FINANCIAL INSTITUTIONS INC
Form 10-Q
November 04, 2009

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

Form 10-Q

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

For the quarterly period ended September 30, 2009

or

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

Commission File Number: 000-26481

(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**

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

Large accelerated filer o	Accelerated filer þ	Non-accelerated filer o (Do not check if a smaller company)	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 registrant had 10,820,268 shares of Common Stock, $0.01 par value, outstanding as of October 30, 2009.

FINANCIAL INSTITUTIONS, INC.
Form 10-Q
For the Quarterly Period Ended September 30, 2009
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PART I. FINANCIAL INFORMATION

ITEM 1. Financial Statements

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

(Dollars in thousands, except share and per share data)		September 30, 2009		December 31, 2008
ASSETS				
Cash and cash equivalents:				
Cash and due from banks	$	48,721	$	34,528
Federal funds sold and interest-bearing deposits in other banks		11,385		20,659
Total cash and cash equivalents		60,106		55,187
Securities available for sale, at fair value		625,744		547,506
Securities held to maturity, at amortized cost (fair value of $46,122 and $59,147, respectively)		45,056		58,532
Loans held for sale		1,032		1,013
Loans		1,259,362		1,121,079
Less: Allowance for loan losses		20,782		18,749
Loans, net		1,238,580		1,102,330
Company owned life insurance		24,532		23,692
Premises and equipment, net		35,210		36,712
Goodwill		37,369		37,369
Other assets		70,576		54,578
Total assets	$	2,138,205	$	1,916,919
LIABILITIES AND SHAREHOLDERS EQUITY				
Deposits:				
Noninterest-bearing demand	$	298,972	$	292,586
Interest-bearing demand		383,982		344,616
Savings and money market		402,042		348,594
Certificates of deposit		712,182		647,467
Total deposits		1,797,178		1,633,263
Short-term borrowings		73,265		23,465
Long-term borrowings		46,848		47,355
Other liabilities		24,979		22,536
Total liabilities		1,942,270		1,726,619
Shareholders equity:				
Series A 3% Preferred Stock, $100 par value, 1,533 shares authorized and issued		153		153

Series A Preferred Stock, $100 par value, 7,503 shares authorized and issued, aggregate liquidation preference of $37,515; net of $1,760 and $2,016 discount, respectively		35,755		35,499
Series B-1 8.48% Preferred Stock, $100 par value, 200,000 shares authorized, 174,223 shares issued		17,422		17,422
Total preferred equity		53,330		53,074
Common stock, $0.01 par value, 50,000,000 shares authorized, 11,348,122 shares issued		113		113
Additional paid-in capital		26,815		26,397
Retained earnings		127,941		124,952
Accumulated other comprehensive loss		(2,381)		(4,013)
Treasury stock, at cost 529,826 and 550,103 shares, respectively		(9,883)		(10,223)
Total shareholders equity		195,935		190,300
Total liabilities and shareholders equity	$	2,138,205	$	1,916,919

See accompanying notes to the consolidated financial statements.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
Consolidated Statements of Operations (Unaudited)

	Three months ended September 30,		Nine months ended September 30,	
(Dollars in thousands, except per share amounts)	**2009**	**2008**	**2009**	**2008**
Interest income:				
Interest and fees on loans	$ 18,712	$ 17,018	$ 53,618	$ 50,146
Interest and dividends on investment securities	4,965	7,472	16,401	23,648
Other interest income	20	68	73	572
Total interest income	23,697	24,558	70,092	74,366
Interest expense:				
Deposits	4,826	6,538	14,729	23,193
Short-term borrowings	77	287	171	571
Long-term borrowings	716	987	2,142	2,584
Total interest expense	5,619	7,812	17,042	26,348
Net interest income	18,078	16,746	53,050	48,018
Provision for loan losses	2,620	1,891	6,614	3,965
Net interest income after provision for loan losses	15,458	14,855	46,436	44,053
Noninterest income:				
Service charges on deposits	2,643	2,794	7,480	7,812
ATM and debit card	920	852	2,639	2,460
Loan servicing	304	112	1,031	530
Company owned life insurance	271	223	806	269
Broker-dealer fees and commissions	238	363	741	1,223
Net gain on sale of loans held for sale	129	48	545	304
Net gain on investment securities	1,721	12	2,928	232
Impairment charges on investment securities	(2,318)	(34,554)	(4,101)	(38,345)
Net gain on sale and disposal of other assets	19	102	177	254
Other	479	700	1,366	1,589
Total noninterest income (loss)	4,406	(29,348)	13,612	(23,672)
Noninterest expense:				
Salaries and employee benefits	8,253	7,021	25,421	23,626
Occupancy and equipment	2,730	2,642	8,289	7,789
FDIC assessments	753	236	3,026	369
Professional services	532	467	1,972	1,504
Computer and data processing	578	603	1,757	1,764
Supplies and postage	473	475	1,414	1,353

Advertising and promotions		227		472		650		905
Other		1,596		1,493		5,131		4,757
Total noninterest expense		15,142		13,409		47,660		42,067
Income (loss) before income taxes		4,722		(27,902)		12,388		(21,686)
Income tax expense		1,313		524		3,384		1,330
Net income (loss)	$	3,409	$	(28,426)	$	9,004	$	(23,016)
Preferred stock dividends, net of amortization		927		371		2,770		1,112
Net income (loss) applicable to common shareholders	$	2,482	$	(28,797)	$	6,234	$	(24,128)
Earnings (loss) per common share (Note 2):								
Basic	$	0.23	$	(2.66)	$	0.58	$	(2.21)
Diluted	$	0.23	$	(2.66)	$	0.57	$	(2.21)

See accompanying notes to the consolidated financial statements.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
Consolidated Statement of Changes in Shareholders Equity (Unaudited)

(Dollars in thousands, except per share data)	Preferred Equity	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Loss	Treasury Stock	Total Shareholders Equity
Balance at January 1, 2009	**$ 53,074**	**$ 113**	**$ 26,397**	**$ 124,952**	**$ (4,013)**	**$ (10,223)**	**$ 190,300**
Comprehensive income:							
Net income				9,004			9,004
Other comprehensive income, net of tax					1,632		1,632
Total comprehensive income							10,636
Issuance costs of Series A Preferred Stock			(68)				(68)
Share-based compensation plans:							
Share-based compensation			690				690
Stock options exercised			(4)			19	15
Restricted stock awards issued, net			(170)			170	
Directors retainer			(30)			151	121
Accrued undeclared cumulative dividend on Series A Preferred Stock, net of amortization	256			(450)			(194)
Cash dividends declared:							
Series A 3% Preferred-$2.25 per share				(3)			(3)
Series A Preferred-$161.11 per share				(1,209)			(1,209)
Series B-1 8.48% Preferred-$6.36 per share				(1,108)			(1,108)
Common-$0.30 per share				(3,245)			(3,245)
Balance at September 30, 2009	**$ 53,330**	**$ 113**	**$ 26,815**	**$ 127,941**	**$ (2,381)**	**$ (9,883)**	**$ 195,935**

See accompanying notes to the consolidated financial statements.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Consolidated Statements of Cash Flows (Unaudited)

