

FINANCIAL INSTITUTIONS INC

Form 10-Q

November 03, 2017

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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2017

or

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

For the transition period from _____ to _____

Commission File Number: 000-26481

(Exact name of registrant as specified in its charter)

NEW YORK
(State or other jurisdiction of
incorporation or organization)

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

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

14569
(Zip Code)

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

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

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the

preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

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

Large accelerated filer

Accelerated filer

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

Smaller reporting company

Emerging growth company

If an emerging growth company, indicate by check mark if the Registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards pursuant to Section 13(a) of the Exchange Act

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

The registrant had 15,626,294 shares of Common Stock, \$0.01 par value, outstanding as of October 27, 2017.

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FINANCIAL INSTITUTIONS, INC.

Form 10-Q

For the Quarterly Period Ended September 30, 2017

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

<i>(Dollars in thousands, except share and per share data)</i>	September 30, 2017	December 31, 2016
ASSETS		
Cash and due from banks	\$ 97,838	\$ 71,277
Securities available for sale, at fair value	551,491	539,926
Securities held to maturity, at amortized cost (fair value of \$539,476 and \$539,991, respectively)	538,332	543,338
Loans held for sale	2,407	1,050
Loans (net of allowance for loan losses of \$34,347 and \$30,934, respectively)	2,581,888	2,309,227
Company owned life insurance	64,829	63,455
Premises and equipment, net	45,668	42,398
Goodwill and other intangible assets, net	74,997	75,640
Other assets	64,141	64,029
Total assets	\$ 4,021,591	\$ 3,710,340
LIABILITIES AND SHAREHOLDERS EQUITY		
Deposits:		
Noninterest-bearing demand	\$ 710,865	\$ 677,076
Interest-bearing demand	656,703	581,436
Savings and money market	1,050,487	1,034,194
Time deposits	863,453	702,516
Total deposits	3,281,508	2,995,222
Short-term borrowings	310,800	331,500
Long-term borrowings, net of issuance costs of \$886 and \$939, respectively	39,114	39,061
Other liabilities	24,167	24,503
Total liabilities	3,655,589	3,390,286
Shareholders equity:		
Series A 3% preferred stock, \$100 par value; 1,533 shares authorized; 1,492 shares issued	149	149
Series B-1 8.48% preferred stock, \$100 par value; 200,000 shares authorized; 171,847 and 171,906 shares issued, respectively	17,185	17,191
Total preferred equity	17,334	17,340
	158	147

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Common stock, \$0.01 par value; 50,000,000 shares authorized; 15,761,849 and 14,692,214 shares issued, respectively		
Additional paid-in capital	112,087	81,755
Retained earnings	249,878	237,687
Accumulated other comprehensive loss	(10,838)	(13,951)
Treasury stock, at cost 135,555 and 154,617 shares, respectively	(2,617)	(2,924)
Total shareholders equity	366,002	320,054
Total liabilities and shareholders equity	\$ 4,021,591	\$ 3,710,340

See accompanying notes to the consolidated financial statements.

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

<i>(In thousands, except per share amounts)</i>	Three months ended		Nine months ended	
	September 30, 2017	September 30, 2016	September 30, 2017	September 30, 2016
Interest income:				
Interest and fees on loans	\$ 27,455	\$ 23,619	\$ 77,540	\$ 68,044
Interest and dividends on investment securities	5,941	5,741	17,736	17,196
Other interest income			67	1
Total interest income	33,396	29,360	95,343	85,241
Interest expense:				
Deposits	3,089	2,192	7,820	6,237
Short-term borrowings	1,251	500	2,815	1,183
Long-term borrowings	618	618	1,853	1,853
Total interest expense	4,958	3,310	12,488	9,273
Net interest income	28,438	26,050	82,855	75,968
Provision for loan losses	2,802	1,961	9,415	6,281
Net interest income after provision for loan losses	25,636	24,089	73,440	69,687
Noninterest income:				
Service charges on deposits	1,901	1,913	5,486	5,392
Insurance income	1,488	1,407	4,052	4,262
ATM and debit card	1,445	1,441	4,230	4,187
Investment advisory	1,497	1,326	4,357	3,934
Company owned life insurance	449	486	1,367	2,340
Investments in limited partnerships	(14)	161	91	253
Loan servicing	105	104	348	332
Net gain on sale of loans held for sale	150	46	270	202
Net gain on investment securities	184	426	600	2,426
Net gain on other assets	21	199	25	285
Contingent consideration liability adjustment			1,200	
Other	1,348	1,030	3,717	3,059
Total noninterest income	8,574	8,539	25,743	26,672
Noninterest expense:				
Salaries and employee benefits	12,348	11,325	35,703	33,757
Occupancy and equipment	4,087	3,617	12,235	10,906
Professional services	1,313	956	3,741	5,236
Computer and data processing	1,208	1,089	3,691	3,335
Supplies and postage	492	490	1,496	1,548

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FDIC assessments	440	406	1,366	1,283
Advertising and promotions	188	302	939	1,259
Amortization of intangibles	288	309	876	946
Goodwill impairment			1,575	
Other	2,103	2,124	5,728	5,686
Total noninterest expense	22,467	20,618	67,350	63,956
Income before income taxes	11,743	12,010	31,833	32,403
Income tax expense	3,464	3,541	9,365	9,165
Net income	\$ 8,279	\$ 8,469	\$ 22,468	\$ 23,238
Preferred stock dividends	366	366	1,097	1,097
Net income available to common shareholders	\$ 7,913	\$ 8,103	\$ 21,371	\$ 22,141
Earnings per common share (Note 3):				
Basic	\$ 0.52	\$ 0.56	\$ 1.44	\$ 1.53
Diluted	\$ 0.52	\$ 0.56	\$ 1.44	\$ 1.53
Cash dividends declared per common share	\$ 0.21	\$ 0.20	\$ 0.63	\$ 0.60
Weighted average common shares outstanding:				
Basic	15,268	14,456	14,806	14,429
Diluted	15,302	14,500	14,847	14,485

See accompanying notes to the consolidated financial statements.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Consolidated Statements of Comprehensive Income (Unaudited)

<i>(Dollars in thousands)</i>	Three months ended		Nine months ended	
	September 30, 2017	September 30, 2016	September 30, 2017	September 30, 2016
Net income	\$ 8,279	\$ 8,469	\$ 22,468	\$ 23,238
Other comprehensive income (loss), net of tax:				
Net unrealized gains (losses) on securities available for sale	284	(1,446)	2,600	8,948
Pension and post-retirement obligations	171	139	513	418
Total other comprehensive income (loss), net of tax	455	(1,307)	3,113	9,366
Comprehensive income	\$ 8,734	\$ 7,162	\$ 25,581	\$ 32,604

See accompanying notes to the consolidated financial statements.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Consolidated Statements of Changes in Shareholders' Equity (Unaudited)

Nine months ended September 30, 2017 and 2016

<i>(Dollars in thousands, except per share data)</i>	Preferred Equity	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Loss	Treasury Stock	Total Shareholders' Equity
Balance at January 1, 2016	\$ 17,340	\$ 144	\$ 72,690	\$ 218,920	\$ (11,327)	\$ (3,923)	\$ 293,844
Comprehensive income:							
Net income				23,238			23,238
Other comprehensive income, net of tax					9,366		9,366
Common stock issued		3	8,097				8,100
Share-based compensation plans:							
Share-based compensation			597				597
Stock options exercised			20			794	814
Restricted stock awards issued, net			24			(24)	
Excess tax benefit on share-based compensation			10				10
Stock awards			21			43	64
Cash dividends declared:							
Series A 3% Preferred-\$2.25 per share				(3)			(3)
Series B-1 8.48% Preferred-\$6.36 per share				(1,094)			(1,094)
Common-\$0.60 per share				(8,665)			(8,665)
Balance at September 30, 2016	\$ 17,340	\$ 147	\$ 81,459	\$ 232,396	\$ (1,961)	\$ (3,110)	\$ 326,271
Balance at December 31, 2016	\$ 17,340	\$ 147	\$ 81,755	\$ 237,687	\$ (13,951)	\$ (2,924)	\$ 320,054
Cumulative-effect adjustment			(279)	279			
Balance at January 1, 2017	\$ 17,340	\$ 147	\$ 81,476	\$ 237,966	\$ (13,951)	\$ (2,924)	\$ 320,054
Comprehensive income:							
Net income				22,468			22,468
Other comprehensive income, net of tax					3,113		3,113

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Common stock issued	11	29,653		29,664
Purchases of common stock for treasury			(148)	(148)
Repurchase of Series B-1 8.48% preferred stock	(6)			(6)
Share-based compensation plans:				
Share-based compensation		885		885
Stock options exercised		5	408	413
Restricted stock awards issued, net		29	(29)	
Stock awards		39	76	115
Cash dividends declared:				
Series A 3% Preferred-\$2.25 per share			(3)	(3)
Series B-1 8.48% Preferred-\$6.36 per share			(1,094)	(1,094)
Common-\$0.63 per share			(9,459)	(9,459)

Balance at September 30, 2017 **\$ 17,334 \$ 158 \$ 112,087 \$ 249,878 \$ (10,838) \$ (2,617) \$ 366,002**

See accompanying notes to the consolidated financial statements.

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

<i>(Dollars in thousands)</i>	Nine months ended September 30,	
	2017	2016
Cash flows from operating activities:		
Net income	\$ 22,468	\$ 23,238
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	4,613	4,480
Net amortization of premiums on securities	2,473	2,325
Provision for loan losses	9,415	6,281
Share-based compensation	885	597
Deferred income tax expense (benefit)	(527)	(523)
Proceeds from sale of loans held for sale	9,439	9,246
Originations of loans held for sale	(10,526)	(8,458)
Income from company owned life insurance	(1,367)	(2,340)
Net gain on sale of loans held for sale	(270)	(202)
Net gain on investment securities	(600)	(2,426)
Goodwill impairment	1,575	
Net gain on other assets	(25)	(285)
(Increase) decrease in other assets	(874)	3,548
(Decrease) increase in other liabilities	(1,266)	1,943
Net cash provided by operating activities	35,413	37,424
Cash flows from investing activities:		
Purchases of available for sale securities	(86,434)	(192,140)
Purchases of held to maturity securities	(70,610)	(90,602)
Proceeds from principal payments, maturities and calls on available for sale securities	29,291	107,418
Proceeds from principal payments, maturities and calls on held to maturity securities	74,205	48,424
Proceeds from sales of securities available for sale	49,424	85,772
Net loan originations	(282,455)	(204,691)
Proceeds from company owned life insurance, net of purchases	(7)	2,443
Proceeds from sales of other assets	189	602
Purchases of premises and equipment	(6,966)	(4,242)
Cash consideration paid for acquisition, net of cash acquired	(676)	(868)
Net cash used in investing activities	(294,039)	(247,884)
Cash flows from financing activities:		
Net increase in deposits	286,286	332,826
Net decrease in short-term borrowings	(20,700)	(62,900)
Proceeds from issuance of common stock	29,664	
Repurchase of preferred stock	(6)	

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Purchase of common stock for treasury	(148)	
Proceeds from stock options exercised	413	814
Excess tax benefit on share-based compensation, net		10
Cash dividends paid to common and preferred shareholders	(10,322)	(9,690)
Net cash provided by financing activities	285,187	261,060
Net increase in cash and cash equivalents	26,561	50,600
Cash and cash equivalents, beginning of period	71,277	60,121
Cash and cash equivalents, end of period	\$ 97,838	\$ 110,721
Supplemental information:		
Cash paid for interest	\$ 10,189	\$ 8,144
Cash paid for income taxes, net of refunds received	8,677	4,708
Noncash investing and financing activities:		
Real estate and other assets acquired in settlement of loans	379	443
Accrued and declared unpaid dividends	3,637	3,257
Increase in net unsettled security purchases	75	2,290
Common stock issued for acquisition		8,100
Assets acquired and liabilities assumed in business combinations:		
Fair value of assets acquired	812	4,848
Fair value of liabilities assumed	44	1,845
See accompanying notes to the consolidated financial statements.		

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

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

Nature of Operations

Financial Institutions, Inc. (the Company) is a financial holding company organized in 1931 under the laws of New York State (New York). The Company provides diversified financial services through its subsidiaries, Five Star Bank, Scott Danahy Naylor, LLC (SDN) and Courier Capital, LLC (Courier Capital). The Company offers a broad array of deposit, lending and other financial services to individuals, municipalities and businesses in Western and Central New York through its wholly-owned New York chartered banking subsidiary, Five Star Bank (the Bank). The Bank also has indirect lending network relationships with franchised automobile dealers in the Capital District of New York and Northern and Central Pennsylvania. SDN provides a broad range of insurance services to personal and business clients across 45 states. Courier Capital provides customized investment management, investment consulting and retirement plan services to individuals, businesses, institutions, foundations and retirement plans across 13 states.

Basis of Presentation

The consolidated financial statements include the accounts of the Company and its subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation. The accounting and reporting policies conform to U.S. generally accepted accounting principles (GAAP). Certain information and footnote disclosures normally included in financial statements prepared in conformity with GAAP have been condensed or omitted pursuant to such rules and regulations. However, in the opinion of management, the accompanying consolidated financial statements reflect all adjustments of a normal and recurring nature necessary for a fair presentation of the consolidated statements of financial condition, income, comprehensive income, changes in shareholders' equity and cash flows for the periods indicated, and contain adequate disclosure to make the information presented not misleading. These consolidated financial statements should be read in conjunction with the Company's 2016 Annual Report on Form 10-K for the year ended December 31, 2016. The results of operations for any interim periods are not necessarily indicative of the results which may be expected for the entire year.

Reclassifications

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

Subsequent Events

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

Use of Estimates

The preparation of these financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates. Material estimates relate to the determination of the allowance for loan losses, the carrying value of goodwill and deferred tax assets, and assumptions used in the defined benefit pension plan

accounting.

Derivative Instruments and Hedging Activities

Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) Topic 815, Derivatives and Hedging (ASC 815), provides the disclosure requirements for derivatives and hedging activities with the intent to provide users of financial statements with an enhanced understanding of: (a) how and why an entity uses derivative instruments, (b) how the entity accounts for derivative instruments and related hedged items, and (c) how derivative instruments and related hedged items affect an entity s financial position, financial performance, and cash flows. Further, qualitative disclosures are required that explain the Company s objectives and strategies for using derivatives, as well as quantitative disclosures about the fair value of and gains and losses on derivative instruments, and disclosures about credit-risk-related contingent features in derivative instruments.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

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

As required by ASC 815, the Company records all derivatives on the balance sheet at fair value. The accounting for changes in the fair value of derivatives depends on the intended use of the derivative, whether the Company has elected to designate a derivative in a hedging relationship and apply hedge accounting and whether the hedging relationship has satisfied the criteria necessary to apply hedge accounting. Currently, none of the Company's derivatives are designated in qualifying hedging relationships, as the derivatives are not used to manage risks within the Company's assets or liabilities. As such, all changes in fair value of the Company's derivatives are recognized directly in earnings.

In accordance with the FASB's fair value measurement guidance, the Company made an accounting policy election to measure the credit risk of its derivative financial instruments that are subject to master netting agreements on a net basis by counterparty portfolio.

Recent Accounting Pronouncements

In May 2014, the FASB issued Accounting Standards Update (ASU) No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*. ASU 2014-09 implements a common revenue standard that clarifies the principles for recognizing revenue. The core principle of ASU 2014-09 is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. To achieve that core principle, an entity should apply the following steps: (i) identify the contract(s) with a customer, (ii) identify the performance obligations in the contract, (iii) determine the transaction price, (iv) allocate the transaction price to the performance obligations in the contract and (v) recognize revenue when (or as) the entity satisfies a performance obligation. The effective date was deferred for one year to the interim and annual periods beginning on or after December 15, 2017. Early adoption is permitted as of the original effective date—interim and annual periods beginning on or after December 15, 2016. Management has completed the scope assessment and contract review for in-scope revenue streams. The Company's largest source of revenue is net interest income on financial assets and liabilities, which is explicitly excluded from the scope of ASU 2014-09. Revenue streams that are within the scope of ASU 2014-09 include insurance income, investment advisory fees, service charges on deposits and ATM and debit card fees. Management does not anticipate a material change in the timing or measurement of in-scope revenues and continues to evaluate the effect that ASU 2014-09 will have on the recognition of certain contract acquisition costs, as well as changes in the required disclosures. The Company plans to adopt ASU 2014-09 using the modified retrospective transition method with a cumulative effect adjustment to opening retained earnings as of January 1, 2018.

