FINANCIAL INSTITUTIONS INC
Form 10-K
March 14, 2018
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

(Mark One) **Form 10-K**

[**X**] ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended **December 31, 2017**

OR

[ ] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from ____________ to ____________
Commission file number **000-26481**

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 No

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 No

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 No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark 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.

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

Large accelerated filer	Accelerated filer
Non-accelerated filer	Smaller reporting company
	Emerging growth company

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

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

The aggregate market value of the registrant s common stock, par value $0.01 per share, held by non-affiliates of the registrant, as computed by reference to the June 30, 2017 closing price reported by NASDAQ, was approximately $427,573,000.

As of February 23, 2018, there were outstanding, exclusive of treasury shares, 15,904,403 shares of the registrant s common stock.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant s proxy statement for the 2018 Annual Meeting of Shareholders are incorporated by reference in Part III of this Annual Report on Form 10-K.

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PART I

FORWARD LOOKING INFORMATION

Statements and financial analysis contained 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 or us); and

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 of Financial Condition and Results of Operations. Factors that might cause such material differences include, but are not limited to:

- If we experience greater credit losses than anticipated, earnings may be adversely impacted;
- Our tax strategies and the value of our deferred tax assets and liabilities could adversely affect our operating results and regulatory capital ratios;
- Geographic concentration may unfavorably impact our operations;
- We depend on the accuracy and completeness of information about or from customers and counterparties;
- Our insurance brokerage subsidiary, SDN, is subject to risk related to the insurance industry;
- Our investment advisory and wealth management operations are subject to risk related to the financial services industry;
- We may be unable to successfully implement our growth strategies, including the integration and successful management of newly-acquired businesses;
- We are subject to environmental liability risk associated with our lending activities;
- Our commercial business and mortgage loans increase our exposure to credit risks;
- Our indirect lending involves risk elements in addition to normal credit risk;
- We accept deposits that do not have a fixed term and which may be withdrawn by the customer at any time for any reason;
- Any future FDIC insurance premium increases may adversely affect our earnings;
- We are highly regulated and any adverse regulatory action may result in additional costs, loss of business opportunities, and reputational damage;
- We make certain assumptions and estimates in preparing our financial statements that may prove to be incorrect, which could significantly impact our results of operations, cash flows and financial condition, and we are subject to new or changing accounting rules and interpretations, and the failure by us to correctly interpret or apply these evolving rules and interpretations could have a material adverse effect;

- Legal and regulatory proceedings and related matters could adversely affect us;
- A breach in security of our or third party information systems, including the occurrence of a cyber incident or a deficiency in cybersecurity, or a failure by us to comply with enhanced New York State cybersecurity regulations, may subject us to liability, result in a loss of customer business or damage our brand image;
- We face competition in staying current with technological changes to compete and meet customer demands;
- We rely on other companies to provide key components of our business infrastructure;
- We use financial models for business planning purposes that may not adequately predict future results;
- We may not be able to attract and retain skilled people;
- Acquisitions may disrupt our business and dilute shareholder value;
- We are subject to interest rate risk;
- Our business may be adversely affected by conditions in the financial markets and economic conditions generally;
- The policies of the Federal Reserve have a significant impact on our earnings;
- The soundness of other financial institutions could adversely affect us;
- The value of our goodwill and other intangible assets may decline in the future;
- We operate in a highly competitive industry and market area;
- Severe weather, natural disasters, acts of war or terrorism, and other external events could significantly impact our business;
- Liquidity is essential to our businesses;
- We may need to raise additional capital in the future and such capital may not be available on acceptable terms or at all;
- We rely on dividends from our subsidiaries for most of our revenue;
- We may not pay or may reduce the dividends on our common stock;

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

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

- The market price of our common stock may fluctuate significantly in response to a number of factors.

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

ITEM 1. BUSINESS

GENERAL

The Parent is a financial holding company organized in 1931 under the laws of New York State (New York or NYS). The principal office of the Parent is located at 220 Liberty Street, Warsaw, New York 14569 and its telephone number is (585) 786-1100. The Parent was incorporated on September 15, 1931, but the continuity of the Company s banking business is traced to the organization of the National Bank of Geneva on March 28, 1817. Except as the context otherwise requires, the Parent and its direct and indirect subsidiaries are collectively referred to in this report as the Company. Five Star Bank is referred to as Five Star Bank, FSB or the Bank, Scott Danahy Naylon, LLC is referre as SDN and Courier Capital, LLC is referred to as Courier Capital. The consolidated financial statements include the accounts of the Parent, the Bank, SDN and Courier Capital. The Parent s common stock is traded on the NASDAQ Global Select Market under the ticker symbol FISI.

At December 31, 2017, the Company had consolidated total assets of $4.11 billion, deposits of $3.21 billion and shareholders equity of $381.2 million.

The Parent s primary business is the operation of its subsidiaries. It does not engage in any other substantial business activities. The Parent s three direct wholly-owned subsidiaries are: (1) the Bank, which provides a full range of banking services to consumer, commercial and municipal customers in Western and Central New York; (2) SDN, which sells various premium-based insurance policies on a commission basis to commercial and consumer customers; and (3) Courier Capital, which provides customized investment management, investment consulting and retirement plan services to individuals, businesses, institutions, foundations and retirement plans. At December 31, 2017, the Bank represented 99.1%, SDN represented 0.5% and Courier Capital represented 0.3% of the consolidated assets of the Company. Further discussion of our segments is included in Note 21 to the Company s Consolidated Financial Statements included under Item 8 of this Annual Report on Form 10-K.

Five Star Bank

The Bank is a New York chartered bank that has its headquarters at 55 North Main Street, Warsaw, NY, and a total of 53 full-service banking offices in the New York State counties of Allegany, Cattaraugus, Cayuga, Chautauqua, Chemung, Erie, Genesee, Livingston, Monroe, Ontario, Orleans, Seneca, Steuben, Wyoming and Yates counties.

At December 31, 2017, the Bank had total assets of $4.07 billion, investment securities of $1.04 billion, net loans of $2.70 billion, deposits of $3.22 billion and shareholders equity of $382.5 million, compared to total assets of $3.68 billion, investment securities of $1.08 billion, net loans of $2.31 billion, deposits of $3.01 billion and shareholders equity of $318.5 million at December 31, 2016. The Bank offers deposit products, which include checking and NOW accounts, savings accounts, and certificates of deposit, as its principal source of funding. The Bank s deposits are insured up to the maximum permitted by the Bank Insurance Fund (the Insurance Fund) of the Federal Deposit Insurance Corporation (FDIC). The Bank offers a variety of loan products to its customers, including commercial and consumer loans and commercial and residential mortgage loans.

Scott Danahy Naylon, LLC

Acquired in August 2014, SDN is a full-service insurance agency founded in 1923 and headquartered in Amherst, NY. SDN offers personal, commercial and financial services products and serves clients in 45 states. For the year ended December 31, 2017, SDN had total revenue of $5.1 million, compared to total revenue of $5.2 million for the year ended December 31, 2016.

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SDN s primary market area is Erie and Niagara counties in New York State. Most lines of personal insurance are provided, including automobile, homeowners, boat, recreational vehicle, landlord, and umbrella coverage. Commercial insurance products are also provided, consisting of property, liability, automobile, inland marine, workers compensation, bonds, crop and umbrella insurance. SDN also provides the following financial services products: life and disability insurance, Medicare supplements, long-term care, annuities, mutual funds, retirement programs and New York State disability.

Courier Capital, LLC

Acquired in January 2016, Courier Capital is an SEC-registered investment advisory and wealth management firm founded in 1967 and based in Western New York, with offices in Buffalo, Amherst and Jamestown. With $1.69 billion in assets under management, Courier Capital offers customized investment management, investment consulting and retirement plan services to individuals, businesses and institutions across nine states. For the year ended December 31, 2017, Courier Capital had total revenue of $4.1 million, compared to total revenue of $3.4 million for the period from date of acquisition through December 31, 2016.

In August 2017, Courier Capital acquired the assets of Robshaw & Julian Associates, Inc., a Buffalo-area registered investment adviser with approximately $175 million assets under management, which increased Courier Capital s total assets under management to approximately $1.6 billion.

Other Subsidiaries

Five Star REIT, Inc. Five Star REIT, Inc. (Five Star REIT), a wholly-owned subsidiary of the Bank, operates as a real estate investment trust that holds residential mortgages and commercial real estate loans. Five Star REIT provides additional flexibility and planning opportunities for the business of the Bank.

Business Strategy

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

A key aspect of our current business strategy is to foster a community-oriented culture where our customers and employees establish long-standing and mutually beneficial relationships. We believe that we are well-positioned to be a strong competitor within our market area because of our focus on community banking needs and customer service, our comprehensive suite of deposit, loan, insurance and wealth management products typically found at larger banks, our highly experienced management team and our strategically located banking centers. We have evolved to meet changing customer needs by opening what we refer to as financial solution center branches. These financial solution centers have a smaller footprint than our traditional branches, focus on technology to provide solutions that fit our customer preferences for transacting business with us, and these branches are staffed by certified personal bankers who are trained to meet a broad array of customer needs. In recent years, we have opened four financial solution

centers in the Rochester and Buffalo markets. We believe that the foregoing factors all help to grow our core deposits, which supports a central element of our business strategy - the growth of a diversified and high-quality loan portfolio.

Acquisition Strategy

We will continue to explore market expansion opportunities in or near our current market areas as opportunities arise. Our primary focus will be on increasing market share within existing markets, while taking advantage of potential growth opportunities within our insurance and wealth management lines of business by acquiring new businesses that can be added to existing operations. We believe our capital position remains strong enough to support an active merger and acquisition strategy, and expansion of our core financial service businesses of banking, insurance and wealth management. Consequently, we continue to explore acquisition opportunities in these activities. In evaluating acquisition opportunities, we will balance the potential for earnings accretion with maintaining adequate capital levels, which could result in our common stock being the predominate form of consideration and/or the need for us to raise capital.

Conversations with potential strategic partners occur on a regular basis. The evaluation of any potential opportunity will favor a transaction that complements our core competencies and strategic intent, with a lesser emphasis being placed on geographic location or size. Additionally, we remain committed to maintaining a diversified revenue stream. Our senior management team has had extensive experience in acquisitions and post-acquisition integration of operations, and is prepared to act quickly should a potential opportunity arise, but will remain disciplined with its approach. We believe this experience positions us to successfully acquire and integrate additional financial services and banking businesses.

MARKET AREAS AND COMPETITION

We provide a wide range of banking and financial services to individuals, municipalities and businesses through a network of over 50 offices and an extensive ATM network throughout Western and Central New York. The region includes the counties of Allegany, Cattaraugus, Cayuga, Chautauqua, Chemung, Erie, Genesee, Livingston, Monroe, Ontario, Orleans, Schuyler, Seneca, Steuben, Wyoming and Yates counties. Our banking activities, though concentrated in the communities where we maintain branches, also extend into neighboring counties. In addition, we have expanded our consumer indirect lending presence to the Capital District of New York and Northern and Central Pennsylvania.

Our market area is economically diversified in that we serve both rural markets and the larger markets in and around Rochester and Buffalo. Rochester and Buffalo are the two largest metropolitan areas in New York outside of New York City, with a combined population of over two million people. We anticipate continuing to increase our presence in and around these metropolitan statistical areas in the coming years.

We face significant competition in both making loans and attracting deposits, as Western and Central New York have a high density of financial institutions. Our competition for loans comes principally from commercial banks, savings banks, savings and loan associations, mortgage banking companies, credit unions, insurance companies and other financial services companies. Our most direct competition for deposits has historically come from commercial banks, savings banks and credit unions. We face additional competition for deposits from non-depository competitors such as the mutual fund industry, securities and brokerage firms and insurance companies. We generally compete with other financial service providers on factors such as level of customer service, responsiveness to customer needs, availability and pricing of products, and geographic location. Our industry frequently experiences merger activity, which affects competition by eliminating some institutions while potentially strengthening the franchises of others.

The following table presents the Bank s market share percentage for total deposits as of June 30, 2017, in each county where we have operations. The table also indicates the ranking by deposit size in each market. All information in the table was obtained from S&P Global Market Intelligence, which compiles deposit data published by the FDIC as of June 30, 2017 and updates the information for any bank mergers and acquisitions completed subsequent to the reporting date.

County	Market Share	Market Rank	Number of Branches [1]
Allegany	8.9%	3	1
Cattaraugus	29.8%	2	5
Cayuga	3.5%	10	1
Chautauqua	1.6%	8	1
Chemung	14.5%	3	3

Erie	0.4%	10	4
Genesee	21.8%	2	3
Livingston	37.5%	1	5
Monroe	1.7%	8	8
Ontario	13.8%	2	5
Orleans	23.8%	2	2
Seneca	28.3%	1	2
Steuben	31.8%	1	7
Wyoming	54.1%	1	4
Yates	42.3%	1	2

(1) Number of branches current as of December 31, 2017.

INVESTMENT ACTIVITIES

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

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

- U.S. treasury securities;
- U.S. government agency securities, which are securities issued by official Federal government bodies (e.g., the Government National Mortgage Association (GNMA) and the Small Business Administration (SBA)), and U.S. government-sponsored enterprise securities, which are securities issued by independent organizations that are in part sponsored by the federal government (e.g., the Federal Home Loan Bank (FHLB) system, the Federal National Mortgage Association (FNMA), the Federal Home Loan Mortgage Corporation (FHLMC) and the Federal Farm Credit Bureau);
- Mortgage-backed securities (MBS), which include mortgage-backed pass-through securities, collateralized mortgage obligations and multi-family MBS issued by GNMA, FNMA and FHLMC;
- Investment grade municipal securities, including revenue, tax and bond anticipation notes, statutory installment notes and general obligation bonds;
- Certain creditworthy unrated securities issued by municipalities;
- Certificates of deposit;
- Equity securities at the holding company level; and
- Limited partnership investments.

LENDING ACTIVITIES

General

We offer a broad range of loans including commercial business and revolving lines of credit, commercial mortgages, equipment loans, residential mortgage loans and home equity loans and lines of credit, home improvement loans, automobile loans and personal loans. Newly originated and refinanced fixed rate residential mortgage loans are either retained in our portfolio or sold to the secondary market with servicing rights retained.

We continually evaluate and update our lending policy. The key elements of our lending philosophy include the following:

To ensure consistent underwriting, employees must share a common view of the risks inherent in lending activities as well as the standards to be applied in underwriting and managing credit risk;

Pricing of credit products should be risk-based;

The loan portfolio must be diversified to limit the potential impact of negative events; and

Careful, timely exposure monitoring through dynamic use of our risk rating system is required to provide early warning and assure proactive management of potential problems.

Commercial Business and Commercial Mortgage Lending

We primarily originate commercial business loans in our market areas and underwrite them based on the borrower s ability to service the loan from operating income. We offer a broad range of commercial lending products, including term loans and lines of credit. Short and medium-term commercial loans, primarily collateralized, are made available to businesses for working capital (including inventory and receivables), business expansion (including acquisition of real estate, expansion and improvements) and the purchase of equipment. We offer commercial business loans to customers in the agricultural industry for short-term crop production, farm equipment and livestock financing. As a general practice, where possible, a first position 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, 2017, $122.4 million, or 27%, of our aggregate commercial business loan portfolio were at fixed rates, while $327.9 million, or 73%, were at variable rates.

We also offer commercial mortgage loans to finance the purchase of real property, which generally consists of real estate with completed structures and, to a smaller extent, agricultural real estate financing. Commercial mortgage loans are secured by first liens on the real estate and are typically amortized over a 10 to 20 year period. The underwriting analysis includes credit verification, appraisals and a review of the borrower s financial condition and repayment capacity. As of December 31, 2017, $348.7 million, or 43%, of the loans in our aggregate commercial mortgage portfolio were at fixed rates, while $460.2 million, or 57%, were at variable rates.

We utilize government loan guarantee programs where available and appropriate.

Government Guarantee Programs

We participate in government loan guarantee programs offered by the SBA, U.S. Department of Agriculture, Rural Economic and Community Development and Farm Service Agency, among others. As of December 31, 2017, we had loans with an aggregate principal balance of $47.8 million that were covered by guarantees under these programs. The guarantees typically only cover a certain percentage of these loans. By participating in these programs, we are able to broaden our base of borrowers while minimizing credit risk.

Residential Real Estate Lending

We originate fixed and variable rate one-to-four family residential mortgages collateralized by owner-occupied properties located in our market areas. We offer a variety of real estate loan products, including home improvement loans, closed-end home equity loans, and home equity lines of credit, which are generally amortized over periods of up to 30 years. Loans collateralized by one-to-four family residential real estate generally have been originated in amounts of no more than 80% of appraised value, or have mortgage insurance. Mortgage title insurance and hazard insurance are normally required. We sell certain one-to-four family residential mortgages to the secondary mortgage market and typically retain the right to service the mortgages. To assure maximum salability of the residential loan products for possible resale, we typically follow the underwriting and appraisal guidelines of the secondary market, including the FHLMC and the Federal Housing Administration, and service the loans in a manner that satisfies the secondary market agreements. As of December 31, 2017, our residential mortgage servicing portfolio totaled $163.3 million, the majority of which has been sold to the FHLMC. As of December 31, 2017, our residential real estate loan portfolio totaled $465.3 million, or 17% of our total loan portfolio. As of December 31, 2017, our residential real estate lines portfolio totaled $116.3 million, or 4% of our total loan portfolio. As of December 31, 2017, $417.4 million, or 90%, of the loans in our residential real estate loan portfolio were at fixed rates, while $47.9 million, or 10%, were at variable rates. The residential real estate lines portfolio primarily consists of variable rate lines. Approximately 88% of the loans and lines in our residential real estate portfolios were in first lien positions at December 31, 2017. We do not engage in sub-prime or other high-risk residential mortgage lending as a line-of-business.

Consumer Lending

We offer a variety of loan products to our consumer customers, including automobile loans, secured installment loans and other types of secured and unsecured personal loans. At December 31, 2017, outstanding consumer loan balances were concentrated in indirect automobile loans.

We originate indirect consumer loans for a mix of new and used vehicles through franchised new car dealers. The consumer indirect loan portfolio is primarily comprised of loans with terms that typically range from 36 to 84 months. We have developed relationships with franchised new car dealers in Western, Central and the Capital District of New York, and Northern and Central Pennsylvania. As of December 31, 2017, our consumer indirect portfolio totaled $876.6 million, or 32% of our total loan portfolio. The consumer indirect loan portfolio primarily consists of fixed rate loans with relatively short durations.

We also originate, independently of the indirect loans described above, consumer automobile loans, recreational vehicle loans, boat loans, personal loans (collateralized and uncollateralized) and deposit account collateralized loans. The terms of these loans typically range from 12 to 60 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 financed automobile, mobile home, boat or recreational vehicle as collateral. The other loans in our consumer portfolio totaled $17.6 million as of December 31, 2017, all but $753 thousand of which were fixed rate loans.

Credit Administration

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

Our credit objectives are to:

- 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 to meet the needs of the small businesses in our communities; and
- Comply with all relevant laws and regulations.

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

We assign risk ratings to loans in the commercial business and commercial mortgage portfolios. We use those risk ratings to:

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

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

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

Allowance for Loan Losses

The allowance for loan losses is established through charges to earnings in the form of a provision for loan losses. The allowance reflects management s estimate of the amount of probable loan losses in the portfolio, based on factors including, but not limited to:

- Specific allocations for individually analyzed credits;
- Risk assessment process;
- Historical net charge-off experience;
- Evaluation of loss emergence and look-back periods;

- Evaluation of the loan portfolio with loan reviews;
- Levels and trends in delinquent 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 trends and conditions;
- Concentrations of credit;
- Interest rate environment;
- Regulatory environment;
- Information (availability of timely financial information); and
- Collateral values.

Our methodology for estimating the allowance for loan losses includes the following:

1. Impaired commercial business and commercial mortgage loans are typically reviewed individually and assigned a specific loss allowance, if considered necessary, in accordance with U.S. generally accepted accounting principles (GAAP).

2. The remaining portfolios of commercial business and commercial mortgage loans are segmented by risk rating into the following loan classification categories: uncriticized or pass, special mention, substandard and doubtful. Uncriticized loans, special mention loans, substandard loans and all doubtful loans not assigned a specific loss allowance are assigned allowance allocations based on historical net loan charge-off experience for each of the respective loan categories, supplemented with loss emergence periods and qualitative factors, if considered necessary. These qualitative factors include the levels and trends in delinquent 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 trends and conditions, concentrations of credit, interest rate environment, regulatory environment, information (availability of timely financial information), and collateral values, among others.

3. The retail loan portfolio is segmented into the following types of loans: residential real estate loans, residential real estate lines, consumer indirect and other consumer. Allowance allocations for the retail loan portfolio are based on the average loss experience for the previous eight quarters, supplemented with loss emergence periods and qualitative factors similar to the elements described above.

Management presents a quarterly review of the adequacy of the allowance for loan losses to the Audit Committee of our Board of Directors based on the methodology described above. See also the section titled Allowance for Loan Losses in Part II, Item 7, Management s Discussion and Analysis of Financial Condition and Results of Operations of this Annual Report on Form 10-K.

SOURCES OF FUNDS

Our primary sources of funds are deposits and borrowed funds.

Deposits

We maintain a full range of deposit products and accounts to meet the needs of the residents and businesses in our primary service area. Products include an array of checking and savings account programs for individuals and businesses, including money market accounts, certificates of deposit, sweep investment capabilities as well as Individual Retirement Accounts and other qualified plan accounts. We rely primarily on competitive pricing of our deposit products, customer service and long-standing relationships with customers to attract and retain these deposits and seek to make our services convenient to the community by offering a choice of several delivery systems and channels, including telephone, mail, online, automated teller machines (ATMs), debit cards, point-of-sale transactions, automated clearing house transactions (ACH), remote deposit, and mobile banking via telephone or wireless devices. We also take advantage of the use of technology by offering business customers banking access via the Internet and various advanced cash management systems.

We had no traditional brokered deposits at December 31, 2017; however, we do participate in the Certificate of Deposit Account Registry Service (CDARS) and Insured Cash Sweep (ICS) programs, which enable depositors to receive FDIC insurance coverage for deposits otherwise exceeding the maximum insurable amount. Through these programs, deposits in excess of the maximum insurable amount are placed with multiple participating financial institutions. Reciprocal CDARS deposits and ICS deposits totaled $159.2 million and $147.3 million, respectively, at December 31, 2017.

Borrowings

We have access to a variety of borrowing sources and use both short-term and long-term borrowings to support our asset base. Borrowings from time-to-time include federal funds purchased, securities sold under agreements to repurchase, FHLB advances and borrowings from the discount window of the FRB, as defined below.

Other sources of funds include scheduled amortization and prepayments of principal from loans and mortgage-backed securities, maturities and calls of investment securities and funds provided by operations

OPERATING SEGMENTS

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

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

firm that provides customized investment management, investment consulting and retirement plan services to individuals, businesses, institutions, foundations and retirement plans.

For a discussion of the segments included in our principal activities and certain financial information for each segment, see Note 21, Segment Reporting, of the notes to consolidated financial statements included in this Annual Report on Form 10-K.

OTHER INFORMATION

We also make available, free of charge, through our website, all reports filed with, or furnished to, the SEC, including our Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q and Current Reports on Form 8-K, as well as any amendments to those reports, as soon as reasonably practicable after those documents are filed with, or furnished to, the SEC. These filings may be viewed by accessing the *SEC Filings* subsection of the *Financials* section of our website (www.fiiwarsaw.com). Information available on our website is not a part of, and is not incorporated into, this Annual Report on Form 10-K.

All of the reports we file with the SEC, including this Annual Report on Form 10-K, Quarterly Reports on Form 10-Q and Current Reports on Form 8-K, as well as any amendments thereto may be accessed at www.sec.gov or 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.

SUPERVISION AND REGULATION

We are subject to extensive regulation under federal and state laws. The regulatory framework is intended primarily for the protection of depositors, federal deposit insurance funds and the banking system as a whole and not for the protection of shareholders and creditors.

We are also subject to the disclosure and regulatory requirements of the Securities Act of 1933, as amended, and the Securities Exchange Act of 1934, as amended, as administered by the Securities and Exchange Commission (SEC). Our common stock is listed on the NASDAQ Global Select Market (NASDAQ) under the trading symbol FISI and is subject to NASDAQ rules for listed companies.

Significant elements of the laws and regulations applicable to the Company are described below. The description is qualified in its entirety by reference to the full text of the statutes, regulations and policies that are described. Also, such statutes, regulations and policies are continually under review by Congress, state legislatures, and federal and state regulatory agencies. A change in statutes, regulations or regulatory policies applicable to the Company could have a material effect on the business, financial condition and results of operations of the Company.

Holding Company Regulation. We are subject to comprehensive regulation by the Board of Governors of the Federal Reserve System, frequently referred to as the Federal Reserve Board (FRB or Federal Reserve), under the Bank Holding Company Act (the BHC Act), as amended by, among other laws, the Gramm-Leach-Bliley Act of 1999 (the Gramm-Leach-Bliley Act), and by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act), enacted in 2010. We are registered with the Federal Reserve as a bank holding company (BHC). We must file reports with the FRB and such additional information as the FRB may require, and our holding company and non-banking affiliates are subject to examination by the FRB. Under FRB policy, a bank holding company must serve as a source of strength for its subsidiary banks. Under this policy, the FRB may require, and has required in the past, a holding company to contribute additional capital to an undercapitalized subsidiary bank. The BHC Act provides that a bank holding company must obtain FRB approval before:

- Acquiring, directly or indirectly, ownership or control of any voting shares of another bank or bank holding company if, after such acquisition, it would own or control more than 5% of such shares (unless it already owns or controls the majority of such shares);

- Acquiring all or substantially all of the assets of another bank or bank holding company, or

- Merging or consolidating with another bank holding company.

The BHC Act generally prohibits a bank holding company from acquiring direct or indirect ownership or control of more than 5% of the voting shares of any company which is not a bank or bank holding company, or from engaging directly or indirectly in activities other than those of banking, managing or controlling banks, or providing services for its subsidiaries. The principal exceptions to these prohibitions involve certain non-bank activities which, by statute or by FRB regulation or order, have been identified as activities closely related to the business of banking or managing or controlling banks. The list of activities permitted by the FRB includes, among other things: lending; operating a savings institution, mortgage company, finance company, credit card company or factoring company; performing certain data processing operations; providing certain investment and financial advice; underwriting and acting as an insurance agent for certain types of credit related insurance; leasing property on a full-payout, non-operating basis; selling money orders, travelers checks and United States Savings Bonds; real estate and personal property appraising; providing tax planning and preparation services; and, subject to certain limitations, providing securities brokerage services for customers. These activities may also be affected by federal legislation.

The Gramm-Leach-Bliley Act amended portions of the BHC Act to authorize bank holding companies, such as us, directly or through non-bank subsidiaries to engage in securities, insurance and other activities that are financial in nature or incidental to a financial activity. In order to undertake these activities, a bank holding company must become a financial holding company by submitting to the appropriate Federal Reserve Bank a declaration that the company elects to be a financial holding company and a certification that all of the depository institutions controlled by the company are well capitalized and well managed.

The Dodd-Frank Act. The Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) significantly changed the regulation of financial institutions and the financial services industry. The Dodd-Frank Act includes provisions affecting large and small financial institutions alike, including several provisions that will profoundly affect how community banks, thrifts, and small bank and thrift holding companies will be regulated in the future. Among other things, these provisions abolished the Office of Thrift Supervision and transferred its functions to the other federal banking agencies, relaxed rules regarding interstate branching, allowed financial institutions to pay interest on business checking accounts, and imposed new capital requirements on bank and thrift holding companies. The Dodd-Frank Act also includes several corporate governance provisions that apply to all public companies, not just financial institutions. These include provisions mandating certain disclosures regarding executive compensation and provisions addressing proxy access by shareholders. We have elected to be treated as a financial holding company.

The Dodd-Frank Act contains numerous other provisions affecting financial institutions of all types, including some that may affect our business in substantial and unpredictable ways. We have incurred higher operating costs in complying with the Dodd-Frank Act, and we expect that these higher costs will continue for the foreseeable future. Our management continues to monitor the ongoing implementation of the Dodd-Frank Act and as new regulations are issued, will assess their effect on our business, financial condition and results of operations.

On February 3, 2017, President Donald J. Trump issued an executive order directing the Secretary of the Treasury to report, within 120 days, on whether current governmental rules and policies either promote or inhibit the Core Principles for Financial Regulation as defined in the executive order (the Executive Order). The Treasury Department has since issued multiple reports in response to the Executive Order, the first of which, issued on June 12, 2017, analyzed and made recommendations with respect to the U.S. banking system (the Treasury Report). In particular, the Treasury Report recommended several actions that would ease the requirements of the Dodd-Frank Act on community banks such as us, as described in greater detail below. While some of these actions may be implemented unilaterally by our regulators, others will require legislation in order to be put into effect.

On June 8, 2017, the U.S. House of Representatives passed the Financial CHOICE Act of 2017 (the Financial CHOICE Act), a bill that, if enacted into law, would repeal or modify key provisions of the Dodd-Frank Act, including elimination of the Volcker Rule, as defined below, and making the director of the CFPB, also defined below, subject to removal by the President. President Trump has indicated that he would sign the Financial CHOICE Act but the U.S. Senate has yet to take up that bill. In early March 2018, the Senate instead opened debate on the Economic Growth, Regulatory Relief, and Consumer Protection Act, a bill that would also impact several of the provisions of the Dodd-Frank Act and that appears to enjoy significant bipartisan support.

We cannot predict how closely a final bill, if any, will resemble either the one passed by the House of Representatives last year or the one currently under debate in the Senate. Similarly, it is too early for us to predict whether any other executive or congressional action will attempt to implement the recommendations of the Treasury Report as they pertain to the Dodd-Frank Act.

See Item 1A, Risk Factors, for a more extensive discussion of this topic.

The Volcker Rule. The Dodd-Frank Act prohibits banks and their affiliates from engaging in proprietary trading and from investing and sponsoring hedge funds and private equity funds. The statutory provision implementing these restrictions is commonly called the Volcker Rule. To implement the Volcker Rule, federal regulators issued final rules in December 2013 that were to become effective April 2014. The Federal Reserve subsequently issued an order extending the period that institutions have to conform their activities to the requirements of the Volcker Rule to July 21, 2015, and extended the compliance date for banks to conform their investments in certain legacy covered funds until July 21, 2016. These final rules exempt the Bank, as a bank with less than $10 billion in total consolidated

assets that does not engage in any covered activities other than trading in certain government, agency, state or municipal obligations, from any significant compliance obligations under the Volcker Rule; therefore, the Volcker Rule will not have a material effect on our business, financial condition and results of operations. We cannot predict whether the Volcker Rule will be repealed by enactment of the Financial CHOICE Act, or modified by implementation of some or all of the relevant recommendations included in the Treasury Report.

Depository Institution Regulation. The Bank is subject to regulation by the FDIC. This regulatory structure includes:

- Real estate lending standards, which provide guidelines concerning loan-to-value ratios for various types of real estate loans;
- Risk-based capital rules, including accounting for interest rate risk, concentration of credit risk and the risks posed by non-traditional activities;
- Rules requiring depository institutions to develop and implement internal procedures to evaluate and control credit and settlement exposure to their correspondent banks;
- Rules restricting types and amounts of equity investments; and
- Rules addressing various safety and soundness issues, including operations and managerial standards, standards for asset quality, earnings and compensation standards.

Capital Requirements. The Company and the Bank are each required to comply with applicable capital adequacy standards established by the Federal Reserve. The current risk-based capital standards applicable to the Company and the Bank, parts of which are currently in the process of being phased in, are based on the final capital framework for strengthening international capital standards, known as Basel III, of the Basel Committee.

Prior to January 1, 2015, the risk-based capital standards applicable to the Company and the Bank (the General Risk-based Capital Rules) were based on the 1988 Capital Accord, known as Basel I, of the Basel Committee. In July 2013, the federal bank regulators approved the final Basel III Rules implementing the Basel III framework as well as certain provisions of the Dodd-Frank Act. The Basel III Rules substantially revised the risk-based capital requirements applicable to BHCs and their depository institution subsidiaries, including the Company and the Bank, as compared to the General Risk-based Capital Rules. The Basel III Rules became effective for the Company and the Bank on January 1, 2015 (subject to a phase-in period for certain provisions).

The Basel III Rules, among other things, (i) introduce a new capital measure called CET1, which consists primarily of retained earnings and common stock, (ii) specify that Tier 1 capital consists of CET1 and Additional Tier 1 capital instruments, such as preferred stock and certain convertible securities, meeting certain revised requirements, (iii) define CET1 narrowly by requiring that most deductions/adjustments to regulatory capital measures be made to CET1 and not to the other components of capital, and (iv) expand the scope of the deductions/adjustments to capital as compared to existing regulations.

Under the Basel III Rules, the minimum capital ratios effective as of January 1, 2015 are:

- 4.5% CET1 to risk-weighted assets;
- 6.0% Tier 1 capital (that is, CET1 plus Additional Tier 1 capital) to risk-weighted assets; and
- 8.0% Total capital (that is, Tier 1 capital plus Tier 2 capital) to risk-weighted assets.

The Basel III Rules also introduce a new capital conservation buffer designed to absorb losses during periods of economic stress. The capital conservation buffer is an amount in addition to these minimum risk-based capital ratio requirements. The Basel III Rules also provide for a countercyclical capital buffer applicable only to certain covered institutions. We do not expect the countercyclical capital buffer to be applicable to the Company or the Bank. Banking institutions that do not hold capital above the required minimum levels, including the capital conservation buffer, will face constraints on dividends and compensation based on the amount of the shortfall.

When fully phased in on January 1, 2019, the Basel III Rules will require the Company and the Bank to maintain an additional capital conservation buffer of 2.5% of risk-weighted assets, effectively resulting in minimum ratios of (i) CET1 to risk-weighted assets of at least 7%, (ii) Tier 1 capital to risk-weighted assets of at least 8.5%, and (iii) Total capital to risk-weighted assets of at least 10.5%.

The Basel III Rules also provide for a number of deductions from and adjustments to CET1. These include, for example, the requirement that MSRs, certain deferred tax assets and significant investments in non-consolidated financial entities be deducted from CET1 to the extent that any one such category exceeds 10% of CET1 or all such items, in the aggregate, exceed 15% of CET1.

Implementation of the deductions and other adjustments to CET1 began on January 1, 2015 and will be phased in over a 4-year period (beginning at 40% on January 1, 2015 and an additional 20% per year thereafter). The implementation of the capital conservation buffer began on January 1, 2016 at the 0.625% level and will be phased in over a 4-year period (increasing by that amount on each subsequent January 1, until it reaches 2.5% on January 1, 2019).

The Basel III Rules prescribe a new standardized approach for risk weightings that expands the risk-weighting categories from the four Basel I-derived categories (0%, 20%, 50% and 100%) to a much larger and more risk-sensitive number of categories, depending on the nature of the assets, generally ranging from 0% for U.S. government and agency securities, to 600% for certain equity exposures, and resulting in higher risk weights for a variety of asset classes.

The recommendations of the Treasury Report include making community banks such as us exempt from the risk-based capital standards included under the Basel III Rules. As no meaningful action has yet been taken to implement these recommendations, we cannot predict whether or to what extent we will continue to be subject to these standards in the future, including on the final phase-in date of January 1, 2019.

Leverage Requirements. BHCs and banks are also required to comply with minimum leverage ratio requirements. These requirements provide for a minimum ratio of Tier 1 capital to total consolidated quarterly average assets (as defined for regulatory purposes), net of the loan loss reserve, goodwill and certain other intangible assets (the leverage ratio), of 4.0%.