	Nine months ended September 30,	
(Dollars in thousands)	**2009**	**2008**
Cash flows from operating activities:		
Net income (loss)	$ 9,004	$ (23,016)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation and amortization	3,067	2,922
Net amortization of premiums and discounts on investment securities	1,792	374
Provision for loan losses	6,614	3,965
Amortization of unvested stock-based compensation	690	529
Deferred income tax expense (benefit)	5,562	(1,865)
Proceeds from sale of loans held for sale	76,704	25,401
Originations of loans held for sale	(76,178)	(25,199)
Increase in company owned life insurance	(806)	(269)
Net gain on investment securities	(2,928)	(232)
Impairment charge on investment securities	4,101	38,345
Net gain on sale of loans held for sale	(545)	(304)
Net gain on sale and disposal of other assets	(177)	(254)
(Increase) decrease in other assets	(5,095)	129
Increase (decrease) in other liabilities	1,562	(2,727)
Net cash provided by operating activities	23,367	17,799
Cash flows from investing activities:		
Purchase of investment securities:		
Available for sale	(451,137)	(287,678)
Held to maturity	(22,350)	(44,065)
Proceeds from principal payments, maturities and calls on investment securities:		
Available for sale	243,439	270,367
Held to maturity	36,512	40,924
Proceeds from sale of securities available for sale	127,142	51,545
Net loan originations	(159,750)	(116,772)
Purchase of company owned life insurance	(34)	(20,066)
Proceeds from sales of other assets	1,577	1,395
Purchase of premises and equipment	(1,439)	(4,058)
Net cash used by investing activities	(226,040)	(108,408)
Cash flows from financing activities:		
Net increase in deposits	163,915	84,443
Net increase in short-term borrowings	49,800	21,566
Proceeds from long-term borrowings		30,000
Repayment of long-term borrowings	(507)	(5,092)

Purchase of common stock				(4,698)
Issuance of preferred and common shares		(68)		112
Stock options exercised		15		32
Cash dividends paid to preferred shareholders		(2,320)		(1,112)
Cash dividends paid to common shareholders		(3,243)		(4,611)
Net cash provided by financing activities		207,592		120,640
Net increase in cash and cash equivalents		4,919		30,031
Cash and cash equivalents, beginning of period		55,187		46,673
Cash and cash equivalents, end of period	$	60,106	$	76,704

See accompanying notes to the consolidated financial statements.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements (Unaudited)

(1.) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Nature of Operations

Financial Institutions, Inc., a financial holding company organized under the laws of New York State, and its subsidiaries provide deposit, lending and other financial services to individuals and businesses in Central and Western New York. The Company owns 100% of Five Star Bank, a New York State-chartered bank, and Five Star Investment Services, Inc., a broker-dealer subsidiary offering noninsured investment products. The Company also owns 100% of FISI Statutory Trust I (the Trust), which was formed in February 2001 for the purpose of issuing trust preferred securities. References to the Company mean the consolidated reporting entities and references to the Bank mean Five Star Bank.

Basis of Presentation

The consolidated financial statements in this Quarterly Report on Form 10-Q include the accounts of the Company and its subsidiaries. The Trust is not included in the consolidated financial statements of the Company under the requirements of the Variable Interest Entities Subsections of the Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC). All significant intercompany accounts and transactions have been eliminated in consolidation. The accounting and reporting policies conform to general practices within the banking industry and to U.S. generally accepted accounting principles. Prior years consolidated financial statements are re-classified whenever necessary to conform to the current year s presentation.

These financial statements have been prepared by the Company, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission (SEC). Certain information and footnote disclosures normally included in financial statements prepared in conformity with U.S. generally accepted accounting principles (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 to present fairly the consolidated balance sheet, statements of operations, shareholders equity and cash flows for the periods indicated, and contain adequate disclosure to make the information presented not misleading. These consolidated financial statements should be read in conjunction with the Company s 2008 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.

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 valuation of goodwill and deferred tax assets, and the valuation and other than temporary impairment considerations related to the securities portfolio.

Cash Flow Information

Supplemental cash flow information addressing certain cash payments (receipts) and noncash investing and financing activities was as follows (in thousands):

	Nine months ended September 30, 2009	Nine months ended September 30, 2008
Cash payments (receipts):		
Interest	$ 15,338	$ 28,306
Income taxes	(1,312)	2,349
Noncash investing and financing activities:		
Real estate and other assets acquired in settlement of loans	$ 903	$ 756
Accrued and declared unpaid dividends	1,692	1,992
Increase in net unsettled security transactions	16,795	1,814

Loans securitized	15,983

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements (Unaudited)

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

Recently Adopted Accounting Pronouncements

Accounting Standards Codification. The ASC became effective on July 1, 2009. At that date, the ASC became FASB s officially recognized source of authoritative GAAP applicable to all public and non-public non-governmental entities, superseding existing FASB, American Institute of Certified Public Accountants, Emerging Issues Task Force and related literature. Rules and interpretive releases of the SEC under the authority of federal securities laws are also sources of authoritative GAAP for SEC registrants. All other accounting literature is considered non-authoritative. The switch to the ASC affects the way companies refer to GAAP in financial statements and accounting policies. The ASC was not intended to change or alter existing GAAP, and therefore did not have an impact on the Company s financial statements.

Earnings Per Share. On January 1, 2009, the Company adopted the requirements of the ASC subsections regarding Participating Securities and the Two-Class Method as those requirements relate to the calculation of earnings per common share. The ASC provides that unvested share-based payment awards that contain nonforfeitable rights to dividends or dividend equivalents (whether paid or unpaid) are participating securities and shall be included in the computation of earnings per common share pursuant to the two-class method. The Company has shares of restricted stock outstanding that are participating securities under the provisions of the ASC. Accordingly, the Company has computed earnings per common share using the two-class method described in the ASC beginning January 1, 2009, and has retrospectively adjusted previously reported earnings per common share data to conform to the two-class method.

Disclosures about Derivative Instruments and Hedging Activities. In March 2008, the FASB issued new guidance regarding disclosures in the Derivatives and Hedging Topic of the ASC (Derivative Disclosure Guidance). The Derivative Disclosure Guidance requires expanded disclosure to provide greater transparency about (i) how and why an entity uses derivative instruments, (ii) how derivative instruments and related hedge items are accounted for under the Derivatives and Hedging Topic, and (iii) how derivative instruments and related hedged items affect an entity s financial condition, results of operations and cash flows. To meet those objectives, the Derivative Disclosure Guidance requires qualitative disclosures about objectives and strategies for using derivatives, quantitative disclosures about fair value amounts of gains and losses on derivative instruments and disclosures about credit risk-related contingent features in derivative agreements. The Derivative Disclosure Guidance became effective for the Company on January 1, 2009 and its adoption did not have an impact on the Company s financial statements.

Fair Value Determination. In April 2009, the FASB issued guidance (Fair Value Determination Guidance) in the Fair Value Measurements and Disclosures Topic of the ASC regarding the determination of fair value in instances where market conditions result in either inactive markets for assets and liabilities or disorderly transactions within markets. The Fair Value Determination Guidance affirms that the objective of fair value when the market for an asset is not active is the price that would be received to sell the asset in an orderly transaction, and clarifies and includes additional factors for determining whether there has been a significant decrease in market activity for an asset when the market for that asset is not active. The Fair Value Determination Guidance requires an entity to base its conclusion about whether a transaction was not orderly on the weight of the evidence and expands certain disclosure requirements. The Fair Value Determination Guidance became effective for the Company in the quarter ended June 30, 2009, and its adoption did not have a significant impact on the Company s financial statements.

