short-term borrowings that typically mature within one to ninety days. Federal funds purchased totaled \$11.6 million and \$38.2 million at December 31, 2011 and 2010, respectively. Repurchase agreements are secured overnight borrowings with customers. These short-term repurchase agreements amounted to \$36.3 million and \$38.9 million as of December 31, 2011 and 2010, respectively. Short-term FHLB borrowings have original maturities of less than one year and include overnight borrowings which we typically utilizes to address short term funding needs as they arise. Short-term FHLB borrowings at December 31, 2011 consisted of \$65.0 million in overnight borrowings and \$37.8 million in short-term advances.

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

	<b>At or for the Year Ended December 31,</b>		
	<b>2011</b>	<b>2010</b>	<b>2009</b>
Year-end balance	\$ 150,698	\$ 77,110	\$ 59,543
Year-end weighted average interest rate	0.39 %	0.21 %	0.59 %
Maximum outstanding at any month-end	\$ 188,355	\$ 77,110	\$ 85,912
Average balance during the year	\$ 99,122	\$ 49,104	\$ 43,092
Average interest rate for the year	0.50 %	0.74 %	0.63 %

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 10.20% junior subordinated debentures. The \$10.1 million of outstanding FHLB advances and repurchase agreements at December 31, 2010 were repaid upon maturity during 2011. During the third quarter of 2011, we redeemed all of the junior subordinated debentures and recognized a \$1.1 million loss on the extinguishment of debt.

### Shareholders' Equity

Total shareholders' equity was \$237.2 million at December 31, 2011, an increase of \$25.1 million from \$212.1 million at December 31, 2010. During February 2011, we redeemed \$12.5 million of Series A preferred stock issued to the U.S. Treasury. During March 2011, we successfully completed a follow-on common equity offering, issuing 2,813,475 shares of common stock at a price of \$16.35 per share before associated offering expenses. After deducting underwriting and other offering costs, we received net proceeds of approximately \$43.1 million. Prior to the end of the first quarter of 2011, we utilized a portion of the net proceeds to redeem the remaining \$25.0 million in Series A preferred stock. The warrant issued to the Treasury was repurchased for \$2.1 million during the second quarter of 2011 and recorded as a reduction of additional paid-in capital. 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, 2011, 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, 2011 and 2010. 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. We performed the annual goodwill impairment test as of September 30, 2011 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 statements of financial condition be designated as impaired and that we may incur a goodwill write-down in the future.

## MANAGEMENT'S DISCUSSION AND ANALYSIS

### 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.

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 \$57.6 million as of December 31, 2011, up from \$39.1 million as of December 31, 2010. Our net cash provided by operating activities totaled \$32.0 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 \$104.9 million, which included outflows for net loan origination funding of \$157.1 million and inflows from net securities transactions of \$60.3 million. Net cash provided by financing activities of \$91.4 million was attributed to a \$48.7 million increase in deposits, a \$73.6 million increase in short-term borrowings and \$43.1 million in net proceeds from the issuance of common stock, partly offset by the \$37.5 million payment to redeem the Series A preferred stock, \$26.8 million of long-term debt repayments and \$7.6 million in dividend payments.

### Contractual Obligations and Other Commitments

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

	At December 31, 2011				
	Within 1 year	Over 1 to 3 years	Over 3 to 5 Years	Over 5 years	Total
<b>On-Balance sheet:</b>					
Certificates of deposit <sup>(1)</sup>	\$ 547,874	\$ 102,661	\$ 50,000	\$ 141	\$ 700,676
Supplemental executive retirement plans	159	318	318	549	1,344
<b>Off-Balance sheet:</b>					
Limited partnership investments <sup>(2)</sup>	\$ 594	\$ 1,187	\$ 593	\$ -	\$ 2,374
Commitments to extend credit <sup>(3)</sup>	374,266	-	-	-	374,266
Standby letters of credit <sup>(3)</sup>	5,488	2,512	855	-	8,855
Operating leases	1,242	2,066	1,889	4,963	10,160

<sup>(1)</sup> Includes the maturity of certificates of deposit amounting to \$100 thousand or more as follows: \$77.7 million in three months or less; \$32.4 million between three months and six months; \$57.7 million between six months and one year; and \$46.4 million over one year.

<sup>(2)</sup> We have committed to capital investments in several limited partnerships of up to \$6.1 million, of which we have contributed \$3.7 million as of December 31, 2011, including \$407 thousand during 2011.

<sup>(3)</sup> 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 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.

## MANAGEMENT'S DISCUSSION AND ANALYSIS

### 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, 2011. 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
<b>Available for sale debt securities:</b>										
U.S. Government agencies and government-sponsored enterprises	\$ 13,574	1.42%	\$ 32,137	2.21%	\$ 34,289	2.32%	\$ 14,947	0.86%	\$ 94,947	1.93%
State and political subdivisions	9,573	3.57	43,534	2.67	65,992	2.44	-	-	119,099	2.62
Mortgage-backed securities	878	4.52	5,812	3.82	83,358	1.77	300,654	3.49	390,702	3.13
Asset-backed securities	-	-	-	-	-	-	297	-	297	-
	<u>24,025</u>	<u>2.39</u>	<u>81,483</u>	<u>2.57</u>	<u>183,639</u>	<u>2.11</u>	<u>315,898</u>	<u>3.49</u>	<u>605,045</u>	<u>2.91</u>
<b>Held to maturity debt securities:</b>										
State and political subdivisions	18,496	2.35	3,763	4.26	905	4.90	133	5.53	23,297	2.77
	<u>\$ 42,521</u>	<u>2.37%</u>	<u>\$ 85,246</u>	<u>2.64%</u>	<u>\$ 184,544</u>	<u>2.13%</u>	<u>\$ 316,031</u>	<u>3.49%</u>	<u>\$ 628,342</u>	<u>2.90%</u>

### Contractual Loan Maturity Schedule

The following table summarizes the contractual maturities of our loan portfolio at December 31, 2011. 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	\$ 135,627	\$ 82,926	\$ 15,283	\$ 233,836
Commercial mortgage	109,782	187,205	96,257	393,244
Residential mortgage	28,673	56,585	28,653	113,911
Home equity	46,468	105,726	79,572	231,766
Consumer indirect	161,053	310,214	16,446	487,713
Other consumer	10,375	12,509	1,422	24,306
Total loans	<u>\$ 491,978</u>	<u>\$ 755,165</u>	<u>\$ 237,633</u>	<u>\$ 1,484,776</u>

#### Loans maturing after one year:

With a predetermined interest rate	\$ 225,553	\$ 157,596	\$ 383,149
With a floating or adjustable rate	<u>529,612</u>	<u>80,037</u>	<u>609,649</u>
Total loans maturing after one year	<u>\$ 755,165</u>	<u>\$ 237,633</u>	<u>\$ 992,798</u>

## MANAGEMENT'S DISCUSSION AND ANALYSIS

### 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):

	<b>2011</b>	<b>2010</b>
Total shareholders' equity	\$ 237,194	\$ 212,144
Less: Unrealized gain on securities available for sale, net of tax	13,570	1,877
Unrecognized net periodic pension & postretirement benefits (costs), net of tax	(12,625)	(6,599)
Disallowed goodwill and other intangible assets	37,369	37,369
Disallowed deferred tax assets	1,794	14,608
Plus: Qualifying trust preferred securities	-	16,200
Tier 1 capital	<u>\$ 197,086</u>	<u>\$ 181,089</u>
Adjusted average total assets (for leverage capital purposes)	<u>\$ 2,282,755</u>	<u>\$ 2,177,911</u>
Tier 1 leverage ratio (Tier 1 capital to adjusted average total assets)	8.63%	8.31%
Total Tier 1 capital	\$ 197,086	\$ 181,089
Plus: Qualifying allowance for loan losses	<u>20,239</u>	<u>18,363</u>
Total risk-based capital	<u>\$ 217,325</u>	<u>\$ 199,452</u>
Net risk-weighted assets	<u>\$ 1,616,119</u>	<u>\$ 1,466,957</u>
Tier 1 capital ratio (Tier 1 capital to net risk-weighted assets)	12.20%	12.34%
Total risk-based capital ratio (Total risk-based capital to net risk-weighted assets)	13.45%	13.60%

### 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.

## MANAGEMENT'S DISCUSSION AND ANALYSIS

### **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 titled "Allowance for Loan Losses" 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.

### **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. We complete our 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, our 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 income. 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 our 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.



## MANAGEMENT'S DISCUSSION AND ANALYSIS

### 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 for which 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 income 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.

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## QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

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### 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, 2011 (dollars in thousands):

Changes in interest rate	Net Interest Income				Economic Value of Equity				
	Amount		Change		Amount		Change		
+ 300 basis points	\$	85,243	\$	2,621	3.17%	\$	343,691	\$ (19,853)	(5.46)%
+ 200 basis points		84,298		1,676	2.03		354,626	(8,918)	(2.45)
+ 100 basis points		83,050		429	0.52		361,887	(1,656)	(0.46)
- 100 basis points		80,484		(2,138)	(2.59)		385,220	21,677	5.96

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, 2011, a 100 basis point increase in rates would increase net interest income by \$429 thousand, or 0.5%, over the next twelve-month period. A 100 basis point decrease in rates would decrease net interest income by \$2.1 million, or 2.6%, over a twelve-month period. As of December 31, 2011, a 100 basis point increase in rates would decrease the economic value of equity by \$1.7 million, or 0.5%, over the next twelve-month period. A 100 basis point decrease in rates would increase the economic value of equity by \$21.7 million, or 6.0%, 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, 2011. 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. 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, 2011				
	Three Months or Less	Over Three Months Through One Year	Over One Year Through Five Years	Over Five Years	Total
<b>INTEREST-EARNING ASSETS:</b>					
Federal funds sold and interest-earning deposits in other banks	\$ -	\$ 94	\$ -	\$ -	\$ 94
Investment securities	117,520	144,472	254,640	111,710	628,342
Loans	469,602	257,217	667,411	92,956	1,487,186
Total interest-earning assets	<u>\$ 587,122</u>	<u>\$ 401,783</u>	<u>\$ 922,051</u>	<u>\$ 204,666</u>	<u>2,115,622</u>
Cash and due from banks					57,489
Other assets <sup>(1)</sup>					163,242
Total assets					<u>\$ 2,336,353</u>
<b>INTEREST-BEARING LIABILITIES:</b>					
Interest-bearing demand, savings and money market	\$ 837,502	\$ -	\$ -	\$ -	\$ 837,502
Certificates of deposit	183,321	364,553	152,661	141	700,676
Borrowings	130,698	20,000	-	-	150,698
Total interest-bearing liabilities	<u>\$ 1,151,521</u>	<u>\$ 384,553</u>	<u>\$ 152,661</u>	<u>\$ 141</u>	<u>1,688,876</u>
Noninterest-bearing deposits					393,421
Other liabilities					16,862
Total liabilities					2,099,159
Shareholders' equity					237,194
Total liabilities and shareholders' equity					<u>\$ 2,336,353</u>
Interest sensitivity gap	<u>\$ (564,399)</u>	<u>\$ 17,230</u>	<u>\$ 769,390</u>	<u>\$ 204,525</u>	<u>\$ 426,746</u>
Cumulative gap	<u>\$ (564,399)</u>	<u>\$ (547,169)</u>	<u>\$ 222,221</u>	<u>\$ 426,746</u>	
Cumulative gap ratio <sup>(2)</sup>	51.0 %	64.4 %	113.2 %	125.3 %	
Cumulative gap as a percentage of total assets	(24.2) %	(23.4) %	9.5 %	18.3 %	

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

<sup>(2)</sup> 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**  
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## 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 U.S. generally accepted accounting principles.