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Liquidity Regulation. During 2014, the U.S. banking agencies adopted final rules implementing one of the two new standards provided for in the Basel III liquidity framework - its liquidity coverage ratio (LCR), which is designed to ensure that a bank maintains an adequate level of unencumbered high quality liquid assets equal to the bank s expected net cash outflows for a thirty-day time horizon under an acute liquidity stress scenario. The rules as adopted apply in their most comprehensive form only to advanced approaches bank holding companies and depository institution subsidiaries of such bank holding companies and, in a modified form, to banking organizations having $50 billion or more in total consolidated assets. Accordingly, they do not apply to either the Company or the Bank. As a result, we do not manage our balance sheet to be compliant with these rules.

The Basel III framework also included a second standard, referred to as the net stable funding ratio (NSFR), which is designed to promote more medium-and long-term funding of the assets and activities of banks over a one-year time horizon. Although the Basel Committee finalized its formulation of the NSFR in 2014, the U.S. banking agencies have not yet proposed an NSFR for application to U.S. banking organizations or addressed the scope of banking organizations to which it will apply. The Basel Committee s final NSFR document states that the NSFR applies to internationally active banks, as did its final LCR document as to that ratio.

Prompt Corrective Action. The Federal Deposit Insurance Act, as amended (FDIA), requires among other things, the federal banking agencies to take prompt corrective action in respect of depository institutions that do not meet minimum capital requirements. The FDIA establishes five capital categories for FDIC-insured banks: well capitalized, adequately capitalized, under-capitalized, significantly under-capitalized and critically under-capitalized. Under rules in effect through December 31, 2014, a depository institution is deemed to be well-capitalized if the institution has a total risk-based capital ratio of 10.0% or greater, a Tier 1 risk-based capital ratio of 6.0% or greater, and a leverage ratio of 5.0% or greater, and the institution is not subject to an order, written agreement, capital directive or prompt corrective action directive to meet and maintain a specific level for any capital measure. As of January 1, 2015, the standards for well-capitalized status under prompt corrective action regulations changed by, among other things, introducing a CET 1 ratio requirement of 6.5% and increasing the Tier 1 risk-based capital ratio requirement from 6.0% to 8.0%. The total risk-based capital ratio and Tier 1 leverage ratio requirements remain at 10.0% and 5.0%, respectively.

The FDIA imposes progressively more restrictive constraints on operations, management and capital distributions, depending on the capital category in which an institution is classified. The current capital rule established by the federal bank regulators, discussed above under Capital Requirements, amend the prompt corrective action requirements in certain respects, including adding a CET1 risk-based capital ratio as one of the metrics (with a minimum 6.5% ratio for well-capitalized status) and increasing the Tier 1 risk-based capital ratio required for each of the five capital categories, including an increase from 6.0% to 8.0% to be well-capitalized.

For further information regarding the capital ratios and leverage ratio of the Company and the Bank see the section titled Capital Resources in Part II, Item 7, Management s Discussion and Analysis of Financial Condition and Results of Operations, included in this Annual Report on Form 10-K. The current requirements and the actual levels for the Company and the Bank are detailed in Note 11, Regulatory Matters, of the notes to consolidated financial statements, included in this Annual Report on Form 10-K.

Dividends. The FRB policy is that a bank holding company should pay cash dividends only to the extent that its net income for the past year is sufficient to cover both the cash dividends and a rate of earnings retention that is consistent with the holding company s capital needs, asset quality and overall financial condition, and that it is inappropriate for a bank holding company experiencing serious financial problems to borrow funds to pay dividends. Furthermore, a bank that is classified under the prompt corrective action regulations as undercapitalized will be prohibited from paying any dividends.

The primary source of cash for dividends we pay is the dividends we receive from the Bank. The Bank is subject to various regulatory policies and requirements relating to the payment of dividends, including requirements to maintain capital above regulatory minimums. Approval of the New York State Department of Financial Services (the NY DFS) is required prior to paying a dividend if the dividend declared by the Bank exceeds the sum of the Bank s net profits for that year and its retained net profits for the preceding two calendar years. At January 1, 2018, the Bank could declare dividends of $42.1 million from retained net profits of the preceding two years. The Bank declared dividends of $12.0 million in 2017 and $16.0 million in 2016.

Federal Deposit Insurance Assessments. The Bank is a member of the FDIC and pays an insurance premium to the FDIC based upon its assessable assets on a quarterly basis. Deposits are insured up to applicable limits by the FDIC and such insurance is backed by the full faith and credit of the United States Government.

Under the Dodd-Frank Act, a permanent increase in deposit insurance was authorized to $250,000. The coverage limit is per depositor, per insured depository institution for each account ownership category.

The Dodd-Frank Act also set a new minimum Deposit Insurance Fund (DIF) reserve ratio at 1.35% of estimated insured deposits. The FDIC is required to attain this ratio by September 30, 2020. The Dodd-Frank Act also required the FDIC to define the deposit insurance assessment base for an insured depository institution as an amount equal to the institution s average consolidated total assets during the assessment period minus average tangible equity. Premiums for the Bank are now calculated based upon the average balance of total assets minus average tangible equity as of the close of business for each day during the calendar quarter.

The FDIC has the flexibility to adopt actual rates that are higher or lower than the total base assessment rates adopted without notice and comment, if certain conditions are met.

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 2017, the FICO assessment was equal to 0.46 basis points (annualized) computed on assets as required by the Dodd-Frank Act. These assessments will continue until the bonds mature in 2019.

The FDIC is authorized to conduct examinations of and require reporting by FDIC-insured institutions. It is also authorized to terminate a depository bank s deposit insurance upon a finding by the FDIC that the bank s financial condition is unsafe or unsound or that the institution has engaged in unsafe or unsound practices or has violated any applicable rule, regulation, order or condition enacted or imposed by the bank s regulatory agency. The termination of deposit insurance for the Bank would have a material adverse effect on our earnings, operations and financial condition.

Consumer Laws and Regulations. In addition to the laws and regulations discussed herein, the Bank is also subject to certain consumer federal and state 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 Fair Credit Reporting Act, 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, the Real Estate Settlement Procedures Act, the Fair Debt Collection Practices Act, the Service Members Civil Relief Act and these laws respective state-law counterparts, as well as state usury laws and laws regarding unfair and deceptive acts and practices. These and other federal and state laws, among other things, require disclosures of the cost of credit and terms of deposit accounts, provide substantive consumer rights, prohibit discrimination in credit transactions, regulate the use of credit report information, provide financial privacy protections, prohibit unfair, deceptive and abusive practices, restrict the Company s ability to raise interest rates and subject the Company to substantial regulatory oversight. Violations of applicable consumer protection laws can result in significant potential liability from litigation brought by customers, including actual damages, restitution and attorneys fees. Federal and state bank regulators, federal law enforcement agencies, state attorneys general and state and local consumer protection agencies may also seek to enforce consumer protection requirements and obtain these and other remedies, including regulatory sanctions, customer rescission rights, fines and civil money penalties. Failure to comply with consumer protection requirements may also result in our failure to obtain any required bank regulatory approval for merger or acquisition transactions the Company may wish to pursue or our prohibition from engaging in such transactions even if approval is not required.

The Dodd-Frank Act centralized responsibility for consumer financial protection by creating the Consumer Financial Protection Bureau (CFPB), and giving it responsibility for implementing, examining and enforcing compliance with federal consumer protection laws. The CFPB focuses on:

- Risks to consumers and compliance with the federal consumer financial laws, when it evaluates the policies and practices of a financial institution;
- The markets in which firms operate and risks to consumers posed by activities in those markets;
- Depository institutions that offer a wide variety of consumer financial products and services; depository institutions with a more specialized focus; and
- Non-depository companies that offer one or more consumer financial products or services.

The CFPB has broad rulemaking authority for a wide range of consumer financial laws that apply to all banks, including, among other things, the authority to prohibit unfair, deceptive or abusive acts and practices. Abusive acts or practices are defined as those that materially interfere with a consumer s ability to understand a term or condition of a consumer financial product or service or take unreasonable advantage of a consumer s (i) lack of financial savvy, (ii) inability to protect himself in the selection or use of consumer financial products or services, or (iii) reasonable reliance on a covered entity to act in the consumer s interests. The CFPB can issue cease-and-desist orders against banks and other entities that violate consumer financial laws. The CFPB may also institute a civil action against an entity in violation of federal consumer financial law in order to impose a civil penalty or injunction. The CFPB has examination and enforcement authority over all banks with more than $10 billion in assets, as well as their affiliates.

Neither the recommendations of the Treasury Report nor the Financial CHOICE Act provide for the abolishment of the CFPB; both, however, call for the director of the CFPB to be subject to removal by the President and for repeal of the CFPB s authority to perform examinations. We cannot predict whether or how the CFPB will be impacted by either pending or future legislation or by possible future executive action.

Banking regulators take into account compliance with consumer protection laws when considering approval of a proposed transaction.

Community Reinvestment Act. Pursuant to the Community Reinvestment Act (the CRA), under federal and New York State law, the Bank is obligated, consistent with safe and sound banking practices, to help meet the credit needs of its entire community, including low and moderate income neighborhoods. The FRB of New York and NY DFS periodically assess the Bank s record of performance under the CRA and issue one of the following ratings: Outstanding, Satisfactory, Needs to Improve, or Substantial Noncompliance.

The most recently completed evaluation of the Bank s performance under the CRA was conducted by the FRB of New York for the time period January 2011 through September 2013 and was disclosed to us in March 2018. This performance evaluation resulted in an overall rating by the FRB of New York of Needs to Improve. In reaching this rating the FRB of New York considered several factors, including the geographic distribution of loans we made from January 2011 through September 2013 in the Buffalo and Rochester metropolitan areas, the accessibility of our retail delivery systems and our level of compliance during the time period with the Equal Credit Opportunity Act and the Fair Housing Act. We believe the Bank has made significant improvements in these areas since September 2013 and we are firmly committed to fair and responsible banking and helping to meet the credit needs of all segments of the communities that we serve.

The FRB of New York s evaluation of the Bank s January 2011 through September 2013 CRA performance may subject the Bank to enhanced scrutiny in any application it files with the FRB of New York or the NY DFS with respect to, among other things, the establishment of new branches, the expansion or relocation of existing branches, or the acquisition by the Bank of another depository institution. While the approval or denial of such an application is typically a facts and circumstances based determination, a less than satisfactory CRA rating would be one of the factors our regulators will consider in their review.

We are in the process of preparing our response to the performance evaluation issued by the FRB of New York and we plan to file a Current Report on Form 8-K when our response and the performance evaluation are publicly available.

In January 2015, we signed an Assurance of Discontinuance (AOD) with the NYS Attorney General s office related to an investigation into lending practices for minority residents within the City of Rochester from 2009 to June 2013. As part of the agreement, we paid NYS $150 thousand to cover its costs. An additional $750 thousand in dedicated funds spread over three-years was earmarked for ongoing business efforts consistent with the Bank s growth initiatives in the Rochester market, and throughout Monroe County, including efforts focused on marketing to minority communities, as well as lending discounts and/or subsidies. The Bank successfully met all requirements of the AOD and in January 2018, the AOD expired by its terms.

The NY DFS is assessing our CRA performance since 2012 and has not yet completed its evaluation. The last CRA evaluation completed by the NY DFS was in 2011 and resulted in the Bank being rated as Outstanding.

Privacy Rules. Federal banking regulators, as required under the Gramm-Leach-Bliley Act, have adopted rules limiting the ability of banks and other financial institutions to disclose nonpublic information about consumers to non-affiliated third parties. The rules require disclosure of privacy policies to consumers and, in some circumstances, allow consumers to prevent disclosure of certain personal information to non-affiliated third parties. The privacy provisions of the Gramm-Leach-Bliley Act affect how consumer information is transmitted through diversified financial services companies and conveyed to outside vendors.

In February 2017, the NY DFS issued a final rule, which became effective on March 1, 2017, requiring New York State-chartered or licensed banks regulated by the NY DFS, such as us, to adopt broad cybersecurity protections. Specifically, we are now required to establish a program designed to ensure the safety of our information systems,

adopt a written cybersecurity policy, designate an information security officer, and comply with NY DFS certification and reporting requirements. Compliance with this rule is subject to four phase-in dates between September 2017 and March 2019.

Anti-Money Laundering and the USA Patriot Act. A major focus of governmental policy on financial institutions in recent years has been aimed at combating money laundering and terrorist financing. The USA PATRIOT Act of 2001, or the USA Patriot Act, substantially broadened the scope of United States anti-money laundering laws and regulations by imposing significant new compliance and due diligence obligations, creating new crimes and penalties and expanding the extra-territorial jurisdiction of the United States. Financial institutions are also prohibited from entering into specified financial transactions and account relationships and must use enhanced due diligence procedures in their dealings with certain types of high-risk customers and implement a written customer identification program. Financial institutions must take certain steps to assist government agencies in detecting and preventing money laundering and report certain types of suspicious transactions. Regulatory authorities routinely examine financial institutions for compliance with these obligations, and for the failure of a financial institution to maintain and implement adequate programs to combat money laundering and terrorist financing, or to comply with all of the relevant laws or regulations, could have serious legal and reputational consequences for the institution, including causing applicable bank regulatory authorities not to approve merger or acquisition transactions when regulatory approval is required or to prohibit such transactions even if approval is not required. Regulatory authorities have imposed cease and desist orders and civil money penalties against institutions found to be violating these obligations.

Interstate Branching. Pursuant to the Dodd-Frank Act, national and state-chartered banks may open an initial branch in a state other than its home state (e.g., a host state) by establishing a de novo branch at any location in such host state at which a bank chartered in such host state could establish a branch. Applications to establish such branches must still be filed with the appropriate primary federal regulator. It is too early to predict whether President Trump s Executive Order or any subsequent presidential or congressional action will result in any change to a bank s ability to establish a de novo branch in a host state.

Transactions with Affiliates. FII, FSB, Five Star REIT, SDN and Courier Capital are affiliates within the meaning of the Federal Reserve Act. The Federal Reserve Act imposes limitations on a bank with respect to extensions of credit to, investments in, and certain other transactions with, its parent bank holding company and the holding company s other subsidiaries. Furthermore, bank loans and extensions of credit to affiliates also are subject to various collateral requirements.

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Various governmental requirements, including Sections 23A and 23B of the Federal Reserve Act and the FRB s Regulation W, limit borrowings by FII and its nonbank subsidiaries from FSB, and also limit various other transactions between FII and its nonbank subsidiaries, on the one hand, and FSB, on the other. For example, Section 23A of the Federal Reserve Act limits the aggregate outstanding amount of any insured depository institution s loans and other covered transactions with any particular nonbank affiliate to no more than 10% of the institution s total capital and limits the aggregate outstanding amount of any insured depository institution s covered transactions with all of its nonbank affiliates to no more than 20% of its total capital. Covered transactions are defined by statute to include a loan or extension of credit, as well as a purchase of securities issued by an affiliate, a purchase of assets (unless otherwise exempted by the FRB) from the affiliate, the acceptance of securities issued by the affiliate as collateral for a loan, and the issuance of a guarantee, acceptance or letter of credit on behalf of an affiliate. Section 23A of the Federal Reserve Act also generally requires that an insured depository institution s loans to its nonbank affiliates be, at a minimum, 100% secured, and Section 23B of the Federal Reserve Act generally requires that an insured depository institution s transactions with its nonbank affiliates be on terms and under circumstances that are substantially the same or at least as favorable as those prevailing for comparable transactions with non-affiliates. The Dodd-Frank Act significantly expanded the coverage and scope of the limitations on affiliate transactions within a banking organization. For example, commencing in July 2012, the Dodd-Frank Act applies the 10% of capital limit on covered transactions to financial subsidiaries and amends the definition of covered transaction to include (i) securities borrowing or lending transactions with an affiliate, and (ii) all derivatives transactions with an affiliate, to the extent that either causes a bank or its affiliate to have credit exposure to the securities borrowing/lending or derivative counterparty.

Office of Foreign Assets Control Regulation. The U.S. Treasury Department s Office of Foreign Assets Control, or OFAC, administers and enforces economic and trade sanctions against targeted foreign countries and regimes, under authority of various laws, including designated foreign countries, nationals and others. OFAC publishes lists of specially designated targets and countries. The Company is responsible for, among other things, blocking accounts of, and transactions with, such targets and countries, prohibiting unlicensed trade and financial transactions with them and reporting blocked transactions after their occurrence. Failure to comply with these sanctions could have serious legal and reputational consequences, including causing applicable bank regulatory authorities not to approve merger or acquisition transactions when regulatory approval is required or to prohibit such transactions even if approval is not required.

Insurance Regulation. SDN is required to be licensed or receive regulatory approval in nearly every state in which it does business. In addition, most jurisdictions require individuals who engage in brokerage and certain other insurance service activities to be personally licensed. These licensing laws and regulations vary from jurisdiction to jurisdiction. In most jurisdictions, licensing laws and regulations generally grant broad discretion to supervisory authorities to adopt and amend regulations and to supervise regulated activities.

Investment Advisory Regulation. Courier Capital is a provider of investment consulting and financial planning services and, as such, is considered an investment adviser under the U.S. Investment Advisers Act of 1940, as amended (the Advisers Act). An investment adviser is any person or entity that provides advice to others, or that issues reports or analyses, regarding securities for compensation. While a BHC is generally excluded from regulation under the Advisers Act, the SEC has stated that this exclusion does not apply to investment adviser subsidiaries of BHCs, such as Courier Capital. Since Courier Capital has over $100 million in assets under management it is considered a large adviser, which requires registration with the SEC by filing Form ADV and updating it at least once each year, and more frequently under certain specified circumstances. This registration covers Courier Capital and its employees as well as other persons under its control and supervision, such as independent contractors, provided that their activities are undertaken on behalf of Courier Capital.

In addition to these registration requirements, the Advisers Act contains numerous other provisions that impose obligations on investment advisors. For example, Section 206 includes anti-fraud provisions that courts have interpreted as establishing fiduciary duties extending to all services undertaken on behalf of the client. These duties include, but are not limited to, the disclosure of all material facts to clients, providing only suitable investment advice, and seeking best price execution of trades. Section 206 also has specific rules relating to, among other things, advertising, safeguarding client assets, the engagement of third-parties, the duty to supervise persons acting on the investment adviser s behalf, and the establishment of an effective internal compliance program and a code of ethics.

Courier Capital is subject to each of these obligations and, as applicable, restrictions, and is also subject to examination by the SEC s Office of Compliance, Investigations, and Examinations to assess its overall compliance with the Advisers Act and the effectiveness of its internal controls.

Prior to our acquisition of Courier Capital in January 2016, the Bank had provided investment advisory and broker-dealer services to its customers through its subsidiary Five Star Investment Services, Inc. Commencing in October 2013, the Bank entered into a partnership with LPL Financial, one of the nation s largest independent financial services companies (LPL), to provide investment advisory and broker-dealer services to its customers through LPL. This partnership continues and the Bank employs wealth advisors, who are licensed by LPL, to provide investment advisory and broker-dealer services to the Bank s customers. LPL is an investment adviser registered under the Advisers Act and is subject to its provisions.

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Incentive Compensation. Our compensation practices are subject to oversight by the Federal Reserve. In June 2010, the Federal banking agencies issued comprehensive final guidance on incentive compensation policies intended to ensure that the incentive compensation policies of banking organizations do not undermine the safety and soundness of such organizations by encouraging excessive risk-taking. The guidance, which covers all employees that have the ability to materially affect the risk profile of an organization, either individually or as part of a group, is based upon the key principles that a banking organization s incentive compensation arrangements should (i) provide incentives that do not encourage risk-taking beyond the organization s ability to effectively identify and manage risks, (ii) be compatible with effective internal controls and risk management, and (iii) be supported by strong corporate governance, including active and effective oversight by the organization s board of directors.

The Dodd-Frank Act requires the federal banking agencies to establish joint regulations or guidelines prohibiting incentive-based payment arrangements at specified regulated entities having at least $1 billion in total consolidated assets (which would include the Company and the Bank) that encourage inappropriate risks by providing an executive officer, employee, director or principal shareholder with excessive compensation, fees or benefits or that could lead to material financial loss to the entity. In addition, the agencies must establish regulations or guidelines requiring enhanced disclosure to regulators of incentive-based compensation arrangements. In May 2016, six federal agencies, including the FRB, the FDIC and the SEC, invited public comments on a proposed rule to accomplish this mandate; no final rule has since been issued, however, and it is uncertain at this time whether the agencies intend to further pursue the rule for the foreseeable future.

The FRB will review, as part of the regular, risk-focused examination process, the incentive compensation arrangements of banking organizations, such as the Company, that are not large, complex banking organizations. These reviews will be tailored to each organization based on the scope and complexity of the organization s activities and the prevalence of incentive compensation arrangements. The findings of the supervisory initiatives will be included in reports of examination. Deficiencies will be incorporated into the organization s supervisory ratings, which can affect the organization s ability to make acquisitions and take other actions. Enforcement actions may be taken against a banking organization if its incentive compensation arrangements, or related risk-management control or governance processes, pose a risk to the organization s safety and soundness and the organization is not taking prompt and effective measures to correct the deficiencies.

Other Future Legislation and Changes in Regulations. In addition to the specific proposals described above, from time to time, various legislative and regulatory initiatives are introduced in Congress and state legislatures, as well as by regulatory agencies. Such initiatives may include proposals to expand or contract the powers of bank holding companies and depository institutions or proposals to substantially change the financial institution regulatory system. Such legislation could change banking statutes and/or our operating environment in substantial and unpredictable ways. If enacted, such legislation could increase or decrease the cost of doing business, limit or expand permissible activities or affect the competitive balance among banks, savings associations, credit unions, and other financial institutions. We cannot predict whether any such legislation will be enacted, and, if enacted, the effect that it, or any implementing regulations, would have on our financial condition or results of operations. A change in statutes, regulations or regulatory policies applicable to us or our subsidiaries could have a material effect on our business.

Impact of Inflation and Changing Prices

Our financial statements included herein have been prepared in accordance with GAAP, which requires us to measure financial position and operating results principally using historic dollars. Changes in the relative value of money due to inflation or recession are generally not considered. The primary effect of inflation on our operations is reflected in increased operating costs. We believe changes in interest rates affect the financial condition of a financial institution to a far greater degree than changes in the inflation rate. While interest rates are generally influenced by changes in the

inflation rate, they do not necessarily change at the same rate or in the same magnitude. Interest rates are sensitive to many factors that are beyond our control, including changes in the expected rate of inflation, general and local economic conditions and the monetary and fiscal policies of the United States government, its agencies and various other governmental regulatory authorities.

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Regulatory and Economic Policies

Our business and earnings are affected by general and local economic conditions and by the monetary and fiscal policies of the U.S. government, its agencies and various other governmental regulatory authorities. The FRB regulates the supply of money in order to influence general economic conditions. Among the instruments of monetary policy available to the FRB are (i) conducting open market operations in U.S. government obligations, (ii) changing the discount rate on financial institution borrowings, (iii) imposing or changing reserve requirements against financial institution deposits, and (iv) restricting certain borrowings and imposing or changing reserve requirements against certain borrowings by financial institutions and their affiliates. These methods are used in varying degrees and combinations to directly affect the availability of bank loans and deposits, as well as the interest rates charged on loans and paid on deposits. For that reason, the policies of the FRB could have a material effect on our earnings.

On December 22, 2017, the Tax Cuts and Jobs Act (the TCJ Act) was signed into law which, among other items, reduces the federal statutory corporate tax rate from 35 percent to 21 percent, effective January 1, 2018.

EMPLOYEES

At December 31, 2017, we had 656 employees, none of whom are subject to a collective bargaining agreement. Management believes our relations with employees are good.

ITEM 1A. RISK FACTORS

An investment in our common stock is subject to risks inherent to our business. The material risks and uncertainties that management believes could affect us are described below. Before making an investment decision, you should carefully consider the risks and uncertainties described below, together with all of the other information included or incorporated by reference herein. This Annual Report on Form 10-K is qualified in its entirety by these risk factors. Further, to the extent that any of the information contained in this Annual Report on Form 10-K constitutes forward-looking statements, the risk factors set forth below also are cautionary statements identifying important factors that could cause our actual results to differ materially from those expressed in any forward-looking statements made by or on behalf of us.

If any of the following risks actually occur, our financial condition and results of operations could be materially and adversely affected. If this were to happen, the value of our common stock could decline significantly, and you could lose all or part of your investment.

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

As a lender, we are exposed to the risk that customers will be unable to repay their loans according to their terms and that any collateral securing the payment of their loans may not be sufficient to assure repayment. Credit losses are inherent in the business of making loans and could have a material adverse impact on our results of operations.

We make various assumptions and judgments about the collectability of our loan portfolio, including the creditworthiness of our borrowers and the value of the real estate and other assets serving as collateral, and we provide an allowance for estimated loan losses based on a number of factors. We believe that the allowance for loan losses is adequate. However, if our assumptions or judgments are wrong, the allowance for loan losses may not be sufficient to cover the actual credit losses. We may have to increase the allowance in the future in response to the request of one of our primary banking regulators, to adjust for changing conditions and assumptions, or as a result of any deterioration in the quality of our loan portfolio. The actual amount of future provisions for credit losses may vary from the amount of past provisions.

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

Our tax strategies are dependent upon our ability to generate taxable income in future periods. Our tax strategies will be less effective in the event we fail to generate taxable income. Our deferred tax assets are subject to an evaluation of whether it is more likely than not that they will be realized for financial statement purposes. In making this determination, we consider all positive and negative evidence available including the impact of recent operating results as well as potential carryback of tax to prior years taxable income, reversals of existing taxable temporary differences, tax planning strategies and projected earnings within the statutory tax loss carryover period. If we were to conclude that a significant portion of our deferred tax assets were not more likely than not to be realized, the required valuation allowance could adversely affect our financial position, results of operations and regulatory capital ratios. In addition, the value of our deferred tax assets could be adversely affected by a change in statutory tax rates.

Geographic concentration may unfavorably impact our operations.

Substantially all of our business and operations are concentrated in the Western and Central New York region. As a result of this geographic concentration, our results depend largely on economic conditions in these and surrounding areas. Deterioration in economic conditions in our market could:

- increase loan delinquencies;
- increase problem assets and foreclosures;
- increase claims and lawsuits;
- decrease the demand for our products and services; and
- decrease the value of collateral for loans, especially real estate, reducing customers borrowing power, the value of assets associated with non-performing loans and collateral coverage.

Generally, we make loans to small to mid-sized businesses whose success depends on the regional economy. These businesses generally have fewer financial resources in terms of capital or borrowing capacity than larger entities. Adverse economic and business conditions in our market areas could reduce our growth rate, affect our borrowers ability to repay their loans and, consequently, adversely affect our business, financial condition and performance. For example, we place substantial reliance on real estate as collateral for our loan portfolio. A sharp downturn in real estate values in our market area could leave many of these loans inadequately collateralized. If we are required to liquidate the collateral securing a loan to satisfy the debt during a period of reduced real estate values, the impact on our results of operations could be materially adverse.

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

In deciding whether to extend credit or enter into other transactions, we may rely on information furnished by or on behalf of customers and counterparties, including financial statements, credit reports, and other financial information. We may also rely on representations of those customers, counterparties, or other third parties, such as independent auditors, as to the accuracy and completeness of that information. Reliance on inaccurate or misleading financial statements, credit reports, or other financial information could cause us to enter into unfavorable transactions, which could have a material adverse effect on our financial condition and results of operations.

Our insurance brokerage subsidiary, SDN, is subject to risk related to the insurance industry.

SDN derives the bulk of its revenue from commissions and fees earned from brokerage services. SDN does not determine the insurance premiums on which its commissions are based. Insurance premiums are cyclical in nature and may vary widely based on market conditions. As a result, insurance brokerage revenues and profitability can be volatile. As insurance companies outsource the production of premium revenue to non-affiliated brokers or agents such as SDN, those insurance companies may seek to further minimize their expenses by reducing the commission rates payable to insurance agents or brokers, which could adversely affect SDN s revenues. In addition, there have been and may continue to be various trends in the insurance industry toward alternative insurance markets including, among other things, increased use of self-insurance, captives, and risk retention groups. While SDN has been able to participate in certain of these activities and earn fees for such services, there can be no assurance that we will realize revenues and profitability as favorable as those realized from SDN s traditional brokerage activities.

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

The financial services industry is subject to extensive regulation at the federal and state levels. It is very difficult to predict the future impact of the legislative and regulatory requirements affecting our business. The securities laws and other laws that govern the activities of our registered investment advisor are complex and subject to change. The activities of our investment advisory and wealth management operations are subject primarily to provisions of the Advisers Act and the Employee Retirement Income Act of 1940, as amended (ERISA). We are a fiduciary under ERISA. Our investment advisory services are also subject to state laws including anti-fraud laws and regulations. Any claim of noncompliance, regardless of merit or ultimate outcome, could subject us to investigation by the SEC or other regulatory authorities. Our compliance processes may not be sufficient to prevent assertions that we failed to comply with any applicable law, rule or regulation. If our investment advisory and wealth management operations are subject to investigation by the SEC or other regulatory authorities or if litigation is brought by clients based on our failure to comply with applicable regulations, our results of operations could be materially adversely effected.

In addition, the majority of our investment advisory revenue is from fees based on the percentage of assets under management. The value of the assets under management is determined, in part by market conditions that can be

volatile. As a result, investment advisory revenues and profitability can fluctuate with market conditions.

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

Our current growth strategy is multi-faceted. We seek to expand our branch network into nearby areas, make strategic acquisitions of loans, portfolios, other regional banks and non-banking firms whose businesses we feel may be complementary with ours, and to continue to organically grow our core deposits. Any failure by us to effectively implement any one or more of these growth strategies could have several negative effects, including a possible decline in the size or the quality, or both, of our loan portfolio or a decrease in profitability caused by an increase in operating expenses.

In particular, we hope to continue an active merger and acquisition strategy. However, even if we use our common stock as the predominant form of consideration, we may need to raise capital in order to negotiate a transaction on terms acceptable to us and there can be no assurance that we will be able to raise a sufficient amount of capital to enable us to complete an acquisition. It is also possible that even with adequate capital we may still be unable to complete an acquisition on favorable terms, causing us to miss opportunities to increase our earnings and expand or diversify our operations.

Our growth strategy is also dependent upon the successful integration of new businesses, including SDN and Courier Capital, as well as any future acquisitions, into our existing operations. While our senior management team has had extensive experience in acquisitions and post-acquisition integration, there is no guarantee that our current or future integration efforts will be successful, and if our senior management is forced to spend a disproportionate amount of time on integrating recently-acquired businesses, it may distract their attention from other growth opportunities.

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

A significant portion of our loan portfolio is secured by real property. During the ordinary course of business, we may foreclose on and take title to properties securing certain loans. There is a risk that hazardous or toxic substances could be found on properties we have foreclosed upon. If hazardous or toxic substances are found, we may be liable for remediation costs, as well as for personal injury and property damage regardless of whether we knew, had reason to know of, or caused the release of such substance. Environmental laws may require us to incur substantial expenses and may materially reduce the affected property s value or limit our ability to use or sell the affected property. In addition, future laws or more stringent interpretations or enforcement policies with respect to existing laws may increase our exposure to environmental liability. The remediation costs and any other financial liabilities associated with an environmental hazard could have a material adverse effect on our financial condition and results of operations.

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

At December 31, 2017, our portfolio of commercial business and mortgage loans totaled $1,259.2 million, or 46.1% of total loans. We plan to continue to emphasize the origination of these types of loans, which generally expose us to a greater risk of nonpayment and loss than residential real estate or consumer loans because repayment of such loans often depends on the successful operations and income stream of the borrowers. Additionally, such loans typically involve larger loan balances to single borrowers or groups of related borrowers compared to consumer loans or residential real estate loans. A sudden downturn in the economy could result in borrowers being unable to repay their loans, thus exposing us to increased credit risk.

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

A portion of our current lending involves the purchase of consumer automobile installment sales contracts from automobile dealers located in Western, Central and the Capital District of New York, and Northern and Central Pennsylvania. These loans are for the purchase of new or used automobiles. We serve customers that cover a range of creditworthiness, and the required terms and rates are reflective of those risk profiles. While these loans have higher yields than many of our other loans, such loans involve risk elements in addition to normal credit risk. Additional risk elements associated with indirect lending include the limited personal contact with the borrower as a result of indirect lending through non-bank channels, namely automobile dealers. While indirect automobile loans are secured, such loans are secured by depreciating assets and characterized by loan-to-value ratios that could result in us not recovering the full value of an outstanding loan upon default by the borrower. If the losses from our indirect loan portfolio are higher than anticipated, it could have a material adverse effect on our financial condition and results of operations.

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

At December 31, 2017, we had $2.36 billion of deposit liabilities that have no maturity and, therefore, may be withdrawn by the depositor at any time. These deposit liabilities include our checking, savings, and money market deposit accounts.

Market conditions may impact the competitive landscape for deposits in the banking industry. The unprecedented low rate environment and future actions the Federal Reserve may take may impact pricing and demand for deposits in the banking industry. The withdrawal of more deposits than we anticipate could have an adverse impact on our profitability as this source of funding, if not replaced by similar deposit funding, would need to be replaced with wholesale funding, the sale of interest-earning assets, or a combination of these two actions. The replacement of deposit funding with wholesale funding could cause our overall cost of funding to increase, which would reduce our net interest income. A loss of interest-earning assets could also reduce our net interest income.

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

The amount that is assessed by the FDIC for deposit insurance is set by the FDIC based on a variety of factors. These include the depositor insurance fund s reserve ratio, the Bank s assessment base, which is equal to average consolidated total assets minus average tangible equity, and various inputs into the FDIC s assessment rate calculation.

If there are financial institution failures, we may be required to pay higher FDIC premiums. Such increases of FDIC insurance premiums may adversely impact our earnings. See Part I, Item 1 Business, Supervision and Regulation-Federal Deposit Insurance Assessments for more information about FDIC insurance premiums.

We are highly regulated and any adverse regulatory action may result in additional costs, loss of business opportunities, and reputational damage.

As described in the section captioned Supervision and Regulation included in Part I, Item 1, Business, both our Banking and Non-Banking segments are subject to extensive supervision, regulation and examination. The various regulatory authorities with jurisdiction over us have significant latitude in addressing our compliance with applicable laws and regulations including, but not limited to, those governing consumer credit, fair lending, anti-money laundering, anti-terrorism, capital adequacy, asset quality and risk, management ability and performance, earnings, liquidity, and various other factors affecting us. As part of this regulatory structure, we are subject to policies and other guidance developed by the regulatory agencies with respect to, among other things, capital levels, the timing and amount of dividend payments, the classification of assets and the establishment of adequate loan loss reserves for regulatory purposes. Our regulators have broad discretion to impose restrictions and limitations on our operations if they determine, for any reason, that our operations are unsafe or unsound, fail to comply with applicable law or are otherwise inconsistent with laws and regulations or with the supervisory policies of these agencies.

This supervisory framework could materially impact the conduct, growth and profitability of our operations. Any failure on our part to comply with current laws, regulations, other regulatory requirements or safe and sound banking, insurance, or investment advisory practices or concerns about our financial condition, or any related regulatory sanctions or adverse actions against us, could increase our costs or restrict our ability to expand our business and result in damage to our reputation.