In January 2016, the FASB issued ASU No. 2016-01, *Financial Instruments—Overall (Subtopic 825-10) Recognition and Measurement of Financial Assets and Financial Liabilities*. ASU 2016-01 is intended to improve the recognition and measurement of financial instruments by requiring equity investments to be measured at fair value with changes in fair value recognized in net income; requiring public business entities to use the exit price notion when measuring

the fair value of financial instruments for disclosure purposes; requiring separate presentation of financial assets and financial liabilities by measurement category and form of financial asset on the balance sheet or the accompanying notes to the financial statements; eliminating the requirement for public business entities to disclose the method(s) and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured and amortized at cost on the balance sheet; and requiring a reporting organization to present separately in other comprehensive income the portion of the total change in the fair value of a liability resulting from a change in the instrument-specific credit risk when the organization has elected to measure the liability at fair value in accordance with the fair value option for financial instruments. ASU 2016-01 is effective for annual periods and interim periods within those annual periods, beginning after December 15, 2017. The amendments should be applied by means of a cumulative-effect adjustment to the balance sheet as of the beginning of the fiscal year of adoption. The amendments related to equity securities without readily determinable fair values (including disclosure requirements) should be applied prospectively to equity investments that exist as of the date of adoption. The Company is assessing the impact of ASU 2016-01 on its financial statements.

In February 2016, the FASB issued ASU No. 2016-02, *Leases (Topic 842)*. ASU 2016-02 establishes a right of use model that requires a lessee to record a right of use asset and a lease liability for all leases with terms longer than 12 months. Leases will be classified as either finance or operating, with classification affecting the pattern of expense recognition in the income statement. For lessors, the guidance modifies the classification criteria and the accounting for sales-type and direct financing leases. A lease will be treated as sale if it transfers all of the risks and rewards, as well as control of the underlying asset, to the lessee. If risks and rewards are conveyed without the transfer of control, the lease is treated as a financing. If the lessor doesn't convey risks and rewards or control, an operating lease results. The amendments are effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years for public business entities. Entities are required to use a modified retrospective approach for leases that exist or are entered into after the beginning of the earliest comparative period in the financial statements, with certain practical expedients available. Early adoption is permitted. The Company is assessing the impact of ASU 2016-02 on its financial statements.

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

In March 2016, the FASB issued ASU No. 2016-09, *Compensation - Stock Compensation (Topic 718) Improvements to Employee Share-Based Payment Accounting*. ASU 2016-09 requires all income tax effects of awards to be recognized in the income statement when the awards vest or are settled. It also allows an employer to repurchase more of an employee's shares than it could previously for tax withholding purposes without triggering liability accounting and to make a policy election for forfeitures as they occur. The guidance is effective for public business entities for fiscal years beginning after December 15, 2016, and interim periods within those years. Early adoption is permitted. The adoption of ASU 2016-09 did not have a significant impact on the Company's financial statements.

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

In August 2016, the FASB issued ASU No. 2016-15, *Statement of Cash Flows (Topic 230) Classification of Certain Cash Receipts and Cash Payments*. ASU 2016-15 provides guidance on the following eight specific cash flow issues: 1) debt prepayment or debt extinguishment costs; 2) settlement of zero-coupon debt instruments or other debt instruments with coupon interest rates that are insignificant in relation to the effective interest rate of the borrowing; 3) contingent consideration payments made after a business combination; 4) proceeds from the settlement of insurance claims; 5) proceeds from the settlement of corporate-owned life insurance policies, including bank-owned life insurance policies; 6) distributions received from equity method investees; 7) beneficial interests in securitization transactions; and 8) separately identifiable cash flows and application of the predominance principle. The guidance is effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. Early adoption is permitted, including adoption in an interim period. As this guidance only affects the classification within the statement of cash flows, this ASU is not expected to have a significant impact on the Company's financial statements.

In January 2017, the FASB issued ASU No. 2017-04, *Intangibles - Goodwill and Other (Topic 350) Simplifying the Test for Goodwill Impairment*. ASU 2017-04 simplifies the subsequent measurement of goodwill by eliminating Step 2 from the goodwill impairment test. Under the new guidance, an entity will recognize an impairment charge for the amount by which the carrying value exceeds the fair value. This standard is effective for annual or any interim goodwill impairment tests in fiscal years beginning after December 15, 2019. Early adoption is permitted for interim or annual goodwill impairment tests performed on testing dates after January 1, 2017. The Company early adopted

ASU 2017-04 during the quarter ended June 30, 2017, in connection with the interim goodwill impairment test that was performed. For additional details, see Note 6, Goodwill and Other Intangible Assets. The early adoption of ASU 2017-04 did not have a significant impact on the Company's financial statements.

In March 2017, the FASB issued ASU No. 2017-07, *Compensation - Retirement Benefits (Topic 715) - Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost*, which provides additional guidance on the presentation of net periodic pension and postretirement benefit costs in the income statement and on the components eligible for capitalization. The amendments in this ASU require that an employer report the service cost component of the net periodic benefit costs in the same income statement line item as other compensation costs arising from services rendered by employees during the period. The non-service-cost components of net periodic benefit costs are to be presented in the income statement separately from the service cost components and outside a subtotal of income from operations. The ASU also allows for the capitalization of the service cost components, when applicable (i.e., as a cost of internally manufactured inventory or a self-constructed asset). The amendments are effective for annual periods beginning after December 15, 2017, including interim periods within those annual periods; early adoption is permitted as of the beginning of an annual period for which financial statements (interim or annual) have not been issued or made available for issuance. The amendments in this ASU are to be applied retrospectively. The Company is assessing the impact of ASU 2017-07 on its financial statements.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

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

In March 2017, the FASB issued ASU No. 2017-08, *Receivables Nonrefundable Fees and Other Costs (Subtopic 310-20) Premium Amortization on Purchased Callable Debt Securities*. These amendments shorten the amortization period for certain callable debt securities held at a premium. Specifically, the amendments require the premium to be amortized to the earliest call date. The amendments do not require an accounting change for securities held at a discount; the discount continues to be amortized to maturity. The guidance is effective for public business entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. Early adoption is permitted, including adoption in an interim period. If an entity early adopts in an interim period, any adjustments should be reflected as of the beginning of the fiscal year that includes that interim period. The amendments should be applied on a modified retrospective basis, with a cumulative-effect adjustment directly to retained earnings as of the beginning of the period of adoption. The Company is assessing the impact of ASU 2017-08 on its financial statements.

In August 2017, the FASB issued ASU No. 2017-12, *Derivatives and Hedging (Topic 815) Targeted Improvements to Accounting for Hedging Activities*. These amendments: (a) expand and refine hedge accounting for both financial and non-financial risk components, (b) align the recognition and presentation of the effects of hedging instruments and hedge items in the financial statements, and (c) include certain targeted improvements to ease the application of current guidance related to the assessment of hedge effectiveness. The guidance is effective for public business entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. Early adoption is permitted, including adoption in an interim period. If an entity early adopts in an interim period, any adjustments should be reflected as of the beginning of the fiscal year that includes that interim period. The amendments related to cash flow and net investment hedges existing at the date of adoption should be applied by means of a cumulative-effect adjustment to the balance sheet as of the beginning of the fiscal year of adoption. The amendments related to presentation and disclosure should be applied prospectively. The Company is assessing the impact of ASU 2017-12 on its financial statements.

Table of Contents**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Unaudited)****(2.) BUSINESS COMBINATIONS*****2017 Activity - Robshaw & Julian Acquisition***

On August 31, 2017, Courier Capital completed the acquisition of the assets of Robshaw & Julian Associates, Inc. (Robshaw & Julian), a registered investment advisor with approximately \$175 million in assets under management, which increased Courier Capital's total assets under management to a total of approximately \$1.6 billion. Consideration for the acquisition included cash and potential future cash bonuses contingent upon achievement of certain revenue performance targets through August 2020. As a result of the acquisition, Courier Capital recorded goodwill of \$1.0 million and other intangible assets of \$810 thousand. The goodwill and other intangible assets are expected to be deductible for income tax purposes. The allocation of acquisition cost to the assets acquired and liabilities assumed and pro forma results of operations for this acquisition have not been presented because the effect of this acquisition was not material to the Company's consolidated financial statements.

2016 Activity - Courier Capital Acquisition

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

This acquisition was accounted for under the acquisition method in accordance with FASB ASC Topic 805. Accordingly, the assets and liabilities, both tangible and intangible, were recorded at their estimated fair values as of the acquisition date. The following table presents the allocation of acquisition cost to the assets acquired and liabilities assumed, based on their estimated fair values (in thousands).

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

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The amounts assigned to goodwill and other intangible assets for the Courier Capital acquisition are as follows (dollars in thousands):

	Amount allocated	Useful life (in years)
Goodwill	\$ 6,015	n/a
Other intangible assets - customer relationships	3,900	20
Other intangible assets - other	28	5
	\$ 9,943	

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Table of Contents**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Unaudited)****(3.) EARNINGS PER COMMON SHARE (EPS)**

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

	Three months ended September 30,		Nine months ended September 30,	
	2017	2016	2017	2016
Net income available to common shareholders	\$ 7,913	\$ 8,103	\$ 21,371	\$ 22,141
Weighted average common shares outstanding:				
Total shares issued	15,448	14,692	15,002	14,688
Unvested restricted stock awards	(44)	(72)	(48)	(76)
Treasury shares	(136)	(164)	(148)	(183)
Total basic weighted average common shares outstanding	15,268	14,456	14,806	14,429
Incremental shares from assumed:				
Exercise of stock options	7	16	11	21
Vesting of restricted stock awards	27	28	30	35
Total diluted weighted average common shares outstanding	15,302	14,500	14,847	14,485
Basic earnings per common share	\$ 0.52	\$ 0.56	\$ 1.44	\$ 1.53
Diluted earnings per common share	\$ 0.52	\$ 0.56	\$ 1.44	\$ 1.53

For each of the periods presented, average shares subject to the following instruments were excluded from the computation of diluted EPS because the effect would be antidilutive:

Stock options				
Restricted stock awards			2	3
Total			2	3

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

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

	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
<u>September 30, 2017</u>				
Securities available for sale:				
U.S. Government agency and government sponsored enterprises	\$ 163,366	\$ 890	\$ 561	\$ 163,695
Mortgage-backed securities:				
Federal National Mortgage Association	332,172	883	2,226	330,829
Federal Home Loan Mortgage Corporation	42,732	128	501	42,359
Government National Mortgage Association	12,864	282	12	13,134
Collateralized mortgage obligations:				
Federal National Mortgage Association	225	1	1	225
Federal Home Loan Mortgage Corporation	52			52
Privately issued		950		950
Total mortgage-backed securities	388,045	2,244	2,740	387,549
Asset-backed securities		247		247
Total available for sale securities	\$ 551,411	\$ 3,381	\$ 3,301	\$ 551,491
Securities held to maturity:				
State and political subdivisions	293,026	4,580	429	297,177
Mortgage-backed securities:				
Federal National Mortgage Association	9,904	32	55	9,881
Federal Home Loan Mortgage Corporation	3,232		110	3,122
Government National Mortgage Association	27,672	15	204	27,483
Collateralized mortgage obligations:				
Federal National Mortgage Association	81,269	28	1,190	80,107
Federal Home Loan Mortgage Corporation	98,399	163	1,418	97,144
Government National Mortgage Association	24,830	18	286	24,562
Total mortgage-backed securities	245,306	256	3,263	242,299
Total held to maturity securities	\$ 538,332	\$ 4,836	\$ 3,692	\$ 539,476
<u>December 31, 2016</u>				

Securities available for sale:

U.S. Government agency and government sponsored enterprises	\$ 187,325	\$ 512	\$ 1,569	\$ 186,268
Mortgage-backed securities:				
Federal National Mortgage Association	288,949	897	4,413	285,433
Federal Home Loan Mortgage Corporation	30,182	114	807	29,489
Government National Mortgage Association	15,473	316	15	15,774
Collateralized mortgage obligations:				
Federal National Mortgage Association	16,921	74	125	16,870
Federal Home Loan Mortgage Corporation	5,142		65	5,077
Privately issued		824		824
Total mortgage-backed securities	356,667	2,225	5,425	353,467
Asset-backed securities		191		191
Total available for sale securities	\$ 543,992	\$ 2,928	\$ 6,994	\$ 539,926

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

	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
December 31, 2016 (continued)				
Securities held to maturity:				
State and political subdivisions	305,248	2,127	1,616	305,759
Mortgage-backed securities:				
Federal National Mortgage Association	10,362	1	124	10,239
Federal Home Loan Mortgage Corporation	3,290		150	3,140
Government National Mortgage Association	24,575	18	182	24,411
Collateralized mortgage obligations:				
Federal National Mortgage Association	83,929	21	1,573	82,377
Federal Home Loan Mortgage Corporation	101,025	80	1,827	99,278
Government National Mortgage Association	14,909	40	162	14,787
Total mortgage-backed securities	238,090	160	4,018	234,232
Total held to maturity securities	\$ 543,338	\$ 2,287	\$ 5,634	\$ 539,991

Investment securities with a total fair value of \$845.5 million at September 30, 2017 were pledged as collateral to secure public deposits and for other purposes required or permitted by law.

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

	Three months ended September 30, 2017		Nine months ended September 30, 2017	
	2017	2016	2017	2016
Proceeds from sales	\$ 24,117	\$ 23,497	\$ 49,424	\$ 85,772
Gross realized gains	190	426	606	2,426
Gross realized losses	6		6	

The scheduled maturities of securities available for sale and securities held to maturity at September 30, 2017 are shown below (in thousands). Actual expected maturities may differ from contractual maturities because issuers may have the right to call or prepay obligations.