Other-Than-Temporary Impairments. In April 2009, the FASB issued guidance in the Investments-Debt and Equity Securities Topic of the ASC regarding the recognition and presentation of Other-Than-Temporary Impairments (OTTI Guidance). The OTTI Guidance (i) changes existing guidance for determining whether an impairment is other than temporary to debt securities and (ii) replaces the existing requirement that the entity s management assert it has both the intent and ability to hold an impaired security until recovery with a requirement that management assert: (a) it does not have the intent to sell the security; and (b) it is more likely than not it will not have to sell the security before recovery of its cost basis. Under the OTTI Guidance, declines in the fair value of held-to-maturity and available-for-sale securities below their cost that are deemed to be other than temporary are reflected in earnings as realized losses to the extent the impairment is related to credit losses. The amount of the impairment related to other factors is recognized in other comprehensive income. The OTTI Guidance became effective for the Company in the quarter ended June 30, 2009, and its adoption did not have a significant impact on the Company s financial statements.

Interim Disclosure about Fair Value of Financial Instruments. In April 2009, the FASB amended the Fair Value of Financial Instruments Subsection of the ASC to require an entity to provide disclosures about fair value of financial instruments in interim financial information (Fair Value Disclosure Amendment). The Fair Value Disclosure Amendment requires a publicly traded company to include disclosures about the fair value of its financial instruments whenever it issues summarized financial information for interim reporting periods. In addition, entities must disclose, in the body or in the accompanying notes of its summarized financial information for interim reporting periods and in its financial statements for annual reporting periods, the fair value of all financial instruments for which it is practicable to estimate that value, whether recognized or not recognized in the statement of financial condition. The Fair Value Disclosure Amendment became effective for the Company in the quarter ended June 30, 2009, and its adoption did not have a significant effect on Company s financial statements. The Company has included the disclosures required by the Fair Value Disclosure Amendment in Note 9, Fair Value Measurements.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements (Unaudited)

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

Subsequent Events. The Company has applied the provisions of the Subsequent Events Topic of the ASC to its consolidated interim financial statements for periods ended after June 15, 2009. The Subsequent Event Topic establishes general standards of accounting for, and disclosure of, events that occur after the balance sheet date but before financial statements are issued or available to be issued. In particular, the Subsequent Events Topic sets forth the period after the balance sheet date during which management of a reporting entity should evaluate events or transactions that may occur for potential recognition or disclosure in the financial statements. Accordingly, the Company has evaluated events and transactions occurring through November 4, 2009, the date the consolidated interim financial statements were issued, for potential recognition or disclosure in the financial statements.

Recently Issued Accounting Pronouncements not Yet Adopted

In June 2009, the FASB issued two related accounting pronouncements changing the accounting principles and disclosures requirements related to securitizations and special-purpose entities. Specifically, these pronouncements eliminate the concept of a qualifying special-purpose entity , change the requirements for derecognizing financial assets and change how a company determines when an entity that is insufficiently capitalized or is not controlled through voting (or similar rights) should be consolidated. These pronouncements also expand existing disclosure requirements to include more information about transfers of financial assets, including securitization transactions, and where companies have continuing exposure to the risks related to transferred financial assets. These pronouncements will be effective as of the beginning of each reporting entity s first annual reporting period that begins after November 15, 2009, for interim periods within that first annual reporting period and for interim and annual reporting periods thereafter. Earlier application is prohibited. The recognition and measurement provisions regarding transfers of financial assets shall be applied to transfers that occur on or after the effective date. These new pronouncements will be effective January 1, 2010 and are not expected to have a significant impact on the Company s financial statements.

Disclosures about Retirement Benefits. Effective for fiscal years ending after December 15, 2009, the *Compensation Retirement Benefits Topic*, requires additional disclosures about employers plan assets of a defined benefit pension or other postretirement plan. The requirements include disclosing investing strategies, major categories of plan assets, concentrations of risk within plan assets, information about fair value measurements of plan assets, and valuation techniques used to measure the fair value of plan assets. Adoption of these additional requirements will not have a significant impact on the Company s financial statements.

(2.) EARNINGS PER COMMON SHARE

The following table presents the computation of basic and diluted earnings per common share for the three and nine months ended September 30, 2009 and 2008 (in thousands, except per share amounts). The Company uses the two-class method prescribed by the Earnings Per Share Topic of the ASC to compute earnings per common share. Participating securities include non-vested restricted stock.

	Three months ended September 30,		Nine months ended September 30,	
	2009	**2008**	**2009**	**2008**
Net income (loss) applicable to common shareholders	$ 2,482	(28,797)	6,234	(24,128)
Less: Earnings (loss) allocated to participating securities	18	(224)	52	(175)
Earnings allocated to common shares outstanding	$ 2,464	$ (28,573)	$ 6,182	$ (23,953)
	10,738	10,738	10,726	10,852

Weighted average common shares used to calculate basic EPS				
Add: Effect of common stock equivalents	41		38	
Weighted average common shares used to calculate diluted EPS	10,779	10,738	10,764	10,852
Earnings (loss) per common share:				
Basic	$ 0.23	$ (2.66)	$ 0.58	$ (2.21)
Diluted	$ 0.23	$ (2.66)	$ 0.57	$ (2.21)

Shares subject to the following securities were considered antidilutive and, therefore, excluded from the computation of diluted EPS:

Stock options	553	452	528	423
Restricted stock awards		31	14	24
Warrant	378		378	
	931	483	920	447

All shares of restricted stock are deducted from weighted average shares outstanding for the computation of basic EPS. Shares of restricted stock, stock options, and warrant are included in the calculation of diluted EPS using the treasury stock method.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements (Unaudited)

(3.) INVESTMENT SECURITIES

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

	September 30, 2009			
	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
Securities available for sale:				
U.S. Government agencies and government sponsored enterprises	$ 177,237	$ 270	$ 242	$ 177,265
State and political subdivisions	86,417	3,258	3	89,672
Mortgage-backed securities:				
Federal National Mortgage Association	80,254	1,616	78	81,792
Federal Home Loan Mortgage Corporation	51,722	1,078	17	52,783
Government National Mortgage Association	118,154	917	35	119,036
Collateralized mortgage obligations:				
Federal National Mortgage Association	18,121	244	122	18,243
Federal Home Loan Mortgage Corporation	23,481	486	20	23,947
Government National Mortgage Association	52,325	40	68	52,297
Privately issued	8,825	464	361	8,928
Total collateralized mortgage obligations	102,752	1,234	571	103,415
Total mortgage-backed securities	352,882	4,845	701	357,026
Asset-backed securities	1,415	366		1,781
Total available for sale securities	$ 617,951	$ 8,739	$ 946	$ 625,744
Securities held to maturity:				
State and political subdivisions	$ 45,056	$ 1,066	$	$ 46,122

	December 31, 2008			
	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
Securities available for sale:				
U.S. Government agencies and government sponsored enterprises	$ 67,871	$ 609	$ 307	$ 68,173
State and political subdivisions	129,572	2,181	42	131,711
Mortgage-backed securities:				
Federal National Mortgage Association	136,348	3,725	86	139,987
Federal Home Loan Mortgage Corporation	94,960	2,649	14	97,595
Government National Mortgage Association	1,926	17	25	1,918
Collateralized mortgage obligations:				
Federal National Mortgage Association	17,856	74	642	17,288
Federal Home Loan Mortgage Corporation	44,838	334	214	44,958
Government National Mortgage Association	1,350	9		1,359