In March 2018, we were notified by the FRB of New York that its most recent evaluation of the Bank s CRA performance for the time period January 2011 through September 2013, resulted in an overall rating of Needs to Improve. This rating may subject the Bank to enhanced scrutiny in any application for business expansion it files with the Federal Reserve or the NY DFS, which may result in a delay in approving or the denial of such application. In addition, the publication of the Needs to Improve rating may damage our reputation, making it more difficult for us to achieve our business goals and objectives, particularly in the Buffalo and Rochester metropolitan areas.

We make certain assumptions and estimates in preparing our financial statements that may prove to be incorrect, which could significantly impact our results of operations, cash flows and financial condition, and we are subject to new or changing accounting rules and interpretations, and the failure by us to correctly interpret or apply these evolving rules and interpretations could have a material adverse effect.

Accounting principles generally accepted in the United States require us to use certain assumptions and estimates in preparing our financial statements, including in determining credit loss reserves and reserves related to litigation, among other items. Certain of our financial instruments, including available-for-sale securities and certain loans, require a determination of their fair value in order to prepare our financial statements. Where quoted market prices are not available, we may make fair value determinations based on internally developed models or other means, which ultimately rely to some degree on management judgment. Some of these and other assets and liabilities may have no direct observable price levels, making their valuation particularly subjective, as they are based on significant estimation and judgment. In addition, sudden illiquidity in markets or declines in prices of certain loans and securities may make it more difficult to value certain balance sheet items, which may lead to the possibility that such valuations will be subject to further change or adjustment. If assumptions or estimates underlying our financial statements are incorrect, we may experience material losses that would impact our results of operations, cash flows and financial condition.

As indicated in Note 1, Summary of Significant Accounting Policies - Recent Accounting Pronouncements, to the Consolidated Financial Statements included in Item 8 of this Annual Report on Form 10-K, the regulations, rules,

standards, policies, and interpretations underlying GAAP are constantly evolving and may change significantly over time. If we fail to interpret any one or more of these GAAP provisions correctly, or if our methodology in applying them to our financial reporting or disclosures is at all flawed, our financial statements may contain inaccuracies that, if severe enough, could warrant a later restatement by us, which in turn could result in a material adverse event.

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

We have been, and may in the future be, subject to various legal and regulatory proceedings. It is inherently difficult to assess the outcome of these matters, and there can be no assurance that we will prevail in any proceeding or litigation. Legal and regulatory matters of any degree of significance could result in substantial cost and diversion of our efforts, which by itself could have a material adverse effect on our financial condition and operating results. While, as disclosed in Part I, Item 3, Legal Proceedings, our management does not believe that there are any pending or threatened proceedings against us, that, if determined adversely, would have a material adverse effect on our business, results of operations or financial condition, there can be no guarantee that such a proceeding will not arise in the near or long-term future. Further, adverse determinations in such matters could result in actions by our regulators that could materially adversely affect our business, financial condition or results of operations.

We establish reserves for legal claims when payments associated with the claims become probable and the costs can be reasonably estimated. We may still incur legal costs for a matter even if we have not established a reserve. In addition, due to the inherent subjectivity of the assessments and unpredictability of the outcome of legal proceedings, the actual cost of resolving a legal claim may be substantially higher than any amounts reserved for that matter. The ultimate resolution of a pending legal proceeding, depending on the remedy sought and granted, could adversely affect our results of operations and financial condition.

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A breach in security of our or third party information systems, including the occurrence of a cyber incident or a deficiency in cybersecurity, or a failure by us to comply with enhanced New York State cybersecurity regulations, may subject us to liability, result in a loss of customer business or damage our brand image.

We rely heavily on communications, information systems (both internal and provided by third parties) and the internet to conduct our business. Our business depends on our ability to process and monitor a large volume of daily transactions in compliance with legal, regulatory and internal standards and specifications. In addition, a significant portion of our operations relies heavily on the secure processing, storage and transmission of personal and confidential information of our customers and clients. These risks may increase in the future as our customers continue to adapt to mobile payment and other internet-based product offerings and we expand the availability of web-based products and applications.

In addition, several U.S. financial institutions have experienced significant distributed denial-of-service attacks, some of which involved sophisticated and targeted attacks intended to disable or degrade service, or sabotage systems. Other potential attacks have attempted to obtain unauthorized access to confidential information or destroy data, often through the introduction of computer viruses or malware, cyber-attacks and other means. To date, none of these types of attacks have had a material effect on our business or operations. Such security attacks can originate from a wide variety of sources, including persons who are involved with organized crime or who may be linked to terrorist organizations or hostile foreign governments. Those same parties may also attempt to fraudulently induce employees, customers or other users of our systems to disclose sensitive information in order to gain access to our data or that of our customers or clients. We are also subject to the risk that our employees may intercept and transmit unauthorized confidential or proprietary information. An interception, misuse or mishandling of personal, confidential or proprietary information being sent to or received from a customer or third party could result in legal liability, remediation costs, regulatory action and reputational harm, any of which could adversely affect our results of operations and financial condition.

As of March 1, 2017, we are required to comply with new cybersecurity regulations promulgated by the NY DFS that will be phased in between September 2017 and March 2019. Any failure by us to timely and successfully implement some or all of these regulations, which mandate, among other things, the creation of a new cybersecurity program, a written policy, the appointment of an information security officer and certification by the NY DFS, could also result in regulatory sanctions, public disclosure and reputational damage even if we do not experience a significant cybersecurity breach.

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

The financial services market, including banking services, faces rapid changes with frequent introductions of new technology-driven products and services. In addition to better serving customers, the effective use of technology increases efficiency and may enable us to reduce costs. Our future success may depend, in part, on our ability to use technology to provide products and services that provide convenience to customers and to create additional efficiencies in our operations. Some of our competitors have substantially greater resources to invest in technological improvements than we currently have. We may not be able to effectively implement new technology-driven products and services or be successful in marketing these products and services to our customers. As a result, our ability to effectively compete to retain or acquire new business may be impaired, and our business, financial condition or results of operations, may be adversely affected.

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

Third party vendors provide key components of our business infrastructure such as internet connections, network access and core application processing. While we have selected these third party vendors carefully, we do not control their actions. Any problems caused by these third parties, including as a result of them not providing us their services for any reason or them performing their services poorly, could adversely affect our ability to deliver products and services to our customers or otherwise conduct our business efficiently and effectively. Replacing these third party vendors could also entail significant delay and expense.

Third parties perform significant operational services on our behalf. These third-party vendors are subject to similar risks as us relating to cybersecurity, breakdowns or failures of their own systems or employees. One or more of our vendors may experience a cybersecurity event or operational disruption and, if any such event does occur, it may not be adequately addressed, either operationally or financially, by the third-party vendor. Certain of our vendors may have limited indemnification obligations or may not have the financial capacity to satisfy their indemnification obligations. Financial or operational difficulties of a vendor could also impair our operations if those difficulties interfere with the vendor s ability to serve us. If a critical vendor is unable to meet our needs in a timely manner or if the services or products provided by such a vendor are terminated or otherwise delayed and if we are not able to develop alternative sources for these services and products quickly and cost-effectively, it could have a material adverse effect on our business. Federal banking regulators recently issued regulatory guidance on how banks select, engage and manage their outside vendors. These regulations may affect the circumstances and conditions under which we work with third parties and the cost of managing such relationships.

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

We use financial models to aid in planning for various purposes including our capital and liquidity needs, interest rate risk, potential charge-offs, reserves, and other purposes. The models used may not accurately account for all variables that could affect future results, may fail to predict outcomes accurately and/or may overstate or understate certain effects. As a result of these potential failures, we may not adequately prepare for future events and may suffer losses or other setbacks due to these failures.

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

Our success depends, in large part, on our ability to attract and retain skilled people. Competition for highly talented people can be intense, and we may not be able to hire sufficiently skilled people or retain them. Further, the rural location of our principal executive offices and many of our bank branches make it challenging for us to attract skilled people to such locations. The unexpected loss of services of one or more of our key personnel could have a material adverse impact on our business because of their skills, knowledge of our markets, years of industry experience, and the difficulty of promptly finding qualified replacement personnel.

Acquisitions may disrupt our business and dilute shareholder value.

We intend to continue to pursue a growth strategy for our business by expanding our branch network into communities within or adjacent to markets where we currently conduct business. We may consider acquisitions of loans or securities portfolios, lending or leasing firms, commercial and small business lenders, residential lenders, direct banks, banks or bank branches, wealth and investment management firms, securities brokerage firms, specialty finance or other financial services-related companies. We also intend to expand our SDN and Courier subsidiaries by acquiring smaller insurance agencies and wealth management firms in areas which complement our current footprint. We may be unsuccessful in expanding our SDN and Courier subsidiaries through acquisition because of the growing interest in acquiring insurance brokers and wealth management firms, which could make it more difficult for us to identify appropriate targets and could make such acquisitions more expensive. Even if we are able to identify appropriate acquisition targets, we may not have sufficient capital to fund acquisitions or be able to execute transactions on favorable terms. If we are unable to expand our SDN and Courier operations through smaller acquisitions, we may not be able to achieve all of the expected benefits of the SDN and Courier acquisitions, which could adversely affect our results of operations and financial condition.

Acquiring other banks, businesses, or branches involves potential adverse impact to our financial results and various other risks commonly associated with acquisitions, including, among other things:

- difficulty in estimating the value of the target company;
- payment of a premium over book and market values that may dilute our tangible book value and earnings per share in the short and long term;
- potential exposure to unknown or contingent liabilities of the target company;
- exposure to potential asset quality issues of the target company;
- volatility in reported income as goodwill impairment losses could occur irregularly and in varying amounts;
- challenge and expense of integrating the operations and personnel of the target company;

- inability to realize the expected revenue increases, cost savings, increases in geographic or product presence, and / or other projected benefits;
- potential disruption to our business;
- potential diversion of our management s time and attention;
- the possible loss of key employees and customers of the target company;
- potential changes in banking or tax laws or regulations that may affect the target company; and
- additional regulatory burdens associated with new lines of business.

We are subject to interest rate risk.

Our earnings and cash flows depend largely upon our net interest income. Interest rates are highly sensitive to many factors that are beyond our control, including general economic conditions and policies of governmental and regulatory agencies, particularly the Federal Reserve. Changes in monetary policy, including changes in interest rates, could influence not only the interest we receive on loans and investments and the amount of interest we pay on deposits and borrowings, but such changes could also affect (i) our ability to originate loans and obtain deposits; (ii) the fair value of our financial assets and liabilities; and (iii) the average duration of our mortgage-backed securities portfolio and other interest-earning assets. If the interest rates paid on deposits and other borrowings increase at a faster rate than the interest rates received on loans and other investments, our net interest income, and therefore earnings, could be adversely affected. Earnings could also be adversely affected if the interest rates received on loans and other investments fall more quickly than the interest rates paid on deposits and other borrowings.

Any substantial, unexpected or prolonged change in market interest rates could have a material adverse effect on our financial condition and results of operations. Also, our interest rate risk modeling techniques and assumptions likely may not fully predict or capture the impact of actual interest rate changes on our balance sheet.

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

Our financial performance generally, and in particular the ability of borrowers to pay interest on and repay principal of outstanding loans and the value of collateral securing those loans, as well as demand for loans and other products and services we offer, is highly dependent on the business environment in the markets where we operate, in the State of New York and in the United States as a whole. A favorable business environment is generally characterized by, among other factors, economic growth, efficient capital markets, low inflation, low unemployment, high business and investor confidence, and strong business earnings. Unfavorable or uncertain economic and market conditions can be caused by declines in economic growth, business activity or investor or business confidence; limitations on the availability or increases in the cost of credit and capital; increases in inflation or interest rates; high unemployment, natural disasters; or a combination of these or other factors.

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

The policies of the Federal Reserve impact us significantly. The Federal Reserve regulates the supply of money and credit in the United States. Its policies directly and indirectly influence the rate of interest earned on loans and paid on borrowings and interest-bearing deposits and can also affect the value of financial instruments we hold. Those policies determine, to a significant extent, our cost of funds for lending and investing and impact our net interest income, our primary source of revenue. Changes in those policies are beyond our control and are difficult to predict. Federal Reserve policies can also affect our borrowers, potentially increasing the risk that they may fail to repay their loans. For example, a tightening of the money supply by the Federal Reserve could reduce the demand for a borrower s products and services. This could adversely affect the borrower s earnings and ability to repay its loan, which could have a material adverse effect on our financial condition and results of operations.

The soundness of other financial institutions could adversely affect us.

Financial services institutions are interrelated as a result of trading, clearing, counterparty, or other relationships. We have exposure to many different industries and counterparties, and we routinely execute transactions with counterparties in the financial services industry, including commercial banks, brokers and dealers, investment banks, and other institutional clients. Many of these transactions expose us to credit risk in the event of a default by our counterparty or client. In addition, our credit risk may be exacerbated when the collateral held by us cannot be realized or is liquidated at prices not sufficient to recover the full amount of the credit or derivative exposure due us. Any such losses could have a material adverse effect on our financial condition and results of operations.

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

As of December 31, 2017, we had $65.8 million of goodwill and $8.9 million of other intangible assets. Significant and sustained declines in our stock price and market capitalization, significant declines in our expected future cash flows, significant adverse changes in the business climate or slower growth rates, any or all of which could be materially impacted by many of the risk factors discussed herein, may necessitate our taking charges in the future related to the impairment of our goodwill. Future regulatory actions could also have a material impact on assessments of goodwill for impairment. If the fair value of our net assets improves at a faster rate than the market value of our reporting units, or if we were to experience increases in book values of a reporting unit in excess of the increase in fair value of equity, we may also have to take charges related to the impairment of our goodwill. If we were to conclude that a future write-down of our goodwill is necessary, we would record the appropriate charge, which could have a material adverse effect on our results of operations.

Identifiable intangible assets other than goodwill consist of core deposit intangibles and other intangible assets (primarily customer relationships). Adverse events or circumstances could impact the recoverability of these intangible assets including loss of core deposits, significant losses of customer accounts and/or balances, increased competition or adverse changes in the economy. To the extent these intangible assets are deemed unrecoverable, a non-cash impairment charge would be recorded which could have a material adverse effect on our results of operations.

During the fourth quarter of 2015, we determined that the carrying value of our SDN reporting unit exceeded its fair value and recorded a $751 thousand impairment charge. During the second quarter of 2017, we again determined that the carrying value of our SDN reporting unit exceeded its fair value and recorded an additional $1.6 million impairment charge. For further discussion, see Note 1, Summary of Significant Accounting Policies, and Note 7, Goodwill and Other Intangible Assets, to the Consolidated Financial Statements included in Item 8 of this Annual Report on Form 10-K.

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We operate in a highly competitive industry and market area.

We face substantial competition in all areas of our operations from a variety of different competitors, many of which are larger and may have more financial resources. Such competitors primarily include national, regional and internet banks within the markets in which we operate. We also face competition from many other types of financial institutions, including, without limitation, savings and loan associations, credit unions, finance companies, brokerage firms, insurance companies and other financial intermediaries. The financial services industry could become even more competitive as a result of legislative, regulatory and technological changes and continued consolidation. Banks, securities firms and insurance companies can merge under the umbrella of a financial holding company, which can offer virtually any type of financial service, including banking, securities underwriting, insurance (both agency and underwriting), and merchant banking. Also, technology has lowered barriers to entry and made it possible for nonbanks to offer products and services traditionally provided by banks, such as automatic transfer and automatic payment systems. More recently, peer to peer lending has emerged as an alternative borrowing source for our customers and many other non-banks offer lending and payment services in competition with banks. Many of these competitors have fewer regulatory constraints and may have lower cost structures. Additionally, due to their size, many competitors may be able to achieve economies of scale and, as a result, may offer a broader range of products and services as well as better pricing for those products and services than we can.

Our ability to compete successfully depends on a number of factors, including, among other things:

- the ability to develop, maintain and build upon long-term customer relationships based on top quality service, high ethical standards and safe, sound assets;
- the ability to expand our market position;
- the scope, relevance and pricing of products and services offered to meet customer needs and demands;
- the rate at which we introduce new products and services relative to our competitors;
- customer satisfaction with our level of service; and
- industry and general economic trends.

Failure to perform in any of these areas could significantly weaken our competitive position, which could adversely affect our growth and profitability, which, in turn, could have a material adverse effect on our financial condition and results of operations.

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

Severe weather, natural disasters, acts of war or terrorism, and other adverse external events could have a significant impact on our ability to conduct business. Such events could affect the operations of our bank branches, stability of

our deposit base, impair the ability of borrowers to repay outstanding loans, impair the value of collateral securing loans, cause significant property damage, result in loss of revenue, and/or cause us to incur additional expenses. The occurrence of any such event could have a material adverse effect on our business, which, in turn, could have a material adverse effect on our financial condition and results of operations.

Liquidity is essential to our businesses.

Our liquidity could be impaired by an inability to access the capital markets or unforeseen outflows of cash. Reduced liquidity may arise due to circumstances that we may be unable to control, such as a general market disruption or an operational problem that affects third parties or us. Our efforts to monitor and manage liquidity risk may not be successful or sufficient to deal with dramatic or unanticipated reductions in our liquidity. In such events, our cost of funds may increase, thereby reducing our net interest income, or we may need to sell a portion of our investment and/or loan portfolio, which, depending upon market conditions, could result in us realizing a loss.

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

We may need to raise additional capital in the future to provide sufficient capital resources and liquidity to meet our commitments and business needs. Our ability to raise additional capital, if needed, will depend on our financial performance and, among other things, conditions in the capital markets at that time which is outside of our control.

In addition, we are highly regulated, and our regulators could require us to raise additional common equity in the future. We and our regulators perform a variety of analyses of our assets, including the preparation of stress case scenarios, and as a result of those assessments we could determine, or our regulators could require us, to raise additional capital.

We cannot assure that required capital will be available on acceptable terms or at all. Any occurrence that may limit our access to the capital markets, such as a decline in the confidence of debt purchasers, depositors of the Bank or counterparties participating in the capital markets, or a downgrade of our debt rating, may adversely affect our capital costs and ability to raise capital and, in turn, our liquidity. An inability to raise additional capital on acceptable terms when needed could have a material adverse impact on our business, financial condition, results of operations or liquidity.

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

We are a separate and distinct legal entity from our subsidiaries. A substantial portion of our revenue comes from dividends from our Bank subsidiary. These dividends are the principal source of funds we use to pay dividends on our common and preferred stock, and to pay interest and principal on our debt. Federal and/or state laws and regulations limit the amount of dividends that our Bank subsidiary may pay to us. Also, our right to participate in a distribution of assets upon a subsidiary s liquidation or reorganization is subject to the prior claims of the subsidiary s creditors. In the event our Bank subsidiary is unable to pay dividends to us, we may not be able to service debt, pay obligations, or pay dividends on our common and preferred stock. The inability to receive dividends from our Bank subsidiary could have a material adverse effect on our business, financial condition, and results of operations.

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

Holders of our common stock are only entitled to receive such dividends as our Board of Directors may declare out of funds legally available for such payments. Although we have historically declared cash dividends on our common stock, we are not required to do so and may reduce or eliminate our common stock dividend in the future. This could adversely affect the market price of our common stock.

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

In the future, we may attempt to increase our capital resources by entering into debt or debt-like financing that is unsecured or secured by all or up to all of our assets, or by issuing additional debt or equity securities, which could include issuances of secured or unsecured commercial paper, medium-term notes, senior notes, subordinated notes, preferred stock or securities convertible into or exchangeable for equity securities. In the event of our liquidation, our lenders and holders of our debt and preferred securities would receive a distribution of our available assets before distributions to the holders of our common stock. Because our decision to incur debt and issue securities in our future offerings will depend on market conditions and other factors beyond our control, we cannot predict or estimate the amount, timing or nature of our future offerings and debt financings. Further, market conditions could require us to accept less favorable terms for the issuance of our securities in the future. We may also issue additional shares of our common stock or securities convertible into or exchangeable for our common stock that could dilute our current shareholders and effect the value of our common stock.

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

Provisions of our certificate of incorporation, our bylaws, and federal and state banking laws, including regulatory approval requirements, could make it more difficult for a third party to acquire us, even if doing so would be perceived to be beneficial to our shareholders. The combination of these provisions may discourage others from initiating a potential merger, takeover or other change of control transaction, which, in turn, could adversely affect the market price of our common stock.

The market price of our common stock may fluctuate significantly in response to a number of factors.

Our quarterly and annual operating results have varied in the past and could vary significantly in the future, which makes it difficult for us to predict our future operating results. Our operating results may fluctuate due to a variety of factors, many of which are outside of our control, including the changing U.S. economic environment and changes in the commercial and residential real estate market, any of which may cause our stock price to fluctuate. If our operating

results fall below the expectations of investors or securities analysts, the price of our common stock could decline substantially. Our stock price can fluctuate significantly in response to a variety of factors including, among other things:

- volatility of stock market prices and volumes in general;
- changes in market valuations of similar companies;
- changes in conditions in credit markets;
- changes in accounting policies or procedures as required by the Financial Accounting Standards Board, or FASB, or other regulatory agencies;
- legislative and regulatory actions (including the impact of the Dodd-Frank Act and related regulations) subjecting us to additional regulatory oversight which may result in increased compliance costs and/or require us to change our business model;
- government intervention in the U.S. financial system and the effects of and changes in trade and monetary and fiscal policies and laws, including the interest rate policies of the Federal Reserve Board;
- additions or departures of key members of management;
- fluctuations in our quarterly or annual operating results; and
- changes in analysts estimates of our financial performance.

ITEM 1B. UNRESOLVED STAFF COMMENTS

None.

ITEM 2. PROPERTIES

We own a 27,400 square foot building in Warsaw, New York that serves as our headquarters, and principal executive and administrative offices. We lease a 52,300 square foot regional administrative facility located in Rochester, New York. This lease expires in August 2027, with options for two additional ten-year extensions.

We are engaged in the banking business through 53 branch offices, of which 35 are owned and 18 are leased, in the following fifteen contiguous counties of Western and Central New York: Allegany, Cattaraugus, Cayuga, Chautauqua, Chemung, Erie, Genesee, Livingston, Monroe, Ontario, Orleans, Seneca, Steuben, Wyoming and Yates Counties. The operating leases for our branch offices expire at various dates through the year 2047 and generally include options to renew. The Bank also has administrative operations at a leased facility in Amherst, New York.

SDN operates from a leased 14,400 square foot office located in Williamsville, New York. The lease for such space, which is used by SDN and several of our Bank s commercial lenders, extends through September 2021. SDN also leases one retail location.

Courier Capital operates from an owned 11,000 square foot office, located in Buffalo, New York. Courier Capital also has operations at a leased facility in Amherst, New York and an owned facility in Jamestown, New York.

We believe that our properties have been adequately maintained, are in good operating condition and are suitable for our business as presently conducted, including meeting the prescribed security requirements. For additional information, see Note 6, Premises and Equipment, Net, and Note 11, Commitments and Contingencies, in the accompanying financial statements included in Part II, Item 8, of this Annual Report on Form 10-K.

ITEM 3. LEGAL PROCEEDINGS

From time to time we are a party to or otherwise involved in legal proceedings arising out of the normal course of business. Management does not believe that there is any pending or threatened proceeding against us, which, if determined adversely, would have a material adverse effect on our business, results of operations or financial condition.

ITEM 4. MINE SAFETY DISCLOSURES

Not applicable.

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PART II

ITEM 5. MARKET FOR REGISTRANT S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

Our common stock is traded on the NASDAQ Global Select Market under the ticker symbol FISI. At February 23, 2018, 15,904,403 shares of our common stock were outstanding and held by approximately 3,400 shareholders of record. During 2017, the high sales price of our common stock was $35.40 and the low sales price was $25.65. The closing price per share of our common stock on December 29, 2017, the last trading day of our fiscal year, was $31.10. We declared dividends of $0.85 per common share during the year ended December 31, 2017. See additional information regarding the market price and dividends paid in Part II, Item 6, Selected Financial Data.

We have paid regular quarterly cash dividends on our common stock and our Board of Directors presently intends to continue this practice, subject to our results of operations and the need for those funds for debt service and other purposes. See the discussions in the section captioned Supervision and Regulation included in Part I, Item 1, Business, in the section captioned Liquidity and Capital Resources included in Part II, Item 7, in Management s Discussion and Analysis of Financial Condition and Results of Operations and in Note 12, Regulatory Matters, in the accompanying financial statements included in Part II, Item 8, Financial Statements and Supplementary Data, all of which are included elsewhere in this report and incorporated herein by reference thereto.

Stock Performance Graph

The stock performance graph below compares (a) the cumulative total return on our common stock for the period beginning December 31, 2012 as reported by the NASDAQ Global Select Market, through December 31, 2017, (b) the cumulative total return on stocks included in the NASDAQ Composite Index over the same period, and (c) the cumulative total return, as compiled by S&P Global Market Intelligence, formerly SNL Financial LC (SNL), of Major Exchange (NYSE, NYSE MKT and NASDAQ) Banks with $1 billion to $5 billion in assets over the same period. Cumulative return assumes the reinvestment of dividends. The graph was prepared by S&P Global Market Intelligence and is expressed in dollars based on an assumed investment of $100.

	Period Ending					
Index	**12/31/12**	**12/31/13**	**12/31/14**	**12/31/15**	**12/31/16**	**12/31/17**
Financial Institutions, Inc.	100.00	137.52	144.64	166.38	208.99	195.36
NASDAQ Composite	100.00	140.12	160.78	171.97	187.22	242.71
SNL Bank $1B-$5B Index	100.00	145.41	152.04	170.20	244.85	261.04

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ITEM 6. SELECTED FINANCIAL DATA

(Dollars in thousands, except per share data)	At or for the year ended December 31,				
	2017	**2016**	**2015**	**2014**	**2013**
Selected financial condition data:					
Total assets	$ 4,105,210	$ 3,710,340	$ 3,381,024	$ 3,089,521	$ 2,928,636
Loans, net	2,700,345	2,309,227	2,056,677	1,884,365	1,806,883
Investment securities	1,041,439	1,083,264	1,030,112	916,932	859,185
Deposits	3,210,174	2,995,222	2,730,531	2,450,527	2,320,056
Borrowings	485,331	370,561	332,090	334,804	337,042
Shareholders equity	381,177	320,054	293,844	279,532	254,839
Common shareholders equity	363,848	302,714	276,504	262,192	237,497
Tangible common shareholders equity[(1)]	289,145	227,074	209,558	193,553	187,495
Selected operations data:					
Interest income	$ 130,110	$ 115,231	$ 105,450	$ 101,055	$ 98,931
Interest expense	17,495	12,541	10,137	7,281	7,337
Net interest income	112,615	102,690	95,313	93,774	91,594
Provision for loan losses	13,361	9,638	7,381	7,789	9,079
Net interest income after provision for loan losses	99,254	93,052	87,932	85,985	82,515
Noninterest income	34,730	35,760	30,337	25,350	24,833
Noninterest expense	90,513	84,671	79,393	72,355	69,441
Income before income taxes	43,471	44,141	38,876	38,980	37,907
Income tax expense	9,945	12,210	10,539	9,625	12,377
Net income	$ 33,526	$ 31,931	$ 28,337	$ 29,355	$ 25,530
Preferred stock dividends	1,462	1,462	1,462	1,462	1,466
Net income available to common shareholders	$ 32,064	$ 30,469	$ 26,875	$ 27,893	$ 24,064
Stock and related per share data:					
Earnings per common share:					
Basic	$ 2.13	$ 2.11	$ 1.91	$ 2.01	$ 1.75
Diluted	$ 2.13	$ 2.10	$ 1.90	$ 2.00	$ 1.75
Cash dividends declared per common share	$ 0.85	$ 0.81	$ 0.80	$ 0.77	$ 0.74
Common book value per share	$ 22.85	$ 20.82	$ 19.49	$ 18.57	$ 17.17
Tangible common book value per share [(1)]	$ 18.16	$ 15.62	$ 14.77	$ 13.71	$ 13.56

Market price (NASDAQ: FISI):					
High	$ 35.40	$ 34.55	$ 29.04	$ 27.02	$ 26.59
Low	$ 25.65	$ 25.98	$ 21.67	$ 19.72	$ 17.92
Close	$ 31.10	$ 34.20	$ 28.00	$ 25.15	$ 24.71

(1) This is a non-GAAP measure that we believe is useful in understanding our financial performance and condition. Refer to the GAAP to Non-GAAP Reconciliation for further information.

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(Dollars in thousands)	At or for the year ended December 31,				
	2017	**2016**	**2015**	**2014**	**2013**
Performance ratios:					
Net income, returns on:					
Average assets	0.86%	0.90%	0.87%	0.98%	0.91%
Average equity	9.62%	10.01%	9.78%	10.80%	10.10%
Average common equity	9.68%	10.10%	9.87%	10.96%	10.23%
Average tangible common equity (1)	12.51%	13.51%	13.16%	14.12%	13.00%
Average tangible assets (1)	0.84%	0.88%	0.84%	0.95%	0.87%
Common dividend payout ratio	39.91%	38.39%	41.88%	38.31%	42.29%
Net interest margin (fully tax-equivalent)	3.21%	3.24%	3.28%	3.50%	3.64%
Effective tax rate	22.9%	27.7%	27.1%	24.7%	32.7%
Efficiency ratio (2)	60.65%	60.95%	62.44%	59.18%	58.92%
Capital ratios:					
Leverage ratio (3)	8.13%	7.36%	7.41%	7.35%	7.63%
Common equity Tier 1 capital ratio (3)	10.16%	9.59%	9.77%	n/a	n/a
Tier 1 capital ratio (3)	10.74%	10.26%	10.50%	10.47%	10.82%
Total risk-based capital ratio (3)	13.19%	12.97%	13.35%	11.72%	12.08%
Average equity to average assets	8.95%	8.99%	8.86%	9.08%	9.01%
Common equity to assets	8.86%	8.16%	8.18%	8.49%	8.11%
Tangible common equity to tangible assets (1)	7.17%	6.25%	6.32%	6.41%	6.51%
Asset quality:					
Non-performing loans	$ 12,531	$ 6,326	$ 8,440	$ 10,153	$ 16,622
Non-performing assets	$ 12,679	$ 6,433	$ 8,603	$ 10,347	$ 17,083
Allowance for loan losses	$ 34,672	$ 30,934	$ 27,085	$ 27,637	$ 26,736
Net loan charge-offs	$ 9,623	$ 5,789	$ 7,933	$ 6,888	$ 7,057
Non-performing loans to total loans	0.46%	0.27%	0.41%	0.53%	0.91%
Non-performing assets to total assets	0.31%	0.17%	0.25%	0.33%	0.58%
Net charge-offs to average loans	0.38%	0.26%	0.40%	0.37%	0.40%
Allowance for loan losses to total loans	1.27%	1.32%	1.30%	1.45%	1.46%
Allowance for loan losses to non-performing loans	277%	489%	321%	272%	161%
Other data:					
Number of branches	53	52	50	49	50
Full time equivalent employees	639	631	660	622	608

(1) This is a non-GAAP measure that we believe is useful in understanding our financial performance and condition. Refer to the GAAP to Non-GAAP Reconciliation for further information.

(2) Efficiency ratio provides a ratio of operating expenses to operating income. Efficiency ratio is calculated by dividing noninterest expense by net revenue, which is defined as the sum of tax-equivalent net interest income and noninterest income before net gains on investment securities. The efficiency ratio is not a financial

measurement required by GAAP. However, the efficiency ratio is used by management in its assessment of financial performance specifically as it relates to noninterest expense control. Management also believes such information is useful to investors in evaluating Company performance.

(3) 2017, 2016 and 2015 ratios calculated under Basel III rules, which became effective January 1, 2015.

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GAAP to Non-GAAP Reconciliation

(In thousands, except per share data)	At or for the year ended December 31,				
	2017	**2016**	**2015**	**2014**	**2013**
Computation of ending tangible common equity:					
Common shareholders equity	$ 363,848	$ 302,714	$ 276,504	$ 262,192	$ 237,497
Less: goodwill and other intangible assets, net	74,703	75,640	66,946	68,639	50,002
Tangible common equity	$ 289,145	$ 227,074	$ 209,558	$ 193,553	$ 187,495
Computation of ending tangible assets:					
Total assets	$ 4,105,210	$ 3,710,340	$ 3,381,024	$ 3,089,521	$ 2,928,636
Less: goodwill and other intangible assets, net	74,703	75,640	66,946	68,639	50,002
Tangible assets	$ 4,030,507	$ 3,634,700	$ 3,314,078	$ 3,020,882	$ 2,878,634
Tangible common equity to tangible assets (1)	7.17%	6.25%	6.32%	6.41%	6.51%
Common shares outstanding	15,925	14,538	14,191	14,118	13,829
Tangible common book value per share (2)	$ 18.16	$ 15.62	$ 14.77	$ 13.71	$ 13.56
Computation of average tangible common equity:					
Average common equity	$ 331,184	$ 301,666	$ 272,367	$ 254,533	$ 235,290
Average goodwill and other intangible assets, net	74,818	76,170	68,138	57,039	50,201
Average tangible common equity	$ 256,366	$ 225,496	$ 204,229	$ 197,494	$ 185,089
Computation of average tangible assets:					
Average assets	$ 3,896,071	$ 3,547,105	$ 3,269,890	$ 2,994,604	$ 2,803,825
Average goodwill and other intangible assets, net	74,818	76,170	68,138	57,039	50,201
Average tangible assets	$ 3,821,253	$ 3,470,935	$ 3,210,752	$ 2,937,565	$ 2,753,624

Net income available to common shareholders	$	32,064	$	30,469	$	26,875	$	27,893	$	24,064
Return on average tangible common equity [3]		12.51%		13.51%		13.16%		14.12%		13.00%
Return on average tangible assets [4]		0.84%		0.88%		0.84%		0.95%		0.87%

(1) Tangible common equity divided by tangible assets.

(2) Tangible common equity divided by common shares outstanding.

(3) Net income available to common shareholders divided by average tangible common equity.

(4) Net income available to common shareholders divided by average tangible assets.

This table contains disclosure that includes calculations for tangible common equity, tangible assets, tangible common equity to tangible assets, tangible common book value per share, average tangible common equity, average tangible assets, return on average tangible common equity and return on average tangible assets, which are determined by methods other than in accordance with GAAP. We believe that these non-GAAP measures are useful to our investors as measures of the strength of our capital and ability to generate earnings on tangible common equity invested by our shareholders. These non-GAAP measures provide supplemental information that may help investors to analyze our capital position without regard to the effects of intangible assets. Non-GAAP financial measures have inherent limitations and are not uniformly utilized by issuers. Therefore, these non-GAAP financial measures should not be considered in isolation, or as a substitute for comparable measures prepared in accordance with GAAP.