	Amortized Cost	Fair Value
Debt securities available for sale:		
Due in one year or less	\$	\$
Due from one to five years	122,268	122,260
Due from five to ten years	314,412	314,212
Due after ten years	114,731	115,019
	\$ 551,411	\$ 551,491
Debt securities held to maturity:		
Due in one year or less	\$ 59,880	\$ 60,067
Due from one to five years	162,385	165,992
Due from five to ten years	81,871	82,139
Due after ten years	234,196	231,278
	\$ 538,332	\$ 539,476

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

Unrealized losses on investment securities and the fair value of the related securities, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, were as follows (in thousands):

	Less than 12 months		12 months or longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
September 30, 2017						
Securities available for sale:						
U.S. Government agency and government sponsored enterprises	\$ 57,316	\$ 477	\$ 5,043	\$ 84	\$ 62,359	\$ 561
Mortgage-backed securities:						
Federal National Mortgage Association	185,246	1,582	39,939	644	225,185	2,226
Federal Home Loan Mortgage Corporation	24,875	101	12,353	400	37,228	501
Government National Mortgage Association			928	12	928	12
Collateralized mortgage obligations:						
Federal National Mortgage Association			122	1	122	1
Federal Home Loan Mortgage Corporation			9		9	
Total mortgage-backed securities	210,121	1,683	53,351	1,057	263,472	2,740
Total available for sale securities	267,437	2,160	58,394	1,141	325,831	3,301
Securities held to maturity:						
State and political subdivisions	18,523	161	15,068	268	33,591	429
Mortgage-backed securities:						
Federal National Mortgage Association	5,249	55			5,249	55
Federal Home Loan Mortgage Corporation	1,851	64	1,270	46	3,121	110
Government National Mortgage Association	19,617	171	1,428	33	21,045	204
Collateralized mortgage obligations:						
Federal National Mortgage Association	30,196	402	39,991	788	70,187	1,190
Federal Home Loan Mortgage Corporation	53,062	703	32,029	715	85,091	1,418
Government National Mortgage Association	18,142	205	3,896	81	22,038	286

Total mortgage-backed securities	128,117	1,600	78,614	1,663	206,731	3,263
Total held to maturity securities	146,640	1,761	93,682	1,931	240,322	3,692
Total temporarily impaired securities	\$ 414,077	\$ 3,921	\$ 152,076	\$ 3,072	\$ 566,153	\$ 6,993

December 31, 2016**Securities available for sale:**

U.S. Government agencies and government sponsored enterprises	\$ 113,261	\$ 1,566	\$ 1,458	\$ 3	\$ 114,719	\$ 1,569
Mortgage-backed securities:						
Federal National Mortgage Association	211,491	4,413			211,491	4,413
Federal Home Loan Mortgage Corporation	24,360	807			24,360	807
Government National Mortgage Association	1,111	15			1,111	15
Collateralized mortgage obligations:						
Federal National Mortgage Association	8,119	125			8,119	125
Federal Home Loan Mortgage Corporation	5,077	65			5,077	65
Total mortgage-backed securities	250,158	5,425			250,158	5,425
Total available for sale securities	363,419	6,991	1,458	3	364,877	6,994

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

	Less than 12 months		12 months or longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
December 31, 2016 (continued)						
Securities held to maturity:						
State and political subdivisions	82,644	1,616			82,644	1,616
Mortgage-backed securities:						
Federal National Mortgage Association	9,253	124			9,253	124
Federal Home Loan Mortgage Corporation	3,141	150			3,141	150
Government National Mortgage Association	10,736	182			10,736	182
Collateralized mortgage obligations:						
Federal National Mortgage Association	72,734	1,560	3,107	13	75,841	1,573
Federal Home Loan Mortgage Corporation	92,256	1,825	430	2	92,686	1,827
Government National Mortgage Association	8,675	161	531	1	9,206	162
Total mortgage-backed securities	196,795	4,002	4,068	16	200,863	4,018
Total held to maturity securities	279,439	5,618	4,068	16	283,507	5,634
Total temporarily impaired securities	\$ 642,858	\$ 12,609	\$ 5,526	\$ 19	\$ 648,384	\$ 12,628

The total number of security positions in the investment portfolio in an unrealized loss position at September 30, 2017 was 317 compared to 463 at December 31, 2016. At September 30, 2017, the Company had positions in 115 investment securities with a fair value of \$152.1 million and a total unrealized loss of \$3.1 million that have been in a continuous unrealized loss position for more than 12 months. At September 30, 2017, there were a total of 202 securities positions in the Company's investment portfolio with a fair value of \$414.1 million and a total unrealized loss of \$3.9 million that had been in a continuous unrealized loss position for less than 12 months. At December 31, 2016, the Company had positions in nine investment securities with a fair value of \$5.5 million and a total unrealized loss of \$19 thousand that had been in a continuous unrealized loss position for more than 12 months. At December 31, 2016, there were a total of 454 securities positions in the Company's investment portfolio with a fair value of \$642.9 million and a total unrealized loss of \$12.6 million that had been in a continuous unrealized loss position for less than 12 months. The unrealized loss on investment securities was predominantly caused by changes in market interest rates subsequent to purchase. The fair value of most of the investment securities in the Company's portfolio fluctuates as market interest rates change.

The Company reviews investment securities on an ongoing basis for the presence of other than temporary impairment (OTTI) with formal reviews performed quarterly. When evaluating debt securities for OTTI, management considers

many factors, including: (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, (3) whether the market decline was affected by macroeconomic conditions, and (4) whether the Company has the intention to sell the debt security or whether it is more likely than not that it will be required to sell the debt security before its anticipated recovery. The assessment of whether OTTI exists involves a high degree of subjectivity and judgment and is based on the information then available to management. There was no impairment recorded during the nine months ended September 30, 2017 and 2016.

Based on management's review and evaluation of the Company's debt securities as of September 30, 2017, the debt securities with unrealized losses were not considered to be OTTI. As of September 30, 2017, the Company did not intend to sell any of the securities in a loss position and believes that it is not likely that it will be required to sell any such securities before the anticipated recovery of amortized cost. Accordingly, as of September 30, 2017, 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.

Table of Contents**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Unaudited)****(5.) LOANS**

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

	Principal Amount Outstanding	Net Deferred Loan (Fees) Costs	Loans, Net
<u>September 30, 2017</u>			
Commercial business	\$ 418,873	\$ 542	\$ 419,415
Commercial mortgage	759,898	(1,911)	757,987
Residential real estate loans	438,936	7,108	446,044
Residential real estate lines	114,747	2,874	117,621
Consumer indirect	827,154	30,374	857,528
Other consumer	17,460	180	17,640
Total	\$ 2,577,068	\$ 39,167	2,616,235
Allowance for loan losses			(34,347)
Total loans, net			\$ 2,581,888
<u>December 31, 2016</u>			
Commercial business	\$ 349,079	\$ 468	\$ 349,547
Commercial mortgage	671,552	(1,494)	670,058
Residential real estate loans	421,476	6,461	427,937
Residential real estate lines	119,745	2,810	122,555
Consumer indirect	725,754	26,667	752,421
Other consumer	17,465	178	17,643
Total	\$ 2,305,071	\$ 35,090	2,340,161
Allowance for loan losses			(30,934)
Total loans, net			\$ 2,309,227

Loans held for sale (not included above) were comprised entirely of residential real estate mortgages and totaled \$2.4 million and \$1.1 million as of September 30, 2017 and December 31, 2016, respectively.

Table of Contents**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Unaudited)****(5.) LOANS (Continued)****Past Due Loans Aging**

The Company's recorded investment, by loan class, in current and nonaccrual loans, as well as an analysis of accruing delinquent loans is set forth as of the dates indicated (in thousands):

	30-59 Days Past Due		60-89 Days Past Due		Greater Than 90 Days Past Due		Total Past Due		Nonaccrual		Current		Total Loans	
<u>September 30, 2017</u>														
Commercial business	\$	99	\$		\$	99	\$	99	\$	7,182	\$	411,592	\$	418,873
Commercial mortgage		103		260		363		363		2,539		756,996		759,898
Residential real estate loans		473		40		513		513		1,263		437,160		438,936
Residential real estate lines		444		39		483		483		325		113,939		114,747
Consumer indirect		2,603		740		3,343		3,343		1,250		822,561		827,154
Other consumer		88		4		11		103		15		17,342		17,460
Total loans, gross	\$	3,810	\$	1,083	\$	11	\$	4,904	\$	12,574	\$	2,559,590	\$	2,577,068
<u>December 31, 2016</u>														
Commercial business	\$	1,337	\$		\$	1,337	\$	1,337	\$	2,151	\$	345,591	\$	349,079
Commercial mortgage		48				48		48		1,025		670,479		671,552
Residential real estate loans		1,073		253		1,326		1,326		1,236		418,914		421,476
Residential real estate lines		216				216		216		372		119,157		119,745
Consumer indirect		2,320		488		2,808		2,808		1,526		721,420		725,754
Other consumer		134		15		9		158		7		17,300		17,465
Total loans, gross	\$	5,128	\$	756	\$	9	\$	5,893	\$	6,317	\$	2,292,861	\$	2,305,071

There were no loans past due greater than 90 days and still accruing interest as of September 30, 2017 and December 31, 2016. There were \$11 thousand and \$9 thousand in consumer overdrafts which were past due greater than 90 days as of September 30, 2017 and December 31, 2016, respectively. Consumer overdrafts are overdrawn deposit accounts which have been reclassified as loans but by their terms do not accrue interest.

Troubled Debt Restructurings

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A modification of a loan constitutes a troubled debt restructuring (TDR) when a borrower is experiencing financial difficulty and the modification constitutes a concession. Commercial loans modified in a TDR may involve temporary interest-only payments, term extensions, reductions in the interest rate for the remaining term of the loan, extensions of the maturity date at an interest rate lower than the current market rate for new debt with similar risk, collateral concessions, forgiveness of principal, forbearance agreements, or substituting or adding a new borrower or guarantor.

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

	Quarter-to-Date		Year-to-Date	
	Pre-Modification Outstanding	Post-Modification Outstanding	Pre-Modification Outstanding	Post-Modification Outstanding
	Number of Recorded Contracts	Recorded Investment	Number of Recorded Contracts	Recorded Investment
September 30, 2017				
Commercial business		\$		\$
Commercial mortgage				
Total		\$		\$
September 30, 2016				
Commercial business		\$	3	\$ 526
Commercial mortgage			1	550
Total		\$	4	\$ 1,076

Table of Contents**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Unaudited)****(5.) LOANS (Continued)**

The loans identified as a TDR by the Company during the nine month periods ended September 30, 2016 were previously reported as impaired loans prior to restructuring. Each of the loans restructured during the nine months ended September 30, 2016 were on nonaccrual status at the end of the respective period. The modifications related to collateral concessions. Nonaccrual loans that are restructured remain on nonaccrual status, but may move to accrual status after they have performed according to the restructured terms for a period of time. The TDR classifications did not have a material impact on the Company's determination of the allowance for loan losses because the modified loans were either classified as substandard, with an increased risk allowance allocation, or impaired and evaluated for a specific reserve both before and after restructuring.

There were no loans modified as a TDR within the previous 12 months that defaulted during the nine months ended September 30, 2017 or 2016. For purposes of this disclosure, a loan modified as a TDR is considered to have defaulted when the borrower becomes 90 days past due.

Impaired Loans

Management has determined that specific commercial loans on nonaccrual status and all loans that have had their terms restructured in a troubled debt restructuring are impaired loans. The following table presents the recorded investment, unpaid principal balance and related allowance of impaired loans as of the dates indicated and average recorded investment and interest income recognized on impaired loans for the nine and twelve month periods ended as of the dates indicated (in thousands):

	Recorded Investment ⁽¹⁾	Unpaid Principal Balance ⁽¹⁾	Related Allowance	Average Recorded Investment	Interest Income Recognized
September 30, 2017					
With no related allowance recorded:					
Commercial business	\$ 991	\$ 1,467	\$	\$ 690	\$
Commercial mortgage	604	604		629	
	1,595	2,071		1,319	
With an allowance recorded:					
Commercial business	6,339	6,339	2,678	4,342	
Commercial mortgage	2,438	2,438	174	1,200	
	8,777	8,777	2,852	5,542	

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\$ 10,372 \$ 10,848 \$ 2,852 \$ 6,861 \$

December 31, 2016

With no related allowance recorded:

Commercial business	\$ 645	\$ 1,044	\$	\$ 1,338	\$
Commercial mortgage	673	882		902	

	1,318	1,926		2,240	
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With an allowance recorded:

Commercial business	1,506	1,506	694	1,467	
Commercial mortgage	352	352	124	461	

	1,858	1,858	818	1,928	
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\$ 3,176 \$ 3,784 \$ 818 \$ 4,168 \$

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

Table of Contents**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Unaudited)****(5.) LOANS (Continued)****Credit Quality Indicators**

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

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

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

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

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

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

	Commercial Business	Commercial Mortgage
<u>September 30, 2017</u>		
Uncriticized	\$ 396,021	\$ 738,843
Special mention	6,569	13,650
Substandard	16,283	7,405
Doubtful		

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Total	\$ 418,873	\$ 759,898
<u>December 31, 2016</u>		
Uncriticized	\$ 326,254	\$ 652,550
Special mention	10,377	12,690
Substandard	12,448	6,312
Doubtful		
Total	\$ 349,079	\$ 671,552

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

	Residential Real Estate Loans	Residential Real Estate Lines	Consumer Indirect	Other Consumer
<u>September 30, 2017</u>				
Performing	\$ 437,673	\$ 114,422	\$ 825,904	\$ 17,434
Non-performing	1,263	325	1,250	26
Total	\$ 438,936	\$ 114,747	\$ 827,154	\$ 17,460
<u>December 31, 2016</u>				
Performing	\$ 420,240	\$ 119,373	\$ 724,228	\$ 17,449
Non-performing	1,236	372	1,526	16
Total	\$ 421,476	\$ 119,745	\$ 725,754	\$ 17,465

Table of Contents**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Unaudited)****(5.) LOANS (Continued)****Allowance for Loan Losses**

Loans and the related allowance for loan losses are presented below as of the dates indicated (in thousands):

	Commercial Business	Commercial Mortgage	Residential Real Estate Loans	Residential Real Estate Lines	Consumer Indirect	Other Consumer	Total
<u>September 30, 2017</u>							
Loans:							
Ending balance	\$ 418,873	\$ 759,898	\$ 438,936	\$ 114,747	\$ 827,154	\$ 17,460	\$ 2,577,068
Evaluated for impairment:							
Individually	\$ 7,126	\$ 2,459	\$	\$	\$	\$	\$ 9,585
Collectively	\$ 411,747	\$ 757,439	\$ 438,936	\$ 114,747	\$ 827,154	\$ 17,460	\$ 2,567,483
Allowance for loan losses:							
Ending balance	\$ 15,749	\$ 3,727	\$ 1,161	\$ 157	\$ 13,217	\$ 336	\$ 34,347
Evaluated for impairment:							
Individually	\$ 2,658	\$ 171	\$	\$	\$	\$	\$ 2,829
Collectively	\$ 13,091	\$ 3,556	\$ 1,161	\$ 157	\$ 13,217	\$ 336	\$ 31,518
<u>September 30, 2016</u>							
Loans:							
Ending balance	\$ 350,181	\$ 637,799	\$ 419,547	\$ 120,901	\$ 703,499	\$ 17,700	\$ 2,249,627
Evaluated for impairment:							
Individually	\$ 2,081	\$ 1,334	\$	\$	\$	\$	\$ 3,415
Collectively	\$ 348,100	\$ 636,465	\$ 419,547	\$ 120,901	\$ 703,499	\$ 17,700	\$ 2,246,212
Allowance for loan losses:							
Ending balance	\$ 6,524	\$ 9,710	\$ 1,428	\$ 315	\$ 11,041	\$ 332	\$ 29,350

Evaluated for impairment:

Individually	\$	436	\$	122	\$		\$		\$		\$	558
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Collectively	\$	6,088	\$	9,588	\$	1,428	\$	315	\$	11,041	\$	332	\$	28,792
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The following table sets forth the changes in the allowance for loan losses for the three and nine month periods ended September 30, 2017 (in thousands):

	Commercial Business		Residential Mortgage		Residential Real Estate Loans		Residential Real Estate Lines		Consumer Indirect		Other Consumer		Total	
<u>Three months ended September 30, 2017</u>														
Beginning balance	\$	14,622	\$	3,906	\$	1,247	\$	232	\$	12,833	\$	319	\$	33,159
Charge-offs		(130)				(198)		(21)		(2,330)		(230)		(2,909)
Recoveries		86		5		37		2		1,086		79		1,295
Provision (credit)		1,171		(184)		75		(56)		1,628		168		2,802
Ending balance	\$	15,749	\$	3,727	\$	1,161	\$	157	\$	13,217	\$	336	\$	34,347
<u>Nine months ended September 30, 2017</u>														
Beginning balance	\$	7,225	\$	10,315	\$	1,478	\$	303	\$	11,311	\$	302	\$	30,934
Charge-offs		(1,908)		(10)		(298)		(64)		(7,343)		(620)		(10,243)
Recoveries		332		257		85		58		3,259		250		4,241
Provision (credit)		10,100		(6,835)		(104)		(140)		5,990		404		9,415
Ending balance	\$	15,749	\$	3,727	\$	1,161	\$	157	\$	13,217	\$	336	\$	34,347

Table of Contents**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Unaudited)****(5.) LOANS (Continued)**

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

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

Risk Characteristics

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

Commercial mortgage loans generally have larger balances and involve a greater degree of risk than residential mortgage loans, potentially resulting in higher 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 real estate loans (comprised of conventional mortgages and home equity loans) and residential real estate lines (comprised of home equity lines) are generally made on the basis of the borrower's ability to make repayment from his or her employment and other income, but are secured by real property whose value tends to be more easily ascertainable. Credit risk for these types of loans is generally influenced by general economic conditions, the characteristics of individual borrowers, and the nature of the loan collateral.