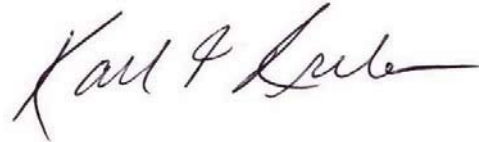
Any system of internal control over financial reporting, no matter how well designed, has inherent limitations, including the possibility that a control can be circumvented or overridden and misstatements due to error or fraud may occur and not be detected. Also, because of changes in conditions, internal 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, 2011. 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, 2011, 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, 2011. That report appears herein.



President and Chief Executive Officer  
March 9, 2012



Executive Vice President and Chief Financial Officer  
March 9, 2012



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, 2011, 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.

In our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2011, 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, 2011 and 2010, and the related consolidated statements of income, changes in shareholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2011, and our report dated March 9, 2012 expressed an unqualified opinion on those consolidated financial statements.

**KPMG LLP**

Rochester, New York  
March 9, 2012





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, 2011 and 2010, and the related consolidated statements of income, changes in shareholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2011. 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, 2011 and 2010, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2011, 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, 2011, 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 9, 2012 expressed an unqualified opinion on the effectiveness of the Company's internal control over financial reporting.

**KPMG LLP**

Rochester, New York  
March 9, 2012

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

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

	<b>December 31,</b>	
	<b>2011</b>	<b>2010</b>
<b>ASSETS</b>		
Cash and cash equivalents:		
Cash and due from banks	\$ 57,489	\$ 38,964
Federal funds sold and interest-bearing deposits in other banks	94	94
Total cash and cash equivalents	57,583	39,058
Securities available for sale, at fair value	627,518	666,368
Securities held to maturity, at amortized cost (fair value of \$23,964 and \$28,849, respectively)	23,297	28,162
Loans held for sale	2,410	3,138
Loans (net of allowance for loan losses of \$23,260 and \$20,466, respectively)	1,461,516	1,325,524
Company owned life insurance	45,556	26,053
Premises and equipment, net	33,085	33,263
Goodwill	37,369	37,369
Other assets	48,019	55,372
Total assets	<u>\$ 2,336,353</u>	<u>\$ 2,214,307</u>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Deposits:		
Noninterest-bearing demand	\$ 393,421	\$ 350,877
Interest-bearing demand	362,555	374,900
Savings and money market	474,947	417,359
Certificates of deposit	700,676	739,754
Total deposits	1,931,599	1,882,890
Short-term borrowings	150,698	77,110
Long-term borrowings	-	26,767
Other liabilities	16,862	15,396
Total liabilities	2,099,159	2,002,163
Commitments and contingencies (Note 9)		
Shareholders' equity:		
Series A 3% preferred stock, \$100 par value; 1,533 shares authorized; 1,500 and 1,533 shares issued, respectively	150	153
Series A preferred stock, \$5,000 liquidation preference per share, 7,503 shares authorized; 7,503 shares issued at December 31, 2010	-	36,210
Series B-1 8.48% preferred stock, \$100 par value, 200,000 shares authorized; 173,235 and 174,223 shares issued, respectively	17,323	17,422
Total preferred equity	17,473	53,785
Common stock, \$0.01 par value, 50,000,000 shares authorized; 14,161,597 and 11,348,122 shares issued, respectively	142	113
Additional paid-in capital	67,247	26,029
Retained earnings	158,079	144,599
Accumulated other comprehensive income (loss)	945	(4,722)
Treasury stock, at cost – 358,481 and 410,616 shares, respectively	(6,692)	(7,660)
Total shareholders' equity	237,194	212,144
Total liabilities and shareholders' equity	<u>\$ 2,336,353</u>	<u>\$ 2,214,307</u>

See accompanying notes to the consolidated financial statements.

**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**  
**Consolidated Statements of Income**

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

	Years ended December 31,		
	2011	2010	2009
Interest income:			
Interest and fees on loans	\$ 77,105	\$ 75,877	\$ 72,706
Interest and dividends on investment securities	18,013	20,622	21,694
Other interest income	-	10	82
Total interest income	95,118	96,509	94,482
Interest expense:			
Deposits	11,434	14,853	19,090
Short-term borrowings	500	365	270
Long-term borrowings	1,321	2,502	2,857
Total interest expense	13,255	17,720	22,217
Net interest income	81,863	78,789	72,265
Provision for loan losses	7,780	6,687	7,702
Net interest income after provision for loan losses	74,083	72,102	64,563
Noninterest income:			
Service charges on deposits	8,679	9,585	10,065
ATM and debit card	4,359	3,995	3,610
Broker-dealer fees and commissions	1,829	1,283	1,022
Company owned life insurance	1,424	1,107	1,096
Loan servicing	835	1,124	1,308
Net gain on sale of loans held for sale	880	650	699
Net gain on sales and calls of investment securities	3,003	169	3,429
Impairment charges on investment securities	(18)	(594)	(4,666)
Net gain (loss) on sale and disposal of other assets	67	(203)	180
Other	2,867	2,338	2,052
Total noninterest income	23,925	19,454	18,795
Noninterest expense:			
Salaries and employee benefits	35,439	32,811	33,634
Occupancy and equipment	10,868	10,818	11,062
Computer and data processing	2,437	2,487	2,340
Professional services	2,617	2,197	2,524
Supplies and postage	1,778	1,772	1,846
FDIC assessments	1,513	2,507	3,651
Advertising and promotions	1,259	1,121	949
Loss on extinguishment of debt	1,083	-	-
Other	6,800	7,204	6,771
Total noninterest expense	63,794	60,917	62,777
Income before income taxes	34,214	30,639	20,581
Income tax expense	11,415	9,352	6,140
Net income	\$ 22,799	\$ 21,287	\$ 14,441
Preferred stock dividends	1,877	3,358	3,160
Accretion of discount on Series A preferred stock	1,305	367	537
Net income available to common shareholders	\$ 19,617	\$ 17,562	\$ 10,744
Earnings per common share (Note 15):			
Basic	\$ 1.50	\$ 1.62	\$ 0.99
Diluted	\$ 1.49	\$ 1.61	\$ 0.99
Cash dividends declared per common share	\$ 0.47	\$ 0.40	\$ 0.40
Weighted average common shares outstanding:			
Basic	13,067	10,767	10,730
Diluted	13,157	10,845	10,769

See accompanying notes to the consolidated financial statements.

**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**  
**Consolidated Statements of Changes in Shareholders' Equity**  
**Years ended December 31, 2011, 2010 and 2009**

*(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
<b>Balance at January 1, 2009</b>	<b>\$ 53,074</b>	<b>\$ 113</b>	<b>\$ 26,397</b>	<b>\$ 124,952</b>	<b>\$ (4,013)</b>	<b>\$ (10,223)</b>	<b>\$ 190,300</b>
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)
<b>Balance at December 31, 2009</b>	<b>\$ 53,418</b>	<b>\$ 113</b>	<b>\$ 26,940</b>	<b>\$ 131,371</b>	<b>\$ (3,702)</b>	<b>\$ (9,846)</b>	<b>\$ 198,294</b>
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)
<b>Balance at December 31, 2010</b>	<b>\$ 53,785</b>	<b>\$ 113</b>	<b>\$ 26,029</b>	<b>\$ 144,599</b>	<b>\$ (4,722)</b>	<b>\$ (7,660)</b>	<b>\$ 212,144</b>

*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, 2011, 2010 and 2009**

*(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
<b>Balance at December 31, 2010</b>	<b>\$ 53,785</b>	<b>\$ 113</b>	<b>\$ 26,029</b>	<b>\$ 144,599</b>	<b>\$ (4,722)</b>	<b>\$ (7,660)</b>	<b>\$ 212,144</b>
<i>Balance carried forward</i>							
Comprehensive income:							
Net income	-	-	-	22,799	-	-	22,799
Other comprehensive income, net of tax	-	-	-	-	5,667	-	5,667
Total comprehensive income							28,466
Issuance of common stock	-	29	43,098	-	-	-	43,127
Purchases of treasury stock	-	-	-	-	-	(215)	(215)
Repurchase of Series A 3% preferred stock	(3)	-	-	-	-	-	(3)
Repurchase of warrant issued to U.S. Treasury	-	-	(2,080)	-	-	-	(2,080)
Redemption of Series A preferred stock	(37,515)	-	68	-	-	-	(37,447)
Repurchase of Series B-1 8.48% preferred stock	(99)	-	-	-	-	-	(99)
Share-based compensation plans:							
Share-based compensation	-	-	1,105	-	-	-	1,105
Stock options exercised	-	-	(28)	-	-	119	91
Restricted stock awards issued, net	-	-	(954)	-	-	954	-
Excess tax benefit on share-based compensation	-	-	21	-	-	-	21
Directors' retainer	-	-	(12)			110	98
Accretion of discount on Series A preferred stock	1,305	-	-	(1,305)	-	-	-
Cash dividends declared:							
Series A 3% preferred-\$3.00 per share	-	-	-	(5)	-	-	(5)
Series A preferred-\$53.24 per share	-	-	-	(399)	-	-	(399)
Series B-1 8.48% preferred-\$8.48 per share	-	-	-	(1,473)	-	-	(1,473)
Common-\$0.47 per share	-	-	-	(6,137)	-	-	(6,137)
<b>Balance at December 31, 2011</b>	<b>\$ 17,473</b>	<b>\$ 142</b>	<b>\$ 67,247</b>	<b>\$ 158,079</b>	<b>\$ 945</b>	<b>\$ (6,692)</b>	<b>\$ 237,194</b>

See accompanying notes to the consolidated financial statements.

