FINANCIAL INSTITUTIONS INC
Form 10-K
March 12, 2014
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-K

(Mark One)

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

For the fiscal year ended December 31, 2013

OR

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

For the transition period from __________ to __________

Commission file number 000-26481

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 registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes ¨ No x

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 x

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 x No ¨

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

Indicate by check mark 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 and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated filer	¨	Accelerated filer	x
Non-accelerated filer	¨	Smaller reporting company	¨

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

The 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, 2013 closing price reported by NASDAQ, was approximately $236,055,000.

As of February 28, 2014, there were outstanding, exclusive of treasury shares, 13,848,258 shares of the registrant s common stock.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant s proxy statement for the 2014 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 in this Annual Report on Form 10-K that are based on other than historical data are forward-looking within the meaning of the Private Securities Litigation Reform Act of 1995. Forward-looking statements provide current expectations or forecasts of future events and include, among others:

- statements with respect to the beliefs, plans, objectives, goals, guidelines, expectations, anticipations, and future financial condition, results of operations and performance of Financial Institutions, Inc. (the parent or FII) and its subsidiaries (collectively the Company, we, our, us); and
- statements preceded by, followed by or that include the words may, could, should, would, believe, anticipate, 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 differences include, but are not limited to:

- If we experience greater credit losses than anticipated, earnings may be adversely impacted;
- Geographic concentration may unfavorably impact our operations;
- We depend on the accuracy and completeness of information about or from customers and counterparties;
- We are subject to environmental liability risk associated with our lending activities;
- Our indirect lending involves risk elements in addition to normal credit risk;
- We are highly regulated and may be adversely affected by changes in banking laws, regulations and regulatory practices;
- The new Basel III Capital Standards may have an adverse effect on us;

New regulations could adversely impact our earnings due to, among other things, increased compliance costs or costs due to noncompliance;

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

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

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 result;

We may not be able to attract and retain skilled people and our ongoing leadership transition may be unsuccessful;

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;

Our earnings are significantly affected by the fiscal and monetary policies of the federal government and its agencies;

The soundness of other financial institutions could adversely affect us;

We may be required to recognize an impairment of goodwill:

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 dividends on our common stock;

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

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

Our certificate of incorporation, our bylaws, and certain banking laws contain anti-takeover provisions.

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

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ITEM 1. BUSINESS
GENERAL

Financial Institutions, Inc. is a financial holding company organized in 1931 under the laws of New York State (New York or NYS), and through its wholly-owned New York chartered banking subsidiary, Five Star Bank, Financial Institutions, Inc. offers a broad array of deposit, lending and other financial services to individuals, municipalities and businesses in Western and Central New York. We have also expanded our indirect lending network to include relationships with franchised automobile dealers in the Capital District of New York and Northern Pennsylvania. All references in this Annual Report on Form 10-K to the parent are to Financial Institutions, Inc. (FII). Unless otherwise indicated, or unless the context requires otherwise, all references in this Annual Report on Form 10-K to the Company, we, our or us means Financial Institutions, Inc. and its subsidiaries on a consolidated basis. Five Star Bank is referred to as Five Star Bank, FSB or the Bank . FII is a legal entity, separate and distinct from its subsidiaries, assisting those subsidiaries by providing financial resources and oversight. Our executive offices are located at 220 Liberty Street, Warsaw, New York.

During late 2013, our subsidiary, Five Star Investment Services, Inc. (FSIS) ceased operations as an active broker-dealer and the securities licenses of advisors associated with FSIS who elected to transfer, as well as their respective client accounts which had previously cleared through a third-party platform, were transferred to the LPL Financial (LPL) clearing platform. Following the completion of these transfer activities, FSB began offering investment and securities-related services, including brokerage and investment advice through a strategic partnership with LPL. FSB has employees who are LPL registered representatives, located throughout its branch network, offering customers insurance and investment products including stocks, bonds, mutual funds, annuities, and managed accounts through a program called Five Star Investment Services. FSIS withdrew its registration with the Financial Industry Regulatory Authority (FINRA) effective December 31, 2013, and is expected to be dissolved in 2014.

Our Business Strategy

Our business strategy has been to maintain a community bank philosophy, which consists of focusing on and understanding the individualized banking needs of individuals, municipalities and businesses of the local communities surrounding our banking centers. 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 comprised of small- to medium-sized businesses, individuals and community organizations who prefer to build a banking relationship with a community bank that offers and combines high quality, competitively-priced banking 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 and loan products typically found at larger banks, our highly experienced management team and our strategically located banking centers. A central part of our strategy is generating core deposits to support growth of a diversified and high-quality loan portfolio.

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 in 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. 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 Pennsylvania.

Our market area is economically diversified in that we serve both rural markets and the larger more affluent markets of suburban Rochester and suburban Buffalo. Rochester and Buffalo are the two largest metropolitan areas in New York outside of New York City, with a combined metropolitan area 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 both 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 service 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.

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The following table presents the Bank s market share percentage for total deposits as of June 30, 2013, 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 SNL Financial of Charlottesville, Virginia, which compiles deposit data published by the FDIC as of June 30, 2013 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	8.2%	3	1
Cattaraugus	24.6%	2	5
Cayuga	3.1%	11	1
Chautauqua	1.2%	9	1
Chemung	15.0%	3	3
Erie	0.4%	11	3
Genesee	21.6%	3	4
Livingston	32.3%	1	5
Monroe	1.3%	10	5
Ontario	13.6%	2	5
Orleans	24.5%	1	2
Seneca	20.7%	3	2
Steuben	27.5%	1	7
Wyoming	48.7%	1	4
Yates	38.3%	1	2

(1) Number of branches current as of December 31, 2013.

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 of 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 centers on providing liquidity to meet loan demand and redeeming liabilities, meeting pledging requirements, managing credit risks, managing overall interest rate risks and maximizing portfolio yield. 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 U.S. government-sponsored enterprise (GSE) securities, which are securities issued by independent organizations that are in part sponsored by the federal government (e.g., the Federal Home Loan Bank (FHLB) system, the Federal National Mortgage Association (FNMA), the Federal Home Loan Mortgage Corporation (FHLMC), the Small Business Administration (SBA) and the Federal Farm Credit Bureau);

Mortgage-backed securities (MBS) include mortgage-backed pass-through securities (pass-throughs), collateralized mortgage obligations (CMO) and DUS (delegated underwriting & servicing) 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 un-rated securities issued by municipalities;

Certificates of deposit;

Equity securities at the holding company level; and

Limited partnership investments.

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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 originate commercial business loans in our primary 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. Commercial business loans are offered to the agricultural industry for short-term crop production, farm equipment and livestock financing. As a general practice, where possible, a collateral lien is placed on any available real estate, equipment or other assets owned by the borrower and a personal guarantee of the owner is obtained. As of December 31, 2013, $86.7 million, or 33%, of our aggregate commercial business loan portfolio were at fixed rates, while $179.1 million, or 67%, 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, 2013, $187.5 million, or 40%, of our aggregate commercial mortgage portfolio were at fixed rates, while $281.8 million, or 60%, 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, 2013, we had loans with an aggregate principal balance of $56.6 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 Mortgage 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, 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 FHA, and service the loans in a manner that satisfies the secondary market agreements. As of December 31, 2013, our residential mortgage servicing portfolio totaled $237.9 million, the majority of which has been sold to the FHLMC. As of December 31, 2013, our residential mortgage loan portfolio totaled $113.0 million, or 6% of our total loan portfolio. 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 home equity loans and lines of credit, automobile loans, secured installment loans and various other types of secured and unsecured personal loans. At December 31, 2013, outstanding consumer loan balances were concentrated in indirect automobile loans and home equity products.

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 expanded our relationships with franchised new car dealers in Western, Central and the Capital District of New York, and Northern Pennsylvania. As of December 31, 2013, our consumer indirect portfolio totaled $636.4 million, or 35% of our total loan portfolio. The consumer indirect loan portfolio is primarily 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, home improvement loans, closed-end home equity loans, home equity lines of credit, personal loans (collateralized and uncollateralized) and deposit account collateralized loans. The terms of these loans typically range from 12 to 180 months and vary based upon the nature of the collateral and the size of loan. The majority of the consumer lending program is underwritten on a secured basis using the customer s home or the financed automobile, mobile home, boat or recreational vehicle as collateral. As of December 31, 2013, $201.3 million, or 62%, of our home equity portfolio was at fixed rates, while $124.8 million, or 38%, was at variable rates. Approximately 76% of the loans in our home equity portfolio are first lien positions at December 31, 2013. The other consumer portfolio totaled $23.1 million as of December 31, 2013, all but $1.1 million 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 loan officer 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 as follows:

- Compete effectively and service the legitimate credit needs of our target market;
- Enhance our reputation for superior quality and timely delivery of products and services;
- Provide pricing that reflects the entire relationship and is commensurate with the risk profiles of our borrowers;
- Retain, develop and acquire profitable, multi-product, value added relationships with high quality borrowers;

Focus on government guaranteed lending and establish a specialization in this area to meet the needs of the small businesses in our communities; and

Comply with the relevant laws and regulations.

Our policy includes loan reviews, under the supervision of the 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.

Risk ratings are assigned to loans in the commercial business and commercial mortgage portfolios. The risk ratings are specifically used as follows:

Profile the risk and exposure in the loan portfolio and identify developing trends and relative levels of risk;

Identify deteriorating credits;

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 assesses 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.

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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 such as:

- Specific allocations for individually analyzed credits;
- Risk assessment process;
- Historical net charge-off experience;
- Evaluation of the loan portfolio with loan reviews;
- Levels and trends in delinquent and non-accruing loans;
- Trends in volume and terms 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;
- Customer leverage;
- Information (availability of timely financial information); and
- Collateral values.

Our methodology in the estimation of the allowance for loan losses includes the following:

1. Impaired commercial business and commercial mortgage loans, generally in excess of $50 thousand are reviewed individually and assigned a specific loss allowance, if considered necessary, in accordance with U.S. generally accepted accounting principles (GAAP).

2. The remaining portfolios of commercial 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 additional reserve amounts, if considered necessary, based upon qualitative factors. 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, customer leverage, 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, home equity (home equity loans and lines of credit), consumer indirect and other consumer. Allowance allocations for the real estate related loan portfolios (residential and home equity) are based on the average loss experience for the previous eight quarters, supplemented with qualitative factors similar to the elements described above. Allowance allocations for the consumer indirect and other consumer portfolios are based on vintage analyses performed with historical loss experience at 36 months and 24 months aging, respectively. The allocations on these portfolios are also supplemented with qualitative factors.

Management presents a quarterly review of the adequacy of the allowance for loan losses to 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.

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SOURCES OF FUNDS

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

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 24-hour ATM access at some of our facilities, access to other ATM networks available at other local financial institutions and retail establishments, and telephone banking services including account inquiry and balance transfers. We also take advantage of the use of technology by allowing our customers banking access via the Internet and various advanced systems for cash management for our business customers.

We had no traditional brokered deposits at December 31, 2013; 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 $61.3 million and $56.4 million, respectively, at December 31, 2013.

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. We also offer customers a deposit account that sweeps balances in excess of an agreed upon target amount into overnight repurchase agreements.

OPERATING SEGMENTS

Our only operating segment is our subsidiary bank, FSB.

OTHER INFORMATION

We also make available, free of charge, through our website, all reports filed with 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 *Company Filings* subsection of the *SEC Filings* section under the *Investor Relations* tab on 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

The Company and our subsidiaries are subject to an extensive system of laws and regulations that are intended primarily for the protection of customers and depositors and not for the protection of our security holders. These laws and regulations govern such areas as capital, permissible activities, allowance for loan losses, loans and investments, and rates of interest that can be charged on loans. Described below are elements of selected laws and regulations. The descriptions are not intended to be complete and are qualified in their entirety by reference to the full text of the statutes and regulations described.

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Holding Company Regulation. As a bank holding company and financial holding company, 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), 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 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 amends the BHC Act to require the federal financial regulatory agencies to adopt rules that prohibit banks and their affiliates from engaging in proprietary trading and investing in and sponsoring certain unregistered investment companies (defined as hedge funds and private equity funds), which is commonly called the Volcker Rule . The Federal Reserve adopted final rules implementing the Volcker Rule on December 10, 2013. The final rules are effective April 1, 2014, but the Federal Reserve issued an order extending the period during which institutions have to conform their activities and investments to the requirements of the Volcker Rule to July 21, 2015.

The Final Rules require each regulated entity to establish an internal compliance program that is consistent with the extent to which it engages in activities covered by the Volcker Rule, which must include (for the largest entities) making regular reports about those activities to regulators. Community banks, such as FSB, have been afforded some relief under the Final Rules. If such banks are engaged only in exempted proprietary trading, such as trading in U.S. government, agency, state and municipal obligations, they are exempt entirely from compliance program requirements. Moreover, even if a community bank engages in proprietary trading or covered fund activities under the rule, they need only incorporate references to the Volcker Rule into their existing policies and procedures. The Final Rules are effective April 1, 2014, but the conformance period has been extended from its statutory end date of July 21, 2014 until July 21, 2015. Although we are continuing to evaluate the impact of the Volcker Rule and the final rules adopted thereunder, we do not currently anticipate that the Volcker Rule will have a material effect on the operations of FII or the Bank, as we do not engage in the businesses prohibited by the Volcker Rule. We may incur costs to adopt additional policies and systems to ensure compliance with the Volcker Rule, but any such costs are not expected to be material.

The Dodd-Frank Act. The Dodd-Frank Act, significantly restructures the financial regulatory regime in the United States. Although the Dodd-Frank Act s provisions that have received the most public attention generally have been those applying to or more likely to affect larger institutions such as bank holding companies with total consolidated assets of $50 billion or more, it contains numerous other provisions that affect all bank holding companies and banks, including FII or the Bank, some of which are described in more detail below.

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Many of the Dodd-Frank Act s provisions are subject to final rulemaking by the U.S. financial regulatory agencies, and the implications of the Dodd-Frank Act for our businesses will depend to a large extent on how such rules are adopted and implemented by the primary U.S. financial regulatory agencies. We continue to analyze the impact of rules adopted under Dodd-Frank, on our business. However, the full impact will not be known until the rules, and other regulatory initiatives that overlap with the rules, are finalized and their combined impacts can be understood.

Depository Institution Regulation. The Bank is subject to regulation by the Federal Deposit Insurance Corporation (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 Adequacy Requirements. The FRB and FDIC have issued substantially similar risk-based and leverage capital guidelines applicable to bank holding companies and banks. In addition, these regulatory agencies may from time to time require that a bank holding company or bank maintain capital above the minimum levels, based on its financial condition or actual or anticipated growth.

The FRB s risk-based guidelines establish a two-tier capital framework. Tier 1 capital generally consists of common shareholders equity, retained earnings, a limited amount of qualifying perpetual preferred stock, qualifying trust preferred securities and non-controlling interests in the equity accounts of consolidated subsidiaries, less goodwill and certain intangibles. Tier 2 capital generally consists of certain hybrid capital instruments and perpetual debt, mandatory convertible debt securities and a limited amount of subordinated debt, qualifying preferred stock, loan loss allowance, and unrealized holding gains on certain equity securities. The sum of Tier 1 and Tier 2 capital represents qualifying total capital, at least 50% of which must consist of Tier 1 capital.