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

Table of Contents**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Unaudited)****(6.) GOODWILL AND OTHER INTANGIBLE ASSETS****Goodwill**

The carrying amount of goodwill totaled \$65.8 and \$66.4 million as of September 30, 2017 and December 31, 2016, respectively. The Company performs a goodwill impairment test on an annual basis as of October 1st or more frequently if events and circumstances warrant.

(in thousands)	Banking	Non-Banking	Total
Balance, December 31, 2016	\$ 48,536	\$ 17,881	\$ 66,417
Impairment		(1,575)	(1,575)
Acquisition		998	998
Balance, September 30, 2017	\$ 48,536	\$ 17,304	\$ 65,840

Goodwill and other intangible assets added during the period relates to the acquisition of assets of Robshaw & Julian, which was completed on August 31, 2017. See Note 2 Business Combinations for additional information.

Goodwill is not amortized but, instead, is subject to impairment tests on at least an annual basis, and more frequently if an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying amount. The Company completed an evaluation of the contingent earn out liability related to its 2014 acquisition of SDN during the second quarter of 2017, resulting in a contingent consideration liability adjustment of \$1.2 million. Based on this event, a goodwill impairment test was performed in the second quarter of 2017. Based on its qualitative assessment, the Company concluded it was more likely than not that the fair value of its SDN reporting unit was less than its carrying value. Accordingly, the Company performed a Step 1 review for possible goodwill impairment.

Under Step 1 of the goodwill impairment review, the fair value of the SDN reporting unit was calculated using income and market-based approaches. Under Step 1, it was determined that the carrying value of our SDN reporting unit exceeded its fair value. Based on this assessment, the Company recorded a goodwill impairment charge related to the SDN reporting unit of \$1.6 million during the quarter ended June 30, 2017.

As discussed above, for the quarter ended June 30, 2017, an ad hoc goodwill impairment test for the SDN reporting unit was performed due to the above mentioned identified event. The annual goodwill impairment test will be performed during the fourth quarter as of October 1, 2017. Management performs a qualitative review for events or circumstances indicating potential goodwill impairment on a quarterly basis for all reporting units, and will perform goodwill impairment tests on a more frequent basis, as warranted.

Other Intangible Assets

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

	September 30, 2017	December 31, 2016
Other intangible assets:		
Gross carrying amount	\$ 13,420	\$ 12,610
Accumulated amortization	(4,263)	(3,387)
Net book value	\$ 9,157	\$ 9,223

Amortization expense for total other intangible assets was \$288 thousand and \$876 thousand for the three and nine months ended September 30, 2017, and \$309 thousand and \$946 thousand for the three and nine months ended September 30, 2016, respectively. As of September 30, 2017, the estimated amortization expense of other intangible assets for the remainder of 2017 and each of the next five years is as follows (in thousands):

2017 (remainder of year)	\$ 294
2018	1,112
2019	1,011
2020	909
2021	803
2022	725

Table of Contents**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Unaudited)****(7.) DERIVATIVE INSTRUMENT AND HEDGING ACTIVITIES****Risk Management Objective of Using Derivatives**

The Company is exposed to certain risks arising from both its business operations and economic conditions. The Company principally manages its exposures to a wide variety of business and operational risks through management of its core business activities. The Company manages economic risks, including interest rate, liquidity, and credit risk, primarily by managing the amount, sources, and duration of its assets and liabilities. The Company's existing credit derivatives result from participations in interest rate swaps provided to external lenders as part of loan participation arrangements, therefore, such derivatives are not used to manage interest rate risk in the Company's assets or liabilities.

Credit-risk-related Contingent Features

The Company has agreements with certain of its derivative counterparties that contain one or more of the following provisions: (a) if the Company defaults on any of its indebtedness, including a default where repayment of the indebtedness has not been accelerated by the lender, the Company could also be declared in default on its derivative obligations, and (b) if the Company fails to maintain its status as a well capitalized institution, the counterparty could terminate the derivative positions and the Company would be required to settle its obligations under the agreements.

Fair Values of Derivative Instruments on the Balance Sheet

The table below presents the notional amounts, respective fair values of the Company's derivative financial instruments, as well as their classification on the balance sheet as of September 30, 2017 and December 31, 2016 (in thousands):

	Gross notional amount		Asset derivatives		Liability derivatives	
	Sept. 30, 2017	Dec. 31, 2016	Balance sheet line item	Fair value Sept. 30, 2017 Dec. 31, 2016	Balance sheet line item	Fair value Sept. 30, 2017 Dec. 31, 2016
Derivatives not designated as hedging instruments						
Credit contracts	\$ 12,349	\$	Other assets	\$	Other liabilities	\$ 9
Total derivatives	\$ 12,349	\$		\$		\$ 9

Effect of Derivative Instruments on the Income Statement

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The table below presents the effect of the Company's derivative financial instruments on the income statement for the three and nine months ended September 30, 2017 and 2016 (in thousands):

	Line item of gain (loss) recognized in income	Gain (loss) recognized in income			
		Three months ended		Nine months ended	
Undesignated derivatives		September 30, 2017	September 30, 2016	September 30, 2017	September 30, 2016
Credit contract	Noninterest income - Other	\$ 127	\$	\$ 127	\$
Total undesignated		\$ 127	\$	\$ 127	\$

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Table of Contents**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Unaudited)****(8.) SHAREHOLDERS EQUITY****Common Stock**

The changes in shares of common stock were as follows for the nine month periods ended September 30, 2017 and 2016:

	Outstanding	Treasury	Issued
<u>September 30, 2017</u>			
Shares outstanding at December 31, 2016	14,537,597	154,617	14,692,214
Common stock issued for at-the-market equity offering	1,069,635		1,069,635
Restricted stock awards issued	8,510	(8,510)	
Restricted stock awards forfeited	(10,359)	10,359	
Stock options exercised	21,320	(21,320)	
Stock awards	3,914	(3,914)	
Treasury stock purchases	(4,323)	4,323	
Shares outstanding at September 30, 2017	15,626,294	135,555	15,761,849
<u>September 30, 2016</u>			
Shares outstanding at December 31, 2015	14,190,192	207,317	14,397,509
Common stock issued for Courier Capital acquisition	294,705		294,705
Restricted stock awards issued	8,800	(8,800)	
Restricted stock awards forfeited	(10,183)	10,183	
Stock options exercised	41,961	(41,961)	
Stock awards	2,244	(2,244)	
Shares outstanding at September 30, 2016	14,527,719	164,495	14,692,214

On May 30, 2017, the Company entered into a sales agency agreement, with Sandler O'Neill + Partners, L.P. as sales agent, under which it may sell up to \$40 million of its common stock through an at-the-market equity offering program. The Company expects to use the net proceeds of this offering to support organic growth and other general corporate purposes, including contributing capital to the Bank. Through the period ended September 30, 2017, the Company has sold 1,069,635 shares of its common stock under this program at a weighted average price of \$29.01, representing gross proceeds of approximately \$31.0 million. Net proceeds received were approximately \$29.7 million.

Table of Contents**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Unaudited)****(9.) ACCUMULATED OTHER COMPREHENSIVE LOSS**

The following tables present the components of other comprehensive income (loss) for the three and nine month periods ended September 30, 2017 and 2016 (in thousands):

	Pre-tax Amount	Tax Effect	Net-of-tax Amount
<u>Three months ended September 30, 2017</u>			
Securities available for sale and transferred securities:			
Change in unrealized gain/loss during the period	\$ 589	\$ 226	\$ 363
Reclassification adjustment for net gains included in net income ⁽¹⁾	(127)	(48)	(79)
Total securities available for sale and transferred securities	462	178	284
Pension and post-retirement obligations:			
Amortization of prior service credit included in income	(12)	(4)	(8)
Amortization of net actuarial loss included in income	291	112	179
Total pension and post-retirement obligations	279	108	171
Other comprehensive income	\$ 741	\$ 286	\$ 455
<u>Three months ended September 30, 2016</u>			
Securities available for sale and transferred securities:			
Change in unrealized gain/loss during the period	\$ (1,922)	\$ (742)	\$ (1,180)
Reclassification adjustment for net gains included in net income ⁽¹⁾	(433)	(167)	(266)
Total securities available for sale and transferred securities	(2,355)	(909)	(1,446)
Pension and post-retirement obligations:			
Amortization of prior service credit included in income	(12)	(5)	(7)
Amortization of net actuarial loss included in income	238	92	146
Total pension and post-retirement obligations	226	87	139
Other comprehensive loss	\$ (2,129)	\$ (822)	\$ (1,307)
<u>Nine months ended September 30, 2017</u>			
Securities available for sale and transferred securities:			
Change in unrealized gain/loss during the period	\$ 4,747	\$ 1,831	\$ 2,916

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Reclassification adjustment for net gains included in net income ⁽¹⁾	(514)	(198)	(316)
Total securities available for sale and transferred securities	4,233	1,633	2,600
Pension and post-retirement obligations:			
Amortization of prior service credit included in income	(38)	(14)	(24)
Amortization of net actuarial loss included in income	874	337	537
Total pension and post-retirement obligations	836	323	513
Other comprehensive income	\$ 5,069	\$ 1,956	\$ 3,113
<u>Nine months ended September 30, 2016</u>			
Securities available for sale and transferred securities:			
Change in unrealized gain/loss during the period	\$ 17,084	\$ 6,593	\$ 10,491
Reclassification adjustment for net gains included in net income ⁽¹⁾	(2,512)	(969)	(1,543)
Total securities available for sale and transferred securities	14,572	5,624	8,948
Pension and post-retirement obligations:			
Amortization of prior service credit included in income	(36)	(14)	(22)
Amortization of net actuarial loss included in income	716	276	440
Total pension and post-retirement obligations	680	262	418
Other comprehensive income	\$ 15,252	\$ 5,886	\$ 9,366

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

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(9.) ACCUMULATED OTHER COMPREHENSIVE LOSS (Continued)

Activity in accumulated other comprehensive loss, net of tax, for the three and nine month periods ended September 30, 2017 and 2016 was as follows (in thousands):

	Securities Available for Sale and Transferred Securities	Pension and Post- retirement Obligations	Accumulated Other Comprehensive Loss
<u>Three months ended September 30,</u>			
<u>2017</u>			
Balance at beginning of period	\$ (1,413)	\$ (9,880)	\$ (11,293)
Other comprehensive income (loss) before reclassifications	363		363
Amounts reclassified from accumulated other comprehensive income (loss)	(79)	171	92
Net current period other comprehensive income (loss)	284	171	455
Balance at end of period	\$ (1,129)	\$ (9,709)	\$ (10,838)
<u>Three months ended September 30,</u>			
<u>2016</u>			
Balance at beginning of period	\$ 9,698	\$ (10,352)	\$ (654)
Other comprehensive income (loss) before reclassifications	(1,180)		(1,180)
Amounts reclassified from accumulated other comprehensive income (loss)	(266)	139	(127)
Net current period other comprehensive income (loss)	(1,446)	139	(1,307)
Balance at end of period	\$ 8,252	\$ (10,213)	\$ (1,961)
<u>Nine months ended September 30, 2017</u>			
Balance at beginning of year	\$ (3,729)	\$ (10,222)	\$ (13,951)

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Other comprehensive income (loss) before reclassifications	2,916		2,916
Amounts reclassified from accumulated other comprehensive income (loss)	(316)	513	197
Net current period other comprehensive income (loss)	2,600	513	3,113
Balance at end of period	\$ (1,129)	\$ (9,709)	\$ (10,838)
<u>Nine months ended September 30, 2016</u>			
Balance at beginning of year	\$ (696)	\$ (10,631)	\$ (11,327)
Other comprehensive income (loss) before reclassifications	10,491		10,491
Amounts reclassified from accumulated other comprehensive income (loss)	(1,543)	418	(1,125)
Net current period other comprehensive income (loss)	8,948	418	9,366
Balance at end of period	\$ 8,252	\$ (10,213)	\$ (1,961)

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Table of Contents**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Unaudited)****(9.) ACCUMULATED OTHER COMPREHENSIVE LOSS (Continued)**

The following tables present the amounts reclassified out of each component of accumulated other comprehensive loss for the three and nine month periods ended September 30, 2017 and 2016 (in thousands):

Details About Accumulated Other Comprehensive Loss Components	Amount Reclassified from Accumulated Other Comprehensive Loss Three months ended September 30,		Affected Line Item in the Consolidated Statement of Income
	2017	2016	
Realized gain on sale of investment securities	\$ 184	\$ 426	Net gain on investment securities
Amortization of unrealized holding gains (losses) on investment securities transferred from available for sale to held to maturity	(57)	7	Interest income
	127	433	Total before tax
	(48)	(167)	Income tax expense
	79	266	Net of tax
Amortization of pension and post-retirement items:			
Prior service credit ⁽¹⁾	12	12	Salaries and employee benefits
Net actuarial losses ⁽¹⁾	(291)	(238)	Salaries and employee benefits
	(279)	(226)	Total before tax
	108	87	Income tax benefit
	(171)	(139)	Net of tax
Total reclassified for the period	\$ (92)	\$ 127	

**Nine months ended
September 30,
2017 2016**

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Realized gain on sale of investment securities	\$ 600	\$ 2,426	Net gain on investment securities
Amortization of unrealized holding gains (losses) on investment securities transferred from available for sale to held to maturity	(86)	86	Interest income
	514	2,512	Total before tax
	(198)	(969)	Income tax expense
	316	1,543	Net of tax
Amortization of pension and post-retirement items:			
Prior service credit ⁽¹⁾	38	36	Salaries and employee benefits
Net actuarial losses ⁽¹⁾	(874)	(716)	Salaries and employee benefits
	(836)	(680)	Total before tax
	323	262	Income tax benefit
	(513)	(418)	Net of tax
Total reclassified for the period	\$ (197)	\$ 1,125	

⁽¹⁾ These items are included in the computation of net periodic pension expense. See Note 11 Employee Benefit Plans for additional information.

Table of Contents**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Unaudited)****(10.) SHARE-BASED COMPENSATION PLANS**

The Company maintains certain stock-based compensation plans, approved by the Company's shareholders that are administered by the Management Development and Compensation Committee (the MD&C Committee) of the Board. The share-based compensation plans were established to allow for the grant of compensation awards to attract, motivate and retain employees, executive officers and non-employee directors who contribute to the long-term growth and profitability of the Company and to give such persons a proprietary interest in the Company, thereby enhancing their personal interest in the Company's success.

The MD&C Committee approved the grant of restricted stock units (RSUs) and performance share units (PSUs) shown in the table below to certain employees and executive officers during the first nine months of 2017.

	Number of Underlying Shares	Weighted Average Per Share Grant Date Fair Value
RSUs	25,331	\$ 32.22
PSUs	12,531	33.07

The grant-date fair value for the RSUs granted during the nine month period ended September 30, 2017 is equal to the closing market price of our common stock on the date of grant reduced by the present value of the dividends expected to be paid on the underlying shares.

The number of PSUs that ultimately vest is contingent on achieving specified total shareholder return (TSR) targets relative to the SNL Small Cap Bank & Thrift Index, a market index the MD&C Committee has selected as a peer group for this purpose. The shares will be earned based on the Company's achievement of a relative TSR performance requirement, on a percentile basis, compared to the SNL Small Cap Bank & Thrift Index over a three-year performance period ending December 31, 2019. The shares earned based on the achievement of the TSR performance requirement, if any, will vest on February 22, 2020 assuming the recipient's continuous service to the Company.

The grant-date fair value of the PSUs granted during the nine month period ended September 30, 2017 was determined using the Monte Carlo simulation model on the date of grant, assuming the following (i) expected term of 2.85 years, (ii) risk free interest rate of 1.45%, (iii) expected dividend yield of 2.41% and (iv) expected stock price volatility over the expected term of the TSR award of 21.9%. The Monte Carlo simulation model is a risk analysis method that selects a random value from a range of estimates.

