FINANCIAL INSTITUTIONS INC
Form 10-Q
November 05, 2013
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2013

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	**16-0816610**
(State or other jurisdiction of	**(I.R.S. Employer**
incorporation or organization)	**Identification No.)**
220 LIBERTY STREET, WARSAW, NEW YORK	**14569**
(Address of principal executive offices)	**(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 x 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 x No ¨

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

Large accelerated filer ¨		Accelerated filer	x
Non-accelerated filer ¨	(Do not check if a smaller company)	Smaller reporting company	¨

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

The registrant had 13,809,890 shares of Common Stock, $0.01 par value, outstanding as of October 28, 2013.

Table of Contents

FINANCIAL INSTITUTIONS, INC.

Form 10-Q

For the Quarterly Period Ended September 30, 2013

TABLE OF CONTENTS

Table of Contents

PART I. FINANCIAL INFORMATION

ITEM 1. Financial Statements

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Consolidated Statements of Financial Condition

(Dollars in thousands, except share and per share data)	September 30, 2013 (Unaudited)	December 31, 2012
ASSETS		
Cash and cash equivalents:		
Cash and due from banks	$ 99,290	$ 60,342
Federal funds sold and interest-bearing deposits in other banks	94	94
Total cash and cash equivalents	99,384	60,436
Securities available for sale, at fair value	583,551	823,796
Securities held to maturity, at amortized cost (fair value of $246,117 and $18,478, respectively)	245,708	17,905
Loans held for sale	2,810	1,518
Loans (net of allowance for loan losses of $26,685 and $24,714, respectively)	1,752,987	1,681,012
Company owned life insurance	48,695	47,386
Premises and equipment, net	36,558	36,618
Goodwill and other intangible assets, net	50,095	50,389
Other assets	47,729	44,805
Total assets	$ 2,867,517	$ 2,763,865
LIABILITIES AND SHAREHOLDERS EQUITY		
Deposits:		
Noninterest-bearing demand	$ 542,517	$ 501,514
Interest-bearing demand	519,283	449,744
Savings and money market	757,454	655,598
Time deposits	594,931	654,938
Total deposits	2,414,185	2,261,794
Short-term borrowings	188,146	179,806
Other liabilities	17,341	68,368
Total liabilities	2,619,672	2,509,968
Shareholders equity:		
Series A 3% preferred stock, $100 par value; 1,533 shares authorized, 1,496 and 1,499 shares issued, respectively	149	150

Series B-1 8.48% preferred stock, $100 par value, 200,000 shares authorized, 171,927 and 173,210 shares issued, respectively	17,193	17,321
Total preferred equity	17,342	17,471
Common stock, $0.01 par value, 50,000,000 shares authorized and 14,161,597 shares issued	142	142
Additional paid-in capital	67,458	67,710
Retained earnings	182,751	172,244
Accumulated other comprehensive (loss) income	(13,318)	3,253
Treasury stock, at cost 351,707 and 373,888 shares, respectively	(6,530)	(6,923)
Total shareholders equity	247,845	253,897
Total liabilities and shareholders equity	$ 2,867,517	$ 2,763,865

See accompanying notes to the consolidated financial statements.

Table of Contents

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Consolidated Statements of Income (Unaudited)

(In thousands, except per share amounts)	Three months ended September 30, 2013	Three months ended September 30, 2012	Nine months ended September 30, 2013	Nine months ended September 30, 2012
Interest income:				
Interest and fees on loans	$ 20,332	$ 21,048	$ 60,775	$ 60,096
Interest and dividends on investment securities	4,291	4,251	12,938	12,384
Total interest income	24,623	25,299	73,713	72,480
Interest expense:				
Deposits	1,624	2,029	4,960	6,596
Short-term borrowings	196	171	539	456
Total interest expense	1,820	2,200	5,499	7,052
Net interest income	22,803	23,099	68,214	65,428
Provision for loan losses	2,770	1,764	6,672	4,608
Net interest income after provision for loan losses	20,033	21,335	61,542	60,820
Noninterest income:				
Service charges on deposits	2,728	2,292	7,437	6,101
ATM and debit card	1,283	1,219	3,849	3,368
Broker-dealer fees and commissions	568	609	1,917	1,630
Company owned life insurance	422	433	1,275	1,300
Net gain on disposal of investment securities		596	1,224	2,164
Loan servicing	227	142	452	645
Net (loss) gain on sale of loans held for sale	(101)	323	134	981
Impairment charges on investment securities				(91)
Net (loss) gain on disposal of other assets		(114)	39	(79)
Other	1,042	853	2,771	2,475
Total noninterest income	6,169	6,353	19,098	18,494
Noninterest expense:				
Salaries and employee benefits	9,473	12,438	28,408	30,565
Occupancy and equipment	2,959	2,915	9,163	8,400
Professional services	814	1,452	2,844	3,243
Computer and data processing	689	976	2,205	2,462
Supplies and postage	518	899	1,806	1,930
FDIC assessments	367	356	1,092	957