Risk-based capital ratios are calculated by dividing Tier 1 and total capital by risk-weighted assets. Assets and off-balance sheet exposures are assigned to one of four categories of risk-weights, based primarily on relative credit risk. For bank holding companies, generally the minimum Tier 1 risk-based capital ratio is 4% and the minimum total risk-based capital ratio is 8%. Our Tier 1 and total risk-based capital ratios under these guidelines at December 31, 2013 were 10.82% and 12.08%, respectively.

The FRB s leverage capital guidelines establish a minimum leverage ratio determined by dividing Tier 1 capital by adjusted average total assets. The minimum leverage ratio is 3% for bank holding companies that meet certain specified criteria, including having the highest regulatory rating. All other bank holding companies generally are required to maintain a leverage ratio of at least 4%. At December 31, 2013, we had a leverage ratio of 7.63%. See also the section titled Capital Resources in Part II, Item 7, Management s Discussion and Analysis of Financial Condition and Results of Operations and Note 11, Regulatory Matters, of the notes to consolidated financial statements, included in this Annual Report on Form 10-K.

Basel III Capital Rules. In July 2013, the Federal Reserve approved final rules that substantially amend the regulatory risk-based capital rules applicable to FII and the Bank. The FDIC and the OCC have subsequently approved these rules. The final rules were adopted following the issuance of proposed rules by the Federal Reserve in June 2012, and implement the Basel III regulatory capital reforms and changes required by the Dodd-Frank Act. Basel III refers to two consultative documents released by the Basel Committee on Banking Supervision in December 2009, the rules text released in December 2010, and loss absorbency rules issued in January 2011, which include significant changes to bank capital, leverage and liquidity requirements.

The rules include new risk-based capital and leverage ratios, which would be phased in from 2015 to 2019, and would refine the definition of what constitutes capital for purposes of calculating those ratios. The new minimum capital level requirements applicable to FII and the Bank under the final rules would be: (i) a new common equity Tier 1 capital ratio of 4.5%; (ii) a Tier 1 capital ratio of 6% (increased from 4%); (iii) a total capital ratio of 8% (unchanged from current rules); and (iv) a Tier 1 leverage ratio of 4% for all institutions. The final rules also establish a capital conservation buffer above the new regulatory minimum capital requirements, which must consist entirely of common equity Tier 1 capital. The capital conservation buffer will be phased-in over four years beginning on January 1, 2016, as follows: the maximum buffer will be 0.625% of risk-weighted assets for 2016, 1.25% for 2017, 1.875% for 2018, and 2.5% for 2019 and thereafter. This will result in the following minimum ratios beginning in 2019: (i) a common equity Tier 1 capital ratio of 7.0%; (ii) a Tier 1 capital ratio of 8.5%; and (iii) a total capital ratio of 10.5%. Under the final rules, institutions are subject to limitations on paying dividends, engaging in share repurchases, and paying discretionary bonuses if its capital level falls below the buffer amount. These limitations establish a maximum percentage of eligible retained income that could be utilized for such actions.

Basel III provided discretion for regulators to impose an additional buffer, the countercyclical buffer, of up to 2.5% of common equity Tier 1 capital to take into account the macro-financial environment and periods of excessive credit growth. However, the final rules permit the countercyclical buffer to be applied only to advanced approach banks (i.e., banks with $250 billion or more in total assets or $10 billion or more in total foreign exposures), which currently excludes the Company and the Bank. The final rules also implement revisions and clarifications consistent with Basel III regarding the various components of Tier 1 capital, including common equity, unrealized gains and losses, as well as certain instruments that will no longer qualify as Tier 1 capital, some of which will be phased out over time. However, the final rules provide that small depository institution holding companies with less than $15 billion in total assets as of December 31, 2009 (which includes the Company) will be able to permanently include non-qualifying instruments that were issued and included in Tier 1 or Tier 2 capital prior to May 19, 2010 in additional Tier 1 or Tier 2 capital until they redeem such instruments or until the instruments mature.

The final rules set forth certain changes for the calculation of risk-weighted assets, which we will be required to utilize beginning January 1, 2015. The standardized approach final rule utilizes an increased number of credit risk exposure categories and risk weights, and also addresses: (i) an alternative standard of creditworthiness consistent with Section 939A of the Dodd-Frank Act; (ii) revisions to recognition of credit risk mitigation; (iii) rules for risk weighting of equity exposures and past due loans; (iv) revised capital treatment for derivatives and repo-style transactions; and (v) disclosure requirements for top-tier banking organizations with $50 billion or more in total assets that are not subject to the advance approach rules that apply to banks with greater than $250 billion in consolidated assets. Based on our current capital composition and levels, we believe that we would be in compliance with the requirements as set forth in the final rules if they were presently in effect.

Prompt Corrective Action. The Federal Deposit Insurance Corporation Improvement Act of 1991, among other things, identifies five capital categories for insured depository institutions (well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized and critically undercapitalized) and requires the respective federal bank regulatory agencies to implement systems for prompt corrective action for insured depository institutions that do not meet minimum capital requirements within these categories. This act imposes progressively more restrictive constraints on operations, management and capital distributions, depending on the category in which an institution is classified. Failure to meet the capital guidelines could also subject a banking institution to capital raising requirements. An undercapitalized bank must develop a capital restoration plan and its parent holding company must guarantee that bank s compliance with the plan. The liability of the parent holding company under any such guarantee is limited to the lesser of five percent of the bank s assets at the time it became undercapitalized or the amount needed to comply with the plan. Furthermore, in the event of the bankruptcy of the parent holding company, such guarantee would take priority over the parent s general unsecured creditors. In addition, the Federal Deposit Insurance Corporation Improvement Act requires the various regulatory agencies to prescribe certain non-capital standards for safety and soundness relating generally to operations and management, asset quality and executive compensation and permits regulatory action against a financial institution that does not meet these standards.

The various federal bank regulatory agencies have adopted substantially similar regulations that define the five capital categories identified by the Federal Deposit Insurance Corporation Improvement Act, using the total risk-based capital, Tier 1 risk-based capital and leverage capital ratios as the relevant capital measures. These regulations establish various degrees of corrective action to be taken when an institution is considered undercapitalized. Under the regulations, a well capitalized institution must have a Tier 1 risk-based capital ratio of at least 6%, a total risk-based capital ratio of at least 10% and a leverage ratio of at least 5% and not be subject to a capital directive or order. An institution is adequately capitalized if it has a Tier 1 risk-based capital ratio of at least 4%, a total risk-based capital ratio of at least 8% and a leverage ratio of at least 4% (3% in certain circumstances). An institution is undercapitalized if it has a Tier 1 risk-based capital ratio of less than 4%, a total risk-based capital ratio of less than 8% or a leverage ratio of less than 4% (3% in certain circumstances). An institution is significantly undercapitalized if it has a Tier 1 risk-based capital ratio of less than 3%, a total risk-based capital ratio of less than 6% or a leverage ratio of less than 3%. An institution is critically undercapitalized if its tangible equity is equal to or less than 2% of total assets. Generally, an institution may be reclassified in a lower capitalization category if it is determined that the institution is in an unsafe or unsound condition or engaged in an unsafe or unsound practice.

As of December 31, 2013, the Bank met the requirements to be classified as well-capitalized .

The Basel III Capital Rules also contain revisions to the prompt corrective action framework, which are designed to place restrictions on insured depository institutions, including the Bank, if their capital levels begin to show signs of weakness. These revisions take effect January 1, 2015. Under the prompt corrective action requirements, which are designed to complement the capital conservation buffer, insured depository institutions will be required to meet the following increased capital level requirements in order to qualify as well capitalized: (i) a new common equity Tier 1 capital ratio of 6.5%; (ii) a Tier 1 capital ratio of 8% (increased from 6%); (iii) a total capital ratio of 10% (unchanged from current rules); and (iv) a Tier 1 leverage ratio of 5% (increased from 4%).

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.

Our primary source for cash dividends 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 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.

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 2013, the FICO assessment was equal to 0.62 basis points 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.

Transactions with Affiliates. FII and FSB 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.

Community Reinvestment Act. Under the Community Reinvestment Act, every FDIC-insured institution 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 Community Reinvestment Act requires the appropriate federal banking regulator, in connection with the examination of an insured institution, to assess the institution s record of meeting the credit needs of its community and to consider this record in its evaluation of certain applications, such as a merger or the establishment of a branch. An unsatisfactory rating may be used as the basis for the denial of an application and will prevent a bank holding company of the institution from making an election to become a financial holding company.

As of its last Community Reinvestment Act examination, the Bank received a rating of outstanding.

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.

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.

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Anti-Terrorism Legislation. The Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act (USA Patriot Act), enacted in 2001:

- prohibits banks from providing correspondent accounts directly to foreign shell banks;
- imposes due diligence requirements on banks opening or holding accounts for foreign financial institutions or wealthy foreign individuals;
- requires financial institutions to establish an anti-money-laundering (AML) compliance program; and
- generally eliminates civil liability for persons who file suspicious activity reports.

The USA Patriot Act also increases governmental powers to investigate terrorism, including expanded government access to account records. The Department of the Treasury is empowered to administer and make rules to implement the Act, which to some degree, affects our record-keeping and reporting expenses. Should the Bank s AML compliance program be deemed insufficient by federal regulators, we would not be able to grow through acquiring other institutions or opening de novo branches.

Ability-to-Repay and Qualified Mortgage Rule. Pursuant to the Dodd Frank Act, the CFPB issued a final rule on January 10, 2013 (effective on January 10, 2014), amending Regulation Z as implemented by the Truth in Lending Act, requiring mortgage lenders to make a reasonable and good faith determination based on verified and documented information that a consumer applying for a mortgage loan has a reasonable ability to repay the loan according to its terms. Mortgage lenders are required to determine consumers ability to repay in one of two ways. The first alternative requires the mortgage lender to consider the following eight underwriting factors when making the credit decision: (1) current or reasonably expected income or assets; (2) current employment status; (3) the monthly payment on the covered transaction; (4) the monthly payment on any simultaneous loan; (5) the monthly payment for mortgage-related obligations; (6) current debt obligations, alimony, and child support; (7) the monthly debt-to-income ratio or residual income; and (8) credit history. Alternatively, the mortgage lender can originate qualified mortgages, which are entitled to a presumption that the creditor making the loan satisfied the ability-to-repay requirements. In general, a qualified mortgage is a mortgage loan without negative amortization, interest-only payments, balloon payments, or terms exceeding 30 years. In addition, to be a qualified mortgage the points and fees paid by a consumer cannot exceed 3% of the total loan amount. Qualified mortgages that are higher-priced (e.g. subprime loans) garner a rebuttable presumption of compliance with the ability-to-repay rules, while qualified mortgages that are not higher-priced (e.g. prime loans) are given a safe harbor of compliance.

Incentive Compensation Policies and Restrictions. In July 2010, the federal banking agencies issued guidance that applies to all banking organizations supervised by the agencies (thereby including both FII and the Bank). Pursuant to the guidance, to be consistent with safety and soundness principles, a banking organization s incentive compensation arrangements should: (1) provide employees with incentives that appropriately balance risk and reward; (2) be compatible with effective controls and risk management; and (3) be supported by strong corporate governance including active and effective oversight by the banking organization s board of directors. Monitoring methods and processes used by a banking organization should be commensurate with the size and complexity of the organization and its use of incentive compensation.

In addition, in March 2011, the federal banking agencies, along with the Federal Housing Finance Agency, and the SEC, released a proposed rule intended to ensure that regulated financial institutions design their incentive compensation arrangements to account for risk. Specifically, the proposed rule would require compensation practices at the Parent Company and at the Bank to be consistent with the following principles: (1) compensation arrangements appropriately balance risk and financial reward; (2) such arrangements are compatible with effective controls and risk management; and (3) such arrangements are supported by strong corporate governance. In addition, financial institutions with $1 billion or more in assets would be required to have policies and procedures to ensure compliance with the rule and would be required to submit annual reports to their primary federal regulator. The comment period has closed but a final rule has not yet been published.

Sarbanes-Oxley Act of 2002. The Sarbanes-Oxley Act of 2002 implemented a broad range of corporate governance, accounting and reporting measures for companies that have securities registered under the Exchange Act, including publicly-held bank holding companies such as FII. Specifically, the Sarbanes-Oxley Act of 2002 and the various regulations promulgated thereunder, established, among other things: (i) requirements for audit committees, including independence, expertise, and responsibilities; (ii) responsibilities regarding financial statements for the Chief Executive Officer and Chief Financial Officer of the reporting company; (iii) the forfeiture of bonuses or other incentive-based compensation and profits from the sale of the reporting company s securities by the Chief Executive Officer and Chief Financial Officer in the twelve-month period following the initial publication of any financial statements that later require restatement; (iv) the creation of an independent accounting oversight board; (v) standards for auditors and regulation of audits, including independence provisions that restrict non-audit services that accountants may provide to their audit clients; (vi) disclosure and reporting obligations for the reporting company and their directors and executive officers, including accelerated reporting of stock transactions and a prohibition on trading during pension blackout periods; (vii) a prohibition on personal loans to directors and officers, except certain loans made by insured financial institutions on non-preferential terms and in compliance with other bank regulatory requirements; and (viii) a range of civil and criminal penalties for fraud and other violations of the securities laws.

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

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 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.

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.

EMPLOYEES

At December 31, 2013, we had 645 employees. None of our employees are subject to a collective bargaining agreement and management believes our relations with employees are good.

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EXECUTIVE OFFICERS

The following table sets forth current information regarding our executive officers and certain other significant employees (ages are as of May 7, 2014, the date of the 2014 Annual Meeting of Shareholders).

Name	Age	Started In	Positions/Offices
Martin K. Birmingham	47	2005	President and Chief Executive Officer since March 2013. Previously, President and Chief of Community Banking of FII and the Bank from August 2012 to March 2013. Executive Vice President and Regional President/Commercial Banking Executive Officer of the Bank from 2005 to 2009. Senior Vice President and Regional President of the Bank from 2005 to 2009. Senior Team Leader and Regional President of the Rochester Market at Bank of America (formally Fleet Boston Financial) from 2000 to 2005.
Paula D. Dolan	60	2013	Senior Vice President and Director of Human Resources of FII and the Bank since September 2013. Before joining the Company, Ms. Dolan worked at Hillside Family of Agencies (Hillside), starting as a consultant in 2010, and most recently as Hillside s Manager of Compensation and Human Resource Information Systems. Previously, she was a Senior Human Resources Consultant with First Niagara Consulting/Burke Group from 2007 to 2010. Prior to working at First Niagara, Ms. Dolan held human resources positions at Unity Health Systems, HR Works, Eastman Kodak Company, Rochester Community Savings Bank and Jones & Laughlin Steel Corporation.
Sonia M. Dumbleton	52	1984	Senior Vice President, Controller and Corporate Secretary of FII and the Bank since May 2013. Senior Vice President and Controller of the Bank since 2006. Vice President and Controller of the Bank from 2001 to 2006.
Michael D. Grover	42	1999	Senior Vice President of Financial Reporting and Tax and Chief Accounting Officer of FII and the Bank since April 2013. Senior Vice President of Financial Reporting and Tax of the Bank since 2008.
Richard J. Harrison	68	2003	Executive Vice President and Chief Operating Officer of FII and the Bank since August 2012. Executive Vice President and Senior Retail Lending Administrator of the Bank since 2009. Senior Vice President and Senior Retail Lending Administrator of the Bank and its predecessor, National Bank of Geneva, from 2003 to 2009. Executive Vice President and Chief Credit Officer of Savings Bank of the Finger Lakes from 2001 to 2003. Director of Transcat, Inc., a publicly traded distributer and calibrator of hand held test and measurement equipment since 2004.
Jeffrey P. Kenefick	47	2006	Executive Vice President and Commercial Banking Executive of FII and the Bank since May 2013. Senior Vice President, Commercial

			Banking Executive and Regional President of the Bank from February 2006 until May 2013.
Kevin B. Klotzbach	61	2001	Executive Vice President, Chief Financial Officer and Treasurer of FII and the Bank since April 2013. Senior Vice President and Treasurer of the Bank since 2001. Prior to joining us, Mr. Klotzbach actively managed fixed income portfolios at several other financial institutions, including Merrill Lynch Asset Management and Empire of America.
R. Mitchell McLaughlin	56	1981	Executive Vice President and Information/Physical Security and Facilities Director of the Bank since January 2014. Executive Vice President and Chief Information Officer of the Bank from 2009 to January 2014. Senior Vice President and Chief Information Officer of the Bank from 2006 to 2009.
Kenneth V. Winn	56	2004	Executive Vice President and Chief Risk Officer of FII and the Bank since July 2012. Senior Vice President and Senior Credit and Compliance Administrator of the Bank since 2006.