During the nine months ended September 30, 2017, the Company issued a total of 3,914 shares of common stock in-lieu of cash for the annual retainer of five non-employee directors and granted a total of 8,510 restricted shares of

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common stock to non-employee directors, of which 4,260 shares vested immediately and 4,250 shares will vest after completion of a one-year service requirement. The market price of the stock and restricted stock on the date of grant was \$29.35.

The following is a summary of restricted stock award and restricted stock units activity for the nine month period ended September 30, 2017:

	Number of Shares	Weighted Average Market Price at Grant Date
Outstanding at beginning of year	114,565	\$ 19.90
Granted	49,739	31.40
Vested	(25,053)	23.84
Forfeited	(11,359)	12.81
Outstanding at end of period	127,892	\$ 24.23

At September 30, 2017, the total unrecognized compensation expense related to the nonvested awards granted and expected to vest was \$1.7 million. This cost is expected to be recognized over a weighted-average period of 2.0 years.

Table of Contents**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Unaudited)****(10.) SHARE-BASED COMPENSATION PLANS (Continued)**

The Company uses the Black-Scholes valuation method to estimate the fair value of its stock option awards. There were no stock options awarded during first nine months of 2017 or 2016. There was no unrecognized compensation expense related to unvested stock options as of September 30, 2017. The following is a summary of stock option activity for the nine months ended September 30, 2017 (dollars in thousands, except per share amounts):

	Number of Options	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value
Outstanding at beginning of year	49,099	\$ 19.00		
Exercised	(21,320)	19.45		
Expired	(5,580)	19.64		
Outstanding and exercisable at end of period	22,199	\$ 18.40	0.6	\$ 231

The aggregate intrinsic value (the amount by which the market price of the stock on the date of exercise exceeded the market price of the stock on the date of grant) of option exercises for the nine months ended September 30, 2017 and 2016 was \$297 thousand and \$342 thousand, respectively. The total cash received as a result of option exercises under stock compensation plans for the nine months ended September 30, 2017 and 2016 was \$413 thousand and \$814 thousand, respectively.

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

	Three months ended September 30,		Nine months ended September 30,	
	2017	2016	2017	2016
Salaries and employee benefits	\$ 248	\$ 131	\$ 676	\$ 386
Other noninterest expense	32	34	209	211

Total share-based compensation expense	\$ 280	\$ 165	\$ 885	\$ 597
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(11.) EMPLOYEE BENEFIT PLANS

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

	Three months ended September 30,		Nine months ended September 30,	
	2017	2016	2017	2016
Service cost	\$ 785	\$ 722	\$ 2,355	\$ 2,164
Interest cost on projected benefit obligation	613	601	1,840	1,804
Expected return on plan assets	(1,193)	(1,150)	(3,581)	(3,450)
Amortization of unrecognized prior service credit	(12)	(12)	(38)	(36)
Amortization of unrecognized net actuarial loss	291	238	874	716
Net periodic pension expense	\$ 484	\$ 399	\$ 1,450	\$ 1,198

The net periodic benefit expense is recorded as a component of salaries and employee benefits in the consolidated statements of income. The Company's funding policy is to contribute, at a minimum, an actuarially determined amount that will satisfy the minimum funding requirements determined under the appropriate sections of the Internal Revenue Code. The Company has no minimum required contribution for the 2017 fiscal year.

Table of Contents**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Unaudited)****(12.) COMMITMENTS AND CONTINGENCIES**

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

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

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

	September 30, 2017	December 31, 2016
Commitments to extend credit	\$ 644,882	\$ 555,713
Standby letters of credit	13,336	12,689

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the agreement. Commitments generally have fixed expiration dates or other termination clauses which 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 \$1.1 million at September 30, 2017. The Company had no forward sales commitments at December 31, 2016. 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.

(13.) FAIR VALUE MEASUREMENTS

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

Valuation Hierarchy

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

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

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

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

Table of Contents**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Unaudited)****(13.) FAIR VALUE MEASUREMENTS (Continued)**

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

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

Derivative instruments credit contracts: The fair value of derivative instruments credit contracts is determined using quoted secondary market prices for similar financial instruments and are classified as Level 2 in the fair value hierarchy.

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

Collateral dependent impaired loans: Fair value of impaired loans with specific allocations of the allowance for loan losses is measured based on the value of the collateral securing these loans and is classified as Level 3 in the fair value hierarchy. Collateral may be real estate and/or business assets including equipment, inventory and/or accounts receivable and collateral value is determined based on appraisals performed by qualified licensed appraisers hired by the Company. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Appraised and reported values may be discounted based on management's historical knowledge, changes in market conditions from the time of valuation, and/or management's expertise and knowledge of the client and the client's business. Such discounts are typically significant and result in a Level 3 classification of the inputs for determining fair value. Impaired loans are reviewed and evaluated on at least a quarterly basis for additional impairment and adjusted accordingly, based on the same factors identified above.

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

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

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

Table of Contents**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Unaudited)****(13.) FAIR VALUE MEASUREMENTS (Continued)****Assets and Liabilities Measured at Fair Value**

The following tables present for each of the fair-value hierarchy levels the Company's assets that are measured at fair value on a recurring and non-recurring basis as of the dates indicated (in thousands).

	Quoted Prices in Active Markets for Identical Assets or Liabilities (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
September 30, 2017				
Measured on a recurring basis:				
Securities available for sale:				
U.S. Government agencies and government sponsored enterprises	\$	\$ 163,695	\$	\$ 163,695
Mortgage-backed securities		387,549		387,549
Asset-backed securities		247		247
	\$	\$ 551,491	\$	\$ 551,491
Other liabilities:				
Derivative instruments - credit contracts	\$	\$ 9	\$	\$ 9
	\$	\$ 9	\$	\$ 9
Measured on a nonrecurring basis:				
Loans:				
Loans held for sale	\$	\$ 2,407	\$	\$ 2,407
Collateral dependent impaired loans			5,812	5,812
Other assets:				
Loan servicing rights			1,008	1,008
Other real estate owned			281	281

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\$ 2,407 \$ 7,101 \$ 9,508

December 31, 2016

Measured on a recurring basis:

Securities available for sale:

U.S. Government agencies and government

sponsored enterprises	\$	\$ 186,268	\$	\$ 186,268
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Mortgage-backed securities		353,467		353,467
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Asset-backed securities		191		191
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	\$	\$ 539,926	\$	\$ 539,926
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Other liabilities:

Derivative instruments	credit contracts	\$	\$	\$	\$
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	\$	\$	\$	\$
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Measured on a nonrecurring basis:

Loans:

Loans held for sale	\$	\$ 1,050	\$	\$ 1,050
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Collateral dependent impaired loans			901	901
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Other assets:

Loan servicing rights			1,075	1,075
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Other real estate owned			107	107
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	\$	\$ 1,050	\$ 2,083	\$ 3,133
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There were no transfers between Levels 1 and 2 during the nine months ended September 30, 2017 and 2016. There were no liabilities measured at fair value on a nonrecurring basis during the nine month periods ended September 30, 2017 and 2016.

Table of Contents**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Unaudited)****(13.) FAIR VALUE MEASUREMENTS (Continued)**

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

Asset	Fair Value	Valuation Technique	Unobservable Input	Unobservable Input Value or Range
Collateral dependent impaired loans	\$ 5,812	Appraisal of collateral ⁽¹⁾	Appraisal adjustments ⁽²⁾	0% - 49% discount
Loan servicing rights	1,008	Discounted cash flow	Discount rate	5.1% ⁽³⁾
			Constant prepayment rate	12.0% ⁽³⁾
Other real estate owned	281	Appraisal of collateral ⁽¹⁾	Appraisal adjustments ⁽²⁾	6% - 43% discount

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

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

(3) Weighted averages.

Changes in Level 3 Fair Value Measurements

There were no assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) as of or during the nine months ended September 30, 2017.

Disclosures about Fair Value of Financial Instruments

The assumptions used below are expected to approximate those that market participants would use in valuing these financial instruments.

Fair value estimates are made at a specific point in time, based on available market information and judgments about the financial instrument, including estimates of timing, amount of expected future cash flows and the credit standing of the issuer. Such estimates do not consider the tax impact of the realization of unrealized gains or losses. In some cases, the fair value estimates cannot be substantiated by comparison to independent markets. In addition, the disclosed fair value may not be realized in the immediate settlement of the financial instrument. Care should be exercised in deriving conclusions about our business, its value or financial position based on the fair value information of financial instruments presented below.

The estimated fair value approximates carrying value for cash and cash equivalents, Federal Home Loan Bank (FHLB) and Federal Reserve Bank (FRB) stock, accrued interest receivable, non-maturity deposits, short-term borrowings and accrued interest payable. Fair value estimates for other financial instruments not included elsewhere in this disclosure are discussed below.

Securities held to maturity: The fair value of the Company's investment securities held to maturity is primarily measured using information from a third-party pricing service. The fair value measurements consider observable data that may include dealer quotes, market spreads, cash flows, the U.S. Treasury yield curve, live trading levels, trade execution data, market consensus prepayment speeds, credit information and the bond's terms and conditions, among other things.

Loans: The fair value of the Company's loans was estimated by discounting the expected future cash flows using the current interest rates at which similar loans would be made for the same remaining maturities. Loans were first segregated by type such as commercial, residential mortgage, and consumer, and were then further segmented into fixed and variable rate and loan quality categories. Expected future cash flows were projected based on contractual cash flows, adjusted for estimated prepayments.

Time deposits: The fair value of time deposits was estimated using a discounted cash flow approach that applies prevailing market interest rates for similar maturity instruments. The fair values of the Company's time deposit liabilities do not take into consideration the value of the Company's long-term relationships with depositors, which may have significant value.

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

Table of Contents**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Unaudited)****(13.) FAIR VALUE MEASUREMENTS (Continued)**

The following presents (in thousands) the placement in the fair value measurement hierarchy of the Company's financial instruments as of the dates indicated, as well as their carrying amount and estimated fair value.

	Level in Fair Value Measurement Hierarchy	September 30, 2017 Carrying Amount	Estimated Fair Value	December 31, 2016 Carrying Amount	Estimated Fair Value
Financial assets:					
Cash and cash equivalents	Level 1	\$ 97,838	\$ 97,838	\$ 71,277	\$ 71,277
Securities available for sale	Level 2	551,491	551,491	539,926	539,926
Securities held to maturity	Level 2	538,332	539,476	543,338	539,991
Loans held for sale	Level 2	2,407	2,407	1,050	1,050
Loans	Level 2	2,576,076	2,552,188	2,308,326	2,285,146
Loans ⁽¹⁾	Level 3	5,812	5,812	901	901
Accrued interest receivable	Level 1	10,937	10,937	9,192	9,192
FHLB and FRB stock	Level 2	21,245	21,245	21,780	21,780
Financial liabilities:					
Non-maturity deposits	Level 1	2,418,055	2,418,055	2,292,706	2,292,706
Time deposits	Level 2	863,453	861,358	702,516	701,097
Short-term borrowings	Level 1	310,800	310,800	331,500	331,500
Long-term borrowings	Level 2	39,114	41,678	39,061	40,701
Accrued interest payable	Level 1	7,693	7,693	5,394	5,394
Derivative instruments - credit contracts	Level 2	9	9		

⁽¹⁾ Comprised of collateral dependent impaired loans.

(14.) SEGMENT REPORTING

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

The Banking segment includes all of the Company's retail and commercial banking operations. The Non-Banking segment includes the activities of SDN, a full service insurance agency that provides a broad range of insurance services to both personal and business clients, and Courier Capital, an investment advisor and wealth management

firm that provides customized investment management, investment consulting and retirement plan services to individuals, businesses, institutions, foundations and retirement plans. Holding company amounts are the primary differences between segment amounts and consolidated totals, and are reflected in the Holding Company and Other column below, along with amounts to eliminate balances and transactions between segments.

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

	Banking	Non-Banking	Holding Company and Other	Consolidated Totals
<u>September 30, 2017</u>				
Goodwill	\$ 48,536	\$ 17,304	\$	\$ 65,840
Other intangible assets, net	421	8,736		9,157
Total assets	3,986,979	30,788	3,824	4,021,591
<u>December 31, 2016</u>				
Goodwill	\$ 48,536	\$ 17,881	\$	\$ 66,417
Other intangible assets, net	579	8,644		9,223
Total assets	3,678,230	31,166	944	3,710,340

Table of Contents**FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (Unaudited)****(14.) SEGMENT REPORTING (Continued)**

	Banking	Non-Banking ⁽¹⁾	Holding Company and Other	Consolidated Totals
<u>Three months ended September 30,</u>				
<u>2017</u>				
Net interest income (expense)	\$ 29,056	\$	\$ (618)	\$ 28,438
Provision for loan losses	(2,802)			(2,802)
Noninterest income	6,410	2,315	(151)	8,574
Noninterest expense	(19,939)	(1,947)	(581)	(22,467)
Income (loss) before income taxes	12,725	368	(1,350)	11,743
Income tax (expense) benefit	(3,923)	(144)	603	(3,464)
Net income (loss)	\$ 8,802	\$ 224	\$ (747)	\$ 8,279
<u>Nine months ended September 30,</u>				
<u>2017</u>				
Net interest income (expense)	\$ 84,708	\$	\$ (1,853)	\$ 82,855
Provision for loan losses	(9,415)			(9,415)
Noninterest income	18,203	6,760	780	25,743
Noninterest expense	(58,263)	(7,209)	(1,878)	(67,350)
Income (loss) before income taxes	35,233	(449)	(2,951)	31,833
Income tax (expense) benefit	(10,544)	(440)	1,619	(9,365)
Net income (loss)	\$ 24,689	\$ (889)	\$ (1,332)	\$ 22,468

(1) Includes activity from the acquisition of assets of Robshaw & Julian since August 31, 2017 (the date of acquisition).

	Banking	Non-Banking ⁽²⁾	Holding Company and Other	Consolidated Totals
<u>Three months ended September 30,</u>				
<u>2016</u>				

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

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

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

This Quarterly Report on Form 10-Q should be read in conjunction with the more detailed and comprehensive disclosures included in our Annual Report on Form 10-K for the year ended December 31, 2016. In addition, please read this section in conjunction with our Consolidated Financial Statements and Notes to Consolidated Financial Statements contained herein.

FORWARD LOOKING INFORMATION

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

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

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

These forward-looking statements are not guarantees of future performance, nor should they be relied upon as representing management's views as of any subsequent date. Forward-looking statements involve significant risks and uncertainties and actual results may differ materially from those presented, either expressed or implied, in this Quarterly Report on Form 10-Q and our Annual Report on Form 10-K for the fiscal year ended December 31, 2016, which we refer to as the Form 10-K, including, but not limited to, those presented in the Management's Discussion and Analysis of Financial Condition and Results of Operations. Factors that might cause such material differences include, but are not limited to:

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

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

Geographic concentration may unfavorably impact our operations;

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

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

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

We may be unable to successfully implement our growth strategies, including the integration and successful management of newly-acquired businesses;

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

Our commercial business and mortgage loans increase our exposure to credit risks;

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

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

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

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

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

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

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

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

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

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

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

Acquisitions may disrupt our business and dilute shareholder value;

We are subject to interest rate risk;

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

The policies of the Federal Reserve have a significant impact on our earnings;

The soundness of other financial institutions could adversely affect us;

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

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

We operate in a highly competitive industry and market area;

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

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MANAGEMENT'S DISCUSSION AND ANALYSIS

Liquidity is essential to our businesses;

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

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

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

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

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

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

GENERAL

The Parent is a financial holding company headquartered in New York State, providing banking and nonbanking financial services to individuals, municipalities and businesses primarily in our Western and Central New York footprint. The Company provides diversified financial services through its subsidiaries, Five Star Bank (the Bank), Scott Danahy Naylor, LLC (SDN) and Courier Capital, LLC (Courier Capital). The Company offers a broad array of deposit, lending and other financial services to individuals, municipalities and businesses in Western and Central New York through its wholly-owned New York chartered banking subsidiary, the Bank. Our indirect lending network includes relationships with franchised automobile dealers in Western and Central New York, the Capital District of New York and Northern and Central Pennsylvania. SDN provides a broad range of insurance services to personal and business clients across 45 states. Courier Capital provides customized investment management, investment consulting and retirement plan services to individuals, businesses, institutions, foundations and retirement plans across nine states.