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

*(Dollars in thousands)*

	<b>Years ended December 31,</b>		
	<b>2011</b>	<b>2010</b>	<b>2009</b>
Cash flows from operating activities:			
Net income	\$ 22,799	\$ 21,287	\$ 14,441
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	3,466	3,537	4,067
Net amortization of premiums on securities	5,722	3,005	2,587
Provision for loan losses	7,780	6,687	7,702
Share-based compensation	1,105	1,031	854
Deferred income tax expense	6,510	2,468	7,470
Proceeds from sale of loans held for sale	32,839	42,195	90,290
Originations of loans held for sale	(31,231)	(44,262)	(88,999)
Net gain on sale of loans held for sale	(880)	(650)	(699)
Increase in company owned life insurance	(1,424)	(1,107)	(1,096)
Net gain on sales and calls of investment securities	(3,003)	(169)	(3,429)
Impairment charges on investment securities	18	594	4,666
Net (gain) loss on sale and disposal of other assets	(67)	203	(180)
Loss on extinguishment of debt	1,083	-	-
Increase in other assets	(7,756)	(353)	(8,773)
(Decrease) increase in other liabilities	(4,943)	961	(6,633)
Net cash provided by operating activities	<u>32,018</u>	<u>35,427</u>	<u>22,268</u>
Cash flows from investing activities:			
Purchases of investment securities:			
Available for sale	(158,013)	(430,952)	(602,259)
Held to maturity	(17,188)	(19,791)	(29,280)
Proceeds from principal payments, maturities and calls on investment securities:			
Available for sale	168,976	219,974	353,545
Held to maturity	21,986	30,885	46,891
Proceeds from sales and calls of securities available for sale	44,514	122,090	224,928
Net increase in loans, excluding sales	(157,110)	(89,507)	(165,716)
Loans sold	13,033	-	-
Purchases of company owned life insurance	(18,079)	(79)	(79)
Proceeds from sales of other assets	705	611	1,709
Purchases of premises and equipment	(3,678)	(2,438)	(1,959)
Net cash used in investing activities	<u>(104,854)</u>	<u>(169,207)</u>	<u>(172,220)</u>
Cash flows from financing activities:			
Net increase in deposits	48,709	139,935	109,692
Net increase in short-term borrowings	73,588	17,567	36,078
Repayments of long-term borrowings	(26,767)	(20,080)	(508)
Proceeds from issuance of common stock, net of issuance costs	43,127	-	-
Purchases of common stock for treasury	(215)	(69)	-
Repurchase of Series A 3% preferred stock	(3)	-	-
Issuance costs of Series A preferred stock	-	-	(68)
Repurchase of warrant issued to U.S. Treasury	(2,080)	-	-
Redemption of Series A preferred stock	(37,447)	-	-
Repurchase of Series B-1 8.48% preferred stock	(99)	-	-
Proceeds from stock options exercised	91	216	15
Excess tax benefit on share-based compensation	21	-	-
Cash dividends paid to preferred shareholders	(2,118)	(3,358)	(3,160)
Cash dividends paid to common shareholders	(5,446)	(4,332)	(4,325)
Net cash provided by financing activities	<u>91,361</u>	<u>129,879</u>	<u>137,724</u>
Net increase (decrease) in cash and cash equivalents	<u>18,525</u>	<u>(3,901)</u>	<u>(12,228)</u>
Cash and cash equivalents, beginning of period	<u>39,058</u>	<u>42,959</u>	<u>55,187</u>
Cash and cash equivalents, end of period	<u>\$ 57,583</u>	<u>\$ 39,058</u>	<u>\$ 42,959</u>

See accompanying notes to the consolidated financial statements.



**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**December 31, 2011, 2010 and 2009**

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

Financial Institutions, Inc., a financial holding company organized under the laws of New York State (“New York” or “NYS”), and its subsidiaries provide deposit, lending and other financial services to individuals and businesses in Central and Western New York. The Company has also expanded its indirect lending network to include relationships with franchised automobile dealers in the Capital District of New York and Northern Pennsylvania. The Company owns all of the capital stock of Five Star Bank, a New York State chartered bank, and Five Star Investment Services, Inc., a broker-dealer and investment advisor subsidiary offering noninsured investment products. 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 Company has evaluated events and transactions for potential recognition or disclosure through the day the financial statements were issued.

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. 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, the carrying value of goodwill and deferred tax assets, the valuation and other than temporary impairment (“OTTI”) considerations related to the securities portfolio, and assumptions used in the defined benefit pension plan accounting. 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):

	<b>2011</b>	<b>2010</b>	<b>2009</b>
Cash paid (received) during the year for:			
Interest expense	\$ 15,668	\$ 17,676	\$ 21,682
Income taxes, net of income tax refunds	5,191	6,923	(1,312)
Non-cash activity:			
Real estate and other assets acquired in settlement of loans	\$ 305	\$ 561	\$ 1,096
Dividends declared and unpaid	2,144	1,694	1,692
Decrease in net unsettled security purchases	(67)	(317)	(1,348)
Loans securitized	-	-	15,983

**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**December 31, 2011, 2010 and 2009**

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

***(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.

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 to identify a mortgage 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 income.

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 income 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. The Company recognized an impairment loss of \$35 thousand during the year ended December 31, 2011. No impairment loss was recognized during the years ended December 31, 2010 or 2009.

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 income) 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.

**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**December 31, 2011, 2010 and 2009**

**(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 may be 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, standby 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, 2011 had original terms ranging from one to five years.

**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**December 31, 2011, 2010 and 2009**

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

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.

***(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. Impaired 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, 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.

**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**December 31, 2011, 2010 and 2009**

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

***(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, 2011 was \$475 thousand.

***(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 income. 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 software, 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 year ended December 31, 2009 was \$280 thousand. 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).



**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
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**(1.) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

***(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 income.

As a member of the FHLB system, the Company is required to maintain a specified investment in FHLB of New York (“FHLB NY”) stock in proportion to its volume of certain transactions with the FHLB. FHLB NY stock totaled \$6.8 million and \$2.5 million as of December 31, 2011 and 2010, 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, 2011 and 2010.

***(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 \$4.0 million and \$3.6 million as of December 31, 2011 and 2010, respectively.

***(o.) Treasury Stock***

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

***(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 income.

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.

***(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 income 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.



**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**  
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**(1.) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

**(s.) Earnings Per Common Share**

The Company calculates earnings per common share ("EPS") using the two-class method in accordance with Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") Topic 260, "Earnings Per Share". The two-class method requires the Company to present EPS as if all of the earnings for the period are distributed to common shareholders and any participating securities, regardless of whether any actual dividends or distributions are made. All outstanding unvested share-based payment awards that contain rights to nonforfeitable dividends are considered participating securities. Certain of the restricted shares issued under the Company's share-based compensation plan are entitled to dividends at the same rate as common stock. The Company has determined that these outstanding non-vested stock awards qualify as participating securities.

Basic EPS is computed by dividing distributed and undistributed earnings available to common shareholders by the weighted average number of common shares outstanding for the period. Distributed and undistributed earnings available to common shareholders represent net income reduced by preferred stock dividends and distributed and undistributed earnings available to participating securities. Common shares outstanding include common stock and vested restricted stock awards. Diluted EPS reflects the assumed conversion of all potential dilutive securities. 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 Per Common Share.

**(t.) Recent Accounting Pronouncements**

In December 2011, the Financial Accounting Standard Board ("FASB") issued Accounting Standards Update ("ASU") 2011-12 "*Comprehensive Income (Topic 220) — Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05.*" ASU 2011-12 defers changes in ASU No. 2011-05 that relate to the presentation of reclassification adjustments to allow the FASB time to reconsider whether to require presentation of such adjustments on the face of the financial statements to show the effects of reclassifications out of accumulated other comprehensive income on the components of net income and other comprehensive income. ASU 2011-12 allows entities to continue to report reclassifications out of accumulated other comprehensive income consistent with the presentation requirements in effect before ASU No. 2011-05. All other requirements in ASU No. 2011-05 are not affected by ASU No. 2011-12. ASU 2011-12 is effective for annual and interim periods beginning after December 15, 2011 and is not expected to have a material impact on the Company's consolidated financial statements.

In November 2011, the FASB issued ASU 2011-11 "*Balance Sheet (Topic 210) - Disclosures about Offsetting Assets and Liabilities.*" ASU 2011-11 amends Topic 210, "*Balance Sheet,*" to require an entity to disclose both gross and net information about financial instruments, such as sales and repurchase agreements and reverse sale and repurchase agreements and securities borrowing/lending arrangements, and derivative instruments that are eligible for offset in the statement of financial position and/or subject to a master netting arrangement or similar agreement. ASU 2011-11 is effective for annual and interim periods beginning on January 1, 2013, and is not expected to have a material impact on the Company's consolidated financial statements.

In September 2011, the FASB issued ASU No. 2011-08 "*Testing Goodwill for Impairment.*" The provisions of ASU 2011-08 permit an entity the option to first perform a qualitative assessment to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount. If an entity believes, as a result of its qualitative assessment, that it is more likely than not that the fair value of a reporting unit is less than its carrying amount, the quantitative impairment test is required. Otherwise, no further impairment testing is required. ASU No. 2011-08 includes examples of events and circumstances that may indicate that a reporting unit's fair value is less than its carrying amount. The provisions of ASU No. 2011-08 are effective for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011. Early adoption is permitted provided that the entity has not yet performed its annual impairment test for goodwill. The Company performs its annual impairment test for goodwill as of September 30 of each year. The adoption of ASU No. 2011-08 is not expected to have a material impact on the Company's consolidated financial statements.

**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**  
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**(1.) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

In June 2011, the FASB issued ASU 2011-05 “*Comprehensive Income (Topic 220) — Presentation of Comprehensive Income.*” ASU 2011-05 amends Topic 220, “Comprehensive Income,” to require that all non-owner changes in stockholders’ equity be presented in either a single continuous statement of comprehensive income or in two separate but consecutive statements. Additionally, ASU 2011-05 requires entities to present, on the face of the financial statements, reclassification adjustments for items that are reclassified from other comprehensive income to net income in the statement or statements where the components of net income and the components of other comprehensive income are presented. The option to present components of other comprehensive income as part of the statement of changes in stockholders’ equity was eliminated. ASU 2011-05 is effective for annual and interim periods beginning after December 15, 2011; however, certain provisions related to the presentation of reclassification adjustments have been deferred by ASU 2011-12 “Comprehensive Income (Topic 220) - Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05,” as further discussed above. The adoption of ASU 2011-05 is not expected to have a significant impact on the Company’s consolidated financial statements.

In May 2011, the FASB issued ASU 2011-04 “*Fair Value Measurement (Topic 820) - Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs.*” ASU 2011-04 changes the wording used to describe many of the requirements in GAAP for measuring fair value and for disclosing information about fair value measurements. Consequently, the amendments in this update result in common fair value measurement and disclosure requirements in GAAP and IFRSs (International Financial Reporting Standards). ASU 2011-04 is effective prospectively during interim and annual periods beginning on or after December 15, 2011. Early adoption by public entities is not permitted. The adoption of ASU 2011-04 is not expected to have a significant impact on the Company’s consolidated financial statements.

In April 2011, the FASB issued ASU 2011-03 “*Transfers and Servicing (Topic 860) - Reconsideration of Effective Control for Repurchase Agreement.*” ASU 2011-03 removes from the assessment of effective control the criterion relating to the transferor’s ability to repurchase or redeem financial assets on substantially the agreed terms, even in the event of default by the transferee. ASU 2011-03 is effective for the first interim or annual period beginning on or after December 15, 2011. The guidance should be applied prospectively to transactions or modifications of existing transactions that occur on or after the effective date. Early adoption is not permitted. The adoption of ASU 2011-03 is not expected to have a significant impact on the Company’s consolidated financial statements.

In April 2011, the FASB issued ASU 2011-02 “*A Creditor’s Determination of Whether a Restructuring is a Troubled Debt Restructuring*”, which clarifies when creditors should classify loan modifications as troubled debt restructurings. The guidance is effective for interim and annual periods beginning on or after June 15, 2011, and applies retrospectively to restructurings occurring on or after the beginning of the year. The guidance on measuring the impairment of a receivable restructured in a troubled debt restructuring, as clarified, is effective on a prospective basis. A provision in ASU No. 2011-02 also ends the FASB’s deferral of the additional disclosures related to troubled debt restructurings as required by ASU No. 2010-20. The Company adopted the provisions of ASU No. 2010-20 retrospectively to all modifications and restructuring activities that have occurred from January 1, 2011. See Note 4 to the Consolidated Financial Statements for the disclosures required by ASU No. 2010-20.

