FINANCIAL INSTITUTIONS INC
Form 10-K
March 12, 2010

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

Form 10-K

þ **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the fiscal year ended December 31, 2009

OR

o **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

FINANCIAL INSTITUTIONS, INC.
(Exact name of registrant as specified in its charter)

NEW YORK	**16-0816610**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer 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**
Securities registered under Section 12(b) of the Exchange Act:

Title of each class	Name of exchange on which registered
Common stock, par value $.01 per share	**NASDAQ Global Select Market**

Securities registered under Section 12(g) of the Exchange Act: **NONE**

Indicate by check mark if the regsitrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes o No þ

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes o No þ

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 past 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 þ No o

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 o No o

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§ 229.405 of this chapter) is not contained herein, and will not be contained, to the best of the registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this form 10-K or any amendment to this Form 10-K. o

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 definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated filer o Accelerated filer þ Non-accelerated filer o Smaller reporting company o

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

The aggregate market value of common equity held by non-affiliates of the registrant, as computed by reference to the June 30, 2009 closing price reported by NASDAQ, was $138,170,500.

As of March 1, 2010, there were issued and outstanding, exclusive of treasury shares, 10,919,608 shares of the registrant s common stock.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Proxy Statement for the 2010 Annual Meeting of Shareholders are incorporated by reference in Part III.

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PART I

FORWARD LOOKING INFORMATION

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

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

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

- the Company s ability to successfully execute its business plans, manage its risks, and achieve its objectives;
- changes in political and economic conditions, including the political and economic effects of the current economic crisis and other major developments, including wars, military actions and terrorist attacks;
- changes in financial market conditions, either internationally, nationally or locally in areas in which the Company conducts its operations, including without limitation, reduced rates of business formation and growth, commercial and residential real estate development and real estate prices;
- fluctuations in markets for equity, fixed-income, commercial paper and other securities, including availability, market liquidity levels, and pricing;
- changes in interest rates, the quality and composition of the loan and securities portfolios, demand for loan products, deposit flows and competition;
- acquisitions and integration of acquired businesses;
- increases in the levels of losses, customer bankruptcies, claims and assessments;
- changes in fiscal, monetary, regulatory, trade and tax policies and laws, including policies of the United States (U.S.) Department of Treasury (the Treasury) and the Federal Reserve Board (FRB);
- the Company s participation or lack of participation in governmental programs implemented under the Emergency Economic Stabilization Act (EESA) and the American Recovery and Reinvestment Act (ARRA), including without limitation the Troubled Asset Relief Program (TARP), the Capital Purchase Program (CPP), and the Temporary Liquidity Guarantee Program (TLGP) and the impact of such programs and related regulations on the Company and on international, national, and local economic and financial markets and conditions;
- the impact of the EESA and the ARRA and related rules and regulations on the business operations and competitiveness of the Company and other participating American financial institutions, including the impact of the executive compensation limits of these acts, which may impact the ability of the Company and other American financial institutions to retain and recruit executives and other personnel necessary for their businesses and competitiveness;
- the impact of certain provisions of the EESA and ARRA and related rules and regulations on the attractiveness of governmental programs to mitigate the effects of the current economic crisis, including the risks that certain financial institutions may elect not to participate in such programs, thereby decreasing the effectiveness of such programs;
- continuing consolidation in the financial services industry;
- new litigation or changes in existing litigation;
- success in gaining regulatory approvals, when required;
- changes in consumer spending and savings habits;
- increased competitive challenges and expanding product and pricing pressures among financial institutions;

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FORWARD LOOKING INFORMATION (Continued)

- demand for financial services in the Company s market areas;
- inflation and deflation;
- technological changes and the Company s implementation of new technologies;
- the Company s ability to develop and maintain secure and reliable information technology systems;
- legislation or regulatory changes which adversely affect the Company s operations or business;
- the Company s ability to comply with applicable laws and regulations;
- changes in accounting policies or procedures as may be required by the Financial Accounting Standards Board or regulatory agencies;
- increased costs of deposit insurance and changes with respect to Federal Deposit Insurance Corporation (FDIC) insurance coverage levels; and
- further declines in the market value of the Company s publicly traded stock price or declines in the Company s ability to generate future cash flows may increase the potential that goodwill recorded on the Company s consolidated statement of financial position be designated as impaired and that the Company may incur a goodwill write-down in the future.

The Company cautions readers not to place undue reliance on any forward-looking statements, which speak only as of the date made, and advises readers that various factors, including those described above, could affect the Company s financial performance and could cause the Company s actual results or circumstances for future periods to differ materially from those anticipated or projected. See also Item 1A, Risk Factors, in this Form 10-K.