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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. The risks and uncertainties described below are not the only ones facing us. Additional risks and uncertainties that management is not aware of or focused on or that management currently deems immaterial may also impair our business operations. 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.

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, in turn 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.

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. In doing so, there is a risk that hazardous or toxic substances could be found on these properties. 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. Although we have policies and procedures to perform an environmental review before initiating any foreclosure action on real property, these reviews may not be sufficient to detect all potential environmental hazards. 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 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 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 risks elements in addition to normal credit risk. Potential risk elements associated with indirect lending include the limited personal contact with the borrower as a result of indirect lending through dealers, the absence of assured continued employment of the borrower, the varying general creditworthiness of the borrower, changes in the local economy, and difficulty in monitoring collateral. While indirect automobile loans are secured, such loans are secured by depreciating assets and characterized by LTV ratios that could result in us not recovering the full value of an outstanding loan upon default by the borrower. If the economic environment in our primary market area contracts, we may experience higher levels of delinquencies, charge-offs and repossessions.

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

We are subject to extensive supervision, regulation and examination. This regulatory structure gives the regulatory authorities extensive discretion in connection with their supervisory and enforcement activities and examination policies to address not only compliance with applicable laws and regulations (including laws and regulations governing consumer credit, and anti-money laundering and anti-terrorism laws), but also capital adequacy, asset quality and risk, management ability and performance, earnings, liquidity, and various other factors. As part of this regulatory structure, we are subject to policies and other guidance developed by the regulatory agencies with respect to capital levels, the timing and amount of dividend payments, the classification of assets and the establishment of adequate loan loss reserves for regulatory purposes. Under this structure the regulatory agencies have broad discretion to impose restrictions and limitations on our operations if they determine, among other things, 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 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.

The new Basel III Capital Standards may have an adverse effect on us.

In July 2013, the Federal Reserve Board released its final rules which will implement in the United States the Basel III regulatory capital reforms from the Basel Committee on Banking Supervision and certain changes required by the Dodd-Frank Act. Under the final rule, minimum requirements will increase for both the quality and quantity of capital held by banking organizations. Consistent with the international Basel framework, the rule includes a new minimum ratio of Common Equity Tier I Capital to Risk-Weighted Assets of 4.5% and a Common Equity Tier I Capital conservation buffer of 2.5% of risk-weighted assets that will apply to all supervised financial institutions. The rule also, among other things, raises the minimum ratio of Tier I Capital to Risk-Weighted Assets from 4% to 6% and includes a minimum leverage ratio of 4% for all banking organizations. We must begin transitioning to the new rules effective January 1, 2015. The impact of the new capital rules is likely to require us to maintain higher levels of capital, which will lower our return on equity.

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New regulations could adversely impact our earnings due to, among other things, increased compliance costs or costs due to noncompliance.

In March 2013, the Consumer Financial Protection Bureau (CFPB) issued supervisory guidance highlighting its concern that the practice of automotive dealers being compensated for arranging customer financing through discretionary markup of wholesale rates offered by financial institutions, such as us (dealer markup), results in a significant risk of pricing disparity in violation of The Equal Credit Opportunity Act (ECOA). The Consumer Financial Protection Bureau recommended that financial institutions under its jurisdiction take steps to ensure compliance with the ECOA, which may include imposing controls on dealer markup, monitoring and addressing the effects of dealer markup policies, and eliminating dealer discretion to markup buy rates and fairly compensating dealers using a different mechanism. In December 2013, the Consumer Financial Protection Bureau and the United States Department of Justice (the DOJ), based on a proxy methodology that combines geography-based and name-based probabilities, alleged that certain presumed-minority borrowers who had obtained automobile financing from a national lender were charged higher dealer markups as a result of such lender s policy and practice of allowing dealer markup. In connection with the investigation, the lender consented to the issuance of a consent order and agreed to pay damages, to implement a compliance plan, and to pay a monetary penalty. Additional investigations and actions by the Consumer Financial Protection Bureau and the DOJ against automotive lenders are likely to occur in the future. We have evaluated our indirect lending practices in light of these events and believe that we are currently conducting our indirect lending business in compliance with ECOA. However, any investigations or allegations of wrongdoing by the Consumer Financial Protection Bureau or DOJ against us could have material adverse impact on our indirect lending business, results of operations and financial condition.

The CFPB has issued a rule, effective as of January 10, 2014, designed to clarify for lenders how they can avoid monetary damages under the Dodd-Frank Act, which would hold lenders accountable for ensuring a borrower s ability to repay a mortgage. Loans that satisfy this qualified mortgage safe-harbor will be presumed to have complied with the new ability-to-repay standard. Under the CFPB s rule, a qualified mortgage loan must not contain certain specified features, including but not limited to:

- excessive upfront points and fees (those exceeding 3% of the total loan amount, less bona fide discount points for prime loans);
- interest-only payments;
- negative-amortization; and
- terms longer than 30 years.

Also, to qualify as a qualified mortgage, a borrower s total monthly debt-to-income ratio may not exceed 43%. Lenders must also verify and document the income and financial resources relied upon to qualify the borrower for the loan and underwrite the loan based on a fully amortizing payment schedule and maximum interest rate during the first five years, taking into account all applicable taxes, insurance and assessments. The CFPB s rule on qualified mortgages could limit our ability or desire to make certain types of loans or loans to certain borrowers, or could make it more expensive and/or time consuming to make these loans, which could adversely impact our growth or profitability.

With the development of the CFPB, our consumer products and services are subject to increasing regulatory oversight and scrutiny with respect to compliance under consumer laws and regulations. We may face a greater number or wider scope of investigations, enforcement actions and litigation in the future related to consumer practices, thereby increasing costs associated with responding to or defending such actions. In addition, increased regulatory inquiries and investigations, as well as any additional legislative or regulatory developments affecting our consumer businesses, and any required changes to our business operations resulting from these developments, could result in significant loss of revenue, limit the products or services we offer, require us to increase our prices and therefore reduce demand for our products, impose additional compliance costs on us, cause harm to our reputation or otherwise adversely affect our consumer businesses.

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

The financial services industry is extensively regulated. Federal and state banking regulations are designed primarily to protect the deposit insurance funds and consumers, not to benefit a company s stockholders. These regulations may sometimes impose significant limitations on operations. The significant federal and state banking regulations that affect us are described in the section captioned Supervision and Regulation included in Part I, Item 1, Business . These regulations, along with the currently existing tax, accounting, securities, insurance, and monetary laws, regulations, rules, standards, policies, and interpretations control the methods by which financial institutions conduct business, implement strategic initiatives and tax compliance, and govern financial reporting and disclosures. These laws, regulations, rules, standards, policies, and interpretations are constantly evolving and may change significantly over time.

A breach in security of our or third party information systems, including the occurrence of a cyber incident or a deficiency in cybersecurity, may result in a loss of customer business or damage to 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 is dependent on our ability to process and monitor large numbers 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, such as the personal information of our customers and clients. These risks may increase in the future as we continue to increase mobile payments and other internet-based product offerings and expand our internal usage of web-based products and applications.

While we have policies and procedures designed to prevent or limit the effect of a possible failure, interruption or breach of our information systems, there can be no assurance that such action will not occur or, if any does occur, that it will be adequately addressed. For example, although we maintain commercially reasonable measures to ensure the cybersecurity of our information systems, other financial service institutions and companies have reported breaches in the security of their websites or other systems. In addition, several U.S. financial institutions have recently 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 efforts has 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.

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 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.

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 and our ongoing leadership transition may be unsuccessful.

Our success depends, in large part, on our ability to attract and retain skilled people. Competition for the best people in most activities engaged in by us can be intense, and we may not be able to hire sufficiently skilled people or to retain them. Further, the rural location of our principal executive offices and many of our bank branches make it difficult 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.

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Acquisitions may disrupt our business and dilute shareholder value.

A key component of our strategy to grow and improve profitability is to expand our branch network into communities within or adjacent to markets where we currently conduct business. We intend to continue to pursue a growth strategy for our business. As a result, negotiations may take place and future mergers or acquisitions involving cash, debt, or equity securities may occur at any time. We seek merger or acquisition partners that are culturally similar, have experienced management, and possess either significant market presence or have potential for improved profitability through financial management, economies of scale, or expanded services.

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;
- there may be 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; and
- potential changes in banking or tax laws or regulations that may affect the target company.

We are subject to interest rate risk.

Our earnings and cash flows are largely dependent 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 various governmental and regulatory agencies and, in particular, 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.

Although management believes we have implemented effective asset and liability management strategies to reduce the potential effects of changes in interest rates on our results of operations, 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.

From December 2007 through June 2009, the U.S. economy was in recession. Business activity across a wide range of industries and regions in the U.S. was greatly reduced. Although economic conditions have begun to improve, certain sectors, such as real estate, remain weak and unemployment remains high. Local governments and many businesses are still in serious difficulty due to lower consumer spending and reduced tax collections.

Market conditions also led to the failure or merger of several prominent financial institutions and numerous regional and community-based financial institutions. These failures had a significant negative impact on the capitalization level of the deposit insurance fund of the FDIC, which, in turn, has led to past increases in deposit insurance premiums paid by financial institutions.

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.

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Our earnings are significantly affected by the fiscal and monetary policies of the federal government and its agencies.

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. 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.

We may be required to recognize an impairment of goodwill.

Under current accounting standards, goodwill is not amortized but, instead, is subject to impairment tests on at least an annual basis or more frequently if an event occurs or circumstances change that reduce the fair value of a reporting unit below its carrying amount. 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 could result in impairment of goodwill. During 2013, the annual impairment test performed as of September 30 indicated that the fair value of our single reporting unit exceeded the fair value of its assets and liabilities. In the event that we conclude that all or a portion of our goodwill may be impaired, a non-cash charge for the amount of such impairment would be recorded to earnings, which could have a material adverse impact on our results of operations or financial condition. Such a charge would have no impact on tangible capital. At December 31, 2013, we had goodwill of $48.5 million, representing approximately 19% of shareholders equity. 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.

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 various 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. Many of our 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.

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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 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. Although management has established disaster recovery policies and procedures, 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. This situation 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, among other things, conditions in the capital markets at that time, which are outside of our control, and our financial performance.

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 such 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. Various 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 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 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.

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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.

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.

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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. Additionally, we are obligated under a lease commitment through 2017 for a 22,200 square foot regional administrative facility in Pittsford, New York.

We are engaged in the banking business through 50 branch offices, of which 34 are owned and 16 are leased, in 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 2036 and generally include options to renew.

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 10, 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 December 31, 2013, 13,829,355 shares of our common stock were outstanding and held by approximately 2,000 shareholders of record. During 2013, the high sales price of our common stock was $26.59 and the low sales price was $17.92. The closing price per share of common stock on December 31, 2013, the last trading day of our fiscal year, was $24.71. We declared dividends of $0.74 per common share during the year ended December 31, 2013. 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 11, 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.

Recent Sales of Unregistered Securities

We provide our directors who are not employees with a convenient way to purchase shares from us at fair market value. Each director may elect to receive half of their annual retainer in shares of our common stock on the date of our annual organizational meeting. Any portion of the annual retainer issued to our directors in the form of stock has historically been issued outside of our 2009 Directors Stock Incentive Plan (the DSIP) and without registration under the Securities Act of 1933 as amended (the Securities Act) in reliance on the exemption from registration pursuant to Section 4(a)(2) of the Securities Act based on our directors financial sophistication and knowledge of the Company. On May 8, 2013, we issued a total of 5,672 shares of our common stock as the stock component of our annual retainer to our non-employee directors without registration under the Securities Act. These shares of common stock are subject to the resale prohibition under the Securities Act and may not be sold or transferred without registration except in accordance with Rule 144 of the Securities Act.

Although any director retainer issued in the form of stock is issued outside of the DSIP, we still deduct these shares from the aggregate share limit under the DSIP. We expect that future director stock retainers will be issued pursuant to a shareholder approved plan and registered under the Securities Act.

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Stock Performance Graph

The stock performance graph below compares (a) the cumulative total return on our common stock for the period beginning December 31, 2008 as reported by the NASDAQ Global Select Market, through December 31, 2013, (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 SNL Financial L.C., 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 SNL Financial, LC and is expressed in dollars based on an assumed investment of $100.

Total Return Performance

	Period Ending					
Index	**12/31/08**	**12/31/09**	**12/31/10**	**12/31/11**	**12/31/12**	**12/31/13**
Financial Institutions, Inc.	100.00	85.77	141.45	123.93	147.89	203.38
NASDAQ Composite	100.00	145.36	171.74	170.38	200.63	281.22
SNL Bank $1B-$5B Index	100.00	71.68	81.25	74.10	91.37	132.87

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ITEM 6. SELECTED FINANCIAL DATA

ars in thousands, except selected ratios and per share data)	At or for the year ended December 31,				
	2013	**2012**	**2011**	**2010**	**2009**
ted financial condition data:					
assets	$ 2,928,636	$ 2,763,865	$ 2,336,353	$ 2,214,307	$ 2,062,3
s, net	1,806,883	1,681,012	1,461,516	1,325,524	1,243,2
tment securities	859,185	841,701	650,815	694,530	620,0
sits	2,320,056	2,261,794	1,931,599	1,882,890	1,742,9
owings	337,042	179,806	150,698	103,877	106,3
holders equity	254,839	253,897	237,194	212,144	198,2
mon shareholders equity (1)	237,497	236,426	219,721	158,359	144,8
ible common shareholders equity (2)	187,495	186,037	182,352	120,990	107,5
ted operations data:					
est income	$ 98,931	$ 97,567	$ 95,118	$ 96,509	$ 94,4
est expense	7,337	9,051	13,255	17,720	22,2
nterest income	91,594	88,516	81,863	78,789	72,2
sion for loan losses	9,079	7,128	7,780	6,687	7,7
nterest income after provision for loan losses	82,515	81,388	74,083	72,102	64,5
nterest income	24,833	24,777	23,925	19,454	18,7
nterest expense	69,441	71,397	63,794	60,917	62,7
ne before income taxes	37,907	34,768	34,214	30,639	20,5
ne tax expense	12,377	11,319	11,415	9,352	6,1
ncome	$ 25,530	$ 23,449	$ 22,799	$ 21,287	$ 14,4
rred stock dividends and accretion	1,466	1,474	3,182	3,725	3,6
ncome applicable to common shareholders	$ 24,064	$ 21,975	$ 19,617	$ 17,562	$ 10,7
and related per share data:					
ngs per common share:					
	$ 1.75	$ 1.60	$ 1.50	$ 1.62	$ 0.
ed	1.75	1.60	1.49	1.61	0.
dividends declared on common stock	0.74	0.57	0.47	0.40	0.
mon book value per share (1)	17.17	17.15	15.92	14.48	13.
ible common book value per share (2)	13.56	13.49	13.21	11.06	9.
et price (NASDAQ: FISI):					
	26.59	19.52	20.36	20.74	15.
	17.92	15.22	12.18	10.91	3.
	24.71	18.63	16.14	18.97	11.

ormance ratios:

ncome, returns on:					
age assets	0.91%	0.93%	1.00%	0.98%	0.
age equity	10.10	9.46	9.82	10.07	7.
age common equity [(1)]	10.23	9.53	9.47	11.14	7.
age tangible common equity [(2)]	13.00	11.74	11.55	14.59	10.
mon dividend payout ratio [(3)]	42.29	35.63	31.33	24.69	40.
nterest margin (fully tax-equivalent)	3.64	3.95	4.04	4.07	4.
ency ratio [(4)]	58.48%	62.87%	60.55%	60.36%	65.