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SELECTED QUARTERLY DATA

(Dollars in thousands, except per share data)	Fourth Quarter	Third Quarter	Second Quarter	First Quarter
2017				
Interest income	$ 34,767	$ 33,396	$ 31,409	$ 30,538
Interest expense	5,007	4,958	3,987	3,543
Net interest income	29,760	28,438	27,422	26,995
Provision for loan losses	3,946	2,802	3,832	2,781
Net interest income after provision for loan losses	25,814	25,636	23,590	24,214
Noninterest income	8,987	8,574	9,333	7,836
Noninterest expense	23,163	22,467	23,941	20,942
Income before income taxes	11,638	11,743	8,982	11,108
Income tax expense	580	3,464	2,736	3,165
Net income	$ 11,058	$ 8,279	$ 6,246	$ 7,943
Preferred stock dividends	365	366	366	365
Net income applicable to common shareholders	$ 10,693	$ 7,913	$ 5,880	$ 7,578
Earnings per common share [1]:				
Basic	$ 0.68	$ 0.52	$ 0.40	$ 0.52
Diluted	0.68	0.52	0.40	0.52
Market price (NASDAQ: FISI):				
High	$ 34.10	$ 31.15	$ 35.35	$ 35.40
Low	28.70	25.65	29.09	30.50
Close	31.10	28.80	29.80	32.95
Cash dividends declared per common share	$ 0.22	$ 0.21	$ 0.21	$ 0.21
2016				
Interest income	$ 29,990	$ 29,360	$ 28,246	$ 27,635
Interest expense	3,268	3,310	3,047	2,916
Net interest income	26,722	26,050	25,199	24,719
Provision for loan losses	3,357	1,961	1,952	2,368
Net interest income after provision for loan losses	23,365	24,089	23,247	22,351
Noninterest income	9,088	8,539	8,916	9,217
Noninterest expense	20,715	20,618	22,120	21,218
Income before income taxes	11,738	12,010	10,043	10,350

Income tax expense		3,045		3,541		2,892		2,732
Net income	$	8,693	$	8,469	$	7,151	$	7,618
Preferred stock dividends		365		366		366		365
Net income applicable to common shareholders	$	8,328	$	8,103	$	6,785	$	7,253
Earnings per common share [1]:								
Basic	$	0.58	$	0.56	$	0.47	$	0.50
Diluted		0.57		0.56		0.47		0.50
Market price (NASDAQ: FISI):								
High	$	34.55	$	27.63	$	29.49	$	29.53
Low		25.98		25.16		24.56		25.38
Close		34.20		27.11		26.07		29.07
Cash dividends declared per common share	$	0.21	$	0.20	$	0.20	$	0.20

[1] Earnings per share data is computed independently for each of the quarters presented. Therefore, the sum of the quarterly earnings per common share amounts may not equal the total for the year.

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2017 FOURTH QUARTER RESULTS

Net income was $11.1 million for the fourth quarter of 2017 compared with $8.7 million for the fourth quarter of 2016. After preferred dividends, net income available to common shareholders for the fourth quarter of 2017 was $10.7 million or $0.68 per diluted share, compared to $8.3 million or $0.57 per share in the fourth quarter of 2016.

Net interest income was $29.8 million for the fourth quarter of 2017 compared with $26.7 million for the fourth quarter of 2016. The increase was primarily related to an increase in average interest-earning assets of $331.6 million, led by a $349.6 million increase in loans.

The provision for loan losses was $3.9 million for the fourth quarter of 2017 compared with $3.4 million for the fourth quarter of 2016. Net charge-offs for the fourth quarter of 2017 were $3.6 million, or 0.54% annualized, of average loans, compared to $1.8 million, or 0.30% annualized, of average loans in the fourth quarter of 2016.

Noninterest income was $9.0 million for the fourth quarter of 2017 compared to $9.1 million in the fourth quarter of 2016.

Noninterest expense was $23.2 million for the fourth quarter of 2017 compared to $20.7 million in the fourth quarter of 2016. The increase was the result of higher salaries and employee benefits related to organic growth initiatives, higher healthcare costs largely attributable to the high cost of specialty pharmaceuticals; higher occupancy and equipment expense related to 2016 and 2017 branch openings and relocation of the Rochester regional administration center; higher computer and data processing expense in connection with technology upgrades; and an increase in advertising and promotions expense related to development of a rebranding initiative launched in the first quarter of 2018.

Income tax expense was $580 thousand in the fourth quarter of 2017, representing an effective tax rate of 5.0%, compared to $3.0 million in the fourth quarter of 2016, representing an effective tax rate of 25.9%. The decrease in income tax expense and lower effective tax rate was the result of an estimated $2.9 million reduction in income tax expense due to the TCJ Act, primarily driven by a revaluation adjustment to our net deferred tax liability. Effective tax rates are impacted by items of income and expense that are not subject to federal or state taxation. Our effective tax rates differ from the statutory rates primarily due to the effect of interest income from tax-exempt securities, earnings on company owned life insurance, the non-cash fair value adjustment of the contingent consideration liability associated with the SDN acquisition, the 2017 non-cash goodwill impairment charge related to SDN and, in 2017, the net impact of the TCJ Act, as described above.

ITEM 7. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following is a discussion and analysis of our financial position and results of operations and should be read in conjunction with the information set forth under Part I, Item 1A, Risks Factors, and our consolidated financial statements and notes thereto appearing under Part II, Item 8, Financial Statements and Supplementary Data of this Annual Report on Form 10-K.

INTRODUCTION

Financial Institutions, Inc. (the Parent and together with all its subsidiaries, we, our, or us), is a financial hold company headquartered in New York State. We offer a broad array of deposit, lending, and other financial services to individuals, municipalities and businesses in Western and Central New York through our wholly-owned New York chartered banking subsidiary, Five Star Bank (the Bank). Our indirect lending network includes relationships with franchised automobile dealers in Western and Central New York, the Capital District of New York and Northern and Central Pennsylvania. We offer insurance services through our wholly-owned subsidiary, Scott Danahy Naylon, LLC (SDN), a full service insurance agency. In addition, we offer customized investment management, investment consulting and retirement plan services through our wholly-owned subsidiary Courier Capital, LLC (Courier Capital), an SEC-registered investment advisory and wealth management firm.

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

EXECUTIVE OVERVIEW

2017 Financial Performance Review

During 2017 we continued to execute on our growth and diversification strategy and we progressed in growing our core banking franchise. We delivered year-over-year increases in both total loans and total deposits of 17% and 7%, respectively, which drove our revenue higher. We completed an at-the-market equity offering (ATM Offering) that generated $38.3 million in net proceeds, positioning us for future growth; added eight mortgage loan officers plus underwriting and servicing support staff, significantly expanding our residential mortgage lending capacity; and acquired a Buffalo-area wealth management firm, furthering our strategy to increase fee-based noninterest income. We also surpassed $4 billion in total assets during the year, a significant milestone for us.

Net income for 2017 was $33.5 million, compared to $31.9 million for 2016. This resulted in a 0.86% return on average assets and a 9.62% return on average equity. Net income available to common shareholders was $32.1 million or $2.13 per diluted share for 2017, compared to $30.5 million or $2.10 per diluted share for 2016. We declared cash

dividends of $0.85 during 2017, an increase of $0.04 per common share or 5% compared to the prior year.

Fully-taxable equivalent net interest income was $115.8 million in 2017, an increase of $9.9 million, or 9%, compared with 2016. This reflected the impact of 10% growth in average interest-earning assets, partially offset by a three basis point decline in the net interest margin to 3.21%.

The provision for loan losses increased $3.7 million, or 39%, from 2016 as our allowance for loan losses reflects growth in our loan portfolio. Net charge-offs increased $3.8 million from the prior year to $9.6 million in 2017. Net charge-offs were an annualized 0.38% of average loans in the current year compared to 0.26% in 2016. In addition, non-performing loans increased $6.2 million compared to a year ago to $12.5 million, or 0.46% of total loans.

Noninterest income totaled $34.7 million for the full year 2017, a decrease of $1.0 million or 3% when compared to the prior year. Investment advisory income increased by $896 thousand to $6.1 million during the current year reflecting higher assets under management driven by the acquisition of the assets of Robshaw & Julian and favorable market conditions. Income from company owned life insurance decreased to $1.8 million in 2017 from $2.8 million in the prior year, as the first quarter of 2016 included $911 thousand of death benefit proceeds. In addition, the net gain on investment securities decreased by $1.4 million. During both 2017 and 2016, we recognized non-cash fair value adjustments of the contingent consideration liability related to the SDN acquisition that resulted in noninterest income of $1.2 million. The fair value of the contingent consideration liability was recorded at the time of the SDN acquisition as a component of the purchase price.

MANAGEMENT S DISCUSSION AND ANALYSIS

Noninterest expense for the full year 2017 totaled $90.5 million, a $5.8 million increase compared to $84.7 million in the prior year. Salaries and benefits expense increased $3.5 million year-over-year, due to our organic growth initiatives and higher healthcare costs largely attributable to the high cost of specialty pharmaceuticals. Also contributing to the increase were higher occupancy and equipment expense, computer and data processing expense, advertising and promotions expense and a $1.6 million goodwill impairment charge related to the SDN acquisition. Partially offsetting, professional services decreased $1.7 million year-over-year, primarily in connection with the Company s 2016 proxy contest.

Income tax expense for the year was $9.9 million, representing an effective tax rate of 22.9% compared with an effective tax rate of 27.7% in 2016. The decrease in income tax expense and lower effective tax rate was the result of an estimated $2.9 million reduction in income tax expense due to the TCJ Act, primarily driven by a revaluation adjustment to the net deferred tax liability.

Total assets were $4.11 billion at December 31, 2017, up $394.9 million from $3.71 billion at December 31, 2016. The increase was largely the result of loan growth funded by deposit growth, short-term borrowings and proceeds from the ATM Offering. Total loans were $2.74 billion at December 31, 2017, up $394.9 million, or 17%, from December 31, 2016.

- Commercial mortgage loans totaled $808.9 million, up $138.9 million, or 21%, from December 31, 2016.
- Commercial business loans totaled $450.3 million, up $100.8 million, or 29%, from December 31, 2016.
- Residential real estate loans totaled $465.3 million, up $37.3 million, or 9%, from December 31, 2016.
- Consumer indirect loans totaled $876.6 million, up $124.1 million, or 16%, from December 31, 2016.

Total deposits were $3.21 billion at December 31, 2017, an increase of $215.0 million from December 31, 2016, which was primarily the result of successful business development efforts in both municipal and retail banking. Short-term borrowings were $446.2 million at December 31, 2017, up $114.7 million from December 31, 2016.

Shareholders equity was $381.2 million at December 31, 2017, compared to $320.1 million at December 31, 2016. Common book value per share was $22.85 at December 31, 2017, an increase of $2.03 or 10% from $20.82 at December 31, 2016. The increase in shareholders equity as compared to December 31, 2016, is attributable to common stock issued through the ATM Offering plus net income less dividends paid, net of the change in pension and post-retirement obligations, a component of accumulated other comprehensive loss.

The Company s leverage ratio was 8.13% at December 31, 2017 compared to 7.36% at December 31, 2016. The increase in the leverage ratio was due to capital raised in the 2017 ATM Offering. The Bank s leverage ratio and total risk-based capital ratio were 8.75% and 12.73%, respectively, at December 31, 2017.

RESULTS OF OPERATIONS FOR THE YEARS ENDED

DECEMBER 31, 2017 AND DECEMBER 31, 2016

Net Interest Income and Net Interest Margin

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

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

MANAGEMENT S DISCUSSION AND ANALYSIS

The Federal Reserve influences the general market rates of interest, which impacts the deposit and loan rates offered by many financial institutions. The intended federal funds rate, which is the cost of immediately available overnight funds, was increased by 25 basis points in each of March, June and December 2017, resulting in a range of 1.25% to 1.50% at year-end 2017. The Federal Reserve had previously increased the intended federal funds rate by 25 basis points to a range of 0.50% to 0.75% in December 2016 and by 25 basis points to a range of 0.25% to 0.50% in December 2015. Prior to that, the intended federal funds rate had remained at a range of zero to 0.25% since 2008. Our loan portfolio is significantly affected by changes in the prime interest rate and changes in the prime interest rate generally follow changes in the federal funds rate. The prime interest rate, which is the rate offered on loans to borrowers with strong credit, increased to 4.50% in December 2017, reflecting the three 25 basis point increases in 2017, after the previous 25 basis point increase to 3.75% in December 2016 and 25 basis point increase to 3.50% in December 2015. Prior to that, the prime interest rate had remained at 3.25% since 2008.

Net Interest Income and Net Interest Margin

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

	2017	2016	2015
Interest income per consolidated statements of income	$ 130,110	$ 115,231	$ 105,450
Adjustment to fully taxable equivalent basis	3,160	3,172	3,097
Interest income adjusted to a fully taxable equivalent basis	133,270	118,403	108,547
Interest expense per consolidated statements of income	17,495	12,541	10,137
Net interest income on a taxable equivalent basis	$ 115,775	$ 105,862	$ 98,410

Net interest income on a taxable equivalent basis for 2017 increased $9.9 million or 9%, compared to 2016. The increase was due to an increase in average interest-earning assets of $339.5 million or 10% compared to 2016. The net interest margin of 3.21% for 2017 declined three basis points compared to 3.24% in 2016. This decrease was a function of a five basis point decrease in interest rate spread to 3.08% during 2017, partially offset by a two basis point higher contribution from net free funds. The lower interest rate spread was a net result of a seven basis point increase in the yield on earning assets and a 12 basis point increase in the cost of interest-bearing liabilities.

For the year ended December 31, 2017, the yield on average earning assets of 3.69% was seven basis points higher than 2016. Loan yields increased four basis points during 2017 to 4.22%. The yield on investment securities increased three basis points during 2017 to 2.48%. Overall, the earning asset rate changes increased interest income by $1.2 million during 2017 and a favorable volume variance increased interest income by $13.7 million, which collectively drove a $14.9 million increase in interest income.

Average interest-earning assets were $3.61 billion for 2017, an increase of $339.5 million or 10% from the prior year, with average loans up $312.5 million, average securities up $23.1 million and average federal funds sold and other interest-earning deposits up $3.9 million. Average loans were $2.52 billion for 2017, an increase of $312.5 million or

14% from the prior year. The growth in average loans reflected increases in most loan categories, which in turn reflects the impact of our growth strategy, with commercial loans up $169.1 million, residential real estate loans up $34.1 million, and consumer loans up $115.1 million, partially offset by a $5.8 million decrease in residential real estate lines. Loans made up 69.7% of average interest-earning assets during 2017 compared to 67.4% during 2016. Loans generally have significantly higher yields compared to securities and federal funds sold and interest-bearing deposits and, as such, have a more positive effect on the net interest margin. The yield on average loans was 4.22% for 2017, an increase of four basis points compared to 4.18% for 2016. The increase in the volume of average loans resulted in a $13.2 million increase in interest income, in addition to a $830 thousand increase due to the favorable rate variance. Average securities were $1.09 billion for 2017, an increase of $23.1 million or 2% from the prior year. Securities made up 30.1% of average interest-earning assets in 2017 compared to 32.5% in 2016. The taxable equivalent yield on average securities was 2.48% in 2017 compared to 2.45% in 2016. The increase in the volume of average securities resulted in a $531 thousand increase in interest income, in addition to a $295 thousand increase due to the favorable rate variance.

For the year ended December 31, 2017, the cost of average interest-bearing liabilities of 0.61% was 12 basis points higher than 2016. The cost of average interest-bearing deposits increased eight basis points to 0.45%, the cost of short-term borrowings increased 51 basis points to 1.16% in 2017 compared to 2016 and the cost of long-term borrowings decreased one basis point to 6.32%. Overall, interest-bearing liability rate and volume increases resulted in $5.0 million of higher interest expense.

Average interest-bearing liabilities of $2.85 billion in 2017 were $278.8 million or 11% higher than 2016. On average, interest-bearing deposits grew $189.3 million, while noninterest-bearing demand deposits (a principal component of net free funds) were up $41.5 million. The increase in average deposits was due to successful business development efforts. Overall, interest-bearing deposit rate and volume changes resulted in $2.6 million of higher interest expense during 2017. Average short-term and long-term borrowings were $377.5 million in 2017, $89.5 million higher than in 2016. Overall, short and long-term borrowing rate and volume changes resulted in $2.3 million of higher interest expense during 2017.

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MANAGEMENT S DISCUSSION AND ANALYSIS

The following tables present, for the periods indicated, information regarding: (i) the average balance sheet; (ii) the amount of interest income from interest-earning assets and the resulting annualized yields (tax-exempt yields have been adjusted to a tax-equivalent basis using the applicable Federal tax rate in each year); (iii) the amount of interest expense on interest-bearing liabilities and the resulting annualized rates; (iv) net interest income; (v) net interest rate spread; (vi) net interest income as a percentage of average interest-earning assets (net interest margin); and (vii) the ratio of average interest-earning assets to average interest-bearing liabilities. Investment securities are at amortized cost for both held to maturity and available for sale securities. Loans include net unearned income, net deferred loan fees and costs and non-accruing loans. Dollar amounts are shown in thousands.

	Years ended December 31,								
	2017			2016			2015		
	Average Balance	Interest	Average Rate	Average Balance	Interest	Average Rate	Average Balance	Interest	Average Rate
Interest-earning assets:									
Federal funds sold and other interest-earning deposits	$ 7,060	$ 73	1.04%	$ 3,116	$ 18	0.56%	$ 37	$ -	0.40%
Investment securities:									
Taxable	788,923	17,886	2.27	767,371	17,025	2.22	727,564	16,123	2.22
Tax-exempt	297,377	9,029	3.04	295,850	9,064	3.06	286,607	8,849	3.09
Total investment securities	1,086,300	26,915	2.48	1,063,221	26,089	2.45	1,014,171	24,972	2.46
Loans:									
Commercial business	396,319	17,400	4.39	336,633	14,091	4.19	286,019	11,774	4.12
Commercial mortgage	727,849	34,019	4.67	618,436	28,465	4.60	522,328	24,136	4.62
Residential real estate loans	438,586	16,409	3.74	404,456	15,722	3.89	366,032	15,053	4.11
Residential real estate lines	118,797	4,838	4.07	124,635	4,734	3.80	128,525	4,669	3.63
Consumer indirect	819,598	31,551	3.85	703,975	27,190	3.86	665,454	25,746	3.87
Other consumer	17,111	2,065	12.07	17,620	2,094	11.89	18,969	2,197	11.58
Total loans	2,518,260	106,282	4.22	2,205,755	92,296	4.18	1,987,327	83,575	4.21
Total interest-earning	3,611,620	133,270	3.69	3,272,092	118,403	3.62	3,001,535	108,547	3.62

assets									
Less: Allowance for loan losses	(32,821)			(28,791)			(27,599)		
Other noninterest-earning assets	317,272			303,804			295,954		
Total assets	$ 3,896,071			$ 3,547,105			$ 3,269,890		
Interest-bearing liabilities:									
Deposits:									
Interest-bearing demand	$ 638,295	897	0.14	$ 576,046	833	0.14	$ 543,690	754	0.14
Savings and money market	1,033,836	1,487	0.14	1,010,510	1,339	0.13	908,614	1,166	0.13
Time deposits	801,394	8,709	1.09	697,654	6,286	0.90	616,747	5,386	0.87
Total interest-bearing deposits	2,473,525	11,093	0.45	2,284,210	8,458	0.37	2,069,051	7,306	0.35
Short-term borrowings	338,392	3,931	1.16	248,938	1,612	0.65	262,494	1,081	0.41
Long-term borrowings	39,094	2,471	6.32	39,023	2,471	6.33	27,886	1,750	6.28
Total borrowings	377,486	6,402	1.70	287,961	4,083	1.42	290,380	2,831	0.98
Total interest-bearing liabilities	2,851,011	17,495	0.61	2,572,171	12,541	0.49	2,359,431	10,137	0.43
Noninterest-bearing deposits	674,884			633,416			599,334		
Other liabilities	21,656			22,512			21,418		
Shareholders equity	348,520			319,006			289,707		
Total liabilities and shareholders equity	$ 3,896,071			$ 3,547,105			$ 3,269,890		
Net interest income (tax-equivalent)		$ 115,775			$ 105,862			$ 98,410	
Interest rate spread			3.08%			3.13%			3.19%
Net earning assets	$ 760,609			$ 699,921			$ 642,104		
Net interest margin (tax-equivalent)			3.21%			3.24%			3.28%

Ratio of average interest-earning assets to average interest-bearing liabilities	126.68%	127.21%	127.21%

The net interest spread, as well as the net interest margin, will be impacted by future changes in short-term and long-term interest rate levels, as well as the impact from the competitive environment. A discussion of the effects of changing interest rates on net interest income is set forth in Item 7A. Quantitative and Qualitative Disclosures About Market Risk included elsewhere in this report.

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MANAGEMENT S DISCUSSION AND ANALYSIS

Rate /Volume Analysis

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

	Change from 2016 to 2017			Change from 2015 to 2016		
Increase (decrease) in:	**Volume**	**Rate**	**Total**	**Volume**	**Rate**	**Total**
Interest income:						
Federal funds sold and interest-earning deposits	$ 34	$ 21	$ 55	$ 18	$ -	$ 18
Investment securities:						
Taxable	484	377	861	883	19	902
Tax-exempt	47	(82)	(35)	283	(68)	215
Total investment securities	531	295	826	1,166	(49)	1,117
Loans:						
Commercial business	2,594	715	3,309	2,116	201	2,317
Commercial mortgage	5,108	446	5,554	4,424	(95)	4,329
Residential real estate loans	1,292	(605)	687	1,524	(855)	669
Residential real estate lines	(228)	332	104	(144)	209	65
Consumer indirect	4,451	(90)	4,361	1,488	(44)	1,444
Other consumer	(61)	32	(29)	(159)	56	(103)
Total loans	13,156	830	13,986	9,249	(528)	8,721
Total interest income	**13,721**	**1,146**	**14,867**	**10,433**	**(577)**	**9,856**
Interest expense:						
Deposits:						
Interest-bearing demand	88	(24)	64	46	33	79
Savings and money market	32	116	148	134	39	173
Time deposits	1,015	1,408	2,423	725	175	900
Total interest-bearing deposits	1,135	1,500	2,635	905	247	1,152
Short-term borrowings	722	1,597	2,319	(59)	590	531
Long-term borrowings	4	(4)	-	705	16	721
Total borrowings	726	1,593	2,319	646	606	1,252
Total interest expense	**1,861**	**3,093**	**4,954**	**1,551**	**853**	**2,404**

Net interest income	**$**	**11,860**	**$**	**(1,947)**	**$**	**9,913**	**$**	**8,882**	**$**	**(1,430)**	**$**	**7,452**

Provision for Loan Losses

The provision for loan losses is based upon credit loss experience, growth or contraction of specific segments of the loan portfolio, and the estimate of losses inherent in the current loan portfolio. The provision for loan losses was $13.4 million for the year ended December 31, 2017 compared with $9.6 million for 2016. See the Allowance for Loan Losses section of this Management s Discussion and Analysis for further discussion.

MANAGEMENT S DISCUSSION AND ANALYSIS

Noninterest Income

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

	2017	2016	2015
Service charges on deposits	$ 7,391	$ 7,280	$ 7,742
Insurance income	5,266	5,396	5,166
ATM and debit card	5,721	5,687	5,084
Investment advisory	6,104	5,208	2,193
Company owned life insurance	1,781	2,808	1,962
Investments in limited partnerships	110	300	895
Loan servicing	439	436	503
Net gain on sale of loans held for sale	376	240	249
Net gain on investment securities	1,260	2,695	1,988
Net gain on other assets	37	313	27
Amortization of tax credit investment	-	-	(390)
Contingent consideration liability adjustment	1,200	1,170	1,093
Other	5,045	4,227	3,825
Total noninterest income	$ 34,730	$ 35,760	$ 30,337

Insurance income decreased by $130 thousand, or 2%, to $5.3 million during 2017. The decrease was primarily the result of non-renewal by a few large commercial accounts due to: one customer being acquired, one customer going out of business and one customer selecting another agency as a result of a competitive bidding process. These non-renewals have been partially replaced with several new, but smaller, commercial and personal accounts.

Investment advisory income increased to $6.1 million in 2017, compared to $5.2 million in 2016, reflecting higher assets under management driven by the acquisition of the assets of Robshaw & Julian and favorable market conditions.

Company owned life insurance decreased by $1.0 million or 37% in 2017. The decrease was primarily due to $911 thousand of non-recurring death benefit proceeds received by the Company in the first quarter of 2016.

We have investments in limited partnerships, primarily small business investment companies, and account for these investments under the equity method. Income from investments in limited partnerships was $110 thousand and $300 thousand for the years ended December 31, 2017 and 2016, respectively. The income from these equity method investments fluctuates based on the maturity and performance of the underlying investments.

During the year ended December 31, 2017, we recognized net gains of $1.3 million from the sale of available for sale (AFS) securities with an amortized cost totaling $48.8 million. The securities sold were comprised of 11 agency securities, six mortgage backed securities and one asset backed security. During the year ended December 31, 2016, we recognized gains of $2.7 million from the sale of AFS securities with an amortized cost totaling $92.6 million. The

securities sold were comprised of 25 agency securities and 22 mortgage backed securities. The amount and timing of net gains on investment securities is dependent on a number of factors, including our prudent efforts to realize gains while managing duration, premium and credit risk.

For each of the years ended December 31, 2017 and 2016, we recognized a $1.2 million non-cash fair value adjustment of the contingent consideration liability related to the SDN acquisition. For additional discussion related to the 2017 fair value adjustment of the contingent consideration liability see Note 7, Goodwill and Other Intangible Assets, of the notes to consolidated financial statements.

MANAGEMENT S DISCUSSION AND ANALYSIS

Noninterest Expense

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

	2017	2016	2015
Salaries and employee benefits	$ 48,675	$ 45,215	$ 42,439
Occupancy and equipment	16,293	14,529	13,856
Professional services	4,083	5,782	3,681
Computer and data processing	4,935	4,451	4,267
Supplies and postage	2,003	2,047	2,155
FDIC assessments	1,817	1,735	1,719
Advertising and promotions	2,171	2,097	1,986
Amortization of intangibles	1,170	1,249	942
Goodwill impairment	1,575	-	751
Other	7,791	7,566	7,597
Total noninterest expense	$ 90,513	$ 84,671	$ 79,393

Salaries and employee benefits increased by $3.5 million or 8% when comparing 2017 to 2016. The increase was primarily due to our organic growth initiatives and higher healthcare costs largely attributable to the high cost of specialty pharmaceuticals.

Occupancy and equipment increased by $1.8 million or 12% when comparing 2017 to 2016. The incremental expenses reflect the 2016 and 2017 financial solution center openings and the relocation of our Rochester regional administration center.

Professional services expense of $4.1 million in 2017 decreased $1.7 million or 29% from 2016. The decrease was primarily due to the Company s 2016 proxy contest, which increased our need for professional services during that year.

Computer and data processing increased by $484 thousand or 11% when comparing 2017 to 2016. We continue to invest in information technology to both maintain and improve our infrastructure.

We recognized $1.6 million of goodwill impairment in the second quarter of 2017 related to the SDN acquisition. For additional discussion related to the goodwill impairment see Note 7, Goodwill and Other Intangible Assets, of the notes to consolidated financial statements.

The efficiency ratio for the year ended December 31, 2017 was 60.65% compared with 60.95% for 2016. The improved efficiency ratio is a result of the higher net interest income associated with our organic growth initiatives. The efficiency ratio provides a ratio of operating expenses to operating income. The efficiency ratio is calculated by dividing total noninterest expense by net revenue, defined as the sum of tax-equivalent net interest income and noninterest income before net gains on investment securities. An increase in the efficiency ratio indicates that more resources are being utilized to generate the same volume of income, while a decrease indicates a more efficient allocation of resources. The efficiency ratio, a banking industry financial measure, is not required by GAAP.

However, the efficiency ratio is used by management in its assessment of financial performance specifically as it relates to noninterest expense control. Management also believes such information is useful to investors in evaluating Company performance.

Income Taxes

We recorded income tax expense of $9.9 million for 2017, compared to $12.2 million for 2016. Our effective tax rate was 22.9% for 2017 compared to 27.7% for 2016. The decrease in income tax expense and lower effective tax rate was the result of an estimated $2.9 million reduction in income tax expense due to the TCJ Act, primarily driven by a revaluation adjustment to our net deferred tax liability. Effective tax rates are impacted by items of income and expense that are not subject to federal or state taxation. Our effective tax rates differ from the statutory rates primarily due to the effect of interest income from tax-exempt securities, earnings on company owned life insurance, the non-cash fair value adjustment of the contingent consideration liability associated with the SDN acquisition, the 2017 non-cash goodwill impairment charge related to SDN and, in 2017, the net impact of the TCJ Act.

On December 22, 2017, the TCJ Act was signed into law which, among other items, reduces the federal statutory corporate tax rate from 35 percent to 21 percent, effective January 1, 2018.

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RESULTS OF OPERATIONS FOR THE YEARS ENDED

DECEMBER 31, 2016 AND DECEMBER 31, 2015

Net Interest Income and Net Interest Margin

Net interest income was $102.7 million in 2016, compared to $95.3 million in 2015. The taxable equivalent adjustments of $3.2 million and $3.1 million for 2016 and 2015, respectively, resulted in fully taxable equivalent net interest income of $105.9 million in 2016 and $98.4 million in 2015.

Net interest income on a taxable equivalent basis for 2016 increased $7.5 million or 8%, compared to 2015. The increase was due to an increase in average interest-earning assets of $270.6 million or 9% compared to 2015. The net interest margin of 3.24% for 2016 declined compared to 3.28% in 2015. This decrease was a function of a six basis point decrease in interest rate spread to 3.13% during 2016, partially offset by a two basis point higher contribution from net free funds. The lower interest rate spread was a net result of no change in the yield on earning assets and a six basis point increase in the cost of interest-bearing liabilities.

For the year ended December 31, 2016, the yield on average earning assets of 3.62% was unchanged from 2015. Loan yields decreased 3 basis points during 2016 to 4.18%. The yield on investment securities decreased 1 basis point during 2016 to 2.45%. Overall, the earning asset rate changes reduced interest income by $577 thousand during 2016, but that was more than offset by a favorable volume variance that increased interest income by $10.4 million, which collectively drove a $9.8 million increase in interest income.

Average interest-earning assets were $3.27 billion for 2016, an increase of $270.6 million or 9% from the prior year, with average loans up $218.4 million, average securities up $49.1 million and average federal funds sold and other interest-earning deposits up $3.1 million. Average loans were $2.21 billion for 2016, an increase of $218.4 million or 11% from the prior year. The growth in average loans reflected increases in most loan categories reflecting the impact of our growth strategy, with commercial loans up $146.7 million, residential real estate loans up $38.4 million, and consumer loans up $37.2 million, partially offset by a $3.9 million decrease in residential real estate lines. Loans made up 67.4% of average interest-earning assets during 2016 compared to 66.2% during 2015. Loans generally have significantly higher yields compared to securities and federal funds sold and interest-bearing deposits and, as such, have a more positive effect on the net interest margin. The yield on average loans was 4.18% for 2016, a decrease of 3 basis points compared to 4.21% for 2015. The yield on average loans was negatively impacted by lower average spreads due to increased competition in loan pricing during 2016 compared to 2015. The increase in the volume of average loans resulted in a $9.2 million increase in interest income, partially offset by a $528 thousand decrease due to the unfavorable rate variance. Average securities were $1.06 billion for 2016, an increase of $49.1 million or 5% from the prior year. Securities made up 32.5% of average interest-earning assets in 2016 compared to 33.8% in 2015. The taxable equivalent yield on average securities was 2.45% in 2016 compared to 2.46% in 2015. The increase in the volume of average securities resulted in a $1.2 million increase in interest income, partially offset by a $49 thousand decrease due to the unfavorable rate variance.

For the year ended December 31, 2016, the cost of average interest-bearing liabilities of 0.49% was 6 basis points higher than 2015. The cost of average interest-bearing deposits increased two basis points to 0.37%, the cost of short-term borrowings increased 24 basis points to 0.65% in 2016 compared to 2015 and the cost of long-term

borrowings increased five basis points to 6.33%. Overall, interest-bearing liability rate and volume increases resulted in $2.4 million of higher interest expense.

Average interest-bearing liabilities of $2.57 billion in 2016 were $212.7 million or 9% higher than 2015. On average, interest-bearing deposits grew $215.2 million, while noninterest-bearing demand deposits (a principal component of net free funds) were up $34.1 million. The increase in average deposits was due to successful business development efforts. Overall, interest-bearing deposit rate and volume changes resulted in $1.2 million of higher interest expense during 2016. Average short-term and long-term borrowings were $288.0 million in 2016, $2.4 million lower than in 2015. Overall, short and long-term borrowing rate and volume changes resulted in $1.2 million of higher interest expense during 2016.

Provision for Loan Losses

The provision for loan losses was $9.6 million for the year ended December 31, 2016 compared with $7.4 million for 2015.

Noninterest Income

Service charges on deposits were $7.3 million for 2016, a decrease of $462 thousand or 6%, compared to 2015. The decrease was primarily due to a decrease in the amount of checking account overdraft activity, primarily due to changes in customer behavior.

Insurance income increased by $230 thousand, or 4%, to $5.4 million during 2016, reflecting successful business development efforts, including cross-selling of SDN products and services to the Bank s customers.

ATM and debit card income was $5.7 million for 2016, an increase of $603 thousand or 12%, compared to 2015. The increase was primarily attributable to more favorable contract terms with a new card vendor and higher transaction volumes.

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Investment advisory income increased to $5.2 million in 2016, compared to $2.2 million in 2015, reflecting the contribution from Courier Capital which was acquired in January 2016 as part of our strategy to diversify our business lines and increase noninterest income through additional fee-based services.

Company owned life insurance increased by $846 thousand or 43% in 2016. The increase was primarily due to $911 thousand of death benefit proceeds received by the Company in first quarter of 2016.

We have investments in limited partnerships, primarily small business investment companies, and account for these investments under the equity method. Income from investments in limited partnerships was $300 thousand and $895 thousand for the years ended December 31, 2016 and 2015, respectively. The income from these equity method investments fluctuates based on the maturity and performance of the underlying investments.

During the year ended December 31, 2016 we recognized net gains of $2.7 million from the sale of available for sale (AFS) securities with an amortized cost totaling $92.6 million. The securities sold were comprised of 25 agency securities and 22 mortgage backed securities. During the year ended December 31, 2015 we recognized gains of $2.0 million from the sale of AFS securities with an amortized cost totaling $52.3 million. The securities sold were comprised of five agency securities and 13 mortgage backed securities. The amount and timing of net gains on investment securities is dependent on a number of factors, including our prudent efforts to realize gains while managing duration, premium and credit risk.

We recognized $390 thousand for the year ended December 31, 2015, of amortization of a historic tax investment in a community-based project. The amortization was included in noninterest income, recorded as contra-income, with an offsetting tax benefit that reduced income tax expense. These types of investments are, for the most part, fully amortized in the first year the project is placed in service.

For the years ended December 31, 2016 and 2015, we recognized a $1.2 million and $1.1 million, respectively, non-cash fair value adjustment of the contingent consideration liability related to the SDN acquisition. For additional discussion related to the fair value adjustment of the contingent consideration liability see Note 2, Business Combinations, of the notes to consolidated financial statements.

Noninterest Expense

Salaries and employee benefits increased by $2.8 million or 7% when comparing 2016 to 2015. The increase was primarily due to the addition of Courier Capital as well as additional personnel to support organic growth as part of our expansion initiatives.

Occupancy and equipment increased by $673 thousand or 5% when comparing 2016 to 2015. The incremental expenses reflect the addition of Courier Capital and our expansion initiatives, including the opening of financial solution centers in the Rochester market.

Professional services expense of $5.8 million in 2016 increased $2.2 million or 60% from 2015. The increase was primarily due to the Company s 2016 proxy contest.

Computer and data processing increased by $184 thousand or 4% when comparing 2016 to 2015. We continue to invest in information technology to both maintain and improve our infrastructure.

Amortization of intangibles increased by $307 thousand or 33% when comparing 2016 to 2015. The increase was primarily due to higher intangible asset amortization associated with the Courier Capital acquisition.

We recognized $751 thousand of goodwill impairment in the fourth quarter of 2015 related to the SDN acquisition.

The efficiency ratio for the year ended December 31, 2016 was 60.95% compared with 62.44% for 2015.