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

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ITEM 1. BUSINESS

GENERAL

Financial Institutions, Inc. is a financial holding company organized in 1931 under the laws of New York State (New York or NYS). Through its subsidiaries, including its wholly-owned, New York State chartered banking subsidiary, Five Star Bank, Financial Institutions, Inc. provides deposit, lending and other financial services to individuals and businesses in Central and Western New York. All references in this Form 10-K to the parent company are to Financial Institutions, Inc. (FII). Unless otherwise indicated or unless the context requires otherwise, all references in this Form 10-K to the Company means Financial Institutions, Inc. and its subsidiaries on a consolidated basis. Five Star Bank is referred to as Five Star Bank, FSB or the Bank . The parent company is a legal entity separate and distinct from its subsidiaries, assisting those subsidiaries by providing financial resources and management. The Company s executive offices are located at 220 Liberty Street, Warsaw, New York.

We conduct our business primarily through our banking subsidiary, Five Star Bank, which adopted its current name in 2005 when the Company merged three of its bank subsidiaries, Wyoming County Bank, National Bank of Geneva and Bath National Bank into its New York chartered bank subsidiary, First Tier Bank & Trust, which was then renamed Five Star Bank. In addition, our business operations include a broker-dealer subsidiary, Five Star Investment Services, Inc. (100% owned) (FSIS).

In February 2001, the FISI Statutory Trust I (the Trust) was formed to facilitate the private placement of $16.2 million in capital securities. FII capitalized the Trust with a $502 thousand investment in the Trust s common securities. The Trust is accounted for as an unconsolidated subsidiary. Therefore, the Company s consolidated statements of financial position reflect the $16.7 million in junior subordinated debentures as a liability and the $502 thousand investment in the Trust s common securities is included in other assets.

OTHER INFORMATION

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

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

MARKET AREAS AND COMPETITION

The Company provides a wide range of consumer and commercial banking and financial services to individuals, municipalities and businesses through a network of 51 offices and over 70 ATMs in fourteen contiguous counties of Western and Central New York: Allegany, Cattaraugus, Cayuga, Chautauqua, Chemung, Erie, Genesee, Livingston, Monroe, Ontario, Seneca, Steuben, Wyoming and Yates Counties.

The Company s market area is geographically and economically diversified in that it serves both rural markets and the larger more affluent markets of suburban Rochester and suburban Buffalo. Rochester and Buffalo are the two largest cities in New York outside of New York City, with combined metropolitan area populations of over two million people. The Company anticipates increasing its presence in and around these metropolitan statistical areas in the coming years.

The Company faces significant competition in both making loans and attracting deposits, as Western and Central New York have a high density of financial institutions. The Company s competition for loans comes principally from commercial banks, savings banks, savings and loan associations, mortgage banking companies, credit unions, insurance companies and other financial service companies. Its most direct competition for deposits has historically come from commercial banks, savings banks and credit unions. The Company faces additional competition for deposits from non-depository competitors such as the mutual fund industry, securities and brokerage firms and insurance companies.

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LENDING ACTVITIES

General

The Company offers a broad range of loans including commercial and agricultural working capital and revolving lines of credit, commercial and agricultural mortgages, equipment loans, crop and livestock loans, residential mortgage loans and home equity loans and lines of credit, home improvement loans, automobile loans and personal loans. Newly originated and refinanced fixed rate residential mortgage loans are either retained in the Company s portfolio or sold to the secondary market and servicing rights are retained.

The Company continually evaluates and updates its lending policy. The key elements of the Company s lending philosophy include the following:

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

Commercial, Commercial Real Estate and Agricultural Lending

The Company originates commercial loans in its primary market areas and underwrites them based on the borrower s ability to service the loan from operating income. The Company offers a broad range of commercial lending products, including term loans and lines of credit. Short and medium-term commercial loans, primarily collateralized, are made available to businesses for working capital (including inventory and receivables), business expansion (including acquisition of real estate, expansion and improvements) and the purchase of equipment. As a general practice, where possible, a collateral lien is placed on any available real estate, equipment or other assets owned by the borrower and a personal guarantee of the owner is obtained. As of December 31, 2009, $49.5 million, or 27%, of the aggregate commercial loan portfolio were at fixed rates, while $136.9 million, or 73%, were at variable rates. The Company utilizes government loan guarantee programs where available and appropriate. See Government Guarantee Programs below.

In addition to commercial loans secured by real estate, the Company makes commercial real estate loans to finance the purchase of real property, which generally consists of real estate with completed structures. Commercial real estate loans are secured by first liens on the real estate and are typically amortized over a 10 to 20 year period. The underwriting analysis includes credit verification, appraisals and a review of the borrower s financial condition and repayment capacity. As of December 31, 2009, $78.2 million, or 25%, of the aggregate commercial real estate loan portfolio were at fixed rates, while $230.7 million, or 75%, were at variable rates.