Privately issued	42,296	5	2,854	39,447
Total collateralized mortgage obligations	106,340	422	3,710	103,052
Total mortgage-backed securities	339,574	6,813	3,835	342,552
Asset-backed securities	3,918			3,918
Equity securities	923	281	52	1,152
Total available for sale securities	$ 541,858	$ 9,884	$ 4,236	$ 547,506
Securities held to maturity:				
State and political subdivisions	$ 58,532	$ 619	$ 4	$ 59,147

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements (Unaudited)

(3.) INVESTMENT SECURITIES (Continued)

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

	Three months ended September 30, 2009	Three months ended September 30, 2008	Nine months ended September 30, 2009	Nine months ended September 30, 2008
Proceeds from sales	$ 45,878	$ 4,000	$ 144,623	$ 51,545
Gross realized gains	1,887	12	4,860	235
Gross realized losses	166		1,932	3

The scheduled maturities of securities available for sale and securities held to maturity at September 30, 2009 are shown below. 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	$ 47,364	$ 47,864
Due from one to five years	196,173	200,082
Due after five years through ten years	72,306	73,301
Due after ten years	302,108	304,497
	$ 617,951	$ 625,744
Debt securities held to maturity:		
Due in one year or less	$ 35,689	$ 35,940
Due from one to five years	7,087	7,572
Due after five years through ten years	1,791	2,022
Due after ten years	489	588
	$ 45,056	$ 46,122

The following tables show the investments gross unrealized losses and fair value, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position at September 30, 2009 and December 31, 2008 (in thousands).

	September 30, 2009					
	Less than 12 months		12 months or longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Securities available for sale:						
U.S. Government agencies and government sponsored enterprises	$ 70,112	$ 37	$ 10,303	$ 205	$ 80,415	$ 242
State and political subdivisions	20	1	195	2	215	3
Mortgage-backed securities:						

Federal National Mortgage Association	16,716	77	3	1	16,719	78
Federal Home Loan Mortgage Corporation	5,346	17			5,346	17
Government National Mortgage Association	13,984	34	61	1	14,045	35
Collateralized mortgage obligations:						
Federal National Mortgage Association	374	1	5,581	121	5,955	122
Federal Home Loan Mortgage Corporation	569	2	888	18	1,457	20
Government National Mortgage Association	15,961	68			15,961	68
Privately issued			3,427	361	3,427	361
Total collateralized mortgage obligations	16,904	71	9,896	500	26,800	571
Total mortgage-backed securities	52,950	199	9,960	502	62,910	701
Total available for sale securities	123,082	237	20,458	709	143,540	946
Securities held to maturity:						
State and political subdivisions						
Total temporarily impaired securities	$ 123,082	$ 237	$ 20,458	$ 709	$ 143,540	$ 946

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements (Unaudited)
(3.) INVESTMENT SECURITIES (Continued)

	December 31, 2008					
	Less than 12 months		12 months or longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Securities available for sale:						
U.S. Government agencies and government sponsored enterprises	$ 50	$ 1	$ 11,704	$ 306	$ 11,754	$ 307
State and political subdivisions	6,191	41	84	1	6,275	42
Mortgage-backed securities:						
Federal National Mortgage Association	10,432	65	484	21	10,916	86
Federal Home Loan Mortgage Corporation	5,533	14			5,533	14
Government National Mortgage Association	227	3	1,059	22	1,286	25
Collateralized mortgage obligations:						
Federal National Mortgage Association	828	1	7,181	641	8,009	642
Federal Home Loan Mortgage Corporation			7,224	214	7,224	214
Privately issued	24,425	2,045	10,975	809	35,400	2,854
Total collateralized mortgage obligations	25,253	2,046	25,380	1,664	50,633	3,710
Total mortgage-backed securities	41,445	2,128	26,923	1,707	68,368	3,835
Equity securities	310	52			310	52
Total available for sale securities	47,996	2,222	38,711	2,014	86,707	4,236
Securities held to maturity:						
State and political subdivisions	554	4			554	4
Total temporarily impaired securities	$ 48,550	$ 2,226	$ 38,711	$ 2,014	$ 87,261	$ 4,240

The Company reviews investment securities on an ongoing basis for the presence of other-than-temporary-impairment (OTTI) with formal reviews performed quarterly. Declines in the fair value of held-to-maturity and available-for-sale securities below their cost that are deemed to be other than temporary are reflected in earnings as realized losses to the extent the impairment is related to credit losses or the security is intended to be sold. The amount of the impairment related to other factors is recognized in other comprehensive income. Evaluating whether the impairment of a debt security is other than temporary involves assessing i.) the intent to sell the debt security or ii.) the likelihood of being required to sell the security before the recovery of its amortized cost basis. In determining whether the other-than temporary impairment includes a credit loss, the Company uses its best estimate of the present value of cash flows expected to be collected from the debt security considering factors such as: a.) the length of time and the extent to which the fair value has been less than the amortized cost basis, b.) adverse conditions specifically related to the security, an industry, or a geographic area, c.) the historical and implied volatility of the fair value of the security, d.) the payment structure of the debt security and the likelihood of the issuer being able to make payments that increase in the future, e.) failure of the issuer of the security to make scheduled interest or principal payments, f.) any changes to the rating of the security by a rating agency, and g.) recoveries or additional declines in fair value subsequent to the balance sheet date.

During the third quarter of 2009, the Company recorded OTTI charges totaling $2.3 million on 12 pooled trust preferred securities, all of which were designated as impaired due to reasons of credit quality, and one privately issued whole loan collateralized mortgage obligation (CMO) which the Company has determined it intends to sell.

The following summarizes the amounts of OTTI recognized during the periods presented by investment category (in thousands):

	Three months ended September 30,		Nine months ended September 30,	
	2009	**2008**	**2009**	**2008**
Mortgage-backed securities Privately issued whole loan CMOs	$ 126	$	$ 1,859	$ 1,728
Other asset-backed securities Trust preferred securities	2,192	3,529	2,242	5,592
Equity securities Auction rate securities		31,025		31,025
	$ 2,318	$ 34,554	$ 4,101	$ 38,345

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements (Unaudited)

(3.) INVESTMENT SECURITIES (Continued)

As of September 30, 2009, management does not have the intent to sell any of the securities in a loss position and believes that it is likely that it will not be required to sell any such securities before the anticipated recovery of amortized cost. The unrealized losses are largely due to increases in market interest rates over the yields available at the time the underlying securities were purchased. The fair value is expected to recover as the bonds approach their maturity date or repricing date or if market yields for such investments decline.

Management does not believe any of the securities in a loss position are impaired due to reasons of credit quality. Accordingly, as of September 30, 2009, 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 operations.

(4.) LOANS

Loans outstanding, including net unearned income and net deferred fees and costs of $16.3 million and $12.3 million as of September 30, 2009 and December 31, 2008, respectively, are summarized as follows (in thousands):

	September 30, 2009	December 31, 2008
Commercial	$ 197,404	$ 158,543
Commercial real estate	296,648	262,234
Agricultural	42,545	44,706
Residential real estate	147,447	177,683
Consumer indirect	345,448	255,054
Consumer direct and home equity	229,870	222,859
Total loans	1,259,362	1,121,079
Less: Allowance for loan losses	20,782	18,749
Total loans, net	$ 1,238,580	$ 1,102,330

(5.) GOODWILL AND OTHER INTANGIBLE ASSETS

The carrying amount of goodwill totaled $37.4 million as of September 30, 2009 and December 31, 2008. The Company performs a goodwill impairment test on an annual basis or more frequently if events and circumstances warrant. As of September 30, 2009, the Company performed the annual goodwill impairment test and determined that no impairment existed.