Income Taxes

We recorded income tax expense of $12.2 million for 2016, compared to $10.5 million for 2015. Our effective tax rate was 27.7% for 2016 compared to 27.1% for 2015. Effective tax rates are impacted by items of income and expense that are not subject to federal or state taxation. Our effective tax rates differ from the statutory rates primarily due to the effect of interest income from tax-exempt securities, earnings on company owned life insurance and the non-cash fair value adjustment of the contingent consideration liability associated with the SDN acquisition.

In March 2014, the New York legislature approved changes in the state tax law to be phased-in over two years, beginning in 2015. The primary changes that impact us included the repeal of the Article 32 franchise tax on banking corporations (Article 32) for 2015, expanded nexus standards for 2015 and a reduction in the corporate tax rate from 7.1% to 6.5% for 2016. The repeal of Article 32 and the expanded nexus standards lowered our taxable income apportioned to New York in 2016 and 2015 compared to 2014.

MANAGEMENT S DISCUSSION AND ANALYSIS

ANALYSIS OF FINANCIAL CONDITION

OVERVIEW

At December 31, 2017, we had total assets of $4.11 billion, an increase of 11% from $3.71 billion as of December 31, 2016, largely attributable to our continued loan growth. Net loans were $2.70 billion as of December 31, 2017, up $391.1 million or 17%, when compared to $2.31 billion as of December 31, 2016. The increase in net loans was primarily attributable to organic growth in the commercial, residential real estate loans and consumer indirect portfolios. Non-performing assets totaled $12.7 million as of December 31, 2017, up $6.2 million from a year ago. Total deposits amounted to $3.21 billion as of December 31, 2017, up $215.0 million or 7%, compared to December 31, 2016. As of December 31, 2017, borrowed funds totaled $485.3 million, compared to $370.6 million as of December 31, 2016. Common book value per common share was $22.85 and $20.82 as of December 31, 2017 and 2016, respectively. As of December 31, 2017, our total shareholders equity was $381.2 million compared to $320.1 million a year earlier.

INVESTING ACTIVITIES

The following table summarizes the composition of our available for sale and held to maturity securities portfolios (in thousands).

Investment Securities Portfolio Composition
At December 31,

	2017		2016		2015	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Securities available for sale:						
U.S. Government agency and government-sponsored enterprise securities	$ 163,025	$ 161,889	$ 187,325	$ 186,268	$ 260,748	$ 260,863
Mortgage-backed securities:						
Agency mortgage-backed securities	365,433	362,108	356,667	352,643	282,873	282,505
Non-Agency mortgage-backed securities	-	976	-	824	-	809
Asset-backed securities	-	-	-	191	-	218
Total available for sale securities	528,458	524,973	543,992	539,926	543,621	544,395
Securities held to maturity:						
State and political subdivisions	283,557	285,212	305,248	305,759	294,423	300,981
Mortgage-backed securities	232,909	227,771	238,090	234,232	191,294	189,083

Total held to maturity securities	516,466	512,983	543,338	539,991	485,717	490,064
Total investment securities	$ 1,044,924	$ 1,037,956	$ 1,087,330	$ 1,079,917	$ 1,029,338	$ 1,034,459

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

Our AFS investment securities portfolio decreased $14.9 million to $525.0 million at December 31, 2017 from $539.9 million at December 31, 2016. Our AFS portfolio had a net unrealized loss totaling $3.5 million at December 31, 2017 compared to a net unrealized loss of $4.1 million at December 31, 2016. The fair value of most of the investment securities in the AFS portfolio fluctuates as market interest rates change.

During the year ended December 31, 2015, we transferred $165.2 million of AFS mortgage backed securities to the held to maturity (HTM) category, reflecting our intent to hold those securities to maturity. Transfers of investment securities into the HTM category from the AFS category are made at fair value at the date of transfer. The related $1.1 million of unrealized holding losses that were included in the transfer during the year ended December 31, 2015 are retained in accumulated other comprehensive income and in the carrying value of the HTM securities. These amounts will be amortized as an adjustment to interest income over the remaining life of the securities. This will offset the impact of amortization of the net premium created in the transfer. There were no gains or losses recognized as a result of this transfer. The transfers of securities from AFS to HTM are expected to reduce the fair value fluctuations in the available for sale portfolio.

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Impairment Assessment

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

As of December 31, 2017, we do not have the intent to sell any of our securities in a loss position and we believe that it is not likely that we will be required to sell any such securities before the anticipated recovery of amortized cost. The unrealized losses are largely due to increases in market interest rates over the yields available at the time the underlying securities were purchased. The fair value is expected to recover as the bonds approach their maturity date, repricing date or if market yields for such investments decline. We do not believe any of the securities in a loss position are impaired due to reasons of credit quality. Accordingly, as of December 31, 2017, we concluded that unrealized losses on our investment securities are temporary and no further impairment loss has been realized in our consolidated statements of income. The following discussion provides further details of our assessment of the securities portfolio by investment category.

U.S. Government Agencies and Government Sponsored Enterprises (GSE). As of December 31, 2017, there were 37 securities in an unrealized loss position in the U.S. Government agencies and GSE portfolio with unrealized losses totaling $1.3 million. Of these, 10 were in an unrealized loss position for 12 months or longer and had an aggregate fair value of $31.6 million and unrealized losses of $687 thousand. The decline in fair value is attributable to changes in interest rates, and not credit quality, and because we do not have the intent to sell these securities and it is likely that we will not be required to sell the securities before their anticipated recovery, we do not consider these securities to be other-than-temporarily impaired at December 31, 2017.

State and Political Subdivisions. As of December 31, 2017, the state and political subdivisions, i.e. municipal securities, portfolio totaled $283.6 million, all of which was classified as HTM. As of that date, there were 156 securities in an unrealized loss position in the municipal securities portfolio with unrealized losses totaling $662 thousand. Of these, 46 were in an unrealized loss position for 12 months or longer and had an aggregate fair value of $14.5 million and unrealized losses of $367 thousand.

The decline in fair value is attributable to changes in interest rates, and not credit quality, and because we do not have the intent to sell these securities and it is not likely that we will be required to sell the securities before their

anticipated recovery, we do not consider these securities to be other-than-temporarily impaired at December 31, 2017.

Agency Mortgage-backed Securities. With the exception of the non-Agency mortgage-backed securities (non-Agency MBS) discussed below, all of the mortgage-backed securities held by us as of December 31, 2017, were issued by U.S. Government sponsored entities and agencies (Agency MBS), primarily FNMA and FHLMC. The contractual cash flows of our Agency MBS are guaranteed by FNMA, FHLMC or GNMA. The GNMA mortgage-backed securities are backed by the full faith and credit of the U.S. Government.

As of December 31, 2017, there were 99 securities in the AFS Agency MBS portfolio that were in an unrealized loss position with unrealized losses totaling $3.9 million. Of these, 35 were in an unrealized loss position for 12 months or longer and had an aggregate fair value of $84.0 million and unrealized losses of $1.9 million. As of December 31, 2017, there were 119 securities in the HTM Agency MBS portfolio that were in an unrealized loss position totaling $5.2 million. Of these, 81 were in an unrealized loss position for 12 months or longer and had an aggregate fair value of $144.7 million and unrealized losses of $4.1 million.

Given the high credit quality inherent in Agency MBS, we do not consider any of the unrealized losses as of December 31, 2017 on such Agency MBS to be credit related or other-than-temporary. As of December 31, 2017, we did not intend to sell any Agency MBS that were in an unrealized loss position, all of which were performing in accordance with their terms.

Non-Agency Mortgage-backed Securities. Our non-Agency MBS portfolio consists of positions in one privately issued whole loan collateralized mortgage obligations with a fair value and net unrealized gain of $976 thousand as of December 31, 2017. As of that date, the one non-Agency MBS was rated below investment grade. This security was not in an unrealized loss position.

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Other Investments. As a member of the FHLB, the Bank is required to hold FHLB stock. The amount of required FHLB stock is based on the Bank s asset size and the amount of borrowings from the FHLB. We have assessed the ultimate recoverability of our FHLB stock and believe that no impairment currently exists. As a member of the FRB system, we are required to maintain a specified investment in FRB stock based on a ratio relative to our capital. At December 31, 2017, our ownership of FHLB and FRB stock totaled $21.9 million and $5.8 million, respectively, and is included in other assets and recorded at cost, which approximates fair value.

LENDING ACTIVITIES

Total loans were $2.74 billion at December 31, 2017, an increase of $394.9 million or 17% from December 31, 2016. Commercial loans increased $239.6 million and represented 46.1% of total loans at the end of 2017. Consumer loans increased $155.2 million to represent 53.9% of total loans at December 31, 2017. The composition of our loan portfolio, excluding loans held for sale and including net unearned income and net deferred fees and costs, is summarized as follows (in thousands):

Loan Portfolio Composition
At December 31,

	2017		2016		2015		2014		2013
	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent	Amount
rcial business	$ 450,326	16.5%	$ 349,547	14.9%	$ 313,758	15.0%	$ 267,409	14.0%	$ 265,766
rcial mortgage	808,908	29.6	670,058	28.6	566,101	27.2	475,092	24.8	469,284
mmercial	1,259,234	46.1	1,019,605	43.5	879,859	42.2	742,501	38.8	735,050
tial real estate	465,283	17.0	427,937	18.3	381,074	18.3	357,187	18.7	310,394
tial real estate	116,309	4.3	122,555	5.2	127,347	6.1	129,529	6.8	128,737
er indirect	876,570	32.0	752,421	32.2	676,940	32.5	661,673	34.6	636,368
onsumer	17,621	0.6	17,643	0.8	18,542	0.9	21,112	1.1	23,070
nsumer	1,475,783	53.9	1,320,556	56.5	1,203,903	57.8	1,169,501	61.2	1,098,569
ans	2,735,017	100.0%	2,340,161	100.0%	2,083,762	100.0%	1,912,002	100.0%	1,833,619
ce for loan	34,672		30,934		27,085		27,637		26,736
ans, net	$ 2,700,345		$ 2,309,227		$ 2,056,677		$ 1,884,365		$ 1,806,883

Commercial loans increased during 2017 as we continued our successful commercial business development efforts. The credit risk related to commercial loans is largely influenced by general economic conditions and the resulting impact on a borrower s operations or on the value of underlying collateral.

Factors that are important to managing overall credit quality are sound loan underwriting and administration, systematic monitoring of existing loans and commitments, effective loan review on an ongoing basis, early identification of potential problems, an appropriate allowance for loan losses, and sound nonaccrual and charge off policies.

An active credit risk management process is used for commercial loans to further ensure that sound and consistent credit decisions are made. Credit risk is controlled by detailed underwriting procedures, comprehensive loan administration, and periodic review of borrowers outstanding loans and commitments. Borrower relationships are formally reviewed and graded on an ongoing basis for early identification of potential problems. Further analyses by customer, industry, and geographic location are performed to monitor trends, financial performance, and concentrations.

We participate in various lending programs in which guarantees are supplied by U.S. government agencies, such as the SBA, U.S. Department of Agriculture, Rural Economic and Community Development and Farm Service Agency, among others. As of December 31, 2017, the principal balance of such loans (included in commercial loans) was $47.8 million and the guaranteed portion amounted to $30.0 million. Most of these loans were guaranteed by the SBA.

Commercial business loans were $450.3 million at the end of 2017, up $100.8 million or 29% since the end of 2016, and comprised 16.5% of total loans outstanding at December 31, 2017, compared to 14.9% at December 31, 2016. We typically originate business loans of up to $15.0 million for small to mid-sized businesses in our market area for working capital, equipment financing, inventory financing, accounts receivable financing, or other general business purposes. Loans of this type are in a diverse range of industries. As of December 31, 2017, commercial business SBA loans accounted for a total of $34.0 million or 8% of our commercial business loan portfolio.

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Commercial mortgage loans totaled $808.9 million at December 31, 2017, up $138.9 million or 21% from December 31, 2016, and comprised 29.6% of total loans, compared to 28.6% at December 31, 2016. Commercial mortgage loans include both owner occupied and non-owner occupied commercial real estate loans. Approximately 35% and 39% of our commercial mortgage portfolio at December 31, 2017 and 2016, respectively, was owner occupied commercial real estate. The majority of our commercial real estate loans are secured by office buildings, manufacturing facilities, distribution/warehouse facilities, and retail centers, which are generally located in our local market area. As of December 31, 2017, commercial mortgage SBA loans accounted for a total of $9.6 million or 1% of our commercial mortgage loan portfolio.

We determine our current lending standards for commercial real estate and real estate construction lending by property type and specifically address many criteria, including: maximum loan amounts, maximum loan-to-value (LTV), requirements for pre-leasing or pre-sales, minimum debt-service coverage ratios, minimum borrower equity, and maximum loan to cost. Currently, the maximum standard for LTV is 85%, with lower limits established for certain higher risk types, such as raw land which has a 65% LTV maximum.

Consumer loans totaled $1.48 billion at December 31, 2017, up $155.2 million or 12% compared to 2016, and represented 53.9% of the 2017 year-end loan portfolio versus 56.5% at year-end 2016. Loans in this classification include residential real estate loans, residential real estate lines, indirect consumer and other consumer installment loans. Credit risk for these types of loans is generally influenced by general economic conditions, the characteristics of individual borrowers, and the nature of the loan collateral. Risks of loss are generally on smaller average balances per loan spread over many borrowers. Once charged off, there is usually less opportunity for recovery on these smaller retail loans. Credit risk is primarily controlled by reviewing the creditworthiness of the borrowers, monitoring payment histories, and taking appropriate collateral and guaranty positions.

Residential real estate portfolios include conventional first lien mortgages and home equity loans and lines of credit. For conventional first lien mortgages, we generally limit the maximum loan to 85% of collateral value without credit enhancement (e.g. personal mortgage insurance). The majority of our fixed-rate conventional mortgage loans are sold in the secondary market with servicing rights retained. Our conventional mortgage products continue to be underwritten using FHLMC secondary marketing guidelines. Our underwriting guidelines for home equity products include a combination of borrower FICO (credit score), the LTV of the property securing the loan and evidence of the borrower having sufficient income to repay the loan. Currently, for home equity products, the maximum acceptable LTV is 90%. The average FICO score for new home equity production was 763 during the years ended December 31, 2017 and 2016.

Residential real estate loans totaled $465.3 million at the end of 2017, up $37.3 million or 9% from the end of the prior year and comprised 17.0% of total loans outstanding at December 31, 2017 compared to 18.3% at year-end 2016. As of December 31, 2017 and 2016, our residential real estate loan portfolio included $8.6 million and $11.3 million, respectively, of loans acquired during the 2012 branch acquisitions. The residential real estate line portfolio amounted to $116.3 million at December 31, 2017 down $6.2 million or 5% compared to 2016, and represented 4.3% of the 2017 year-end loan portfolio versus 5.2% at year-end 2016. As of December 31, 2017 and 2016, our residential real estate line portfolio included $9.5 million and $11.5 million, respectively, of loans acquired during the 2012 branch acquisitions.

The residential real estate loans and lines portfolios had a weighted average LTV at origination of approximately 64% and 63% at December 31, 2017 and 2016, respectively. Approximately 88% and 87% of the loans and lines were first lien positions at December 31, 2017 and 2016, respectively. We continue to grow our home equity portfolio as the lower origination cost and convenience to customers has made these products an attractive alternative to conventional residential mortgage loans.

Consumer indirect loans amounted to $876.6 million at December 31, 2017 up $124.1 million or 16% compared to 2016, and represented 32.0% of the 2017 year-end loan portfolio versus 32.2% at year-end 2016. The loans are primarily for the purchase of automobiles (both new and used) and light duty trucks primarily by individuals, but also by corporations and other organizations. The loans are originated through dealerships and assigned to us with terms that typically range from 36 to 84 months. During the year ended December 31, 2017, we originated $433.1 million in indirect loans with a mix of approximately 42% new vehicles and 58% used vehicles. This compares with $356.4 million in indirect loans with a mix of approximately 43% new vehicles and 57% used vehicles for the same period in 2016. We do business with over 450 franchised auto dealers located in Western, Central, and the Capital District of New York, and Northern and Central Pennsylvania. The average FICO score for indirect loan production was 734 and 731 during the years ended December 31, 2017 and 2016, respectively. Other consumer loans totaled $17.6 million at December 31, 2017, down $22 thousand or less than 1% compared to 2016, and represented less than one percent of the 2017 and 2016 year-end loan portfolio. Other consumer loans consist of personal loans (collateralized and uncollateralized) and deposit account collateralized loans.

Our loan portfolio is widely diversified by types of borrowers, industry groups, and market areas within our core footprint. Significant loan concentrations are considered to exist for a financial institution when there are amounts loaned to numerous borrowers engaged in similar activities that would cause them to be similarly impacted by economic or other conditions. At December 31, 2017, no significant concentrations, as defined above, existed in our portfolio in excess of 10% of total loans.

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Loans Held for Sale and Loan Servicing Rights. Loans held for sale (not included in the loan portfolio composition table) were entirely comprised of residential real estate loans and totaled $2.7 million and $1.1 million as of December 31, 2017 and 2016, respectively.

We sell certain qualifying newly originated or refinanced residential real estate loans on the secondary market. Residential real estate loans serviced for others, which are not included in the consolidated statements of financial condition, amounted to $163.3 million and $173.7 million as of December 31, 2017 and 2016, respectively.

Allowance for Loan Losses

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

	Loan Loss Analysis Year Ended December 31,				
	2017	**2016**	**2015**	**2014**	**2013**
Allowance for loan losses, beginning of year	$ 30,934	$ 27,085	$ 27,637	$ 26,736	$ 24,714
Charge-offs:					
Commercial business	3,614	943	1,433	204	1,070
Commercial mortgage	10	385	895	304	553
Residential real estate loans	431	289	397	382	748
Residential real estate lines	106	104	199	148	54
Consumer indirect	10,164	8,748	9,156	10,004	8,125
Other consumer	926	607	878	972	928
Total charge-offs	15,251	11,076	12,958	12,014	11,478
Recoveries:					
Commercial business	416	447	212	201	349
Commercial mortgage	262	45	146	143	319
Residential real estate loans	130	174	114	76	169
Residential real estate lines	60	15	31	19	42
Consumer indirect	4,444	4,259	4,200	4,321	3,161
Other consumer	316	347	322	366	381
Total recoveries	5,628	5,287	5,025	5,126	4,421
Net charge-offs	9,623	5,789	7,933	6,888	7,057
Provision for loan losses	13,361	9,638	7,381	7,789	9,079
Allowance for loan losses, end of year	$ 34,672	$ 30,934	$ 27,085	$ 27,637	$ 26,736
Net charge-offs to average loans	0.38%	0.26%	0.40%	0.37%	0.40%

Allowance to end of period loans	1.27%	1.32%	1.30%	1.45%	1.46%
Allowance to end of period non-performing loans	277%	489%	321%	272%	161%

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The following table sets forth the allocation of the allowance for loan losses by loan category as of the dates indicated. The allocation is made for analytical purposes and is not necessarily indicative of the categories in which actual losses may occur. The total allowance is available to absorb losses from any segment of the loan portfolio (in thousands).

Allowance for Loan Losses by Loan Category
At December 31,

	2017		2016		2015		2014		2013	
	Loan Loss Allowance	Percentage of loans by category to total loans	Loan Loss Allowance	Percentage of loans by category to total loans	Loan Loss Allowance	Percentage of loans by category to total loans	Loan Loss Allowance	Percentage of loans by category to total loans	Loan Loss Allowance	Percentage of loans by category to total loans
Commercial business	$ 15,668	16.5%	$ 7,225	14.9%	$ 5,540	15.0%	$ 5,621	14.0%	$ 4,273	14.5%
Commercial mortgage	3,696	29.6	10,315	28.6	9,027	27.2	8,122	24.8	7,743	25.6
Residential real estate loans	1,322	17.0	1,478	18.3	1,347	18.3	1,620	18.7	1,607	16.9
Residential real estate lines	180	4.3	303	5.2	345	6.1	435	6.8	436	7.0
Consumer indirect	13,415	32.0	11,311	32.2	10,458	32.5	11,383	34.6	12,230	34.7
Other consumer	391	0.6	302	0.8	368	0.9	456	1.1	447	1.3
Total	$ 34,672	100.0%	$ 30,934	100.0%	$ 27,085	100.0%	$ 27,637	100.0%	$ 26,736	100.0%

Management believes that the allowance for loan losses at December 31, 2017 is adequate to cover probable losses in the loan portfolio at that date. Factors beyond our control, however, such as general national and local economic conditions, can adversely impact the adequacy of the allowance for loan losses. As a result, no assurance can be given that adverse economic conditions or other circumstances will not result in increased losses in the portfolio or that the allowance for loan losses will be sufficient to meet actual loan losses. See Part I, Item 1A Risk Factors for the risks impacting this estimate. Management presents a quarterly review of the adequacy of the allowance for loan losses to the Audit Committee of our Board of Directors based on the methodology that is described in further detail in Part I, Item I Business under the section titled Lending Activities. See also Critical Accounting Estimates for additiona information on the allowance for loan losses.

Non-performing Assets and Potential Problem Loans

The following table sets forth information regarding non-performing assets (in thousands):

Non-performing Assets
At December 31,

	2017	2016	2015	2014	2013

Non-accruing loans:										
Commercial business	$	5,344	$	2,151	$	3,922	$	4,288	$	3,474
Commercial mortgage		2,623		1,025		947		3,020		9,663
Residential real estate loans		2,252		1,236		1,848		1,451		1,723
Residential real estate lines		404		372		235		206		280
Consumer indirect		1,895		1,526		1,467		1,169		1,471
Other consumer		2		7		13		11		5
Total non-accruing loans		12,520		6,317		8,432		10,145		16,616
Restructured accruing loans		-		-		-		-		-
Accruing loans contractually past due over 90 days		11		9		8		8		6
Total non-performing loans		12,531		6,326		8,440		10,153		16,622
Foreclosed assets		148		107		163		194		333
Non-performing investment securities		-		-		-		-		128
Total non-performing assets	$	12,679	$	6,433	$	8,603	$	10,347	$	17,083
Non-performing loans to total loans		0.46%		0.27%		0.41%		0.53%		0.91%
Non-performing assets to total assets		0.31%		0.17%		0.25%		0.33%		0.58%

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Non-performing assets include non-performing loans, foreclosed assets and non-performing investment securities. Non-performing assets at December 31, 2017 were $12.7 million, an increase of $6.3 million from the $6.4 million balance at December 31, 2016. The primary component of non-performing assets is non-performing loans, which were $12.5 million or 0.46% of total loans at December 31, 2017, an increase of $6.2 million from $6.3 million or 0.27% of total loans at December 31, 2016.

Approximately $870 thousand, or 7%, of the $12.5 million in non-performing loans as of December 31, 2017 were current with respect to payment of principal and interest, but were classified as non-accruing because repayment in full of principal and/or interest was uncertain. The amount of interest income forgone totaled $481 thousand and $234 thousand for non-accruing loans outstanding as of December 31, 2017 and 2016, respectively. Included in nonaccrual loans are troubled debt restructurings (TDRs) of $1.3 million and $1.4 million at December 31, 2017 and 2016, respectively. We had one TDR of $633 thousand that was accruing interest as of December 31, 2017, and we had no TDRs that were accruing interest as of December 31, 2016.

Foreclosed assets consist of real property formerly pledged as collateral for loans, which we have acquired through foreclosure proceedings or acceptance of a deed in lieu of foreclosure. Foreclosed asset holdings represented four properties totaling $148 thousand at December 31, 2017 and four properties totaling $107 thousand at December 31, 2016.

Potential problem loans are loans that are currently performing, but information known about possible credit problems of the borrowers causes us to have concern as to the ability of such borrowers to comply with the present loan payment terms and may result in disclosure of such loans as nonperforming at some time in the future. These loans remain in a performing status due to a variety of factors, including payment history, the value of collateral supporting the credits, and/or personal or government guarantees. We consider loans classified as substandard, which continue to accrue interest, to be potential problem loans. We identified $12.5 million and $15.6 million in loans that continued to accrue interest which were classified as substandard as of December 31, 2017 and 2016, respectively.

FUNDING ACTIVITIES

Deposits

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

	At December 31,					
	2017		2016		2015	
	Amount	Percent	Amount	Percent	Amount	Percent
Noninterest-bearing demand	$ 718,498	22.4 %	$ 677,076	22.6 %	$ 641,972	23.5 %
Interest-bearing demand	634,203	19.8	581,436	19.4	523,366	19.2
Savings and money market	1,005,317	31.3	1,034,194	34.5	928,175	34.0
Time deposits < $250,000	698,179	21.7	602,715	20.2	545,044	19.9
Time deposits of $250,000 or more	153,977	4.8	99,801	3.3	91,974	3.4

Total deposits	$ 3,210,174	100.0 %	$ 2,995,222	100.0 %	$ 2,730,531	100.0 %

We offer a variety of deposit products designed to attract and retain customers, with the primary focus on building and expanding long-term relationships. At December 31, 2017, total deposits were $3.21 billion, representing an increase of $215.0 million for the year.

Nonpublic deposits, the largest component of our funding sources, totaled $2.07 billion and $1.90 billion at December 31, 2017 and 2016, respectively, and represented 65% and 63% of total deposits as of the end of each period, respectively. We have managed this segment of funding through a strategy of competitive pricing that minimizes the number of customer relationships that have only a single service high cost deposit account.

As an additional source of funding, we offer a variety of public (municipal) deposit products to the towns, villages, counties and school districts within our market. Public deposits generally range from 20% to 30% of our total deposits. There is a high degree of seasonality in this component of funding, because the level of deposits varies with the seasonal cash flows for these public customers. We maintain the necessary levels of short-term liquid assets to accommodate the seasonality associated with public deposits. Total public deposits were $829.5 million and $803.6 million at December 31, 2017 and December 31, 2016, respectively, and represented 26% and 27% of total deposits as of the end of each period, respectively. The increase in public deposits during 2017 was due largely to higher balances with existing customers.

We had no traditional brokered deposits at December 31, 2017 or December 31, 2016; however, we do participate in the CDARS and ICS programs, which enable depositors to receive FDIC insurance coverage for deposits otherwise exceeding the maximum insurable amount. CDARS and ICS deposits are considered brokered deposits for regulatory reporting purposes. Through these programs, deposits in excess of the maximum insurable amount are placed with multiple participating financial institutions. Reciprocal CDARS deposits and ICS deposits totaled $159.2 million and $147.3 million, respectively, at December 31, 2017, compared to $143.2 million and $152.9 million, respectively, at December 31, 2016, and collectively represented 9% and 10% of total deposits as of the end of each period, respectively.

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Borrowings

The Company classifies borrowings as short-term or long-term in accordance with the original terms of the agreement. Outstanding borrowings are summarized as follows as of December 31 (in thousands):

	2017	2016
Short-term borrowings:		
Short-term FHLB borrowings	$ 446,200	$ 331,500
Long-term borrowings:		
Subordinated notes, net	39,131	39,061
Total borrowings	$ 485,331	$ 370,561

Short-term borrowings

Short-term FHLB borrowings have original maturities of less than one year and include overnight borrowings which we typically utilize to address short term funding needs as they arise. Short-term FHLB borrowings at December 31, 2017 consisted of $304.7 million in overnight borrowings and $141.5 million in short-term advances. Short-term FHLB borrowings at December 31, 2016 consisted of $171.5 million in overnight borrowings and $160.0 million in short-term advances. The FHLB borrowings are collateralized by securities from the Company s investment portfolio and certain qualifying loans. At December 31, 2017 and 2016, the Company s borrowings had a weighted average rate of 1.50% and 0.76%, respectively.

We have credit capacity with the FHLB and can borrow through facilities that include amortizing and term advances or repurchase agreements. We had approximately $32 million of immediate credit capacity with the FHLB as of December 31, 2017. We had approximately $622 million in secured borrowing capacity at the Federal Reserve Bank (FRB) discount window, none of which was outstanding at December 31, 2017. The FHLB and FRB credit capacity are collateralized by securities from our investment portfolio and certain qualifying loans. We had $165 million of credit available under unsecured federal funds purchased lines with various banks as of December 31, 2017. Additionally, we had approximately $184 million of unencumbered liquid securities available for pledging.

The Parent has a revolving line of credit with a commercial bank allowing borrowings up to $20.0 million in total as an additional source of working capital. At December 31, 2017, no amounts have been drawn on the line of credit.

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

	At or for the Year Ended December 31,		
	2017	2016	2015
Year-end balance	$ 446,200	$ 331,500	$ 293,100
Year-end weighted average interest rate	1.50 %	0.76 %	0.53 %

Maximum outstanding at any month-end	$ 446,900	$ 358,700	$ 351,600
Average balance during the year	$ 338,392	$ 248,938	$ 262,494
Average interest rate for the year	1.16 %	0.65 %	0.41 %

Long-term borrowings

On April 15, 2015, we issued $40.0 million of Subordinated Notes in a registered public offering. The Subordinated Notes bear interest at a fixed rate of 6.0% per year, payable semi-annually, for the first 10 years. From April 15, 2025 to the April 15, 2030 maturity date, the interest rate will reset quarterly to an annual interest rate equal to the then current three-month London Interbank Offered Rate (LIBOR) plus 3.944%, payable quarterly. The Subordinated Notes are redeemable by us at any quarterly interest payment date beginning on April 15, 2025 to maturity at par, plus accrued and unpaid interest. Proceeds, net of debt issuance costs of $1.1 million, were $38.9 million. The net proceeds from this offering were used for general corporate purposes, including but not limited to, contribution of capital to the Bank to support both organic growth and opportunistic acquisitions. The Subordinated Notes qualify as Tier 2 capital for regulatory purposes.

Shareholders Equity

Total shareholders equity was $381.2 million at December 31, 2017, an increase of $61.1 million from $320.1 million at December 31, 2016. Net income for the year and stock issued from the at-the-market common stock offering increased shareholders equity by $33.5 million and $38.3 million, respectively, which were partially offset by common and preferred stock dividends declared of $14.4 million. Accumulated other comprehensive loss included in shareholders equity decreased $2.0 million during the year due primarily to the change in pension and post-retirement obligations. For detailed information on shareholders equity, see Note 13, Shareholders Equity, of the notes to consolidated financial statements. FII and the Bank are subject to various regulatory capital requirements. At December 31, 2017 both FII and the Bank exceeded all regulatory requirements. For detailed information on regulatory capital requirements, see Note 12, Regulatory Matters, of the notes to consolidated financial statements.

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LIQUIDITY AND CAPITAL RESOURCES

The objective of maintaining adequate liquidity is to ensure that we meet our financial obligations. These obligations include the withdrawal of deposits on demand or at their contractual maturity, the repayment of matured borrowings, the ability to fund new and existing loan commitments and the ability to take advantage of new business opportunities. We achieve liquidity by maintaining a strong base of core customer funds, maturing short-term assets, our ability to sell or pledge securities, lines-of-credit, and access to the financial and capital markets.

Liquidity for the Bank is managed through the monitoring of anticipated changes in loans, the investment portfolio, core deposits and wholesale funds. The strength of the Bank s liquidity position is a result of its base of core customer deposits. These core deposits are supplemented by wholesale funding sources that include credit lines with the other banking institutions, the FHLB and the FRB.

The primary sources of liquidity for FII are dividends from the Bank and access to financial and capital markets. Dividends from the Bank are limited by various regulatory requirements related to capital adequacy and earnings trends. The Bank relies on cash flows from operations, core deposits, borrowings and short-term liquid assets.

Cash and cash equivalents were $99.2 million as of December 31, 2017, an increase of $27.9 million from $71.3 million as of December 31, 2016. Net cash provided by operating activities totaled $46.3 million and the principal source of operating activity cash flow was net income adjusted for noncash income and expense items. Net cash used in investing activities totaled $372.6 million, which included outflows of $404.9 million for net loan originations and partially offset by inflows of $40.5 million from net investment securities transactions. Net cash provided by financing activities of $354.3 million was attributed to a $215.0 million increase in deposits, a $114.7 million increase in short-term borrowings and $38.3 million from the at-the-market common stock offering, partly offset by $14.0 million in dividend payments.

Contractual Obligations and Other Commitments

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

	At December 31, 2017				
	Within 1 year	Over 1 to 3 years	Over 3 to 5 Years	Over 5 years	Total
On-Balance sheet:					
Time deposits [1]	$ 678,352	$ 138,647	$ 35,157	$ -	$ 852,156
Supplemental executive retirement plans	390	687	466	604	2,147
Earn-out liabilities	-	1,990	-	-	1,990
Subordinated notes	-	-	-	40,000	40,000
Off-Balance sheet:					
Purchase commitments	$ -	$ 359	$ -	$ -	$ 359

Limited partnership investments [2]	646	1,293	646	-	2,585
Commitments to extend credit [3]	661,021	-	-	-	661,021
Standby letters of credit [3]	10,424	1,579	178	-	12,181
Operating leases	2,459	4,587	3,814	30,815	41,675

(1) Includes the maturity of time deposits amounting to $100 thousand or more as follows: $265.4 million in three months or less; $85.1 million between three months and six months; $79.4 million between six months and one year; and $61.5 million over one year.

(2) We have committed to capital investments in several limited partnerships of up to $9.0 million, of which we have contributed $6.4 million as of December 31, 2017, including $583 thousand during 2017.

(3) We do not expect all of the commitments to extend credit and standby letters of credit to be funded. Thus, the total commitment amounts do not necessarily represent our future cash requirements.

Off-Balance Sheet Arrangements

With the exception of obligations in connection with our irrevocable loan commitments, operating leases and limited partnership investments as of December 31, 2017, we had no other off-balance sheet arrangements that have or are reasonably likely to have a current or future effect on our financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources that is material to investors. For additional information on off-balance sheet arrangements, see Note 1, Summary of Significant Accounting Policies and Note 11, Commitments and Contingencies, in the notes to the accompanying consolidated financial statements.

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Security Yields and Maturities Schedule

The following table sets forth certain information regarding the amortized cost (Cost), weighted average yields (Yield) and contractual maturities of our debt securities portfolio as of December 31, 2017. Mortgage-backed securities are included in maturity categories based on their stated maturity date. Actual maturities may differ from the contractual maturities presented because borrowers may have the right to call or prepay certain investments. No tax-equivalent adjustments were made to the weighted average yields (dollars in thousands).

	Due in less than one year		Due from one to five years		Due after five years through ten years		Due after ten years		Total	
	Cost	Yield	Cost	Yield	Cost	Yield	Cost	Yield	Cost	Yi
ilable for sale debt securities:										
Government agencies and ernment-sponsored enterprises	$ -	- %	$ 26,215	1.96%	$ 132,984	2.34%	$ 3,826	2.08%	$ 163,025	2.2
tgage-backed securities	2	4.05	96,795	1.89	161,828	2.52	106,808	2.34	365,433	2.3
	2	4.05	123,010	1.91	294,812	2.44	110,634	2.33	528,458	2.2
d to maturity debt securities:										
e and political subdivisions	57,692	1.89	159,758	2.17	66,107	1.84	-	-	283,557	2.0
tgage-backed securities	-	-	-	-	37,486	1.68	195,423	2.25	232,909	2.1
	57,692	1.89	159,758	2.17	103,593	1.78	195,423	2.25	516,466	2.0
al investment securities	$ 57,694	1.89%	$ 282,768	2.06%	$ 398,405	2.27%	$ 306,057	2.28%	$ 1,044,924	2.1

Contractual Loan Maturity Schedule

The following table summarizes the contractual maturities of our loan portfolio at December 31, 2017. Loans, net of deferred loan origination costs, include principal amortization and non-accruing loans. Demand loans having no stated schedule of repayment or maturity and overdrafts are reported as due in one year or less (in thousands).