**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**  
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**(2.) INVESTMENT SECURITIES**

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

<b>December 31, 2011</b>				
	<b>Amortized Cost</b>	<b>Unrealized Gains</b>	<b>Unrealized Losses</b>	<b>Fair Value</b>
<b>Securities available for sale:</b>				
U.S. Government agencies and government sponsored enterprises	\$ 94,947	\$ 2,770	\$ 5	\$ 97,712
State and political subdivisions	119,099	5,336	11	124,424
Mortgage-backed securities:				
Federal National Mortgage Association	98,679	2,944	-	101,623
Federal Home Loan Mortgage Corporation	63,838	1,017	-	64,855
Government National Mortgage Association	73,226	3,376	-	76,602
Collateralized mortgage obligations:				
Federal National Mortgage Association	28,339	581	7	28,913
Federal Home Loan Mortgage Corporation	22,318	675	1	22,992
Government National Mortgage Association	103,975	2,654	18	106,611
Privately issued	327	1,762	-	2,089
Total collateralized mortgage obligations	154,959	5,672	26	160,605
Total mortgage-backed securities	390,702	13,009	26	403,685
Asset-backed securities	297	1,400	-	1,697
Total available for sale securities	<u>\$ 605,045</u>	<u>\$ 22,515</u>	<u>\$ 42</u>	<u>\$ 627,518</u>
<b>Securities held to maturity:</b>				
State and political subdivisions	<u>\$ 23,297</u>	<u>\$ 667</u>	<u>\$ -</u>	<u>\$ 23,964</u>

<b>December 31, 2010</b>				
	<b>Amortized Cost</b>	<b>Unrealized Gains</b>	<b>Unrealized Losses</b>	<b>Fair Value</b>
<b>Securities available for sale:</b>				
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	<u>\$ 663,260</u>	<u>\$ 9,331</u>	<u>\$ 6,223</u>	<u>\$ 666,368</u>
<b>Securities held to maturity:</b>				
State and political subdivisions	<u>\$ 28,162</u>	<u>\$ 687</u>	<u>\$ -</u>	<u>\$ 28,849</u>

**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**  
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**(2.) INVESTMENT SECURITIES (Continued)**

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

	<b>2011</b>	<b>2010</b>	<b>2009</b>
Taxable interest and dividends	\$ 14,185	\$ 17,101	\$ 16,466
Tax-exempt interest and dividends	3,828	3,521	5,228
Total interest and dividends on securities	<u>\$ 18,013</u>	<u>\$ 20,622</u>	<u>\$ 21,694</u>

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

	<b>2011</b>	<b>2010</b>	<b>2009</b>
Proceeds from sales and calls	\$ 44,514	\$ 122,090	\$ 224,928
Gross realized gains	3,051	173	6,826
Gross realized losses	48	4	3,397

The scheduled maturities of securities available for sale and securities held to maturity at December 31, 2011 are shown below. Actual expected maturities may differ from contractual maturities because issuers may have the right to call or prepay obligations (in thousands).

	<b>Amortized Cost</b>	<b>Fair Value</b>
<b>Debt securities available for sale:</b>		
Due in one year or less	\$ 24,025	\$ 24,166
Due from one to five years	81,483	84,008
Due after five years through ten years	183,639	190,461
Due after ten years	315,898	328,883
	<u>\$ 605,045</u>	<u>\$ 627,518</u>
<b>Debt securities held to maturity:</b>		
Due in one year or less	\$ 18,496	\$ 18,631
Due from one to five years	3,763	4,062
Due after five years through ten years	905	1,096
Due after ten years	133	175
	<u>\$ 23,297</u>	<u>\$ 23,964</u>

**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**  
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**(2.) INVESTMENT SECURITIES (Continued)**

There were no unrealized losses in held to maturity securities at December 31, 2011 or December 31, 2010. Unrealized losses on investment securities available for sale and the fair value of the related securities, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position as of December 31 are summarized as follows (in thousands):

	December 31, 2011					
	Less than 12 months		12 months or longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
<b>Securities available for sale:</b>						
U.S. Government agencies and government sponsored enterprises	\$ 2,177	\$ 1	\$ 5,246	\$ 4	\$ 7,423	\$ 5
State and political subdivisions	452	2	646	9	1,098	11
<b>Mortgage-backed securities:</b>						
Collateralized mortgage obligations:						
Federal National Mortgage Association	-	-	1,817	7	1,817	7
Federal Home Loan Mortgage Corporation	-	-	388	1	388	1
Government National Mortgage Association	6,138	18	-	-	6,138	18
Total collateralized mortgage obligations	6,138	18	2,205	8	8,343	26
Total mortgage-backed securities	6,138	18	2,205	8	8,343	26
<b>Total temporarily impaired securities</b>	<b>\$ 8,767</b>	<b>\$ 21</b>	<b>\$ 8,097</b>	<b>\$ 21</b>	<b>\$ 16,864</b>	<b>\$ 42</b>

	December 31, 2010					
	Less than 12 months		12 months or longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
<b>Securities available for sale:</b>						
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
<b>Mortgage-backed securities:</b>						
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	18,410	290	2,332	11	20,742	301
Total mortgage-backed securities	131,029	2,644	2,332	11	133,361	2,655
Asset-backed securities	111	61	96	70	207	131
<b>Total temporarily impaired securities</b>	<b>\$ 217,290</b>	<b>\$ 6,088</b>	<b>\$ 11,249</b>	<b>\$ 135</b>	<b>\$ 228,539</b>	<b>\$ 6,223</b>

**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**  
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**(2.) INVESTMENT SECURITIES (Continued)**

The following summarizes the amounts of OTTI recognized during the years ended December 31 by investment category (in thousands).

	<b>2011</b>	<b>2010</b>	<b>2009</b>
Mortgage-backed securities – Privately issued whole loan CMOs	\$ 18	\$ -	\$ 2,353
Asset-backed securities - Trust preferred securities	-	526	1,787
Asset-backed securities - Other	-	68	526
Total OTTI	<u>\$ 18</u>	<u>\$ 594</u>	<u>\$ 4,666</u>

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

The total number of security positions in the investment portfolio in an unrealized loss position at December 31, 2011 was 14 compared to 156 at December 31, 2010. At December 31, 2011, the Company had positions in 9 investment securities with an amortized cost of \$8.1 million and an unrealized loss of \$21 thousand that have been in a continuous unrealized loss position for more than 12 months. There were a total of 5 securities positions in the Company's investment portfolio, with an amortized cost of \$8.8 million and a total unrealized loss of \$21 thousand at December 31, 2011, that have been in a continuous unrealized loss position for less than 12 months. The unrealized loss on these investment securities was predominantly caused by changes in market interest rates, average life or credit spreads subsequent to purchase. The fair value of most of the investment securities in the Company's portfolio fluctuates as market interest rates change.

Based on management's review and evaluation of the Company's debt securities as of December 31, 2011, the debt securities with unrealized losses were not considered to be OTTI. As of December 31, 2011, the Company does not intend to sell any debt securities which have an unrealized loss, it is unlikely the Company will be required to sell these securities before recovery and the Company expects to recover the entire amortized cost of these impaired securities. Accordingly, as of December 31, 2011, management has concluded that unrealized losses on its investment securities are temporary and no further impairment loss has been realized in the Company's consolidated statements of income.



**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**  
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**(3.) LOANS HELD FOR SALE AND LOAN SERVICING RIGHTS**

Loans held for sale were entirely comprised of residential real estate mortgages and totaled \$2.4 million and \$3.1 million as of December 31, 2011 and 2010, 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 \$297.8 million and \$328.9 million as of December 31, 2011 and 2010, respectively. In connection with these mortgage-servicing activities, the Company administered escrow and other custodial funds which amounted to approximately \$5.9 million and \$6.2 million as of December 31, 2011 and 2010, respectively.

The activity in capitalized mortgage servicing assets is summarized as follows for the years ended December 31 (in thousands):

	<u>2011</u>	<u>2010</u>	<u>2009</u>
Mortgage servicing assets, beginning of year	\$ 1,642	\$ 1,534	\$ 925
Originations	319	408	952
Amortization	(352)	(300)	(343)
Mortgage servicing assets, end of year	1,609	1,642	1,534
Valuation allowance	(210)	(175)	(185)
Mortgage servicing assets, net, end of year	<u>\$ 1,399</u>	<u>\$ 1,467</u>	<u>\$ 1,349</u>

The Company did not securitize any residential mortgage loans in 2011 or 2010. 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 income under net gain on sales and calls of investment securities.

Automobile loan servicing rights are accounted for using the amortization method. A servicing asset is established at fair value at the time of the sale. The servicing asset is reported in other assets in the consolidated statements of financial position and amortized to noninterest income in the consolidated statements of income in proportion to and over the period of estimated net servicing income. Impairment, if any, is recognized when carrying value exceeds the fair value as determined by calculating the present value of expected net future cash flows. The primary risk characteristic for measuring servicing assets is payoff rates of the underlying loan pools. Valuation calculations rely on the predicted payoff assumption and, if actual payoff is quicker than expected, then future value would be impaired.

During 2011, the Company sold \$13.0 million of indirect auto loans under a 90%/10% participation agreement, recognizing a gain of \$153 thousand. The loans were reclassified from portfolio to loans held for sale during the second quarter of 2011. As of December 31, 2011, a loan servicing asset for these loans of \$574 thousand is included in other assets in the consolidated statements of financial condition. Management reviewed the servicing asset for impairment as of December 31, 2011 and determined that no valuation allowance was necessary. The Company will continue to service the loans for a fee in accordance with the participation agreement.

**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**  
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**(4.) LOANS**

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

	<b>Loans, Gross</b>	<b>Net Deferred Loan (Fees) Costs</b>	<b>Loans, Net</b>
<b>2011</b>			
Commercial business	\$ 233,727	\$ 109	\$ 233,836
Commercial mortgage	394,034	(790)	393,244
Residential mortgage	113,865	46	113,911
Home equity	227,853	3,913	231,766
Consumer indirect	465,807	21,906	487,713
Other consumer	24,138	168	24,306
Total	<u>\$ 1,459,424</u>	<u>\$ 25,352</u>	1,484,776
Allowance for loan losses			(23,260)
Total loans, net			<u>\$ 1,461,516</u>
<b>2010</b>			
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>

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 \$378 thousand and \$609 thousand at December 31, 2011 and 2010, respectively. During 2011, new borrowings amounted to \$4 thousand (including borrowings of executive officers and directors that were outstanding at the time of their election), and repayments and other reductions were \$235 thousand.