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

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements (Unaudited)

(6.) COMPREHENSIVE INCOME (LOSS)

Presented below is a reconciliation of net income (loss) to comprehensive income (loss) including the components of other comprehensive income (loss) for the periods indicated (in thousands):

	Nine months ended September 30,					
	2009			2008		
	Pre-tax Amount	Tax Expense (Benefit)	Net-of-tax Amount	Pre-tax Amount	Tax Expense (Benefit)	Net-of-tax Amount
Securities available for sale:						
Net unrealized gains (losses) arising during the period	$ 972	$ 376	$ 596	$ (53,276)	$ (20,610)	$ (32,666)
Reclassification adjustments:						
Realized net gains included in income	(2,928)	(1,133)	(1,795)	(232)	(90)	(142)
Impairment charges included in income	4,101	1,587	2,514	38,345	14,834	23,511
	2,145	830	1,315	(15,163)	(5,866)	(9,297)
Pension and post-retirement benefit liabilities	517	200	317	(34)	(14)	(20)
Other comprehensive income (loss)	$ 2,662	$ 1,030	1,632	$ (15,197)	$ (5,880)	(9,317)
Net income (loss)			9,004			(23,016)
Comprehensive income (loss)			$ 10,636			$ (32,333)

The components of accumulated other comprehensive loss, net of tax, for the periods indicated were as follows (in thousands):

	September 30, 2009	December 31, 2008
Net unrealized gain on securities available for sale	$ 4,778	$ 3,463
Unfunded pension and post-retirement benefit liabilities	(7,159)	(7,476)
	$ (2,381)	$ (4,013)

(7.) SHARE-BASED COMPENSATION PLANS

The Company maintains certain stock-based compensation plans, approved by the Company s shareholders that are administered by the Board, or the Management Development and Compensation Committee of the Board. On May 6, 2009 the shareholders of the Company approved two share-based compensation plans, the 2009 Management Stock Incentive Plan (Management Plan) and the 2009 Directors Stock Incentive Plan (Director s Plan). An aggregate o 690,000 shares has been reserved for issuance by the Company under the terms of the Management Plan pursuant to the grant of incentive stock options (not to exceed 500,000 shares), non-qualified stock options and restricted stock grants all which are defined in the Plan. An aggregate of 250,000 shares has been reserved for issuance by the Company under the terms of the Director s Plan pursuant to the grant of non-qualified stock options and restricted stock grants, all which are defined in the Plan.

The share-based compensation plans were established to allow for the granting of compensation awards to attract, motivate and retain employees, executive officers and non-employee directors who contribute to the success and profitability of the Company and to give such persons a proprietary interest in the Company, thereby enhancing their personal interest in the Company s success.

The Company awarded grants of 48,500 restricted shares to certain key officers during the nine months ended September 30, 2009. The market price of the restricted shares on the date of grant was $13.21. Both a performance requirement and a service requirement must be satisfied before the participant becomes vested in the shares. The performance period for the awards is the Company s fiscal year ending on December 31, 2009. As a result of not satisfying certain performance requirements for the fiscal year ending December 31, 2008, 41,200 restricted shares granted in the first nine months of 2008 were forfeited during the first nine months of 2009. There was no reversal of restricted stock award expense required during the nine months ended September 30, 2009, as the Company reduced share-based compensation expense related to the forfeited shares during 2008. During the nine months ended September 30, 2009 the Company granted 8,000 restricted shares to directors, of which 4,000 shares vested immediately and 4,000 shares will vest after completion of a one-year service requirement. The market price of the restricted shares on the date of grant was $14.86.

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements (Unaudited)

(7.) SHARE-BASED COMPENSATION PLANS (Continued)

The share-based compensation expense associated included in the consolidated statements of operations (unaudited) is as follows for the periods indicated (in thousands):

	Three months ended September 30,		Nine months ended September 30,	
	2009	2008	2009	2008
Stock options:				
Management Stock Incentive Plan	$ 57	$ 125	$ 179	$ 304
Director Stock Incentive Plan	11	12	34	28
	68	137	213	332
Restricted stock awards:				
Management Stock Incentive Plan	92	(160)	394	197
Director Stock Incentive Plan	15		83	
	107	(160)	477	197
Total share-based compensation	$ 175	$ (23)	$ 690	$ 529

(8.) EMPLOYEE BENEFIT PLANS

Defined Benefit Pension Plan

The Company participates in The New York State Bankers Retirement System (the System), a defined benefit pension plan covering substantially all employees, subject to the limitations related to the plan closure effective December 31, 2006. The benefits are based on years of service and the employee s highest average compensation during five consecutive years of employment. The defined benefit plan was closed to new participants effective December 31, 2006. Only employees hired on or before December 31, 2006 and who met participation requirements on or before January 1, 2008 are eligible to receive benefits.

The components of the Company s net periodic benefit expense for its pension plan were as follows (in thousands):

	Three months ended September 30,		Nine months ended September 30,	
	2009	2008	2009	2008
Service cost	$ 423	$ 364	$ 1,267	$ 1,092
Interest cost on projected benefit obligation	456	391	1,369	1,171
Expected return on plan assets	(462)	(524)	(1,386)	(1,570)
Amortization of unrecognized prior service cost	3	3	9	9
Amortization of unrecognized loss	182		546	
Net periodic pension cost	$ 602	$ 234	$ 1,805	$ 702

The Company s funding policy is to contribute, at a minimum, an actuarially determined amount that will satisfy the minimum funding requirements determined under the appropriate sections of Internal Revenue Code. In April 2009, the Company made the minimum required contribution for fiscal year 2009 of $1.6 million to the pension plan. The Company may make additional contributions to its pension plan in fiscal year 2009.

Defined Contribution Plan

Employees that meet certain age and service requirements are eligible to participate in the Company sponsored 401(k) plan. Under the plan, participants may make contributions, in the form of salary deferrals, up to the maximum Internal Revenue Code limit. The Company matches a participant s contributions up to 4.5% of compensation, calculated as 100% of the first 3% of compensation and 50% of the next 3% of compensation deferred by the participant. The Company may also make additional discretionary matching contributions, although no such additional discretionary contributions were made in 2008 or during the first nine months of 2009. The expense included in salaries and employee benefits in the consolidated statements of operations for this plan amounted to $234 thousand and $244 thousand for the three months ended September 30, 2009 and September 30, 2008, respectively. For the nine months ended September 30, 2009 and September 30, 2008 the expense for the plan amounted to $686 thousand and $760 thousand, respectively.

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(8.) EMPLOYEE BENEFIT PLANS (Continued)

Supplemental Executive Retirement Plans

During the third quarter of 2008 the Company established non-qualified supplemental executive retirement plans (SERPs) for two active executives. The Company has accrued a liability, all of which is unfunded, of $876 thousand as of September 30, 2009, and recorded expense of $78 thousand and $567 thousand for the three and nine month periods, respectively, ended September 30, 2009. The Company expensed $76 thousand during the three month and nine months periods ended September 30, 2008.

(9.) FAIR VALUE MEASUREMENTS

Valuation Hierarchy

On January 1, 2008, the Company adopted the Fair Value Measurements and Disclosures Topic of the ASC (Fair Value Topic). The Fair Value Topic defines fair value as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. The Fair Value Topic establishes a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value into three levels.