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

Our business strategy has been to maintain a community bank philosophy, which consists of focusing on and understanding the individualized banking and other financial needs of individuals, municipalities and businesses of the local communities surrounding our primary service area. 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 businesses, individuals and community organizations who prefer to build banking, insurance and wealth management relationships with a community bank that combines high quality, competitively-priced products and services with personalized service. Because of our identity and origin as a locally operated bank, we believe that our level of personal service provides a competitive advantage over larger banks, which tend to consolidate decision-making authority outside local communities.

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

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MANAGEMENT'S DISCUSSION AND ANALYSIS

EXECUTIVE OVERVIEW

Summary of 2017 Third Quarter Results

Net income decreased \$190 thousand or 2% to \$8.3 million for the third quarter of 2017 compared to \$8.5 million for the third quarter of 2016. Net income available to common shareholders for the third quarter of 2017 was \$7.9 million, or \$0.52 per diluted share, compared with \$8.1 million, or \$0.56 per diluted share, for the third quarter of last year. Return on average equity was 9.17% and return on average assets was 0.83% for the third quarter of 2017 compared to 10.34% and 0.94%, respectively, for the third quarter of 2016.

Net interest income totaled \$28.4 million in the third quarter of 2017, up from \$26.1 million in the third quarter of 2016. Average earning assets were up \$351.4 million, led by a \$323.9 million increase in average loans in the third quarter of 2017 compared to the same quarter in 2016. The growth in earning assets was partially offset by a lower net interest margin. Third quarter of 2017 net interest margin was 3.17%, a decrease of six basis points from 3.23% reported in the third quarter of 2016.

The provision for loans losses was \$2.8 million in the third quarter of 2017 compared to \$2.0 million in the third quarter of 2016. Net charge-offs during the third quarter of 2017 were \$1.6 million, up from \$1.1 million from the third quarter of 2016. Net charge-offs expressed as an annualized percentage of average loans outstanding were 0.25% during the third quarter of 2017 compared with 0.20% in the third quarter of 2016. See the Allowance for Loan Losses and Non-Performing Assets and Potential Problem Loans sections of this Management's Discussion and Analysis for further discussion regarding the increases in the provision for loan losses and net charge-offs.

Noninterest income totaled \$8.6 million in the third quarter of 2017, compared to \$8.5 million in the third quarter of 2016. Included in these totals are net gains realized from the sale of investment securities totaling \$184 thousand for the third quarter of 2017 and \$426 thousand for the third quarter of 2016. Exclusive of this item, noninterest income was \$8.4 million in the third quarter of 2017 and \$8.1 million in the third quarter of 2016.

Noninterest expense in the third quarter of 2017 totaled \$22.5 million compared with \$20.6 million in the third quarter of 2016. The increase in noninterest expense was primarily the result of higher salaries and employee benefits and occupancy and equipment expenses related to our organic growth initiatives, including the residential mortgage lending expansion.

The regulatory Common equity Tier 1 ratio and Total risk-based capital ratio were 10.09%, and 13.24%, respectively, for the third quarter of 2017. See the Liquidity and Capital Management section of this Management's Discussion and Analysis for further discussion regarding regulatory capital and the Basel III capital rules.

RESULTS OF OPERATIONS

Net Interest Income and Net Interest Margin

Net interest income is our primary source of revenue. Net interest income is the difference between interest income on interest-earning assets, such as loans and investment securities, and the interest expense on interest-bearing deposits and other borrowings used to fund interest-earning and other assets or activities. Net interest income is affected by

changes in interest rates and by the amount and composition of earning assets and interest-bearing liabilities, as well as the sensitivity of the balance sheet to changes in interest rates, including characteristics such as the fixed or variable nature of the financial instruments, contractual maturities and repricing frequencies.

We use interest rate spread and net interest margin 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.

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

	Three months ended		Nine months ended	
	September 30,		September 30,	
	2017	2016	2017	2016
Interest income per consolidated statements of income	\$ 33,396	\$ 29,360	\$ 95,343	\$ 85,241
Adjustment to fully taxable equivalent basis	776	789	2,395	2,367
Interest income adjusted to a fully taxable equivalent basis	34,172	30,149	97,738	87,608
Interest expense per consolidated statements of income	4,958	3,310	12,488	9,273
Net interest income on a taxable equivalent basis	\$ 29,214	\$ 26,839	\$ 85,250	\$ 78,335

Analysis of Net Interest Income for the Three Month Periods ended September 30, 2017 and 2016

Net interest income on a taxable equivalent basis for the three months ended September 30, 2017, was \$29.2 million, an increase of \$2.4 million versus the comparable quarter last year. The increase in net interest income was due to an increase in average earning assets of \$351.4 million or 11% compared to the third quarter of 2016.

The net interest margin for the third quarter of 2017 was 3.17%, six basis points lower than 3.23% for the same period in 2016. This comparable period decrease was a function of an eight basis point decrease in net interest spread, partially offset by a higher contribution from net free funds of two basis points (due principally to increases in average noninterest-bearing deposits and other net free funds). The lower net interest spread was a result of a 17 basis point increase in the cost of average interest-bearing liabilities partly offset by a nine basis point increase in the yield on earning assets.

For the third quarter of 2017, the yield on average earning assets of 3.71% was nine basis points higher than the third quarter of 2016. Loan yields increased six basis points to 4.24% when comparing the third quarter of 2017 to the same period in 2016. The yield on investment securities increased one basis point during the third quarter of 2017 to 2.45%. Overall, the earning asset rate changes increased interest income by \$416 thousand during the third quarter of 2017, along with a favorable volume variance that increased interest income by \$3.6 million, which collectively drove a \$4.0 million increase in interest income.

Average interest-earning assets were \$3.67 billion for the third quarter 2017, an increase of \$351.4 million or 11% from the comparable quarter last year, with average loans up \$323.9 million and average securities up \$27.5 million. The growth in average loans reflected increases in most loan categories. Commercial loans, in particular, were up \$180.2 million or 18% from the third quarter of 2016. In addition, consumer indirect loans were up \$129.1 million or 18% from the third quarter of 2016. Loans represented 70.1% of average interest-earning assets during the third quarter of 2017 compared to 67.8% during the third quarter of 2016. The increase in the volume of average loans resulted in a \$3.5 million increase in interest income, along with a \$376 thousand increase due to the favorable rate

variance. Securities represented 29.9% of average interest-earning assets during the third quarter of 2017 compared to 32.2% during the third quarter of 2016. The increase in the volume of average securities resulted in a \$147 thousand increase in interest income, along with a \$40 thousand increase due to the favorable rate variance.

The cost of average interest-bearing liabilities of 0.68% in the third quarter of 2017 was 17 basis points higher than the third quarter of 2016. The cost of average interest-bearing deposits increased 11 basis points to 0.50% and the cost of short-term borrowings increased 66 basis points to 1.29% in the third quarter of 2017 compared to the same quarter of 2016. The cost of long-term borrowings for the third quarter of 2017 decreased one basis point to 6.32% compared to the same quarter of 2016. Overall, interest-bearing liability rate and volume increases resulted in \$1.6 million of higher interest expense.

Average interest-bearing liabilities of \$2.89 billion in the third quarter of 2017 were \$286.2 million or 11% higher than the third quarter of 2016. On average, interest-bearing deposits grew \$215.7 million, while noninterest-bearing demand deposits (a principal component of net free funds) were up \$40.9 million. The increase in average deposits was due in part to seasonal inflows of municipal deposits, successful business development efforts in retail banking, and an increase in deposits from our Certificate of Deposit Account Registry Service (CDARS) and Insured Cash Sweep (ICS) programs. For further discussion of the CDARS and ICS programs, refer to the Funding Activities Deposits section of this Management s Discussion and Analysis. Overall, interest-bearing deposit rate and volume changes resulted in \$897 thousand of higher interest expense during the third quarter of 2017. Average borrowings increased \$70.5 million compared to the third quarter of 2016. Overall, short and long-term borrowing rate and volume changes resulted in \$751 thousand of higher interest expense during the third quarter of 2017.

Table of Contents**MANAGEMENT'S DISCUSSION AND ANALYSIS*****Analysis of Net Interest Income for the Nine Months ended September 30, 2017 and September 30, 2016***

Net interest income on a taxable equivalent basis for the first nine months of 2017 was \$85.3 million compared to \$78.3 million for the same period last year. The increase in net interest income was due to an increase in average earning assets of \$342.0 million or 11% compared to the first nine months of 2016.

The net interest margin for the first nine months of 2017 was 3.19%, five basis points lower than 3.24% for the same period last year. This comparable period decrease was a function of a six basis point decrease in net interest spread to 3.07% during the first nine months of 2017, partially offset by a one basis point higher contribution from net free funds. The lower net interest spread was a result of a ten basis point increase in the cost of average interest-bearing liabilities.

For the first nine months of 2017, the yield on average earning assets of 3.66% was four basis points higher than the first nine months of 2016. Loan yields increased one basis point during the first nine months of 2017 to 4.20%. The yield on investment securities decreased one basis point during the first nine months of 2017 to 2.46%. Overall, the earning asset rate changes increased interest income by \$88 thousand during the first nine months of 2017, along with a favorable volume variance that increased interest income by \$10.0 million, which collectively drove a \$10.1 million increase in interest income.

Average interest-earning assets were \$3.57 billion for the first nine months of 2017, an increase of \$342.0 million or 11% from the comparable period last year, with average loans up \$299.9 million and average securities up \$33.5 million. The growth in average loans was comprised of increases in most loan categories. Commercial loans, in particular, were up \$158.2 million or 17% from the first nine months of 2016. Residential real estate loans increased \$35.5 million or 9% and consumer indirect loans increased \$112.7 million or 16% when comparing the first nine months of 2017 with the same period in 2016. Loans represented 69.2% of average interest-earning assets during the first nine months of 2017 compared to 67.2% during the first nine months of 2016. The increase in the volume of average loans resulted in a \$9.4 million increase in interest income, along with a \$124 thousand increase due to the favorable rate variance. Securities represented 30.6% of average interest-earning assets during the first nine months of 2017 compared to 32.8% during the first nine months of 2016. The increase in the volume of average securities resulted in a \$604 thousand increase in interest income, partially offset by a \$36 thousand decrease due to the unfavorable rate variance.

The cost of interest-bearing liabilities of 0.59% for the first nine months of 2017 was ten basis points higher than the same period in 2016. Rates on interest-bearing deposits were up six basis points to 0.43% for the first nine months of 2017 versus the same period in 2016. The cost of short-term borrowings for the first nine months of 2017 was 1.09% or 46 basis points higher than 0.63% for the same period last year. The cost of long-term borrowings for the first nine months of 2017 decreased one basis point to 6.32% compared to the same period of 2016. Overall, interest-bearing liability rate and volume increases resulted in \$3.2 million of higher interest expense.

Average interest-bearing liabilities of \$2.83 billion in the first nine months of 2017 were \$288.5 million or 11% higher than the first nine months of 2016. On average, interest-bearing deposits grew \$193.1 million, while noninterest-bearing demand deposits were up \$39.2 million. Overall, interest-bearing deposit rate and volume changes resulted in \$1.6 million of higher interest expense during the first nine months of 2017. Average borrowings increased \$95.4 million compared to the first nine months of 2016. Overall, short and long-term borrowing rate and volume

changes resulted in \$1.6 million of higher interest expense during the first nine months of 2017.

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The following table sets forth certain information relating to the consolidated balance sheets and reflects the average yields earned on interest-earning assets, as well as the average rates paid on interest-bearing liabilities for the periods indicated (in thousands).

	Three months ended September 30,					
	2017			2016		
	Average Balance	Average Interest	Average Rate	Average Balance	Average Interest	Average Rate
Interest-earning assets:						
Federal funds sold and interest-earning deposits	\$	\$	%	\$	\$	%
Investment securities ⁽¹⁾ :						
Taxable	803,814	4,501	2.24	773,037	4,276	2.21
Tax-exempt ⁽²⁾	292,560	2,216	3.03	295,829	2,254	3.05
Total investment securities	1,096,374	6,717	2.45	1,068,866	6,530	2.44
Loans:						
Commercial business	405,308	4,586	4.49	352,696	3,691	4.16
Commercial mortgage	752,634	8,876	4.68	625,003	7,261	4.62
Residential real estate loans	438,436	4,080	3.72	417,854	3,987	3.82
Residential real estate lines	117,597	1,241	4.19	123,312	1,165	3.76
Consumer indirect	841,081	8,145	3.84	711,948	6,987	3.90
Other consumer	17,184	527	12.17	17,548	528	11.97
Total loans	2,572,240	27,455	4.24	2,248,361	23,619	4.18
Total interest-earning assets	3,668,614	34,172	3.71	3,317,228	30,149	3.62
Allowance for loan losses	(33,740)			(29,314)		
Other noninterest-earning assets	316,128			305,758		
Total assets	\$ 3,951,002			\$ 3,593,672		
Interest-bearing liabilities:						
Deposits:						
Interest-bearing demand	\$ 612,401	\$ 224	0.14%	\$ 547,545	\$ 206	0.15%
Savings and money market	998,769	386	0.15	981,207	335	0.14
Time deposits	855,371	2,479	1.15	722,098	1,651	0.91
Total interest-bearing deposits	2,466,541	3,089	0.50	2,250,850	2,192	0.39
Short-term borrowings	385,512	1,251	1.29	315,122	500	0.63
Long-term borrowings	39,103	618	6.32	39,032	618	6.33

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Total borrowings	424,615	1,869	1.75	354,154	1,118	1.26
Total interest-bearing liabilities	2,891,156	4,958	0.68	2,605,004	3,310	0.51
Noninterest-bearing demand deposits	679,303			638,417		
Other noninterest-bearing liabilities	22,226			24,387		
Shareholders equity	358,317			325,864		
Total liabilities and shareholders equity	\$ 3,951,002			\$ 3,593,672		
Net interest income (tax-equivalent)		\$ 29,214			\$ 26,839	
Net interest spread			3.03%			3.11%
Net earning assets	\$ 777,458			\$ 712,224		
Net interest margin (tax-equivalent)			3.17%			3.23%
Ratio of average interest-earning assets to average interest-bearing liabilities			126.89%			127.34%

(1) Investment securities are shown at amortized cost.

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

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

	Nine months ended September 30,					
	2017			2016		
	Average Balance	Interest	Average Rate	Average Balance	Interest	Average Rate
Interest-earning assets:						
Federal funds sold and interest-earning deposits	\$ 8,869	\$ 67	1.02%	\$ 129	\$ 1	0.61%
Investment securities ⁽¹⁾ :						
Taxable	790,407	13,287	2.24	763,796	12,800	2.23
Tax-exempt ⁽²⁾	300,318	6,844	3.04	293,476	6,763	3.07
Total investment securities	1,090,725	20,131	2.46	1,057,272	19,563	2.47
Loans:						
Commercial business	385,025	12,522	4.35	332,985	10,396	4.17
Commercial mortgage	710,690	24,761	4.66	604,577	20,846	4.61
Residential real estate loans	432,838	12,157	3.74	397,327	11,669	3.92
Residential real estate lines	119,493	3,611	4.04	125,273	3,555	3.79
Consumer indirect	804,051	22,962	3.82	691,343	20,009	3.87
Other consumer	16,941	1,527	12.05	17,678	1,569	11.85
Total loans	2,469,038	77,540	4.20	2,169,183	68,044	4.19
Total interest-earning assets	3,568,632	97,738	3.66	3,226,584	87,608	3.62
Allowance for loan losses	(32,325)			(28,423)		
Other noninterest-earning assets	315,283			304,467		
Total assets	\$ 3,851,590			\$ 3,502,628		
Interest-bearing liabilities:						
Deposits:						
Interest-bearing demand	\$ 632,596	\$ 667	0.14%	\$ 566,419	\$ 617	0.15%
Savings and money market	1,027,927	1,073	0.14	988,224	989	0.13
Time deposits	780,374	6,080	1.04	693,153	4,631	0.89
Total interest-bearing deposits	2,440,897	7,820	0.43	2,247,796	6,237	0.37
Short-term borrowings	345,637	2,815	1.09	250,329	1,183	0.63
Long-term borrowings	39,085	1,853	6.32	39,015	1,853	6.33
Total borrowings	384,722	4,668	1.62	289,344	3,036	1.40
Total interest-bearing liabilities	2,825,619	12,488	0.59	2,537,140	9,273	0.49
Noninterest-bearing demand deposits	665,221			626,018		

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Other noninterest-bearing liabilities	20,954	22,032
Shareholders' equity	339,796	317,438
Total liabilities and shareholders' equity	\$ 3,851,590	\$ 3,502,628
Net interest income (tax-equivalent)	\$ 85,250	\$ 78,335
Net interest spread	3.07%	3.13%
Net earning assets	\$ 743,013	\$ 689,444
Net interest margin (tax-equivalent)	3.19%	3.24%
Ratio of average interest-earning assets to average interest-bearing liabilities	126.30%	127.17%

(1) Investment securities are shown at amortized cost.