**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**  
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**(4) LOANS (Continued)**

**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):

	<b>30-59 Days Past Due</b>	<b>60-89 Days Past Due</b>	<b>Greater Than 90 Days</b>	<b>Total Past Due</b>	<b>Nonaccrual</b>	<b>Current</b>	<b>Total Loans</b>
<b>2011</b>							
Commercial business	\$ 35	\$ -	\$ -	\$ 35	\$ 1,259	\$ 232,433	\$ 233,727
Commercial mortgage	165	-	-	165	2,928	390,941	394,034
Residential mortgage	517	-	-	517	1,644	111,704	113,865
Home equity	749	68	-	817	682	226,354	227,853
Consumer indirect	984	92	-	1,076	558	464,173	465,807
Other consumer	106	10	5	121	-	24,017	24,138
Total loans, gross	<u>\$ 2,556</u>	<u>\$ 170</u>	<u>\$ 5</u>	<u>\$ 2,731</u>	<u>\$ 7,071</u>	<u>\$ 1,449,622</u>	<u>\$ 1,459,424</u>
<b>2010</b>							
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>

There were no loans past due greater than 90 days and still accruing interest as of December 31, 2011 and December 31, 2010. There were \$5 thousand and \$3 thousand in consumer overdrafts which were past due greater than 90 days as of December 31, 2011 and December 31, 2010, respectively. Consumer overdrafts are overdrawn deposit accounts which have been reclassified as loans but by their terms do not accrue 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, 2011, 2010 and 2009. For the years ended December 31, 2011, 2010 and 2009, estimated interest income of \$438 thousand, \$474 thousand, and \$388 thousand, respectively, would have been recorded if all such loans had been accruing interest according to their original contractual terms.

**Troubled Debt Restructurings**

A modification of a loan constitutes a troubled debt restructuring ("TDR") when a borrower is experiencing financial difficulty and the modification constitutes a concession. The Company offers various types of concessions when modifying loans, however, forgiveness of principal is rarely granted. Commercial loans modified in a TDR may involve temporary interest-only payments, term extensions, reducing the interest rate for the remaining term of the loan, extending the maturity date at an interest rate lower than the current market rate for new debt with similar risk, requesting additional collateral, releasing collateral for consideration, or substituting or adding a new borrower or guarantor. The following presents, by loan class, information related to loans modified in a TDR during the year ended December 31, 2011 (in thousands).

	<b>Number of Contracts</b>	<b>Pre- Modification Outstanding Recorded Investment</b>	<b>Post- Modification Outstanding Recorded Investment</b>
Commercial business	6	\$ 142	\$ 142
Commercial mortgage	1	280	280
Total	<u>7</u>	<u>\$ 422</u>	<u>\$ 422</u>

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**(4.) LOANS (Continued)**

All of the loans identified as TDRs by the Company were previously on nonaccrual status and reported as impaired loans prior to restructuring. The modifications primarily related to extending the amortization periods of the loans. All loans restructured during the year ended December 31, 2011 are on nonaccrual status as of December 31, 2011. Nonaccrual loans that are restructured remain on nonaccrual status, but may move to accrual status after they have performed according to the restructured terms for a period of time. The TDR classification did not have a material impact on the Company's determination of the allowance for loan losses because the modified loans were impaired and evaluated for a specific reserve both before and after restructuring.

For purposes of this disclosure, a loan modified as a TDR is considered to have defaulted when the borrower becomes 90 days past due. As of December 31, 2011, one commercial real estate loan restructured in 2011 with a balance of \$261 thousand at December 31, 2011 was in default. This default did not significantly impact the Company's determination of the allowance for loan losses.

**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>
<b>2011</b>					
With no related allowance recorded:					
Commercial business	\$ 342	\$ 1,266	\$ -	\$ 361	\$ -
Commercial mortgage	605	696	-	583	-
	<u>947</u>	<u>1,962</u>	<u>-</u>	<u>944</u>	<u>-</u>
With an allowance recorded:					
Commercial business	917	917	436	1,033	-
Commercial mortgage	2,323	2,323	644	2,172	-
	<u>3,240</u>	<u>3,240</u>	<u>1,080</u>	<u>3,205</u>	<u>-</u>
	<u>\$ 4,187</u>	<u>\$ 5,202</u>	<u>\$ 1,080</u>	<u>\$ 4,149</u>	<u>\$ -</u>
<b>2010</b>					
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>

During the year ended December 31, 2009, the Company's average investment in impaired loans was \$3.8 million. The Company recognized \$69 thousand of interest income on impaired loans during the year ended December 31, 2009. At December 31, 2011, there were no commitments to lend additional funds to those borrowers whose loans were classified as impaired.

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**(4.) LOANS (Continued)**

**Credit Quality Indicators**

The Company categorizes loans into risk categories based on relevant information about the ability of borrowers to service their debt such as: current financial information, historical payment experience, credit documentation, public information, and current economic trends, among other factors such as the fair value of collateral. The Company analyzes commercial business and commercial mortgage loans individually by classifying the loans as to credit risk. Risk ratings are updated any time the situation warrants. The Company uses the following definitions for risk ratings:

**Special Mention:** Loans classified as special mention have a potential weakness that deserves management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the loan or of the Company's credit position at some future date.

**Substandard:** Loans classified as substandard are inadequately protected by the current net worth and paying capacity of the obligor or of the collateral pledged, if any. Loans so classified have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the Company will sustain some loss if the deficiencies are not corrected.

**Doubtful:** Loans classified as doubtful have all the weaknesses inherent in those classified as Substandard, with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable.

Loans not meeting the criteria above that are analyzed individually as part of the process described above are considered "Uncriticized" or pass-rated loans and are included in groups of homogeneous loans with similar risk and loss characteristics.

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

	<b>Commercial Business</b>	<b>Commercial Mortgage</b>
<b>2011</b>		
Uncriticized	\$ 221,477	\$ 383,700
Special mention	7,445	2,388
Substandard	4,805	7,946
Doubtful	-	-
Total	<u>\$ 233,727</u>	<u>\$ 394,034</u>
<b>2010</b>		
Uncriticized	\$ 194,510	\$ 338,061
Special mention	11,479	4,931
Substandard	4,959	10,545
Doubtful	-	-
Total	<u>\$ 210,948</u>	<u>\$ 353,537</u>

**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**  
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**(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):

	<b>Residential Mortgage</b>	<b>Home Equity</b>	<b>Consumer Indirect</b>	<b>Other Consumer</b>
<b>2011</b>				
Performing	\$ 112,221	\$ 227,171	\$ 465,249	\$ 24,138
Non-performing	1,644	682	558	-
Total	<u>\$ 113,865</u>	<u>\$ 227,853</u>	<u>\$ 465,807</u>	<u>\$ 24,138</u>
<b>2010</b>				
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>

**Allowance for Loan Losses**

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

	<b>Commercial</b>	<b>Commercial Mortgage</b>	<b>Residential Mortgage</b>	<b>Home Equity</b>	<b>Consumer Indirect</b>	<b>Other Consumer</b>	<b>Total</b>
<b>2011</b>							
<b>Allowance for loan losses:</b>							
Beginning balance	\$ 3,712	\$ 6,431	\$ 1,013	\$ 972	\$ 7,754	\$ 584	\$ 20,466
Charge-offs	(1,346)	(751)	(152)	(449)	(4,713)	(877)	(8,288)
Recoveries	401	245	90	44	2,066	456	3,302
Provision (credit)	1,269	493	(93)	675	5,082	354	7,780
Ending balance	<u>\$ 4,036</u>	<u>\$ 6,418</u>	<u>\$ 858</u>	<u>\$ 1,242</u>	<u>\$ 10,189</u>	<u>\$ 517</u>	<u>\$ 23,260</u>
Evaluated for impairment:							
Individually	\$ 436	\$ 644	\$ -	\$ -	\$ -	\$ -	\$ 1,080
Collectively	<u>\$ 3,600</u>	<u>\$ 5,774</u>	<u>\$ 858</u>	<u>\$ 1,242</u>	<u>\$ 10,189</u>	<u>\$ 517</u>	<u>\$ 22,180</u>
<b>Loans:</b>							
Ending balance	<u>\$ 233,727</u>	<u>\$ 394,034</u>	<u>\$ 113,865</u>	<u>\$ 227,853</u>	<u>\$ 465,807</u>	<u>\$ 24,138</u>	<u>\$ 1,459,424</u>
Evaluated for impairment:							
Individually	\$ 1,259	\$ 2,928	\$ -	\$ -	\$ -	\$ -	\$ 4,187
Collectively	<u>\$ 232,468</u>	<u>\$ 391,106</u>	<u>\$ 113,865</u>	<u>\$ 227,853</u>	<u>\$ 465,807</u>	<u>\$ 24,138</u>	<u>\$ 1,455,237</u>



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**(4.) LOANS (Continued)**

	<b>Commercial</b>	<b>Commercial Mortgage</b>	<b>Residential Mortgage</b>	<b>Home Equity</b>	<b>Consumer Indirect</b>	<b>Other Consumer</b>	<b>Total</b>
<b>2010</b>							
<b>Allowance for loan losses:</b>							
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	<u>\$ 149</u>	<u>\$ 883</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 1,032</u>
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>
<b>Loans:</b>							
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	<u>\$ 948</u>	<u>\$ 3,100</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 4,048</u>
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>

<b>2009</b>	<b>Total</b>
<b>Allowance for loan losses:</b>	
Beginning balance	\$ 18,749
Charge-offs	(7,830)
Recoveries	2,120
Provision	7,702
Ending balance	<u>\$ 20,741</u>

**Risk Characteristics**

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

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

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

Consumer indirect and other consumer loans may entail greater credit risk than residential mortgage loans and home equities, 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.

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**(5.) PREMISES AND EQUIPMENT, NET**

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

	<b>2011</b>	<b>2010</b>
Land and land improvements	\$ 4,330	\$ 4,335
Buildings and leasehold improvements	40,590	39,215
Furniture, fixtures, equipment and vehicles	23,414	23,645
Premises and equipment	68,334	67,195
Accumulated depreciation and amortization	(35,249)	(33,932)
Premises and equipment, net	<u>\$ 33,085</u>	<u>\$ 33,263</u>

Depreciation and amortization expense, included in occupancy and equipment expense in the consolidated statements of income, amounted to \$3.5 million for the years ended December 31, 2011 and 2010, and \$3.8 million for the year ended December 31, 2009.

**(6.) GOODWILL AND OTHER INTANGIBLE ASSETS**

The carrying amount of goodwill totaled \$37.4 million as of December 31, 2011 and 2010. 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. As of September 30, 2011, 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 (in thousands):

	<b>2011</b>	<b>2010</b>
Noninterest-bearing demand	\$ 393,421	\$ 350,877
Interest-bearing demand	362,555	374,900
Savings and money market	474,947	417,359
Certificates of deposit, due:		
Within one year	547,874	554,104
One to two years	84,687	126,955
Two to three years	17,974	14,653
Three to five years	50,000	43,888
Thereafter	141	154
Total certificates of deposit	<u>700,676</u>	<u>739,754</u>
Total deposits	<u>\$ 1,931,599</u>	<u>\$ 1,882,890</u>

Certificates of deposit in denominations of \$100,000 or more at December 31, 2011, 2010 and 2009 amounted to \$214.2 million, \$183.9 million and \$173.4 million, respectively.