	Due in less than one year	Due from one to five years	Due after five years	Total
Commercial business	$ 154,559	$ 220,836	$ 74,931	$ 450,326
Commercial mortgage	213,912	370,727	224,269	808,908
Residential real estate loans	62,823	182,361	220,099	465,283
Residential real estate lines	15,814	39,346	61,149	116,309
Consumer indirect	310,347	546,327	19,896	876,570
Other consumer	7,649	8,878	1,094	17,621

Total loans	$ 765,104	$ 1,368,475	$ 601,438	$ 2,735,017
Loans maturing after one year:				
With a predetermined interest rate		$ 977,794	$ 311,034	$ 1,288,828
With a floating or adjustable rate		390,681	290,404	681,085
Total loans maturing after one year		$ 1,368,475	$ 601,438	$ 1,969,913

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Capital Resources

The FRB has adopted a system using risk-based capital guidelines to evaluate the capital adequacy of bank holding companies on a consolidated basis. The final rules implementing the Basel Committee on Banking Supervision s (BCBS) capital guidelines for U.S. banks became effective for the Company on January 1, 2015, with full compliance with all of the final requirements phased in over a multi-year schedule, to be fully phased-in by January 1, 2019. As of December 31, 2017, the Company s capital levels remained characterized as well-capitalized under the new rules. We continue to evaluate the potential impact that regulatory rules may have on our liquidity and capital management strategies, including Basel III and those required under the Dodd-Frank Act. See Note 12, Regulatory Matters of the notes to consolidated financial statements and the Basel III Capital Rules section below for further discussion. The following table reflects the Company s ratios and their components as of December 31 (in thousands):

		2017		**2016**
Common shareholders equity	$	363,848	$	302,714
Less: Goodwill and other intangible assets		70,413		68,759
Net unrealized (loss) gain on investment securities (1)		(3,275)		(3,729)
Net periodic pension & postretirement benefits plan adjustments		(8,641)		(10,222)
Other		-		-
Common equity Tier 1 (CET1) capital		305,351		247,906
Plus: Preferred stock		17,329		17,340
Less: Other		-		-
Tier 1 Capital		322,680		265,246
Plus: Qualifying allowance for loan losses		34,672		30,934
Subordinated Notes		39,131		39,061
Total regulatory capital	$	396,483	$	335,241
Adjusted average total assets (for leverage capital purposes)	$	3,967,749	$	3,602,377
Total risk-weighted assets	$	3,005,655	$	2,584,161
Regulatory Capital Ratios				
Tier 1 leverage (Tier 1 capital to adjusted average assets)		8.13%		7.36%
CET1 capital (CET1 capital to total risk-weighted assets)		10.16		9.59
Tier 1 capital (Tier 1 capital to total risk-weighted assets)		10.74		10.26
Total risk-based capital (Total regulatory capital to total risk-weighted assets)		13.19		12.97

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

Basel III Capital Rules

In July 2013, the FRB and the FDIC approved the final rules implementing the BCBS s capital guidelines for U.S. banks. Under the final rules, minimum requirements will increase for both the quantity and quality of capital held by the Company. The rules include a new common equity Tier 1 capital to risk-weighted assets minimum ratio of 4.5%, raise the minimum ratio of Tier 1 capital to risk-weighted assets from 4.0% to 6.0%, require a minimum ratio of total capital to risk-weighted assets of 8.0%, and require a minimum Tier 1 leverage ratio of 4.0%. A new capital conservation buffer is also established above the regulatory minimum capital requirements. This capital conservation buffer will be phased in beginning January 1, 2016 at 0.625% of risk-weighted assets and will increase each subsequent year by an additional 0.625% until reaching its final level of 2.5% on January 1, 2019. Strict eligibility criteria for regulatory capital instruments were also implemented under the final rules. The final rules also revise the definition and calculation of Tier 1 capital, total capital, and risk-weighted assets.

The phase-in period for the final rules became effective for the Company on January 1, 2015, with full compliance with all of the final rules requirements phased in over a multi-year schedule, to be fully phased-in by January 1, 2019. As of December 31, 2017, the Company s capital levels remained characterized as well-capitalized under the new rules.

MANAGEMENT S DISCUSSION AND ANALYSIS

CRITICAL ACCOUNTING ESTIMATES

Our consolidated financial statements are prepared in accordance with GAAP and are consistent with predominant practices in the financial services industry. Application of critical accounting policies, which are those policies that management believes are the most important to our financial position and results, requires management to make estimates, assumptions, and judgments that affect the amounts reported in the consolidated financial statements and accompanying notes and are based on information available as of the date of the financial statements. Future changes in information may affect these estimates, assumptions and judgments, which, in turn, may affect amounts reported in the financial statements.

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

Adequacy of the Allowance for Loan Losses

The allowance for loan losses represents management s estimate of probable credit losses inherent in the loan portfolio. Determining the amount of the allowance for loan losses is considered a critical accounting estimate because it requires significant judgment and the use of subjective measurements including management s assessment of the internal risk classifications of loans, changes in the nature of the loan portfolio, industry concentrations, existing economic conditions, the fair value of underlying collateral, and other qualitative and quantitative factors which could affect probable credit losses. Because current economic conditions and borrower strength can change and future events are inherently difficult to predict, the anticipated amount of estimated loan losses, and therefore the appropriateness of the allowance for loan losses, could change significantly. As an integral part of their examination process, various regulatory agencies also review the allowance for loan losses. Such agencies may require additions to the allowance for loan losses or may require that certain loan balances be charged off or downgraded into criticized loan categories when their credit evaluations differ from those of management, based on their judgments about information available to them at the time of their examination. We believe the level of the allowance for loan losses is appropriate as recorded in the consolidated financial statements.

For additional discussion related to our accounting policies for the allowance for loan losses, see the sections titled Allowance for Loan Losses in Part II, Item 7, Management s Discussion and Analysis of Financial Condition and Results of Operations and Note 1, Summary of Significant Accounting Policies, of the notes to consolidated financial

statements.

Valuation of Goodwill

Goodwill represents the excess of the purchase price over the fair value of net assets acquired in accordance with the purchase method of accounting for business combinations. Goodwill has an indefinite useful life and is not amortized, but is tested for impairment. GAAP requires goodwill to be tested for impairment at our reporting unit level on an annual basis and more frequently if events or circumstances indicate that there may be impairment. We test goodwill for impairment as of October 1st of each year.

Impairment exists when a reporting unit s carrying value of goodwill exceeds its implied fair value. In testing goodwill for impairment, GAAP permits us to first assess qualitative factors to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying value (Step 0). If, after assessing the totality of events and circumstances, we determine it is not more likely than not that the fair value of a reporting unit is less than its carrying value, then performing the two-step impairment test would be unnecessary. However, if we conclude otherwise, we would then be required to perform the goodwill impairment test (Step 1). Step 1 compares the fair value of a reporting unit with its carrying value, including goodwill. If the carrying value of the reporting unit exceeds its fair value, a goodwill impairment charge is recognized.

MANAGEMENT S DISCUSSION AND ANALYSIS

Valuation of Deferred Tax Assets and Liabilities

The determination of deferred tax expense or benefit is based on changes in the carrying amounts of assets and liabilities that generate temporary differences. The carrying value of our net deferred tax assets or liabilities assumes that we will be able to generate sufficient future taxable income based on estimates and assumptions (after consideration of historical taxable income as well as tax planning strategies). If these estimates and related assumptions change, we may be required to record valuation allowances against our deferred tax assets and liabilities resulting in additional income tax expense or benefit in the consolidated statements of income. We evaluate deferred tax assets and liabilities on a quarterly basis and assess the need for a valuation allowance, if any. A valuation allowance is established when management believes that it is more likely than not that some portion of its deferred tax assets and liabilities will not be realized. Changes in valuation allowance from period to period are included in our tax provision in the period of change. For additional discussion related to our accounting policy for income taxes see Note 16, Income Taxes, of the notes to consolidated financial statements.

Defined Benefit Pension Plan

We have a defined benefit pension plan covering substantially all employees. For employees hired prior to December 31, 2006, who met participation requirements on or before January 1, 2008 (Tier 1 Participant), the benefits are generally based on years of service and the employee s highest average compensation during five consecutive years of employment. For eligible employees who were hired on and after January 1, 2007 (Tier 2 Participant), the benefits are generally based on a cash balance benefit formula. Assumptions are made concerning future events that will determine the amount and timing of required benefit payments, funding requirements and defined benefit pension expense. The major assumptions are the weighted average discount rate used in determining the current benefit obligation, the weighted average expected long-term rate of return on plan assets, the rate of compensation increase and the estimated mortality rate. The weighted average discount rate was based upon the projected benefit cash flows and the market yields of high grade corporate bonds that are available to pay such cash flows as of the measurement date, December 31. The weighted average expected long-term rate of return is estimated based on current trends experienced by the assets in the plan as well as projected future rates of return on those assets and reasonable actuarial assumptions for long term inflation, and the real and nominal rate of investment return for a specific mix of asset classes. The current target asset allocation model for the plans is detailed in Note 18 to the consolidated financial statements. The expected returns on these various asset categories are blended to derive one long-term return assumption. The assets are invested in certain collective investment and mutual funds, common stocks, U.S. Treasury and other U.S. government agency securities, and corporate and municipal bonds and notes. The rate of compensation increase is based on reviewing the compensation increase practices of other plan sponsors in similar industries and geographic areas as well as the expectation of future increases. Mortality rate assumptions are based on mortality tables published by third-parties such as the Society of Actuaries (SOA), considering other available information including historical data as well as studies and publications from reputable sources. We review the pension plan assumptions on an annual basis with our actuarial consultants to determine if the assumptions are reasonable and adjust the assumptions to reflect changes in future expectations.

The assumptions used to calculate 2017 expense for the defined benefit pension plan were a weighted average discount rate of 4.00%, a weighted average long-term rate of return on plan assets of 6.50% and a rate of compensation increase of 3.00%. Defined benefit pension expense in 2018 is expected to decrease to $1.2 million from the $2.0 million recorded in 2017, primarily driven by an increase in the expected return on assets, driven by

overall higher plan asset values, and a decrease in the amount of accumulated actuarial losses to be amortized.

Due to the long-term nature of pension plan assumptions, actual results may differ significantly from the actuarial-based estimates. Differences resulting in actuarial gains or losses are required to be recorded in shareholders equity as part of accumulated other comprehensive loss and amortized to defined benefit pension expense in future years. For 2017, the actual return on plan assets in the qualified defined benefit pension plan was a gain of $11.3 million, compared to an expected return on plan assets of $5.0 million. Total pretax losses recognized in accumulated other comprehensive loss at December 31, 2017 were $14.3 million for the defined benefit pension plan. Actuarial pretax net gains recognized in other comprehensive income for the year ended December 31, 2017 were $1.5 million for the defined benefit pension plan.

Defined benefit pension expense is recorded in Salaries and employee benefits expense on the consolidated statements of income.

RECENT ACCOUNTING PRONOUNCEMENTS

See Note 1, Summary of Significant Accounting Policies - Recent Accounting Pronouncements, in the notes to consolidated financial statements for a discussion of recent accounting pronouncements.

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ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Asset-Liability Management

The principal objective of our interest rate risk management is to evaluate the interest rate risk inherent in assets and liabilities, determine the appropriate level of risk to us given our business strategy, operating environment, capital and liquidity requirements and performance objectives, and manage the risk consistent with the guidelines approved by our Board of Directors. Management is responsible for reviewing with the Board of Directors our activities and strategies, the effect of those strategies on net interest income, the fair value of the portfolio and the effect that changes in interest rates will have on the portfolio and exposure limits. Management has developed an Asset-Liability Management and Investment Policy that meets the strategic objectives and regularly reviews the activities of the Bank.

Portfolio Composition

Our balance sheet assets are a mix of fixed and variable rate assets with consumer indirect loans, commercial loans, and MBSs comprising a significant portion of our assets. Our consumer indirect loan portfolio comprised 21% of assets and is primarily fixed rate loans with relatively short durations. Our commercial loan portfolio totaled 31% of assets and is a combination of fixed and variable rate loans, lines and mortgages. The MBS portfolio, including collateralized mortgages obligations, totaled 15% of assets with durations averaging three to five years.

Our liabilities are made up primarily of deposits, which account for 86% of total liabilities. Of these deposits, the majority, or 51%, is in nonpublic variable rate and noninterest bearing products including demand (both noninterest and interest- bearing), savings and money market accounts. In addition, fixed rate nonpublic certificate of deposit products make up 23% of total deposits. The Bank also has a significant amount of public deposits, which represented 26% of total deposits as of December 31, 2017.

Net Interest Income at Risk

A primary tool used to manage interest rate risk is rate shock simulation to measure the rate sensitivity. Rate shock simulation is a modeling technique used to estimate the impact of changes in rates on net interest income as well as economic value of equity. At December 31, 2017, the Bank s sensitivity was relatively neutral, meaning that net interest income is modestly impacted as interest rates change.

Net interest income at risk is measured by estimating the changes in net interest income resulting from instantaneous and sustained parallel shifts in interest rates of different magnitudes over a period of 12 months. The following table sets forth the estimated changes to net interest income over the 12-month period ending December 31, 2018 assuming instantaneous changes in interest rates for the given rate shock scenarios (dollars in thousands):

	Changes in Interest Rate			
	-100 bp	**+100 bp**	**+200 bp**	**+300 bp**
	$ (1,834)	$ (1,890)	$ (3,968)	$ (6,132)

Estimated change in net interest income				
% Change	(1.46)%	(1.50)%	(3.16)%	(4.88)%

In addition to the changes in interest rate scenarios listed above, other scenarios are typically modeled to measure interest rate risk. These scenarios vary depending on the economic and interest rate environment.

The simulation referenced above is based on our assumption as to the effect of interest rate changes on assets and liabilities and assumes a parallel shift of the yield curve. It also includes certain assumptions about the future pricing of loans and deposits in response to changes in interest rates. Further, it assumes that delinquency rates would not change as a result of changes in interest rates, although there can be no assurance that this will be the case. While this simulation is a useful measure as to net interest income at risk due to a change in interest rates, it is not a forecast of the future results, does not measure the effect of changing interest rates on noninterest income and is based on many assumptions that, if changed, could cause a different outcome.

Economic Value of Equity At Risk

The economic (or fair) value of financial instruments on our balance sheet will also vary under the interest rate scenarios previously discussed. This variance is measured by simulating changes in our economic value of equity (EVE), which is calculated by subtracting the estimated fair value of liabilities from the estimated fair value of assets. Fair values for financial instruments are estimated by discounting projected cash flows (principal and interest) at current replacement rates for each account type, while fair values of non-financial assets and liabilities are assumed to equal book value and do not vary with interest rate fluctuations. An economic value simulation is a static measure for balance sheet accounts at a given point in time, but this measurement can change substantially over time as the characteristics of our balance sheet evolve and as interest rate and yield curve assumptions are updated.

The amount of change in economic value under different interest rate scenarios depends on the characteristics of each class of financial instrument, including the stated interest rate or spread relative to current market rates or spreads, the likelihood of prepayment, whether the rate is fixed or floating, and the maturity date of the instrument. As a general rule, fixed-rate financial assets become more valuable in declining rate scenarios and less valuable in rising rate scenarios, while fixed-rate financial liabilities gain in value as interest rates rise and lose value as interest rates decline. The longer the duration of the financial instrument, the greater the impact a rate change will have on its value. In our economic value simulations, estimated prepayments are factored in for financial instruments with stated maturity dates, and decay rates for non-maturity deposits are projected based on historical data (back-testing).

The analysis that follows presents the estimated EVE resulting from market interest rates prevailing at a given quarter-end (Pre-Shock Scenario), and under other interest rate scenarios (each a Rate Shock Scenario) represented by immediate, permanent, parallel shifts in interest rates from those observed at December 31, 2017 and 2016. The analysis additionally presents a measurement of the interest rate sensitivity at December 31, 2017 and 2016. EVE amounts are computed under each respective Pre- Shock Scenario and Rate Shock Scenario. An increase in the EVE amount is considered favorable, while a decline is considered unfavorable.

	December 31, 2017			December 31, 2016		
Rate Shock Scenario:	**EVE**	**Change**	**Percentage Change**	**EVE**	**Change**	**Percentage Change**
Pre-Shock Scenario	$ 578,550			$ 532,744		
- 100 Basis Points	592,527	$ 13,977	2.42%	543,506	$ 10,762	2.02%
+ 100 Basis Points	544,507	(34,043)	(5.88)	507,924	(24,820)	(4.66)
+ 200 Basis Points	507,137	(71,413)	(12.34)	481,692	(51,052)	(9.58)
+ 300 Basis Points	468,787	(109,763)	(18.97)	445,207	(87,537)	(16.43)

The Pre-Shock Scenario EVE was $578.6 million at December 31, 2017, compared to $532.7 million at December 31, 2016. The increase in the Pre-Shock Scenario EVE at December 31, 2017, compared to December 31, 2016 resulted primarily from a more favorable valuation of non-maturity deposits and certain fixed rate assets that reflected alternative funding rate changes used for discounting future cash flows.

The +200 basis point Rate Shock Scenario EVE increased from $481.7 million at December 31, 2016 to $507.1 million at December 31, 2017. The percentage change in the EVE amount from the Pre-Shock Scenario to the +200 basis point Rate Shock Scenario changed from (9.58)% at December 31, 2016 to (12.34)% at December 31, 2017. The increase in sensitivity resulted from a decreased benefit in the valuation of certain fixed rate assets in the +200 basis point Rate Shock Scenario EVE as of December 31, 2017, compared to December 31, 2016.

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Interest Rate Sensitivity Gap

The following table presents an analysis of our interest rate sensitivity gap position at December 31, 2017. All interest-earning assets and interest-bearing liabilities are shown based on the earlier of their contractual maturity or re-pricing date. The expected maturities are presented on a contractual basis or, if more relevant, based on projected call dates. Investment securities are at amortized cost for both securities available for sale and securities held to maturity. Loans, net of deferred loan origination costs, include principal amortization adjusted for estimated prepayments (principal payments in excess of contractual amounts) and non-accruing loans. Because the interest rate sensitivity levels shown in the table could be changed by external factors such as loan prepayments and liability decay rates or by factors controllable by us, such as asset sales, it is not an absolute reflection of our potential interest rate risk profile (in thousands).

	At December 31, 2017				
	Three Months or Less	Over Three Months Through One Year	Over One Year Through Five Years	Over Five Years	Total
INTEREST-EARNING ASSETS:					
Investment securities	$ 56,012	$ 140,089	$ 474,956	$ 373,867	$ 1,044,924
Loans	810,119	406,864	1,178,077	342,675	2,737,735
Total interest-earning assets	$ 866,131	$ 546,953	$ 1,653,033	$ 716,542	3,782,659
Cash and due from banks					99,195
Other assets [(1)]					223,356
Total assets					$ 4,105,210
INTEREST-BEARING LIABILITIES:					
Interest-bearing demand, savings and money market	$ 1,639,520	$ -	$ -	$ -	$ 1,639,520
Time deposits	352,352	326,001	173,803	-	852,156
Borrowings	414,400	31,800	-	39,131	485,331
Total interest-bearing liabilities	$ 2,406,272	$ 357,801	$ 173,803	$ 39,131	2,977,007
Noninterest-bearing deposits					718,498
Other liabilities					28,528
Total liabilities					3,724,033
Shareholders equity					381,177
Total liabilities and shareholders equity					$ 4,105,210

Interest sensitivity gap	$ (1,540,141)	$ 189,152	$ 1,479,230	$ 677,411	$ 805,652
Cumulative gap	$ (1,540,141)	$ (1,350,989)	$ 128,241	$ 805,652	
Cumulative gap ratio [2]	36.0 %	51.1 %	104.4 %	127.1 %	
Cumulative gap as a percentage of total assets	(37.5) %	(32.9) %	3.1 %	19.6 %	

[1] Includes net unrealized loss on securities available for sale and allowance for loan losses.
[2] Cumulative total interest-earning assets divided by cumulative total interest-bearing liabilities.

For purposes of interest rate risk management, we direct more attention on simulation modeling, such as net interest income at risk as previously discussed, rather than gap analysis. We consider the net interest income at risk simulation modeling to be more informative in forecasting future income at risk.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

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Management s Report on Internal Control over Financial Reporting

Management is responsible for establishing and maintaining adequate internal control over financial reporting for Financial Institutions, Inc. and its subsidiaries (the Company), as such term is defined in Exchange Act Rule 13a-15(f). The Company s system of internal control over financial reporting has been designed to provide reasonable assurance to the Company s management and board of directors regarding the reliability of financial reporting and the preparation and fair presentation of financial statements for external purposes in accordance with U.S. generally accepted accounting principles.

Any system of internal control over financial reporting, no matter how well designed, has inherent limitations, including the possibility that a control can be circumvented or overridden and misstatements due to error or fraud may occur and not be detected. Also, because of changes in conditions, internal control effectiveness may vary over time. Accordingly, even an effective system of internal control will provide only reasonable assurance with respect to financial statement preparation and presentation.

The Company s management has, including the Company s principal executive officer and principal financial officer as identified below, assessed the effectiveness of the Company s internal control over financial reporting as of December 31, 2017. To make this assessment, we used the criteria for effective internal control over financial reporting described in *Internal Control Integrated Framework (2013)*, issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on our assessment and based on such criteria, we believe that, as of December 31, 2017, the Company s internal control over financial reporting was effective.

KPMG LLP, the Company s independent registered public accounting firm that audited the Company s consolidated financial statements has issued an attestation report on internal control over financial reporting as of December 31, 2017. That report appears herein.

/s/ Martin K. Birmingham
President and Chief Executive Officer
March 14, 2018

/s/ Kevin B. Klotzbach
Executive Vice President and Chief Financial Officer
March 14, 2018

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Report of Independent Registered Public Accounting Firm

To the Shareholders and Board of Directors

Financial Institutions, Inc.:

Opinion on the Consolidated Financial Statements

We have audited the accompanying consolidated statements of financial condition of Financial Institutions, Inc. and subsidiaries (the Company) as of December 31, 2017 and 2016, the related consolidated statements of income, comprehensive income, changes in shareholders equity, and cash flows for each of the years in the three-year period ended December 31, 2017, and the related notes (collectively, the consolidated financial statements). In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of the Company as of December 31, 2017 and 2016, and the results of its operations and its cash flows for each of the years in the three-year period ended December 31, 2017, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) (PCAOB), the Company s internal control over financial reporting as of December 31, 2017, based on criteria established in *Internal Control Integrated Framework (2013)* issued by the Committee of Sponsoring Organizations of the Treadway Commission, and our report dated March 14, 2018 expressed an unqualified opinion on the effectiveness of the Company s internal control over financial reporting.

Basis for Opinion

These consolidated financial statements are the responsibility of the Company s management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We are a public accounting firm registered with the PCAOB and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement, whether due to error or fraud. Our audits included performing procedures to assess the risks of material misstatement of the consolidated financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the consolidated financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements. We believe that our audits provide a reasonable basis for our opinion.

/s/ KPMG LLP

We have served as the Company s auditor since 1995.

Rochester, New York

March 14, 2018

Report of Independent Registered Public Accounting Firm

To the Shareholders and Board of Directors

Financial Institutions, Inc.:

Opinion on Internal Control Over Financial Reporting

We have audited Financial Institutions, Inc. and subsidiaries (the Company) internal control over financial reporting as of December 31, 2017, based on criteria established in *Internal Control Integrated Framework (2013)* issued by the Committee of Sponsoring Organizations of the Treadway Commission. In our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2017, based on criteria established in *Internal Control Integrated Framework (2013)* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) (PCAOB), the consolidated statements of financial condition of the Company as of December 31, 2017 and 2016, the related consolidated statements of income, comprehensive income, changes in shareholders equity, and cash flows for each of the years in the three-year period ended December 31, 2017, and the related notes (collectively, the consolidated financial statements), and our report dated March 14, 2018 expressed an unqualified opinion on those consolidated financial statements.

Basis for Opinion

The Company s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management s Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the Company s internal control over financial reporting based on our audit. We are a public accounting firm registered with the PCAOB and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audit in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

Definition and Limitations of Internal Control Over Financial Reporting

A company s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company s internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance

with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company s assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

/s/ KPMG LLP

Rochester, New York

March 14, 2018

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Consolidated Statements of Financial Condition

(in thousands, except share and per share data)	December 31, 2017	2016
ASSETS		
Cash and due from banks	$ 99,195	$ 71,277
Securities available for sale, at fair value	524,973	539,926
Securities held to maturity, at amortized cost (fair value of $512,983 and $539,991, respectively)	516,466	543,338
Loans held for sale	2,718	1,050
Loans (net of allowance for loan losses of $34,672 and $30,934, respectively)	2,700,345	2,309,227
Company owned life insurance	65,288	63,455
Premises and equipment, net	45,189	42,398
Goodwill and other intangible assets, net	74,703	75,640
Other assets	76,333	64,029
Total assets	$ 4,105,210	$ 3,710,340
LIABILITIES AND SHAREHOLDERS EQUITY		
Deposits:		
Noninterest-bearing demand	$ 718,498	$ 677,076
Interest-bearing demand	634,203	581,436
Savings and money market	1,005,317	1,034,194
Time deposits	852,156	702,516
Total deposits	3,210,174	2,995,222
Short-term borrowings	446,200	331,500
Long-term borrowings, net of issuance costs of $869 and $939, respectively	39,131	39,061
Other liabilities	28,528	24,503
Total liabilities	3,724,033	3,390,286
Commitments and contingencies (Note 11)		
Shareholders equity:		
Series A 3% preferred stock, $100 par value; 1,533 shares authorized; 1,439 and 1,492 shares issued	144	149
Series B-1 8.48% preferred stock, $100 par value; 200,000 shares authorized; 171,847 and 171,906 shares issued	17,185	17,191
Total preferred equity	17,329	17,340
Common stock, $0.01 par value; 50,000,000 shares authorized; 16,056,178 and 14,692,214 shares issued	161	147
Additional paid-in capital	121,058	81,755

Retained earnings	257,078	237,687
Accumulated other comprehensive loss	(11,916)	(13,951)
Treasury stock, at cost 131,240 and 154,617 shares, respectively	(2,533)	(2,924)
Total shareholders equity	381,177	320,054
Total liabilities and shareholders equity	$ 4,105,210	$ 3,710,340

See accompanying notes to the consolidated financial statements.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Consolidated Statements of Income

(in thousands, except per share data)	Years ended December 31,		
	2017	**2016**	**2015**
Interest income:			
Interest and fees on loans	$ 106,282	$ 92,296	$ 83,575
Interest and dividends on investment securities	23,755	22,917	21,875
Other interest income	73	18	-
Total interest income	130,110	115,231	105,450
Interest expense:			
Deposits	11,093	8,458	7,306
Short-term borrowings	3,931	1,612	1,081
Long-term borrowings	2,471	2,471	1,750
Total interest expense	17,495	12,541	10,137
Net interest income	112,615	102,690	95,313
Provision for loan losses	13,361	9,638	7,381
Net interest income after provision for loan losses	99,254	93,052	87,932
Noninterest income:			
Service charges on deposits	7,391	7,280	7,742
Insurance income	5,266	5,396	5,166
ATM and debit card	5,721	5,687	5,084
Investment advisory	6,104	5,208	2,193
Company owned life insurance	1,781	2,808	1,962
Investments in limited partnerships	110	300	895
Loan servicing	439	436	503
Net gain on sale of loans held for sale	376	240	249
Net gain on investment securities	1,260	2,695	1,988
Net gain on other assets	37	313	27
Amortization of tax credit investment	-	-	(390)
Contingent consideration liability adjustment	1,200	1,170	1,093
Other	5,045	4,227	3,825
Total noninterest income	34,730	35,760	30,337
Noninterest expense:			
Salaries and employee benefits	48,675	45,215	42,439
Occupancy and equipment	16,293	14,529	13,856
Professional services	4,083	5,782	3,681

Computer and data processing		4,935		4,451		4,267
Supplies and postage		2,003		2,047		2,155
FDIC assessments		1,817		1,735		1,719
Advertising and promotions		2,171		2,097		1,986
Amortization of intangibles		1,170		1,249		942
Goodwill impairment		1,575		-		751
Other		7,791		7,566		7,597
Total noninterest expense		90,513		84,671		79,393
Income before income taxes		43,471		44,141		38,876
Income tax expense		9,945		12,210		10,539
Net income	$	33,526	$	31,931	$	28,337
Preferred stock dividends		1,462		1,462		1,462
Net income available to common shareholders	$	32,064	$	30,469	$	26,875
Earnings per common share (Note 17):						
Basic	$	2.13	$	2.11	$	1.91
Diluted	$	2.13	$	2.10	$	1.90
Cash dividends declared per common share	$	0.85	$	0.81	$	0.80
Weighted average common shares outstanding:						
Basic		15,044		14,436		14,081
Diluted		15,085		14,491		14,135

See accompanying notes to the consolidated financial statements.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Consolidated Statements of Comprehensive Income

(in thousands)	Years ended December 31,		
	2017	**2016**	**2015**
Net income	$ 33,526	$ 31,931	$ 28,337
Other comprehensive income (loss), net of tax:			
Net unrealized gains (losses) on securities available for sale	454	(3,033)	(2,321)
Pension and post-retirement obligations	1,581	409	5
Total other comprehensive income (loss), net of tax	2,035	(2,624)	(2,316)
Comprehensive income	$ 35,561	$ 29,307	$ 26,021

See accompanying notes to the consolidated financial statements.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Consolidated Statements of Changes in Shareholders Equity

Years ended December 31, 2017, 2016 and 2015

(in thousands, except per share data)	Preferred Equity	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Treasury Stock	Total Shareholders Equity
Balance at January 1, 2015	**$ 17,340**	**$ 144**	**$ 72,955**	**$ 203,312**	**$ (9,011)**	**$ (5,208)**	**$ 279,532**
Comprehensive income:							
Net income	-	-	-	28,337	-	-	28,337
Other comprehensive loss, net of tax	-	-	-	-	(2,316)	-	(2,316)
Purchases of common stock for treasury	-	-	-	-	-	(202)	(202)
Share-based compensation plans:							
Share-based compensation	-	-	674	-	-	-	674
Stock options exercised	-	-	6	-	-	353	359
Restricted stock awards issued, net	-	-	(1,052)	-	-	1,052	-
Excess tax benefit	-	-	79	-	-	-	79
Stock awards	-	-	28	-	-	82	110
Cash dividends declared:							
Series A 3% Preferred-$3.00 per share	-	-	-	(4)	-	-	(4)
Series B-1 8.48% Preferred-$8.48 per share	-	-	-	(1,458)	-	-	(1,458)
Common-$0.80 per share	-	-	-	(11,267)	-	-	(11,267)
Balance at December 31, 2015	**$ 17,340**	**$ 144**	**$ 72,690**	**$ 218,920**	**$ (11,327)**	**$ (3,923)**	**$ 293,844**
Comprehensive income:							
Net income	-	-	-	31,931	-	-	31,931
Other comprehensive loss, net of tax	-	-	-	-	(2,624)	-	(2,624)

Common stock issued	-	3	8,097	-	-	-	8,100
Share-based compensation plans:							
Share-based compensation	-	-	845	-	-	-	845
Stock options exercised	-	-	23	-	-	941	964
Restricted stock awards issued, net	-	-	24	-	-	(24)	-
Excess tax benefit	-	-	30	-	-	-	30
Stock awards	-	-	46	-	-	82	128
Cash dividends declared:							
Series A 3% Preferred-$3.00 per share	-	-	-	(4)	-	-	(4)
Series B-1 8.48% Preferred-$8.48 per share	-	-	-	(1,458)	-	-	(1,458)
Common-$0.81 per share	-	-	-	(11,702)	-	-	(11,702)
Balance at December 31, 2016	**$ 17,340**	**$ 147**	**$ 81,755**	**$ 237,687**	**$ (13,951)**	**$ (2,924)**	**$ 320,054**

Continued on next page

See accompanying notes to the consolidated financial statements.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Consolidated Statements of Changes in Shareholders Equity (Continued)

Years ended December 31, 2017, 2016 and 2015

(in thousands, except per share data)	Preferred Equity	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Treasury Stock	Total Shareholders Equity
Balance at December 31, 2016 *Balance carried forward*	**$ 17,340**	**$ 147**	**$ 81,755**	**$ 237,687**	**$ (13,951)**	**$ (2,924)**	**$ 320,054**
Cumulative-effect adjustment	-	-	(279)	279	-	-	-
Balance at January 1, 2017	**$ 17,340**	**$ 147**	**$ 81,476**	**$ 237,966**	**$ (13,951)**	**$ (2,924)**	**$ 320,054**
Comprehensive income:							
Net income	-	-	-	33,526	-	-	33,526
Other comprehensive income, net of tax	-	-	-	-	2,035	-	2,035
Common stock issued	-	14	38,289	-	-	-	38,303
Purchase of common stock for treasury	-	-	-	-	-	(148)	(148)
Repurchase of Series A 3% preferred stock	(5)	-	2	-	-	-	(3)
Repurchase of Series B-1 8.48% preferred stock	(6)	-	-	-	-	-	(6)
Share-based compensation plans:							
Share-based compensation	-	-	1,174	-	-	-	1,174
Stock options exercised	-	-	5	-	-	408	413
Restricted stock awards issued, net	-	-	21	-	-	(21)	-
Stock awards	-	-	91	-	-	152	243
Cash dividends declared:							
Series A 3% Preferred-$3.00 per share	-	-	-	(4)	-	-	(4)
Series B-1 8.48% Preferred-$8.48 per share	-	-	-	(1,458)	-	-	(1,458)
Common-$0.85 per share	-	-	-	(12,952)	-	-	(12,952)
Balance at December 31, 2017	**$ 17,329**	**$ 161**	**$ 121,058**	**$ 257,078**	**$ (11,916)**	**$ (2,533)**	**$ 381,177**

See accompanying notes to the consolidated financial statements.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

Consolidated Statements of Cash Flows

(in thousands)	Years ended December 31,		
	2017	2016	2015
Cash flows from operating activities:			
Net income	$ 33,526	$ 31,931	$ 28,337
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	6,177	5,958	5,429
Net amortization of premiums on securities	3,298	3,192	3,150
Provision for loan losses	13,361	9,638	7,381
Share-based compensation	1,174	845	674
Deferred income tax expense (benefit)	12,403	(1,718)	1,798
Proceeds from sale of loans held for sale	14,555	11,655	16,195
Originations of loans held for sale	(15,847)	(11,035)	(16,621)
Increase in company owned life insurance	(1,781)	(2,808)	(1,962)
Net gain on sale of loans held for sale	(376)	(240)	(249)
Net gain on investment securities	(1,260)	(2,695)	(1,988)
Amortization of tax credit investment	-	-	390
Goodwill impairment	1,575	-	751
Net gain on other assets	(37)	(313)	(27)
(Increase) decrease in other assets	(24,505)	2,027	(545)
Increase (decrease) in other liabilities	4,016	257	376
Net cash provided by operating activities	46,279	46,694	43,089
Cash flows from investing activities:			
Purchases of investment securities:			
Available for sale	(86,434)	(213,413)	(271,899)
Held to maturity	(71,479)	(126,375)	(64,397)
Proceeds from principal payments, maturities and calls on investment securities:			
Available for sale	51,978	119,190	127,257
Held to maturity	96,376	66,579	36,162
Proceeds from sales of securities available for sale	50,084	95,261	54,277
Net loan originations	(404,905)	(262,684)	(180,067)
Proceeds from company owned life insurance, net of purchases	(52)	2,398	(79)
Proceeds from sales of other assets	234	854	365
Purchases of premises and equipment	(7,740)	(7,619)	(7,493)
Cash consideration paid for acquisition, net of cash acquired	(676)	(868)	-
Net cash used in investing activities	(372,614)	(326,677)	(305,874)

Cash flows from financing activities:			
Net increase in deposits	214,952	264,691	280,004
Net increase (decrease) in short-term borrowings	114,700	38,400	(41,704)
Issuance of long-term debt	-	-	40,000
Debt issuance costs	-	-	(1,060)
Repurchase of preferred stock	(9)	-	-
Proceeds from issuance of common stock	38,303	-	-
Purchases of common stock for treasury	(148)	-	(202)
Proceeds from stock options exercised	413	964	359
Excess tax benefit on share-based compensation	-	30	79
Cash dividends paid to preferred shareholders	(1,462)	(1,462)	(1,462)
Cash dividends paid to common shareholders	(12,496)	(11,484)	(11,259)
Net cash provided by financing activities	354,253	291,139	264,755
Net increase in cash and cash equivalents	27,918	11,156	1,970
Cash and cash equivalents, beginning of period	71,277	60,121	58,151
Cash and cash equivalents, end of period	$ 99,195	$ 71,277	$ 60,121

See accompanying notes to the consolidated financial statements.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2017, 2016 and 2015

(1.) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Financial Institutions, Inc. (individually referred to herein as the Parent Company and together with all of its subsidiaries, collectively referred to herein as the Company) is a financial holding company organized in 1931 under the laws of New York State (New York). At December 31, 2017, the Company conducted its business through its three subsidiaries: Five Star Bank (the Bank), a New York chartered bank; Scott Danahy Naylon, LLC (SDN), a full service insurance agency; and Courier Capital, LLC (Courier Capital), an SEC-registered investment advisory and wealth management firm. The Company provides a full range of banking and related financial services to consumer, commercial and municipal customers through its bank and nonbank subsidiaries.