Advertising and promotions	209	261	676	499
Other	1,980	2,321	5,861	5,800
Total noninterest expense	17,009	21,618	52,055	53,856
Income before income taxes	9,193	6,070	28,585	25,458
Income tax expense	3,029	1,805	9,422	8,341
Net income	$ 6,164	$ 4,265	$ 19,163	$ 17,117
Preferred stock dividends	365	368	1,100	1,105
Net income available to common shareholders	$ 5,799	$ 3,897	$ 18,063	$ 16,012
Earnings per common share (Note 3):				
Basic	$ 0.42	$ 0.28	$ 1.32	$ 1.17
Diluted	$ 0.42	$ 0.28	$ 1.31	$ 1.16
Cash dividends declared per common share	$ 0.19	$ 0.14	$ 0.55	$ 0.41
Weighted average common shares outstanding:				
Basic	13,745	13,703	13,734	13,692
Diluted	13,787	13,759	13,774	13,748

See accompanying notes to the consolidated financial statements.

Table of Contents

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Consolidated Statements of Comprehensive (Loss) Income (Unaudited)

	Three months ended September 30,		Nine months ended September 30,	
(Dollars in thousands)	**2013**	**2012**	**2013**	**2012**
Net income	$ 6,164	$ 4,265	$ 19,163	$ 17,117
Other comprehensive (loss) income, net of tax:				
Securities available for sale:				
Net unrealized (losses) gains arising during the period	(382)	3,051	(16,428)	4,860
Reclassification adjustment for gains included in income		(360)	(739)	(1,307)
Reclassification adjustment for impairment charges included in income				55
Reclassification adjustment for net unrealized holding gains on securities transferred to held to maturity during the period	(47)		(47)	
	(429)	2,691	(17,214)	3,608
Net unrealized holding gains on securities transferred from available for sale to held to maturity during the period	47		47	
Pension and post-retirement obligations:				
Net amortization of actuarial loss and prior service credit included in income	198	203	596	608
Total other comprehensive (loss) income	(184)	2,894	(16,571)	4,216
Total comprehensive income	$ 5,980	$ 7,159	$ 2,592	$ 21,333

See accompanying notes to the consolidated financial statements.

Table of Contents

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Consolidated Statements of Changes in Shareholders Equity (Unaudited)

Nine months ended September 30, 2013 and 2012

(Dollars in thousands, except per share data)	Preferred Equity	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Treasury Stock	Total Shareholders Equity
Balance at January 1, 2012	**$ 17,473**	**$ 142**	**$ 67,247**	**$ 158,079**	**$ 945**	**$ (6,692)**	**$ 237,194**
Comprehensive income:							
Net income				17,117			17,117
Other comprehensive income, net of tax					4,216		4,216
Total comprehensive income							21,333
Purchases of common stock for treasury						(554)	(554)
Repurchase of Series B-1 8.48% preferred stock	(2)						(2)
Share-based compensation plans:							
Share-based compensation			373				373
Stock options exercised			(5)			31	26
Restricted stock awards issued, net			(140)			140	
Excess tax benefit on share-based compensation			97				97
Directors retainer			(10)			107	97
Cash dividends declared:							
Series A 3% Preferred-$2.25 per share				(3)			(3)
Series B-1 8.48% Preferred-$6.36 per share				(1,102)			(1,102)
Common-$0.41 per share				(5,617)			(5,617)
Balance at September 30, 2012	**$ 17,471**	**$ 142**	**$ 67,562**	**$ 168,474**	**$ 5,161**	**$ (6,968)**	**$ 251,842**
Balance at January 1, 2013	**$ 17,471**	**$ 142**	**$ 67,710**	**$ 172,244**	**$ 3,253**	**$ (6,923)**	**$ 253,897**
Comprehensive income:							
Net income				19,163			19,163
Other comprehensive loss, net of tax					(16,571)		(16,571)
Total comprehensive income							2,592