(1) Excludes preferred shareholders equity.

(2) Excludes preferred shareholders equity, goodwill and other intangible assets.

(3) Common dividend payout ratio equals dividends declared during the year divided by earnings per share for the year.

(4) Efficiency ratio equals noninterest expense less other real estate expense and amortization of intangible assets as a percentage of net revenue, defined as the sum of tax-equivalent net interest income and noninterest income before net gains and impairment charges on investment securities and proceeds from company owned life insurance included in income (all from continuing operations).

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(Dollars in thousands, except per share data)	At or for the year ended December 31,				
	2013	**2012**	**2011**	**2010**	**2009**
Capital ratios:					
Leverage ratio	7.63%	7.71%	8.63%	8.31%	7.96%
Tier 1 capital ratio	10.82	10.73	12.20	12.34	11.95
Total risk-based capital ratio	12.08	11.98	13.45	13.60	13.21
Equity to assets (3)	9.01	9.84	10.20	9.75	9.55
Common equity to assets (1) (3)	8.39	9.15	9.10	7.28	6.94
Tangible common equity to tangible assets (2) (3)	6.72%	7.56%	7.58%	5.65%	5.19%
Asset quality:					
Non-performing loans	$ 16,622	$ 9,125	$ 7,076	$ 7,582	$ 8,681
Non-performing assets	17,083	10,062	9,187	8,895	10,442
Allowance for loan losses	26,736	24,714	23,260	20,466	20,741
Net loan charge-offs	$ 7,057	$ 5,674	$ 4,986	$ 6,962	$ 5,710
Non-performing loans to total loans	0.91%	0.53%	0.48%	0.56%	0.69%
Non-performing assets to total assets	0.58	0.36	0.39	0.40	0.51
Net charge-offs to average loans	0.40	0.36	0.36	0.54	0.47
Allowance for loan losses to total loans	1.46	1.45	1.57	1.52	1.64
Allowance for loan losses to non-performing loans	161%	271%	329%	270%	239%
Other data:					
Number of branches	50	52	50	50	50
Full time equivalent employees	608	628	575	577	572

(1) Excludes preferred shareholders equity.

(2) Excludes preferred shareholders equity, goodwill and other intangible assets.

(3) Ratios calculated using average balances for the periods shown.

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SELECTED QUARTERLY DATA

(Dollars in thousands, except per share data)	Fourth Quarter	Third Quarter	Second Quarter	First Quarter
2013				
Interest income	$ 25,218	24,623	24,342	24,748
Interest expense	1,838	1,820	1,818	1,861
Net interest income	23,380	22,803	22,524	22,887
Provision for loan losses	2,407	2,770	1,193	2,709
Net interest income, after provision for loan losses	20,973	20,033	21,331	20,178
Noninterest income	5,735	6,169	6,376	6,553
Noninterest expense	17,386	17,009	17,462	17,584
Income before income taxes	9,322	9,193	10,245	9,147
Income tax expense	2,955	3,029	3,395	2,998
Net income	$ 6,367	6,164	6,850	6,149
Preferred stock dividends	366	365	367	368
Net income applicable to common shareholders	$ 6,001	5,799	6,483	5,781
Earnings per common share [1]:				
Basic	$ 0.44	0.42	0.47	0.42
Diluted	0.43	0.42	0.47	0.42
Market price (NASDAQ: FISI):				
High	$ 26.59	21.99	20.66	20.83
Low	20.14	18.39	17.92	18.51
Close	24.71	20.46	18.41	19.96
Dividends declared	$ 0.19	0.19	0.18	0.18
2012				
Interest income	$ 25,087	$ 25,299	$ 23,731	$ 23,450
Interest expense	1,999	2,200	2,343	2,509
Net interest income	23,088	23,099	21,388	20,941
Provision for loan losses	2,520	1,764	1,459	1,385
Net interest income, after provision for loan losses	20,568	21,335	19,929	19,556
Noninterest income	6,283	6,353	6,690	5,451
Noninterest expense	17,541	21,618	16,581	15,657
Income before income taxes	9,310	6,070	10,038	9,350
Income tax expense	2,978	1,805	3,382	3,154

Net income	$ 6,332	$ 4,265	$ 6,656	$ 6,196
Preferred stock dividends	369	368	368	369
Net income applicable to common shareholders	$ 5,963	$ 3,897	$ 6,288	$ 5,827
Earnings per common share [1]:				
Basic	$ 0.44	$ 0.28	$ 0.46	$ 0.43
Diluted	0.43	0.28	0.46	0.42
Market price (NASDAQ: FISI):				
High	$ 19.39	$ 19.52	$ 17.66	$ 17.99
Low	17.61	16.50	15.51	15.22
Close	18.63	18.64	16.88	16.17
Dividends declared	$ 0.16	$ 0.14	$ 0.14	$ 0.13

(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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2013 FOURTH QUARTER RESULTS

Net income was $6.4 million for the fourth quarter of 2013 compared with $6.3 million for the fourth quarter of 2012. After preferred dividends, diluted earnings per share was $0.43 for the fourth quarters of 2013 and 2012.

Net interest income totaled $23.4 million for the three months ended December 31, 2013, an increase of $292 thousand or 1% over the fourth quarter of 2012. Average earning assets increased $243.7 million during the fourth quarter 2013 compared to the same quarter last year, the result of a $122.3 million increase in average loans combined with a $121.4 million increase in investment securities.

The net interest margin on a tax-equivalent basis was 3.61% in the fourth quarter of 2013, compared with 3.92% in the fourth quarter of 2012. Our yield on earning-assets decreased 37 basis points in the fourth quarter of 2013 compared with the same quarter last year, a result of cash flows being reinvested in the current low interest rate environment, which includes the impact of our leverage strategy implemented during the first quarter of 2013. The cost of interest-bearing liabilities decreased 7 basis points compared with the fourth quarter of 2012, primarily a result of the continued downward re-pricing of our certificates of deposit.

The provision for loan losses was $2.4 million for the fourth quarter of 2013 compared with $2.5 million for the fourth quarter of 2012. Net charge-offs for the fourth quarter of 2013 were $2.4 million, or 0.52% annualized, of average loans, compared to $2.1 million, or 0.50% annualized, of average loans in the fourth quarter of 2012. See the sections Allowance for Loan Losses and Non-performing Assets and Potential Problem Loans for additional information on net charge-offs and non-performing loans.

Noninterest income totaled $5.7 million for the fourth quarter of 2013, a 9% decrease over the fourth quarter of 2012. Decreases in net gain on loans held for sale and net gains from the sale of investment securities were partially offset by an increase in other income and lower losses attributed to the sale of other assets when comparing the fourth quarter 2013 compared with the same quarter last year.

Noninterest expense was $17.4 million for the fourth quarter of 2013, a decrease of $155 thousand or 1% from the fourth quarter of 2012. Lower salaries and employee benefits expense, computer and data processing and advertising and promotions expense was partially offset by increases in occupancy and equipment expense and professional services expense when comparing the fourth quarter 2013 compared with the same quarter last year.

Income tax expense was $3.0 million for the fourth quarters of 2013 and 2012, as pre-tax income was essentially unchanged between the periods.

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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. is a financial holding company headquartered in New York State, providing banking and nonbanking financial services to individuals and businesses primarily in our Western and Central New York footprint. We have also expanded our indirect lending network to include relationships with franchised automobile dealers in the Capital District of New York and Northern Pennsylvania. Through our wholly-owned banking subsidiary, Five Star Bank, we offer a wide range of services, including business and consumer loan and depository services, brokerage and investment advisory services, as well as other financial services and traditional banking services.

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 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

Industry Overview

In December 2013, the Federal Open Market Committee of the Federal Reserve Board (FOMC) kept the target range for federal funds rate at 0-25 basis points noting that a highly accommodative stance of monetary policy will remain appropriate after the economy strengthens to support maximum employment and price stability. The FOMC expects to maintain the target federal funds rate at 0-25 basis points for at least as long as the unemployment rate remains above 6.5%, inflation projections are no more than 0.5% above the FOMCs 2% long-run goal and longer-term inflation expectations continue to be well-anchored. The FOMC also announced that due to cumulative progress toward maximum employment and the improvement in the labor market outlook, it will reduce the purchase of agency mortgage-backed securities to $35 billion per month, down from the previous pace of $40 billion per month. The FOMC will also reduce the purchase of longer-term Treasury securities from its previous pace of $45 billion per month to $40 billion per month. These actions are intended to lower longer-term interest rates and support the mortgage and credit markets, among other things.

The actions by the FOMC have compressed net interest income and net interest margins for the banking industry by maintaining low rates on interest-earning assets. Throughout 2013, margins in the banking industry were pressured downward as higher-yielding legacy assets rolled off and were reinvested in the current low rate environment. Low interest rates, coupled with a competitive lending environment, have proven challenging for the profitability of the banking industry. It is expected that these challenges will continue until interest rates rise.

Although the expectation for capital spending increased during 2013, it is significantly lower than the pre-recession pace of 2006-2007. Reduced capital spending has resulted in record levels of deposits and tempered small businesses demand for loans. The high level of liquidity from the amount of deposits has exacerbated the pressure on net interest margins in the banking industry, as banks are challenged to deploy the excess liquidity at profitable spreads.

The banking industry continues to be impacted by new legislative and regulatory reform proposals. In July 2013, the Board of Governors of the Federal Reserve Bank, the FDIC, and the Office of the Comptroller of the Currency (OCC) approved the final U.S. version of the Basel III agreement. Basel III replaces the federal banking agencies general risk-based capital rules, includes a narrower definition of capital and requires higher minimum capital levels. Basel III will be effective for us in 2015. In December 2013, the federal banking agencies also adopted final rules implementing a provision of the Dodd-Frank Act known as the Volcker Rule, a complex regulation that prohibits banks from engaging in proprietary trading and investments in certain asset classes. Upon initial issuance, a significant unintended consequence emerged, as banks faced impairments on certain investments that were no longer allowed to be held. While the federal banking agencies issued additional guidance in January 2014 allowing banks to retain certain investments that were originally prohibited by the Volcker Rule, it underscored the complexity of the Rule and the potential ramifications to the industry. A comprehensive discussion of legislative and regulatory matters affecting us can be found in the Supervision and Regulation section included in Part 1, Item 1, of this Annual Report on Form 10-K.

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MANAGEMENT S DISCUSSION AND ANALYSIS

2013 Financial Performance Review

During 2013 we continued to strengthen our balance sheet, as measured by ongoing deposit growth and quality loan growth in commercial and consumer indirect lending. Our deposit and lending growth is the result of our execution on key strategic initiatives over the last few years. We have done all of this while controlling expenses through disciplined expense management.

In 2013, we reported net income of $25.5 million compared to $23.4 million for 2012. This resulted in a 0.91% return on average assets and a 13.00% return on average tangible common equity. Net income available to common shareholders was $24.1 million or $1.75 per diluted share for 2013, compared to $22.0 million or $1.60 per diluted common share for 2012. We declared cash dividends of $0.74 during 2013, an increase of $0.17 per common share or 30% compared to the prior year. In addition, we grew our base of consumer and business customers while our efficiency ratio improved to 58.48% in 2013 from 62.87% in 2012.

Fully-taxable equivalent net interest income was $94.2 million in 2013, an increase of $3.4 million, or 4%, compared with 2012. This reflected the impact of 19% growth in average investment securities and 10% average loan growth, offset by a 31 basis point decline in the net interest margin to 3.64%. The loan growth reflected a 7% increase in average commercial loans, an 18% increase in average home equities and a 13% increase in average automobile loans.

Noninterest income was $24.8 million in 2013, relatively unchanged from the prior year. Service charges on deposits increased $1.3 million and ATM and debit card income increased $382 thousand in 2013, reflecting volume growth resulting from the 2012 branch acquisitions and changes we made in the second quarter of 2013 to our fee waiver process. An increase in sales volume primarily contributed to a $241 thousand increase in investment advisory income in 2013. Mortgage banking income was down $1.4 million due to a reduction in volume, lower gains on sale, and a higher percentage of originations retained on our balance sheet.

Noninterest expense was $69.4 million in 2013, a 3% decrease compared with 2012. Noninterest expense for 2012 included expenses totaling $3.0 million related to the 2012 branch acquisitions and $2.6 million related to the retirement of our former CEO. These expenses were included in salaries and employee benefits ($2.9 million), occupancy and equipment ($56 thousand), professional services ($1.1 million), computer and data processing ($480 thousand), supplies and postage ($395 thousand), advertising and promotions ($56 thousand) and other expense ($591 thousand) for 2012. Excluding these expenses, which we consider to be non-recurring in nature, noninterest expense increased $3.6 million or 5% when comparing 2013 to 2012.

Asset quality related metrics remain strong despite the increase in nonaccrual and non-performing assets in 2013. Nonaccrual loans increased $7.5 million compared to a year ago to $16.6 million. Non-performing assets increased $7.0 million compared to a year ago to $17.1 million, or 0.58% of total assets. The increases primarily reflect the addition of one commercial mortgage loan with a principal balance of $6.9 million at December 31, 2013. The provision for loan losses increased $2.0 million, or 27%, from 2012 as we continue to maintain the allowance for loan losses consistent with the growth in our loan portfolio and trends in asset quality. Net charge-offs increased $1.4 million, or 24%, from the prior year to $7.1 million. Net charge-offs were an annualized 0.40% of average loans in the current year compared to 0.36% in 2012.

The tangible common equity to tangible assets ratio at December 31, 2013, was 6.51%, down 35 basis points from a year ago. Our leverage ratio at year end was 7.63%, down from 7.71% at the end of 2012. The decrease in the tangible common equity to tangible assets and leverage ratios reflect our asset growth outpacing the increase in retained earnings. Our tier 1 and total risk-based capital ratios were 10.82% and 12.08%, respectively, at December 31, 2013, up from 10.73% and 11.98%, respectively, at December 31, 2012.