The accounting and reporting policies conform to general practices within the banking industry and to U.S. generally accepted accounting principles (GAAP).

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

The following is a description of the Company s significant accounting policies.

(a.) Principles of Consolidation

The consolidated financial statements include the accounts of the Company and its subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation.

(b.) Use of Estimates

In preparing the consolidated financial statements in conformity with GAAP, management is required to make estimates and assumptions that affect the reported amount of assets and liabilities as of the date of the statement of financial condition and reported amounts of revenue and expenses during the reporting period. Material estimates relate to the determination of the allowance for loan losses, the carrying value of goodwill and deferred tax assets, and assumptions used in the defined benefit pension plan accounting. These estimates and assumptions are based on management s best estimates and judgment and are evaluated on an ongoing basis using historical experience and other factors, including the current economic environment. The Company adjusts these estimates and assumptions when facts and circumstances dictate. As future events cannot be determined with precision, actual results could differ significantly from the Company s estimates.

(c.) Cash Flow Reporting

Cash and cash equivalents include cash and due from banks, federal funds sold and interest-bearing deposits in other banks. Net cash flows are reported for loans, deposit transactions and short-term borrowings.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2017, 2016 and 2015

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

Supplemental cash flow information is summarized as follows for the years ended December 31 (in thousands):

	2017	2016	2015
Cash payments:			
Interest expense	$ 14,850	$ 11,823	$ 9,323
Income taxes	13,187	10,555	7,494
Noncash investing and financing activities:			
Real estate and other assets acquired in settlement of loans	$ 426	$ 496	$ 374
Accrued and declared unpaid dividends	3,859	3,403	3,185
Increase (decrease) in net unsettled security purchases	-	(170)	(478)
Securities transferred from available for sale to held to maturity	-	-	165,238
Common stock issued for acquisition	-	8,100	-
Assets acquired and liabilities assumed in business combinations:			
Loans and other non-cash assets, excluding goodwill and other intangible assets	812	4,848	-
Deposits and other liabilities	44	1,845	-

(d.) Investment Securities

Investment securities are classified as either available for sale or held to maturity. Debt securities that management has the positive intent and ability to hold to maturity are classified as held to maturity and are recorded at amortized cost. Other investment securities are classified as available for sale and recorded at fair value, with unrealized gains and losses excluded from earnings and reported as a component of comprehensive income and shareholders equity.

Purchase premiums and discounts are recognized in interest income using the interest method over the terms of the securities. Securities are evaluated periodically to determine whether a decline in their fair value is other than temporary. Management utilizes criteria such as, the current intent to hold or sell the security, the magnitude and duration of the decline and, when appropriate, consideration of negative changes in expected cash flows, creditworthiness, near term prospects of issuers, the level of credit subordination, estimated loss severity, and delinquencies, to determine whether a loss in value is other than temporary. The term other than temporary is not intended to indicate that the decline is permanent, but indicates that the prospect for a near-term recovery of value is not necessarily favorable. Declines in the fair value of investment securities below their cost that are deemed to be other than temporary are reflected in earnings as realized losses to the extent the impairment is related to credit issues or concerns, or the security is intended to be sold. The amount of impairment related to non-credit related factors is

recognized in other comprehensive income. Gains and losses on the sale of securities are recorded on the trade date and are determined using the specific identification method.

(e.) Loans Held for Sale and Loan Servicing Rights

The Company generally makes the determination of whether to identify a mortgage as held for sale at the time the loan is closed based on the Company s intent and ability to hold the loan. Loans held for sale are recorded at the lower of cost or market computed on the aggregate portfolio basis. The amount, by which cost exceeds market value, if any, is accounted for as a valuation allowance with changes included in the determination of results of operations for the period in which the change occurs. The amount of loan origination costs and fees are deferred at origination and recognized as part of the gain or loss on sale of the loans, determined using the specific identification method, in the consolidated statements of income.

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2017, 2016 and 2015

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

The Company originates and sells certain residential real estate loans in the secondary market. The Company typically retains the right to service the mortgages upon sale. Mortgage-servicing rights (MSRs) represent the cost of acquiring the contractual rights to service loans for others. MSRs are recorded at their fair value at the time a loan is sold and servicing rights are retained. MSRs are reported in other assets in the consolidated statements of financial position and are amortized to noninterest income in the consolidated statements of income in proportion to and over the period of estimated net servicing income. The Company uses a valuation model that calculates the present value of future cash flows to determine the fair value of servicing rights. In using this valuation method, the Company incorporates assumptions to estimate future net servicing income, which include estimates of the cost to service the loan, the discount rate, an inflation rate and prepayment speeds. On a quarterly basis, the Company evaluates its MSRs for impairment and charges any such impairment to current period earnings. In order to evaluate its MSRs the Company stratifies the related mortgage loans on the basis of their predominant risk characteristics, such as interest rates, year of origination and term, using discounted cash flows and market-based assumptions. Impairment of MSRs is recognized through a valuation allowance, determined by estimating the fair value of each stratum and comparing it to its carrying value. Subsequent increases in fair value are adjusted through the valuation allowance, but only to the extent of the valuation allowance.

Mortgage loan servicing includes collecting monthly mortgagor payments, forwarding payments and related accounting reports to investors, collecting escrow deposits for the payment of mortgagor property taxes and insurance, paying taxes and insurance from escrow funds when due and administrating foreclosure actions when necessary. Loan servicing income (a component of noninterest income in the consolidated statements of income) consists of fees earned for servicing mortgage loans sold to third parties, net of amortization expense and impairment losses associated with capitalized mortgage servicing assets.

(f.) Loans

Loans are classified as held for investment when management has both the intent and ability to hold the loan for the foreseeable future, or until maturity or payoff. Loans are carried at the principal amount outstanding, net of any unearned income and unamortized deferred fees and costs on originated loans. Loan origination fees and certain direct loan origination costs are deferred, and the net amount is amortized into net interest income over the contractual life of the related loans or over the commitment period as an adjustment of yield. Interest income on loans is based on the principal balance outstanding computed using the effective interest method.

A loan is considered delinquent when a payment has not been received in accordance with the contractual terms. The accrual of interest income for commercial loans is discontinued when there is a clear indication that the borrower s cash flow may not be sufficient to meet payments as they become due, while the accrual of interest income for retail loans is discontinued when loans reach specific delinquency levels. Loans are generally placed on nonaccrual status when contractually past due 90 days or more as to interest or principal payments, unless the loan is well secured and

in the process of collection. Additionally, if management becomes aware of facts or circumstances that may adversely impact the collectability of principal or interest on loans, it is management s practice to place such loans on a nonaccrual status immediately, rather than delaying such action until the loans become 90 days past due. When a loan is placed on nonaccrual status, previously accrued and uncollected interest is reversed, amortization of related deferred loan fees or costs is suspended, and income is recorded only to the extent that interest payments are subsequently received in cash and a determination has been made that the principal balance of the loan is collectible. If collectability of the principal is in doubt, payments received are applied to loan principal. A nonaccrual loan may be returned to accrual status when all delinquent principal and interest payments become current in accordance with the terms of the loan agreement, the borrower has demonstrated a period of sustained performance (generally a minimum of six months) and the ultimate collectability of the total contractual principal and interest is no longer in doubt.

The Company s loan policy dictates the guidelines to be followed in determining when a loan is charged-off. All charge offs are approved by the Bank s senior loan officers or loan committees, depending on the amount of the charge off, and are reported in aggregate to the Bank s Board of Directors. Commercial business and commercial mortgage loans are charged-off when a determination is made that the financial condition of the borrower indicates that the loan will not be collectible in the ordinary course of business. Residential mortgage loans and home equities are generally charged-off or written down when the credit becomes severely delinquent and the balance exceeds the fair value of the property less costs to sell. Indirect and other consumer loans, both secured and unsecured, are generally charged-off in full during the month in which the loan becomes 120 days past due, unless the collateral is in the process of repossession in accordance with the Company s policy.

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2017, 2016 and 2015

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

A loan is accounted for as a troubled debt restructuring if the Company, for economic or legal reasons related to the borrower s financial condition, grants a significant concession to the borrower that it would not otherwise consider. A troubled debt restructuring may involve the receipt of assets from the debtor in partial or full satisfaction of the loan, or a modification of terms such as a reduction of the stated interest rate or face amount of the loan, a reduction of accrued interest, an extension of the maturity date at a stated interest rate lower than the current market rate for a new loan with similar risk, or some combination of these concessions. Troubled debt restructurings generally remain on nonaccrual status until there is a sustained period of payment performance (usually six months or longer) and there is a reasonable assurance that the payments will continue. See Allowance for Loan Losses below for further policy discussion and see Note 5 Loans for additional information.

(g.) Off-Balance Sheet Financial Instruments

In the ordinary course of business, the Company enters into off-balance sheet financial instruments consisting of commitments to extend credit, standby letters of credit and financial guarantees. Such financial instruments are recorded in the consolidated financial statements when they are funded or when related fees are incurred or received. The Company periodically evaluates the credit risks inherent in these commitments and establishes loss allowances for such risks if and when these are deemed necessary.

The Company recognizes as liabilities the fair value of the obligations undertaken in issuing the guarantees under the standby letters of credit, net of the related amortization at inception. The fair value approximates the unamortized fees received from the customers for issuing the standby letters of credit. The fees are deferred and recognized on a straight-line basis over the commitment period. Standby letters of credit outstanding typically have original terms ranging from one to five years. Fees received for providing loan commitments and letters of credit that result in loans are typically deferred and amortized to interest income over the life of the related loan, beginning with the initial borrowing. Fees on commitments and letters of credit are amortized to other income as banking fees and commissions over the commitment period when funding is not expected.

(h.) Allowance for Loan Losses

The allowance for loan losses is established through charges to earnings in the form of a provision for loan losses. When a loan or portion of a loan is determined to be uncollectible, the portion deemed uncollectible is charged against the allowance and subsequent recoveries, if any, are credited to the allowance.

The allowance for loan losses is evaluated on a regular basis and is based upon periodic review of the collectability of the loans in light of historical experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower s ability to repay, estimated value of any underlying collateral, and prevailing economic conditions. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more

information becomes available.

The allowance consists of specific and general components. Specific allowances are established for impaired loans. Impaired commercial business and commercial mortgage loans are individually evaluated and measured for impairment based on the present value of expected future cash flows discounted at the loan s effective interest rate, a loan s observable market price, or the fair value of the collateral if the loan is collateral dependent. Regardless of the measurement method, impairment is based on the fair value of the collateral when foreclosure is probable. If the recorded investment in impaired loans exceeds the measure of estimated fair value, a specific allowance is established as a component of the allowance for loan losses. Interest payments on impaired loans are typically applied to principal unless collectability of the principal amount is reasonably assured, in which case interest is recognized on a cash basis. Impaired loans, or portions thereof, are charged-off when deemed uncollectible.

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2017, 2016 and 2015

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

A loan is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered in determining impairment include payment status and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. The Company determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower s prior payment record, and the amount of the shortfall in relation to the principal and interest owed. Impairment is measured on a loan by loan basis by either the present value of expected future cash flows discounted at the loan s effective interest rate, the loans obtainable market price, or the fair value of the collateral if the loan is collateral dependent. Large groups of homogeneous loans are collectively evaluated for impairment. Accordingly, the Company does not separately identify individual consumer and residential loans for impairment disclosures unless the loan has been subject to a troubled debt restructure. At December 31, 2017, there were no commitments to lend additional funds to those borrowers whose loans were classified as impaired.

General allowances are established for loan losses on a portfolio basis for loans that are collectively evaluated for impairment. The portfolio is grouped into similar risk characteristics, primarily loan type. The Company applies an estimated loss rate, which considers both look-back and loss emergence periods, to each loan group. The loss rate is based on historical experience, with a look-back period of 24 months, and as a result can differ from actual losses incurred in the future. The historical loss rate is adjusted by the loss emergence periods that range from 12 to 28 months depending on the loan type, and for qualitative factors such as; levels and trends of delinquent and non-accruing loans, trends in volume and terms, effects of changes in lending policy, the experience, ability and depth of management, national and local economic trends and conditions, concentrations of credit risk, interest rates, highly leveraged borrowers, information risk and collateral risk. The qualitative factors are reviewed at least quarterly and adjustments are made as needed.

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

(i.) Other Real Estate Owned

Other real estate owned consists of properties acquired through foreclosure or by acceptance of a deed in lieu of foreclosure. These assets are recorded at the lower of fair value of the asset acquired less estimated costs to sell or cost

(defined as the fair value at initial foreclosure). At the time of foreclosure, or when foreclosure occurs in-substance, the excess, if any, of the loan over the fair market value of the assets received, less estimated selling costs, is charged to the allowance for loan losses and any subsequent valuation write-downs are charged to other expense. In connection with the determination of the allowance for loan losses and the valuation of other real estate owned, management obtains appraisals for properties. Operating costs associated with the properties are charged to expense as incurred. Gains on the sale of other real estate owned are included in income when title has passed and the sale has met the minimum down payment requirements prescribed by GAAP. The balance of other real estate owned was $148 thousand and $107 thousand at December 31, 2017 and 2016, respectively.

(j.) Company Owned Life Insurance

The Company holds life insurance policies on certain current and former employees. The Company is the owner and beneficiary of the policies. The cash surrender value of these policies is included as an asset on the consolidated statements of financial condition, and any increase in cash surrender value is recorded as noninterest income on the consolidated statements of income. In the event of the death of an insured individual under these policies, the Company would receive a death benefit which would be recorded as noninterest income.

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2017, 2016 and 2015

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

(k.) Premises and Equipment

Premises and equipment are stated at cost, less accumulated depreciation and amortization. Depreciation is computed on the straight-line method over the estimated useful lives of the assets. The Company generally amortizes buildings and building improvements over a period of 15 to 39 years and software, furniture and equipment over a period of 3 to 10 years. Leasehold improvements are amortized over the shorter of the lease term or the useful life of the improvements. Premises and equipment are periodically reviewed for impairment or when circumstances present indicators of impairment.

(l.) Goodwill and Other Intangible Assets

The excess of the cost of an acquisition over the fair value of the net assets acquired consists primarily of goodwill, core deposit intangibles, and other identifiable intangible assets. Intangible assets are acquired assets that lack physical substance but can be distinguished from goodwill because of contractual or other legal rights or because the asset is capable of being sold or exchanged either on its own or in combination with a related contract, asset, or liability. The Company s intangible assets consist of core deposits and other intangible assets (primarily customer relationships). Core deposit intangible assets are amortized on an accelerated basis over their estimated life of approximately nine and a half years. Other intangible assets are amortized on an accelerated basis over their weighted average estimated life of approximately twenty years. The Company reviews long-lived assets and certain identifiable intangibles for impairment at least annually, or whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable, in which case an impairment charge would be recorded.

Goodwill is not amortized but, instead, is subject to impairment tests on at least an annual basis, and more frequently if an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying amount. The impairment testing process is conducted by assigning net assets and goodwill to each reporting unit. An initial qualitative evaluation (Step 0) is made to assess the likelihood of impairment and determine whether further quantitative testing to calculate the fair value is necessary. When the qualitative evaluation indicates that impairment is more likely than not, quantitative testing is required whereby the fair value of each reporting unit is calculated and compared to the recorded book value (Step 1). If the calculated fair value of the reporting unit exceeds its carrying value, then goodwill is not considered impaired. However, if the carrying value of a reporting unit exceeds its calculated fair value, a goodwill impairment charge is recognized. See Note 7 for additional information on goodwill and other intangible assets.

(m.) Federal Home Loan Bank (FHLB) and Federal Reserve Bank (FRB) Stock

The non-marketable investments in FHLB and FRB stock are included in other assets in the consolidated statements of financial condition at par value or cost and are periodically reviewed for impairment. The dividends received

relative to these investments are included in other noninterest income in the consolidated statements of income.

As a member of the FHLB system, the Company is required to maintain a specified investment in FHLB of New York (FHLBNY) stock in proportion to its volume of certain transactions with the FHLB. FHLBNY stock totaled $21.9 million and $16.9 million as of December 31, 2017 and 2016, respectively.

As a member of the FRB system, the Company is required to maintain a specified investment in FRB stock based on a ratio relative to the Company s capital. FRB stock totaled $5.8 million and $4.9 million as of December 31, 2017 and 2016, respectively.

(n.) Equity Method Investments

The Company has investments in limited partnerships, primarily Small Business Investment Companies, and accounts for these investments under the equity method. These investments are included in other assets in the consolidated statements of financial condition and totaled $5.7 million and $5.6 million as of December 31, 2017 and 2016, respectively.

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2017, 2016 and 2015

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

(o.) Derivative Instruments and Hedging Activities

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

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

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

(p.) Treasury Stock

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

(q.) Employee Benefits

The Company maintains an employer sponsored 401(k) plan where participants may make contributions in the form of salary deferrals and the Company may provide discretionary matching contributions in accordance with the terms of the plan. Contributions due under the terms of our defined contribution plans are accrued as earned by employees.

The Company also participates in a non-contributory defined benefit pension plan for certain employees who previously met participation requirements. The Company also provides post-retirement benefits, principally health and dental care, to employees of a previously acquired entity. The Company has closed the pension and post-retirement

plans to new participants. The actuarially determined pension benefit is based on years of service and the employee s highest average compensation during five consecutive years of employment. The Company s policy is to at least fund the minimum amount required by the Employment Retirement Income Security Act of 1974. The cost of the pension and post-retirement plans are based on actuarial computations of current and future benefits for employees, and is charged to noninterest expense in the consolidated statements of income.

The Company recognizes an asset or a liability for a plans overfunded status or underfunded status, respectively, in the consolidated financial statements and reports changes in the funded status as a component of other comprehensive income, net of applicable taxes, in the year in which changes occur.

Effective January 1, 2016, the Company s 401(k) plan was amended and the Company s prior matching contribution was discontinued. Concurrent with the 401(k) plan amendment, the Company s defined benefit pension plan was amended to modify the current benefit formula to reflect the discontinuance of the matching contribution in the 401(k) plan, to open the defined benefit pension plan up to eligible employees who were hired on and after January 1, 2007, which provides those new participants with a cash balance benefit formula.

(r.) Share-Based Compensation Plans

Compensation expense for stock options and restricted stock awards is based on the fair value of the award on the measurement date, which, for the Company, is the date of grant and is recognized ratably over the service period of the award. The fair value of stock options is estimated using the Black-Scholes option-pricing model. The fair value of restricted stock awards is generally the market price of the Company s stock on the date of grant.

Share-based compensation expense is included in the consolidated statements of income under salaries and employee benefits for awards granted to management and in other noninterest expense for awards granted to directors.

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2017, 2016 and 2015

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

(s.) Income Taxes

Income taxes are accounted for using the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates in effect for the year in which those temporary differences are expected to be recovered or settled. The effect of a change in tax rates on deferred tax assets and liabilities is recognized in income in the period that includes the enactment date. A valuation allowance is recognized on deferred tax assets if, based upon the weight of available evidence, it is more likely than not that some or all of the assets may not be realized. The Company recognizes interest and/or penalties related to income tax matters in income tax expense.

(t.) Comprehensive Income

Comprehensive income includes all changes in shareholders equity during a period, except those resulting from transactions with shareholders. In addition to net income, other components of the Company s comprehensive income include the after-tax effect of changes in net unrealized gain / loss on securities available for sale and changes in net actuarial gain / loss on defined benefit post-retirement plans. Comprehensive income is reported in the accompanying consolidated statements of changes in shareholders equity and consolidated statements of comprehensive income. See Note 14 - Accumulated Other Comprehensive Income (Loss) for additional information.

(u.) Earnings Per Common Share

The Company calculates earnings per common share (EPS) using the two-class method in accordance with FASB ASC Topic 260, Earnings Per Share . The two-class method requires the Company to present EPS as if all of the earnings for the period are distributed to common shareholders and any participating securities, regardless of whether any actual dividends or distributions are made. All outstanding unvested share-based payment awards that contain rights to non-forfeitable dividends are considered participating securities.

Basic EPS is computed by dividing distributed and undistributed earnings available to common shareholders by the weighted average number of common shares outstanding for the period. Distributed and undistributed earnings available to common shareholders represent net income reduced by preferred stock dividends and distributed and undistributed earnings available to participating securities. Common shares outstanding include common stock and vested restricted stock awards. Diluted EPS reflects the assumed conversion of all potential dilutive securities. A reconciliation of the weighted-average shares used in calculating basic earnings per common share and the weighted average common shares used in calculating diluted earnings per common share for the reported periods is provided in Note 17 - Earnings Per Common Share.

(v.) Reclassifications

Certain items in prior financial statements have been reclassified to conform to the current presentation.

(w.) Recent Accounting Pronouncements

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

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2017, 2016 and 2015

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

In January 2016, the FASB issued ASU No. 2016-01, *Financial Instruments - Overall (Subtopic 825-10) - Recognition and Measurement of Financial Assets and Financial Liabilities*. ASU 2016-01 is intended to improve the recognition and measurement of financial instruments by requiring equity investments to be measured at fair value with changes in fair value recognized in net income; requiring entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes; requiring separate presentation of financial assets and financial liabilities by measurement category and form of financial asset on the balance sheet or the accompanying notes to the financial statements; eliminating the requirement for entities to disclose the method(s) and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured and amortized at cost on the balance sheet; and requiring an entity to present separately in other comprehensive income the portion of the total change in the fair value of a liability resulting from a change in the instrument-specific credit risk when the entity has elected to measure the liability at fair value in accordance with the fair value option for financial instruments. ASU 2016-01 is effective for annual periods and interim periods within those annual periods, beginning after December 15, 2017. The amendments should be applied by means of a cumulative-effect adjustment to the balance sheet as of the beginning of the fiscal year of adoption. The amendments related to equity securities without readily determinable fair values (including disclosure requirements) should be applied prospectively to equity investments that exist as of the date of adoption. The adoption of ASU 2016-01 is not expected to have a significant impact on the Company s financial statements.

In February 2016, the FASB issued ASU No. 2016-02, *Leases (Topic 842)*. ASU 2016-02 establishes a right of use model that requires a lessee to record a right of use asset and a lease liability for all leases with terms longer than 12 months. Leases will be classified as either finance or operating, with classification affecting the pattern of expense recognition in the income statement. For lessors, the guidance modifies the classification criteria and the accounting for sales-type and direct financing leases. A lease will be treated as a sale if it transfers all of the risks and rewards, as well as control of the underlying asset, to the lessee. If risks and rewards are conveyed without the transfer of control, the lease is treated as a financing. If the lessor doesn t convey risks and rewards or control, an operating lease results. The amendments are effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years for public business entities. Entities are required to use a modified retrospective approach for leases that exist or are entered into after the beginning of the earliest comparative period in the financial statements, with certain practical expedients available. Early adoption is permitted. The Company is assessing the impact of ASU 2016-02 on its financial statements.

In March 2016, the FASB issued ASU No. 2016-09, *Compensation - Stock Compensation (Topic 718) - Improvements to Employee Share-Based Payment Accounting*. ASU 2016-09 requires all income tax effects of awards to be recognized in the income statement when the awards vest or are settled. It also allows an employer to repurchase more of an employee s shares than it can today for tax withholding purposes without triggering liability accounting and to make a policy election for forfeitures as they occur. The guidance is effective for fiscal years beginning after December 15, 2016, and interim periods within those years. Early adoption was permitted. The adoption of ASU

2016-09 did not have a significant impact on the Company s financial statements.

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

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2017, 2016 and 2015

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

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

In January 2017, the FASB issued ASU No. 2017-04, *Intangibles - Goodwill and Other (Topic 350) Simplifying the Test for Goodwill Impairment*. ASU 2017-04 simplifies the subsequent measurement of goodwill by eliminating Step 2 from the goodwill impairment test. Under the new guidance, an entity will recognize an impairment charge for the amount by which the carrying value exceeds the fair value. This standard is effective for annual or any interim goodwill impairment tests in fiscal years beginning after December 15, 2019. Early adoption is permitted for interim or annual goodwill impairment tests performed on testing dates after January 1, 2017. The Company early adopted ASU 2017-04 during the quarter ended June 30, 2017, in connection with the interim goodwill impairment test that was performed. For additional details, see Note 6, Goodwill and Other Intangible Assets. The early adoption of ASU 2017-04 did not have a significant impact on the Company s financial statements.

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

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

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

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2017, 2016 and 2015

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

In February 2018, the FASB issued ASU No. 2018-02, *Income Statement-Reporting Comprehensive Income (Topic 220) Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income*. ASU 2018-02 permits a reclassification from accumulated other comprehensive income to retained earnings for stranded tax effects resulting from the TCJ Act. The guidance is effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Early adoption is permitted, including adoption in any interim period. The amendments should be applied either in the period of adoption or retrospectively to each period (or periods) in which the effect of the change in the federal corporate income tax rate in the TCJ Act is recognized. The Company is assessing the impact of ASU 2018-02 on its financial statements.

(2.) BUSINESS COMBINATIONS

2017 Activity - Robshaw & Julian Acquisition

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

2016 Activity - Courier Capital Acquisition

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

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

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

The amounts assigned to goodwill and other intangible assets for the Courier Capital acquisition are as follows:

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

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2017, 2016 and 2015

(3.) INVESTMENT SECURITIES

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

	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
December 31, 2017				
Securities available for sale:				
U.S. Government agencies and government sponsored enterprises	$ 163,025	$ 122	$ 1,258	$ 161,889
Mortgage-backed securities:				
Federal National Mortgage Association	311,830	313	3,220	308,923
Federal Home Loan Mortgage Corporation	41,290	76	675	40,691
Government National Mortgage Association	12,051	193	12	12,232
Collateralized mortgage obligations:				
Federal National Mortgage Association	217	1	1	217
Federal Home Loan Mortgage Corporation	45	-	-	45
Privately issued	-	976	-	976
Total mortgage-backed securities	365,433	1,559	3,908	363,084
Total available for sale securities	$ 528,458	$ 1,681	$ 5,166	$ 524,973
Securities held to maturity:				
State and political subdivisions	283,557	2,317	662	285,212
Mortgage-backed securities:				
Federal National Mortgage Association	9,732	16	88	9,660
Federal Home Loan Mortgage Corporation	3,213	-	119	3,094
Government National Mortgage Association	26,841	-	330	26,511
Collateralized mortgage obligations:				
Federal National Mortgage Association	76,432	-	1,958	74,474
Federal Home Loan Mortgage Corporation	93,810	3	2,165	91,648
Government National Mortgage Association	22,881	5	502	22,384
Total mortgage-backed securities	232,909	24	5,162	227,771

Total held to maturity securities	$ 516,466	$ 2,341	$ 5,824	$ 512,983
December 31, 2016				
Securities available for sale:				
U.S. Government agencies and government sponsored enterprises	$ 187,325	$ 512	$ 1,569	$ 186,268
Mortgage-backed securities:				
Federal National Mortgage Association	288,949	897	4,413	285,433
Federal Home Loan Mortgage Corporation	30,182	114	807	29,489
Government National Mortgage Association	15,473	316	15	15,774
Collateralized mortgage obligations:				
Federal National Mortgage Association	16,921	74	125	16,870
Federal Home Loan Mortgage Corporation	5,142	-	65	5,077
Privately issued	-	824	-	824
Total mortgage-backed securities	356,667	2,225	5,425	353,467
Asset-backed securities	-	191	-	191
Total available for sale securities	$ 543,992	$ 2,928	$ 6,994	$ 539,926

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2017, 2016 and 2015

(3.) INVESTMENT SECURITIES (Continued)

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

Investment securities with a total fair value of $838.4 million and $907.7 million at December 31, 2017 and 2016, respectively, were pledged as collateral to secure public deposits and for other purposes required or permitted by law.

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

	2017	2016	2015
Taxable interest and dividends	$ 17,886	$ 17,025	$ 16,123
Tax-exempt interest and dividends	5,869	5,892	5,752
Total interest and dividends on securities	$ 23,755	$ 22,917	$ 21,875

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

	2017	2016	2015
Proceeds from sales	$ 50,084	$ 95,261	$ 54,277
Gross realized gains	1,266	2,695	2,000
Gross realized losses	6	-	12

The scheduled maturities of securities available for sale and securities held to maturity at December 31, 2017 are shown below. Actual expected maturities may differ from contractual maturities because issuers may have the right to call or prepay obligations (in thousands).

	Amortized Cost	Fair Value
Debt securities available for sale:		
Due in one year or less	$ 2	$ 2
Due from one to five years	123,010	122,228
Due after five years through ten years	294,812	292,544
Due after ten years	110,634	110,199
	$ 528,458	$ 524,973
Debt securities held to maturity:		
Due in one year or less	$ 57,692	$ 57,757
Due from one to five years	159,758	161,514
Due after five years through ten years	103,593	102,507
Due after ten years	195,423	191,205
	$ 516,466	$ 512,983

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2017, 2016 and 2015

(3.) INVESTMENT SECURITIES (Continued)

Unrealized losses on investment securities and the fair value of the related securities, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position as of December 31 are summarized as follows (in thousands):

	Less than 12 months		12 months or longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
December 31, 2017						
Securities available for sale:						
U.S. Government agencies and government sponsored enterprises	$ 95,046	$ 571	$ 31,561	$ 687	$ 126,607	$ 1,258
Mortgage-backed securities:						
Federal National Mortgage Association	201,754	1,855	67,383	1,365	269,137	3,220
Federal Home Loan Mortgage Corporation	20,446	192	15,601	483	36,047	675
Government National Mortgage Association	2,432	-	880	12	3,312	12
Collateralized mortgage obligations:						
Federal National Mortgage Association	-	-	119	1	119	1
Federal Home Loan Mortgage Corporation	-	-	8	-	8	-
Total mortgage-backed securities	224,632	2,047	83,991	1,861	308,623	3,908
Total available for sale securities	319,678	2,618	115,552	2,548	435,230	5,166
Securities held to maturity:						
State and political subdivisions	36,368	295	14,492	367	50,860	662
Mortgage-backed securities:						
Federal National Mortgage Association	3,766	29	2,694	59	6,460	88
	-	-	3,094	119	3,094	119

Federal Home Loan Mortgage Corporation						
Government National Mortgage Association	17,327	136	9,184	194	26,511	330
Collateralized mortgage obligations:						
Federal National Mortgage Association	16,830	202	57,645	1,756	74,475	1,958
Federal Home Loan Mortgage Corporation	23,727	337	66,467	1,828	90,194	2,165
Government National Mortgage Association	15,401	340	5,635	162	21,036	502
Total mortgage-backed securities	77,051	1,044	144,719	4,118	221,770	5,162
Total held to maturity securities	113,419	1,339	159,211	4,485	272,630	5,824
Total temporarily impaired securities	$ 433,097	$ 3,957	$ 274,763	$ 7,033	$ 707,860	$ 10,990

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2017, 2016 and 2015

(3.) INVESTMENT SECURITIES (Continued)

	Less than 12 months		12 months or longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
December 31, 2016						
Securities available for sale:						
U.S. Government agencies and government sponsored enterprises	$ 113,261	$ 1,566	$ 1,458	$ 3	$ 114,719	$ 1,569
Mortgage-backed securities:						
Federal National Mortgage Association	211,491	4,413	-	-	211,491	4,413
Federal Home Loan Mortgage Corporation	24,360	807	-	-	24,360	807
Government National Mortgage Association	1,111	15	-	-	1,111	15
Collateralized mortgage obligations:						
Federal National Mortgage Association	8,119	125	-	-	8,119	125
Federal Home Loan Mortgage Corporation	5,077	65	-	-	5,077	65
Total mortgage-backed securities	250,158	5,425	-	-	250,158	5,425
Total available for sale securities	363,419	6,991	1,458	3	364,877	6,994
Securities held to maturity:						
State and political subdivisions	82,644	1,616	-	-	82,644	1,616
Mortgage-backed securities:						
Federal National Mortgage Association	9,253	124	-	-	9,253	124
Federal Home Loan Mortgage Corporation	3,141	150	-	-	3,141	150
Government National Mortgage Association	10,736	182	-	-	10,736	182

Collateralized mortgage obligations:						
Federal National Mortgage Association	72,734	1,560	3,107	13	75,841	1,573
Federal Home Loan Mortgage Corporation	92,256	1,825	430	2	92,686	1,827
Government National Mortgage Association	8,675	161	531	1	9,206	162
Total mortgage-backed securities	196,795	4,002	4,068	16	200,863	4,018
Total held to maturity securities	279,439	5,618	4,068	16	283,507	5,634
Total temporarily impaired securities	$ 642,858	$ 12,609	$ 5,526	$ 19	$ 648,384	$ 12,628

The total number of security positions in the investment portfolio in an unrealized loss position at December 31, 2017 was 411 compared to 463 at December 31, 2016. At December 31, 2017, the Company had positions in 172 investment securities with a fair value of $274.8 million and a total unrealized loss of $7.0 million that have been in a continuous unrealized loss position for more than 12 months. At December 31, 2017, there were a total of 239 securities positions in the Company s investment portfolio with a fair value of $433.1 million and a total unrealized loss of $4.0 million that had been in a continuous unrealized loss position for less than 12 months. At December 31, 2016, the Company had positions in nine investment securities with a fair value of $5.5 million and a total unrealized loss of $19 thousand that have been in a continuous unrealized loss position for more than 12 months. At December 31, 2016, there were a total of 454 securities positions in the Company s investment portfolio with a fair value of $642.9 million and a total unrealized loss of $12.6 million that had been in a continuous unrealized loss position for less than 12 months. The unrealized loss on investment securities was predominantly caused by changes in market interest rates subsequent to purchase. The fair value of most of the investment securities in the Company s portfolio fluctuates as market interest rates change.