Level 1 Unadjusted quoted prices in active markets for assets or liabilities identical to those to be reported at fair value. An active market is a market in which transactions occur for the item to be fair valued with sufficient frequency and volume to provide pricing information on an ongoing basis.

Level 2 Inputs other than quoted prices included within Level 1 inputs that are observable for the asset or liability, either directly or indirectly. These inputs include: (a) quoted prices for similar assets or liabilities in active markets; (b) quoted prices for identical or similar assets or liabilities in markets that are not active, such as when there are few transactions for the asset or liability, the prices are not current, price quotations vary substantially over time or in which little information is released publicly; (c) inputs other than quoted prices that are observable for the asset or liability; and (d) inputs that are derived principally from or corroborated by observable market data by correlation or other means. The Company s Level 2 assets primarily include debt securities classified as available for sale and not included in Level 3.

Level 3 Significant unobservable inputs for the asset or liability. These inputs should be used to determine fair value only when observable inputs are not available. Unobservable inputs should be developed based on the best information available in the circumstances, which might include internally generated data and assumptions being used to price the asset or liability. The Company s Level 3 assets primarily include pooled trust preferred securities.

Investment Securities. Fair values of equity securities are determined using public quotations, when available. Where quoted market prices are not available, fair values may be estimated based on dealer quotes, pricing models, discounted cash flow methodologies, or similar techniques for which the determination of fair value may require significant judgment or estimation. Fair values of public bonds and those private securities that are actively traded in the secondary market have been determined through the use of third-party pricing services using market observable inputs. Private placement securities and other securities where the Company does not receive a public quotation are valued by discounting the expected cash flows. Market rates used are applicable to the yield, credit quality and average maturity of each security. Private equity securities may also utilize internal valuation methodologies appropriate for the specific asset. Fair values might also be determined using broker quotes or through the use of internal models or analysis.

Financial Assets Measured at Fair Value on a Recurring Basis

The following table summarizes financial assets measured and recorded at fair value on a recurring basis as of September 30, 2009, segregated by the level of the valuation inputs within the fair value hierarchy utilized to measure fair value (in thousands):

	Level 1	Level 2	Level 3	Total
Securities available for sale:				

U.S. Government agencies and government sponsored enterprises	$	$ 177,265	$	$ 177,265
State and political subdivisions		89,672		89,672
Mortgage-backed securities		357,026		357,026
Asset-backed securities:				
Trust preferred securities			1,335	1,335
Other		350	96	446
Total available for sale securities	$	$ 624,313	$ 1,431	$ 625,744

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements (Unaudited)

(9.) FAIR VALUE MEASUREMENTS (Continued)

The following table presents changes in Level 3 available for sale securities measured at fair value on a recurring basis during the nine months ended September 30, 2009 (in thousands):

Balance at December 31, 2008	$	3,772
Capitalized interest		184
Principal paydowns and amortization of premiums		(9)
Coupon payments applied to principal		(224)
Total losses (realized/unrealized):		
Included in earnings		(2,192)
Included in other comprehensive income		(100)
Balance at September 30, 2009	$	1,431

Financial Assets and Liabilities Measured at Fair Value on a Nonrecurring Basis

Certain financial assets and financial liabilities are measured at fair value on a nonrecurring basis; that is, the instruments are not measured at fair value on an ongoing basis but are subject to fair value adjustments in certain circumstances (for example, when there is evidence of impairment). Examples of these nonrecurring uses of fair value include: loans held for sale, mortgage servicing assets and collateral dependent impaired loans. As of September 30, 2009, the Company had no liabilities measured at fair value on a nonrecurring basis.

Loans held for sale are carried at the lower of cost or fair value. As of September 30, 2009, a valuation allowance against loans held for sale was not necessary as their fair value was in excess of their cost. Fair value is based on observable market rates for comparable loan products which is considered a level 2 fair value measurement.

Mortgage servicing rights (MSR) are carried at the lower of cost or fair value. Due primarily to a decline in the estimated prepayment speed of the Company s sold loan portfolio with servicing retained, the fair value of the Company s MSR increased during 2009. As a result of this increase, the Company reduced its corresponding valuation allowance by $165 thousand during the first nine months of 2009. A valuation allowance of $197 thousand existed as of September 30, 2009. The mortgage servicing rights are a Level 3 fair value measurement, as fair value is determined by calculating the present value of the future servicing cash flows from the underlying mortgage loans.

During the third quarter of 2009, certain impaired loans were remeasured and reported at fair value through a specific valuation allowance allocation of the allowance for loan losses based upon the fair value of the underlying collateral. Impaired loans with a carrying value of $1.1 million were reduced by specific valuation allowance allocations totaling $247 thousand to a total reported fair value of $872 thousand. The collateral dependent impaired loans are a Level 2 fair measurement, as fair value is determined based upon estimates of the fair value of the collateral underlying the impaired loans typically using appraisals of comparable property or valuation guides.

Nonfinancial Assets and Nonfinancial Liabilities

Certain nonfinancial assets measured at fair value on a non-recurring basis include nonfinancial assets and nonfinancial liabilities measured at fair value in the second step of a goodwill impairment test, and intangible assets and other nonfinancial long-lived assets measured at fair value for impairment assessment. There were no nonfinancial assets or nonfinancial liabilities measured at fair value during the three or nine month periods ended September 30, 2009.

Fair Value of Financial Instruments

The Fair Value of Financial Instruments Subsection of the ASC requires disclosure of the fair value of financial assets and financial liabilities, including those financial assets and financial liabilities that are not measured and reported at fair value on a recurring basis or non-recurring basis.

The following discussion describes the valuation methodologies used for assets and liabilities measured or disclosed at fair value. The techniques utilized in estimating the fair values of financial instruments are reliant on the assumptions used, including discount rates and estimates of the amount and timing of future cash flows. Care should be exercised in deriving conclusions about our business, its value or financial position based on the fair value information of financial instruments presented below.

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements (Unaudited)

(9.) FAIR VALUE MEASUREMENTS (Continued)

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

The estimated fair value approximates carrying value for cash and cash equivalents, Federal Home Loan Bank (FHLB) and Federal Reserve Bank (FRB) stock, company owned life insurance, accrued interest receivable, short-term borrowings and accrued interest payable. Fair value estimates for other financial instruments are discussed below.

Loans held for sale. The fair value is based on estimates, quoted market prices and investor commitments.

Loans. For variable rate loans that re-price frequently, fair value approximates carrying amount. The fair value for fixed rate loans is estimated through discounted cash flow analysis using interest rates currently being offered on loans with similar terms and credit quality. For criticized and classified loans, fair value is estimated by discounting expected cash flows at a rate commensurate with the risk associated with the estimated cash flows, or estimates of fair value discounts based on observable market information.

Deposits. The fair values for demand accounts, money market and savings deposits are equal to their carrying amounts. The fair values of certificates of deposit are estimated using a discounted cash flow approach that applies prevailing market interest rates for similar maturity instruments.

Long-term borrowings (excluding junior subordinated debentures). The fair value for long-term borrowings is estimated using a discounted cash flow approach that applies prevailing market interest rates for similar maturity instruments.

Junior subordinated debentures. The fair value for the junior subordinated debentures is estimated using a discounted cash flow approach that applies prevailing market interest rates for similar maturity instruments.