Branch Consolidations

In October 2013, we closed our Pavilion and North Java branches and transferred customer accounts and employees into nearby branches. These branch consolidations are one component of our long term strategic plan, which provides for the optimal combination of branches and online/mobile banking technologies, supported by highly experienced bankers, to offer customers convenience and high service levels while maintaining an efficient, competitive cost structure. Expenses related to the consolidation of these two branches were not material. In January 2014, we consolidated one of our supermarket branches into a nearby location in Batavia.

Dissolution of Broker-Dealer

During late 2013, our subsidiary, Five Star Investment Services, Inc. (FSIS) ceased operations as an active broker-dealer and the securities licenses of advisors associated with FSIS who elected to transfer, as well as their respective client accounts which had previously cleared through a third-party platform, were transferred to the LPL Financial (LPL) clearing platform. Following the completion of these transfer activities, FSB began offering investment and securities-related services, including brokerage and investment advice through a strategic partnership with LPL. FSB has employees who are LPL registered representatives, located throughout its branch network, offering customers insurance and investment products including stocks, bonds, mutual funds, annuities, and managed accounts through a program called Five Star Investment Services. FSIS withdrew its registration with the Financial Industry Regulatory Authority (FINRA) effective December 31, 2013, and is expected to be dissolved in 2014.

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MANAGEMENT S DISCUSSION AND ANALYSIS

2012 Branch Acquisitions

During 2012, we successfully completed the acquisition of eight retail bank branch locations in Upstate New York. Former HSBC Bank USA, N.A. branches located in Albion, Elmira, Elmira Heights, and Horseheads were acquired in August, complementing the former First Niagara Bank, N.A. locations in Batavia, Brockport, Medina, and Seneca Falls acquired in June. Through the acquisition we assumed deposits of $286.8 million and acquired in-market performing loans of $75.6 million. The acquisition of these branch offices was a marked success. We were able to integrate the offices and customer accounts seamlessly. Through detailed planning, we ensured that our sales and support staff members were ready to assist customers with any questions or issues. The feedback we received from our customers was positive and executing on our detailed planning process ultimately resulted in deposit retention rates that were better than expected. We incurred approximately $3.0 million in pre-tax expense during 2012 related to the branch acquisitions.

The combined assets acquired and deposits assumed in the two transactions were recorded at their estimated fair values as follows:

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

For detailed information on the accounting for the branch acquisitions, see Note 2, Branch Acquisitions, of the notes to consolidated financial statements.

2014 Expectations

Net interest income is expected to increase moderately in 2014. We anticipate an increase in earning assets as we remained focused on loan growth, which will be partly funded with expected paydowns and liquidity from our securities portfolio. However, those benefits to net interest income are expected to be partially offset by continued downward pressure on net interest margin. We plan to maintain a disciplined approach to loan pricing, but asset yields remain under pressure due to the low interest rate environment, while the opportunity for deposit repricing is limited.

The commercial loan portfolio is expected to grow consistent with our strategic initiatives and continued support of middle market lending. Automobile loan originations remain strong, reflecting the positive impact from our investment in automotive dealer relationships. The home equity portfolio is expected to increase as the lower origination cost to customers and the convenient application process has made these products an increasingly attractive alternative to conventional residential mortgage loans, accordingly we expect run-off to outpace new originations in the residential mortgage portfolio.

We anticipate the increase in total loans will modestly outpace growth in total deposits. This reflects our continued focus on the overall cost of funds, through the use of short-term borrowings as well as the continued shift towards low- and no-cost demand deposits and money market deposit accounts.

Noninterest income is expected to be slightly higher than recent levels, reflecting our continued efforts to increase both account and transaction-based fee income. Management will continue to explore opportunities to increase noninterest income from non-deposit related sources.

Noninterest expense is expected to remain around current levels as we remain committed to diligent expense control during 2014.

We do not expect significant changes in overall asset quality and allowance measurements.

The effective tax rate for 2014 is expected to be lower, primarily reflecting the impacts of tax-exempt income, tax advantaged investments, and the formation of our real estate investment trust in early 2014.

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MANAGEMENT S DISCUSSION AND ANALYSIS

RESULTS OF OPERATIONS FOR THE YEARS ENDED

DECEMBER 31, 2013 AND DECEMBER 31, 2012

Significant Items Influencing Financial Performance Comparisons

Earnings comparisons among the years ended December 31, 2013 and 2012 were impacted by the significant items summarized below.

Retirement of Former CEO. In August 2012, Peter G. Humphrey our former President and Chief Executive Officer retired. We incurred approximately $2.6 million in pre-tax expense during 2012 related to the retirement of Mr. Humphrey.

2012 Branch Acquisitions. During 2012, we completed the acquisition of eight retail bank branch locations in Upstate New York. We incurred approximately $3.0 million in pre-tax expense during 2012 related to the branch acquisitions.

Net Interest Income and Net Interest Margin

Net interest income is the primary source of our 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.

Interest rate spread and net interest margin are utilized 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.

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):

	2013	2012	2011
Interest income per consolidated statements of income	$ 98,931	$ 97,567	$ 95,118

Adjustment to fully taxable equivalent basis	2,650	2,284	2,062
Interest income adjusted to a fully taxable equivalent basis	101,581	99,851	97,180
Interest expense per consolidated statement of income	7,337	9,051	13,255
Net interest income on a taxable equivalent basis	$ 94,244	$ 90,800	$ 83,925

2013 Leverage Strategy

During the first quarter of 2013, we utilized the proceeds of short-term FHLB advances to purchase high-quality investment securities as part of a leverage strategy of approximately $100 million. Our purchase of investment securities was comprised of mortgage-backed securities, U.S. Government agencies and sponsored enterprise bonds and tax-exempt municipal bonds. All of the securities purchased were of high credit quality with a low to moderate duration. This strategy allowed us to increase net interest income by taking advantage of the positive interest rate spread between the FHLB advances and the newly acquired investment securities. While the underlying leverage strategy contributed to a lower net interest margin, it successfully increased net interest income by approximately $1.1 million for the year ended December 31, 2013.

Taxable equivalent net interest income of $94.2 million for 2013 was $3.4 million or 4% higher than 2012. The impact of a decline in average yields on our assets was diminished by a $288.7 million or 13% increase in interest-earning assets. The average balance of loans rose $158.1 million or 10% to $1.75 billion, reflecting growth in most loan categories. Consistent with our strategic plan, we continue to pursue loan development efforts in the commercial and consumer indirect lending portfolios in accordance with prudent underwriting standards.

MANAGEMENT S DISCUSSION AND ANALYSIS

The increase in taxable equivalent net interest income was a function of a favorable volume variance as balance sheet changes in both volume and mix increased taxable equivalent net interest income by $10.8 million, partially offset by an unfavorable rate variance that decreased taxable equivalent net interest income by $7.4 million. The change in mix and volume of earning assets increased taxable equivalent interest income by $10.8 million, while the change in volume and composition of interest-bearing liabilities decreased interest expense by $70 thousand, for a net favorable volume impact of $10.8 million on taxable equivalent net interest income. Rate changes on earning assets reduced interest income by $9.0 million, while changes in rates on interest-bearing liabilities lowered interest expense by $1.6 million, for a net unfavorable rate impact of $7.4 million.

The net interest margin for 2013 was 3.64% compared to 3.95% in 2012. As discussed in the industry overview above, the actions by the FOMC have compressed net interest income and net interest margins for the banking industry by maintaining low rates on interest-earning assets. Throughout 2013, margins in the banking industry were pressured downward as higher-yielding legacy assets rolled off and were reinvested in the current low rate environment. Low interest rates, coupled with a competitive lending environment, have proven challenging for the profitability of the banking industry. It is expected that these challenges will continue until interest rates rise.

The decrease in net interest margin was attributable to a 3 basis point lower contribution from net free funds (primarily attributable to lower rates on interest-bearing liabilities reducing the value of noninterest-bearing deposits and other net free funds). The interest rate spread decreased by 28 basis points to 3.57% for the year ended December 31, 2013, as a 42 basis point decrease in the yield on earning assets more than offset the 14 basis point decrease in the cost of interest-bearing liabilities.

For 2013, the yield on average earning assets of 3.93% was 42 basis points lower than 2012. Loan yields decreased 44 basis points to 4.65%. Commercial mortgage and consumer indirect loans in particular, down 45 and 66 basis points, respectively, continued to experience lower yields given the competitive pricing pressures and re-pricing of loans in a low interest rate environment. The yield on investment securities dropped 25 basis points to 2.41%, also impacted by the low interest rate environment, prepayments of mortgage-related investment securities and the previously mentioned 2013 leverage strategy. Overall, earning asset rate changes reduced interest income by $9.0 million.

The average cost of interest-bearing deposits was 0.36% in 2013, 14 basis points lower than 2012, reflecting the low interest rate environment, mitigated by a focus on product pricing to retain balances. The cost of borrowings decreased 9 basis points to 0.39% for 2013. The interest-bearing liability rate changes reduced interest expense by $1.6 million during 2013.

Average interest-earning assets of $2.59 billion in 2013 were $288.7 million or 13% higher than 2012. Average investment securities increased $130.6 million while average loans increased $158.1 million or 10%. The growth in average loans was comprised of increases in most loan categories, with consumer and commercial loans up $116.9 million and $45.2 million, respectively, partially offset by a $4.1 million decrease in residential mortgage loans.

Average interest-bearing liabilities of $2.03 billion in 2013 were up $203.0 million or 11% versus 2012. On average, interest-bearing deposits grew $134.5 million, while average noninterest-bearing demand deposits (a principal component of net free funds) increased by $79.1 million. The increase in average deposits reflects the full-year impact of the deposits acquired in the 2012 branch acquisitions. Average borrowings increased $68.6 million, largely due to the incremental borrowings associated with the previously mentioned 2013 leverage strategy.

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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,								
	2013			2012			2011		
	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	$ 191	$	0.19%	$ 113	$	0.29%	$ 140	$	0.20%
Investment securities:									
Taxable	601,146	12,541	2.09	525,912	12,202	2.32	545,112	14,185	2.60
Tax-exempt	233,067	7,572	3.25	177,731	6,526	3.67	140,657	5,890	4.19
Total investment securities	834,213	20,113	2.41	703,643	18,728	2.66	685,769	20,075	2.93
Loans:									
Commercial business	256,236	11,311	4.41	242,100	11,263	4.65	215,598	10,311	4.78
Commercial mortgage	438,821	21,878	4.99	407,737	22,182	5.44	370,843	21,216	5.72
Residential mortgage	123,277	6,174	5.01	127,363	6,637	5.21	121,742	6,868	5.64
Home equity	304,868	12,446	4.08	257,537	10,984	4.27	216,428	9,572	4.42
Consumer indirect	604,148	26,976	4.47	533,589	27,371	5.13	444,527	26,549	5.97
Other consumer	24,089	2,683	11.14	25,058	2,686	10.72	24,686	2,589	10.49
Total loans	1,751,439	81,468	4.65	1,593,384	81,123	5.09	1,393,824	77,105	5.53
Total interest-earning assets	2,585,843	101,581	3.93	2,297,140	99,851	4.35	2,079,733	97,180	4.67

Less: Allowance for loan losses	26,000			24,305			21,567		
Other noninterest-earning assets	243,982			246,423			218,983		
Total assets	$ 2,803,825			$ 2,519,258			$ 2,277,149		
Interest-bearing liabilities:									
Deposits:									
Interest-bearing demand	$ 488,047	729	0.15	$ 423,096	598	0.14	$ 383,122	614	0.16
Savings and money market	727,737	978	0.13	586,329	998	0.17	451,030	1,056	0.23
Certificates of deposit	621,455	4,893	0.79	693,353	6,866	0.99	712,411	9,764	1.37
Total interest-bearing deposits	1,837,239	6,600	0.36	1,702,778	8,462	0.50	1,546,563	11,434	0.74
Short-term borrowings	190,310	737	0.39	121,735	589	0.48	99,122	500	0.50
Long-term borrowings							15,905	1,321	8.31
Total borrowings	190,310	737	0.39	121,735	589	0.48	115,027	1,821	1.58
Total interest-bearing liabilities	2,027,549	7,337	0.36	1,824,513	9,051	0.50	1,661,590	13,255	0.80
Noninterest-bearing deposits	509,383			430,240			368,268		
Other liabilities	14,207			16,506			15,041		
Shareholders equity	252,686			247,999			232,250		
Total liabilities and shareholders equity	$ 2,803,825			$ 2,519,258			$ 2,277,149		
Net interest income (tax-equivalent)		$ 94,244			$ 90,800			$ 83,925	
Interest rate spread			3.57%			3.85%			3.87%
Net earning assets	$ 558,294			$ 472,627			$ 418,143		
Net interest margin (tax-equivalent)			3.64%			3.95%			4.04%

Ratio of average interest-earning assets to average interest-bearing liabilities	127.54%	125.90%	125.17%

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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 2013 to 2012			Change from 2012 to 2011		
Increase (decrease) in:	**Volume**	**Rate**	**Total**	**Volume**	**Rate**	**Total**
Interest income:						
Federal funds sold and other interest-earning deposits	$	$	$	$	$	$
Investment securities:						
Taxable	1,643	(1,304)	339	(487)	(1,496)	(1,983)
Tax-exempt	1,861	(815)	1,046	1,422	(786)	636
Total investment securities	3,504	(2,119)	1,385	935	(2,282)	(1,347)
Loans:						
Commercial business	640	(592)	48	1,239	(287)	952
Commercial mortgage	1,624	(1,928)	(304)	2,041	(1,075)	966
Residential mortgage	(209)	(254)	(463)	308	(539)	(231)
Home equity	1,948	(486)	1,462	1,763	(351)	1,412
Consumer indirect	3,383	(3,778)	(395)	4,879	(4,057)	822
Other consumer	(106)	103	(3)	39	58	97
Total loans	7,280	(6,935)	345	10,269	(6,251)	4,018
Total interest income	**10,784**	**(9,054)**	**1,730**	**11,204**	**(8,533)**	**2,671**
Interest expense:						
Deposits:						
Interest-bearing demand	96	35	131	60	(76)	(16)
Savings and money market	214	(234)	(20)	271	(329)	(58)
Certificates of deposit	(663)	(1,310)	(1,973)	(255)	(2,643)	(2,898)
Total interest-bearing deposits	(353)	(1,509)	(1,862)	76	(3,048)	(2,972)
Short-term borrowings	283	(135)	148	110	(21)	89
Long-term borrowings				(660)	(661)	(1,321)
Total borrowings	283	(135)	148	(550)	(682)	(1,232)
Total interest expense	**(70)**	**(1,644)**	**(1,714)**	**(474)**	**(3,730)**	**(4,204)**

Net interest income	**$ 10,854**	**$ (7,410)**	**$ 3,444**	**$ 11,678**	**$ (4,803)**	**$ 6,875**

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 $9.1 million for the year ended December 31, 2013 compared with $7.1 million for 2012. See the Allowance for Loan Losses section of this Management s Discussion and Analysis for further discussion.