Agricultural loans are offered for short-term crop production, farm equipment and livestock financing and agricultural real estate financing, including term loans and lines of credit. Short and medium-term agricultural loans, primarily collateralized, are made available for working capital (crops and livestock), business expansion (including acquisition of real estate, expansion and improvement) and the purchase of equipment. As of December 31, 2009, $11.3 million, or 27%, of the agricultural loan portfolio were at fixed rates, while $30.6 million, or 73%, were at variable rates. The Company utilizes government loan guarantee programs where available and appropriate. See Government Guarantee Programs below.

Government Guarantee Programs

The Company participates in government loan guarantee programs offered by the Small Business Administration (SBA), U.S. Department of Agriculture, Rural Economic and Community Development and Farm Service Agency, among others. As of December 31, 2009, the Company had loans with an aggregate principal balance of $44.4 million that were covered by guarantees under these programs. The guarantees only cover a certain percentage of these loans. By participating in these programs, the Company is able to broaden its base of borrowers while minimizing credit risk.

Consumer Lending

The Company offers a variety of loan products to its consumer customers located in Western and Central New York, including home equity loans and lines of credit, automobile loans, secured installment loans and various other types of secured and unsecured personal loans. At December 31, 2009, outstanding consumer loan balances were concentrated in indirect automobile loans and home equity products.

The Company indirectly originates, through dealers, consumer indirect automobile loans. The consumer indirect loan portfolio is primarily comprised of new and used automobile loans with terms that typically range from 36 to 84 months. The Company has expanded its relationships with franchised new car dealers, primarily in our general market area, and has selectively originated a mix of new and used automobile loans from those dealers. As of December 31, 2009, the consumer indirect portfolio totaled $352.6 million, nearly all of which were fixed rate automobile loans.

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The Company also originates, independently of the indirect loans described above, consumer automobile loans, recreational vehicle loans, boat loans, home improvement loans, closed-end home equity loans, home equity lines of credit, personal loans (collateralized and uncollateralized) and deposit account collateralized loans. The terms of these loans typically range from 12 to 180 months and vary based upon the nature of the collateral and the size of loan. The majority of the consumer lending program is underwritten on a secured basis using the customer s home or the financed automobile, mobile home, boat or recreational vehicle as collateral. As of December 31, 2009, $121.5 million, or 53%, of consumer and home equity loans were at fixed rates, while $108.5 million, or 47%, were at variable rates.

Residential Mortgage Lending

The Company originates fixed and variable rate one-to-four family residential mortgages collateralized by owner-occupied properties located in its market areas. The Company offers a variety of real estate loan products, which are generally amortized for periods up to 30 years. Loans collateralized by one-to-four family residential real estate generally have been originated in amounts of no more than 80% of appraised value or have mortgage insurance. Mortgage title insurance and hazard insurance are normally required. The Company sells certain one-to-four family residential mortgages to the secondary mortgage market and typically retains the right to service the mortgages. To assure maximum salability of the residential loan products for possible resale, the Company has formally adopted the underwriting, appraisal, and servicing guidelines of the Federal Home Loan Mortgage Corporation (FHLMC) as part of its standard loan policy. As of December 31, 2009, the residential mortgage servicing portfolio totaled $349.8 million, the majority of which have been sold to FHLMC. As of December 31, 2009, $103.5 million, or 72%, of residential real estate loans retained in portfolio were at fixed rates, while $40.7 million, or 28%, were at variable rates. The Company does not engage in sub-prime or other high-risk residential mortgage lending as a line-of-business.

Credit Administration

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

The Company s credit objectives are as follows:

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

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

Risk ratings are assigned to loans in the commercial, commercial real estate and agricultural portfolios. The risk ratings are specifically used as follows:

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

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

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

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Allowance for Loan Losses

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

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

The Company s methodology in the estimation of the allowance for loan losses includes the following broad areas:

1. Impaired commercial, commercial real estate and agricultural loans, generally in excess of $50 thousand are reviewed individually and assigned a specific loss allowance, if considered necessary, in accordance with U.S. generally accepted accounting principles (GAAP).
2. The remaining portfolios of commercial, commercial real estate and agricultural loans are segmented by risk rating into the following loan classification categories: uncriticized or pass, special mention and substandard. Uncriticized loans, special mention loans and all substandard loans not assigned a specific loss allowance are assigned allowance allocations based on historical net loan charge-off experience for each of the respective loan categories, supplemented with additional reserve amounts, if considered necessary, based upon qualitative factors. These qualitative factors include the levels and trends in delinquencies and non-accruing loans; trends in volume and terms of loans; effects of changes in lending policy; experience, ability, and depth of management; national and local economic conditions; concentrations of credit, interest rate environment; customer leverage; information (availability of timely financial information); and collateral values, among others.
3. The consumer loan portfolio is segmented into six types of loans: residential real estate, home equity loans, home equity lines of credit, consumer direct, consumer indirect, and overdrafts. Allowance allocations for the real estate related loan portfolios (residential and home equity) are based on the average loss experience for the previous eight quarters, supplemented with qualitative factors similar to the elements described above. Allowance allocations for the consumer direct and consumer indirect portfolios are based on vintage analyses performed with loss data collected over the previous 48 months and 36 months, respectively. The allocations on these portfolios are also supplemented with qualitative factors. The allowance allocation for overdrafts is based on an analysis of the aging of overdrafts as of each quarter end with larger loss assumptions assigned by the aging of accounts.