Purchases of common stock for treasury						(229)	(229)
Repurchase of Series A 3% preferred stock	(1)						(1)
Repurchase of Series B-1 8.48% preferred stock	(128)		(2)				(130)
Share-based compensation plans:							
Share-based compensation			312				312
Stock options exercised			(5)			71	66
Restricted stock awards issued, net			(446)			446	
Excess tax expense on share-based compensation			(118)				(118)
Directors retainer			7			105	112
Cash dividends declared:							
Series A 3% Preferred-$2.25 per share				(3)			(3)
Series B-1 8.48% Preferred-$6.36 per share				(1,097)			(1,097)
Common-$0.55 per share				(7,556)			(7,556)
Balance at September 30, 2013	**$ 17,342**	**$ 142**	**$ 67,458**	**$ 182,751**	**$ (13,318)**	**$ (6,530)**	**$ 247,845**

See accompanying notes to the consolidated financial statements.

Table of Contents

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Consolidated Statements of Cash Flows (Unaudited)

(Dollars in thousands)	**Nine months ended September 30, 2013**	**2012**
Cash flows from operating activities:		
Net income	$ 19,163	$ 17,117
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	3,145	2,761
Net amortization of premiums on securities	3,656	3,958
Provision for loan losses	6,672	4,608
Share-based compensation	312	373
Deferred income tax expense	1,907	3,684
Proceeds from sale of loans held for sale	22,963	42,847
Originations of loans held for sale	(27,413)	(40,867)
Increase in company owned life insurance	(1,275)	(1,300)
Net gain on sale of loans held for sale	(134)	(981)
Net gain on disposal of investment securities	(1,224)	(2,164)
Impairment charges on investment securities		91
Net (gain) loss on sale and disposal of other assets	(39)	79
Decrease in other assets	6,878	4,745
Increase in other liabilities	215	3,419
Net cash provided by operating activities	34,826	38,370
Cash flows from investing activities:		
Purchases of available for sale securities	(194,360)	(245,020)
Purchases of held to maturity securities	(9,228)	(10,803)
Proceeds from principal payments, maturities and calls on available for sale securities	123,864	136,912
Proceeds from principal payments, maturities and calls on held to maturity securities	8,886	14,479
Proceeds from sales of securities available for sale	1,327	2,303
Net loan originations	(76,010)	(102,391)
Purchases of company owned life insurance	(34)	(34)
Proceeds from sales of other assets	469	549
Purchases of premises and equipment	(2,870)	(4,554)
Net cash received in branch acquisition		195,778
Net cash used in investing activities	(147,956)	(12,781)
Cash flows from financing activities:		
Net increase in deposits	152,391	113,301
Net increase (decrease) in short-term borrowings	8,340	(112,416)
Repurchase of preferred stock	(131)	(2)
Purchase of common stock for treasury	(229)	(554)

Proceeds from stock options exercised	66	26
Excess tax (expense) benefit on share-based compensation, net	(118)	97
Cash dividends paid to common and preferred shareholders	(8,241)	(6,579)
Net cash provided by (used in) financing activities	152,078	(6,127)
Net increase in cash and cash equivalents	38,948	19,462
Cash and cash equivalents, beginning of period	60,436	57,583
Cash and cash equivalents, end of period	$ 99,384	$ 77,045
Supplemental information:		
Cash paid for interest	$ 5,738	$ 8,046
Cash paid for income taxes	4,006	3,787
Noncash investing and financing activities:		
Real estate and other assets acquired in settlement of loans	655	250
Accrued and declared unpaid dividends	2,977	2,287
(Decrease) increase in net unsettled security purchases	(51,061)	11,148
Securities transferred from available for sale to held to maturity (at fair value)	227,330	
Loans transferred from held for sale to held for investment	3,292	
Assets acquired and liabilities assumed in branch acquisition:		
Loans and other non-cash assets, excluding goodwill and core deposit intangible asset		77,912
Deposits and other liabilities		287,331

See accompanying notes to the consolidated 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

Nature of Operations

Financial Institutions, Inc., a financial holding company organized under the laws of New York State (New York or NYS), and its subsidiaries provide deposit, lending and other financial services to individuals and businesses in Central and Western New York. The Company has also expanded its indirect lending network to include relationships with franchised automobile dealers in the Capital District of New York and Northern Pennsylvania. Financial Institutions, Inc. owns all of the capital stock of Five Star Bank, a New York State chartered bank, and Five Star Investment Services, Inc., a financial services subsidiary offering noninsured investment products and investment advisory services. References to the Company mean the consolidated reporting entities and references to the Bank mean Five Star Bank.