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MANAGEMENT S DISCUSSION AND ANALYSIS

Noninterest Income

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

	2013	2012	2011
Service charges on deposits	$ 9,948	8,627	8,679
ATM and debit card	5,098	4,716	4,359
Investment advisory	2,345	2,104	1,829
Company owned life insurance	1,706	1,751	1,424
Loan servicing	570	617	835
Net gain on sale of loans held for sale	117	1,421	880
Net gain on disposal of investment securities	1,226	2,651	3,003
Impairment charges on investment securities		(91)	(18)
Net (loss) gain on sale and disposal of other assets	(103)	(381)	67
Other	3,926	3,362	2,867
Total noninterest income	$ 24,833	24,777	23,925

Service charges on deposits were $9.9 million for 2013, an increase of $1.3 million or 15%, compared to 2012. ATM and debit card income was $5.1 million for 2013, an increase of $382 thousand or 8%, compared to 2012. These increases reflect volume related growth in fees resulting from the 2012 branch acquisitions coupled with the second quarter 2013 retail checking account repositioning that involved simplifying the suite of products offered to customers and modifications to the fee structure for our accounts. Our fee waiver process was also reevaluated, which resulted in a reduction in the number of fee waivers and an increase in service charges.

Management continues to focus on diversifying its sources of revenue to further reduce our reliance on traditional spread-based interest income, as fee-based activities are a relatively stable revenue source during periods of changing interest rates.

Investment advisory income was $2.3 million for 2013, up $240 thousand or 11%, compared to 2012, as fees and commissions fluctuate with sales volume, which increased during 2013 as a result of favorable market conditions and new business opportunities.

Loan servicing income represents fees earned primarily for servicing mortgage loans sold to third parties, net of amortization expense and impairment losses, if any, associated with capitalized loan servicing assets. Loan servicing income was $570 thousand in 2013, down $47 thousand or 8%, compared to 2012. The decrease was a result of more rapid amortization of servicing rights due to loans paying off and lower fees collected due to a decrease in the sold and serviced portfolio partially offset by adjustments to the valuation allowance for capitalized mortgage servicing assets.

Gains from the sale of loans held for sale decreased $1.3 million in 2013 compared to 2012. The decrease was primarily due to a reduction in origination volume and margins resulting from higher interest rates in addition to a higher percentage of originations held on the balance sheet.

Net gains from the sales of investment securities were $1.2 million for the year ended December 31, 2013, compared to $2.7 million for the year ended December 31, 2012. During 2013, we recognized gains totaling $1.2 million from the sale of four pooled trust-preferred securities. Net gains for 2012 included $2.6 million from the sale of five pooled trust-preferred securities. The amount and timing of our sale of investments securities is dependent on a number of factors, including our prudent efforts to realize gains while managing duration, premium and credit risk.

Other noninterest income increased $564 thousand or 17% for the year ended December 31, 2013, compared to 2012. Merchant services income, rental income and income from our investment in several limited partnerships comprised the majority of the year-over-year increase.

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MANAGEMENT S DISCUSSION AND ANALYSIS

Noninterest Expense

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

	2013	2012	2011
Salaries and employee benefits	$ 37,828	40,127	35,743
Occupancy and equipment	12,366	11,419	10,868
Professional services	3,836	4,133	2,617
Computer and data processing	2,848	3,271	2,437
Supplies and postage	2,342	2,497	1,778
FDIC assessments	1,464	1,300	1,513
Advertising and promotions	896	929	1,259
Loss on extinguishment of debt			1,083
Other	7,861	7,721	6,496
Total noninterest expense	$ 69,441	71,397	63,794

Salaries and employee benefits decreased $2.3 million or 6% when comparing 2013 to 2012. Included in salaries and employee benefits for the year ended December 31, 2012 are pre-tax costs of approximately $2.9 million that were incurred in association with the 2012 branch acquisitions and retirement of our former CEO. After adjusting for these expenses, the increase in salaries and employee benefits for 2013 when compared to the prior year is primarily attributable to annual merit increases. The number of full time equivalent employees decreased to 608 at December 31, 2013 from 628 at December 31, 2012.

Occupancy and equipment increased by $947 thousand or 8% when comparing 2013 to 2012. The increase was primarily related to the growth in the branch network related to the branch acquisitions combined with increased snow removal costs.

Professional services expense of $3.8 million in 2013 decreased $297 thousand or 7% from 2012. Excluding the expenses related to the 2012 branch acquisitions, the increase in professional fees was due in part to executive management transitions and other corporate governance initiatives.

Computer and data processing and supplies and postage expense decreased, collectively, by $578 thousand when comparing 2013 to 2012. Excluding the expenses related to the 2012 branch acquisitions, the increase was primarily due to higher printing costs resulting from the previously mentioned retail checking account repositioning.

FDIC assessments increased $164 thousand or 13% for the year ended December 31, 2013, compared to 2012. The increased assessments are a direct result of the growth in our balance sheet.

The efficiency ratio for the year ended December 31, 2013 was 58.48% compared with 62.87% for 2012. The 2012 efficiency ratio was elevated as a result of the aforementioned expenses associated with our 2012 branch acquisitions and the retirement of our former CEO. An increase in the efficiency ratio indicates that more resources are being utilized to generate the same volume of income, while a decrease would indicate a more efficient allocation of resources.

Income Taxes

We recognized income tax expense of $12.4 million for 2013 compared to $11.3 million for 2012. The higher tax provision was primarily attributable to a $3.1 million increase in in pre-tax income when comparing 2013 to 2012. Our effective tax rate was 32.7% for 2013 compared to 32.6% for 2012. Effective tax rates are impacted by items of income and expense that are not subject to federal or state taxation. Our effective tax rates reflect the impact of these items, which include, but are not limited to, interest income from tax-exempt securities and earnings on company owned life insurance.

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MANAGEMENT S DISCUSSION AND ANALYSIS

RESULTS OF OPERATIONS FOR THE YEARS ENDED

DECEMBER 31, 2012 AND DECEMBER 31, 2011

Net Interest Income and Net Interest Margin

Net interest income was $88.5 million in 2012, compared to $81.9 million in 2011. The taxable equivalent adjustments of $2.3 million and $2.0 million for 2012 and 2011, respectively, resulted in fully taxable equivalent net interest income of $90.8 million in 2012 and $83.9 million in 2011.

Taxable equivalent net interest income of $90.8 million for 2012 was $6.9 million or 8% higher than 2011. The impact of a decline in average yields on our assets was diminished by a $217.4 million or 10% increase in interest-earning assets. The average balance of loans rose $199.6 million or 14% to $1.593 billion, reflecting growth in every loan category.

The increase in taxable equivalent net interest income was a function of a favorable volume variance as balance sheet changes in both volume and mix increased taxable equivalent net interest income by $11.7 million, partially offset by an unfavorable rate variance that decreased taxable equivalent net interest income by $4.8 million. The change in mix and volume of earning assets increased taxable equivalent interest income by $11.2 million, while the change in volume and composition of interest-bearing liabilities decreased interest expense by $474 thousand, for a net favorable volume impact of $11.7 million on taxable equivalent net interest income. Rate changes on earning assets reduced interest income by $8.5 million, while changes in rates on interest-bearing liabilities lowered interest expense by $3.7 million, for a net unfavorable rate impact of $4.8 million.

The net interest margin for 2012 was 3.95% compared to 4.04% in 2011. The decrease in net interest margin was attributable to a 7 basis point lower contribution from net free funds (primarily attributable to lower rates on interest-bearing liabilities reducing the value of noninterest-bearing deposits and other net free funds). The interest rate spread decreased by 2 basis points to 3.85% for the year ended December 31, 2012, as a 32 basis point decrease in the yield on earning assets more than offset the 30 basis point decrease in the cost of interest-bearing liabilities. The Federal Reserve left the Federal funds rate unchanged at 0.25% during 2011 and 2012.

For 2012, the yield on average earning assets of 4.35% was 32 basis points lower than 2011. Loan yields decreased 44 basis points to 5.09%. Commercial mortgage and consumer indirect loans in particular, down 28 and 84 basis points, respectively, continued to experience lower yields given the competitive pricing pressures and re-pricing of loans in a low interest rate environment. The yield on investment securities dropped 27 basis points to 2.66%, also impacted by the lower interest rate environment, prepayments of mortgage-related investment securities and the impact of investing the excess cash related to our branch acquisitions into low yielding securities. Overall, earning asset rate changes reduced interest income by $8.5 million.

The cost of average interest-bearing liabilities of 0.50% in 2012 was 30 basis points lower than 2011. The average cost of interest-bearing deposits was 0.50% in 2012, 24 basis points lower than 2011, reflecting the sustained low-rate environment. The cost of borrowings decreased 110 basis points to 0.48% for 2012, primarily a result of the redemption of our 10.20% junior subordinated debentures during the third quarter of 2011. The interest-bearing liability rate changes reduced interest expense by $3.7 million during 2012.

Average interest-earning assets of $2.297 billion in 2012 were $217.4 million or 10% higher than 2011. Average investment securities increased $17.9 million while average loans increased $199.6 million or 14%. The growth in average loans was comprised of increases in all loan categories, with consumer loans up $130.5 million, commercial loans up $63.4 million and residential mortgage loans up $5.6 million.

Average interest-bearing liabilities of $1.825 billion in 2012 were up $162.9 million or 10% versus 2011. On average, interest-bearing deposits grew $156.2 million, while average noninterest-bearing demand deposits increased by $62.0 million. Average borrowings increased $6.7 million, representing a $22.6 million increase and $15.9 million decrease in short-term and long-term borrowings, respectively.

Provision for Loan Losses

The provision for loan losses was $7.1 million for the year ended December 31, 2012 compared with $7.8 million for 2011.

Noninterest Income

Service charges on deposits decreased slightly during 2012 compared to 2011. An increase in the number of customer accounts, including those added from the branch acquisitions in June and August of 2012, helped offset decreases in service charge income related to changes in customer behavior and regulatory changes that included the requirement that customers opt-in for overdraft coverage for certain types of electronic banking activities.

ATM and debit card income was $4.7 million for 2012, an increase of $357 thousand or 8%, compared to 2011. The increased popularity of electronic banking and transaction processing resulted in higher ATM and debit card point-of-sale usage income.

MANAGEMENT S DISCUSSION AND ANALYSIS

Investment advisory income was up $275 thousand or 15%, compared to 2011. Investment advisory income fluctuates mainly due to sales volume, which continued to increase during 2012 as a result of improving market and economic conditions and our renewed focus on this line of business.

The full-year impact of an additional $18.0 million of company owned life insurance purchased during the third quarter of 2011 was largely responsible for the $327 thousand increase in company owned life insurance income for 2012.

Loan servicing income was down $218 thousand or 26% for the year ended December 31, 2012 compared to 2011. Loan servicing income decreased as a result of more rapid amortization of servicing rights due to loans paying off, lower fees collected due to a decrease in the sold and serviced portfolio and write-downs on capitalized mortgage servicing assets.

Net gain on loans held for sale was $1.4 million in 2012, an increase of $541 thousand or 61%, compared to 2011, mainly due to increased origination volume related primarily to refinancing activity, a result of low interest rates.

Net gains from the sales of investment securities were $2.7 million for the year ended December 31, 2012, compared to $3.0 million for the year ended December 31, 2011. During 2012, we recognized gains totaling $2.6 million from the sale of five pooled trust-preferred securities. Net gains for 2011 included $2.3 million from the sale of four pooled trust-preferred securities and $730 thousand from the sale of eight mortgage-backed securities.

Due to their proximity to our existing locations, we consolidated four branches as part of the branch acquisitions. The majority of the loss on the disposal of other assets for 2012 was due to write-off of leasehold improvements and other fixed assets for these branches that were closed.

Other noninterest income increased $495 thousand or 17% for the year ended December 31, 2012, compared to 2011. Income from our investment in several limited partnerships and dividends from FHLB stock comprised the majority of the year-over-year increase.

Noninterest Expense

Salaries and employee benefits was $40.1 million for 2012, up $4.4 million or 12% from 2011. As discussed earlier, salaries and employee benefits for 2012 included pre-tax costs of approximately $2.6 million that were incurred in association with the retirement of our former CEO. After adjusting for these expenses, the increase in salaries and employee benefits for 2012 when compared to the prior year is attributable to higher pension costs along with increased staffing levels. Full time equivalent employees increased by 9% to 628 at December 31, 2012 from 575 at December 31, 2011, primarily due to the branch acquisitions.

Occupancy and equipment increased by $551 thousand or 5% when comparing 2012 to 2011. The increase was primarily related to the growth in the branch network related to the branch acquisitions.

Professional services expense of $4.1 million in 2012 increased $1.5 million or 58% from 2011. Professional fees increased primarily due to legal expenses related to the branch acquisitions. The management transition described earlier also contributed to the increase in professional fees.

Computer and data processing and supplies and postage expense increased, collectively, by $1.6 million when comparing 2012 to 2011. The year-over-year increase was due to expenses related to the branch acquisition transactions.

FDIC assessments decreased $213 thousand for the year ended December 31, 2012, compared to 2011, primarily a result of changes implemented by the FDIC in the method of calculating assessment rates which became effective in the second quarter of 2011.

Advertising and promotions costs were $330 thousand or 26% lower in 2012 compared to 2011 due to the timing of marketing campaigns and promotions, coupled with cost management strategies.

We redeemed all of our 10.20% junior subordinated debentures during the third quarter of 2011. As a result of the redemption, we recognized a loss on extinguishment of debt of $1.1 million, consisting of a redemption premium of $852 thousand and a write-off of the remaining unamortized issuance costs of $231 thousand in 2011.

Other noninterest expense increased $1.2 million or 19% during 2012 compared to 2011. The increases in other noninterest expenses were primarily related to the branch acquisition transactions.

The efficiency ratio for the year ended December 31, 2012 was 62.87% compared with 60.55% for 2011. The higher efficiency ratio is attributable to the additional expenses related to the branch acquisitions and retirement of our former CEO, as previously discussed.

Income Taxes

We recognized income tax expense of $11.3 million for 2012 compared to $11.4 million for 2011. The lower tax provision was primarily attributable to a decrease in our effective tax rate to 32.6% for 2012 compared to 33.4% for 2011. The lower effective tax rate in 2012 was a result of the greater impact of tax-exempt income on lower taxable income.

MANAGEMENT S DISCUSSION AND ANALYSIS

ANALYSIS OF FINANCIAL CONDITION

OVERVIEW

At December 31, 2013, we had total assets of $2.93 billion, an increase of 6% from $2.76 billion as of December 31, 2012, largely attributable to our continued loan growth. Net loans were $1.81 billion as of December 31, 2013, up $125.9 million, or 8%, when compared to $1.68 billion as of December 31, 2012. The increase in net loans was primarily attributed to the continued expansion of the indirect lending program and commercial business development efforts. Non-performing assets totaled $17.1 million as of December 31, 2013, up $7.0 million from a year ago. Total deposits amounted to $2.32 billion as of December 31, 2013, up $58.3 million or 3%, compared to December 31, 2012. As of December 31, 2013, borrowed funds totaled $337.0 million, compared to $179.8 million as of December 31, 2012. Book value per common share was $17.17 and $17.15 as of December 31, 2013 and 2012, respectively. As of December 31, 2013 our total shareholders equity was $254.8 million compared to $253.9 million a year earlier.

INVESTING ACTIVITIES

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

	Investment Securities Portfolio Composition At December 31,					
	2013		2012		2011	
	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	$ 135,840	$ 134,452	$ 128,097	$ 131,695	$ 94,947	$ 97,712
State and political subdivisions			188,997	195,210	119,099	124,424
Mortgage-backed securities:						
Agency mortgage-backed securities	482,308	473,082	479,913	494,770	390,375	401,596
Non-Agency mortgage-backed securities		1,467	73	1,098	327	2,089
Asset-backed securities	18	399	121	1,023	297	1,697
Total available for sale securities	618,166	609,400	797,201	823,796	605,045	627,518
Securities held to maturity:						
State and political subdivisions	249,785	250,657	17,905	18,478	23,297	23,964
Total investment securities	$ 867,951	$ 860,057	$ 815,106	$ 842,274	$ 628,342	$ 651,482

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.