The fair value of a financial instrument is the current amount that would be exchanged between willing parties, other than in a forced liquidation. Fair value is best determined based upon quoted market prices. However, in many instances, there are no quoted market prices for the Company s various financial instruments. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. Accordingly, the fair value estimates may not be realized in an immediate settlement of the instrument. The accounting guidelines exclude certain financial instruments and all non-financial instruments from its disclosure requirements. Accordingly, the aggregate fair value amounts presented at September 30, 2009 and December 31, 2008 may not necessarily represent the underlying fair value of the Company.

The estimated fair values of financial instruments were as follows:

	September 30, 2009		December 31, 2008	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
Financial assets:				
Cash and cash equivalents	$ 60,106	$ 60,106	$ 55,187	$ 55,187
Securities available for sale	625,744	625,744	547,506	547,506
Securities held to maturity	45,056	46,122	58,532	59,147
Loans held for sale	1,032	1,055	1,013	1,032
Loans	1,238,580	1,305,274	1,102,330	1,169,660
Company owned life insurance	24,532	24,532	23,692	23,692
Accrued interest receivable	8,777	8,777	7,556	7,556

FHLB and FRB stock	7,185	7,185	6,035	6,035
Financial liabilities:				
Demand, savings and money market deposits	1,084,996	1,084,996	985,796	985,796
Time deposits	712,182	719,037	647,467	654,334
Short-term borrowings	73,265	73,265	23,465	23,465
Long-term borrowings (excluding junior subordinated debentures)	30,146	31,097	30,653	32,005
Junior subordinated debentures	16,702	12,249	16,702	12,232
Accrued interest payable	8,745	8,745	7,041	7,041

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

FORWARD LOOKING INFORMATION

Statements in this Quarterly Report on Form 10-Q 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 Quarterly Report on Form 10-Q, 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:

- 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;
- changes in fiscal, monetary, regulatory, trade and tax policies and laws, including policies of the U.S. Department of Treasury and the Federal Reserve Board;
- 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;
- changes in consumer spending and savings habits;
- increased competitive challenges and expanding product and pricing pressures among financial institutions;
- demand for financial services in the Company s market areas;
- legislation or regulatory changes which adversely affect the Company s operations or business, including the Obama Administration s regulatory reform proposals concerning the financial services sector released on June 17, 2009;
- the Company s ability to comply with applicable laws and regulations, including restrictions on dividend payments;
- 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
- declines in the market value of the Company s publicly traded stock price or declines in the Company s ability to generate future cash flows may increase the potential that goodwill recorded on the Company s consolidated statement of financial condition be designated as impaired and that the Company may incur a goodwill write-down in the future.

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.

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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APPLICATION OF CRITICAL ACCOUNTING POLICIES AND ACCOUNTING ESTIMATES

The Company s consolidated financial statements are prepared in accordance with U.S. generally accepted accounting principles and are consistent with predominant practices in the banking industry. Application of critical accounting policies, which are those policies that management believes are the most important to the Company s financial condition and results, requires management to make estimates, assumptions, and judgments that affect the amounts reported in the consolidated financial statements and accompanying notes and are based on information available as of the date of the financial statements. Future changes in information may affect these estimates, assumptions and judgments, which, in turn, may affect amounts reported in the financial statements.

The Company has numerous accounting policies, of which the most significant are presented in Note 1, Summary of Significant Accounting Policies, of the notes to consolidated financial statements included in the Company s 2008 Annual Report on Form 10-K. These policies, along with the disclosures presented in the other financial statement notes and in this discussion, provide information on how significant assets, liabilities, revenues and expenses are reported in the consolidated financial statements and how those reported amounts are determined. Based on the sensitivity of financial statement amounts to the methods, assumptions, and estimates underlying those amounts, management has determined that the accounting policies with respect to the allowance for loan losses, valuation of goodwill and deferred tax assets, the valuation of securities and determination of other-than-temporary impairment (OTTI), and accounting for defined benefit plans require particularly subjective or complex judgments important to the Company s financial condition and results of operations, and, as such, are considered to be critical accounting policies. These estimates and assumptions are based on management s best estimates and judgment and are evaluated on an ongoing basis using historical experience and other factors, including the current economic environment. The Company adjusts these estimates and assumptions when facts and circumstances dictate. Illiquid credit markets and volatile equity have combined with declines in consumer spending to increase the uncertainty inherent in these estimates and assumptions. As future events cannot be determined with precision, actual results could differ significantly from the Company s estimates.

For additional information regarding critical accounting policies, refer to Note 1, Summary of Significant Accounting Policies, of the notes to consolidated financial statements and the section captioned Critical Accounting Estimates in Management s Discussion and Analysis of Financial Condition and Results of Operations included in the 2008 Annual Report on Form 10-K. There have been no material changes in the Company s application of critical accounting policies related to the allowance for loan losses, valuation of goodwill and deferred tax assets, the valuation of securities and determination of OTTI, and accounting for defined benefit plans since December 31, 2008.

OVERVIEW

The principal objective of this discussion is to provide an overview of the financial condition and results of operations of the Company for the periods covered in this quarterly report. Certain reclassifications have been made to make prior periods comparable. This discussion and tabular presentations should be read in conjunction with the accompanying consolidated financial statements and accompanying notes.

During third quarter of 2009, we announced the appointment of Karl F. Krebs to the position of Executive Vice President and Chief Financial Officer (CFO). Mr. Krebs succeeded Mr. Ronald Miller, who retired as CFO effective October 1, 2009 as part of the Company s management succession plan. As previously announced, Mr. Miller will continue to serve as Executive Vice President and Secretary and will be assisting with the transition and special projects until his formal retirement in early 2010.

RESULTS OF OPERATIONS

Summary of Performance

Net income was $3.4 million for the third quarter of 2009 compared to a net loss of $28.4 million for the third quarter of 2008. Net income applicable to common shareholders for the third quarter of 2009 was $2.5 million, or $0.23 per diluted share, compared with a net loss of $28.8 million, or $2.66 per diluted share, for the third quarter of last year. Net income for the nine months ended September 30, 2009 totaled $9.0 million compared to a net loss of $23.0 million for the same period in 2008. For the first nine months of 2009 net income applicable to common shareholders was $6.2 million, or $0.57 per diluted share, compared with a net loss of $24.1 million, or $2.21 per diluted share, for the first nine months of 2008.

Included in the results for the three and nine month periods ended September 30, 2008, is a pre-tax OTTI charge of $31.0 million related to auction rate preferred equity securities collateralized by preferred stock of Federal National Mortgage Association (FNMA) and Federal Home Loan Mortgage Corporation (FHLMC). The tax benefit recognized on this OTTI charge was based on its treatment being classified as a capital loss for tax purposes, which significantly limited the tax benefit. A provision of EESA, enacted during the fourth quarter of 2008, permitting banks to recognize losses relating to FNMA and FHLMC preferred stock as an ordinary loss, increased the tax benefit to the Company in the fourth quarter. Had the tax benefit been recognized during the third quarter of 2008, it would have reduced the net losses for the three and nine month periods ended September 30, 2008 by $12.0 million.

Details of the changes in the various components of net income are further discussed in the sections that follow.

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Net Interest Income

The principal source of the Company s revenue is net interest income. Net interest income is the difference between interest income on interest-earning assets, such as loans and investment securities and the interest expense on liabilities used to fund those assets, such as interest-bearing deposits and borrowings. Net interest income is impacted by both changes in the amount and composition of interest-earning assets and interest-bearing liabilities, as well as market interest rates.