Management presents a quarterly review of the adequacy of the allowance for loan losses to the Company s Board of Directors based on the methodology described above. See also the sections titled Analysis of Allowance for Loan Losses and Allocation of Allowance for Loan Losses in Part II, Item 7, Management s Discussion and Analysis of Financial Condition and Results of Operations.

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INVESTMENT ACTIVITIES

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

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

- U.S. treasury securities;
- U.S. government agency securities, which are securities issued by official Federal government bodies (e.g. the Government National Mortgage Association (GNMA)) and U.S. government-sponsored enterprise (GSE) securities, which are securities issued by independent organizations that are in part sponsored by the federal government (e.g. the Federal Home Loan Bank (FHLB) system, the Federal National Mortgage Association (FNMA), FHLMC, SBA and the Federal Farm Credit Bureau (FFCB));
- Mortgage-backed securities (MBS) include mortgage-backed pass-through securities (pass-throughs) and collateralized mortgage obligations (CMO) issued by GNMA, FNMA and FHLMC. See also the section titled Investing Activities in Part II, Item 7, Management s Discussion and Analysis of Financial Condition and Results of Operations;
- Investment grade municipal securities, including revenue, tax and bond anticipation notes, statutory installment notes and general obligation bonds;
- Certain creditworthy un-rated securities issued by municipalities;
- Certificates of deposit;
- Equity securities at the holding company level; and
- Limited partnership investments in Small Business Investment Companies (SBIC).

SOURCES OF FUNDS

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

The Company offers a variety of deposit account products with a range of interest rates and terms. The deposit accounts consist of noninterest-bearing demand, interest-bearing demand, savings, money market, club accounts and certificates of deposit. The Company also offers certificates of deposit with balances in excess of $100,000 to local municipalities, businesses, and individuals as well as Individual Retirement Accounts and other qualified plan accounts. The flow of deposits is influenced significantly by general economic conditions, prevailing interest rates and competition. The Company s deposits are obtained predominantly from the areas in which its branch offices are located. The Company relies primarily on competitive pricing of its deposit products, customer service and long-standing relationships with customers to attract and retain these deposits. The Company has also utilized certificate of deposit sales in the national brokered market (brokered deposits) as a wholesale funding source, however, the Company had no brokered deposits at December 31, 2009. The Company s borrowings consist mainly of advances entered into with the FHLB, the Federal Reserve s Term Auction Facility, federal funds purchased and securities sold under repurchase agreements.

OPERATING SEGMENTS

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

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SUPERVISION AND REGULATION

General

FII and FSB are subject to extensive federal and state laws and regulations that impose restrictions on, and provide for regulatory oversight of, FII s and FSB s operations. These laws and regulations are generally intended to protect depositors and not shareholders. Any change in any applicable statute or regulation could have a material effect on FII s and FSB s business.

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

The Company is also affected by various governmental requirements and regulations, general economic conditions, and the fiscal and monetary policies of the federal government and the FRB. The monetary policies of the FRB influence to a significant extent the overall growth of loans, investments, deposits, interest rates charged on loans, and interest rates paid on deposits. The nature and impact of future changes in monetary policies are often not predictable.

The following description summarizes some of the laws to which the Company is subject. References to applicable statutes and regulations are brief summaries and do not claim to be complete. They are qualified in their entirety by reference to such statutes and regulations. Management believes the Company is in compliance in all material respects with these laws and regulations. Changes in the laws, regulations or policies that impact the Company cannot necessarily be predicted, but they may have a material effect on the Company s consolidated financial position, consolidated results of operations, or liquidity.

Regulation of FII

FII is a financial holding company registered under the Bank Holding Company Act of 1956, as amended, and is subject to supervision, regulation and examination by the FRB. The Bank Holding Company Act and other federal laws subject bank holding companies to particular restrictions on the types of activities in which they may engage, and to a range of supervisory requirements and activities, including regulatory enforcement actions for violations of laws and regulations.