The Company reviews investment securities on an ongoing basis for the presence of other than temporary impairment (OTTI) with formal reviews performed quarterly. When evaluating debt securities for OTTI, management considers many factors, including: (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, (3) whether the market decline was affected by macroeconomic conditions, and (4) whether the Company has the intention to sell the debt security or whether it is more likely than not that it will be required to sell the debt security before its anticipated recovery. The assessment of whether OTTI exists involves a high degree of subjectivity and judgment and is based on the information available to management. No impairment was recorded during the years ended December 31, 2017, 2016 and 2015.

Based on management s review and evaluation of the Company s debt securities as of December 31, 2017, the debt securities with unrealized losses were not considered to be OTTI. As of December 31, 2017, the Company does not have the intent to sell any of the securities in a loss position and believes that it is not likely that it will be required to sell any such securities before the anticipated recovery of amortized cost. Accordingly, as of December 31, 2017, management has concluded that unrealized losses on its investment securities are temporary and no further impairment loss has been realized in the Company s consolidated statements of income.

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2017, 2016 and 2015

(4.) LOANS HELD FOR SALE AND LOAN SERVICING RIGHTS

Loans held for sale were entirely comprised of residential real estate loans and totaled $2.7 million and $1.1 million as of December 31, 2017 and 2016, respectively.

The Company sells certain qualifying newly originated or refinanced residential real estate loans on the secondary market. Residential real estate loans serviced for others, which are not included in the consolidated statements of financial condition, amounted to $163.3 million and $173.7 million as of December 31, 2017 and 2016, respectively. In connection with these mortgage-servicing activities, the Company administered escrow and other custodial funds which amounted to approximately $3.7 million and $4.0 million as of December 31, 2017 and 2016, respectively.

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

	2017	2016	2015
Mortgage servicing assets, beginning of year	$ 1,077	$ 1,225	$ 1,335
Originations	231	150	166
Amortization	(318)	(298)	(276)
Mortgage servicing assets, end of year	990	1,077	1,225
Valuation allowance	-	(2)	(1)
Mortgage servicing assets, net, end of year	$ 990	$ 1,075	$ 1,224

(5.) LOANS

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

	Principal Amount Outstanding	Net Deferred Loan (Fees) Costs	Loans, Net
2017			
Commercial business	$ 449,763	$ 563	$ 450,326
Commercial mortgage	810,851	(1,943)	808,908

Residential real estate loans	457,761	7,522	465,283
Residential real estate lines	113,422	2,887	116,309
Consumer indirect	845,682	30,888	876,570
Other consumer	17,443	178	17,621
Total	$ 2,694,922	$ 40,095	2,735,017
Allowance for loan losses			(34,672)
Total loans, net			$ 2,700,345
2016			
Commercial business	$ 349,079	$ 468	$ 349,547
Commercial mortgage	671,552	(1,494)	670,058
Residential real estate loans	421,476	6,461	427,937
Residential real estate lines	119,745	2,810	122,555
Consumer indirect	725,754	26,667	752,421
Other consumer	17,465	178	17,643
Total	$ 2,305,071	$ 35,090	2,340,161
Allowance for loan losses			(30,934)
Total loans, net			$ 2,309,227

The Company s significant concentrations of credit risk in the loan portfolio relate to a geographic concentration in the communities that the Company serves.

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2017, 2016 and 2015

(5.) LOANS (Continued)

Certain executive officers, directors and their business interests are customers of the Company. Transactions with these parties are based on the same terms as similar transactions with unrelated third parties and do not carry more than normal credit risk. Borrowings by these related parties amounted to $6.6 million and $3.5 million at December 31, 2017 and 2016, respectively. During 2017, new borrowings amounted to $5.7 million (including borrowings of executive officers and directors that were outstanding at the time of their appointment), and repayments and other reductions were $2.6 million.

Past Due Loans Aging

The Company s recorded investment, by loan class, in current and nonaccrual loans, as well as an analysis of accruing delinquent loans is set forth as of December 31 (in thousands):

	30-59 Days Past Due	60-89 Days Past Due	Greater Than 90 Days	Total Past Due	Nonaccrual	Current	Total Loans
2017							
Commercial business	$ 64	$ 36	$ -	$ 100	$ 5,344	$ 444,319	$ 449,763
Commercial mortgage	56	375	-	431	2,623	807,797	810,851
Residential real estate loans	1,908	56	-	1,964	2,252	453,545	457,761
Residential real estate lines	349	-	-	349	404	112,669	113,422
Consumer indirect	2,806	672	-	3,478	1,895	840,309	845,682
Other consumer	174	15	11	200	2	17,241	17,443
Total loans, gross	$ 5,357	$ 1,154	$ 11	$ 6,522	$ 12,520	$ 2,675,880	$ 2,694,922

2016							
Commercial business	$ 1,337	$ -	$ -	$ 1,337	$ 2,151	$ 345,591	$ 349,079
Commercial mortgage	48	-	-	48	1,025	670,479	671,552
Residential real estate loans	1,073	253	-	1,326	1,236	418,914	421,476
Residential real estate lines	216	-	-	216	372	119,157	119,745
Consumer indirect	2,320	488	-	2,808	1,526	721,420	725,754
Other consumer	134	15	9	158	7	17,300	17,465
Total loans, gross	$ 5,128	$ 756	$ 9	$ 5,893	$ 6,317	$ 2,292,861	$ 2,305,071

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

Interest income on nonaccrual loans, if recognized, is recorded using the cash basis method of accounting. There was no interest income recognized on nonaccrual loans during the years ended December 31, 2017, 2016 and 2015. For the years ended December 31, 2017, 2016 and 2015, estimated interest income of $481 thousand, $234 thousand, and $432 thousand, respectively, would have been recorded if all such loans had been accruing interest according to their original contractual terms.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2017, 2016 and 2015

(5.) LOANS (Continued)

Troubled Debt Restructurings

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

The following presents, by loan class, information related to loans modified in a TDR during the years ended December 31 (in thousands).

	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
2017			
Commercial business	1	$ 3,081	$ 565
Commercial mortgage	-	-	-
Total	1	$ 3,081	$ 565
2016			
Commercial business	3	$ 526	$ 526
Commercial mortgage	1	550	550
Total	4	$ 1,076	$ 1,076

The loans identified as TDRs by the Company during the years ended December 31, 2017 and 2016 were previously reported as impaired loans prior to restructuring. The modifications during the year ended December 31, 2017 primarily related to collateral concessions. For the year ended December 31, 2016, the restructured loan modifications primarily related to collateral concessions and forbearance. All loans restructured during the years ended December 31, 2017 and 2016 were on nonaccrual status at the end of those respective years. Nonaccrual loans that are restructured remain on nonaccrual status, but may move to accrual status after they have performed according to the

restructured terms for a period of time. The TDR classification did not have a material impact on the Company s determination of the allowance for loan losses because the modified loans were either classified as substandard, with an increased risk allowance allocation, or impaired and evaluated for a specific reserve both before and after restructuring.

There were no loans modified as a TDR during the years ended December 31, 2017 and 2016 that defaulted during the year ended December 31, 2017. For purposes of this disclosure, a loan modified as a TDR is considered to have defaulted when the borrower becomes 90 days past due.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2017, 2016 and 2015

(5.) LOANS (Continued)

Impaired Loans

Management has determined that specific commercial loans on nonaccrual status and all loans that have had their terms restructured in a troubled debt restructuring are impaired loans. The following table presents data on impaired loans at December 31 (in thousands):

	Recorded Investment (1)	Unpaid Principal Balance (1)	Related Allowance	Average Recorded Investment	Interest Income Recognized
2017					
With no related allowance recorded:					
Commercial business	$ 1,635	$ 2,370	$ -	$ 853	$ -
Commercial mortgage	584	584	-	621	-
	2,219	2,954	-	1,474	-
With an allowance recorded:					
Commercial business	3,853	3,853	2,056	4,468	-
Commercial mortgage	2,528	2,528	115	1,516	-
	6,381	6,381	2,171	5,984	-
	$ 8,600	$ 9,335	$ 2,171	$ 7,458	$ -
2016					
With no related allowance recorded:					
Commercial business	$ 645	$ 1,044	$ -	$ 1,032	$ -
Commercial mortgage	673	882	-	725	-
	1,318	1,926	-	1,757	-
With an allowance recorded:					
Commercial business	1,506	1,506	694	1,141	-
Commercial mortgage	352	352	124	486	-
	1,858	1,858	818	1,627	-

	$	3,176	$	3,784	$	818	$	3,384	$	-

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

Credit Quality Indicators

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

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

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

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

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

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2017, 2016 and 2015

(5.) LOANS (Continued)

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

	Commercial Business	Commercial Mortgage
2017		
Uncriticized	$ 429,692	$ 791,127
Special mention	7,120	12,185
Substandard	12,951	7,539
Doubtful	-	-
Total	$ 449,763	$ 810,851
2016		
Uncriticized	$ 326,254	$ 652,550
Special mention	10,377	12,690
Substandard	12,448	6,312
Doubtful	-	-
Total	$ 349,079	$ 671,552

The Company utilizes payment status as a means of identifying and reporting problem and potential problem retail loans. The Company considers nonaccrual loans and loans past due greater than 90 days and still accruing interest to be non-performing. The following table sets forth the Company s retail loan portfolio, categorized by payment status, as of December 31 (in thousands):

	Residential Real Estate Loans	Residential Real Estate Lines	Consumer Indirect	Other Consumer
2017				

Performing	$ 455,509	$ 113,018	$ 843,787	$ 17,430
Non-performing	2,252	404	1,895	13
Total	$ 457,761	$ 113,422	$ 845,682	$ 17,443
2016				
Performing	$ 420,240	$ 119,373	$ 724,228	$ 17,449
Non-performing	1,236	372	1,526	16
Total	$ 421,476	$ 119,745	$ 725,754	$ 17,465

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2017, 2016 and 2015

(5.) LOANS (Continued)

Allowance for Loan Losses

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

	Commercial Business	Commercial Mortgage	Residential Real Estate Loans	Residential Real Estate Lines	Consumer Indirect	Other Consumer	Total
17							
lowance for loan losses:							
ginning balance	$ 7,225	$ 10,315	$ 1,478	$ 303	$ 11,311	$ 302	$ 30,93
harge-offs	(3,614)	(10)	(431)	(106)	(10,164)	(926)	(15,25
ecoveries	416	262	130	60	4,444	316	5,62
ovision (credit)	11,641	(6,871)	145	(77)	7,824	699	13,36
ding balance	$ 15,668	$ 3,696	$ 1,322	$ 180	$ 13,415	$ 391	$ 34,67
aluated for impairment:							
dividually	$ 2,001	$ 107	$ -	$ -	$ -	$ -	$ 2,10
ollectively	$ 13,667	$ 3,589	$ 1,322	$ 180	$ 13,415	$ 391	$ 32,56
ans:							
ding balance	$ 449,763	$ 810,851	$ 457,761	$ 113,422	$ 845,682	$ 17,443	$ 2,694,92
aluated for impairment:							
dividually	$ 5,322	$ 2,852	$ -	$ -	$ -	$ -	$ 8,17
ollectively	$ 444,441	$ 807,999	$ 457,761	$ 113,422	$ 845,682	$ 17,443	$ 2,686,74
16							
lowance for loan losses:							
ginning balance	$ 5,540	$ 9,027	$ 1,347	$ 345	$ 10,458	$ 368	$ 27,08

harge-offs	(943)	(385)	(289)	(104)	(8,748)	(607)	(11,07
ecoveries	447	45	174	15	4,259	347	5,28
rovision	2,181	1,628	246	47	5,342	194	9,63
ding balance	$ 7,225	$ 10,315	$ 1,478	$ 303	$ 11,311	$ 302	$ 30,93
aluated for impairment:							
dividually	$ 663	$ 105	$ -	$ -	$ -	$ -	$ 76
ollectively	$ 6,562	$ 10,210	$ 1,478	$ 303	$ 11,311	$ 302	$ 30,16
ans:							
ding balance	$ 349,079	$ 671,552	$ 421,476	$ 119,745	$ 725,754	$ 17,465	$ 2,305,07
aluated for impairment:							
dividually	$ 2,052	$ 935	$ -	$ -	$ -	$ -	$ 2,98
ollectively	$ 347,027	$ 670,617	$ 421,476	$ 119,745	$ 725,754	$ 17,465	$ 2,302,08

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2017, 2016 and 2015

(5.) LOANS (Continued)

	Commercial Business	Commercial Mortgage	Residential Mortgage	Home Equity	Consumer Indirect	Other Consumer	Total
2015							
Allowance for loan losses:							
Beginning balance	$ 5,621	$ 8,122	$ 1,620	$ 435	$ 11,383	$ 456	$ 27,637
Charge-offs	(1,433)	(895)	(397)	(199)	(9,156)	(878)	(12,958)
Recoveries	212	146	114	31	4,200	322	5,025
Provision	1,140	1,654	10	78	4,031	468	7,381
Ending balance	$ 5,540	$ 9,027	$ 1,347	$ 345	$ 10,458	$ 368	$ 27,085
Evaluated for impairment:							
Individually	$ 996	$ 10	$ -	$ -	$ -	$ -	$ 1,006
Collectively	$ 4,544	$ 9,017	$ 1,347	$ 345	$ 10,458	$ 368	$ 26,079
Loans:							
Ending balance	$ 313,475	$ 567,481	$ 376,023	$ 124,766	$ 652,494	$ 18,361	$ 2,052,600
Evaluated for impairment:							
Individually	$ 3,922	$ 947	$ -	$ -	$ -	$ -	$ 4,869
Collectively	$ 309,553	$ 566,534	$ 376,023	$ 124,766	$ 652,494	$ 18,361	$ 2,047,731

Risk Characteristics

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

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

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

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

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(6.) PREMISES AND EQUIPMENT, NET

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

	2017	2016
Land and land improvements	$ 6,003	$ 6,003
Buildings and leasehold improvements	52,900	52,005
Furniture, fixtures, equipment and vehicles	38,716	32,972
Premises and equipment	97,619	90,980
Accumulated depreciation and amortization	(52,430)	(48,582)
Premises and equipment, net	$ 45,189	$ 42,398

Depreciation and amortization expense relating to premises and equipment, included in occupancy and equipment expense in the consolidated statements of income, amounted to $4.9 million, $4.6 million and $4.4 million for the years ended December 31, 2017, 2016 and 2015, respectively.

(7.) GOODWILL AND OTHER INTANGIBLE ASSETS

Goodwill

Goodwill is not amortized but, instead, is subject to impairment tests on at least an annual basis, and more frequently if an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying amount. The Company performs its annual impairment test of goodwill as of October 1st of each year. See Note 1 for the Company s accounting policy for goodwill and other intangible assets.

The Company completed an evaluation of the contingent earn out liability related to its 2014 acquisition of SDN during the second quarter of 2017, resulting in a contingent consideration liability adjustment of $1.2 million. Based on this event, a goodwill impairment test was also performed in the second quarter of 2017. Based on its qualitative assessment, the Company concluded it was more likely than not that the fair value of its SDN reporting unit was less than its carrying value. Accordingly, the Company performed a Step 1 review for possible goodwill impairment.

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

The results of the Company s 2017 annual impairment test indicated no impairment for its Banking segment or its Courier Capital reporting unit; consequently, no goodwill impairment charge for either was recorded in 2017. In addition, the Company s 2017 annual impairment test indicated no additional impairment for the SDN reporting unit.

The results of the Company s 2016 annual impairment test indicated no impairment; consequently, no goodwill impairment charge was recorded in 2016.

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 change in the balance for goodwill during the years ended December 31 was as follows (in thousands):

	Banking	Non-Banking	Total
Balance, January 1, 2016	$ 48,536	$ 11,866	$ 60,402
Acquisition	-	6,015	6,015
Balance, December 31, 2016	48,536	17,881	66,417
Impairment	-	(1,575)	(1,575)
Acquisition	-	998	998
Balance, December 31, 2017	$ 48,536	$ 17,304	$ 65,840

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2017, 2016 and 2015

(7.) GOODWILL AND OTHER INTANGIBLE ASSETS (Continued)

Other Intangible Assets

The Company has other intangible assets that are amortized, consisting of core deposit intangibles and other intangibles. Changes in the gross carrying amount, accumulated amortization and net book value for the years ended December 31 were as follows (in thousands):

	2017	2016
Core deposit intangibles:		
Gross carrying amount	$ 2,042	$ 2,042
Accumulated amortization	(1,669)	(1,464)
Net book value	$ 373	$ 578
Amortization during the year	$ 205	$ 251
Other intangibles:		
Gross carrying amount	$ 11,378	$ 10,568
Accumulated amortization	(2,888)	(1,923)
Net book value	$ 8,490	$ 8,645
Amortization during the year	$ 965	$ 998

Core deposit intangible and other intangibles amortization expense was $296 thousand and $646 thousand, respectively, for the year ended December 31, 2015. Estimated amortization expense of other intangible assets for each of the next five years is as follows:

2018	$ 1,112
2019	1,011
2020	909
2021	803
2022	725

(8.) DEPOSITS

A summary of deposits as of December 31 are as follows (in thousands):

	2017	2016
Noninterest-bearing demand	$ 718,498	$ 677,076
Interest-bearing demand	634,203	581,436
Savings and money market	1,005,317	1,034,194
Time deposits, due:		
Within one year	678,352	471,494
One to two years	108,653	158,399
Two to three years	29,994	23,548
Three to five years	35,157	49,075
Thereafter	-	-
Total time deposits	852,156	702,516
Total deposits	$ 3,210,174	$ 2,995,222

Time deposits in denominations of $250,000 or more at December 31, 2017 and 2016 amounted to $154.0 million and $99.8 million, respectively.

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

	2017	2016	2015
Interest-bearing demand	$ 897	$ 833	$ 754
Savings and money market	1,487	1,339	1,166
Time deposits	8,709	6,286	5,386
Total interest expense on deposits	$ 11,093	$ 8,458	$ 7,306

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(9.) BORROWINGS

The Company classifies borrowings as short-term or long-term in accordance with the original terms of the agreement. Outstanding borrowings are summarized as follows as of December 31 (in thousands):

	2017	2016
Short-term borrowings:		
Short-term FHLB borrowings	$ 446,200	$ 331,500
Long-term borrowings:		
Subordinated notes, net	39,131	39,061
Total borrowings	$ 485,331	$ 370,561

Short-term borrowings

Short-term FHLB borrowings have original maturities of less than one year and include overnight borrowings that we typically utilize to address short term funding needs as they arise. Short-term FHLB borrowings at December 31, 2017 consisted of $304.7 million in overnight borrowings and $141.5 million in short-term advances. Short-term FHLB borrowings at December 31, 2016 consisted of $171.5 million in overnight borrowings and $160.0 million in short-term advances. The FHLB borrowings are collateralized by securities from the Company s investment portfolio and certain qualifying loans. At December 31, 2017 and 2016, the Company s borrowings had a weighted average rate of 1.50% and 0.76%, respectively.

Long-term borrowings

On April 15, 2015, the Company issued $40.0 million of 6.0% fixed to floating rate subordinated notes due April 15, 2030 (the Subordinated Notes) in a registered public offering. The Subordinated Notes bear interest at a fixed rate of 6.0% per year, payable semi-annually, for the first 10 years. From April 15, 2025 to the April 15, 2030 maturity date, the interest rate will reset quarterly to an annual interest rate equal to the then current three-month London Interbank Offered Rate (LIBOR) plus 3.944%, payable quarterly. The Subordinated Notes are redeemable by the Company at any quarterly interest payment date beginning on April 15, 2025 to maturity at par, plus accrued and unpaid interest. Proceeds, net of debt issuance costs of $1.1 million, were $38.9 million. The net proceeds from this offering were used for general corporate purposes, including but not limited to, contribution of capital to the Bank to support both organic growth and opportunistic acquisitions. The Subordinated Notes qualify as Tier 2 capital for regulatory purposes.

The Company adopted ASU 2015-03 that requires debt issuance costs to be reported as a direct deduction from the face value of the Subordinated Notes and not as a deferred charge. Refer to Note 1 for additional information. The debt issuance costs will be amortized as an adjustment to interest expense over 15 years.

(10.) DERIVATIVE INSTRUMENT AND HEDGING ACTIVITIES
Risk Management Objective of Using Derivatives

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

Credit-risk-related Contingent Features

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

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(10.) DERIVATIVE INSTRUMENT AND HEDGING ACTIVITIES (Continued)

Fair Values of Derivative Instruments on the Balance Sheet

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

	Gross notional amount		Asset derivatives			Liability derivatives		
			Balance sheet line item	Fair value		Balance sheet line item	Fair value	
	2017	2016		2017	2016		2017	2016
Derivatives not designated as hedging instruments								
Credit contracts	$ 12,282	$ -	Other assets	$ -	$ -	Other liabilities	$ 4	$ -
Total derivatives	$ 12,282	$ -		$ -	$ -		$ 4	$ -

Effect of Derivative Instruments on the Income Statement

The table below presents the effect of the Company s derivative financial instruments on the income statement for the years ended December 31 (in thousands):

Undesignated derivatives	Line item of gain (loss) recognized in income	Gain (loss) recognized in income 2017	2016	2015
Credit contract	Noninterest income - Other	$ 131	$ -	$ -
Total undesignated		$ 131	$ -	$ -

(11.) COMMITMENTS AND CONTINGENCIES
Financial Instruments with Off-Balance Sheet Risk

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

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

Off-balance sheet commitments as of December 31 consist of the following (in thousands):

	2017	2016
Commitments to extend credit	$ 661,021	$ 555,713
Standby letters of credit	12,181	12,689

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the agreement. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Commitments may expire without being drawn upon; therefore, the total commitment amounts do not necessarily represent future cash requirements. Each customer s creditworthiness is evaluated on a case-by-case basis. The amount of collateral obtained, if any, is based on management s credit evaluation of the borrower. Standby letters of credit are conditional lending commitments issued by the Company to guarantee the performance of a customer to a third party. These standby letters of credit are primarily issued to support private borrowing arrangements. The credit risk involved in issuing standby letters of credit is essentially the same as that involved in extending loan facilities to customers.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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(11.) COMMITMENTS AND CONTINGENCIES (Continued)

The Company also extends rate lock agreements to borrowers related to the origination of residential mortgage loans. To mitigate the interest rate risk inherent in these rate lock agreements when the Company intends to sell the related loan, once originated, as well as closed residential mortgage loans held for sale, the Company enters into forward commitments to sell individual residential mortgages. Rate lock agreements and forward commitments are considered derivatives and are recorded at fair value. Forward sales commitments totaled $566 thousand at December 31, 2017. The Company had no forward sales commitments at December 31, 2016. The net change in the fair values of these derivatives was recognized as other noninterest income or other noninterest expense in the consolidated statements of income.

Lease Obligations

The Company is obligated under a number of non-cancellable operating lease agreements for land, buildings and equipment. Certain of these leases provide for escalation clauses and contain renewal options calling for increased rentals if the lease is renewed. Future minimum payments by year and in the aggregate, under the non-cancellable leases with initial or remaining terms of one year or more, are as follows at December 31, 2017 (in thousands):

2018	$	2,459
2019		2,370
2020		2,217
2021		2,039
2022		1,775
Thereafter		30,815
	$	41,675

Rent expense relating to these operating leases, included in occupancy and equipment expense in the statements of income, was $2.6 million, $2.1 million and $2.0 million in 2017, 2016 and 2015, respectively.

Contingent Liabilities

In the ordinary course of business there are various threatened and pending legal proceedings against the Company. Based on consultation with outside legal counsel, management believes that the aggregate liability, if any, arising from such litigation would not have a material adverse effect on the Company s consolidated financial statements.

(12.) REGULATORY MATTERS
General

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

Capital

Banks and bank holding companies are subject to various regulatory capital requirements administered by state and federal banking agencies. Capital adequacy guidelines and, additionally for banks, prompt corrective action regulations, involve quantitative measures of assets, liabilities, and certain off-balance-sheet items calculated under regulatory accounting practices. Capital amounts and classifications are also subject to qualitative judgments by regulators about components, risk weighting and other factors.

The Basel III Capital Rules, a new comprehensive capital framework for U.S. banking organizations, became effective for the Company and the Bank on January 1, 2015 (subject to a phase-in period for certain provisions). Quantitative measures established by the Basel III Capital Rules to ensure capital adequacy require the maintenance of minimum amounts and ratios (set forth in the table that follows) of Common Equity Tier 1 capital (CET1), Tier 1 capital and Total capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier 1 capital to adjusted quarterly average assets (as defined).

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2017, 2016 and 2015

(12.) REGULATORY MATTERS (Continued)

The Company s and the Bank s Common Equity Tier 1 capital includes common stock and related paid-in capital, net of treasury stock, and retained earnings. In connection with the adoption of the Basel III Capital Rules, we elected to opt-out of the requirement to include most components of accumulated other comprehensive income in Common Equity Tier 1. Common Equity Tier 1 for both the Company and the Bank is reduced by goodwill and other intangible assets, net of associated deferred tax liabilities, and subject to transition provisions.

Tier 1 capital includes Common Equity Tier 1 capital and additional Tier 1 capital. For the Company, additional Tier 1 capital at December 31, 2017 includes, subject to limitation, $17.3 million of preferred stock.

Total capital includes Tier 1 capital and Tier 2 capital. Tier 2 capital for both the Company and the Bank includes a permissible portion of the allowance for loan losses. Tier 2 capital for the Company also includes qualified subordinated debt. At December 31, 2017, the Company s Tier 2 capital included $39.1 million of Subordinated Notes.

The Common Equity Tier 1, Tier 1 and Total capital ratios are calculated by dividing the respective capital amounts by risk-weighted assets. Risk-weighted assets are calculated based on regulatory requirements and include total assets, with certain exclusions, allocated by risk weight category, and certain off-balance-sheet items, among other things. The leverage ratio is calculated by dividing Tier 1 capital by adjusted quarterly average total assets, which exclude goodwill and other intangible assets, among other things.

When fully phased in on January 1, 2019, the Basel III Capital Rules will require the Company and the Bank to maintain (i) a minimum ratio of Common Equity Tier 1 capital to risk-weighted assets of at least 4.5%, plus a 2.5% capital conservation buffer (which is added to the 4.5% Common Equity Tier 1 capital ratio as that buffer is phased in, effectively resulting in a minimum ratio of Common Equity Tier 1 capital to risk-weighted assets of at least 7.0% upon full implementation), (ii) a minimum ratio of Tier 1 capital to risk-weighted assets of at least 6.0%, plus the capital conservation buffer (which is added to the 6.0% Tier 1 capital ratio as that buffer is phased in, effectively resulting in a minimum Tier 1 capital ratio of 8.5% upon full implementation), (iii) a minimum ratio of Total capital (that is, Tier 1 plus Tier 2) to risk-weighted assets of at least 8.0%, plus the capital conservation buffer (which is added to the 8.0% total capital ratio as that buffer is phased in, effectively resulting in a minimum total capital ratio of 10.5% upon full implementation) and (iv) a minimum leverage ratio of 4.0%, calculated as the ratio of Tier 1 capital to average quarterly assets.

The implementation of the capital conservation buffer began on January 1, 2016 at the 0.625% level and will be phased in over a four-year period (increasing by that amount on each subsequent January 1, until it reaches 2.5% on January 1, 2019). The Basel III Capital Rules also provide for a countercyclical capital buffer that is applicable to only certain covered institutions and does not have any current applicability to the Company or the Bank. The capital conservation buffer is designed to absorb losses during periods of economic stress and, as detailed above, effectively increases the minimum required risk-weighted capital ratios. Banking institutions with a ratio of Common Equity Tier

1 capital to risk-weighted assets below the effective minimum (4.5% plus the capital conservation buffer and, if applicable, the countercyclical capital buffer) will face constraints on dividends, equity repurchases and compensation based on the amount of the shortfall.

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FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2017, 2016 and 2015

(12.) REGULATORY MATTERS (Continued)

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

	Actual		Minimum Capital Required Basel III Phase-in Schedule		Minimum Capital Required Basel III Fully Phased-in		Required to be Considered Well Capitalized	
	Amount	Ratio	Amount	Ratio	Amount	Ratio	Amount	Ratio
2017								
Tier 1 leverage:								
Company	$ 322,680	8.13 %	$ 158,710	4.00 %	$ 158,710	4.00 %	$ 198,387	5.00 %
Bank	346,532	8.75	158,372	4.00	158,372	4.00	197,965	5.00
CET1 capital:								
Company	305,351	10.16	172,825	5.75	210,396	7.00	195,368	6.50
Bank	346,532	11.57	172,224	5.75	209,664	7.00	194,688	6.50
Tier 1 capital:								
Company	322,680	10.74	217,910	7.25	255,481	8.50	240,452	8.00
Bank	346,532	11.57	217,152	7.25	254,592	8.50	239,616	8.00
Total capital:								
Company	396,483	13.19	278,023	9.25	315,594	10.50	300,565	10.00
Bank	381,204	12.73	277,056	9.25	314,496	10.50	299,520	10.00
2016								
Tier 1 leverage:								
Company	$ 265,246	7.36 %	$ 144,095	4.00 %	$ 144,095	4.00 %	$ 180,119	5.00 %
Bank	284,765	7.92	143,862	4.00	143,862	4.00	179,828	5.00
CET1 capital:								
Company	247,906	9.59	132,438	5.13	180,891	7.00	167,970	6.50
Bank	284,765	11.06	132,014	5.13	180,312	7.00	167,432	6.50
Tier 1 capital:								

Company	265,246	10.26	171,201	6.63	219,654	8.50	206,733	8.00
Bank	284,765	11.06	170,652	6.63	218,950	8.50	206,070	8.00
Total capital:								
Company	335,241	12.97	222,884	8.63	271,337	10.50	258,416	10.00
Bank	315,699	12.26	222,170	8.63	270,467	10.50	257,588	10.00

As of December 31, 2017, the Company and Bank were considered well capitalized under all regulatory capital guidelines. Such determination has been made based on the Tier 1 leverage, CET1capital, Tier 1 capital and total capital ratios.

Federal Reserve Requirements

The Bank is required to maintain a reserve balance at the FRB of New York. As of December 31, 2017, the Bank was not required to maintain a reserve balance at the FRB of New York. The reserve requirement for the Bank totaled $629 thousand as of December 31, 2016.

Dividend Restrictions

In the ordinary course of business, the Company is dependent upon dividends from the Bank to provide funds for the payment of dividends to shareholders and to provide for other cash requirements. Banking regulations may limit the amount of dividends that may be paid. Approval by regulatory authorities is required if the effect of dividends declared would cause the regulatory capital of the Bank to fall below specified minimum levels. Approval is also required if dividends declared exceed the net profits for that year combined with the retained net profits for the preceding two years.

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2017, 2016 and 2015

(13.) SHAREHOLDERS EQUITY

The Company s authorized capital stock consists of 50,210,000 shares of capital stock, 50,000,000 of which are common stock, par value $0.01 per share, and 210,000 of which are preferred stock, par value $100 per share, which is designated into two classes, Class A of which 10,000 shares are authorized, and Class B of which 200,000 shares are authorized. There are two series of Class A preferred stock: Series A 3% preferred stock and the Series A preferred stock. There is one series of Class B preferred stock: Series B-1 8.48% preferred stock. There were 173,286 and 173,398 shares of preferred stock issued and outstanding as of December 31, 2017 and 2016, respectively.

Common Stock

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

	Outstanding	Treasury	Issued
2017			
Shares outstanding at beginning of year	14,537,597	154,617	14,692,214
Common stock issued for at-the-market equity offering	1,363,964	-	1,363,964
Restricted stock awards issued	8,898	(8,898)	-
Restricted stock awards forfeited	(10,359)	10,359	-
Stock options exercised	21,320	(21,320)	-
Stock awards	7,841	(7,841)	-
Treasury stock purchases	(4,323)	4,323	-
Shares outstanding at end of year	15,924,938	131,240	16,056,178
2016			
Shares outstanding at beginning of year	14,190,192	207,317	14,397,509
Common stock issued for Courier Capital acquisition	294,705	-	294,705
Restricted stock awards issued	8,800	(8,800)	-
Restricted stock awards forfeited	(10,183)	10,183	-
Stock options exercised	49,761	(49,761)	-
Stock awards	4,322	(4,322)	-
Shares outstanding at end of year	14,537,597	154,617	14,692,214

On May 30, 2017, the Company entered into a sales agency agreement, with Sandler O Neill + Partners, L.P. as sales agent, under which it could sell up to $40.0 million of its common stock through an at-the-market equity offering program. The program was completed in November 2017. The Company sold 1,363,964 shares of its common stock

under the program at a weighted average price of $29.33, representing gross proceeds of approximately $40.0 million. Net proceeds received were approximately $38.3 million. The Company used the net proceeds of this offering to support organic growth and other general corporate purposes, including contributing capital to the Bank.

Preferred Stock

Series A 3% Preferred Stock. There were 1,439 and 1,492 shares of Series A 3% preferred stock issued and outstanding as of December 31, 2017 and 2016, respectively. Holders of Series A 3% preferred stock are entitled to receive an annual dividend of $3.00 per share, which is cumulative and payable quarterly. Holders of Series A 3% preferred stock have no pre-emptive right in, or right to purchase or subscribe for, any additional shares of the Company s capital stock and have no voting rights. Dividend or dissolution payments to the Class A shareholders must be declared and paid, or set apart for payment, before any dividends or dissolution payments can be declared and paid, or set apart for payment, to the holders of Class B preferred stock or common stock. The Series A 3% preferred stock is not convertible into any other of the Company s securities.

FINANCIAL INSTITUTIONS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2017, 2016 and 2015

(13.) SHAREHOLDERS EQUITY (Continued)

Series B-1 8.48% Preferred Stock. There were 171,847 and 171,906 shares of Series B-1 8.48% preferred stock issued and outstanding as of December 31, 2017 and 2016, respectively. Holders of Series B-1 8.48% preferred stock are entitled to receive an annual dividend of $8.48 per share, which is cumulative and payable quarterly. Holders of Series B-1 8.48% preferred stock have no pre-emptive right in, or right to purchase or subscribe for, any additional shares of the Company s common stock and have no voting rights. Accumulated dividends on the Series B-1 8.48% preferred stock do not bear interest, and the Series B-1 8.48% preferred stock is not subject to redemption. Dividend or dissolution payments to the Class B shareholders must be declared and paid, or set apart for payment, before any dividends or dissolution payments are declared and paid, or set apart for payment, to the holders of common stock. The Series B-1 8.48% preferred stock is not convertible into any other of the Company s securities.

(14.) ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS)

The following table presents the components of other comprehensive income (loss) for the years ended December 31 (in thousands):

	Pre-tax Amount	Tax Effect	Net-of-tax Amount
2017			
Securities available for sale and transferred securities:			
Change in unrealized gain/loss during the period	$ 1,841	$ 710	$ 1,131
Reclassification adjustment for net gains included in net income [1]	(1,103)	(426)	(677)
Total securities available for sale and transferred securities	738	284	454
Pension and post-retirement obligations:			
Net actuarial gains (losses) arising during the year	1,460	563	897
Amortization of net actuarial loss and prior service cost included in income	1,115	431	684
Total pension and post-retirement obligations	2,575	994	1,581
Other comprehensive income	$ 3,313	$ 1,278	$ 2,035
2016			

Securities available for sale and transferred securities:						
Change in unrealized gain/loss during the period	$	(2,146)	$	(828)	$	(1,318)
Reclassification adjustment for net gains included in net income (1)		(2,793)		(1,078)		(1,715)