Basis of Presentation

The consolidated financial statements include the accounts of Financial Institutions, Inc. and its subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation. The accounting and reporting policies conform to U.S. generally accepted accounting principles (GAAP). Certain information and footnote disclosures normally included in financial statements prepared in conformity with GAAP have been condensed or omitted pursuant to such rules and regulations. However, in the opinion of management, the accompanying consolidated financial statements reflect all adjustments of a normal and recurring nature necessary for a fair presentation of the consolidated statements of financial condition, income, comprehensive income, changes in shareholders equity and cash flows for the periods indicated, and contain adequate disclosure to make the information presented not misleading. Prior years consolidated financial statements are re-classified whenever necessary to conform to the current year s presentation. These consolidated financial statements should be read in conjunction with the Company s 2012 Annual Report on Form 10-K. The results of operations for any interim periods are not necessarily indicative of the results which may be expected for the entire year.

Subsequent Events

The Company has evaluated events and transactions for potential recognition or disclosure through the day the financial statements were issued.

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

Reclassifications

Certain reclassifications have been made to the prior years financial statements in order to reflect retrospective adjustments made to the balance of goodwill at December 31, 2012 to reflect the effect of these measurement period adjustments made in accordance with accounting requirements. The reclassifications had no impact on shareholders equity or net income.

Recent Accounting Pronouncements

In February 2013, the Financial Accounting Standards Board issued Accounting Standards Update (ASU) No. 2013-02, *Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income*. ASU No. 2013-02 does not amend any existing requirements for reporting net income or other comprehensive income in the financial statements. ASU No. 2013-02 requires an entity to disaggregate the total change of each component of other comprehensive income (e.g., unrealized gains or losses on available-for-sale investment securities) and separately present reclassification adjustments and current period other comprehensive income. The provisions of ASU No. 2013-02 also requires that entities present either in a single note or parenthetically on the face of the financial statements, the effect of significant amounts reclassified from each component of accumulated other comprehensive income based on its source (e.g., unrealized gains or losses on available-for-sale investment securities) and the income statement line item affected by the reclassification (e.g., realized gains (losses) on sales of investment securities). If a component is not required to be reclassified to net income in its entirety (e.g., amortization of defined benefit plan items), entities would instead cross reference to the related note to the financial statements for additional information (e.g., pension footnote). The Company adopted the provisions of ASU No. 2013-02 effective January 1, 2013. As the Company provided these required disclosures in the notes to the consolidated financial statements, the adoption of ASU No. 2013-02 had no impact on the Company s consolidated statements of income and condition. See Note 8 Accumulated Other Comprehensive Income to the consolidated financial statements for the disclosures required by ASU No. 2013-02.

Table of Contents

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(2.) BRANCH ACQUISITIONS

On January 19, 2012, the Bank entered into agreements with First Niagara Bank, National Association (First Niagara) to acquire four retail bank branches in Medina, Brockport, Batavia and Waterloo, New York (the First Niagara Branches) and four retail bank branches previously owned by HSBC Bank USA, National Association (HSBC) in Elmira, Elmira Heights, Horseheads and Albion, New York (the HSBC Branches). First Niagara assigned its rights to the HSBC branches in connection with its acquisition of HSBC s Upstate New York banking franchise. Under the terms of the agreements, the Bank assumed substantially all related deposits and purchased the related branch premises and certain performing loans. The transaction to acquire the First Niagara Branches was completed on June 22, 2012 and the transaction to acquire the HSBC Branches was completed on August 17, 2012. The combined assets acquired and deposits assumed in the two transactions were recorded at their estimated fair values as follows (in thousands):

Cash	$ 195,778
Loans	75,635
Bank premises and equipment	1,938
Goodwill	11,167
Core deposit intangible asset	2,042
Other assets	601
Total assets acquired	$ 287,161
Deposits assumed	$ 286,819
Other liabilities	342
Total liabilities assumed	$ 287,161

The transactions were accounted for using the acquisition method of accounting and accordingly, assets acquired, liabilities assumed and consideration exchanged were recorded at their estimated fair values on the acquisition dates. The Company acquired the loan portfolios at a fair value discount, net of market premium, of $824 thousand. The discount represented expected credit losses, net of market interest rate adjustments. The discount on loans receivable is being amortized to interest income over the estimated remaining life of the acquired loans using the level yield method. The time deposit premium of $335 thousand is being accreted over the estimated remaining life of the related deposits as a reduction of interest expense. The core deposit intangible asset is being amortized on an accelerated basis over the estimated average life of the core deposits.