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

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

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

Increase (decrease) in:	Three months ended September 30, 2017 vs. 2016			Nine months ended September 30, 2017 vs. 2016		
	Volume	Rate	Total	Volume	Rate	Total
Interest income:						
Federal funds sold and interest-earning deposits	\$	\$	\$	\$ 66	\$	\$ 66
Investment securities:						
Taxable	172	53	225	447	40	487
Tax-exempt	(25)	(13)	(38)	157	(76)	81
Total investment securities	147	40	187	604	(36)	568
Loans:						
Commercial business	579	316	895	1,678	448	2,126
Commercial mortgage	1,503	112	1,615	3,695	220	3,915
Residential real estate loans	193	(100)	93	1,012	(524)	488
Residential real estate lines	(56)	132	76	(169)	225	56
Consumer indirect	1,252	(94)	1,158	3,222	(269)	2,953
Other consumer	(11)	10	(1)	(66)	24	(42)
Total loans	3,460	376	3,836	9,372	124	9,496
Total interest income	3,607	416	4,023	10,042	88	10,130
Interest expense:						
Deposits:						
Interest-bearing demand	24	(6)	18	70	(20)	50
Savings and money market	6	45	51	40	44	84
Time deposits	338	490	828	625	824	1,449
Total interest-bearing deposits	368	529	897	735	848	1,583
Short-term borrowings	132	619	751	562	1,070	1,632
Long-term borrowings	1	(1)		3	(3)	
Total borrowings	133	618	751	565	1,067	1,632
Total interest expense	501	1,147	1,648	1,300	1,915	3,215

Net interest income	\$ 3,106	\$ (731)	\$ 2,375	\$ 8,742	\$(1,827)	\$ 6,915
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Provision for Loan Losses

The provision for loan losses is based upon credit loss experience, growth or contraction of specific segments of the loan portfolio, and the estimate of losses inherent in the current loan portfolio. The provision for loan losses for the three and nine month periods ended September 30, 2017 were \$2.8 million and \$9.4 million, respectively, compared to \$2.0 million and \$6.3 million for the corresponding periods in 2016. The increase in provision is primarily attributable to growth in the total loan portfolio combined with the impact of the downgrade of one commercial credit relationship in the second quarter of 2017. The downgrade necessitated a provision and increase in allowance for loan losses of approximately \$925 thousand.

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

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

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

	Three months ended		Nine months ended	
	September 30, 2017	September 30, 2016	September 30, 2017	September 30, 2016
Service charges on deposits	\$ 1,901	\$ 1,913	\$ 5,486	\$ 5,392
Insurance income	1,488	1,407	4,052	4,262
ATM and debit card	1,445	1,441	4,230	4,187
Investment advisory	1,497	1,326	4,357	3,934
Company owned life insurance	449	486	1,367	2,340
Investments in limited partnerships	(14)	161	91	253
Loan servicing	105	104	348	332
Net gain on sale of loans held for sale	150	46	270	202
Net gain on investment securities	184	426	600	2,426
Net gain on other assets	21	199	25	285
Contingent consideration liability adjustment			1,200	
Other	1,348	1,030	3,717	3,059
Total noninterest income	\$ 8,574	\$ 8,539	\$ 25,743	\$ 26,672

Insurance income decreased \$210 thousand, or 5%, to \$4.1 million for the first nine months of 2017 compared to \$4.3 million for the first nine months of 2016. The decrease was primarily the result of non-renewal by a few large commercial accounts during 2016 due to: one customer being acquired, one customer going out of business and one customer selecting another agency during a competitive bidding process. These non-renewals have been partially replaced with several new, but smaller, commercial and personal accounts.

Investment advisory income increased to \$4.4 million in the first nine months of 2017 compared to \$3.9 million in the first nine months of 2016, reflecting higher assets under management driven by the acquisition of assets of Robshaw & Julian and favorable market conditions and successful business development efforts.

Income from company owned life insurance decreased to \$1.4 million in the first nine months of 2017 compared to \$2.3 million in the same period in 2016, as the first quarter of 2016 included \$911 thousand of death benefit proceeds.

We have investments in limited partnerships, primarily small business investment companies, and account for these investments under the equity method. The income from these equity method investments fluctuates based on the performance of the underlying investments.

During the first nine months of 2017, we recognized net gains on investment securities totaling \$600 thousand from the sale of eleven agency securities and six mortgage backed securities. The \$2.4 million in gains realized during the first nine months of 2016 resulted from the sale of 24 agency securities and nine mortgage backed securities. The

amount and timing of our sale of investment securities is dependent on a number of factors, including our prudent efforts to realize gains while managing duration, premium and credit risk.

In the second quarter of 2017, we recognized a \$1.2 million non-cash fair value adjustment of the contingent liability related to the SDN acquisition. We also recognized \$1.6 million of goodwill impairment related to the same acquisition.

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

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

	Three months ended		Nine months ended	
	September 30,		September 30,	
	2017	2016	2017	2016
Salaries and employee benefits	\$ 12,348	\$ 11,325	\$ 35,703	\$ 33,757
Occupancy and equipment	4,087	3,617	12,235	10,906
Professional services	1,313	956	3,741	5,236
Computer and data processing	1,208	1,089	3,691	3,335
Supplies and postage	492	490	1,496	1,548
FDIC assessments	440	406	1,366	1,283
Advertising and promotions	188	302	939	1,259
Amortization of intangibles	288	309	876	946
Goodwill impairment			1,575	
Other	2,103	2,124	5,728	5,686
Total noninterest expense	\$ 22,467	\$ 20,618	\$ 67,350	\$ 63,956

Salaries and employee benefits expense increased by \$1.9 million or 6% in the first nine months of 2017 compared to the same period in 2016, primarily due to additional personnel to support our organic growth initiatives.

Occupancy and equipment expense increased \$1.3 million in the first nine months of 2017 compared to the same period in 2016, primarily due to organic growth initiatives.

Professional services decreased \$1.5 million when comparing the first nine months of 2017 to the same period in 2016. The prior year includes approximately \$2.1 million of professional services associated with responding to the demands of an activist shareholder.

Computer and data processing expense increased \$356 thousand, or 11%, when comparing the first nine months of 2017 to the first nine months of 2016 primarily due to information technology projects to maintain and improve our infrastructure.

We recognized \$1.6 million of goodwill impairment in the second quarter of 2017 related to the SDN acquisition. For additional discussion related to the goodwill impairment see Note 6, Goodwill and Other Intangible Assets, of the notes to consolidated financial statements.

Our efficiency ratio for the nine months ended September 30, 2017 was 61.01% compared with 62.35% for the first nine months of 2016. The lower efficiency ratio is a result of the higher net interest income associated with our organic growth initiatives. The efficiency ratio is calculated by dividing total noninterest expense by net revenue,

defined as the sum of tax-equivalent net interest income and noninterest income before net gains on investment securities. An increase in the efficiency ratio indicates that more resources are being utilized to generate the same volume of income, while a decrease indicates a more efficient allocation of resources. The efficiency ratio, a banking industry financial measure, is not required by GAAP. However, the efficiency ratio is used by management in its assessment of financial performance specifically as it relates to noninterest expense control. Management also believes such information is useful to investors in evaluating Company performance.

Income Taxes

For the nine months ended September 30, 2017 and 2016, we recorded income tax expense of \$9.4 million and \$9.2 million, respectively. The effective tax rates for the year-to-date periods in 2017 and 2016 were 29.4% and 28.3%, respectively. The increase in income tax expense and effective tax rate was primarily due to the non-taxable death benefits proceeds on company owned life insurance received in the first quarter of 2016. In addition, the higher effective tax rate in 2017 was a result of the \$1.6 million non-cash goodwill impairment charge related to the SDN acquisition, partially offset by the \$1.2 million non-cash fair value adjustment of the contingent consideration liability related to the SDN acquisition, both of which were non-taxable adjustments. Effective tax rates are impacted by items of income and expense that are not subject to federal or state taxation. Our effective tax rates reflect the impact of these items, which include, but are not limited to, interest income from tax-exempt securities and earnings on company owned life insurance. In addition, our effective tax rate for 2017 and 2016 reflects the New York State tax savings generated by our real estate investment trust.

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

The following table summarizes the composition of our investment securities portfolio as of the dates indicated (in thousands):

	Investment Securities Portfolio Composition			
	September 30, 2017		December 31, 2016	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Securities available for sale (AFS):				
U.S. Government agencies and government-sponsored enterprise securities	\$ 163,366	\$ 163,695	\$ 187,325	\$ 186,268
Mortgage-backed securities:				
Agency mortgage-backed securities	388,045	386,599	356,667	352,643
Non-Agency mortgage-backed securities		950		824
Asset-backed securities		247		191
Total AFS securities	551,411	551,491	543,992	539,926
Securities held to maturity (HTM):				
State and political subdivisions	293,026	297,177	305,248	305,759
Mortgage-backed securities	245,306	242,299	238,090	234,232
Total HTM securities	538,332	539,476	543,338	539,991
Total investment securities	\$ 1,089,743	\$ 1,090,967	\$ 1,087,330	\$ 1,079,917

The AFS investment securities portfolio increased \$11.6 million from \$539.9 million at December 31, 2016 to \$551.5 million at September 30, 2017. The AFS portfolio had net unrealized gains (losses) totaling \$80 thousand and \$(4.1) million at September 30, 2017 and December 31, 2016, respectively. The unrealized gains (losses) in the AFS portfolio were predominantly caused by changes in market interest rates. The fair value of most of the investment securities in the AFS portfolio fluctuates as market interest rates change.

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 September 30, 2017. 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. No tax-equivalent

adjustments were made to the weighted average yields (dollars in thousands).

	Due in one year or less		Due from one to five years		Due after five years through ten years		Due after ten years		Total	
	Cost	Yield	Cost	Yield	Cost	Yield	Cost	Yield	Cost	Yield
Available for sale debt securities:										
U.S. Government agencies and government-sponsored enterprises	\$		15,210	1.87%	\$ 144,055	2.32%	\$ 4,101	2.08%	\$ 163,366	2.27%
Mortgage-backed securities			107,058	1.92	170,357	2.52	110,630	2.29	388,045	2.29
			122,268	1.92	314,412	2.43	114,731	2.28	551,411	2.29
Held to maturity debt securities:										
State and political subdivisions	59,880	1.83	162,385	2.16	70,761	1.85			293,026	2.02
Mortgage-backed securities					11,110	1.61	234,196	2.17	245,306	2.15
	59,880	1.83	162,385	2.16	81,871	1.82	234,196	2.17	538,332	2.08
Total investment securities	\$ 59,880	1.83%	\$ 284,653	2.06%	\$ 396,283	2.30%	\$ 348,927	2.21%	\$ 1,089,743	2.18%

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

We review investment securities on an ongoing basis for the presence of other than temporary impairment (OTTI) with formal reviews performed quarterly. Declines in the fair value of held to maturity and available for sale securities below their cost that are deemed to be other than temporary are reflected in earnings as realized losses to the extent the impairment is related to credit losses or the security is intended to be sold 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 OTTI 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. 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. There were no securities deemed to be other-than-temporarily impaired during the nine month periods ended September 30, 2017 and 2016.

LENDING ACTIVITIES

The following table summarizes the composition of our loan portfolio, excluding loans held for sale and including net unearned income and net deferred fees and costs, as of the dates indicated (in thousands).

	Loan Portfolio Composition			
	September 30, 2017		December 31, 2016	
	Amount	% of Total	Amount	% of Total
Commercial business	\$ 419,415	16.0%	\$ 349,547	14.9%
Commercial mortgage	757,987	29.0	670,058	28.6
Total commercial	1,177,402	45.0	1,019,605	43.5
Residential real estate loans	446,044	17.0	427,937	18.3
Residential real estate lines	117,621	4.5	122,555	5.2
Consumer indirect	857,528	32.8	752,421	32.2
Other consumer	17,640	0.7	17,643	0.8
Total consumer	1,438,833	55.0	1,320,556	56.5
Total loans	2,616,235	100.0%	2,340,161	100.0%

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Less: Allowance for loan losses	34,347	30,934
Total loans, net	\$ 2,581,888	\$ 2,309,227

Total loans increased \$276.1 million to \$2.62 billion at September 30, 2017 from \$2.34 billion at December 31, 2016. The increase in loans was attributable to our organic growth initiatives.

Commercial loans increased \$157.8 million and represented 45.0% of total loans as of September 30, 2017, a result of our continued commercial business development efforts.

The consumer indirect portfolio totaled \$857.5 million and represented 32.8% of total loans as of September 30, 2017. During the first nine months of 2017, we originated \$334.9 million in indirect auto loans with a mix of approximately 42% new auto and 58% used auto. During the first nine months of 2016, we originated \$265.2 million in indirect auto loans with a mix of approximately 43% new auto and 57% used auto. Our origination volumes and mix of new and used vehicles financed fluctuate depending on general market conditions.

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 loans and totaled \$2.4 million and \$1.1 million as of September 30, 2017 and December 31, 2016, respectively.

We sell certain qualifying newly originated or refinanced residential real estate loans on the secondary market. Residential real estate loans serviced for others, which are not included in the consolidated statements of financial condition, amounted to \$164.6 million and \$173.7 million as of September 30, 2017 and December 31, 2016, respectively.

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

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

	Loan Loss Analysis			
	Three months ended		Nine months ended	
	September 30,		September 30,	
	2017	2016	2017	2016
Balance as of beginning of period	\$ 33,159	\$ 28,525	\$ 30,934	\$ 27,085
Charge-offs:				
Commercial business	130	44	1,908	688
Commercial mortgage		156	10	168
Residential real estate loans	198	78	298	258
Residential real estate lines	21	8	64	59
Consumer indirect	2,330	2,056	7,343	6,452
Other consumer	230	158	620	434
Total charge-offs	2,909	2,500	10,243	8,059
Recoveries:				
Commercial business	86	75	332	244
Commercial mortgage	5	29	257	40
Residential real estate loans	37	17	85	142
Residential real estate lines	2	4	58	11
Consumer indirect	1,086	1,160	3,259	3,324
Other consumer	79	79	250	282
Total recoveries	1,295	1,364	4,241	4,043
Net charge-offs	1,614	1,136	6,002	4,016
Provision for loan losses	2,802	1,961	9,415	6,281
Balance at end of period	\$ 34,347	\$ 29,350	\$ 34,347	\$ 29,350
Net loan charge-offs to average loans (annualized)	0.25%	0.20%	0.33%	0.25%
Allowance for loan losses to total loans	1.31%	1.29%	1.31%	1.29%
Allowance for loan losses to non-performing loans	273%	481%	273%	481%

The allowance for loan losses represents the estimated amount of probable credit losses inherent in our loan portfolio. We perform periodic, systematic reviews of the loan portfolio to estimate probable losses in the respective loan portfolios. In addition, we regularly evaluate prevailing economic and business conditions, industry concentrations, changes in the size and characteristics of the portfolio and other pertinent factors. The process we use to determine the overall allowance for loan losses is based on this analysis. Based on this analysis, we believe the allowance for loan losses is adequate as of September 30, 2017.