Regulatory Restrictions on Dividends; Source of Strength. It is the policy of the FRB that bank holding companies should pay cash dividends on common stock only out of income available over the past year, and only if prospective earnings retention is consistent with the holding company s expected future needs and financial condition. The policy provides that bank holding companies should not maintain a level of cash dividends that undermines the bank holding company s ability to serve as a source of strength to its subsidiaries.

Under FRB policy, a bank holding company is expected to act as a source of financial strength to each of its subsidiaries and commit resources to their support. Such support may be required at times when, absent this FRB policy, a holding company may not be inclined to provide it. As discussed below, a bank holding company in certain circumstances could be required to guarantee the capital plan of an undercapitalized banking subsidiary.

Safe and Sound Banking Practices. Bank holding companies are not permitted to engage in unsafe and unsound banking practices. The FRB s Regulation Y, for example, generally requires a holding company to give the FRB prior notice of any redemption or repurchase of its own equity securities, if the consideration to be paid, together with the consideration paid for any repurchases or redemptions in the preceding year, is equal to 10% or more of the company s consolidated net worth. The FRB may oppose the transaction if it believes that the transaction would constitute an unsafe or unsound practice or would violate any law or regulation. Depending upon the circumstances, the FRB could take the position that paying a dividend would constitute an unsafe or unsound banking practice.

The FRB has broad authority to prohibit activities of bank holding companies and their non-banking subsidiaries which represent unsafe and unsound banking practices or which constitute violations of laws or regulations, and can assess civil money penalties for certain activities conducted on a knowing and reckless basis, if those activities caused a substantial loss to a depository institution. The penalties can be as high as $1,000,000 for each day the activity continues.

Anti-Tying Restrictions. Bank holding companies and their affiliates are prohibited from tying the provision of certain services, such as extensions of credit, to other services offered by a holding company or its affiliates. In 2002, the FRB adopted Regulation W, a comprehensive synthesis of prior opinions and interpretations under Sections 23A and 23B of the Federal Reserve Act. Regulation W contains an extensive discussion of tying arrangements, which could impact the way banks and bank holding companies transact business with affiliates.

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Capital Adequacy Requirements. The FRB has adopted a system using risk-based capital guidelines to evaluate the capital adequacy of bank holding companies. Under the guidelines, specific categories of assets are assigned different risk weights, based generally on the perceived credit risk of the asset. These risk weights are multiplied by corresponding asset balances to determine a risk-weighted asset base. The guidelines require a minimum total risk-based capital ratio of 8.0% (of which at least 4.0% is required to consist of Tier 1 capital elements). Total capital is the sum of Tier 1 and Tier 2 capital. As of December 31, 2009, the Company s ratio of Tier 1 capital to total risk-weighted assets was 11.95% and the ratio of total capital to total risk-weighted assets was 13.21%. See also the section titled Capital Resources in Part II, Item 7, Management s Discussion and Analysis of Financial Condition and Results of Operations and Note 10, Regulatory Matters, of the notes to consolidated financial statements.

In addition to the risk-based capital guidelines, the FRB uses a leverage ratio as an additional tool to evaluate the capital adequacy of bank holding companies. The leverage ratio is a company s Tier 1 capital divided by quarterly average consolidated assets. Certain highly rated bank holding companies may maintain a minimum leverage ratio of 3.0%, but other bank holding companies may be required to maintain a leverage ratio of up to 200 basis points above the regulatory minimum. As of December 31, 2009, the Company s leverage ratio was 7.96%.

The federal banking agencies risk-based and leverage ratios are minimum supervisory ratios generally applicable to banking organizations that meet certain specified criteria, assuming that they have the highest regulatory rating. Banking organizations not meeting these criteria are expected to operate with capital positions well above the minimum ratios. The federal bank regulatory agencies may set capital requirements for a particular banking organization that are higher than the minimum ratios when circumstances warrant. FRB guidelines also provide that banking organizations experiencing internal growth or making acquisitions will be expected to maintain strong capital positions substantially above the minimum supervisory levels, without significant reliance on intangible assets.

Imposition of Liability for Undercapitalized Subsidiaries. Bank regulators are required to take prompt corrective action to resolve problems associated with insured depository institutions whose capital declines below certain levels. In the event an institution becomes undercapitalized, it must submit a capital restoration plan. The capital restoration plan will not be accepted by the regulators unless each company having control of the undercapitalized institution guarantees the subsidiary s compliance with the capital restoration plan up to a certain specified amount. Any such guarantee from a depository institution holding company is entitled to a priority of payment in bankruptcy.

The aggregate liability of the holding company of an undercapitalized bank is limited to the lesser of 5% of the institution s assets at the time it became undercapitalized or the amount necessary to cause the institution to be adequately capitalized. The bank regulators have greater power in situations where an institution becomes significantly or critically undercapitalized or fails to submit a capital restoration plan. For example, a bank holding company controlling such an institution can be required to obtain prior FRB approval of proposed dividends, or might be required to consent to a consolidation or to divest the troubled institution or other affiliates.