During the nine months ended September 30, 2013, the Company recorded a decrease to the estimated fair value of liabilities assumed and an increase to the related deferred income taxes based upon information obtained subsequent to the acquisition. In addition to changes in those assets and liabilities, the revisions resulted in a reduction in goodwill of approximately $432 thousand. The final purchase price allocation was completed during the three months ended

September 30, 2013, and the Company has recorded final goodwill totaling approximately $11.2 million in connection with the acquisitions. All goodwill and core deposit intangible assets arising from this acquisition are expected to be deductible for tax purposes.

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, 2013	Three months ended September 30, 2012	Nine months ended September 30, 2013	Nine months ended September 30, 2012
Net income available to common shareholders	$ 5,799	$ 3,897	$ 18,063	$ 16,012
Less: Earnings allocated to participating securities				3
Net income available to common shareholders for EPS	$ 5,799	$ 3,897	$ 18,063	$ 16,009
Weighted average common shares outstanding:				
Total shares issued	14,162	14,162	14,162	14,162
Unvested restricted stock awards	(64)	(99)	(70)	(116)
Treasury shares	(353)	(360)	(358)	(354)
Total basic weighted average common shares outstanding	13,745	13,703	13,734	13,692
Incremental shares from assumed:				
Exercise of stock options	12	4	8	4
Vesting of restricted stock awards	30	52	32	52
Total diluted weighted average common shares outstanding	13,787	13,759	13,774	13,748
Basic earnings per common share	$ 0.42	$ 0.28	$ 1.32	$ 1.17
Diluted earnings per common share	$ 0.42	$ 0.28	$ 1.31	$ 1.16
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	86	295	154	309
Restricted stock awards			3	1
	86	295	157	310

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
September 30, 2013				
Securities available for sale:				
U.S. Government agencies and government sponsored enterprises	$ 112,697	$ 1,683	$ 2,082	$ 112,298
Mortgage-backed securities:				
Federal National Mortgage Association	155,677	2,029	4,551	153,155
Federal Home Loan Mortgage Corporation	34,137	918	62	34,993
Government National Mortgage Association	62,775	2,690		65,465
Collateralized mortgage obligations:				
Federal National Mortgage Association	66,251	548	2,086	64,713
Federal Home Loan Mortgage Corporation	105,507	308	3,942	101,873
Government National Mortgage Association	48,400	1,170	281	49,289
Privately issued		1,341		1,341
Total collateralized mortgage obligations	220,158	3,367	6,309	217,216
Total mortgage-backed securities	472,747	9,004	10,922	470,829
Asset-backed securities	18	406		424
Total available for sale securities	$ 585,462	$ 11,093	$ 13,004	583,551
Securities held to maturity:				
State and political subdivisions	$ 245,708	$ 409	$	$ 246,117
December 31, 2012				
Securities available for sale:				
U.S. Government agencies and government sponsored enterprises	$ 128,097	$ 3,667	$ 69	$ 131,695
State and political subdivisions	188,997	6,285	72	195,210
Mortgage-backed securities:				
Federal National Mortgage Association	147,946	4,394	188	152,152
Federal Home Loan Mortgage Corporation	65,426	1,430		66,856
Government National Mortgage Association	56,166	3,279		59,445
Collateralized mortgage obligations:				

Federal National Mortgage Association	60,805	1,865	2	62,668
Federal Home Loan Mortgage Corporation	78,581	1,911		80,492
Government National Mortgage Association	70,989	2,168		73,157
Privately issued	73	1,025		1,098
Total collateralized mortgage obligations	210,448	6,969	2	217,415
Total mortgage-backed securities	479,986	16,072	190	495,868
Asset-backed securities	121	902		1,023
Total available for sale securities	$ 797,201	$ 26,926	$ 331	$ 823,796
Securities held to maturity:				
State and political subdivisions	$ 17,905	$ 573	$	$ 18,478