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

	<b>2011</b>	<b>2010</b>	<b>2009</b>
Interest-bearing demand	\$ 614	\$ 705	\$ 772
Savings and money market	1,056	1,133	1,090
Certificates of deposit	9,764	13,015	17,228
Total interest expense on deposits	<u>\$ 11,434</u>	<u>\$ 14,853</u>	<u>\$ 19,090</u>

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**(8.) BORROWINGS**

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

	<b>2011</b>	<b>2010</b>
Short-term borrowings:		
Federal funds purchased	\$ 11,597	\$ 38,200
Repurchase agreements	36,301	38,910
Short-term FHLB borrowings	102,800	-
Total short-term borrowings	<u>150,698</u>	<u>77,110</u>
Long-term borrowings:		
FHLB advances and repurchase agreements	-	10,065
Junior subordinated debentures	-	16,702
Total long-term borrowings	<u>-</u>	<u>26,767</u>
Total borrowings	<u>\$ 150,698</u>	<u>\$ 103,877</u>

The Company classifies borrowings as short-term or long-term in accordance with the original terms of the agreement. At December 31, 2011, the Company's short-term borrowings had a weighted average rate of 0.39%.

**Short-term Borrowings**

Federal funds purchased are short-term borrowings that typically mature within one to ninety days. Federal funds purchased totaled \$11.6 million and \$38.2 million at December 31, 2011 and 2010, respectively. Repurchase agreements are secured overnight borrowings with customers. These short-term repurchase agreements amounted to \$36.3 million and \$38.9 million as of December 31, 2011 and 2010, respectively. Short-term FHLB borrowings have original maturities of less than one year and include overnight borrowings which the Company typically utilizes to address short term funding needs as they arise. Short-term FHLB borrowings at December 31, 2011 consisted of \$65.0 million in overnight borrowings and \$37.8 million in short-term advances.

**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 as of 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 as of December 31, 2010. The \$10.1 million of outstanding FHLB advances and repurchase agreements at December 31, 2010 were repaid upon maturity 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 was classified in the consolidated statements of financial condition as other assets and \$16.7 million of related 10.20% junior subordinated debentures were classified as long-term borrowings. In 2001, the Company incurred costs relating to the issuance of the debentures totaling \$487 thousand. These costs, which were included in other assets on the consolidated statements of financial condition, were deferred and were being amortized to interest expense using the straight-line method over a twenty year period.

In August 2011, the Company redeemed all of the 10.20% junior subordinated debentures at a redemption price equaling 105.1% of the principal amount redeemed, plus all accrued and unpaid interest. As a result of the redemption, the Company recognized a loss on extinguishment of debt of \$1.1 million, consisting of the redemption premium of \$852 thousand and the write-off of the remaining unamortized issuance costs of \$231 thousand.

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

	<b>2011</b>	<b>2010</b>	<b>2009</b>
Short-term borrowings	\$ 500	\$ 365	\$ 270
Long-term borrowings	1,321	2,502	2,857
Total interest expense on borrowings	<u>\$ 1,821</u>	<u>\$ 2,867</u>	<u>\$ 3,127</u>

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**(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>2011</u>	<u>2010</u>
Commitments to extend credit	\$ 374,266	\$ 357,240
Standby letters of credit	8,855	6,524

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 \$2.9 million and \$8.0 million at December 31, 2011 and 2010, respectively. In addition, the net change in the fair values of these derivatives was recognized as other noninterest income or other noninterest expense in the consolidated statements of income.

**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, 2011 (in thousands):

2012	\$ 1,242
2013	1,049
2014	1,017
2015	962
2016	927
Thereafter	4,963
	<u>\$ 10,160</u>

Rent expense relating to these operating leases, included in occupancy and equipment expense in the statements of income, was \$1.5 million, \$1.4 million and \$1.5 million in 2011, 2010 and 2009, 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.

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**(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 income), goodwill and other intangible assets and disallowed portions of deferred tax assets. As of December 31, 2011, Tier 1 capital for the Company includes, subject to limitation, \$17.5 million of preferred stock. As of December 31, 2010, Tier 1 capital for the Company also includes, subject to limitation, \$16.7 million of trust preferred securities issued by FISI Statutory Trust I (see Note 8, Borrowings) 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 risk-based 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 rules). The leverage ratio is calculated by dividing Tier 1 capital by adjusted quarterly average total assets, which exclude goodwill and other intangible assets and disallowed portions of deferred tax assets.

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**(10.) REGULATORY MATTERS (Continued)**

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

		<b>Actual</b>		<b>For Capital Adequacy Purposes</b>		<b>Well Capitalized</b>	
		<b>Amount</b>	<b>Ratio</b>	<b>Amount</b>	<b>Ratio</b>	<b>Amount</b>	<b>Ratio</b>
<b>December 31, 2011:</b>							
Tier 1 leverage:	Company	\$ 197,086	8.63 %	\$ 91,310	4.00 %	\$ 114,138	5.00 %
	Bank	184,639	8.10	91,192	4.00	113,990	5.00
Tier 1 capital:	Company	197,086	12.20	64,645	4.00	96,967	6.00
	Bank	184,639	11.46	64,445	4.00	96,667	6.00
Total risk-based capital:	Company	217,325	13.45	129,290	8.00	161,612	10.00
	Bank	204,817	12.71	128,890	8.00	161,112	10.00
<b>December 31, 2010:</b>							
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

As of December 31, 2011, the Company and Bank were considered "well capitalized" under all regulatory capital guidelines. Such determination has been made based on the Tier 1 leverage, Tier 1 capital and total risk-based capital 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, 2011 and 2010.

**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. The Company is no longer subject to the limitations prescribed by the terms of the Treasury's TARP Capital Purchase Program (see Note 11, Shareholders' Equity).



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**(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. There were 174,735 shares and 183,259 shares of preferred stock issued and outstanding as of December 31, 2011 and 2010, respectively.

**Common Stock**

The following table sets forth the changes in the number of shares of common stock for the years ended December 31 (in thousands):

	<u>Outstanding</u>	<u>Treasury</u>	<u>Issued</u>
<b>2011</b>			
Shares outstanding at beginning of year	10,937,506	410,616	11,348,122
Shares issued in common stock offering	2,813,475	-	2,813,475
Restricted stock awards issued, net of forfeitures	51,070	(51,070)	-
Stock options exercised	6,357	(6,357)	-
Treasury stock purchases	(11,181)	11,181	-
Directors' retainer	5,889	(5,889)	-
Shares outstanding at end of year	<u>13,803,116</u>	<u>358,481</u>	<u>14,161,597</u>
<b>2010</b>			
Shares outstanding at beginning of year	10,820,268	527,854	11,348,122
Restricted stock awards issued, net of forfeitures	99,324	(99,324)	-
Stock options exercised	15,563	(15,563)	-
Treasury stock purchases	(3,658)	3,658	-
Directors' retainer	6,009	(6,009)	-
Shares outstanding at end of year	<u>10,937,506</u>	<u>410,616</u>	<u>11,348,122</u>

**Issuance of Common Stock**

In March 2011, the Company completed the sale of 2,813,475 shares of its common stock through an underwritten public offering at a price of \$16.35 per share. The net proceeds of the offering, after deducting underwriting discounts and commissions and offering expenses, were \$43.1 million. A portion of the proceeds from this offering was used to redeem the Company's Series A preferred stock and the 10.20% junior subordinated debentures.

**Preferred Stock**

**Series A 3% Preferred Stock.** There were 1,500 shares and 1,533 shares of Series A 3% preferred stock issued and outstanding as of December 31, 2011 and 2010, respectively. 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 B-1 8.48% Preferred Stock.** There were 173,235 shares and 174,223 shares of Series B-1 8.48% preferred stock issued and outstanding as of December 31, 2011 and 2010, respectively. 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.

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**(11.) SHAREHOLDERS' EQUITY (Continued)**

**Redemption of 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 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 (the "Warrant"), of the Company.

Pursuant to the terms of the Purchase Agreement, the Company's ability to declare or pay dividends on any of its shares was limited. Specifically, the Company was 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 stock, other junior securities or preferred stock ranking *pari passu* with the Series A preferred stock in any quarter unless all accrued and unpaid dividends were paid on the Series A preferred stock for all past dividend periods (including the latest completed dividend period), subject to certain limited exceptions.

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 resulting discount for the Series A preferred stock was to be accreted over five years through retained earnings as a preferred stock dividend. The Warrant was to remain in additional paid-in-capital at its initial book value until it was exercised or expired.

In February 2011, the Company redeemed one-third, or \$12.5 million, of the Series A preferred stock. In March 2011, the remaining \$25.0 million of the Series A preferred stock was redeemed. The unamortized discount related to the Series A preferred stock was charged to retained earnings upon redemption. The complete redemption of the Series A preferred stock removed the TARP restrictions pertaining to the Company's ability to declare and pay dividends and repurchase its common stock, as well as certain restrictions associated with executive compensation.

In May 2011, the Company repurchased the Warrant issued to the Treasury. The repurchase price of \$2.1 million was recorded as a reduction of additional paid-in capital.

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**(12.) COMPREHENSIVE INCOME**

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

	Pre-tax Amount	Tax Expense (Benefit)	Net-of-tax Amount
<b>2011</b>			
Securities available for sale:			
Change in net unrealized gain/loss during the period	\$ 22,350	\$ 8,855	\$ 13,495
Reclassification adjustment for gains included in income	(3,003)	(1,190)	(1,813)
Reclassification adjustment for impairment charges included in income	18	7	11
	<u>19,365</u>	<u>7,672</u>	<u>11,693</u>
Change in net actuarial gain/loss and prior service benefit (cost) on defined benefit pension and post-retirement plans	(9,979)	(3,953)	(6,026)
Other comprehensive income	<u>\$ 9,386</u>	<u>\$ 3,719</u>	5,667
Net income			22,799
Comprehensive income			<u>\$ 28,466</u>
<b>2010</b>			
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>	(1,020)
Net income			21,287
Comprehensive income			<u>\$ 20,267</u>
<b>2009</b>			
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>	311
Net income			14,441
Comprehensive income			<u>\$ 14,752</u>

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

	<b>2011</b>	<b>2010</b>
Net actuarial loss and prior service cost on defined benefit pension and post-retirement plans	\$ (12,625)	\$ (6,599)
Net unrealized gain on securities available for sale	13,570	1,877
	<u>\$ 945</u>	<u>\$ (4,722)</u>

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**(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. In May 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, 2011, there were approximately 213,000 and 451,000 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 vest 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):

	<b>2011</b>	<b>2010</b>	<b>2009</b>
Stock options:			
Management Stock Incentive Plan	\$ 55	\$ 110	\$ 222
Director Stock Incentive Plan	14	43	46
Total stock option expense	69	153	268
Restricted stock awards:			
Management Stock Incentive Plan	917	761	488
Director Stock Incentive Plan	119	117	98
Total restricted stock award expense	1,036	878	586
Total share-based compensation	\$ 1,105	\$ 1,031	\$ 854

The Company uses the Black-Scholes valuation method to estimate the fair value of its stock option awards. There were no stock options awarded during 2011, 2010 or 2009. The following is a summary of stock option activity for the year ended December 31, 2011 (dollars in thousands, except per share amounts):

	<b>Number of Options</b>	<b>Weighted Average Exercise Price</b>	<b>Weighted Average Remaining Contractual Term</b>	<b>Aggregate Intrinsic Value</b>
Outstanding at beginning of year	409,893	\$ 20.64		
Granted	-	-		
Exercised	(6,357)	14.26		
Forfeited	(550)	15.85		
Expired	(34,928)	21.28		
Outstanding at end of year	368,058	\$ 20.70	3.65 years	\$ 9
Exercisable at end of year	361,033	\$ 20.79	3.60 years	\$ 7

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**(13.) SHARE-BASED COMPENSATION (Continued)**

As of December 31, 2011, there was \$13 thousand of unrecognized compensation expense related to unvested stock options, all of which is expected to be recognized during 2012.