Acquisitions by Bank Holding Companies. The Bank Holding Company Act requires every bank holding company to obtain the prior approval of the FRB before it may acquire all or substantially all of the assets of any bank, or ownership or control of any voting shares of any bank, if after such acquisition it would own or control, directly or indirectly, more than 5% of the voting shares of such bank. In approving bank acquisitions by bank holding companies, the FRB is required to consider the financial and managerial resources and future prospects of the bank holding company and the banks involved, the convenience and needs of the communities to be served, and various competitive factors.

Control Acquisitions. The Change in Bank Control Act prohibits a person or group of persons from acquiring control of a bank holding company unless the FRB has been notified and has not objected to the transaction. Under a rebuttable presumption established by the FRB, the acquisition of 10% or more of a class of voting stock of a bank holding company with a class of securities registered under Section 12 of the Exchange Act, would, under the circumstances set forth in the presumption, constitute acquisition of control of the Company.

In addition, any entity is required to obtain the approval of the FRB under the Bank Holding Company Act before acquiring 25% (5% in the case of an acquirer that is a bank holding company) or more of the Company s outstanding common stock, or otherwise obtaining control or a controlling influence over the Company.

Regulation of FSB

Five Star Bank (FSB or the Bank) is a New York chartered bank and a member of the Federal Reserve System. The FDIC, through the Deposit Insurance Fund (DIF), insures deposits of the Bank. The supervision and regulation of FSB subjects the Bank to special restrictions, requirements, potential enforcement actions and periodic examination by the FDIC, the FRB and the New York State Banking Department (NYSBD). Because the FRB regulates the holding company parent, the FRB also has supervisory authority that directly affects FSB.

Restrictions on Transactions with Affiliates and Insiders. Transactions between the holding company and its subsidiaries, including the Bank, are subject to Section 23A of the Federal Reserve Act, and to the requirements of Regulation W. In general, Section 23A imposes limits on the amount of such transactions, and also requires certain levels of collateral for loans to affiliated parties. It also limits the amount of advances to third parties, which are collateralized by the securities, or obligations of FII or its subsidiaries.

Affiliate transactions are also subject to Section 23B of the Federal Reserve Act, and to the requirements of Regulation W which generally requires that certain transactions between the holding company and its affiliates be on terms substantially the same, or at least as favorable to the Bank, as those prevailing at the time for comparable transactions with or involving other nonaffiliated persons.

The restrictions on loans to directors, executive officers, principal shareholders and their related interests (collectively referred to herein as insiders) contained in the Federal Reserve Act and Regulation O apply to all insured institutions and their subsidiaries and holding companies. These restrictions include limits on loans to one borrower and conditions that must be met before such a loan can be made. There is also an aggregate limitation on all loans to insiders and their related interests. These loans cannot exceed the institution s total unimpaired capital and surplus, and the FDIC may determine that a lesser amount is appropriate. Insiders are subject to enforcement actions for knowingly accepting loans in violation of applicable restrictions.

Restrictions on Distribution of Subsidiary Bank Dividends and Assets. Dividends paid by the Bank provide a substantial part of FII s operating funds and, for the foreseeable future, it is anticipated that dividends paid by the Bank will continue to be its principal source of operating funds. Capital adequacy requirements serve to limit the amount of dividends that may be paid by the subsidiaries. Under federal law, the subsidiaries cannot pay a dividend if, after paying the dividend, a particular subsidiary will be undercapitalized. The FDIC may declare a dividend payment to be unsafe and unsound even though the bank would continue to meet its capital requirements after the dividend.

Because FII is a legal entity separate and distinct from its subsidiaries, FII s right to participate in the distribution of assets of any subsidiary upon the subsidiary s liquidation or reorganization will be subject to the prior claims of the subsidiary s creditors. In the event of a liquidation or other resolution of an insured depository institution, the claims of depositors and other general or subordinated creditors are entitled to a priority of payment over the claims of holders of any obligation of the institution to its shareholders, including any depository bank holding company (such as FII) or any shareholder or creditor thereof.

Examinations. The NYSBD, the FRB and the FDIC periodically examine and evaluate the Bank. Based upon such examinations, the appropriate regulator may revalue the assets of the institution and require that it establish specific reserves to compensate for the difference between what the regulator determines the value to be and the book value of such assets.