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

The available for sale (AFS) investment securities portfolio decreased $214.4 million or 26%, from $823.8 million at December 31, 2012 to $609.4 million at December 31, 2013. The decrease was largely attributable to the transfer of available for sale state and municipal debt securities to the held to maturity category during the third quarter of 2013, combined with scheduled principal paydowns on amortizing securities and a change in the net unrealized gain/loss on the AFS portfolio.

The AFS portfolio had net unrealized losses totaling $8.8 million at December 31, 2013 compared to net unrealized gains of $26.6 million at December 31, 2012. The unrealized loss on the AFS portfolio was predominantly caused by changes in market interest rates. The fair value of most of the investment securities in the AFS portfolio fluctuates as market interest rates change. The transfer of securities from available for sale to held to maturity is expected to reduce the fair value fluctuations in the available for sale portfolio.

MANAGEMENT S DISCUSSION AND ANALYSIS

As previously discussed, we utilized the proceeds from short-term FHLB advances to purchase high-quality investment securities as part of our leverage strategy of approximately $100 million implemented during the first quarter of 2013. Our purchase of investment securities was comprised of mortgage-backed securities, U.S. Government agencies and sponsored enterprise bonds and tax-exempt municipal bonds. This strategy allowed us to increase net interest income by taking advantage of the positive interest rate spread between the FHLB advances and the newly acquired investment securities.

Impairment Assessment

We review investment securities on an ongoing basis for the presence of 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 other-than-temporary impairment 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, 2013, management 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. 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. Management does not believe any of the securities in a loss position are impaired due to reasons of credit quality. Accordingly, as of December 31, 2013, management has concluded that unrealized losses on its 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, 2013, there were 18 securities in an unrealized loss position in the U.S. Government agencies and GSE portfolio with unrealized losses totaling $2.8 million. Of these, three were in an unrealized loss position for 12 months or longer and had an aggregate fair value of $2.7 million and unrealized losses of $14 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, 2013.

State and Political Subdivisions. As of December 31, 2013, the state and political subdivisions (municipals) portfolio totaled $249.8 million, all of which was classified as held to maturity. As of that date, each of the 234 municipals in an unrealized loss position had been in an unrealized loss position for less than 12 months. Those securities had an aggregate fair value of $72.3 million and unrealized losses totaling $468 thousand.

Because 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, 2013.

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, 2013, were issued by U.S. Government sponsored entities and agencies (Agency MBS), primarily FNMA. 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, 2013, there were 79 securities in the Agency MBS portfolio that were in an unrealized loss position. Of these, 11 were in an unrealized loss position for 12 months or longer and had an aggregate fair value of $48.2 million and unrealized losses of $2.8 million. Given the high credit quality inherent in Agency MBS, we do not consider any of the unrealized losses as of December 31, 2013 on such MBS to be credit related or other-than-temporary. As of December 31, 2013, we did not intend to sell any of 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 two privately issued whole loan collateralized mortgage obligations with a fair value and net unrealized gains of $1.5 million as of December 31, 2013. As of that date, each of the two non-Agency MBS were rated below investment grade. None of these securities were in an unrealized loss position.

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MANAGEMENT S DISCUSSION AND ANALYSIS

Asset-backed Securities (ABS). As of December 31, 2013, the fair value of our ABS portfolio totaled $399 thousand and consisted of positions in two securities, one of which is a pooled trust preferred security (TPS) issued by a U.S. financial institution and backed by preferred debt issued by dozens of companies, primarily banks. As a result of some issuers defaulting and others electing to defer interest payments, we considered the TPS to be non-performing and stopped accruing interest on these investments during 2009. As of December 31, 2013, each of the securities in the ABS portfolio was rated below investment grade. None of these securities were in an unrealized loss position.

During 2013, we recognized gains totaling $1.2 million from the sale of four TPS. The four securities had a fair value of $550 thousand at December 31, 2012. We continue to monitor the market for these securities and evaluate the potential for future dispositions.

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, 2013, our ownership of FHLB and FRB stock totaled $15.8 million and $3.9 million, respectively and is included in other assets and recorded at cost, which approximates fair value.

LENDING ACTIVITIES

Total loans were $1.83 billion at December 31, 2013, an increase of $127.9 million or 8% from December 31, 2012. Commercial loans increased $63.1 million or 9% and represented 40.1% of total loans at the end of 2013. Residential mortgage loans were $113.0 million, down $20.5 million or 15% and represented 6.2% of total loans at December 31, 2013, while consumer loans increased $85.3 million to represent 53.7% of total loans at December 31, 2013 compared to 52.8% at December 31, 2012. 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,

	2013		2012		2011		2010		2009	
	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent
ommercial usiness	$ 265,766	14.5%	$ 258,675	15.2%	$ 233,836	15.7%	$ 211,031	15.7%	$ 206,383	16.3
ommercial ortgage	469,284	25.6	413,324	24.2	393,244	26.5	352,930	26.2	330,748	26.2
otal ommercial	735,050	40.1	671,999	39.4	627,080	42.2	563,961	41.9	537,131	42.5
esidential ortgage	113,045	6.2	133,520	7.8	113,911	7.7	129,580	9.6	144,215	11.4
ome quity	326,086	17.8	286,649	16.8	231,766	15.6	208,327	15.5	200,684	15.9
	636,368	34.7	586,794	34.4	487,713	32.9	418,016	31.1	352,611	27.9

onsumer direct										
ther onsumer	23,070	1.2	26,764	1.6	24,306	1.6	26,106	1.9	29,365	2.3
otal onsumer	985,524	53.7	900,207	52.8	743,785	50.1	652,449	48.5	582,660	46.1
otal loans	1,833,619	100.0%	1,705,726	100.0%	1,484,776	100.0%	1,345,990	100.0%	1,264,006	100.0%
llowance r loan sses	26,736		24,714		23,260		20,466		20,741	
otal loans, et	$ 1,806,883		$ 1,681,012		$ 1,461,516		$ 1,325,524		$ 1,243,265	

As of December 31, 2013 and 2012, the residential mortgage portfolio included $19.3 million and $28.2 million, respectively, of loans acquired with the 2012 branch acquisitions and $93.7 million and $105.3 million of organic loans, respectively. The decrease in organic residential mortgage loans from $113.9 million to $105.3 million to $93.7 million for the periods ending December 31, 2011, 2012 and 2013, respectively, and the increase in consumer indirect loans from $487.7 million to $586.8 million to $636.4 million for the same periods reflects a strategic shift to increase our consumer indirect loan portfolio, while placing less emphasis on expanding our residential mortgage loan portfolio, coupled with our practice of selling the majority of our fixed-rate residential mortgages in the secondary market with servicing rights retained.

Commercial loans increased during 2013 as we continued our 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.

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, 2013, the principal balance of such loans (included in commercial loans) was $56.3 million and the guaranteed portion amounted to $38.5 million. Most of these loans were guaranteed by the SBA.

MANAGEMENT S DISCUSSION AND ANALYSIS

Commercial business loans were $265.8 million at the end of 2013, up $7.1 million or 3% since the end of 2012, and comprised 14.5% of total loans outstanding at December 31, 2013. 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. Within the commercial business classification, loans to finance agricultural production totaled approximately 8% of commercial business loans as of December 31, 2013. As of December 31, 2013, commercial business SBA loans accounted for a total of $35.5 million or 13% of our commercial business loan portfolio.

Commercial mortgage loans totaled $469.3 million at December 31, 2013, up $56.0 million or 14% from December 31, 2012, and comprised 25.6% of total loans, compared to 24.2% at December 31, 2012. Commercial mortgage includes both owner occupied and non-owner occupied commercial real estate loans. Approximately 44% and 46% of the commercial mortgage portfolio at December 31, 2013 and 2012, 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, 2013, commercial mortgage SBA loans accounted for a total of $16.2 million or 3% of our commercial mortgage loan portfolio.

Our current lending standards for commercial real estate and real estate construction lending are determined by property type and specifically address many criteria, including: maximum loan amounts, maximum loan-to-value (LTV), requirements for pre-leasing and / 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.

Residential mortgage loans totaled $113.0 million at the end of 2013, down $20.5 million or 15% from the end of the prior year and comprised 6.2% of total loans outstanding at December 31, 2013 and 7.8% at December 31, 2012. Residential mortgage loans include conventional first lien home mortgages and we generally limit the maximum loan to 85% of collateral value without credit enhancement (e.g. PMI insurance). As part of management s historical practice of originating and servicing residential mortgage loans, the majority of our fixed-rate residential mortgage loans are sold in the secondary market with servicing rights retained. Residential mortgage products continue to be underwritten using FHLMC and FNMA secondary marketing guidelines.

Consumer loans totaled $985.5 million at December 31, 2013, up $85.3 million or 10% compared to 2012, and represented 53.7% of the 2013 year-end loan portfolio versus 52.8% at year-end 2012. Loans in this classification include indirect consumer, home equity 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.

Consumer indirect loans amounted to $636.4 million at December 31, 2013 up $49.6 million or 8% compared to 2012, and represented 34.7% of the 2013 year-end loan portfolio versus 34.4% at year-end 2012. The loans are primarily for the purchase of automobiles (both new and used) and light duty trucks primarily to individuals, but also to 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, 2013, we originated $306.4 million in indirect loans with a mix of approximately 47% new auto and 53% used vehicles. This compares with $324.6 million in indirect loans with a mix of approximately 49% new auto and 51% used vehicles for the same period in 2012. The decrease in loans for new autos reflects changes in market conditions in 2013. We do business with over 400 franchised auto dealers located in Western, Central, and the Capital District of New York, and Northern Pennsylvania.

Home equity consists of home equity lines as well as home equity loans. Home equities amounted to $326.1 million at December 31, 2013 up $39.4 million or 14% compared to 2012, and represented 17.8% of the 2013 year-end loan portfolio versus 16.8% at year-end 2012. The portfolio had a weighted average LTV at origination of approximately 55% and 54% at December 31, 2013 and 2012, respectively. Approximately 76% and 69% f the loans in the home equity portfolio were first lien positions at December 31, 2013 and 2012, respectively. We continue to grow our home equity portfolio as the lower origination cost and convenience to customers has made these products an increasingly attractive alternative to conventional residential mortgage loans.

Our underwriting guidelines for home equity products includes 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 758 in both 2013 and 2012.

Other consumer loans totaled $23.1 million at December 31, 2013, down $3.7 million or 14% compared to 2012, and represented 1.2% of the 2013 year-end loan portfolio versus 1.6% at year-end 2012. Other consumer loans consists of personal loans (collateralized and uncollateralized) and deposit account collateralized loans.

MANAGEMENT S DISCUSSION AND ANALYSIS

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.

The 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, 2013, no significant concentrations, as defined above, existed in our portfolio in excess of 10% of total loans.

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 mortgages and totaled $3.4 million and $1.5 million as of December 31, 2013 and 2012, respectively.

We sell certain qualifying newly originated or refinanced residential real estate mortgages on the secondary market. Residential real estate mortgages serviced for others, which are not included in the consolidated statements of financial condition, amounted to $237.9 million and $273.3 million as of December 31, 2013 and 2012, 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,				
	2013	2012	2011	2010	2009
Allowance for loan losses, beginning of year	$ 24,714	$ 23,260	$ 20,466	$ 20,741	$ 18,749
Charge-offs:					
Commercial business	1,070	729	1,346	3,426	2,360
Commercial mortgage	553	745	751	263	355
Residential mortgage	411	326	152	290	225
Home equity	391	305	449	259	195
Consumer indirect	8,125	6,589	4,713	4,669	3,637
Other consumer	928	874	877	909	1,058
Total charge-offs	11,478	9,568	8,288	9,816	7,830

Recoveries:					
Commercial business	349	336	401	326	428
Commercial mortgage	319	261	245	501	150
Residential mortgage	54	130	90	21	12
Home equity	157	44	44	36	20
Consumer indirect	3,161	2,769	2,066	1,485	1,030
Other consumer	381	354	456	485	480
Total recoveries	4,421	3,894	3,302	2,854	2,120
Net charge-offs	7,057	5,674	4,986	6,962	5,710
Provision for loan losses	9,079	7,128	7,780	6,687	7,702
Allowance for loan losses, end of year	$ 26,736	$ 24,714	$ 23,260	$ 20,466	$ 20,741
Net charge-offs to average loans	0.40%	0.36%	0.36%	0.54%	0.47%
Allowance to end of period loans	1.46%	1.45%	1.57%	1.52%	1.64%
Allowance to end of period non-performing loans	161%	271%	329%	270%	239%

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MANAGEMENT S DISCUSSION AND ANALYSIS

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,

	2013		2012		2011		2010		2009	
	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	$ 4,273	14.5%	$ 4,884	15.2%	$ 4,036	15.7%	$ 3,712	15.7%	$ 4,407	16.3%
Commercial mortgage	7,743	25.6	6,581	24.2	6,418	26.5	6,431	26.2	6,638	26.2
Residential mortgage	676	6.2	740	7.8	858	7.7	1,013	9.6	1,251	11.4
Home equity	1,367	17.8	1,282	16.8	1,242	15.6	972	15.5	1,043	15.9
Consumer indirect	12,230	34.7	10,715	34.4	10,189	32.9	7,754	31.1	6,837	27.9
Other consumer	447	1.2	512	1.6	517	1.6	584	1.9	565	2.3
Total	$ 26,736	100.0%	$ 24,714	100.0%	$ 23,260	100.0%	$ 20,466	100.0%	$ 20,741	100.0%

Management believes that the allowance for loan losses at December 31, 2013 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 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 additional 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,				
	2013	2012	2011	2010	2009
Non-accruing loans:					
Commercial business	$ 3,474	$ 3,413	$ 1,259	$ 947	$ 650
Commercial mortgage	9,663	1,799	2,928	3,100	2,288
Residential mortgage	1,078	2,040	1,644	2,102	2,376
Home equity	925	939	682	875	880
Consumer indirect	1,471	891	558	514	621
Other consumer	5	25		41	7
Total non-accruing loans	16,616	9,107	7,071	7,579	6,822
Restructured accruing loans					
Accruing loans contractually past due over 90 days	6	18	5	3	1,859
Total non-performing loans	16,622	9,125	7,076	7,582	8,681
Foreclosed assets	333	184	475	741	746
Non-performing investment securities	128	753	1,636	572	1,015
Total non-performing assets	$ 17,083	$ 10,062	$ 9,187	$ 8,895	$ 10,442
Non-performing loans to total loans	0.91%	0.53%	0.48%	0.56%	0.69%
Non-performing assets to total assets	0.58%	0.36%	0.39%	0.40%	0.51%

Non-performing assets include non-performing loans, foreclosed assets and non-performing investment securities. Non-performing assets at December 31, 2013 were $17.1 million, an increase of $7.0 million from the $10.1 million balance at December 31, 2012. The primary component of non-performing assets is non-performing loans, which were $16.6 million or 0.91% of total loans at December 31, 2013, an increase of $7.5 million from $9.1 million or 0.53% of total loans at December 31, 2012.