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, 2011, 2010 and 2009 was \$31 thousand, \$59 thousand, and \$1 thousand, respectively. The total cash received as a result of option exercises under stock compensation plans for the years ended December 31, 2011, 2010 and 2009 was \$91 thousand, \$216 thousand, and \$14 thousand, respectively. The tax benefits realized in connection with these stock option exercises were not significant.

The following is a summary of restricted stock award activity for the year ended December 31, 2011:

	<b>Number of Shares</b>	<b>Weighted Average Market Price at Grant Date</b>
Outstanding at beginning of year	150,796	\$ 12.76
Granted	53,070	18.88
Vested	(35,212)	14.38
Forfeited	(2,000)	15.44
Outstanding at end of year	<u>166,654</u>	<u>\$ 14.34</u>

As of December 31, 2011, there was \$804 thousand of unrecognized compensation expense related to unvested restricted stock awards that is expected to be recognized over a weighted average period of 1.48 years.

**(14.) INCOME TAXES**

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

	<b>2011</b>	<b>2010</b>	<b>2009</b>
Income tax expense	\$ 11,415	\$ 9,352	\$ 6,140
Shareholder's equity	3,718	(763)	197

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

	<b>2011</b>	<b>2010</b>	<b>2009</b>
Current tax expense (benefit):			
Federal	\$ 3,747	\$ 5,781	\$ (1,355)
State	1,158	1,103	25
Total current tax expense (benefit)	<u>4,905</u>	<u>6,884</u>	<u>(1,330)</u>
Deferred tax expense (benefit):			
Federal	5,584	2,852	6,189
State	926	(384)	1,281
Total deferred tax expense	<u>6,510</u>	<u>2,468</u>	<u>7,470</u>
Total income tax expense	<u>\$ 11,415</u>	<u>\$ 9,352</u>	<u>\$ 6,140</u>

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**(14.) INCOME TAXES (Continued)**

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

	<u>2011</u>	<u>2010</u>	<u>2009</u>
Statutory federal tax rate	35.0 %	35.0 %	34.0 %
Increase (decrease) resulting from:			
Tax exempt interest income	(4.3)	(4.2)	(8.6)
Non-taxable earnings on company owned life insurance	(1.5)	(1.3)	(1.8)
State taxes, net of federal tax benefit	4.0	1.5	4.2
Nondeductible expenses	0.4	0.6	1.0
Disallowed interest expense	0.2	0.2	0.5
Other, net	(0.4)	(1.3)	0.5
Effective tax rate	<u>33.4 %</u>	<u>30.5 %</u>	<u>29.8 %</u>

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):

	<u>2011</u>	<u>2010</u>
Deferred tax assets:		
Other than temporary impairment of investment securities	\$ 11,326	\$ 15,418
Allowance for loan losses	9,106	8,108
Share-based compensation	1,437	1,250
Interest on non-accruing loans	716	781
Accrued pension costs	538	-
Tax attribute carryforward benefits	463	2,033
Core deposit intangible	79	158
Other	1,172	665
Gross deferred tax assets	<u>24,837</u>	<u>28,413</u>
Deferred tax liabilities:		
Net unrealized gain on securities available for sale	8,903	1,231
Depreciation and amortization	1,741	1,489
Deferred loan origination costs	930	2,263
Loan servicing assets	781	581
Prepaid pension costs	-	139
Gross deferred tax liabilities	<u>12,355</u>	<u>5,703</u>
Net deferred tax asset	<u>\$ 12,482</u>	<u>\$ 22,710</u>

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's 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, 2011 or 2010.

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 2011. The NYS income tax years currently open for audits are 2009 through 2011.



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**(14.) INCOME TAXES (Continued)**

At December 31, 2011, the Company had no federal or NYS net operating loss carryforwards. The Company has federal tax credits of approximately \$463 thousand 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, 2011 and 2010. There were no interest or penalties recorded in the income statement in income tax expense for the year ended December 31, 2011. As of December 31, 2011, there were no amounts accrued for interest or penalties related to uncertain tax positions.

**(15.) EARNINGS PER COMMON 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).

	<b>2011</b>	<b>2010</b>	<b>2009</b>
Net income available to common shareholders	\$ 19,617	\$ 17,562	\$ 10,744
Less: Earnings allocated to participating securities	38	105	87
Net income available to common shareholders for EPS	<u>\$ 19,579</u>	<u>\$ 17,457</u>	<u>\$ 10,657</u>
Weighted average common shares outstanding:			
Total shares issued	13,599	11,348	11,348
Unvested restricted stock awards	(166)	(154)	(92)
Treasury shares	<u>(366)</u>	<u>(427)</u>	<u>(526)</u>
Total basic weighted average common shares outstanding	13,067	10,767	10,730
Incremental shares from assumed:			
Exercise of stock options	3	6	-
Vesting of restricted stock awards	65	27	39
Exercise of warrant	<u>22</u>	<u>45</u>	<u>-</u>
Total diluted weighted average common shares outstanding	13,157	10,845	10,769
Basic earnings per common share	<u>\$ 1.50</u>	<u>\$ 1.62</u>	<u>\$ 0.99</u>
Diluted earnings per common share	<u>\$ 1.49</u>	<u>\$ 1.61</u>	<u>\$ 0.99</u>
For each of the periods presented, average shares subject to the following instruments were excluded from the computation of diluted EPS because the effect would be antidilutive:			
Stock options	339	353	459
Restricted stock awards	-	-	-
Warrant	<u>-</u>	<u>-</u>	<u>378</u>
	<u>339</u>	<u>353</u>	<u>837</u>

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**(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):

	<b>2011</b>	<b>2010</b>
Change in projected benefit obligation:		
Projected benefit obligation at beginning of period	\$ 38,381	\$ 33,441
Service cost	1,756	1,633
Interest cost	2,027	1,933
Actuarial loss	7,939	2,969
Benefits paid and plan expenses	(1,800)	(1,595)
Projected benefit obligation at end of period	<u>48,303</u>	<u>38,381</u>
Change in plan assets:		
Fair value of plan assets at beginning of period	38,731	33,203
Actual return on plan assets	12	2,823
Employer contributions	10,000	4,300
Benefits paid and plan expenses	(1,800)	(1,595)
Fair value of plan assets at end of period	<u>46,943</u>	<u>38,731</u>
Funded (unfunded) status at end of period	<u>\$ (1,360)</u>	<u>\$ 350</u>

The accumulated benefit obligation was \$43.3 million and \$34.3 million at December 31, 2011 and 2010, respectively.

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 \$1.7 million for the 2012 fiscal year by contributing \$10.0 million prior to December 31, 2011.

Estimated benefit payments under the pension plan over the next ten years at December 31, 2011 are as follows (in thousands):

2012	\$ 1,553
2013	1,623
2014	1,733
2015	1,876
2016	2,101
2017 - 2021	12,782

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

	<b>2011</b>	<b>2010</b>	<b>2009</b>
Service cost	\$ 1,756	\$ 1,633	\$ 1,689
Interest cost on projected benefit obligation	2,027	1,933	1,826
Expected return on plan assets	(2,653)	(2,444)	(1,848)
Amortization of unrecognized loss	608	458	728
Amortization of unrecognized prior service cost	19	11	11
Net periodic pension cost	<u>\$ 1,757</u>	<u>\$ 1,591</u>	<u>\$ 2,406</u>

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**(16.) EMPLOYEE BENEFIT PLANS (Continued)**

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

	<u>2011</u>	<u>2010</u>	<u>2009</u>
Weighted average discount rate	5.38%	5.89%	6.03%
Rate of compensation increase	3.00%	3.50%	3.50%
Expected long-term rate of return	7.00%	7.50%	7.50%

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

	<u>2011</u>	<u>2010</u>	<u>2009</u>
Weighted average discount rate	4.27%	5.38%	5.89%
Rate of compensation increase	3.00%	3.00%	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.

The weighted average expected long-term rate of return is estimated based on current trends in the 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.

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**(16.) EMPLOYEE BENEFIT PLANS (Continued)**

Effective September 2011, the Plan revised its investment guidelines. The Plan currently prohibits its investment managers from purchasing any security greater than 5% of the portfolio at the time of purchase or greater than 8% at market value in any one issuer. In addition, the following are prohibited:

Equity securities	Short sales
	Unregistered securities
	Margin purchases
Fixed income securities	Mortgage backed derivatives that have an inverse floating rate coupon or that are interest only securities
	Any ABS that is not issued by the U.S. Government or its agencies or its instrumentalities
	Generally securities of less than Baa2/BBB quality may not be purchased
	Securities of less than A-quality may not in the aggregate exceed 10% of the investment manager's portfolio
Other financial instruments	Unhedged currency exposure in countries not defined as "high income economies" by the World Bank

Prior to September 2011 investments in emerging countries as defined by the Morgan Stanley Emerging Markets Index and structured notes were prohibited.

All other investments not prohibited by the Plan are permitted. At December 31, 2011, 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:	2012 Target Allocation	Percentage of Plan Assets at December 31,		Weighted Average Expected Long-term Rate of Return
		2011	2010	
Cash equivalents	0 – 20%	10.6%	11.2%	0.39%
Equity securities	40 – 60	47.9	48.2	4.62
Fixed income securities	40 – 60	41.5	40.6	1.85
Other financial instruments	0 – 5	-	-	-

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**(16.) EMPLOYEE BENEFIT PLANS (Continued)**

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). There were no assets classified as Level 3 assets during the years ended December 31, 2011 and 2010. The major categories of Plan assets measured at fair value on a recurring basis are presented in the following table (in thousands).

	<b>Level 1 Inputs</b>	<b>Level 2 Inputs</b>	<b>Level 3 Inputs</b>	<b>Total Fair Value</b>
<b>December 31, 2011:</b>				
Cash equivalents:				
Foreign currencies	\$ 81	\$ -	\$ -	\$ 81
Short term investment funds	-	4,901	-	4,901
Total cash equivalents	81	4,901	-	4,982
Equity securities:				
U.S. Large Cap	13,993	-	-	13,993
U.S. Mid Cap	1,903	-	-	1,903
U.S. Small Cap	44	-	-	44
International	6,553	-	-	6,553
Total equity securities	22,493	-	-	22,493
Fixed income securities:				
Corporate bonds:				
Rated single A or higher by S&P	-	1,949	-	1,949
Rated below single A by S&P	-	2,281	-	2,281
Government issues	-	10,651	-	10,651
Collateralized mortgage obligations:				
Rated single A or higher by S&P	-	4,233	-	4,233
Rated below single A by S&P	-	354	-	354
Total fixed income securities	-	19,468	-	19,468
Total Plan investments	\$ 22,574	\$ 24,369	\$ -	\$ 46,943
<b>December 31, 2010:</b>				
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 equity securities	18,683	-	-	18,683
Fixed income securities:				
Corporate bonds:				
Rated single A or higher by S&P	-	2,113	-	2,113
Rated 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
Rated 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

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**(16.) EMPLOYEE BENEFIT PLANS (Continued)**

At December 31, 2011 the portfolio was managed by two investment firms, with control of the portfolio split approximately 46% and 52% under the control of the investment managers with the remaining 2% under the direct control of the Plan. A portfolio concentration in the State Street Bank & Trust Co. Short Term Investment Fund of 10% and 11% existed at December 31, 2011 and 2010, respectively.