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

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

Net charge-offs of \$1.6 million in the third quarter of 2017 represented 0.25% of average loans on an annualized basis compared to \$1.1 million or 0.20% in the third quarter of 2016. For the nine months ended September 30, 2017, net charge-offs of \$6.0 million represented 0.33% of average loans on an annualized basis, compared to \$4.0 million or 0.25% for the same period in 2016. The allowance for loan losses was \$34.3 million at September 30, 2017, compared with \$30.9 million at December 31, 2016. The ratio of the allowance for loan losses to total loans was 1.31% at September 30, 2017, compared with 1.32% at December 31, 2016. The ratio of allowance for loan losses to non-performing loans was 273% at September 30, 2017, compared with 489% at December 31, 2016.

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

The table below summarizes our non-performing assets at the dates indicated (in thousands).

	Non-Performing Assets	
	September 30, 2017	December 31, 2016
Nonaccrual loans:		
Commercial business	\$ 7,182	\$ 2,151
Commercial mortgage	2,539	1,025
Residential real estate loans	1,263	1,236
Residential real estate lines	325	372
Consumer indirect	1,250	1,526
Other consumer	15	7
Total nonaccrual loans	12,574	6,317
Accruing loans or consumer overdrafts 90 days or more delinquent	11	9
Total non-performing loans	12,585	6,326
Foreclosed assets	281	107
Total non-performing assets	\$ 12,866	\$ 6,433
Non-performing loans to total loans	0.48%	0.27%
Non-performing assets to total assets	0.32%	0.17%

Changes in the level of nonaccrual loans typically represent increases for loans that reach a specified past due status, offset by reductions for loans that are charged-off, paid down, sold, transferred to foreclosed real estate, or are no longer classified as nonaccrual because they have returned to accrual status. Activity in nonaccrual loans for the three and nine months ended September 30, 2017 was as follows (in thousands):

	Three months ended September 30, 2017	Nine months ended September 30, 2017
Nonaccrual loans, beginning of period	\$ 12,619	\$ 6,317
Additions	4,608	21,910
Payments	(1,364)	(3,927)
Charge-offs	(2,747)	(9,871)

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Returned to accruing status	(317)	(1,476)
Transferred to other real estate or repossessed assets	(225)	(379)
Nonaccrual loans, end of period	\$ 12,574	\$ 12,574

Non-performing assets include non-performing loans and foreclosed assets. Non-performing assets at September 30, 2017 were \$12.9 million, an increase of \$6.4 million from December 31, 2016. The primary component of non-performing assets is non-performing loans, which were \$12.6 million or 0.48% of total loans at September 30, 2017, compared with \$6.3 million or 0.27% of total loans at December 31, 2016. The increase was primarily the result of the second quarter internal downgrade of two commercial credit relationships with unpaid principal balances totaling \$5.6 million.

Approximately \$823 thousand, or 7%, of the \$12.6 million in non-performing loans as of September 30, 2017 were current with respect to payment of principal and interest, but were classified as non-accruing because repayment in full of principal and/or interest was uncertain. Included in nonaccrual loans are troubled debt restructurings (TDRs) of \$164 thousand and \$1.4 million at September 30, 2017 and December 31, 2016, respectively. We had one TDR of \$650 thousand that was accruing interest as of September 30, 2017, and we had no TDRs that were accruing interest as of December 31, 2016.

Foreclosed assets consist of real property formerly pledged as collateral for loans, which we have acquired through foreclosure proceedings or acceptance of a deed in lieu of foreclosure. Foreclosed asset holdings represented five properties totaling \$281 thousand at September 30, 2017 and four properties totaling \$107 thousand at December 31, 2016.

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

Potential problem loans are loans that are currently performing, but information known about possible credit problems of the borrowers causes us 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. We consider loans classified as substandard, which continue to accrue interest, to be potential problem loans. We identified \$14.0 million and \$15.6 million in loans that continued to accrue interest which were classified as substandard as of September 30, 2017 and December 31, 2016, respectively.

FUNDING ACTIVITIES**Deposits**

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

	Deposit Composition			
	September 30, 2017		December 31, 2016	
	Amount	% of Total	Amount	% of Total
Noninterest-bearing demand	\$ 710,865	21.7%	\$ 677,076	22.6%
Interest-bearing demand	656,703	20.0	581,436	19.4
Savings and money market	1,050,487	32.0	1,034,194	34.5
Time deposits < \$250,000	706,373	21.5	602,715	20.2
Time deposits of \$250,000 or more	157,080	4.8	99,801	3.3
Total deposits	\$ 3,281,508	100.0%	\$ 2,995,222	100.0%

We offer a variety of deposit products designed to attract and retain customers, with the primary focus on building and expanding long-term relationships. At September 30, 2017, total deposits were \$3.28 billion, representing an increase of \$286.3 million for the year. Time deposits were approximately 26% of total deposits at September 30, 2017 and 24% at December 31, 2016.

Nonpublic deposits, the largest component of our funding sources, totaled \$2.36 billion and \$2.19 billion at September 30, 2017 and December 31, 2016, respectively, and represented 72% and 73% of total deposits as of the end of each period, respectively. We have managed this segment of funding through a strategy of competitive pricing that minimizes the number of customer relationships that have only a single service high cost deposit account.

As an additional source of funding, we offer a variety of public (municipal) deposit products to the towns, villages, counties and school districts within our market. Public deposits generally range from 20% to 30% of our total deposits. There is a high degree of seasonality in this component of funding, because the level of deposits varies with the seasonal cash flows for these public customers. We maintain the necessary levels of short-term liquid assets to accommodate the seasonality associated with public deposits. Total public deposits were \$926.0 million and \$803.6 million at September 30, 2017 and December 31, 2016, respectively, and represented 28% and 27% of total

deposits as of the end of each period, respectively. The increase in public deposits during 2017 was due largely to successful business development efforts.

We had no traditional brokered deposits at September 30, 2017 or December 31, 2016; however, we do participate in the CDARS and ICS programs, which enable depositors to receive FDIC insurance coverage for deposits otherwise exceeding the maximum insurable amount. CDARS and ICS deposits are considered brokered deposits for regulatory reporting purposes. Through these programs, deposits in excess of the maximum insurable amount are placed with multiple participating financial institutions. Reciprocal CDARS deposits and ICS deposits totaled \$168.0 million and \$146.1 million, respectively, at September 30, 2017, compared to \$143.2 million and \$152.9, respectively, at December 31, 2016.

Borrowings

The Company classifies borrowings as short-term or long-term in accordance with the original terms of the applicable agreement. Outstanding borrowings consisted of the following as of the dates indicated (in thousands):

	September 30, 2017	December 31, 2016
Short-term borrowings - Short-term FHLB borrowings	\$ 310,800	\$ 331,500
Long-term borrowings - Subordinated notes	39,114	39,061
Total borrowings	\$ 349,914	\$ 370,561

Table of Contents**MANAGEMENT'S DISCUSSION AND ANALYSIS*****Short-term Borrowings***

Short-term Federal Home Loan Bank (FHLB) borrowings have original maturities of less than one year and include overnight borrowings which we typically utilize to address short term funding needs as they arise. Short-term FHLB borrowings at September 30, 2017 consisted of \$163.3 million in overnight borrowings and \$147.5 million in short-term advances. The maximum amount of short-term FHLB borrowings outstanding at any month-end during the nine months ended September 30, 2017 was \$446.9 million. Short-term FHLB borrowings at December 31, 2016 consisted of \$171.5 million in overnight borrowings and \$160.0 million in short-term advances.

We have credit capacity with the FHLB and can borrow through facilities that include amortizing and term advances or repurchase agreements. We had approximately \$204.8 million of immediate credit capacity with the FHLB as of September 30, 2017. We had approximately \$606.4 million in secured borrowing capacity at the Federal Reserve Bank (FRB) discount window, none of which was outstanding at September 30, 2017. The FHLB and FRB credit capacity are collateralized by securities from our investment portfolio and certain qualifying loans. We had approximately \$140.0 million of credit available under unsecured federal funds purchased lines with various banks as of September 30, 2017. Additionally, we had approximately \$227.7 million of unencumbered liquid securities available for pledging.

The Parent has a revolving line of credit with a commercial bank allowing borrowings up to \$20.0 million in total as an additional source of working capital. At September 30, 2017, no amounts have been drawn on the line of credit.

Long-term Borrowings

On April 15, 2015, we issued \$40.0 million of Subordinated Notes in a registered public offering. The Subordinated Notes bear interest at a fixed rate of 6.0% per year, payable semi-annually, for the first 10 years. From April 15, 2025 to the April 15, 2030 maturity date, the interest rate will reset quarterly to an annual interest rate equal to the then current three-month London Interbank Offered Rate plus 3.944%, payable quarterly. The Subordinated Notes are redeemable by us at any quarterly interest payment date beginning on April 15, 2025 to maturity at par, plus accrued and unpaid interest. Proceeds, net of debt issuance costs of \$1.1 million, were \$38.9 million. The Subordinated Notes qualify as Tier 2 capital for regulatory purposes.

LIQUIDITY AND CAPITAL MANAGEMENT**Liquidity**

The objective of maintaining adequate liquidity is to assure that we meet our financial obligations. These obligations include the withdrawal of deposits on demand or at their contractual maturity, the repayment of matured borrowings, the ability to fund new and existing loan commitments and the ability to take advantage of new business opportunities. We achieve liquidity by maintaining a strong base of both core customer funds and maturing short-term assets; we also rely on our ability to sell or pledge securities and lines-of-credit and our overall ability to 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 source of our non-deposit borrowings is FHLB advances, of which we had \$310.8 million outstanding at September 30, 2017. In addition to this amount, we have additional collateralized wholesale borrowing capacity of approximately \$951.2 million from various funding sources which include the FHLB, the FRB, and commercial banks that we can use to fund lending activities, liquidity needs, and/or to adjust and manage our asset and liability position.

The Parent's funding requirements consist primarily of dividends to shareholders, debt service, income taxes, operating expenses, funding of nonbank subsidiaries, repurchases of our stock, and acquisitions. The Parent obtains funding to meet obligations from dividends received from the Bank, net taxes collected from subsidiaries included in the federal consolidated tax return, and the issuance of debt and equity securities. In addition, the Parent maintains a revolving line of credit with a commercial bank for an aggregate amount of up to \$20.0 million, all of which was available at September 30, 2017. The line of credit has a one year term and matures in May 2018. Funds drawn would be used for general corporate purposes and backup liquidity.

Cash and cash equivalents were \$97.8 million as of September 30, 2017, up \$26.6 million from \$71.3 million as of December 31, 2016. Net cash provided by operating activities totaled \$35.4 million and the principal source of operating activity cash flow was net income adjusted for noncash income and expense items. Net cash used in investing activities totaled \$294.0 million, which included outflows of \$282.5 million for net loan originations and \$4.1 million from net investment securities transactions. Net cash provided by financing activities of \$285.2 million was attributed to a \$286.3 million increase in deposits and \$29.7 million from the at-the-market common stock offering, partly offset by a \$20.7 million decrease in short-term borrowings and \$10.3 million in dividend payments.

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

We actively manage capital, commensurate with our risk profile, to enhance shareholder value. We also seek to maintain capital levels for the Company and the Bank at amounts in excess of the regulatory well-capitalized thresholds. Periodically, we may respond to market conditions by implementing changes to our overall balance sheet positioning to manage our capital position.

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

Shareholders' equity was \$366.0 million at September 30, 2017, an increase of \$45.9 million from \$320.1 million at December 31, 2016. Net income for the year and stock issued from the at-the-market common stock offering increased shareholders' equity by \$22.5 million and \$29.7 million, respectively, which were partially offset by common and preferred stock dividends declared of \$10.6 million. Accumulated other comprehensive loss included in shareholders' equity decreased \$3.1 million during the first nine months of 2017 due primarily to lower net unrealized losses on securities available for sale.

The FRB and FDIC have adopted a system using risk-based capital guidelines to evaluate the capital adequacy of banks and bank holding companies. The final rules implementing the Basel Committee on Banking Supervision's (BCBS) capital guidelines for U.S. banks became effective for the Company on January 1, 2015, with full compliance with all of the final requirements phased in over a multi-year schedule, to be fully phased-in by January 1, 2019. As of September 30, 2017, the Company's capital levels remained characterized as well-capitalized under these rules.

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

	September 30, 2017	December 31, 2016
Common shareholders' equity	\$ 348,668	\$ 302,714
Less: Goodwill and other intangible assets, net of deferred tax liabilities	69,324	68,759
Net unrealized (loss) gain on investment securities ⁽¹⁾	(1,129)	(3,729)
Net periodic pension & postretirement benefits plan adjustments	(9,709)	(10,222)
Other		
Common equity Tier 1 (CET1) capital	290,182	247,906

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Plus: Preferred stock	17,334	17,340
Less: Other		
Tier 1 Capital	307,516	265,246
Plus: Qualifying allowance for loan losses	34,347	30,934
Subordinated Notes	39,114	39,061
 Total regulatory capital	 \$ 380,977	 \$ 335,241
 Adjusted average total assets (for leverage capital purposes)	 \$ 3,889,673	 \$ 3,602,377
 Total risk-weighted assets	 \$ 2,877,061	 \$ 2,584,161
Regulatory Capital Ratios		
Tier 1 leverage (Tier 1 capital to adjusted average assets)	7.91%	7.36%
CET1 capital (CET1 capital to total risk-weighted assets)	10.09	9.59
Tier 1 capital (Tier 1 capital to total risk-weighted assets)	10.69	10.26
Total risk-based capital (Total regulatory capital to total risk-weighted assets)	13.24	12.97

- (1) Includes unrealized gains and losses related to the Company's reclassification of available for sale investment securities to the held to maturity category.

Table of Contents**MANAGEMENT'S DISCUSSION AND ANALYSIS****BCBS Capital Rules**

The BCBS Capital Rules include a new common equity Tier 1 capital to risk-weighted assets minimum ratio of 4.5%, increase the minimum Tier 1 capital to risk-weighted assets ratio from 4.0% to 6.0%, require a minimum total capital to risk-weighted assets ratio of 8.0%, and require a minimum Tier 1 leverage ratio of 4.0%. A new capital conservation buffer is also established above the regulatory minimum capital requirements, effectively increasing the minimum required risk-weighted asset ratios. This capital conservation buffer is being phased-in as of January 1, 2016 at 0.625% of risk-weighted assets and increases each subsequent year by an additional 0.625% until reaching its final level of 2.5% on January 1, 2019. Banking institutions with a capital conservation buffer below the minimum level will face constraints on dividends, equity repurchases and compensation based on the amount of the shortfall. The BCBS Capital Rules also provide for a countercyclical capital buffer that is applicable to only certain covered institutions and does not have any current applicability to the Company or the Bank. Strict eligibility criteria for regulatory capital instruments were also implemented under the final rules. The final rules also revised the definition and calculation of Tier 1 capital, total capital, and risk-weighted assets.

The following table presents actual and required capital ratios as of September 30, 2017 and December 31, 2016 for the Company and the Bank under the BCBS Capital Rules. The minimum required capital amounts presented include the minimum required capital levels as of those dates based on the phase-in provisions of the BCBS Capital Rules and the minimum required capital levels as of January 1, 2019 when the BCBS Capital Rules have been fully phased-in. Capital levels required to be considered well capitalized are based upon prompt corrective action regulations, as amended to reflect the changes under the BCBS Capital Rules (in thousands):

	Actual		Minimum Capital Required Phase-in Schedule		Minimum Capital Required Fully Phased-in		Required to be Considered Well Capitalized	
	Amount	Ratio	Amount	Ratio	Amount	Ratio	Amount	Ratio
<u>September 30, 2017</u>								
Tier 1 leverage:								
Company	\$ 307,516	7.91%	\$ 155,587	4.00%	\$ 155,587	4.00%	\$ 194,484	5.00%