Net interest income was $18.1 million and $16.7 million for the three months ended September 30, 2009 and 2008, respectively. For the nine months ended September 30, 2009 and 2008, net interest income was $53.1 million and $48.0 million, respectively. The increases for both periods resulted primarily from favorable changes in the mix of our interest-earning assets and repricing of interest-bearing liabilities at lower interest rates.

Net interest income was $18.1 million for the third quarter, up $1.3 million or 8%, from the third quarter of 2008. For the third quarter of 2009, average loans and securities represented 66% and 31%, respectively, of average earning assets compared to 59% and 41% in the third quarter of 2008. The tax equivalent net interest margin was relatively unchanged at 3.99% and 3.98% for the third quarters of 2009 and 2008, respectively. A decrease of $861 thousand, or 4%, in total interest income was surpassed by a decrease of $2.2 million, or 28%, in total interest expense.

Interest on investment securities and interest-earning deposits was $5.0 million for the third quarter of 2009, compared to $7.5 million for the third quarter of 2008. The average balance of investment securities was $585.8 million with an average tax equivalent yield of 3.79% for the third quarter of 2009, compared to an average balance of $721.4 million with an average yield of 4.66% for the third quarter of 2008. The decrease in yield is primarily due to lower market interest rates, coupled with less risk and shorter average maturities in the investment securities. In addition, selected higher yielding securities were sold for gains during the three months ended September 30, 2009. The sale of these securities, coupled with principal payments, maturities and calls on investment securities has contributed to lower interest income as the proceeds from these transactions were reinvested at lower yields.

Interest on loans was $18.7 million for third quarter of 2009, compared to $17.0 million for the third quarter of 2008. The average balance of loans was $1.236 billion with an average yield of 6.01% for the third quarter of 2009 compared to an average balance of $1.039 billion with an average yield of 6.52% for the third quarter of 2008. Average commercial loans in the third quarter of 2009 increased $83.6 million, as compared to the third quarter of 2008 primarily due to continued strong growth in our commercial loan portfolio. The average balance of consumer indirect loans, comprised almost entirely of automobile loans, increased $133.5 million for the third quarter of 2009 over the corresponding quarter last year. This 67% increase in volume was primarily responsible for the $2.3 million increase in interest income on consumer indirect loans when comparing the third quarter of 2009 to that of 2008.

Interest on deposits was $4.8 million for the third quarter of 2009, compared to $6.5 million for the third quarter of 2008. The average balance of interest-bearing deposits was $1.430 billion with an average cost of 1.34% for the third quarter of 2009 compared to an average balance of $1.300 billion with an average cost of 2.00% for the third quarter of 2008. The average balance of noninterest-bearing deposits increased by 2% to $298.7 million during the third quarter of this year compared to the same quarter last year. The increase in the balance of total average deposits is due to a 7% increase in public and 9% increase in nonpublic deposits, while the decrease in average cost is due primarily to the beneficial repricing of certificates of deposits, and to a lesser extent savings and money market accounts, at lower interest rates. The declines in interest and average cost on total borrowed funds from last year s third quarter to this year s third quarter are due to a combination of lower market interest rates and average borrowings outstanding.

For the nine months ended September 30, 2009, net interest income was $53.1 million, an increase of $5.0 million or 10% over the same period in 2008. For the nine months ended September 30, 2009, average loans and securities represented 65% and 32%, respectively, of average earning assets compared to 56% and 42% for the same period in 2008. The nine month period ended September 30, 2009 reflected an increase of 15 basis points in net interest margin to 4.03% compared to the same period last year. The improved net interest margin resulted principally from lower funding costs and the benefits associated with a higher percentage of earning assets being deployed in higher yielding loan assets. A decrease of $4.3 million, or 6%, in total interest income was surpassed by a decrease of $9.3 million, or 35%, in total interest expense.

Interest on investment securities and interest-earning deposits was $16.5 million for the nine months ended September 30, 2009, compared to $24.2 million for the same period in 2008. The average balance of investment securities was $593.5 million with an average tax equivalent yield of 4.17% for the nine months ended September 30, 2009 compared to an average balance of was $739.9 million with an average yield of 4.87% for the same period in 2008. The decrease in yield is primarily due to lower market interest rates as proceeds from securities transactions, including the sale of selected higher yielding securities during the nine months ended September 30, 2009, were reinvested at lower rates. A change in the mix of the investment portfolio that included a decline in the level of tax-exempt securities and resulting interest income also contributed to the decrease in yield.

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Interest on loans was $53.5 million for first nine months of 2009, compared to $50.1 million for the first nine months of 2008. The average balance of loans was $1.190 billion with an average yield of 6.01% for the nine month period ended September 30, 2009 compared to an average balance of $998.0 million with an average yield of 6.70% for the same period in 2008. Average commercial loans increased by $64.0 million during the first nine months of 2009, as compared to same period in 2008 primarily due to strong growth in our commercial loan portfolio. The average balance of consumer indirect loans, comprised almost entirely of automobile loans, increased $136.0 million for the first nine months of 2009 over the corresponding period last year. This 82% increase in volume was primarily responsible for the $6.9 million increase in interest income on consumer indirect loans when comparing the nine months ended September 30, 2009 to the same period in 2008.

Interest on deposits was $14.7 million for the nine month period ended September 30, 2009, compared to $23.2 million for the same period in 2008. The average balance of interest-bearing deposits was $1.422 billion with an average cost of 1.38% for the nine month period ended September 30, 2009 compared to an average balance of $1.326 billion with an average cost of 2.34% for the same period in 2008. The average balance of noninterest-bearing deposits increased by 4% to $288.9 million during the first nine months of this year compared to the same period last year. The increase in the balance of total average deposits is due to a 4% increase in public and a 10% increase in nonpublic deposits, while the decrease in average cost is due primarily to the beneficial repricing of certificates of deposits, and to a lesser extent savings and money market accounts, at lower interest rates.

The following table provides a reconciliation between tax equivalent net interest income as presented in the average balance sheets above and net interest income in the consolidated financial statements filed herewith in Part I, Item 1, Financial Statements (in thousands).

	Three months ended September 30,		Nine months ended September 30,	
	2009	**2008**	**2009**	**2008**
Net interest income (tax equivalent)	$ 18,669	$ 17,686	$ 55,202	$ 51,448
Less: tax-exempt tax equivalent adjustment	591	940	2,152	3,430
Net interest income	$ 18,078	$ 16,746	$ 53,050	$ 48,018

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

	Three months ended September 30,					
	2009			2008		
	Average Balance	Interest	Average Rate	Average Balance	Interest	Average Rate
Interest-earning assets:						
Federal funds sold and interest-earning deposits	$ 39,945	$ 20	0.20%	$ 12,897	$ 68	2.10%
Investment securities [1]:						
Taxable	450,266	3,819	3.39	493,438	5,577	4.52
Tax-exempt [2]	135,564	1,737	5.13	227,981	2,835	4.96
Total investment securities	585,830	5,556	3.79	721,419	8,412	4.66
Loans held for sale	1,490	21	5.76	799	14	6.81
Loans:						
Commercial	194,803	2,299	4.68	147,350	2,244	6.06
Commercial real estate	288,658	4,515	6.20	249,769	4,234	6.74
Agricultural	43,250	597	5.48	45,965	732	6.34
Residential real estate	148,325	2,266	6.11	173,175	2,669	6.17
Consumer indirect	334,123	5,938	7.05	200,586	3,626	7.19
Consumer direct and home equity	226,355	3,076	5.39	222,241	3,499	6.26
Total loans	1,235,514	18,691	6.01	1,039,086		