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

	Three months ended September 30,		**Nine months ended September 30,**	
	2013	**2012**	**2013**	**2012**
Proceeds from sales	$	$ 633	$ 1,327	$ 2,303
Gross realized gains		596	1,224	2,164

Table of Contents

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(4.) INVESTMENT SECURITIES (Continued)

During the third quarter of 2013, the Company transferred $227.3 million of available for sale state and municipal debt securities to the held to maturity category, reflecting the Company s intent to hold those securities to maturity. Transfers of investment securities into the held to maturity category from the available for sale category are made at fair value at the date of transfer. The related $78 thousand of unrealized holding gains that were included in the transfer are retained in accumulated other comprehensive income and in the carrying value of the held to maturity securities. This amount will be amortized as an adjustment to interest income over the remaining life of the securities. This will offset the impact of amortization of the net premium created in the transfer. There were no gains or losses recognized as a result of this transfer.

The scheduled maturities of securities available for sale and securities held to maturity at September 30, 2013 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	$ 399	$ 405
Due from one to five years	27,911	28,804
Due after five years through ten years	226,693	222,567
Due after ten years	330,459	331,775
	$ 585,462	$ 583,551
Debt securities held to maturity:		
Due in one year or less	$ 25,145	$ 25,236
Due from one to five years	104,563	104,770
Due after five years through ten years	115,955	116,055
Due after ten years	45	56
	$ 245,708	$ 246,117

There were no unrealized losses in held to maturity securities at September 30, 2013 or December 31, 2012. Unrealized losses on investment securities available for sale and the fair value of the related securities, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, 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
<u>September 30, 2013</u>						
U.S. Government agencies and government sponsored enterprises	$ 63,080	$ 2,066	$ 2,812	$ 16	$ 65,892	$ 2,082
Mortgage-backed securities:						
Federal National Mortgage Association	103,595	4,551			103,595	4,551
Federal Home Loan Mortgage Corporation	4,081	62			4,081	62
Collateralized mortgage obligations:						
Federal National Mortgage Association	49,555	2,085	517	1	50,072	2,086
Federal Home Loan Mortgage Corporation	92,536	3,942			92,536	3,942
Government National Mortgage Association	6,313	281			6,313	281
Total collateralized mortgage obligations	148,404	6,308	517	1	148,921	6,309
Total mortgage-backed securities	256,080	10,921	517	1	256,597	10,922
Total temporarily impaired securities	$ 319,160	$ 12,987	$ 3,329	$ 17	$ 322,489	$ 13,004

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, 2012						
U.S. Government agencies and government sponsored enterprises	$ 13,265	$ 67	$ 2,967	$ 2	$ 16,232	$ 69
State and political subdivisions	8,471	72			8,471	72
Mortgage-backed securities:						
Federal National Mortgage Association	25,200	188			25,200	188
Collateralized mortgage obligations:						
Federal National Mortgage Association			1,173	2	1,173	2
Total collateralized mortgage obligations			1,173	2	1,173	2
Total mortgage-backed securities	25,200	188	1,173	2	26,373	190
Total temporarily impaired securities	$ 46,936	$ 327	$ 4,140	$ 4	$ 51,076	$ 331

The total number of security positions in the investment portfolio in an unrealized loss position at September 30, 2013 was 81 compared to 52 at December 31, 2012. At September 30, 2013, the Company had positions in 5 investment securities with a fair value of $3.3 million and a total unrealized loss of $17 thousand that have been in a continuous unrealized loss position for more than 12 months. There were a total of 76 securities positions in the Company s investment portfolio, with a fair value of $319.2 million and a total unrealized loss of $13.0 million at September 30, 2013, that have been in a continuous unrealized loss position for less than 12 months. The unrealized loss on these investment securities was predominantly caused by changes in market interest rates subsequent to purchase. The fair value of most of the investment securities in the Company s portfolio fluctuates as market interest rates change.

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.

No impairment was recorded in the nine months ended September 30, 2013. During the nine months ended September 30, 2012, the Company recognized an OTTI charge of $91 thousand related to a privately issued whole loan CMO that was determined to be impaired due to credit quality.