Audit Reports. Insured institutions with total assets of $500 million or more at the beginning of a fiscal year must submit annual audit reports prepared by independent auditors to federal and state regulators. In some instances, the audit report of the institution s holding company can be used to satisfy this requirement. Auditors must receive examination reports, supervisory agreements and reports of enforcement actions. In addition, financial statements prepared in accordance with GAAP, management s certifications concerning responsibility for the financial statements, internal controls and compliance with legal requirements designated by the FDIC, and if total assets exceed $1.0 billion, an attestation by the auditor regarding the statements of management relating to the internal controls must be submitted. The FDIC Improvement Act of 1991 requires that independent audit committees be formed, consisting of outside directors only. The committees of institutions with assets of more than $3.0 billion must include members with experience in banking or financial management must have access to outside counsel and must not include representatives of large customers.

Capital Adequacy Requirements. The FDIC has adopted regulations establishing minimum requirements for the capital adequacy of insured institutions. The FDIC may establish higher minimum requirements if, for example, a bank has previously received special attention or has a high susceptibility to interest rate risk. The most recent notification from the FDIC categorized the Bank as well capitalized under the regulatory framework for prompt corrective action.

The FDIC s risk-based capital guidelines generally require banks to have a minimum ratio of Tier 1 capital to total risk-weighted assets of 4.0% and a ratio of total capital to total risk-weighted assets of 8.0%. The capital categories have the same definitions for the Company. As of December 31, 2009, the ratio of Tier 1 capital to total risk-weighted assets for the Bank was 11.33% and the ratio of total capital to total risk-weighted assets was 12.58%. The FDIC s leverage guidelines require banks to maintain Tier 1 capital of no less than 4.0% of average total assets, except in the case of certain highly rated banks for which the requirement is 3.0% of average total assets. As of December 31, 2009, the ratio of Tier 1 capital to quarterly average total assets (leverage ratio) was 7.53% for FSB. For further discussion, see Note 10, Regulatory Matters, of the notes to consolidated financial statements included in Item 8 of this Annual Report on Form 10-K.

Corrective Measures for Capital Deficiencies. The federal banking regulators are required to take prompt corrective action with respect to capital-deficient institutions. Agency regulations define, for each capital category, the levels at which institutions are well-capitalized, adequately capitalized, undercapitalized, significantly undercapitalized critically undercapitalized. A well-capitalized bank has a total risk-based capital ratio of 10.0% or higher; a Tier 1 risk-based capital ratio of 6.0% or higher; a leverage ratio of 5.0% or higher; and is not subject to any written agreement, order or directive requiring it to maintain a specific capital level for any capital measure. An adequately capitalized bank has a total risk-based capital ratio of 8.0% or higher; a Tier 1 risk-based capital ratio of 4.0% or higher; a leverage ratio of 4.0% or higher (3.0% or higher if the bank was rated a composite 1 in its most recent examination report and is not experiencing significant growth); and does not meet the criteria for a well-capitalized bank. A bank is undercapitalized if it fails to meet any one of the adequately capitalized ratios.

In addition to requiring undercapitalized institutions to submit a capital restoration plan, agency regulations contain broad restrictions on certain activities of undercapitalized institutions including asset growth, acquisitions, branch establishment and expansion into new lines of business. With certain exceptions, an insured depository institution is prohibited from making capital distributions, including dividends, and is prohibited from paying management fees to control persons if the institution would be undercapitalized after any such distribution or payment.

As an institution s capital decreases, the FDIC s enforcement powers become more severe. A significantly undercapitalized institution is subject to mandated capital raising activities, restrictions on interest rates paid and transactions with affiliates, removal of management and other restrictions. The FDIC has only very limited discretion in dealing with a critically undercapitalized institution and is virtually required to appoint a receiver or conservator.

Banks with risk-based capital and leverage ratios below the required minimums may also be subject to certain administrative actions, including the termination of deposit insurance upon notice and hearing, or a temporary suspension of insurance without a hearing in the event the institution has no tangible capital.

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

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

DIF-insured institutions pay a Financing Corporation (FICO) assessment in order to fund the interest on bonds issued in the 1980s in connection with the failures in the thrift industry. For the fourth quarter of 2009, the FICO assessment is equal to 1.06 basis points for each $100 in domestic deposits. These assessments will continue until the bonds mature in 2019. The FDIC bills and collects this assessment on behalf of FICO.

Enforcement Powers. The FDIC, the NYSBD and the FRB have broad enforcement powers, including the power to terminate deposit insurance, impose substantial fines and other civil and criminal penalties and appoint a conservator or receiver. Failure to comply with applicable laws, regulations and supervisory agreements could subject the Company or the Bank, as well as the officers, directors and other institution-affiliated parties of these organizations, to administrative sanctions and potentially substantial civil money penalties.