MANAGEMENT S DISCUSSION AND ANALYSIS

Approximately $10.7 million, or 64%, of the $16.6 million in non-performing loans as of December 31, 2013 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. For non-accruing loans outstanding as of December 31, 2013, the amount of interest income forgone totaled $531 thousand. Included in nonaccrual loans are troubled debt restructurings (TDRs) of $8.9 million at December 31, 2013. We had no TDRs that were accruing interest as of December 31, 2013. The increase in non-performing loans and TDRs was primarily due to a single commercial mortgage loan with a principal balance of $6.9 million at December 31, 2013. This loan was modified as a troubled debt restructuring and placed on nonaccrual status during the fourth quarter 2013. The Company had internally downgraded the loan to substandard status from special mention during the third quarter 2013. The loan, which is secured by income property and guaranteed by the owners, was current per the terms of the restructured loan agreement as of December 31, 2013.

Foreclosed assets consist of real property formerly pledged as collateral to loans, which we have acquired through foreclosure proceedings or acceptance of a deed in lieu of foreclosure. Foreclosed asset holdings represented four properties totaling $333 thousand at December 31, 2013 and five properties totaling $184 thousand at December 31, 2012.

Non-performing investment securities for which we have stopped accruing interest were $128 thousand at December 31, 2013, compared to $753 thousand at December 31, 2012. Non-performing investment securities are included in non-performing assets at fair value and are comprised of pooled trust preferred securities. There have been no securities transferred to non-performing status since the first quarter of 2009. During 2013, we recognized gains totaling $1.2 million from the sale of four TPS. The four securities had a fair value of $550 thousand at December 31, 2012. We continue to monitor the market for these securities and evaluate the potential for future dispositions.

Potential problem loans are loans that are currently performing, but information known about possible credit problems of the borrowers causes management 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. Management considers loans classified as substandard, which continue to accrue interest, to be potential problem loans. We identified $9.7 million and $13.8 million in loans that continued to accrue interest which were classified as substandard as of December 31, 2013 and 2012, respectively. The decrease in potential problem loans relates primarily to a $3.4 million credit relationship which migrated to non-performing during the first quarter of 2013.

FUNDING ACTIVITIES

Deposits

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

	At December 31,		
	2013	2012	2011

	Amount	Percent	Amount	Percent	Amount	Percent
Noninterest-bearing demand	$ 535,472	23.1%	$ 501,514	22.2%	$ 393,421	20.3%
Interest-bearing demand	470,733	20.3	449,744	19.9	362,555	18.8
Savings and money market	717,928	30.9	655,598	28.9	474,947	24.6
Certificates of deposit < $100,000	369,915	16.0	432,506	19.2	486,496	25.2
Certificates of deposit of $100,000 or more	226,008	9.7	222,432	9.8	214,180	11.1
Total deposits	$ 2,320,056	100.0%	$ 2,261,794	100.0%	$ 1,931,599	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, 2013, total deposits were $2.32 billion, representing an increase of $58.3 million for the year. Public deposit balances increased $79.2 million during 2013 due largely to the seasonality of municipal cash flows and successful business development efforts in our newly acquired branches. Time deposits were approximately 26% and 29% of total deposits at December 31, 2013 and 2012, respectively. Depositors remain hesitant to invest in time deposits, such as certificates of deposit, for long periods due to the low interest rate environment. This has resulted in lower amounts being placed in time deposits for generally shorter terms.

Nonpublic deposits, the largest component of our funding sources, totaled $1.79 billion and $1.81 billion at December 31, 2013 and 2012, respectively, and represented 77% and 80% 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.

MANAGEMENT S DISCUSSION AND ANALYSIS

As an additional source of funding, we offer a variety of public (municipal) deposit products to the many towns, villages, counties and school districts within our market. Public deposits generally range from 20% to 28% 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 $533.5 million and $454.2 million at December 31, 2013 and 2012, respectively, and represented 23% and 20% of total deposits as of the end of each period, respectively.

We had no traditional brokered deposits at December 31, 2013 or 2012; 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. 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 $61.3 million and $56.4 million, respectively, at December 31, 2013.

Borrowings

There were no long-term borrowings outstanding as of December 31, 2013 and 2012. Outstanding short-term borrowings are summarized as follows as of December 31 (in thousands):

	2013	2012
Short-term borrowings:		
Repurchase agreements	$ 39,042	$ 40,806
Short-term FHLB borrowings	298,000	139,000
Total short-term borrowings	$ 337,042	$ 179,806

We classify borrowings as short-term or long-term in accordance with the original terms of the agreement.

We have credit capacity with the FHLB and can borrow through facilities that include amortizing and term advances or repurchase agreements. We had approximately $12 million of immediate credit capacity with the FHLB as of December 31, 2013. We had approximately $480 million in secured borrowing capacity at the Federal Reserve Bank (FRB) Discount Window, none of which was outstanding at December 31, 2013. The FHLB and FRB credit capacity are collateralized by securities from our investment portfolio and certain qualifying loans. We had approximately $120 million of credit available under unsecured federal funds purchased lines with various banks as of December 31, 2013. Additionally, we had approximately $61 million of unencumbered liquid securities available for pledging.

Federal funds purchased are short-term borrowings that typically mature within one to ninety days. Short-term repurchase agreements are secured overnight borrowings with customers. 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, 2013 consisted of $198.0 million in overnight borrowings and $100.0 million in short-term advances. Short-term FHLB borrowings at December 31, 2012 consisted of $99.0 million in overnight borrowings and $40.0 million in short-term advances.

As previously discussed, during the first quarter of 2013 we leveraged our balance sheet through the execution of short-term FHLB advances in order to acquire investment securities to take advantage of the positive interest rate spread and increase net interest income.

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

	At or for the Year Ended December 31,		
	2013	**2012**	**2011**
Year-end balance	$ 337,042	$ 179,806	$ 150,698
Year-end weighted average interest rate	0.38%	0.54%	0.39%
Maximum outstanding at any month-end	$ 337,042	$ 229,598	$ 188,355
Average balance during the year	$ 190,310	$ 121,735	$ 99,122
Average interest rate for the year	0.39%	0.48%	0.50%

There were no long-term borrowings outstanding at December 31, 2013 and 2012. In August 2011, we redeemed all of our 10.20% junior subordinated debentures at a redemption price equaling 105.1% of the principal amount redeemed, plus all accrued and unpaid interest. As a result of the redemption, we recognized a loss on extinguishment of debt of $1.1 million, consisting of the redemption premium of $852 thousand and the write-off of the remaining unamortized issuance costs of $231 thousand.

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MANAGEMENT S DISCUSSION AND ANALYSIS

Shareholders Equity

Total shareholders equity was $254.8 million at December 31, 2013, an increase of $942 thousand from $253.9 million at December 31, 2012. Net income for the year increased shareholders equity by $25.5 million, which was partially offset by common and preferred stock dividends declared of $11.6 million. Accumulated other comprehensive income included in shareholders equity decreased $13.4 million during the year due primarily to higher net unrealized losses on securities available for sale. For detailed information on shareholders equity, see Note 12, Shareholders Equity, of the notes to consolidated financial statements.

FII and the Bank are subject to various regulatory capital requirements. At December 31, 2013, both FII and the Bank exceeded all regulatory requirements. For detailed information on regulatory capital, see Note 11, Regulatory Matters, of the notes to consolidated financial statements.

GOODWILL AND OTHER INTANGIBLE ASSETS

The carrying value of goodwill totaled $48.5 million as of December 31, 2013 and 2012. We performed a qualitative assessment of goodwill at the reporting unit level, the Bank, to determine if it was more likely than not that the fair value of the reporting unit is less than its carrying value. In performing a qualitative analysis, factors considered include, but are not limited to, business strategy, financial performance and market and regulatory dynamics. The results of the qualitative assessment for 2013 indicated that it was not more likely than not that the fair value of the reporting unit is less than its carrying value. Consequently, no additional quantitative two-step impairment test was required, and no impairment was recorded in 2013.

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

	2013	2012
Goodwill, beginning of year	$ 48,536	$ 37,369
Branch acquisitions		11,167
Impairment		
Goodwill, end of year	$ 48,536	$ 48,536

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

Our other intangible assets consisted entirely of a core deposit intangible asset. Changes in the accumulated amortization and net book value were as follows (in thousands):

	2013	2012

Gross carrying amount	$ 2,042	$ 2,042
Accumulated amortization	(576)	(189)
Net book value	$ 1,466	$ 1,853
Amortization during the year	$ 387	$ 189

There were no core deposit intangible assets or amortization expense for the year ended December 31, 2011.

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.

MANAGEMENT S DISCUSSION AND ANALYSIS

LIQUIDITY AND CAPITAL RESOURCES

The objective of maintaining adequate liquidity is to assure that we meet our financial obligations. These obligations include the withdrawal of deposits on demand or at their contractual maturity, the repayment of matured borrowings, the ability to fund new and existing loan commitments and the ability to take advantage of new business opportunities. We achieve liquidity by maintaining a strong base of 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.

Our cash and cash equivalents were $59.7 million as of December 31, 2013, down $744 thousand from $60.4 million as of December 31, 2012. Our net cash provided by operating activities totaled $37.2 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 $242.2 million, which included outflows of $131.9 million for net loan originations and $107.3 million from net investment securities transactions. Net cash provided by financing activities of $204.3 million was attributed to a $58.3 million increase in deposits and a $157.2 million increase in short-term borrowings, partly offset by $11.2 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, 2013				
	Within 1 year	Over 1 to 3 years	Over 3 to 5 Years	Over 5 years	Total
On-Balance sheet:					
Certificates of deposit [1]	$ 448,997	$ 100,861	$ 46,045	$ 20	$ 595,923
Supplemental executive retirement plans	197	618	618	1,093	2,526
Off-Balance sheet:					
Limited partnership investments [2]	$ 356	$ 713	$ 356	$	$ 1,425
Commitments to extend credit [3]	431,236				431,236
Standby letters of credit [3]	5,498	3,091	29		8,618

Operating leases	1,440	2,654	1,504	3,796	9,394

(1) Includes the maturity of certificates of deposit amounting to $100 thousand or more as follows: $67.9 million in three months or less; $32.3 million between three months and six months; $79.6 million between six months and one year; and $46.2 million over one year.

(2) We have committed to capital investments in several limited partnerships of up to $6.0 million, of which we have contributed $4.6 million as of December 31, 2013, including $121 thousand during 2013.

(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, 2013, 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 10, Commitments and Contingencies, in the notes to the accompanying consolidated financial statements.

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MANAGEMENT S DISCUSSION AND ANALYSIS

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, 2013. 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. We have stopped accruing interest on our asset-backed securities. No tax-equivalent adjustments were made to the weighted average yields (in thousands).

	Due in one year or less		Due from one to five years		Due after five years through ten years		Due after ten years		Total	
	Cost	Yield	Cost	Yield	Cost	Yield	Cost	Yield	Cost	Yield
Available for sale debt securities:										
U.S. Government agencies and government-sponsored enterprises	$ 23,996	0.07%	$ 27,185	2.16%	$ 74,177	1.74%	$ 10,482	0.89%	$ 135,840	1.46%
Mortgage-backed securities	209	3.16	978	3.59	164,187	1.95	316,934	2.35	482,308	2.22
Asset-backed securities							18		18	
	24,205	0.10	28,163	2.21	238,364	1.88	327,434	2.30	618,166	2.05
Held to maturity debt securities:										
State and political subdivisions	25,289	1.46	109,911	1.55	114,543	2.25	42	5.54	249,785	1.86
	$ 49,494	0.79%	$ 138,074	1.69%	$ 352,907	2.00%	$ 327,476	2.30%	$ 867,951	2.00%

Contractual Loan Maturity Schedule

The following table summarizes the contractual maturities of our loan portfolio at December 31, 2013. 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).

Total

	Due in less than one year	Due from one to five years	Due after five years	
Commercial business	$ 143,899	$ 99,208	$ 22,659	$ 265,766
Commercial mortgage	154,586	220,073	94,625	469,284
Residential mortgage	19,426	48,468	45,151	113,045
Home equity	57,727	150,071	118,288	326,086
Consumer indirect	252,946	375,198	8,224	636,368
Other consumer	9,991	11,537	1,542	23,070
Total loans	$ 638,575	$ 904,555	$ 290,489	$ 1,833,619
Loans maturing after one year:				
With a predetermined interest rate		$ 661,458	$ 149,218	$ 810,676
With a floating or adjustable rate		243,097	141,271	384,368
Total loans maturing after one year		$ 904,555	$ 290,489	$ 1,195,044

MANAGEMENT S DISCUSSION AND ANALYSIS

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 guidelines require a minimum Tier 1 leverage ratio of 4.00%, a minimum Tier 1 capital ratio of 4.00% and a minimum total risk-based capital ratio of 8.00%. The following table reflects the ratios and their components as of December 31 (in thousands):

	2013	2012
Total shareholders equity	$ 254,839	$ 253,897
Less: Unrealized (loss) gain on securities available for sale, net of tax	(5,293)	16,060
Net unrecognized gain on available for sale securities transferred to held to maturity, net of tax	(44)	
Unrecognized net periodic pension & postretirement benefits (costs), net of tax	(4,850)	(12,807)
Disallowed goodwill and other intangible assets	50,002	50,389
Tier 1 capital	$ 215,024	$ 200,255
Adjusted average total assets (for leverage capital purposes)	$ 2,816,491	$ 2,596,122
Tier 1 leverage ratio (Tier 1 capital to adjusted average total assets)	7.63%	7.71%
Total Tier 1 capital	$ 215,024	$ 200,255
Plus: Qualifying allowance for loan losses	24,854	23,355
Total risk-based capital	$ 239,878	$ 223,610
Net risk-weighted assets	$ 1,986,473	$ 1,867,032
Tier 1 capital ratio (Tier 1 capital to net risk-weighted assets)	10.82%	10.73%
Total risk-based capital ratio (Total risk-based capital to net risk-weighted assets)	12.08%	11.98%

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, the valuation of securities and determination of OTTI, 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.

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MANAGEMENT S DISCUSSION AND ANALYSIS

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 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, which for us is September 30th, and more frequently if events or circumstances indicate that there may be impairment. Currently, our goodwill is evaluated at the entity level as there is only one reporting unit.

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. 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 first step (Step 1) of the goodwill impairment test, and continue to the second step (Step 2), if necessary. 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, Step 2 of the goodwill impairment test is performed to measure the value of impairment loss, if any.

Valuation of Deferred Tax Assets

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 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 resulting in additional income tax expense in the consolidated statements of income. Management evaluates deferred tax assets on a quarterly basis and assesses 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 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 15, Income Taxes, of the notes to consolidated financial statements.

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MANAGEMENT S DISCUSSION AND ANALYSIS

Valuation and Other Than Temporary Impairment of Securities

We record all of our securities that are classified as available for sale at fair value. The fair value of equity securities are determined using public quotations, when available. Where quoted market prices are not available, fair values are estimated based on dealer quotes, pricing models, discounted cash flow methodologies, or similar techniques for which the determination of fair value may require significant judgment or estimation. Fair values of public bonds and those private securities that are actively traded in the secondary market have been determined through the use of third-party pricing services using market observable inputs. Private placement securities and other corporate fixed maturities for which we do not receive a public quotation are valued using a variety of acceptable valuation methods. Market rates used are applicable to the yield, credit quality and average maturity of each security. Private equity securities may also utilize internal valuation methodologies appropriate for the specific asset. Fair values might also be determined using broker quotes or through the use of internal models or analysis.