Based on management s review and evaluation of the Company s debt securities as of September 30, 2013, the debt securities with unrealized losses were not considered to be OTTI. As of September 30, 2013, the Company does not have the intent to sell any of the securities in a loss position and believes that it is not likely that it will be required to sell any such securities before the anticipated recovery of amortized cost. Accordingly, as of September 30, 2013, 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
September 30, 2013			
Commercial business	$ 253,928	$ (3)	$ 253,925
Commercial mortgage	450,602	(1,037)	449,565
Residential mortgage	117,650	(26)	117,624
Home equity	311,521	5,105	316,626
Consumer indirect	591,242	26,846	618,088
Other consumer	23,683	161	23,844
Total	$ 1,748,626	$ 31,046	1,779,672
Allowance for loan losses			(26,685)
Total loans, net			$ 1,752,987
December 31, 2012			
Commercial business	$ 258,706	$ (31)	$ 258,675
Commercial mortgage	414,282	(958)	413,324
Residential mortgage	133,341	179	133,520
Home equity	282,503	4,146	286,649
Consumer indirect	559,964	26,830	586,794
Other consumer	26,657	107	26,764
Total	$ 1,675,453	$ 30,273	1,705,726
Allowance for loan losses			(24,714)
Total loans, net			$ 1,681,012

Loans held for sale (not included above) were comprised entirely of residential real estate mortgages and totaled $2.8 million and $1.5 million as of September 30, 2013 and December 31, 2012, 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	Total Past Due	Nonaccrual	Current	Total Loans
September 30, 2013							
Commercial business	$ 72	$ 4	$	$ 76	$ 4,078	$ 249,774	$ 253,928
Commercial mortgage	53			53	2,835	447,714	450,602
Residential mortgage	434			434	1,337	115,879	117,650
Home equity	417	20		437	911	310,173	311,521
Consumer indirect	1,172	258		1,430	1,161	588,651	591,242
Other consumer	117	20	9	146	7	23,530	23,683
Total loans, gross	$ 2,265	$ 302	$ 9	$ 2,576	$ 10,329	$ 1,735,721	$ 1,748,626
December 31, 2012							
Commercial business	$ 160	$	$	$ 160	$ 3,413	$ 255,133	$ 258,706
Commercial mortgage	331			331	1,799	412,152	414,282
Residential mortgage	376			376	2,040	130,925	133,341
Home equity	675	10		685	939	280,879	282,503
Consumer indirect	1,661	163		1,824	891	557,249	559,964
Other consumer	127	35	18	180	25	26,452	26,657
Total loans, gross	$ 3,330	$ 208	$ 18	$ 3,556	$ 9,107	$ 1,662,790	$ 1,675,453

There were no loans past due greater than 90 days and still accruing interest as of September 30, 2013 and December 31, 2012. There were $9 thousand and $18 thousand in consumer overdrafts which were past due greater than 90 days as of September 30, 2013 and December 31, 2012, respectively. Consumer overdrafts are overdrawn deposit accounts which have been reclassified as loans but by their terms do not accrue interest.

Troubled Debt Restructurings

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

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

	Quarter-to-Date			Year-to-Date		
	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
September 30, 2013						
Commercial business		$	$	3	$ 1,462	$ 1,454
Commercial mortgage						
Total		$	$	3	$ 1,462	$ 1,454
September 30, 2012						
Commercial business	1	$ 103	$ 103	3	$ 536	$ 536
Commercial mortgage				4	648	648
Total	1	$ 103	$ 103	7	$ 1,184	$ 1,184

Table of Contents

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(5.) LOANS (Continued)

All of the loans identified as TDRs by the Company were previously on nonaccrual status and reported as impaired loans prior to restructuring. The modifications primarily related to extending the amortization periods of the loans. All loans restructured during the nine months ended September 30, 2013 were classified as nonaccrual as of September 30, 2013. Nonaccrual loans that are restructured remain on nonaccrual status, but may move to accrual status after they have performed according to the restructured terms for a period of time. The TDR classification did not have a material impact on the Company s determination of the allowance for loan losses because the modified loans were impaired and evaluated for a specific reserve both before and after restructuring.

There were no loans modified as a TDR within the previous 12 months that defaulted during the three months ended September 30, 2013 or 2012. For purposes of this disclosure, a loan modified as a TDR is considered to have defaulted when the borrower becomes 90 days past due.