Federal Home Loan Bank System. FSB is a member of the FHLB System, which consists of 12 regional branches. The FHLB System provides a central credit facility primarily for member institutions. As members of the FHLB of New York (FHLBNY), the Bank is required to acquire and hold shares of capital stock in the FHLB. The minimum investment requirement is determined by a membership investment component and an activity-based investment component. Under the membership component, a certain minimum investment in capital stock is required to be maintained as long as the institution remains a member of the FHLB. Under the activity-based component, members are required to purchase capital stock in proportion to the volume of certain transactions with the FLHB. As of December 31, 2009, FSB complied with these requirements.

Community Reinvestment Act. The Community Reinvestment Act of 1977 (CRA) and the regulations issued hereunder are intended to encourage banks to help meet the credit needs of their service area, including low and moderate income neighborhoods, consistent with the safe and sound operations of the banks. These regulations also provide for regulatory assessment of a bank s record in meeting the needs of its service area when considering applications regarding establishing branches, mergers or other bank or branch acquisitions. The Financial Institutions Reform, Recovery and Enforcement Act of 1989 requires federal banking agencies to make public a rating of a bank s performance under the CRA. In the case of a bank holding company, the CRA performance record of the banks involved in the transaction are reviewed in connection with the filing of an application to acquire ownership or control of shares or assets of a bank or to merge with any other bank holding company. An unsatisfactory record can substantially delay or block the transaction. FSB received a rating of outstanding as of its most recent CRA performance evaluation.

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

Gramm-Leach-Bliley Act

The Gramm-Leach-Bliley Act (Gramm-Leach) was signed into law on November 12, 1999. Gramm-Leach permits, subject to certain conditions, combinations among banks, securities firms and insurance companies. Under Gramm-Leach, bank holding companies are permitted to offer their customers virtually any type of financial service including banking, securities underwriting, insurance (both underwriting and agency), and merchant banking. In order to engage in these additional financial activities, a bank holding company must qualify and register with the Board of Governors of the Federal Reserve System as a financial holding company by demonstrating that each of its subsidiaries is well capitalized, well managed, and has at least a satisfactory rating under the CRA. During the second quarter of 2008, FII received FRB approval for an election to re-instate its status as a financial holding company, which the Company terminated during 2003. The change in status did not affect the activities being conducted by the Company or its subsidiaries. Gramm-Leach establishes that the federal banking agencies will regulate the banking activities of financial holding companies and banks financial subsidiaries, the SEC will regulate their securities activities and state insurance regulators will regulate their insurance activities. Gramm-Leach also provides new protections against the transfer and use by financial institutions of consumers nonpublic, personal information.

The major provisions of Gramm-Leach include:

Financial Holding Companies and Financial Activities. Title I establishes a comprehensive framework to permit affiliations among commercial banks, insurance companies, securities firms, and other financial service providers by revising and expanding the Bank Holding Company Act framework to permit a holding company system to engage in a full range of financial activities through qualification as a new entity known as a financial holding company. A bank holding company that qualifies as a financial holding company can expand into a wide variety of services that are financial in nature, if its subsidiary depository institutions are well-managed , well-capitalized and have received at least a satisfactory rating on their last CRA examination. Services that have been deemed to be financial in nature include securities underwriting, dealing and market making, sponsoring mutual funds and investment companies, insurance underwriting and agency activities and merchant banking.

Securities Activities. Title II narrows the exemptions from the securities laws previously enjoyed by banks, requires the FRB and the SEC to work together to draft rules governing certain securities activities of banks and creates a new, voluntary investment bank holding company.

Insurance Activities. Title III restates the proposition that the states are the functional regulators for all insurance activities, including the insurance activities of federally chartered banks, and bars the states from prohibiting insurance activities by depository institutions. The law encourages the states to develop uniform or reciprocal rules for the licensing of insurance agents.

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Privacy. Under Title V, federal banking regulators were required to adopt rules that have limited the ability of banks and other financial institutions to disclose non-public information about consumers to nonaffiliated third parties. These limitations require disclosure of privacy policies to consumers and, in some circumstances, allow consumers to prevent disclosure of certain personal information to a nonaffiliated third party. Federal banking regulators issued final rules on May 10, 2000 to implement the privacy provisions of Title V. Under the rules, financial institutions must provide:

- Initial notices to customers about their privacy policies, describing the conditions under which they may disclose nonpublic personal information to nonaffiliated third parties and affiliates;
- Annual notices of their privacy policies to current customers; and
- A reasonable method for customers to opt out of disclosures to nonaffiliated third parties.

The Bank is in full compliance with the rules.

Safeguarding Confidential Customer Information. Under Title V, federal banking regulators are required to adopt rules requiring financial institutions to implement a program to protect confidential customer information. In January 2000, the federal banking agencies adopted guidelines requiring financial institutions to establish an information security program to:

- Identify and assess the risks that may threaten customer information;
- Develop a written plan containing policies and procedures to manage and control these risks;