**Postretirement Benefit Plan**

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 \$122 thousand and \$162 thousand as of December 31, 2011 and 2010, respectively. The postretirement expense for the plan that was included in salaries and employee benefits in the consolidated statements of income was not significant for the years ended December 31, 2011, 2010 and 2009. 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):

	<u>2011</u>	<u>2010</u>
<b>Defined benefit plan:</b>		
Net actuarial loss	\$ (21,160)	\$ (11,188)
Prior service cost	(113)	(132)
	<u>(21,273)</u>	<u>(11,320)</u>
<b>Postretirement benefit plan:</b>		
Net actuarial loss	(210)	(252)
Prior service credit	575	643
	<u>365</u>	<u>391</u>
Total recognized in accumulated other comprehensive loss	<u>\$ (20,908)</u>	<u>\$ (10,929)</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):

	<u>2011</u>	<u>2010</u>
<b>Defined benefit plan:</b>		
Net actuarial loss	\$ (10,580)	\$ (2,590)
Amortization of net loss	608	458
Amortization of prior service cost	19	11
	<u>(9,953)</u>	<u>(2,121)</u>
<b>Postretirement benefit plan:</b>		
Net actuarial gain (loss)	42	(4)
Amortization of prior service credit	(68)	(67)
	<u>(26)</u>	<u>(71)</u>
Total recognized in other comprehensive income (loss)	<u>\$ (9,979)</u>	<u>\$ (2,192)</u>

For the year ending December 31, 2012, 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 \$1.4 million and \$20 thousand, respectively.



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**(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 2011, 2010 or 2009. The expense included in salaries and employee benefits in the consolidated statements of income for this plan amounted to \$1.0 million, \$936 thousand and \$914 thousand in 2011, 2010 and 2009, respectively.

**Supplemental Executive Retirement Plans**

The Company has a non-qualified Supplemental Executive Retirement Plan ("SERP") covering three former executives. At December 31, 2011, there was a \$1.0 million unfunded pension liability related to the SERP. SERP expense was \$67 thousand, \$262 thousand, and \$648 thousand for 2011, 2010 and 2009, 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.

**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**  
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**(17.) FAIR VALUE MEASUREMENTS (Continued)**

**Investment securities available for sale:** 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.

**Loans held for sale:** The fair value of loans held for sale is determined using quoted secondary market prices and investor commitments. Loans held for sale are classified as Level 2 in the fair value hierarchy.

**Collateral dependent impaired loans:** 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, 2011 (in thousands).

	<u>Level 1 Inputs</u>	<u>Level 2 Inputs</u>	<u>Level 3 Inputs</u>	<u>Total Fair Value</u>
<b>Measured on a recurring basis:</b>				
Securities available for sale:				
U.S. Government agencies and government sponsored enterprises	\$ -	\$ 97,712	\$ -	\$ 97,712
State and political subdivisions	-	124,424	-	124,424
Mortgage-backed securities	-	403,685	-	403,685
Asset-backed securities:				
Trust preferred securities	-	-	1,636	1,636
Other	-	61	-	61
	<u>\$ -</u>	<u>\$ 625,882</u>	<u>\$ 1,636</u>	<u>\$ 627,518</u>
<b>Measured on a nonrecurring basis:</b>				
Loans:				
Loans held for sale	\$ -	\$ 2,410	\$ -	\$ 2,410
Collateral dependent impaired loans	-	-	2,160	2,160
Other assets:				
Mortgage servicing rights	-	-	1,973	1,973
Other real estate owned	-	-	475	475
	<u>\$ -</u>	<u>\$ 2,410</u>	<u>\$ 4,608</u>	<u>\$ 7,018</u>

**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**  
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**(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, 2010 (in thousands).

	<u>Level 1</u> <u>Inputs</u>	<u>Level 2</u> <u>Inputs</u>	<u>Level 3</u> <u>Inputs</u>	<u>Total</u> <u>Fair Value</u>
<b>Measured on a recurring basis:</b>				
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>
<b>Measured on a nonrecurring basis:</b>				
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>

There were no liabilities measured at fair value on a recurring or nonrecurring basis during the years ended December 31, 2011 and 2010.

**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):

	<u>2011</u>	<u>2010</u>
Securities available for sale (Level 3), beginning of year	\$ 572	\$ 1,015
Transfers into Level 3	-	-
Sales	(2,478)	-
Principal paydowns and other	(53)	263
Total gains (losses) realized/unrealized:		
Included in earnings	2,263	(526)
Included in other comprehensive income	1,332	(180)
Securities available for sale (Level 3), end of year	<u>\$ 1,636</u>	<u>\$ 572</u>

**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**  
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**(17.) FAIR VALUE MEASUREMENTS (Continued)**

**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.

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, 2011 and December 31, 2010 may not necessarily represent the underlying fair value of the Company.

**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**  
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**(17.) FAIR VALUE MEASUREMENTS (Continued)**

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

	<b>December 31, 2011</b>		<b>December 31, 2010</b>	
	<b>Carrying Amount</b>	<b>Estimated Fair Value</b>	<b>Carrying Amount</b>	<b>Estimated Fair Value</b>
<b>Financial assets:</b>				
Cash and cash equivalents	\$ 57,583	\$ 57,583	\$ 39,058	\$ 39,058
Securities available for sale	627,518	627,518	666,368	666,368
Securities held to maturity	23,297	23,964	28,162	28,849
Loans held for sale	2,410	2,442	3,138	3,138
Loans	1,461,516	1,493,159	1,325,524	1,388,787
Accrued interest receivable	7,655	7,655	7,613	7,613
FHLB and FRB stock	10,674	10,674	6,353	6,353
<b>Financial liabilities:</b>				
Demand, savings and money market deposits	1,230,923	1,230,923	1,143,136	1,143,136
Certificate of deposit	700,676	702,720	739,754	740,440
Short-term borrowings	150,698	150,698	77,110	77,110
Long-term borrowings (excluding junior subordinated debentures)	-	-	10,065	10,244
Junior subordinated debentures	-	-	16,702	10,564
Accrued interest payable	5,207	5,207	7,620	7,620

**(18.) PARENT COMPANY FINANCIAL INFORMATION**

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

<b>Condensed Statements of Condition</b>	<b>December 31,</b>	
	<b>2011</b>	<b>2010</b>
<b>Assets:</b>		
Cash and due from subsidiary	\$ 11,621	\$ 23,894
Investment in and receivables due from subsidiary	223,577	202,754
Other assets	4,337	4,623
Total assets	<u>\$ 239,535</u>	<u>\$ 231,271</u>
<b>Liabilities and shareholders' equity:</b>		
Junior subordinated debentures	\$ -	\$ 16,702
Other liabilities	2,341	2,425
Shareholders' equity	237,194	212,144
Total liabilities and shareholders' equity	<u>\$ 239,535</u>	<u>\$ 231,271</u>

**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**  
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**(18.) PARENT COMPANY FINANCIAL INFORMATION (Continued)**

**Condensed Statements of Income**

	<b>Years ended December 31,</b>		
	<b>2011</b>	<b>2010</b>	<b>2009</b>
Dividends from subsidiary and associated companies	\$ 9,233	\$ 23,151	\$ 5,051
Management and service fees from subsidiary	1,161	1,163	603
Other income (loss)	78	(134)	182
Total income	10,472	24,180	5,836
Operating expenses	3,787	4,005	4,436
Loss on extinguishment of debt	1,083	-	-
Total expenses	4,870	4,005	4,436
Income before income tax benefit and equity in undistributed earnings (excess distributions) of subsidiary	5,602	20,175	1,400
Income tax benefit	1,539	1,323	1,286
Income before equity in undistributed earnings (excess distributions) of subsidiary	7,141	21,498	2,686
Equity in undistributed earnings (excess distributions) of subsidiary	15,658	(211)	11,755
Net income	<u>\$ 22,799</u>	<u>\$ 21,287</u>	<u>\$ 14,441</u>

**Condensed Statements of Cash Flows**

	<b>Years ended December 31,</b>		
	<b>2011</b>	<b>2010</b>	<b>2009</b>
Cash flows from operating activities:			
Net income	\$ 22,799	\$ 21,287	\$ 14,441
Adjustments to reconcile net income to net cash provided by operating activities:			
Equity in (undistributed earnings) excess distributions of subsidiary	(15,658)	211	(11,755)
Depreciation and amortization	116	193	318
Share-based compensation	1,105	1,031	854
Decrease in other assets	771	980	797
(Decrease) increase in other liabilities	(534)	8	(230)
Net cash provided by operating activities	8,599	23,710	4,425
Cash flows from investing activities:			
Purchase of investment assets, net of disposals	-	-	(1,323)
Capital investment in subsidiary	-	-	(15,000)
Net cash used in investing activities	-	-	(16,323)
Cash flows from financing activities:			
Redemption of junior subordinated debentures	(16,702)	-	-
Proceeds from issuance of preferred and common shares, net of issuance costs	43,127	-	(68)
Purchase of preferred and common shares	(37,764)	(69)	-
Proceeds from issuance of common stock warrant	(2,080)	-	-
Proceeds from stock options exercised	91	216	15
Dividends paid	(7,564)	(7,690)	(7,485)
Other	20	-	-
Net cash used in financing activities	(20,872)	(7,543)	(7,538)
Net (decrease) increase in cash and cash equivalents	(12,273)	16,167	(19,436)
Cash and cash equivalents as of beginning of year	23,894	7,727	27,163
Cash and cash equivalents as of end of the year	<u>\$ 11,621</u>	<u>\$ 23,894</u>	<u>\$ 7,727</u>



**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**December 31, 2011, 2010 and 2009**

**(19.) SUBSEQUENT EVENT (Unaudited)**

On January 19, 2012, Five Star Bank entered into an agreement to acquire four retail banking branches currently owned by HSBC Bank USA, N.A. and four retail banking branches currently owned by First Niagara Bank, N.A. The deposits associated with these branches total approximately \$376 million, while loans total approximately \$94 million. The transactions are subject to customary closing conditions, including regulatory approvals, and are expected to close by the end of the third quarter of 2012.

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## **CONTROLS AND PROCEDURES**

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### **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 this Annual Report.

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

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 the 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, 2011, 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 Annual Report.

KPMG LLP, an independent registered public accounting firm, has audited the consolidated financial statements included in this Annual Report, 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" in this Annual 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, 2011 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 9, 2012, 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](http://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](mailto: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 2011, contact the Corporate Secretary at 220 Liberty Street, Warsaw, New York 14569.

This and other financial information is also available at:

### WEBSITE ADDRESS

[www.fiiwarsaw.com](http://www.fiiwarsaw.com)



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