Impaired Loans

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

	Recorded Investment[1]	Unpaid Principal Balance[1]	Related Allowance	Average Recorded Investment	Interest Income Recognized
September 30, 2013					
With no related allowance recorded:					
Commercial business	$ 276	$ 460	$	$ 583	$
Commercial mortgage	737	759		707	
	1,013	1,219		1,290	
With an allowance recorded:					
Commercial business	3,802	3,822	649	4,108	
Commercial mortgage	2,098	2,098	603	2,227	
	5,900	5,920	1,252	6,335	
	$ 6,913	$ 7,139	$ 1,252	$ 7,625	$

December 31, 2012									
With no related allowance recorded:									
Commercial business	$	963	$	1,425	$		$	755	$
Commercial mortgage		911		1,002				1,310	
		1,874		2,427				2,065	
With an allowance recorded:									
Commercial business		2,450		2,450		664		2,114	
Commercial mortgage		888		888		310		1,858	
		3,338		3,338		974		3,972	
	$	5,212	$	5,765	$	974	$	6,037	$

(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
September 30, 2013		
Uncriticized	$ 237,601	$ 427,902
Special mention	6,159	6,703
Substandard	10,168	15,997
Doubtful		

Total	$ 253,928	$ 450,602
December 31, 2012		
Uncriticized	$ 240,291	$ 400,576
Special mention	6,591	6,495
Substandard	11,824	7,211
Doubtful		
Total	$ 258,706	$ 414,282

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

	Residential Mortgage	Home Equity	Consumer Indirect	Other Consumer
September 30, 2013				
Performing	$ 116,313	$ 310,610	$ 590,081	$ 23,667
Non-performing	1,337	911	1,161	16
Total	$ 117,650	$ 311,521	$ 591,242	$ 23,683
December 31, 2012				
Performing	$ 131,301	$ 281,564	$ 559,073	$ 26,632
Non-performing	2,040	939	891	25
Total	$ 133,341	$ 282,503	$ 559,964	$ 26,657

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 Mortgage	Home Equity	Consumer Indirect	Other Consumer	Total
September 30, 2013							
Loans:							
Ending balance	$ 253,928	$ 450,602	$ 117,650	$ 311,521	$ 591,242	$ 23,683	$ 1,748,626
Evaluated for impairment:							
Individually	$ 4,078	$ 2,835	$	$	$	$	$ 6,913
Collectively	$ 249,850	$ 447,767	$ 117,650	$ 311,521	$ 591,242	$ 23,683	$ 1,741,713
Allowance for loan losses:							
Ending balance	$ 4,410	$ 8,281	$ 729	$ 1,383	$ 11,416	$ 466	$ 26,685
Evaluated for impairment:							
Individually	$ 649	$ 603	$	$	$	$	$ 1,252
Collectively	$ 3,761	$ 7,678	$ 729	$ 1,383	$ 11,416	$ 466	$ 25,433
September 30, 2012							
Loans:							
Ending balance	$ 245,404	$ 403,924	$ 139,785	$ 275,345	$ 538,058	$ 27,599	$ 1,630,115
Evaluated for impairment:							
Individually	$ 3,621	$ 3,388	$	$	$	$	$ 7,009
Collectively	$ 241,783	$ 400,536	$ 139,785	$ 275,345	$ 538,058	$ 27,599	$ 1,623,106

Allowance for loan losses:							
Ending balance	$ 4,276	$ 6,648	$ 796	$ 1,232	$ 10,808	$ 541	$ 24,301
Evaluated for impairment:							
Individually	$ 620	$ 664	$	$	$	$	$ 1,284
Collectively	$ 3,656	$ 5,984	$ 796	$ 1,232	$ 10,808	$ 541	$ 23,017

The following table sets forth the changes in the allowance for loan losses for the three and nine month periods ended September 30, 2013 (in thousands):

	Commercial Business	Commercial Mortgage	Residential Mortgage	Home Equity	Consumer Indirect	Other Consumer	Total
Three months ended September 30, 2013							
Beginning balance	$ 4,755	$ 7,125	$ 701	$ 1,424	$ 11,095	$ 490	$ 25,590
Charge-offs	163	35	34	30	2,131	253	2,646
Recoveries	59	122	12	16	666	96	971
Provision (credit)	(241)	1,069	50	(27)	1,786	133	2,770
Ending balance	$ 4,410	$ 8,281	$ 729	$ 1,383	$ 11,416	$ 466	